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provement. The question which then arises is: What is the property which was acquired by the heir or devisee, for which he has a basis? Did he inherit only land, land plus a lease, or also an interest in the building? Specifically, may any part of the fair market value determined for estate tax purposes be allocated to the building, the lease, or both, and can such value be amortized through charges against income?

If it can be established that there is a premium value in the lease, it seems clear that the lease will be regarded as a separate asset, the fair market value of which may be amortized over the remaining term of the lease.[17] It has been held, however, that the heirs cannot allocate a portion of the value to an interest in the building, even though the lease will terminate within a short period, and the building, which has a longer useful life, will then revert to the lessor.[18] The correctness of this decision appears to be questionable.

The practitioner must be alert in this situation to such possibilities as may exist for the heir or devisee to allocate a portion of the date-of-death-value to the lease or the building, separately from the land, and to amortize the bases allocable to those assets over the appropriate useful lives.

# VII

# CURRENT PROBLEM AREAS IN INCOME TAXATION

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Recent developments have pointed up several areas in which significant valuation problems exist. Three of these areas, involving valuation of contingent payments, valuation of non-restricted stock options, and valuation by presumption that equal values are exchanged, will be considered in this article.

## VALUATION OF CONTINGENT PAYMENTS AND OTHER VARIABLE AMOUNT ITEMS

In a number of instances, the amount received in a transaction such as a sale of property or a liquidation of a corporation is not a fixed amount of cash, but a contingent or variable amount dependent on the number or size of sales, profits, or production to be achieved in the

17. Commissioner v. Moore, 207 F.2d 265 (9th Cir. 1953), *cert. denied*, 347 U.S. 942 (1954); *but cf.* Goelet v. United States, 266 F.2d 881 (2d Cir. 1959).

18. Goelet v. United States, 266 F.2d 881 (2d Cir. 1959).

future. Thus, for example, property may be sold for a specified dollar amount plus a percentage of profits for a number of years.

The general rule is that the amount realized on a sale or other disposition of property is the sum of money received plus the fair market value of property (other than money) received.[2] The question is therefore presented of determining the fair market value, if any, of the "property" received, that is, of the contingent payments and other payments variable in amount.[3] This question must be considered in light of the position taken by the Commissioner that "only in rare and extraordinary cases will property be considered to have no fair market value."[4]

If the nature of the right to receive future payments is such that it can be valued when received, the transaction is treated as "closed," and gain is realized in the year of the sale or other disposition in an amount which includes the value attributed to the right to receive future payments.[5] Receipts in later years in excess of the value attributed to the right to future payments are treated as ordinary income.[6] If the value attributed to such right is not recovered in the subsequent years, an ordinary loss should become available, although the law is not clear on this point.[7]

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1. This article is based on an outline prepared by Warren E. Hacker for the Fifth Annual Cleveland Regional Tax Institute.

2. INT. REV. CODE OF 1954, § 1001(b) [hereinafter cited as CODE §]. See also Treas. Reg. §§ 1.61-2(d) (1957), as amended, T.D. 6416, 1959-2 CUM. BULL. 126, 1.446-1(a)(3) (1957), as amended, T.D. 6584, 1962 INT. REV. BULL. NO. 4 at 12 [hereinafter cited as Reg. §], the latter of which provides that "items of gross income . . . need not be in the form of cash. It is sufficient that such items can be valued in terms of money."

3. Quaere: Does the result upon a sale or other disposition of property depend upon the method of accounting used by the taxpayer? Although nothing in the statute or Regulations indicates that this is a relevant factor, the Tax Court has stated that a taxpayer on the accrual method could accrue the gain on a contract of sale providing for payments subsequent to the year of sale, but that a taxpayer on the cash method could not. Harold W. Johnston, 14 T.C. 560, 565-66 (1950). See also Fisher Brown, 9 CCH Tax Ct. Mem. 1054 (1950); George L. Castner Co., 30 T.C. 1061 (1958) (requiring accrual basis taxpayers to accrue notes received on the sale of property and mentioning the distinction between cash and accrual methods). At least one writer has suggested that this distinction should not be controlling and that the only real issue is whether the item received — the contract or the notes — has an ascertainable fair market value. Webster, *Ascertainable Value,* N.Y.U. 19TH INST. ON FED. TAX., 509, 522-23 (1961).

4. Reg. § 1.1001-1(a) (1957). To the same effect is Rev. Rul. 58-402, 1958-2 CUM. BULL. 15.

5. Estate of Sam Marsack v. Commissioner, 288 F.2d 533 (7th Cir. 1961) (distribution of patent license agreements in corporate dissolution); Chamberlin v. Commissioner, 286 F.2d 850 (7th Cir. 1960) (distribution of right to future patent royalties in exchange for stock); Rev. Rul. 58-402, 1958-2 CUM. BULL. 15 (contracts and claims to receive indefinite amounts received in exchange for stock in corporate liquidations).

6. Glenn E. Alexander, 34 T.C. 758 (1960), *acq.,* 1961-1 CUM. BULL. 3 (sale of stock for cash plus oil and gas royalties); Warren v. United States, 148 Ct. Cl. 729, 171 F. Supp. 846, *cert. denied,* 361 U.S. 916 (1958) (involving the same transaction considered in the *Alexander* case).

7. Alexander, *Valuation of Intangibles,* N.Y.U. 20TH INST. ON FED. TAX. 567, 573-74 (1962). *But cf.* Miller, *Tax Planning Is Vital When Rights to Income Are Distributed in Liquidation,* 13 J. TAXATION 294, 295 (1960).

