different treatment of corporate distributions from fixed assets. The Massachusetts rule awards cash dividends and dividends in stock of a corporation other than the declaring one to the life beneficiary as long as the distributing corporation has surplus available. The Uniform Principal and Income Act awards to corpus all distributions, i.e., disbursements of corporate assets, which the distributing corporation designates as a return of capital or division of corporate property.

Since fixed assets, for almost all purposes, are thought of as "capital," it is not surprising that distributions traceable to their sale tend to be treated as returns of capital and awarded to corpus rather than as distributions of income and awarded to the life beneficiary. However, since a corporation in the course of its business activities regularly transforms its assets by recovering depreciation expense in the form of liquid assets, the source of a distribution should not determine its apportionment. Instead, attention should be directed to the state of the surplus account of the distributing corporation. Does it, immediately before the distribution, reflect profits which, if distributed, would be awarded to the life beneficiary pursuant to the various apportionment rules? Will all or part of the distribution, as a matter of corporate accounting, be charged against this increase, so that the amount involved is no longer available for ordinary distribution? If the answer to both of these questions is in the affirmative, trustees should be allowed to award the distribution, whatever its source, to the life beneficiary. Such an approach to the problem gives recognition to the accounting concept of income and would facilitate a more equitable allocation between the life beneficiary and corpus.

TAX EFFECTS OF ABSENCE OF MARKET VALUE ON EMPLOYEE BARGAIN PURCHASES—THE *MARSHALL* PLAN

Corporations have often attempted to compensate employees by selling the corporation's securities to them at less than the market value[1] so that the benefits are taxed at bargain capital gain rates.[2] Where the market value at the time of sale is ascertainable, courts have defeated such schemes by holding the excess of market over cost to be taxable as ordinary income to the employee.[3] The re-

[1] E.g.: Commissioner v. Smith, 324 U.S. 177 (1945); Wanda V. Van Dusen, 8 T.C. 388 (1947), aff'd 166 F. 2d 647 (C.A. 9th, 1948). Stock given to an employee as a bonus involves the same problems: Mason v. Commissioner, 125 F. 2d 540 (C.A. 6th, 1942); O.D. 570, 1920 Cum. Bull. 144.

[2] Int. Rev. Code § 117, 26 U.S.C.A. § 117 (1948). Consult Brodskey, Planning Business Transactions to Produce Capital Gain, N.Y.U. Seventh Ann. Inst. on Fed. Tax 302, 309 (1949).

[3] Authorities cited note 1 supra. But cf. Omaha Nat'l Bank v. Commissioner, 75 F. 2d 434 (C.A. 8th, 1935).

cent opinion of the Tax Court in *Estate of Raymond T. Marshall*[4] suggests that a corporation may succeed in such a project by using for this purpose securities whose subsequent sale is so restricted that they have no determinable market value when received by the employee. The case also illustrates ways in which taxation of the benefit to the employees may be postponed and spread over a number of years—usually post-retirement years, when the taxpayer's total income, being smaller, will be taxed at lower rates.

Marshall had been the owner of 3500 shares of capital stock of an insurance brokerage corporation in which he was formerly an officer and director, one thousand shares of which he had purchased at a nominal price, the remainder at a substantial cost.[5] Restrictions placed on the stock by the charter of the corporation greatly limited its worth to possible purchasers,[6] making impossible market appraisal of its value. When an employee or director retired or otherwise severed connections with the firm, he had an option to take in exchange for his shares either a lump sum equivalent to one year's dividends,[7] or a "ten-year certificate" which entitled him to "such dividends as may be declared upon said stock for the next succeeding period of ten years. . . ." Payments, however, were made from the "general reserve."[8] Stock turned in for the "ten-year certificates" was reissued to other employees at the nominal price, the cycle beginning anew. No dividends could be paid to the new holders of the shares until the obligation to the prior holder under the certificates had been satisfied.[9]

Relinquishing his stock on retirement, Marshall chose the "ten-year certificate" plan.[10] He did not report the first payments received under the certificates

[4] 20 T.C. No. 137 (September 11, 1953).

[5] The total cost basis was $49,659.00 of which $1,000.00 represented his nominally purchased shares.

