Gresham v. Commissioner, 79 T. C. 322 (1982)

Restrictions on stock sale, such as those required by the Securities Act of 1933, must be considered in determining the fair market value for minimum tax purposes.

Summary

In Gresham v. Commissioner, the U. S. Tax Court invalidated a regulation that disregarded restrictions on stock when calculating fair market value for minimum tax purposes under section 57(a)(6). Louis Gresham exercised a qualified stock option for shares of General Energy Corp. (GEC), which were subject to restrictions that limited their sale to a private placement market at a discounted value. The court held that the fair market value should reflect the actual marketability of the shares, considering the restrictions imposed by the Securities Act of 1933. This decision emphasized the need to use the willing buyer, willing seller test to determine the fair market value, rather than ignoring restrictions as the regulation suggested.

Facts

Louis Gresham, CEO of General Energy Corp. (GEC), exercised a qualified stock option in 1974, 1975, and 1976 to acquire 50,000 shares of GEC stock. The option price was $2. 50 per share. The shares were subject to restrictions under the Securities Act of 1933, requiring Gresham to execute an investment letter. This restricted the sale of the shares to a private placement market for two years, at a discounted value of 66 2/3% of the over-the-counter market price. Gresham reported the fair market value of the shares at this discounted rate for minimum tax purposes, while the Commissioner valued them at the full over-the-counter market price, disregarding the restrictions.

Procedural History

The Commissioner determined deficiencies in Gresham’s income taxes for 1975 and 1976, arguing that the fair market value of the shares should be calculated without considering the restrictions. Gresham petitioned the U. S. Tax Court, which found that the regulation directing the disregard of restrictions was invalid and that the fair market value should reflect the private placement market value of the shares.

Issue(s)

1. Whether section 1. 57-1(f)(3) of the Income Tax Regulations, which directs that restrictions which lapse should be ignored in determining fair market value for minimum tax purposes, is valid?

Holding

1. No, because the regulation is inconsistent with the unambiguous language of

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section 57(a)(6), which requires that the fair market value be determined using the willing buyer, willing seller test, taking into account any restrictions on the shares.

Court's Reasoning

The court reasoned that the term "fair market value" in section 57(a)(6) must be interpreted using the traditional willing buyer, willing seller test, which considers all relevant facts, including restrictions on the sale of stock. The court found that the regulation, which adopted the principles of section 83(a)(1) and ignored restrictions, was inconsistent with the statute's plain language. The court emphasized that Congress deliberately omitted the language from section 83(a)(1) in section 57(a)(6), indicating an intent to use the traditional fair market value definition. The court also noted that the restrictions in this case significantly affected the stock's marketability, and thus its value. Justice Featherston concurred, highlighting the congressional policy of encouraging employee stock ownership and the lack of evidence supporting the regulation's interpretation. Judge Simpson dissented, arguing that the regulation was necessary to carry out the legislative objective of the minimum tax.

Practical Implications

This decision has significant implications for the valuation of stock options for tax purposes, particularly when the shares are subject to restrictions. Attorneys and tax professionals must now consider any restrictions on stock sales when calculating fair market value for minimum tax purposes, potentially reducing the tax liability for taxpayers with similar stock options. The ruling may lead to changes in how companies structure their stock option plans to account for these valuation considerations. Subsequent cases have cited Gresham to support the principle that restrictions must be considered in determining fair market value, and it has influenced the drafting of regulations and legislation concerning stock options and minimum tax.

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