On the other hand, if the nature of the right to receive future payments is such that it cannot be valued with fair certainty when received, the transaction is kept open and no gain is realized until the aggregate payments received exceed the basis of the property transferred.[8] Thereafter, the character of the gain depends upon the character of the asset originally disposed of, so that capital gain would follow from the sale or exchange of a capital asset.[9]

With these basic rules in mind, most taxpayers will be inclined to take the position that the right to future payments is not subject to valuation in the year of sale. In the case of a sale of a capital asset, this viewpoint would reduce the tax[10] in the year of the sale, while all future receipts in excess of basis would be treated as capital gains.[11] This has the advantage not only of deferring the tax until such time as the gain is actually realized, but also of obtaining capital gains rates instead of ordinary income treatment on payments received in later years in excess of the amount at which such payments might have been valued. For example, assume that an interest in a partnership with a basis of $10,000 is sold for $7,500 cash plus a percentage of profits for ten years. If the right to share in profits is not subject to valuation, there will be no tax in the year of sale and each of the ten annual payments subsequent to the recovery of the transferor's basis will be taxed entirely at capital gains rates. If actual payments of profits aggregate $20,000, the first $2,500 will be a recovery of basis and the remaining $17,500 will be taxed as capital gains. On the other hand, if the right to receive profits is capable of valuation at, for example, $15,000, but again actual payments of profits total $20,000, there will be a tax on $12,500 ($7,-500 cash plus $15,000 in estimated future payments minus $10,000 basis) at capital gains rates in the year of the sale, no tax on the receipt of the next $15,000, but a tax on the final $5,000 (excess of actual payments over valuation placed thereon at time of sale) at ordinary income rates in the years received. Thus, if the right to a share of profits is not subject to valuation at the time of sale, the last $5,000 will be taxed as capital gains, rather than as ordinary income.

For this reason the Commissioner has taken the position that "only in rare and extraordinary cases" will property be deemed not subject to

8. Burnet v. Logan, 283 U.S. 404 (1931) (sale of stock for cash plus sixty cents for each ton of ore extracted under a lease having seventy-six years to run).

9. Burnet v. Logan, *supra* note 8 (sale of stock); United States v. Yerger, 55 F. Supp. 521 (E.D. Pa. 1944) (sale of partnership interest for corporate stock plus percentage of corporate profits for five years); Tuttle v. United States, 145 Ct. Cl. 577, 101 F. Supp. 532 (1951) (sale of stock for cash plus oil payments).

10. The savings would be in capital gains tax, not ordinary income tax.

11. Similarly, if a non-capital asset were sold, the tax would be at ordinary rates both in the year of sale and in subsequent years. The advantage to the taxpayer would thus only be one of postponing the tax until the gain is definitely realized.

valuation.[12] The wisdom of the Commissioner's position, however, is subject to question. Many sales involving future payments provide for little, if any, cash consideration passing at the time of the sale. Consequently, the Commissioner's view produces a tax on the sale at a time when the seller has not received the cash with which to pay it. Moreover, the seller cannot, in this situation, elect to report his gain on the installment method[13] since that solution is not available when the sales price is subject to variation.

A further objection to the Commissioner's position is that sales under contingent price arrangements have a valuable place in the economy. By making the price dependent upon such factors as profits or production, the guesswork in determining the value of the property sold is reduced and the ultimate fairness of the price is thereby increased. Moreover, by providing for deferred payments geared to the success of the use of the property purchased, greater opportunities are created for the investment of capital in that buyers without sizeable financial resources are enabled to acquire valuable assets.[14]

In any case, assume that the Commissioner is successful in his attack on the taxpayer's assertion of absence of an ascertainable fair market value. At this point, the question would be raised as to the proper value to be ascribed. The taxpayer could then argue, on the basis of hindsight, that the right to receive payments had the highest possible value that could properly be attributed to it. This would minimize the proportion of the payments taxable as ordinary income. However, the Commissioner is certain to contend for the lowest possible value in order to increase the tax at ordinary income rates. Since the taxpayer originally asserted that there was no ascertainable value, a court may well accept such a low valuation. In this situation, the taxpayer clearly would have fared better to have placed a substantial but reasonable value on the right to receive future payments in the year of the sale and thus have a closed transaction.

Thus, the taxpayer is faced with a difficult choice in deciding how to treat a right to receive future payments acquired on a sale of property, a corporate liquidation, or otherwise. In light of the Commissioner's

12. Reg. § 1.1001-1(a) (1957); Rev. Rul. 58-402, 1958-2 CUM. BULL. 15, 17. "Therefore, it is necessary . . . in order to prevent escape from the ordinary income tax by converting income payments into capital gains, to ascertain the value of the property in the prior sale or exchange and to close that transaction, except in rare and extraordinary cases. Otherwise, the ordinary income tax on the income collected from the contract or claim after the sale or exchange is converted into a tax on capital gains."

