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Taxation of Stock Transfers Between Corporate Shareholders and Employees

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This article analyzes the judicial interpretations of "amount realized" to a shareholder upon transfer of stock to a corporate employee. The author criticizes the overextension of the Davis presumption — when properties are exchanged at arms length their values are approximately equal — to the stock transfer situation. He concludes that a more appropriate test would be to examine the nature of the property received to determine whether the Davis presumption should be applied.
issues shares to an employee for services rendered, or those to be rendered, the tax consequences are fairly straightforward. The corporation will not recognize any gain1 and may be entitled to deduct the fair market value of the stock under section 162.2 The employee will ordinarily have to recognize the fair market value of the stock as compensation income.3

However, if a shareholder gratuitously transfers stock to an employee of the corporation, the tax issues may become quite complex.4 The Internal Revenue Service has taken the position that such a transfer is a nontaxable capital contribution to the corporation.5 As such, the shareholder cannot recognize either gain or loss,6 but can increase his basis in the shares he retains.7 The corporation will be entitled to deduct the fair market value of the stock as a business expense8 and the transferee-employee will be required to include the fair market value of the stock as compensation income.9

The courts, however, have generally not adopted this characterization.10 The opinions emphasize that one of the salient features of a capital contribution is that the percentage ownership of the corporation’s stock remains the same before and after the transaction.11 When a shareholder transfers stock to an employee there is a clear change in the stock holdings of the corporation. One argument

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1. A corporation does not recognize gain or loss upon receipt of money or property in exchange for its stock. INT. REV. CODE OF 1954, §1032.

2. Rev. Rul. 75, 1969-1 CUM. BULL. 52. But the corporation will not be allowed a deduction when it is merely acting as a conduit for a stock transfer by a majority shareholder to the employee. Rev. Rul. 369, 1969-2 CUM. BULL. 27.

3. A person who receives stock on other property in return for services performed realizes income to the extent that the fair market value of the property received exceeds the amount paid for it, provided the recipient’s ownership of such stock or other property is free from certain restrictions or conditions. INT. REV. CODE OF 1954, §83; Treas. Reg. §1.61-2(d)(1).

4. For a discussion of some of the issues involved in such transfers, see Manwell, Transfers of Partial Stock Interests to Corporate Employees: A Composite Alternative, 1 J. CORP. TAX. 275 (1974); O’Brien, Stock Transfers by Shareholders to Outsiders for Nontangible Consideration, 39 TAXES 675 (1961).


7. Greer v. Commissioner, 230 F.2d 490 (5th Cir. 1956); Edward Mallinckrodt, Jr., 38 B.T.A. 960 (1938).

8. INT. REV. CODE OF 1954, §162(a).

9. Id. §61; see note 3 supra.


which has been frequently advanced by taxpayers is that a wholly
gratuitous transfer of stock by a shareholder to an employee does not
constitute a sale or exchange. If this view were to be adopted, then
the shareholder would not be required to recognize any gain which
might have been realized\footnote{12} and any loss incurred would be ordi-
nary.\footnote{13} Likewise, the courts have not wholeheartedly approved of
this characterization.\footnote{14}

Most courts have held that a partly or wholly gratuitous trans-
fer from a shareholder to a corporate employee constitutes a taxable
sale or exchange.\footnote{15} However, the authorities are divided over the
amount realized by the transferor. Some courts have held that any
intangible benefits received by the transferor are so nebulous that
they do not constitute property or that they are so speculative that
they have no fair market value.\footnote{16} Other courts have held that such
benefits are property, and that their fair market value can be ap-
proximated from the value of the property given up.\footnote{17} To date, there
has not been a definitive resolution of this issue.

While the courts have disagreed to some extent over the charac-
terization of the transaction, and to a large extent over the amount
realized as a result of the transfer, they are undivided in disallowing
shareholders deductions for the fair market value of the property
transferred under both sections 162 and 212.\footnote{18} A transfer of stock by
a corporate shareholder, whether or not he is also a corporate officer,
simply is not sufficiently "ordinary" to qualify as a business or
investment expense.

