38 T.C. 125 (1962)

When a seller of mortgages is required to purchase stock in the Federal National Mortgage Association (FNMA) as a condition of sale, the fair market value of the FNMA stock received is considered part of the proceeds from the mortgage sale and is includible in the seller's income; the basis of the FNMA stock is its fair market value at the time of receipt, and its character as a capital asset depends on the holding purpose.

Summary

Ancel Greene & Co. sold mortgages to FNMA and, as required by FNMA, subscribed to FNMA capital stock. FNMA withheld a percentage of the mortgage purchase price for this stock subscription, issuing stock at par value ($100) but with a lower fair market value. The Tax Court held that the fair market value of the FNMA stock was part of the income from the mortgage sales. Further, because Ancel Greene & Co. held the stock for varying periods, including long-term investment, the stock was deemed a capital asset, and any gain or loss on its sale was capital gain or loss, with the basis being the stock's fair market value at receipt.

Facts

1. Ancel Greene & Co. was in the business of buying, selling, and servicing mortgages.
2. To sell mortgages to FNMA, Ancel Greene & Co. was contractually obligated to subscribe to FNMA's capital stock.
3. FNMA withheld a percentage of the mortgage purchase price as a stock subscription, issuing stock at a par value of $100 per share.
4. The fair market value of the FNMA stock was less than $100 per share at the time of issuance.
5. Ancel Greene & Co. held the FNMA stock for varying periods, some for over 2.5 years, and received dividends.
6. Ancel Greene & Co. sold some of the FNMA stock and claimed ordinary business expense deductions for the difference between the capital contribution and the stock's market value.

Procedural History

This case originated in the United States Tax Court. Ancel Greene & Co. petitioned the Tax Court to contest the Commissioner of Internal Revenue's deficiency determinations for income tax years 1956, 1957, and 1958. The Commissioner disallowed the deductions claimed by Ancel Greene & Co. related to the FNMA stock.

Issue(s)

1. Whether the portion of the mortgage purchase price withheld by FNMA for

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capital stock subscription is includible in or deductible from Ancel Greene & Co.'s income.
2. Whether the FNMA stock received by Ancel Greene & Co. was a capital asset, and if so, what is the basis for determining capital gain or loss upon its sale.

Holding

1. Yes, the portion withheld for FNMA stock subscription is includible in Ancel Greene & Co.'s income as part of the proceeds from the mortgage sale.
2. Yes, the FNMA stock was a capital asset because Ancel Greene & Co. held it for investment purposes. The basis of the stock is its fair market value at the date of issuance.

Court's Reasoning

The Tax Court reasoned as follows:

- **Inseparable Transaction:** The court found the mortgage sale and stock subscription to be a single, inseparable transaction. Quoting *Schumacher Mortgage Co. v. United States*, it acknowledged the exchange of cash and stock for mortgages as one transaction.
- **Income Inclusion:** The court determined that Ancel Greene & Co. received consideration for the mortgages in both cash and stock. Therefore, the fair market value of the FNMA stock at the time of issuance was part of the income from the mortgage sales.
- **Capital Asset Determination:** Unlike cases where stock was immediately disposed of, Ancel Greene & Co. held the FNMA stock for extended periods and received dividends, indicating an investment purpose. The court stated, "*the purpose for which stock is owned and held can change, and the purpose at the time of sale is determinative of the effect of the sale for tax purposes.*" Because Ancel Greene & Co. failed to prove the stock was not held for investment, the court assumed it was.
- **Basis:** Since the FNMA stock was part of the consideration received for the mortgages, the court held that the basis of the stock was its fair market value at the time of issuance, not the par value or the amount of capital contribution.

Practical Implications

- **Income Recognition:** Mortgage sellers receiving FNMA stock as part of a sale must recognize the fair market value of the stock as income in the year of receipt. This case clarifies that mandatory stock purchases tied to business transactions are not necessarily deductible expenses but can be part of the income consideration.
- **Capital Asset vs. Ordinary Asset:** The holding period and purpose for holding mandatory stock acquisitions are crucial in determining whether they are capital assets. Holding stock for investment purposes, even if initially

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acquired as a business requirement, can lead to capital gain or loss treatment upon sale.

- **Basis Calculation:** The basis of stock received as part of a business transaction is its fair market value at the time of receipt, not necessarily its par value or the cost of mandatory purchase. This is vital for calculating gains or losses upon subsequent sale of the stock.
- **Subsequent Cases:** This case, along with *McMillan Mortgage Co.*, provides precedent for the tax treatment of FNMA stock received in similar mortgage sale transactions before statutory amendments specifically addressed this issue. It highlights the importance of factual analysis regarding the purpose and duration of holding such stock.

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