13. CODE § 453.

14. The Commissioner's position, furthermore, may impair some of the significance of CODE § 1235, providing for capital gain treatment on the sale or exchange of certain patent rights even though the sales price is "contingent on the productivity, use, or disposition of the property transferred."

published position,[15] the taxpayer will always have a contest on his hands if he seeks an open transaction. To make matters even more difficult, the United States Supreme Court has adopted a viewpoint similar to that of the Commissioner. Recently, in *United States v. Davis* the Court said:

> once it is recognized that the transfer was a taxable event, it is more consistent with the general purpose and scheme of the taxing statute to make a rough approximation of the gain realized thereby than to ignore altogether its tax consequences.[16]

Moreover, to compound the taxpayer's problems, the Court of Claims recently held, in *Warren v. United States*,[17] that payments derived from an overriding oil and gas royalty were always ordinary income, irrespective of the fact that the royalty interest was acquired as part of the consideration for the sale of property. In this court's opinion, the fact that under local law the royalty was considered a property interest recordable in the local land records meant that it should be treated in the same manner as an apartment house, securities, or other income-producing property; that is, that the income derived from it should be taxed at ordinary rates, without regard to the question of valuation in the year of sale. Although the nature of the property involved was somewhat uncommon, the *Warren* case does raise the specter that an open transaction might be achieved without the desired goal of capital gains treatment of future payments.

To overcome certain of these obstacles, the taxpayer could take steps to increase the contingent aspects of the future payments.[18] For one thing, floors and ceilings could be eliminated; that is, the future payments would not be limited to either a minimum or maximum amount, either annually or in the aggregate. In addition, the payments could be made contingent on factors other than the amount of production or profits, such as whether the payor acquires certain facilities, enters a certain contract, or obtains a patent. Of course, it must be recognized that increasing the contingent elements for tax purposes may be undesirable from a business standpoint, since the added uncertainty may complicate business planning on the part of both the buyer and seller. In such a case, a weighing of business and tax considerations would be necessary.

Perhaps the ultimate solution to this problem is to make the test depend on whether the value of the future payments is "readily ascertainable." Such a test has been established by the Commissioner in connec-

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15. Reg. § 1.1001-1(a) (1957); Rev. Rul. 58-402, 1958-2 CUM. BULL. 15.

16. 370 U.S. 65, 72-73 (1962).

17. 148 Ct. Cl. 729, 171 F. Supp. 846, *cert. denied*, 361 U.S. 916 (1958).

18. In Estate of Sam Marsack v. Commissioner, 288 F.2d 533, 536 (7th Cir. 1961), the Court of Appeals for the Seventh Circuit stated that its decision therein and in Chamberlin v. Commissioner, 286 F.2d 850 (7th Cir. 1960), "does not mean that speculative contracts which contain highly contingent possibilities of future realization of income, can and must be valued for income tax purposes as a matter of law. The question is one of fact and not of law."

tion with non-restricted stock options[19] and could be made applicable in general. Although this test may result in more open transactions, it would at least require the value to be ascertainable with reasonable accuracy and thus would eliminate rough approximations which are no better than guesses. In this aspect, the test would be advantageous to both the Commissioner and taxpayers. Such a test should, moreover, provide a greater degree of certainty in tax planning. In any case, the existing state of the law in this area is such that further consideration, looking toward a more practicable solution, is necessary.

## VALUATION OF NON-RESTRICTED STOCK OPTIONS

If a corporation seeks to compensate its employees by granting options to purchase its stock at a discount price, no tax is imposed at the time the stock option is either granted or exercised,[20] provided the option constitutes a "restricted stock option"[21] within the meaning of the Internal Revenue Code, and provided further that the stock acquired pursuant to such option is held for the required period of time.[22] The tax is not imposed until the stock acquired pursuant to such option is subsequently disposed of, at which time the entire tax may be determined at capital gains rates.[23]

If an option is granted in connection with the employment of an employee, but for some reason[24] fails to qualify as a "restricted stock option" under section 421, certain non-statutory rules, promulgated by the Commissioner, come into effect.[25] It is the application of these rules, adopted in 1961, to non-restricted stock options that is the subject of this article.

The general effect of these rules is that if the fair market value of

19. Reg. § 1.421-6 (1959), as amended, T.D. 6481, 1960-2 CUM. BULL. 159, T.D. 6540, 1961-1 CUM. BULL. 161. Of course, the requirements necessary to meet such a "readily ascertainable" test should not be as stringent and burdensome as those provided for non-restricted stock options.

20. CODE § 421(a)(1).

21. CODE § 421(d)(1).

22. CODE § 421(a).

23. Reg. § 1.421-5(a)(4), example 2 (1959), as amended, T.D. 6540, 1961-1 CUM. BULL. 161. This assumes that the option price was at least ninety-five per cent of the fair market value of the stock at the date the option was granted. If, however, the option price was between eighty-five and ninety-five per cent of such fair market value, the optionee realizes ordinary income at the time of disposition in the amount of the difference between (1) the lesser of fair market value at the date the option was granted or the date the stock was disposed of and (2) the price paid under the option. CODE § 421(b)(1). The balance of the gain on disposition is taxed as capital gains.

24. Reg. § 1.421-6(a)(1) (1959), as amended, T.D. 6540, 1961-1 CUM. BULL. 161, states that § 421 does not apply ". . . when an option is not a restricted stock option at the time it is granted . . . or when an option is modified so that it no longer qualifies as a restricted stock option . . . or when there is a disqualifying disposition of stock acquired by the exercise of a restricted stock option. . . ."