[6] The charter provided that stock held by a person other than an employee or director was not entitled to dividends, and could be recalled by the issuer. See further discussion, pages 466–67 infra.

[7] If the holder had never been in the corporation's service, he was paid a lump sum upon relinquishment equivalent to one year's dividends based on the last five years' average.

[8] See note 46 infra.

[9] If a present employee, rather than paying a lump sum to a former employee, assigns the dividends for the next ten years, we have a situation essentially equivalent to the Marshall case, complicated by the question of whether the dividends would also be income to the assignor-purchaser. Where dividends are assigned to satisfy a debt, they are taxable to the assignor. Under Heyman v. Commissioner, 176 F. 2d 389 (C.A. 2d, 1949), the assignor-purchaser would be taxed on the dividends. See Commissioner's argument in the Marshall case, section III, infra.

[10] Marshall received two certificates. One covered 2500 shares and provided for payments over ten years; the other covered 1000 shares and provided for payments over three years, to commence seven years after relinquishment. These latter shares, having been purchased for a

as income, but applied them against the cost basis of his stock. After basis was completely recouped, the further payments were reported as long-term capital gain in the years received. The Commissioner assessed a deficiency on the theory that all payments were dividends, taxable as ordinary income, and that the basis should have been amortized over the period of payments. The Tax Court approved the taxpayer's method of reporting, finding that the payments were proceeds from the sale of a capital asset.

The possibilities offered by the *Marshall* decision for future schemes to disguise compensation depend upon: (1) the treatment of the bargain purchase in the year of receipt; (2) the determination of the proper years in which to include the annual payments under the "certificates" in income; and (3) the treatment of the payments as ordinary income or capital gain.

I

The possibility that the bargain purchase gave rise to taxable income when the stock was received was not raised as an issue in the *Marshall* case, the basis of the stock having been stipulated as being cost. The Commissioner may not have challenged the cost basis due to the running of the statute of limitations.[11] In future attempts to set up plans to take advantage of tax benefits suggested by this decision, two substantive problems relating to the initial purchase may arise: whether the bargain constitutes compensation to employees, and what restrictions on the stock sufficiently impair marketability to make valuation of the stock impossible.

The courts have characterized bargain stock purchase plans as motivated either by an intent to compensate,[12] or by a desire to give a proprietary interest in the corporation for incentive purposes.[13] Where an intent to compensate is found, the bargain is taxed to the employee as ordinary income.[14] Under this test, the facts of the *Marshall* case would not support a finding of compensation. The charter was originally adopted to enable the corporation to be managed as a

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nominal amount and held by Marshall only three years, were subject to a remaining seven year obligation to the prior holder.

[11] Int. Rev. Code § 275, 26 U.S.C.A. § 275 (1948). At the time of the assessment, more than five years had elapsed since the receipt of the stock. In situations where the taxpayer has neglected to report the difference between market value and cost of stock received as income, and asserts market value as his basis at the time of sale, the Commissioner under Int. Rev. Code § 3801, can assess a tax on this unreported excess, though the statute of limitations has run. Consult Greenbaum, The Basis of Property Shall Be the Cost of Such Property. How is Cost Defined?, 3 Tax. L. Rev. 351, 367 (1947–48).

[12] In stock option cases, the presence of a spread between market and the cost under the option at the date the option is granted favors a finding of intent to compensate. E.g.: Connolly's Estate v. Commissioner, 135 F. 2d 64 (C.A 6th, 1943); Albert Russel Erskine, 26 B.T.A. 147 (1932).

[13] E.g., Rossheim v. Commissioner, 92 F. 2d 247 (C.A. 3d, 1937).

[14] Authorities cited note 12 supra.

partnership,[15] restricting stock ownership so that only employees, officers and board members could be beneficial owners, and conversely. The stock was given to provide a proprietary interest, and thus under the rule of the courts, the transfer did not give rise to taxable compensation. The present Regulations,[16] however, remove the intent criterion and state that in any bargain transfer of stock from employer to employee, the excess of market over cost is "in the nature of compensation." The Commissioner's Regulation, which he based in part on his interpretation[17] of the Supreme Court's decision in *Commissioner v. Smith*,[18] has not been tested by the courts.[19]

Even if the present regulation should prevail, restrictions in the corporate charter or in the contract of sale which impair marketability may still prevent taxation of the compensation by making its measurement impossible. Although the regulations[20] provide that "fair market value of property is a question of fact,"[21] and "only in rare and extraordinary cases will property be considered to

[15] See Prindiville v. Johnson & Higgins, 92 N.J.E. 515, 517, 113 Atl. 915, 916 (1921).