Since the most controversial issue arising from transfers for
stock between shareholders and employees centers around the
amount realized therefrom, this paper will analyze in detail the
judicial authorities which have discussed both sides of this issue. In

\footnote{12}{INT. REV. CODE OF 1954, § 1002 provides for recognition of a gain or loss when there
is a "sale or exchange."}
\footnote{13}{INT. REV. CODE OF 1954, § 165.}
\footnote{14}{J. K. Downer, 48 T.C. 86, 92 (1967) and case cited therein.}
\footnote{15}{Henry T. Simonson, 34 CCH Tax Ct. Mem. 47 (1975); Harold J. Plumley, 39 P-H
Tax Ct. Mem. ¶ 70,035 (1970); J.K. Downer, 48 T.C. 86 (1967).}
\footnote{16}{Scherman v. Helvering, 74 F.2d 742 (2d Cir. 1935); Kress v. Stanton, 98 F. Supp.
470 (W.D. Pa. 1951); Berner v. United States, 282 F.2d 720 (Ct. Cl. 1960); Peabody Coal Co.
v. United States, 8 F. Supp. 845 (Ct. Cl. 1934).}
\footnote{17}{Henry T. Simonson, 34 CCH Tax Ct. Mem. 47 (1975); Harold J. Plumley, 39 P-H
Tax Ct. Mem. ¶ 70,035 (1970); J. K. Downer, 48 T.C. 86 (1967).}
\footnote{18}{See, e.g., Bert B. Rand, 35 T.C. 956 (1961); Aldo R. Balsum Trust, 13 P-H Tax Ct.
Mem. 1315 (1944).}
addition, a new test for determining the amount realized will be proposed, and a method for structuring the transaction to minimize tax liability will be discussed.

II. AMOUNT REALIZED BY A TRANSFEROR-SHAREHOLDER

A. Statutory Framework and Judicial Interpretations

Sections 6119 and 100120 of the Internal Revenue Code jointly define the basic tax consequences resulting from dealings in property. Pursuant to these statutory provisions, a transferor of stock cannot be taxed unless the transfer constitutes a sale or other disposition and unless he realizes an amount of property and/or money, the joint value of which exceeds his adjusted basis in the stock. Absent a close family or personal relationship between a transferor-shareholder and a transferee-employee, any transfer of stock between such parties, whether wholly or partly gratuitous, will usually constitute a taxable sale.21 Whether the transferor-shareholder will have realized a particular amount as a result of the transfer is not, however, so clear.

There are essentially two ways of viewing the issue of whether the transferor realizes an amount. From an economic standpoint it seems clear that the transferor has made use of his stock by transferring it to the employee. This use of the transferor's property would seem to constitute a realization of the value of the stock. It is therefore appealing to argue that the transferor should recognize any gain

   Except as otherwise provided in this sub-title, gross income means all income from whatever source derived, including (but not limited to) the following items:
   (3) Gains derived from dealings in property.

20. Int. Rev. Code of 1954, § 1001 provides:
   (a) Computation of Gain or Loss. - The gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in section 1011 for determining gain, and the loss shall be the excess of the adjusted basis provided in such section for determining loss over the amount realized.
   (b) Amount Realized. - The amount realized from the sale or other disposition of property shall be the sum of any money received plus the fair market value of the property (other than money) received.

or loss attributable to a fluctuation in value from his basis. On the other hand, it is clear that section 1001 measures the gain or loss resulting from the sale or disposition of property by the amount realized. The amount realized is defined in terms of the amount of cash and the fair market value of property received by the taxpayer. Since the transferor may not be vested with any legal rights as a result of the transfer, it can be cogently argued that he did not receive cash or property. Because of these conflicting views, the courts have been faced with the perplexing problem of analyzing the tax consequences of a transaction which appears to be a taxable event but which does not neatly fall within the terms of the statute.

Prior to 1967, the majority of courts which considered this issue held that any intangible benefits which might flow to the transferor-shareholder did not constitute property and did not have a reasonably ascertainable fair market value. As a result, the transferor was entitled to a loss measured by the difference between his adjusted basis and the amount of cash and the fair market value of property (other than the intangible benefits stemming from the services performed by the employee for the corporation) received.

The clearest articulation of the pre-1967 approach may be found in Scherman v. Helvering. Scherman was one of the original Book-of-the-Month Club incorporators. To induce a key employee to accept a position with the corporation, Scherman sold the employee a portion of his stock for less than cost. Scherman claimed a loss measured by the difference between his adjusted basis in the stock transferred and the amount of cash received. The court assumed that Scherman could have enjoined the employee from working for another employer during the term specified in the employment contract between the employee and the corporation. The employee did not otherwise do or promise to do anything in consideration for the stock transfer. The language used by the court in concluding that Scherman incurred an allowable loss is illustrative since it focuses on the issue of whether he received any property in connection with the transfer.