25. Reg. § 1.421-6 (1959), as amended, T.D. 6540, 1961-1 CUM. BULL. 161.

the option is "readily ascertainable" at the time it is granted, the employee realizes income in the form of compensation at the time the option is granted to the extent of the excess, if any, of such fair market value of the stock option over the amount paid pursuant to the option. If the fair market value of the option is not "readily ascertainable" at the time the option is granted, the employee realizes compensation at a later date.[26] This is based upon the general rule that gross income includes compensation for services paid for in property rather than money, measured by the fair market value of such property.[27] But under the Treasury Regulations, the determination of when and in what amount such options are taxable depends upon the newly-introduced element of whether the fair market value of the option is "readily ascertainable."

### *"Readily Ascertainable" Fair Market Value Test*

The fair market value of an option is "readily ascertainable" if the option is actively traded on an established market.[28] If the option is not actively traded on an established market, it may still have a "readily ascertainable" fair market value, provided the following stringent requirements are met:[29]

(a) The option is freely transferable by the optionee;
(b) The option is exercisable immediately in full by the optionee;
(c) The option or the property subject to the option is not subject to any restriction or condition (other than a lien or other condition to secure the payment of the purchase price) which has a significant effect upon the fair market value of the option on such property; and
(d) The fair market value of the option privilege is readily ascertainable in accordance with subdivision (ii) of this subparagraph.[30]

26. Reg. § 1.421-6(c)(1) (1959), as amended, T.D. 6540, 1961-1 CUM. BULL. 161.

27. Reg. § 1.61-2(d) (1959), T.D. 6416, 1959-2 CUM. BULL. 126.

28. Reg. § 1.421-6(c)(2) (1959), as amended, T.D. 6540, 1961-1 CUM. BULL. 161.

29. Reg. § 1.421-6(c)(3) (1959), as amended, T.D. 6540, 1961-1 CUM. BULL. 161.

30. Subparagraph (ii) of Reg. § 1.421-6(c)(3) (1959), as amended, T.D. 6540, 1961-1 CUM. BULL. 161, defines "option privilege" as the opportunity to benefit, at any time during the period the stock option may be exercised, from any appreciation in the value of the property during that period, without risking any capital. It is clear, under this provision of the Regulations, that the value of the option privilege is more than the mere spread between option price and market value of the stock at the time the option is exercised. Thus, the Regulations go on to state: "In determining whether the value of the option privilege is readily ascertainable, and in determining the amount of such value, when such value is readily ascertainable, it is necessary to consider — (a) Whether the value of the property subject to the option can be ascertained; (b) The probability of any ascertainable value of such property increasing or decreasing; and (c) The length of the period during which the option can be exercised."

In Colton v. Williams, 209 F. Supp. 381, 383-84 (N.D. Ohio 1962), the court indicated that under prior law, the value of an option was determined solely by a comparison between option price and market price, without regard to the "option privilege." The court criticized this view because of the "gross disparity" it produced, since if a stock had a fair market value of $3.00, an option to buy at $2.98 would have value, but an option to buy at $3.01 would not. The former option would, therefore, meet the requirement of a present intention to compensate, and would be includible in gross income at the time the option was granted. Subsequently, if

If a stock option has a "readily ascertainable" fair market value at the time the option is granted, the employee realizes ordinary income in the year that the option is *granted*, in an amount equal to the difference between the fair market value of the option at such time and the amount paid for it.[31] The employer becomes entitled to a deduction in a corresponding amount.[32] In the year the option is subsequently *exercised*, there is no additional income to the employee, and the employer is not permitted to take a further deduction.[33]

If, on the other hand, the option is not actively traded on an established market and the employee cannot establish each of the conditions required by the Regulations, the stock option is considered not to have a "readily ascertainable" fair market value. Under these circumstances, the employee does not realize income in the year the option is granted, but at one of the following times.

If the stock is not subject to "a restriction which has a significant effect on its value,"[34] income is realized at such time on or after the *exercise* of the option as the employee acquires an unconditional right to receive the stock subject to the option.[35] An employee has an "unconditional right" to receive the stock if, upon exercise of the option, he can make payment at any time and receive the stock immediately thereafter.[36] The income is treated as compensation, taxable at ordinary rates, in an amount equal to the difference between the price paid under the option and the fair market value of the stock as of the date upon which an unconditional right to receive the stock is acquired.[37]

If the stock is subject to a restriction which significantly affects its value,[38] the employee realizes income upon the first to occur of the following events after the exercise of the option: (a) the restrictions lapse, or (b) the property is sold or exchanged in an arm's length transaction.[39]

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the options were exercised and the fair market value of the stock were $50.00, the former would qualify for capital gain treatment, but the latter would not, the court stated.

31. Reg. § 1.421-6(c)(1) (1959), as amended, T.D. 6540, 1961-1 CUM. BULL. 161.

32. Reg. § 1.421-6(f) (1959), as amended, T.D. 6540, 1961-1 CUM. BULL. 161.

33. Reg. § 1.421-6(a)(3) (1959), as amended, T.D. 6540, 1961-1 CUM. BULL. 161.

34. Reg. § 1.421-6(d)(2)(i) (1959), as amended, T.D. 6540, 1961-1 CUM. BULL. 161.

35. Reg. § 1.421-6(d)(1) (1959), as amended, T.D. 6540, 1961-1 CUM. BULL. 161.

36. *Ibid.*

37. *Ibid.*

38. See Harold H. Kuchman, 18 T.C. 154 (1952), holding that restrictions on the stock subject to option rendered the option without an ascertainable fair market value.