"The corporation was designed to be a strictly personal service concern, a copartnership, as nearly as ingenuity could achieve, and to embody all of the advantages of both without incurring, in full, the obligations of the other. The scheme was simple. The common stock was to be held only by the officers, directors, and employees of the company actively promoting its affairs, and among them was to be divided the net annual profits in part according to the appraised or real value of their services and in part according to their stock holdings, and when any of them became inactive, the right to dividends was to cease after the expiration of ten years."

[16] Treas. Reg. 118, § 39.22(a)-1(c) (1953).

"Except as otherwise provided in section 130 A, if property is transferred by an employer to an employee for an amount less than its fair market value, regardless of whether the transfer is in the form of a sale or exchange, the difference between the amount paid for the property and the amount of its fair market value is in the nature of compensation and shall be included in the gross income of the employee."

Where no purchase is made, Treas. Reg. 118, § 39.22(a) (3) (1953), provides:

"If services are paid for with something other than money, the fair market value of the thing taken in payment is the amount to be included in income. If the services were rendered at a stipulated price, in the absence of evidence to the contrary such price will be presumed to be the fair market value of the compensation received. If a corporation transfers to its employees its own stock as compensation for services rendered by the employee, the amount of such compensation to be included in the gross income of the employee is the fair market value of the stock at the time of transfer."

[17] I.T. 3795, 1946-1 Cum. Bull. 15. When the option is exercised, the employee realizes income as compensation on the date he receives the stock to the extent of the difference between the fair market value when received and the price paid for it.

[18] 324 U.S. 177 (1945). See further discussion, page 472 infra.

[19] The new Regulation is not to apply to options granted before February 26, 1945. In the only case to date involving an option granted after February 26, 1945, the Regulation was not put in issue and the court applied the intent doctrine, Harley V. McNamara, 19 T.C. No. 112 (March 5, 1953), pending before the Seventh Circuit. The cases decided after February 26, 1945, but involving options granted before this date, have continued to use the intent rule. E.g.: Martin L. Strauss, II, 11 T.C.M. 786 (1952); Malcolm S. Clark, 9 T.C.M. 719 (1950); Wanda V. Van Dusen, 8 T.C. 388 (1947), aff'd 166 F. 2d 647 (C.A. 9th, 1948); James L. Lamond, 5 T.C.M. 51 (1946).

[20] Treas. Reg. 118, § 39.111-1 (1953).

[21] See e.g., John Vaccaro, 2 T.C.M. 820 (1943).

have no market value,"[22] courts in income tax cases have refused to attempt to determine market value where the right to income from the property received is contingent upon uncertain events[23] or where stock is received with restrictions affecting its resale,[24] particularly where the value is otherwise speculative.[25]

In *Harold H. Kuchman*[26] the taxpayer purchased shares of his employer-corporation from an underwriter who had purchased the controlling block of stock pursuant to a plan or reorganization. The price of the stock was $5.00 per share, which was held to be the proper basis. The court said the market determination could not be made since, under the purchase agreement, the taxpayer was bound for a period of one year after the purchase date to dispose of the shares only with the seller's consent and, if the taxpayer should leave his employment, to offer the stock to the seller for $5.00 per share.[27]

In the *Marshall* case, although the market for the stock was severely limited by provisions in the corporate charter, the prohibition against trading was not complete. Employee-holders of the stock apparently could resell to outsiders. In the hands of an outsider, however, the stock was not entitled to dividends, and could be recalled by the corporation upon payment to the outside-holder of a lump sum equal to one year's dividends. It seems clear that re-

[22] For definition of "fair market value," see Helvering v. Walbridge, 70 F. 2d 683 (C.A. 2d, 1934); T.B.R. 57, 1919 Cum. Bull. 40.