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24. 74 F.2d 742 (2d Cir. 1935).
25. Id. at 743.
If [the loss] existed, it was the difference between the “amount realized” . . . and the “basis” which was the cost of the shares . . . . “[T]he amount realized” . . . is defined as “the sum of any money received plus the fair market value of the property (other than money) received.” The only “property received” was the right of action against [the employee] . . . . A contract between a shareholder and the prospective manager of a company, even if it be property, certainly has nothing that by any stretch of words can be regarded as a “fair market value” . . . . Nor can [the transferor-shareholder] be supposed to have received any “property” indirectly as a shareholder of the company . . . . [T]he company also contracted with [the employee]; [the transferor's] shares might rise in value for that reason, and larger dividends might ensue. But none of these increments in value were present “property”; certainly not the undeclared dividends, equally not the increase in value of the shares, until they were sold.26

The thrust of Scherman and its progeny is simple—a transferor-shareholder suffers a loss when he gratuitously transfers stock to an employee of the corporation because he does not receive property having fair market value equal to or greater than his adjusted basis.

In 1967, the Tax Court rejected this line of reasoning in the J.K. Downer27 decision. In Downer the majority shareholder of a failing corporation gratuitously transferred stock to a key employee to induce him to remain with the corporation. The shareholder claimed as a loss the amount of his adjusted basis in the stock. The Service argued that the shareholder should have offset his basis in the stock by the amount he realized, and that the amount realized was equal to the fair market value of the stock at the time of the disposition. The court adopted the government’s position with this cryptic statement:

We further conclude that the measure of such loss is the difference between petitioner's adjusted basis in the shares and their fair market value at the time of transfer to [the employee]. . . . To the extent that Peabody Coal Co. v. United States, . . . Berner v. United States, . . . Scherman v. Helvering, . . . and Kress v. Stanton . . . adopt a contrary approach, their efficacy has been washed away by the tides of more recent decisions.

26. Id.
27. 48 T.C. 86 (1967).
TAXATION OF STOCK TRANSFERS

Since 1967, the Tax Court has consistently applied the Downer rule to shareholder-employee transfers of stock.29

The basic distinction between these two lines of cases is that in Downer the Tax Court presumed that intangible benefits received by the shareholder-transferor constituted property, the fair market value of which could be estimated by the fair market value of the property given up, whereas the Scherman court analyzed the nature and extent of the rights received by the transferor-shareholder, if any, and concluded that such rights did not constitute property or were so ephemeral that they could not be valued. While the Scherman approach may have been supported by logic and lower appellate authorities, the Downer court supported its holding with a citation to the Supreme Court decision of United States v. Davis.30

A careful analysis of that Supreme Court opinion and its progeny is therefore necessary to determine whether it should control the tax consequences of a partly or wholly gratuitous transfer of stock by a shareholder to a corporate employee.

B. The Davis Rule

Davis involved the tax consequences of a divorce settlement agreement, the terms of which provided for a release of the wife's inchoate marital rights to the husband's estate as consideration for his transfer to her of appreciated property. The Service contended that the husband realized gain measured by the difference between the fair market value of the stock at the time of the transfer and his adjusted basis. The Court of Claims heard the case and rejected the Service's argument.31 That court reasoned that the fair market value of the property received could not be estimated from the fair market value of the property given up because the emotion, tension, and practical necessities attendant upon a divorce precluded application of the willing buyer/willing seller rule.32 Thus, even if the prop-

28. Id. at 94.
erty received by the husband resulted in economic gain to him, he could not be taxed because the property either had no fair market value or the Service had failed to prove its fair market value.\(^3\)

In a relatively short opinion, the Supreme Court reversed the Court of Claims and stated:

\[ \text{[T]} \text{he "property received" was the release of the wife's inchoate marital rights. . . .} \]

\[ \text{It must be assumed, we think, that the parties acted at arm's length and that they judged the marital rights to be equal in value to the property for which they were exchanged. There was no evidence to the contrary here. Absent a readily ascertainable value it is accepted practice where property is exchanged to hold . . . that the values "of the two properties exchanged in an arm's length transaction are either equal in fact or presumed to be equal. . . ." To be sure there is much to be said of the argument that such an assumption is weakened by the emotion, tension and practical necessities involved in divorce negotiations and the property settlements arising therefrom. However, once it is recognized that the transfer was a taxable event, it is more consistent with the general purpose and scheme of the taxing statutes to make a rough approximation of the gain realized thereby than to ignore altogether its tax consequences.}^{4}\]

Two principles can be distilled from the Court's language. First, when two individuals exchange property pursuant to arm's length negotiation it can be presumed that the fair market values of the properties exchanged are approximately equal. Second, once it has been determined that a transaction is a taxable event, it is better to estimate the amount realized than let the taxpayer escape taxation altogether.

