Barton Naphtha Co. v. Commissioner, 61 T. C. 75 (1973)

Employee stock with restrictions on transferability can be treated as excluded stock for determining controlled group status under IRC Section 1563.

Summary

In Barton Naphtha Co. v. Commissioner, the Tax Court held that restrictions on employee stock, specifically rights of first refusal, were substantial enough to classify the stock as excluded under IRC Section 1563(c)(2)(B). This classification led to the determination that Barton Naphtha Co. and Barton Solvents Co. were a controlled group of corporations, thus limiting them to a single surtax exemption. The court's reasoning hinged on the interpretation of the term 'substantial restriction' and the validity of the stock transfer restrictions under Iowa law. The decision underscores the importance of understanding how stock ownership and restrictions affect tax treatment of corporate groups.

Facts

Barton Naphtha Co. and Barton Solvents Co. were Iowa corporations engaged in distributing industrial solvents. Barton, the principal shareholder of Barton Naphtha, also owned a significant portion of Barton Solvents. Barton Solvents issued stock to its employees with a restrictive endorsement, granting the corporation a right of first refusal at book value in case of sale, death, or termination of employment. Barton's ownership in Barton Solvents, when considering the employee stock as excluded under IRC Section 1563(c)(2)(B), exceeded 80%, potentially classifying the companies as a controlled group.

Procedural History

The IRS determined deficiencies in the corporations' income taxes for 1965-1967, asserting they were a controlled group entitled to only one surtax exemption under IRC Section 1561. The corporations filed an election under IRC Section 1562 to avoid controlled group treatment but still claimed multiple exemptions. The Tax Court considered whether the employee stock restrictions rendered the companies a controlled group.

Issue(s)

1. Whether the stock owned by Barton Solvents' employees was excluded stock under IRC Section 1563(c)(2)(B) due to the restrictive endorsements on the stock certificates.
2. Whether the restrictions on the employee stock were substantial within the meaning of the statute.
3. Whether the restrictive endorsements were valid under Iowa law.

Holding

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1. Yes, because the restrictive endorsements granted the corporation a right of first refusal, which the court found to be a substantial restriction under the statute.
2. Yes, because the right of first refusal, even at book value equal to fair market value, was deemed a substantial restriction on the employees' right to dispose of their stock.
3. Yes, because the court determined that the restrictions were valid under Iowa law as reasonable contractual agreements between the corporation and its shareholders.

Court's Reasoning

The court applied IRC Section 1563, which defines a controlled group and specifies conditions under which employee stock is excluded from the calculation of ownership percentages. The court found that the right of first refusal was a substantial restriction, supported by the regulations and committee reports, as it augmented the control of the common shareholder. The court rejected the argument that tax-avoidance motives were necessary for the application of the statute, focusing instead on the objective criteria of common control. The validity of the restrictions under Iowa law was upheld, citing cases that supported the enforceability of reasonable restrictions on stock transfers, even if not specified in the articles or bylaws but in the stock certificates. The court emphasized the contractual nature of these restrictions.

Practical Implications

This decision impacts how corporations with employee stock ownership plans should structure their stock to avoid unintended controlled group status. Corporations must be cautious about the nature of restrictions placed on employee stock, as rights of first refusal or other transfer limitations may lead to classification as excluded stock, affecting the number of surtax exemptions available. The ruling also clarifies that the validity of stock restrictions under state law can be based on contractual agreements between shareholders and the corporation, not solely on provisions in corporate documents. Subsequent cases and IRS guidance have continued to refine the application of these principles, particularly in the context of employee stock ownership and corporate tax planning.

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