39. Reg. § 1.421-6(d)(2)(i) (1959), as amended, T.D. 6540, 1961-1 CUM. BULL. 161. *Contra,* Robert H. Lehman, 17 T.C. 652 (1951), *gov't appeal dismissed,* 2d Cir., June 8, 1952, *acq.,* 1951-1 CUM. BULL. 3, *acq. withdrawn and nonacq.,* 1962-43 INT. REV. BULL. 8.

Additional rules are provided for situations in which: (1) the property is sold or exchanged in a transaction not at arm's length, Reg. § 1.421-6(d)(2)(i) (1959), as amended, T.D. 6540, 1961-1 CUM. BULL. 161; (2) the option is transferred prior to exercise, Reg. §§ 1.421-6(d)(3)-(4) (1959), as amended, T.D. 6540, 1961-1 CUM. BULL. 161; and (3) the employee dies before realizing compensation by virtue of exercising or transferring the option, Reg. § 1.421-6(d)(5) (1959), as amended, T.D. 6540, 1961-1 CUM. BULL. 161.

A restriction which has a significant effect on the value of the stock is one which, for example, either requires the employee to resell it to the employer upon termination of employment, or gives the employer a first option to purchase the stock during his employment, with the purchase price set at book value or some other figure not representing fair market value.[40] In the above examples, the employee would realize compensation upon his death or termination of employment,[41] at which time the restrictions would lapse. The amount of ordinary income realized by the employee is the difference between the purchase price under the option and the lesser of the following: (a) the fair market value of the stock at the time acquired, without regard to the restriction, or (b) the fair market value of the stock at the time the restriction lapses or, if the stock is sold or exchanged, the consideration received therefor.[42] Thus, if an employee exercises an option to buy one hundred shares of stock, subject to a restriction on disposition effective during employment, at $10 per share at a time when the fair market value of the stock, without considering the restriction, is $15, and he subsequently terminates his employment when the fair market value is $25, he realizes compensation in the amount of $500 ($5 gain per share) in the year of termination of employment. If, however, he had sold the stock during employment at $12.50 per share, he would have realized $250 ($2.50 gain per share) in compensation in the year of sale.

Regardless of whether the fair market value of the option is or is not "readily ascertainable," the employer is considered to have paid compensation, in the same amount and at the same time that the employee, under the above rules, is considered to have received compensation.[43] Such payments may, of course, be deductible by the employer.[44]

### *Critique of the "Readily Ascertainable" Test*

Since an option is ordinarily granted with the expectation that the value of the stock subject to it will rise, it is generally to the employee's advantage for the fair market value of the option to be considered "readily ascertainable." In such case, the amount of gain will be based on the fair market value as of the date the option is granted. If the value is not "readily ascertainable," the amount of compensation income will, in a rising market, be based on the higher value at a future date. Consequently, the employee will have the benefit of substantial tax savings if the option is taxed at the time it is granted, for any subsequent increase in the value

40. Reg. § 1.421-6(d)(2)(ii) (1959), as amended, T.D. 6540, 1961-1 CUM. BULL. 161.
41. *Ibid.*
42. Reg. § 1.421-6(d)(2)(i) (1959), as amended, T.D. 6540, 1961-1 CUM. BULL. 161.
43. Reg. § 1.421-6(f) (1959), as amended, T.D. 6540, 1961-1 CUM. BULL. 161.
44. CODE § 162.

of the stock option will be treated, when the option is later sold or exchanged, at favorable capital gains rates.[45] It is apparently for this reason that the Commissioner's new Regulations, under which certain options are taxed in the year in which they are granted, have established stringent requirements in determining whether an option has a "readily ascertainable" fair market value if the option is, like most options, not actively traded on an established market.

It will be recalled that the new Regulations provide that an option does not have a "readily ascertainable" fair market value when granted *unless* the taxpayer can show[46] that (1) the option is freely transferable; (2) the option is exercisable immediately in full; (3) the option or the stock subject thereto is not subject to a restriction significantly affecting its fair market value; and (4) the fair market value of the option privilege is readily ascertainable.[47]

The strict requirements under the "readily ascertainable" test are contrary to the rule applied by the Commissioner in all areas other than non-restricted stock options. The general rule is that "only in rare and extraordinary cases will property be considered to have no fair market value."[48] Moreover, the test applied in the statute as to restricted stock options, both in regard to the qualification of an option as such and as to the amount of gain, is based on "fair market value," not "readily ascertainable fair market value."[49] As one commentator has stated, ". . . the contrast between these Regulations and the Commissioner's usual rule for taxing income which is difficult to value is so striking as to raise a question of basic fairness."[50] In this one special situation in which the absence of an ascertainable fair market value is beneficial to the Commissioner, his Regulations, under the guise of the "readily ascertainable" test, have thus made it extremely difficult to establish fair market value.

It should also be recognized that the new Regulations are, in effect, an attempt at legislation by the Commissioner. The statutory provision with respect to stock options deals only with restricted stock options, not non-restricted options, and as indicated, does not use the "readily ascertainable" test. There is no basis in either the statute, the cases, or the Com-

45. Commissioner v. Estate of Lauson Stone, 210 F.2d 33 (3d Cir. 1954); McNamara v. Commissioner, 210 F.2d 505 (7th Cir. 1954); Dean Babbitt, 23 T.C. 850 (1955); John C. Wahl, 19 T.C. 651 (1953).