Predictably enough, some courts have focused on the second principle and have readily estimated the amount realized by transferors from the fair market values of the properties given up.\(^5\) Other courts have been reticent in applying Davis\(^6\) and have stressed that the Davis rule should be applied only when the fair market value of

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33. 287 F.2d at 174-75.
34. 370 U.S. at 72-73.
36. Some courts have taken the apparently erroneous position that Davis is inapplicable unless the parties assign a monetary value to the property given up. See e.g., Bankers Trust Co. v. United States, 518 F.2d 1210 (Ct. Cl. 1975).
the property received is uncertain,\textsuperscript{37} and that the \textit{Davis} rule is only a presumption or method of proof which can be overcome by showing that its application to a given state of facts would be arbitrary and capricious. \textit{Seas Shipping Co. v. Commissioner}\textsuperscript{38} is representative of the latter view. There the court stated:

While under the circumstances of this case the Tax Court's adoption of this method of valuation—the equation of two sides of a barter—is not clearly erroneous, it is a means which should be used only under certain limited conditions. The authority for it comes almost exclusively from cases involving valuation of property for which there is little or no market . . . . There are obvious dangers in evaluating the consideration involved in one side of a barter by determining the worth of the consideration on the other side. In the first place, the two sides of the barter may, for various reasons, not be equal in value. Secondly, the barter-equation method is in the nature of a bootstrap operation since there is usually no logical reason to start with one side rather than the other . . . . Thirdly, the evidence on the value of one side of a barter may be no more reliable than that on the value of the other side. The determination of value by this means is particularly complex in a case such as this where . . . the seller [receives an equity interest in the buyer as part of the consideration for the sale] . . . .\textsuperscript{39}

The dichotomy between these two lines of cases is apparent. The courts which readily apply the \textit{Davis} rule have opted for certainty even though application of that rule may have the effect of taxing the appreciation in property as soon as it is sold or otherwise disposed of, without regard to whether the transferor received any property or cash—an effect which amounts to judicial amendment of section 1001. On the other hand, courts which analyze the facts of a particular transaction in determining whether it is an appropriate instance for the application of the \textit{Davis} rule have decided that \textit{Davis} should only be applied when it reflects the economic and practical realities of the transaction; and when it does not, then section 1001 requires that another method of evaluation be utilized.

\textsuperscript{38} 371 F.2d 528 (2d Cir. 1967).
\textsuperscript{39} Id. at 529-30.
When Should Davis Be Applied Under Seas Shipping?

Seas Shipping Co. suggests at least two factors which might be considered in determining whether Davis should be invoked in a particular case—whether it can be reasonably supposed that the properties are in fact equal in value and whether the value of the property given up is also uncertain. To determine whether the value of the property received can reasonably be estimated by the value of the property given up, it is necessary to first identify each right or benefit accruing to the transferor as a result of the transaction. There are essentially three types of intangible benefits or rights which may inure to a shareholder from a transfer of stock to a corporate employee: (1) contract rights; (2) future profits; and (3) tax benefits.

1. Contract Rights

The nature and extent of any contractual obligations resulting from a transfer of stock are not only dependent upon the terms of any agreement between the shareholder and the employee, but also upon governing state law. For example, in Downer no contractual rights were created between the shareholder and the employee by virtue of the stock transfer. The shareholder unilaterally decided to transfer the stock and did not expressly or impliedly impose any restrictions or conditions upon the employee's ownership of such stock. Under the laws of most states, the transfer would be considered a gift. It is easy to envision a situation, however, where the transferor-shareholder would extract a promise, express or implied, from the transferee-employee to perform services for the corporation under specified terms and conditions as a quid pro quo for the stock transfer. Under such circumstances, the transferor-shareholder presumably would be vested with all the rights, duties, and privileges of a promisee under the local law governing third party beneficiary contracts.

