Eastern Service Corp. v. Commissioner, 73 T. C. 833 (1980)

In determining the fair market value of restricted stock for tax deductions under IRC section 162(d), the restrictions on the stock's sale must be considered.

Summary

Eastern Service Corp. sold mortgages to FNMA and was required to purchase and retain FNMA stock. The company sought a deduction under IRC section 162(d) for the difference between the stock's purchase price and its fair market value, arguing the stock was restricted due to FNMA's retention requirements. The Tax Court agreed, ruling that the fair market value must account for these restrictions, leading to a 75% discount on the stock's value, and allowing a deduction for the difference.

Facts

Eastern Service Corp. (ESC) was a mortgage banker that sold and serviced mortgages, including those to the Federal National Mortgage Association (FNMA). Under FNMA's rules, ESC was required to purchase FNMA stock as part of the mortgage sale proceeds and retain it for an average of 15 years. In 1969, ESC sold $33 million in mortgages to FNMA and purchased 3,701 shares of FNMA stock for $498,513. The average market price of FNMA stock in 1969 was $184. 50 per share.

Procedural History

The Commissioner of Internal Revenue determined a deficiency in ESC's 1969 income tax and denied the deduction claimed under IRC section 162(d). ESC petitioned the U. S. Tax Court for a redetermination of the deficiency. The court found in favor of ESC, allowing a deduction based on the discounted fair market value of the FNMA stock.

Issue(s)

1. Whether the restrictions on the sale of FNMA stock imposed by FNMA must be considered in determining the fair market value of the stock for purposes of a deduction under IRC section 162(d).

Holding

1. Yes, because the restrictions on the sale of the stock must be taken into account when calculating the fair market value for the purposes of IRC section 162(d), resulting in a deduction for the excess of the purchase price over the discounted fair market value.

Court's Reasoning

The court reasoned that the fair market value of restricted stock, which cannot be

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freely sold, is less than the quoted market price of unrestricted stock. The court cited the legislative history of IRC section 162(d), which was enacted to allow deductions for the difference between the purchase price and the fair market value of FNMA stock acquired as part of mortgage sales. The court found that the retention requirements imposed by FNMA were integral to the sales and servicing operations, and thus, the restrictions must be considered in valuing the stock. The court applied a 75% discount to the stock's value due to the long-term restriction on its sale, resulting in a fair market value of $46. 13 per share. The court relied on expert testimony and Revenue Rulings supporting discounts for restricted securities.

Practical Implications

This decision impacts how companies that are required to purchase and retain stock as part of business transactions should value that stock for tax purposes. When calculating deductions under IRC section 162(d), businesses must consider any restrictions on the stock's sale, potentially leading to significant deductions if long-term restrictions are involved. The ruling may affect how similar stock purchase requirements are structured by other entities to comply with tax laws while still achieving business objectives. Subsequent cases involving restricted stock valuations for tax purposes have referenced this decision, often applying discounts to account for sale restrictions.

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