46. Reg. § 1.421-6(c)(3)(i) (1959), as amended, T.D. 6540, 1961-1 CUM. BULL. 161.

47. Reg. §§ 1.421-6(c)(3)(i)(a)-(d) (1959), as amended, T.D. 6540, 1961-1 CUM. BULL. 161.

48. Reg. § 1.1001-1(a) (1959); Rev. Rul. 58-402, 1958-2 CUM. BULL. 15.

49. Code §§ 421(b), (d), (e). See also Reg. § 1.421-2(a)(5) (1958), as amended, T.D. 6527, 1961-1 CUM. BULL. 153: "Any reasonable valuation methods may be used for the purpose of determining whether" the option qualifies as a restricted stock option.

50. Hawkins, *Employee Stock Options*, 100 TRUSTS & ESTATES 516 (1961).

missioner's Regulations for the employment of such strict requirements under such a test. In addition, there were no changes in the statutory or decisional law immediately prior to 1961 justifying the adoption of such a new standard. Consequently, the new Regulations are also subject to attack on the grounds of arbitrariness.

Because of the newness of these provisions, only one decision has been reported in which an opportunity for judicial consideration of these strict requirements has been presented.[51] In *Colton v. Williams*,[52] the district court held that an option not actively traded on an established market nevertheless had a "readily ascertainable" fair market value. The court did not endeavor to apply the requirements of the Regulations in detail, but merely stated that the option "appears to conform to a *reasonable interpretation* of the conditions imposed by the Regulations."[53] This conclusion was based essentially on expert testimony by a broker and on evidence of a prior public offering of stock analogous to that subject to the option. The court thought that the value of the option could thus be measured with "reasonable accuracy" and that the Regulations had therefore been complied with.[54]

The court thus refused to apply the new rules with the strictness intended by the Commissioner. The court was apparently influenced by the taxpayer's contention that "the provisions of the Regulations are so restrictive and artificial as to be arbitrary and unreasonable,"[55] even though it did not hold the Regulations invalid.

Thus, the *Colton* case affords some basis for optimism on the part of taxpayers that judicial relief from the stringency of the Commissioner's new standards may be obtainable. It is to be hoped that other courts may, at the very least, also apply a "reasonable interpretation" of the Regulations.

## VALUATION BY PRESUMPTION THAT EQUAL VALUES ARE EXCHANGED

Where property is exchanged rather than sold, the fair market value of what is received cannot always be ascertained with reasonable accuracy, although the property surrendered may have an established fair market value. One such situation occurs in the case of the husband who transfers

51. Colton v. Williams, 209 F. Supp. 381 (N.D. Ohio 1962). In William S. Thornhill, 37 T.C. No. 97 (February 27, 1962), the question was as to whether the exercise of the option was compensatory; the Regulations were not discussed.

52. 209 F. Supp. 381 (N.D. Ohio 1962) (notice of appeal filed by government).

53. *Id.* at 385 (Emphasis added.).

54. The court's Conclusions of Law (not reported) make clear, although the opinion does not, that it thought that each of the four requirements of the test under Reg. § 1.421-6(c) (3)-(i) (1958), as amended, T.D. 6540, 1961-1 CUM. BULL. 161, had been complied with.

55. Brief for Petitioner, p. 18, Colton v. Williams, 209 F. Supp. 381 (N.D. Ohio 1962).

property which has appreciated in value to his wife in return for a release of her marital rights — the right to support and to an interest in his property upon his death. Often the property transferred by the husband consists of securities, the value of which can be ascertained without much difficulty. But the value of the marital rights is practically impossible to determine independent of the exchange.

In such situations, a problem arises in measuring the amount of gain realized by the husband.[56] The general statutory rule is that the gain on a disposition of property is the excess of the amount realized over the adjusted basis of the property.[57] The amount realized is the "sum of any money received plus the fair market value of the property (other than money) *received.*"[58] A judicial gloss has been added to the statute, the effect of which is that the values of "two properties exchanged in an arm's length transaction are either equal in fact, or are presumed to be equal."[59] Consequently, there is a presumption that the value of the property received is equal to the value of the property surrendered.

Recently, the United States Supreme Court, in *United States v. Davis,*[60] applied this presumption to the wife's release of marital rights in a divorce situation, the value of which rights it was otherwise unable to compute. Presumably, the Supreme Court thereby firmly established the principle which for over two decades had been a subject of disagreement among the courts. This disagreement began when the Board of Tax Appeals held in *L. W. Mesta*[61] and *Walter S. Halliwell*[62] that the value of the wife's release of marital rights was *not* capable of determination. These decisions were reversed on appeal by the Courts of Appeals for the Third and Second Circuits,[63] respectively, and thereafter the Tax

56. Since this symposium deals with valuation problems, the question of whether an exchange of property for the release of marital rights is a taxable event is not treated here. However, the Supreme Court has held that such an exchange is a taxable event, overruling the taxpayer's argument that the transaction with his wife constituted a nontaxable division of property. United States v. Davis, 370 U.S. 65, 69-71 (1962). *Cf.* Hacker, *Tax Clinic on Capital Gains — Bringing Capital Gains Into Focus,* 12 W. RES. L. REV. 244, 245-48 (1961).