A transferor-shareholder who is vested with extensive contractual rights against the transferee-employee as a result of a stock transfer is in a position similar to that of the corporate employer who transfers appreciated property in lieu of salary. If a corporate

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40. This approach was pursued to some extent in Scherman v. Helvering, 74 F.2d 742 (2d Cir. 1935). See text accompanying notes 24–26 supra.
41. See Scherman v. Helvering, 74 F.2d 742 (2nd Cir. 1935).
employer transfers appreciated property to an employee in lieu of salary, it can expect to be directly benefitted by the employee's services. If the employee breaches his contract with the corporation before he has fully performed all services due, the corporation will usually be entitled to recover damages measured by the difference between the cost of hiring a new employee and the salary it would have paid to the old, or, if the services of the transferee-employee are unique, the corporation might even be entitled to enjoin the employee from performing similar work for another employer during the term specified in the employment contract. Similarly, a transferor-shareholder who conditions the transfer upon the employee's promise to perform services will be entitled to recover any measurable damages which he suffers and may be entitled to an injunction if the employee fails to substantially perform. Since the corporation is the direct recipient of this bundle of rights and since an employer's and an employee's financial interests with respect to salary are usually adverse, it is reasonable to say that the corporation received an intangible benefit, the value of which can be measured by the difference between the fair market value of the property transferred and its adjusted basis. Furthermore, the parties' interests are adverse since each is suffering a legal detriment. It is therefore reasonable to presume that the fair market value of the property received by the transferor approximates the fair market value of the property given up. However, where a transferee-employee does not incur any additional legal obligations or liabilities, he is not dealing at arm's length with the shareholder-transferor, and consequently there is less reason to approximate the value of any intangible benefits received by the transferor by the value of property transferred.

44. Rev. Rul. 181, 1969-1 CUM. BULL. 196; see United States v. General Shoe Corp., 282 F.2d 9 (6th Cir. 1960); International Freighting Corp. v. Commissioner, 135 F.2d 310 (2nd Cir. 1943).
45. A basic premise of Davis is that it can be assumed that parties bargaining at arm's length will exchange properties which are approximately equal in value. Where there is no bargain between a shareholder and an employee, because the employee incurs no additional
2. FUTURE PROFITS

Even if no contractual rights are created as a result of the stock transfer, it is still necessary to determine whether the value of any future profits which might accrue to the transferor from the employee's services can reasonably be estimated by the value of the property given up. The recent decision of Diamond v. Commissioner contains language discussing the valuation of a profits interest, and in addition, discusses the propriety of presently taxing such an interest. In Diamond the Tax Court held that a partner who contributes services to partnership in exchange for a profits interest could be presently subjected to tax if he has fully performed all services to be performed and if the profits interest has a reasonably ascertainable fair market value. If the profits interest does not have a reasonably ascertainable fair market value, however, then the service partner can apparently be taxed only upon actual receipt of profits. In Diamond the Tax Court expressly found that the profits interest in the income produced by the venture had a present value which could be readily ascertained.

The Tax Court's finding that Diamond's profits interest had a reasonably ascertainable fair market value was crucial to that decision's affirmation on appeal. The Seventh Circuit expressly stated:

legal obligation, it is questionable whether Davis should be applied. But see Matthews v. United States, 425 F.2d 738 (Ct. Cl. 1970).

It should be noted, however, that while discussing the issue of a sale or exchange, the Tax Court in Downer stated:

Petitioner does not deny the fact that he transferred his shares to Wootten in the hope and expectation that the latter would help in the negotiations with Tirey Ford and would continue to work for the corporation. The shares were the not-so-hidden persuader to these ends. Moreover, we have found that Wootten either knew or reasonably should have known that petitioner was so motivated. Admittedly, the benefits might not materialize and admittedly petitioner had no legal claim on Wootten, but such considerations have not prevented the finding of a "sale or exchange." United States v. General Shoe Corporation, . . . . Nor is it without significance that Wootten did in fact render services for 18 months after the promise of transfer.

48 T.C. at 92-93 (emphasis added, citations omitted). The Tax Court may decide to use this ad hoc approach in determining the amount realized by a transferor-shareholder.

46. No court has yet stated that the intangible benefits which are being taxed are future profits. However, this was intimated by the court in Scherman v. Helvering, 74 F.2d 742 (2d Cir. 1935), and it was assumed by the author in Manwell, Transfers of Partial Stock Interests to Corporate Employees: A Composite Alternative, 1 J. Corp. Tax. 275 (1974).

47. 492 F.2d 286 (7th Cir. 1974), aff'g 56 T.C. at 530 (1971).