[23] Authorities cited notes 38–41 infra.

[24] E.g.: Harold H. Kuchman, 18 T.C. 154 (1952); Robert Lehman, 17 T.C. 652 (1951).

[25] The recent cases have either disregarded or treated lightly the speculative value of stock, absence of market value being attributed to restrictions alone. E.g.: authorities cited note 24 supra; United States v. State Street Trust Co., 124 F. 2d 948 (C.A. 1st, 1942); John C. Wahl, 19 T.C. No. 81 (1953); Society Brand Clothes Inc., 18 T.C. 304 (1952). However, the Third Circuit has ruled that the absence of proof of speculative value of stock is fatal to taxpayer's contention of no market value. Heiner v. Gwinner, 114 F. 2d 723 (C.A. 3d, 1940); see La Motte T. Cohu, 8 T.C. 796 (1947); Estate of Morgan J. Hammers, 2 T.C.M. 934 (1943). The concept of speculative value was initially used by the Supreme Court to preclude the determination of a market value in Helvering v. Tex-Penn Oil Co., 300 U.S. 481 (1937). Prior to this time, courts had not considered restraints on alienation as precluding a market value. E.g.: G. & K. Mfg. Co. v. Commissioner, 76 F. 2d 454 (C.A. 4th, 1935), rev'd on other grounds, 296 U.S. 389 (1935); Rodrigues v. Edwards, 40 F. 2d 408 (C.A. 2d, 1930). Courts have considered certain restrictions insufficient to affect a market value: promise to offer stock to certain persons at market before public sale, James Couzens, 11 B.T.A. 1040, 1163 (1928); Jay N. Darling, 4 B.T.A. 499 (1926); promise to offer at book value, Fostoria Glass Co. v. Yoke, 45 F. Supp. 962 (D.C. W.Va., 1942); "understanding" to hold stock as investment, Phillip W. Haberman, 31 B.T.A. 75 (1934), aff'd 79 F. 2d 995 (C.A. 2d, 1935). In certain cases the restrictions have been considered as a factor reducing a market value: Edith G. Goldwasser, 47 B.T.A. 445 (1942), aff'd 142 F. 2d 556 (C.A. 2d 1944); La Motte T. Cohu, 8 T.C. 796 (1947).

[26] 18 T.C. 154 (1952).

[27] The inability to determine a market value for restricted shares is unaffected by the presence of a market for equivalent unrestricted shares. Thus the Tax Court in Estate of Salt, 17 T.C. 92 (1951), valued restricted stock for estate tax purposes at $20.00 per share though the market for equivalent unrestricted stock was $60.00. The stock was subject to the restriction that before decedent could sell to the public, he had first to offer it back to the original vendor at $20.00. Cf. Salvage v. Commissioner, 76 F. 2d 112 (C.A. 2d, 1935), aff'd 297 U.S. 106 (1936).

strictions of such severity effectively destroy meaningful market valuation from outsider sales, although the point was not discussed by the court. In any subsequent scheme modelled after this one, the possibility that other insiders might constitute a sufficient market to destroy the desired immunity from taxation will need to be considered.[28]

II

If the original bargain purchase in a plan similar to that of the *Marshall* case is not taxed, the time at which the transaction is "closed" and the gain realized must be either the transfer of the stock for a "ten-year certificate" or a comparable obligation, or the subsequent receipt of cash payments thereunder. The taxable event is the transfer of stock if the purchaser's obligation is of a kind freely sold and is either unconditional or has a market.[29] Notes, bonds and other securities meeting these standards are treated as cash to the extent of their fair market value for determining gain at the time of their receipt in a sale or exchange.[30]

If the obligation, in return for which the securities are transferred, is to bestow pension benefits[31] on the employee, it may provide either for future payments of a fixed amount, or for payments indefinite in amount, for an uncertain period of time, or contingent upon uncertain future events, as in the principal case. Though the issue is not clearly settled, the decisions indicate that the taxable event in these latter circumstances will be the receipt of payments under the employer's obligation.[32] Where the obligation calls for payments of a fixed amount over definite periods, the employee's basis is properly amortized over the period of receipt of the payments.[33] The Commissioner argued that the same procedure was required as to the payments under the certificate in the *Marshall* case, which were contingent upon the uncertain future declaration of dividends.[34]

[28] See John C. Wahl, 19 T.C. No. 81 (January 12, 1953).