57. CODE § 1001(a).

58. CODE § 1001(b) (Emphasis added.).

59. Philadelphia Park Amusement Co. v. United States, 130 Ct. Cl. 166, 172, 126 F. Supp. 184, 189 (1954) (exchange of bridge for extension of railroad franchise held taxable; the amount realized was based on the fair market value of the bridge, which was presumed to be equal in value to the extension). See also United States v. General Shoe Corp., 282 F.2d 9 (6th Cir.), *cert. denied,* 365 U.S. 843 (1960) (real estate contributed to exempt employees' trust resulted in taxable gain measured by appraised valuation of such property which taxpayer used in computing a deduction for income tax purposes); International Freighting Corp. v. Commissioner, 135 F.2d 310 (2d Cir. 1943) (stock delivered to employees as bonus in exchange for services held taxable, with gain measured by value of stock).

60. 370 U.S. 65 (1962).

61. 42 B.T.A. 933 (1940).

62. 44 B.T.A. 740 (1941).

63. Commissioner v. Halliwell, 131 F.2d 642 (2d Cir.), *cert. denied,* 319 U.S. 741 (1942); Commissioner v. Mesta, 123 F.2d 986 (3d Cir. 1941), *cert. denied,* 316 U.S. 695 (1942).

Court adopted the position taken by the Courts of Appeals.[64] Then, in 1960, the Court of Appeals for the Sixth Circuit, in *Commissioner v. Marshman,*[65] held that such marital rights were not subject to valuation, creating a conflict between the Sixth Circuit, on the one hand, and the Second and Third Circuits, on the other. The Court of Claims, in the *Davis* case,[66] then followed *Marshman,* and it was on the appeal from the *Davis* decision that the Supreme Court was able to put the controversy to rest.

*Validity of the Presumption*

It is important to recognize that the basis of the Supreme Court's decision in the *Davis* case was merely a presumption. Thus, the Court stated that: "It must be assumed, we think, that the parties acted at arm's length, and that they judged the marital rights to be equal in value to the property for which they were exchanged."[67] Similarly, in the *Mesta* case, the Third Circuit reasoned as follows: "We think that we may make the practical assumption that a man who spends money or gives property of a fixed value for an unliquidated claim is getting his money's worth."[68] The Court in the *Davis* case did not mention any factual basis for such an assumption, especially in a divorce situation, except to state that there was no evidence to the contrary. Apparently, however, the Court felt that it was "more consistent with the general purpose and scheme of the taxing statutes to make a rough approximation of the gain realized thereby than to ignore altogether its tax consequences."[69] Consequently, the Supreme Court did not attempt to establish that its presumption had any basis in fact, although it did recognize that there was merit to the argument that such presumption is "weakened by the emotion, tension and practical necessities involved in divorce negotiations and the property settlements arising therefrom."[70]

In the *Marshman* case, however, the Court of Appeals for the Sixth Circuit considered in detail the realities of the divorce situation.

64. E. Eugene King, 31 T.C. 108 (1958); Estate of Gordon A. Stouffer, 30 T.C. 1244 (1958), *rev'd,* 279 F.2d 27 (6th Cir. 1960); Homer H. Marshman, 31 T.C. 269 (1958), *rev'd,* 279 F.2d 27 (6th Cir. 1960). See also Rev. Rul. 57-507, 1957-2 CUM. BULL. 511.

65. 279 F.2d 27 (6th Cir.), *cert. denied,* 364 U.S. 918 (1960).

66. Davis v. United States, 287 F.2d 168 (Ct. Cl. 1961), *rev'd,* 370 U.S. 65 (1962).

67. United States v. Davis, 370 U.S. 65, 72 (1962).

68. Commissioner v. Mesta, 123 F.2d 986, 988 (3d Cir. 1941), *cert. denied,* 316 U.S. 695 (1942).

69. United States v. Davis, 370 U.S. 65, 72-73. Compare the view adopted here to the one taken by the Commissioner in Reg. § 1.421-6 (1959), as amended, T.D. 6540, 1961-1 CUM. BULL. 161, dealing with non-restricted stock options and discussed in the previous topic, that the tax consequences of an option are to be ignored (in both instances, "deferred" would be more appropriate than "ignored"), *unless* the value of the option is "readily ascertainable."

70. *Id.* at 72.

> To say that the fair market value of the property received is the same as the fair market value of the property given up . . . ignores realities . . . . A property settlement in a divorce proceeding is usually influenced and often dictated by numerous intangible, personal and practical considerations which play no part in a transaction between a willing seller and a willing buyer in the open market.[71]

In particular, the court emphasized that it is often the case that what the husband transfers is not merely in exchange for a release of the wife's alimony and dower rights, but also includes "such additional amount as the husband may be willing to pay in order to have the marriage status terminated."[72] Consequently, the court concluded that the value of the property surrendered was not a "criterion of the fair market value of the 'property' received."[73]

Moreover, the court of appeals pointed out that the government's position ignored the well-recognized elements of the fair market value concept that a willing buyer and a willing seller, neither being under compulsion to buy or sell, were required. "A single transaction between a husband and wife made under the emotion, tension and practical necessities involved in a divorce proceeding does not comply with this rule."[74]

The effect of the decision in *Davis* is to reinforce the Commissioner's position that "only in rare and extraordinary cases will property be considered to have no fair market value."[75] This result is achieved, however, at the expense of reasonable accuracy and fairness in measuring value. Moreover, it places an added burden on the husband. In addition to the emotion and tension of the divorce proceeding, he is required to pay a tax when he is surrendering property and not receiving cash or its equivalent with which to pay it. The rationale behind such a rule is not likely to be apparent to the average taxpayer.