48. See 56 T.C. at 545-47.
[W]e think it sound policy to defer to the expertise of the Commissioner and the Judges of the Tax Court, and to sustain their decision that the receipt of a profit-share with determinable market value is income.\(^4\)

In light of Diamond's concern with determining the fair market value of the profits interest therein transferred, it is surprising that the Downer court was so willing to approximate the fair market value of the intangible benefits received by the transferor-shareholder from the fair market value of the stock given up. If the Downer rationale were applied to a Diamond set of facts, then the court would always find that the profits interest had a reasonably ascertainable fair market value which could be estimated from the fair market value of the services performed. In addition, automatic application of the Downer rationale to other sales or exchanges involving profits interests would have the effect of overruling a long line of cases which have held that a transaction is open if the fair market value of the property received in the exchange cannot be ascertained with reasonable certainty.\(^5\)

To be consistent with the reasoning of Diamond, and to avoid conflict with the "open transaction" cases, courts should examine the facts and circumstances surrounding the stock transfer to determine whether the present value of future profits is roughly approximated by the fair market value of the stock transferred. To do this courts should first determine the nature of the profits interest to be taxed and the probability that that profits interest will be realized by the transferor-shareholder. Profits from corporate business activity can be realized by a shareholder either through distributions or appreciation in stock value. Realization by the shareholder of any such profits, without regard to form, is dependent upon a myriad of factors, including, among other things, the continued employment of the transferee-employee, the transferee-employee's earnings record, and the transferor-shareholder's power to control the dividend policy of the corporation. If the transferee-employee is not already legally bound to work for the corporation, then it is clear that any profits expected to be derived from his services are wholly speculative. If there is no way to measure the

\(^4\) 492 F.2d at 291.

\(^5\) See, e.g., William A. Cluff, 17 T.C. 225 (1951); Maro Brownfield, 8 B.T.A. 1164 (1927).
past profits which have accrued, or the future profits which may accrue as a result of the employee's services, any profits to be derived by the transferor-shareholder are again wholly speculative. If the transferor-shareholder is not in control of the corporation, then his right to corporate distributions is dependent upon the discretion of an independent board of directors. Absent an established dividend policy, a transferor-shareholder who is not in control of the corporation may never receive any distributions in respect of his stock, even if the corporation has a surplus which is directly attributable to the transferee-employee's services.

Before applying the Davis-Downer rationale, a Court should thus examine each of the ensuing factors to determine if it is reasonable to apply the Davis presumption: whether the transferor-shareholder controls the corporation; whether the transferee-employee has an established earnings record; whether the employee was obligated to work for the corporation; whether the corporation had an established dividend policy; and the term of employment of the transferee-employee. Only by evaluating such factors could the court conclude that it was reasonable to approximate the fair market value of future profits accruing to the transferor-shareholder by the fair market value of the stock transferred.

3. TAX BENEFITS

The third type of benefit that a transferor-shareholder might receive as a result of the transfer is a tax benefit. There have been Revenue Rulings and cases involving employer transfers of appreciated property directly to employees or to pension or profit sharing trusts. In each instance, the employers deducted as a business expense the fair market value of the property transferred, and did not report any gain on the transaction. In each instance, it was held that the transferor realized an amount equal to the fair market value of the property transferred. It is not difficult to justify these holdings by applying concepts grounded in the tax benefit rule.

52. See United States v. General Shoe Corp., 282 F.2d 9 (6th Cir. 1960). International Freighting Corp. v. Commissioner, 135 F.2d 310 (2d Cir. 1943); Tasty Baking Co. v. United States, 393 F.2d 992 (Ct. Cl. 1968).
53. The tax benefit rule generally requires the inclusion of items of income which were expensed in previous years to the extent that they produce a tax benefit when recovered. Although the issue discussed in the text does not fall squarely within the tax benefit rule, it seems that the concept could apply.
The employer attempted to expense an item he had not previously included in income. Tax benefit concepts should clearly require recognition of gain measured by the difference between the fair market value of the property transferred and its basis.\(^4\)

Although the tax benefit concept is appropriate where the transferor claims a deduction for the fair market value of the property transferred, it is not appropriate in the context of shareholder transfers of stock to corporate employees because the shareholder cannot take a deduction under sections 162 and 212.\(^5\) Consequently, the transferor-shareholder will not have any tax benefit. Any loss claimed by the transferor-shareholder on the transaction measured by the basis in his stock does not result in a tax benefit which requires the recognition of gain or disallowance of loss. The shares transferred would be acquired with after-tax dollars and thus a loss measured by the basis of the property transferred should reflect the shareholder's economic outlay.