[29] Consult: G.C.M. 3350, VII–I Cum. Bull. 62 (1928); Treas. Reg. 118, § 39.44-4 (1953).

[30] E.g.: Wells Amusement Co. v. Commissioner, 70 F. 2d 208 (C.A. 4th, 1934); Walter I. Bones, 4 T.C. 415 (1944).

[31] The net effect of the Marshall plan was to give the employee a pension for the ten years following retirement. Consult Biegel, Some Deferred Compensation Plans, 3 Am. Univ. Tax Inst. 253 (1951).

[32] Hooker v. Hoey, 27 F. Supp. 489 (S.D. N.Y., 1939); James F. Oates, 18 T.C. 570 (1952); Jean Laing Carter, 17 T.C. 994 (1951); Frederick John Wolfe, 8 T.C. 689 (1947), aff'd 170 F. 2d 73 (C.A. 9th, 1948). Cf. Howard Veit, 8 T.C. 809 (1947) and 8 T.C.M. 919 (1949). Consult Rudick, Income Taxes and Deferred Compensation Agreements, So. Calif. Tax Inst., 1948 Major Tax Problems 163 (1949).

[33] Int. Rev. Code § 44a, b, 26 U.S.C.A. § 44a, b (1948). This is the installment sales method of reporting gain on a sale.

[34] His theory was based on the amortization of a wasting asset, the asset there being the right to receive dividends for the ten year period. The charges were divided up as to the $48,659.00 and the $1,000.00 bases. The former was to be amortized over the ten years of payments, one-tenth each year; the latter was to be amortized only over the last three years, one-third each year, because payments were not to begin on this stock until the expiration of seven years.

The court, however, accepted the petitioner's theory that the doctrine of *Burnet v. Logan*[35] applied because the "certificate" provided for contingent payments. In that case, the Supreme Court held the basis of stock sold could be completely recouped before any tax payment need be made because the contract of sale provided for payment of a royalty based on the uncertain periodic mining of ore:

> "[T]he promise of future money payments [is] wholly contingent upon facts and circumstances not possible to foretell with anything like fair certainty. The promise was in no proper sense equivalent to cash. It had no ascertainable fair market value. The transaction was not a closed one. Respondent might never recoup her capital investment from payments only conditionally promised."[36]

There are many types of sales arrangements which would fall within this rule.[37] The market value has been held unascertainable and taxation postponed until the basis has been recovered where the contract payments were based on (1) future production,[38] (2) future sales or profits,[39] (3) performance of conditions,[40] and (4) uncertain length of payments combined with instability and/or unreliability of the promisor.[41]

Unascertainable market value thus appears to yield substantial tax benefits at two points in a *Marshall* type scheme: first, in the original bargain stock purchase, which escapes taxation because the amount of income cannot be computed, and second, in the resale to the employer, where realization of the gain is deferred. Because of the contingency of payments under the new corporate obligation, the employee postpones payment of tax on his gain until the entire basis has been recovered. The decision in *Burnet v. Logan* was justified chiefly on the ground that the taxpayer might never recover her basis, although the decision may have depended on the presence of a valid business reason for payment based on the future mining operations. Uncertain payments in employee-employer stock sales may not be justified by similar business reasons.[42] Also the risk of non-recovery of basis may not be significant in the *Marshall* type scheme, the basis being typically small and below the value of the shares. But the corresponding tax advantage through postponement is also small, since the basis

[35] 283 U.S. 404 (1931).

[36] Ibid., at 413.

[37] See Levy, Bringing Sales Within Burnet v. Logan, N.Y.U. Eighth Ann. Inst. Fed. Tax 937 (1950).

[38] Rocky Mountain Development Co., 38 B.T.A. 1303 (1938); Teck Hobbs, 26 B.T.A. 241 (1932), where capital recovery allowed first even though there was an ascertainable market value. Contra: Lee v. Commissioner, 126 F. 2d 825 (C.A. 5th, 1942), where depletion is allowed to recover capital.

