T.C. Memo. 1979-510

When a taxpayer is required to purchase stock with restrictions on resale as a condition of doing business, the fair market value of that stock for tax deduction purposes under Section 162(d) must reflect those restrictions, even if the unrestricted stock trades at a higher price.

Summary

Eastern Service Corp. was required to purchase and retain Federal National Mortgage Association (FNMA) stock to sell mortgages to FNMA. The Tax Court addressed whether Eastern could deduct the difference between the purchase price and the fair market value of the stock under Section 162(d), considering resale restrictions. The court held that the restrictions on the stock significantly reduced its fair market value, allowing a deduction for the difference between the purchase price and the discounted fair market value, reflecting the impact of the resale restrictions. This case clarifies that mandated retention requirements affect a stock's fair market value.

Facts

Eastern Service Corp. (petitioner) was a mortgage seller-servicer that sold mortgages to permanent investors, including FNMA. FNMA required mortgage sellers to purchase its stock as a condition of selling mortgages. In 1968, FNMA amended its charter to require seller-servicers to retain a minimum amount of FNMA stock. In 1969, Eastern purchased 3,701 shares of FNMA stock for $498,513 to comply with these requirements, and was restricted from reselling the stock as long as it serviced the related mortgages. The parties stipulated that the market price of unrestricted FNMA stock was not less than the issue price.

Procedural History

The Commissioner of Internal Revenue determined a deficiency in Eastern's income tax for 1969. Eastern contested the deficiency, arguing it was entitled to a deduction under Section 162(d) for the difference between the purchase price and the fair market value of the restricted FNMA stock. The case was brought before the Tax Court.

Issue(s)

Whether the fair market value of FNMA stock purchased by a mortgage seller-servicer, which is subject to retention requirements, should be determined by considering the restrictions on the stock's resale for purposes of calculating a deduction under Section 162(d).

Holding

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Yes, because the retention requirements imposed on the FNMA stock directly impacted its fair market value, and Section 162(d) allows a deduction for the excess of the purchase price over the fair market value, considering all restrictions.

Court's Reasoning

The court reasoned that Section 162(d) was enacted to address the situation where the required purchase price of FNMA stock exceeded its market value. While the market price of unrestricted FNMA stock was at or above the purchase price, the retention requirements imposed a significant restriction on the stock's value to Eastern. The court emphasized that it is a well-established principle that restricted stock is worth less than freely tradable stock. The court found that Eastern, as a seller-servicer, was required to retain the stock as part of its overall business operation with FNMA. The court rejected the IRS's argument that fair market value should only consider the quoted market price, stating that Congress intended "fair market value" in Section 162(d) to account for restrictions imposed under Section 303(c) of the FNMA Charter Act. The court accepted expert testimony that the restricted stock should be discounted, ultimately settling on a 75% discount to reflect the illiquidity and governmental influence on FNMA.

Practical Implications

This case establishes that when valuing stock for tax purposes, especially under Section 162(d), mandatory retention or resale restrictions must be considered, potentially leading to a lower fair market value and a larger deductible expense. Legal practitioners should analyze all restrictions placed on stock ownership when determining its fair market value for tax implications. This ruling informs how similar cases involving mandatory stock purchases and retention, particularly in regulated industries, should be analyzed. Subsequent cases must consider the specific restrictions imposed and their economic impact on the stock's value. The principles from Eastern Service Corp. have been applied in analogous situations where the value of an asset is directly tied to the ability to freely dispose of it.

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