4. **UNCERTAIN VALUE OF PROPERTY EXCHANGED**

In addition to cautioning against the use of *Davis* where the value of property received cannot realistically be considered equal to the value of the property given up, *Seas Shipping* also cautioned against application of the *Davis* presumption when the property given up has an uncertain value. The fair market value of the shares transferred may or may not be difficult to ascertain, depending upon the nature of the corporation and its capital structure. If the corporation's stock is publicly traded its shares can be readily valued. If, however, the corporation is closely held, not only would it be difficult to value all of the outstanding shares as a unit, the difficulty will be compounded by trying to value a minority interest transferred to an employee. Furthermore, if the alienation of the shares is restricted pursuant to securities laws or shareholder agreements, any estimation of the fair market value may well be impossible.

\(^4\) While the court in *Tasty Baking Co. v. United States*, 393 F.2d 992 (Ct. Cl. 1968), stated that its decision was not based on tax benefit concepts, the Tax Court in *K.C. Bellows*, 36 P.H Tax Ct. Mem. ¶ 67,199 (1967), expressly relied on tax benefit concepts in requiring recognition of gain, and the court in *United States v. General Shoe Corp.*, 282 F.2d 9 (6th Cir. 1960), referred to the taxpayer's claim for a deduction equal to the fair market value of the property transferred no less than six times.

\(^5\) See note 18 *supra* and accompanying text.
5. RECAPITULATION

From the foregoing analysis three principles can be distilled. First, where the transferor-shareholder is vested with contractual rights vis-a-vis the transferee-employee as a result of the stock transfer, it is reasonable to assume that the fair market value of the property transferred equals the fair market value of the property received. Second, where the transferor is not vested with such contractual rights the surrounding facts and circumstances should be examined before presuming that the fair market value of the property received is equal to the fair market value of the property given up. Third, Davis should not be applied when the property given up as well as the property received both have very speculative values. If a transferor-shareholder can demonstrate that he did not receive any contract rights and that any future profits are too speculative to value, or that the value of the property given up is speculative, then the Davis principle should not be applied. In the Tax Court, the Internal Revenue Service will then have the burden of proving the value of the intangible benefits received by the transferor-shareholder, a burden which will be difficult to sustain. Consequently, the transferor-shareholder should not be required to recognize any gain, and loss should be measured by his basis in the stock transferred, a result which is consistent with the pre-1967 cases. However, if Davis is applicable under the particular facts or if the Service proves an alternative measure of valuation, then any gain would be recognized and the loss would be the difference between the basis of the stock and the amount realized.

Even if a transferor-shareholder is required to recognize a gain, he may nevertheless be entitled to an amortization deduction to the extent of the gain realized. A shareholder should be so entitled when the court finds that the property received by him is future profits. If the transferor-shareholder is not allowed an amortization deduction, or at least a basis adjustment in his remaining shares, he could be taxed on the present value of future profits at the time of the transfer and he will again be taxed on those same profits when received.

56. This result would not obtain, however, when the taxpayer litigates in a forum other than the Tax Court.
III. Planning

The foregoing discussion makes it clear that the authorities are divided on the tax effect of a transfer of stock to a corporate employee by a shareholder. Given this state of uncertainty, coupled with the trend towards defining the amount realized in terms of the fair market value of the property transferred, the best planning device may be to advise shareholders against transferring their stock to employees. In closely held corporations there are alternative methods of structuring this transaction which may lead to more favorable tax results with less risk. Before these structures are discussed, however, it should be recognized that certain tax consequences are inherent in non-gift transfers of stock to employees. The employee will ordinarily have to include the fair market value of the stock in his gross income.\footnote{7} Also, a transferor-shareholder cannot deduct the fair market value of the stock transferred under either section 162 or 212.\footnote{11} Consequently, the only two factors which can be varied to alter the tax consequences of the transaction are the deduction to the corporation and the amount realized by the transferor-shareholder.