[39] Cassatt v. Commissioner, 137 F. 2d 745 (1943); William A. Cluff, 17 T.C. 225 (1951).

[40] Harding Glass Co., 1 T.C.M. 943 (1943); Higgins Estate, Inc., 30 B.T.A. 814 (1934).

[41] Hill's Estate v. Maloney, 58 F. Supp. 164 (D.C. N.J., 1944); Estate of Bertha F. Kann, 6 T.C.M. 913 (1947); Bella Hommel, 7 T.C. 992 (1946); Frank C. Deering, 40 B.T.A. 984 (1939); J. Darsie Lloyd, 33 B.T.A. 903 (1936).

[42] Consult Eisenstein, A Case of Deferred Compensation, 4 Tax L. Rev. 391, 418 (1949).

will be quickly recovered. Thus the risk of non-recovery is proportional to the tax advantage and the application of the *Logan* case is not objectionable.[43]

III

The *Logan* case, although prescribing the time of reporting the income, did not decide whether the annual payments received after the basis has been recovered constituted capital gain because no special capital gains treatment was legislated until after the time of the transaction.[44] In the principal case, the taxpayer justified reporting payments under the "ten-year certificate" as capital gain on the theory that his relinquishment of the shares was the sale of a capital asset.[45] The Commissioner contended that "so far as the dividend payments during the taxable year are concerned the decedent retained his status as a stockholder,"[46] and his relinquishment of voting rights and participation upon liquidation was not relevant for tax purposes.

To support his argument the Commissioner cited *Bettendorf v. Commissioner*[47] and *Roger Morton, Executor*.[48] In these cases shares of stock had been given with an express reservation of dividends by the donor. Though a valid transfer of legal title was found in each case, dividends were held taxable to the donors. In both cases the issue was to whom the income should be taxed, and they are therefore inappropriate as authority in the principal case. The taxpayer in the *Marshall* case admitted that the payments were taxable to the estate, but insisted they should be taxed at capital gains rates.[49] The court agreed with the

[43] A suggestion has been made that an arbitrary ratio for gross income inclusion, much like the annuity treatment, Treas. Reg. 118, § 39.22(b)(2)-2 (1953), might be legislated such that proceeds would be taxable from the inception of receipts. See note, 63 Harv. L. Rev. 853, 861 (1950).

[44] Provisions were legislated in 1921. Rev. Act of 1921, § 206(a)(1); 42 Stat. 227 (1921) provided: "The term 'capital gain' means taxable gain from the sale or exchange of capital assets consummated after December 31, 1921."

[45] In an alternative argument, not considered by the court, the petitioner contended that the dividends received were not ordinary dividends, but were proceeds from "redemption" of all the stock of a particular stockholder as a "partial liquidation." Brief for Petitioner at 15.

[46] Brief for the Commissioner of Internal Revenue as Respondent, at 23. Under yet another approach, suggestive of the Commissioner's dividend argument, proceeds of sale of wasting assets may be taxed as ordinary income under the economic interest theory. When oil and gas rights were sold, the Supreme Court in Burton-Sutton Oil Co. v. Commissioner, 328 U.S. 25 (1946), looked beyond the "sale" and taxed gain as ordinary income when the interest was wholly contingent upon the amount of production, or upon the net profit derived from that figure. The Commssioner has indicated that he intends to tax patents similarly. Mim. 6490, 1950-1 Cum. Bull. 9. Under this economic interest theory, it is the source of the payments which is determinative. Its application to stock can be easily seen when sales payments are arranged as in the Marshall case. The dividends, though payable from a reserve, were derived from profits of the corporation and contingent upon a dividend declaration.

[47] 49 F. 2d 173 (C.A. 8th, 1931).

[48] 23 B.T.A. 930 (1931), aff'd 61 F. 2d 1036 (C.A. 2d, 1932).