The effect of the *Davis* case on several important questions in this area, however, is unclear. The Court left undecided the question of under what circumstances, if any, the transaction would be a taxable event as to the *wife*. The Court stated, without citation, that "under the present administrative practice, the release of marital rights in exchange for property or other consideration is not considered a taxable event as to the wife."[76] Nevertheless, it would seem that if the wife transferred appreciated property in addition to releasing marital rights, she would also be subject to tax on the appreciation.[77]

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71. Commissioner v. Marshman, 279 F.2d 27, 32 (6th Cir.) *cert. denied,* 364 U.S. 918 (1960).
72. *Ibid.*
73. *Ibid.*
74. *Ibid.*
75. Reg. § 1.1001-1(a) (1957); Rev. Rul. 58-402, 1958-2 CUM. BULL. 15.
76. United States v. Davis, 370 U.S. 65, 73 n.7 (1962).
77. Although CODE § 71 provides that lump sum payments made by the husband to the wife are not includible in the wife's gross income, this rule applies only to payments made

Another interesting but unresolved issue in the *Davis* case concerns the taxpayer's argument that the date on which the stock was delivered was not the appropriate valuation date.[78] The agreement pursuant to which the transfer was made was executed in 1954, but the transfers were not made until 1955 and thereafter. Between 1954 and 1955 the value of the stock increased from $145.63 per share to $164.50. Mr. Davis' basis was $149.55.[79] Consequently, the taxpayer argued that a loss, rather than a gain, had been sustained, but the Court refused to decide this question on procedural grounds. To be consistent with the Court's opinion, the date of valuation should have been the date upon which the agreement was signed. The opinion is based on the presumption that the parties "judged the marital rights to be equal in value" to the stock surrendered.[80] This type of judging could have taken place only when the agreement was entered, as the parties could not have known what the value of the stock would be at some future date. In the *Davis* situation, therefore, the taxpayer seems correct in contending that a loss was sustained.[81]

Certain limitations on the doctrine of the *Davis* case, some explicit and some implicit, should also be pointed out. The presumption that the value of the property received is equal to the value of the property surrendered does not apply if the transaction is clearly not at arm's length.[82] For example, if a father and son exchange properties in a situation where the father intends the excess in the value of the property surrendered over the value of the property received as a gift to the son, the presumption should not apply. Similarly, in an exchange in an employment situation, where the employer intends the excess in value

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"because of the family or marital relationship in recognition of the general obligation to support. . . ." Reg. § 1.71-1(b)(4) (1956). Payments made in consideration for the transfer by the wife of appreciated property, in addition to her release of marital rights, would not be subject to this rule, since they are not made because of the marital relationship. *Cf.* Walther, *Can Advance Planning Avoid Harshness of Davis Rule on Appreciated Property?*, 17 J. TAXATION 301, 303 (1962).

78. Petition for Rehearing, pp. 2-3, United States v. Davis, 370 U.S. 65 (1962).

79. Brief for Thomas Crawley Davis, pp. 21-22, United States v. Davis, *supra* note 78.

80. United States v. Davis, *supra* note 78.

81. *But cf.* CODE § 267, disallowing a deduction for a loss sustained on an exchange of property between spouses. It is questionable, however, whether the parties would be "spouses" for purposes of CODE § 267, since the transfer is ordinarily not effective until after the entry of the divorce decree. A more fundamental objection is that the rationale behind CODE § 267 does not apply in a divorce situation. The dangers at which CODE § 267 is directed — transactions between related taxpayers not dealing at arm's length and often constituting only one economic unit — are not present here. *First*, under the *Davis* rule, it is presumed that the parties were dealing at arm's length. *Second*, the exchange was in anticipation of the parties' becoming separate economic units. Consequently, CODE § 267 should not be applicable in a divorce situation.

82. The first part of the presumption is "that the parties acted at arm's length." United States v. Davis, 370 U.S. 65, 72 (1962).

to be compensation to the employee, the presumption should likewise be inapplicable.

Finally, it is implicit in the *Davis* case that the presumption could not be relied upon if the value of neither the property surrendered nor the property received could be computed.[83] Thus, if both the husband and wife were independently wealthy, and the settlement agreement constituted merely a release of marital rights in each other's property, the application of the *Davis* presumption would be to no avail. The same conclusion ought to be reached in a non-divorce situation where the properties exchanged are highly speculative stocks or similar property difficult of valuation.

Thus, if the transaction is not at arm's length, or if the value of neither properties can be determined, the *Davis* rule should not apply. This still leaves many areas where the rule may be adopted and, in divorce situations in particular, the *Davis* holding makes it much more imperative that careful tax planning[84] precede settlement agreement negotiations.

83. This was one aspect of the taxpayer's case in *Marshman,* where the court stated: "Even if we accept the ruling of the *Mesta* case that the fair market value of the release is the same as the fair market value of the option [the property surrendered], it is impossible to tell from the evidence in this case what the fair market value of the option was. . . . [I]t necessarily follows that the assessment was invalid and must be set aside." Commissioner v. Marshman, 279 F.2d 27, 34 (6th Cir.), *cert. denied,* 364 U.S. 918 (1960). See also Philadelphia Park Amusement Co. v. United States, 130 Ct. Cl. 166, 126 F. Supp. 184 (1954) (dictum to the same effect).

84. See generally, Walther, *Can Advance Planning Avoid Harshness of Davis Rule on Appreciated Property?,* 17 J. TAXATION 301 (1962).