One possible structure is suggested by Proposed Internal Revenue Regulation section 1.83-6(d), which provides:

Where a shareholder of a corporation transfers stock to an employee of such corporation in consideration of services performed for the corporation, the transaction shall be considered to be a contribution of such stock to the capital of such corporation by the shareholder and a transfer of the stock by the corporation to the employee.\footnote{5}

Assuming that this regulation is valid,\footnote{60} a transferor-shareholder

\footnotesize{\textsuperscript{57.} Section 83 generally requires the inclusion in the employee's gross income of the fair market value of stock or other property given him by his employer when his rights in the property become transferable or not subject to a substantial risk of forfeiture. This is basically a timing provision for transfers of restricted stock. An employee may not have to report income in the year of transfer if the stock is restricted or subject to forfeiture. INT. REV. CODE OF 1954, § 83.} 
\footnotesize{\textsuperscript{58.} See note 18 supra and accompanying text.} 
\footnotesize{\textsuperscript{59.} 7 P-H 1976 Fed. Taxes § 65,325.} 
\footnotesize{\textsuperscript{60.} A regulation may be held invalid if it is enacted after and conflicts with a prior judicial decision construing the statute. Trust of Bingham v. Commissioner, 325 U.S. 365 (1945). In Downer, the court expressly rejected the characterization now embodied in Proposed Treas. Reg. § 1.83-6 insofar as § 1001 is concerned. Whether the Treasury will be bound by that interpretation in the context of § 83 remains to be seen. One situation in which}
will not be required to recognize gain and will not be permitted to recognize loss if, and only if, the fictitious transfer of stock to the corporation is treated as a contribution to which section 351 applies, or if it is treated as a contribution which does not trigger realization of gain or loss. The employee to whom the stock is transferred will recognize income and the corporation will recognize a deduction in accordance with the provisions of section 83. The problems with this structure are threefold: the transferor-shareholder may still be required to recognize gain pursuant to *Downer*; the stock transferred must be restricted as to alienation and must be subject to a substantial risk of forfeiture; and the transferor-shareholder will not have received any cash or property outright. Conditioning the employee's ownership of stock and restricting his power of alienation may not fulfill the needs of either the employee or the transferor-shareholder. In such situations, the parties must seek another means by which to accomplish their goals.

A second possible structure may be increasing the employee's salary to the extent that he can afford to purchase stock from the shareholder at its fair market value. If the employee is contractually obligated, as a condition to payment of the bonus salary, to use those funds to purchase stock, the Commissioner may of course be able to attack the transaction as a sham. But if the transferee-employee is entitled to use the bonus funds as he sees fit, then the transaction should withstand such attack.

This latter structure will be particularly beneficial when the corporation is a Subchapter S corporation and the installment method of reporting gain is elected by the transferor-shareholder. Then, the employee will be able to defer taxation of the salary 

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61. *Downer* made it clear that some "contributions to capital" may in fact constitute taxable events. See 48 T.C. at 90.

62. While the applicability of Proposed Treas. Reg. § 1.83-6(d) is not by its terms limited to situations where restricted stock is transferred to a corporate employer, it can fairly be inferred that its applicability is so restricted. Proposed Treas. Reg. § 1.86-3 is captioned "Deduction by Employer," and subparagraph (d) is captioned "Special Rules". Every subparagraph under § 1.86-6 explicitly mentions § 83 except for subparagraph (d). Taken together these facts indicate Proposed Treas. Reg. § 1.83-6(d) was intended to apply only when § 83 applies.

63. In *Downer*, for example, restricted stock would not have been anywhere near the incentive that unrestricted stock was. It is hard to imagine a more valueless property interest than restricted stock of a failing corporation.
bonuses and the shareholder will be able to defer any gain realized. Furthermore, every dollar taken out of the corporation as salary and paid to the transferor-shareholder at capital gains rates decreases the amount of the constructive dividend which would otherwise have been reported by shareholders as ordinary income.

IV. CONCLUSION

The *Davis* case, as interpreted by *Downer*, has become more than a method of proving the value of intangible benefits—it has become a rule of substantive law. If the courts extend *Downer* to its logical extreme, then any disposition of appreciated property other than a gift will result in taxable gain to the transferor without regard to the nature or extent of any property or benefits received by him. The courts would then be effectively amending section 1001 by judicial fiat, and would also be overruling the "open-transaction" cases. Applying the *Davis-Downer* principles to a case like *Diamond* would require the recognition of gain upon a transfer of virtually any profits interest. *Downer* should not be given such a sweeping impact. Rather, the courts should apply the reasoning of *Seas Shipping* and examine the nature and characteristics of the property received by the transferor to determine whether it is reasonable to apply the *Davis* presumption. Only by so analyzing the facts of a given case can *Downer* and *Davis* be applied consistently with the "open-transaction" cases and with *Diamond*.

64. *See* cases cited note 50 *supra.*