18 T.C. 304 (1952)

When a corporation acquires its own stock subject to a significant restriction, such as a long-term option, and the stock's fair market value is undeterminable due to the restriction, the corporation's cost basis in the stock is the remaining debt balance canceled in exchange for the stock.

Summary

Society Brand Clothes, Inc. acquired its own stock as part of a debt settlement, granting the debtor's wife a 10-year option to repurchase the shares. The Tax Court addressed whether the stock had a determinable fair market value at the time of acquisition, and therefore, what the cost basis of the stock would be. The Court held that because of the 10-year option, the stock's fair market value was not determinable. The basis was the remaining debt canceled in exchange for the stock. The court also addressed the valuation of goodwill, debentures, and accrued interest.

Facts

Alfred Decker, an officer and stockholder of Society Brand Clothes, Inc. (the Petitioner), owed the company $188,566.74. To settle the debt, Decker proposed transferring certain assets, including company stock, to the Petitioner. As part of the agreement, the Petitioner paid $15,075 to a bank to cover Decker's debt, acquiring 10,000 shares of its own stock that Decker had pledged as collateral. The Petitioner then granted Decker's wife, Raye Decker, a 10-year option to repurchase 24,000 shares (including the 10,000 shares). The agreement stipulated repurchase prices at specific dates within the option period. In December 1943, Raye Decker exercised the option.

Procedural History

The Commissioner of Internal Revenue determined deficiencies in the Petitioner's income, declared value excess-profits, and excess profits taxes. The petitioner contested the Commissioner's assessment in Tax Court. The Tax Court addressed four issues related to adjustments that impacted net income and the computation of excess profits credit. The first involved the gain realized from the sale of stock and the determination of the cost basis.

Issue(s)

1. What is the amount of long-term capital gain realized by the Petitioner upon the transfer of 24,000 shares of its treasury stock to Raye H. Decker pursuant to the exercise of an option by her during the taxable year ended October 31, 1944?

Holding

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1. The taxable long term capital gain realized by the petitioner upon the transfer of the 24,000 shares of its common stock to Raye Decker in its fiscal year 1944 was $61,822.11 because the shares of stock, encumbered as they were by the 10-year option, had no fair market value at the time they were received.

Court's Reasoning

The Tax Court reasoned that the acquisition of the stock, the granting of the option, and the release of Alfred Decker's debt were a single, integrated transaction. If the stock, burdened by the 10-year option, had a determinable fair market value when received, that value would represent the extent to which Decker's debt was settled, and that would be the cost basis for the stock. However, because of the 10-year option, the Court found the stock had no ascertainable fair market value at the time of acquisition. Expert testimony indicated the option significantly diminished the stock's value. As one expert stated, the stock would have "almost a nominal value, five cents a share, or something of that." The Court relied on *Gould Securities Co. v. United States*, 96 F.2d 780. Therefore, the cost basis to the Petitioner was the remaining portion of Alfred Decker's debt, which amounted to $133,438.55. The Court stated, "If the rule as to fixing the basis for taxpayers' *loss* in *Gould Securities Co*. case is as stated in that case, we fail to see why the same rule would not apply in fixing petitioner's *gain* in the instant case." The long-term capital gain was calculated as the difference between the cash received from Decker ($195,260.66) and the remaining debt balance ($133,438.55), resulting in a gain of $61,822.11.

Practical Implications

This case provides guidance on determining the tax basis of assets acquired with significant restrictions. It highlights that restrictions, such as long-term options, can eliminate the possibility of determining fair market value. In such cases, courts may look to the underlying transaction (e.g., debt cancellation) to establish a cost basis. This impacts how corporations should account for and report gains or losses on the subsequent sale of such assets. This case is particularly relevant in situations involving complex financial instruments or restructuring, emphasizing the need to carefully assess the impact of restrictions on valuation.

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