[49] The court cited two cases which held that the sale of a life estate was not the sale of the "income or naked rights to receive income," but of the full interest in the income producing assets. McAllister v. Commissioner, 157 F. 2d 235 (C.A. 2d, 1946); Bell's Estate v. Commissioner, 137 F. 2d 454 (C.A. 8th, 1943). In the McAllister case, Judge Frank rendered a vigor-

taxpayer, finding a valid sale. It did not consider the dividend terminology in the charter controlling,[50] reasoning that in the circumstances the payments under the certificates constituted the sales price.[51]

Finding the sale of a capital asset, the court held that all the profit was properly reported as capital gain. This result is consistent with the Tax Court's earlier decision in *Robert Lehman.*[52] In that case options to purchase restricted stock were given as compensation and were later exercised. No tax was assessable at the date of receipt due to lack of market value. The Tax Court held that the lifting of restrictions nine months after purchase was not a taxable event and sanctioned without discussion the reporting of the full profit as capital gain.

Neither the *Lehman* nor the *Marshall* case has been tested in the Courts of Appeals. Further, the *Lehman* case did not even discuss whether the profit on the sale of the stock, under these circumstances, should receive capital gains treatment. In view of the weak precedents, courts are relatively free to determine whether future plans for employee compensation may qualify for the tax savings illustrated by the *Marshall* case.

In future cases, the decision of the Supreme Court in *Commissioner v. Smith*[53] might be taken to require taxation of the profit as ordinary income. In that case, an employee was given an option[54] to purchase stock of another corporation at a price not then in excess of the market. The facts clearly showed an intent to compensate. The option was contingent upon the success of a reorganization designed to enhance the value of the stock. The Supreme Court held that the gain "to be derived from the exercise of the option after the anticipated advance in market price of the stock" was taxable as compensation at the time of exercise. The temporary restrictions upon sale which prevent ascertainable market value in schemes of the *Marshall* type may be designed to produce future compensation just as the option in the *Smith* case.

In taxing the gain under these schemes, three solutions are possible: treating

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ous dissent based on the theory that such transactions were not within the policy of the capital gains provisions. For a brief discussion of the problem, see Levy, The Line Between a Sale of Property and the Anticipation of Ordinary Income, N.Y.U. Seventh Ann. Inst. on Fed. Tax 399 (1949).

[50] Citing Nordberg Mfg. Co. v. Kuhl, 166 F. 2d 331 (C.A. 7th, 1948).

[51] In the sale of a partnership interest, capital gain may result though the payment be measured by partnership profits. Hill v. Commissioner, 38 F. 2d 165 (C.A. 1st, 1930).

[52] 17 T.C. 652 (1951).

[53] 324 U.S. 177 (1945).

[54] Dicta in the Smith case to the effect that "[w]hen the option price is less than the market value of the property for the purchase of which the option is given, it may have present value and be found to be itself compensation for services rendered," has given taxpayers a new argument. The Tax Court has held that the excess of market over cost of options at the date of exercise will be compensation where the employer so intends. Restrictions as to assignment and indeterminate market value on receipt of the option indicate such an intent. Harley V. McNamara, 19 T.C. No. 112 (March 5, 1953), pending before the Seventh Circuit; John C. Wahl, 19 T.C. No. 81 (January 12, 1953). Cf. Estate of Lauson Stone, 19 T.C. No. 105 (1953), aff'd 5 CCH 1954 Fed. Tax Rep. ¶ 9209 (Feb. 3, 1954).

it entirely as capital gain, entirely as ordinary income, or apportionment[55]—treating a part of the proceeds of resale as capital gain and part as ordinary income. Treatment wholly as capital gain gives an unfair advantage to those employees who are in a position to receive bargain purchases, while the compensation of others is properly subject to taxation at the normal rates. It would be better to tax the entire gain on the sale as ordinary income[56] where compensation would have been taxed at receipt but for the absence of a market value caused by restrictions imposed by the corporation-employer.

Taxing the profit entirely as ordinary income is also inequitable insofar as any capital increment is present. Apportionment, where possible, would be the best solution.[57] If the employee is viewed as having received compensation in the year of the bargain purchase, he can then be said to have invested this compensation in the stock received. All subsequent increase in value of the stock would be capital gain. Because of the restrictions, the amount of this profit is indeterminable. Where the restrictions are lifted, however, a profit properly treated as capital gain can be determined by the increase of the market value at date of resale over the market value at the date of the lifting of restrictions. The tax should be assessed when the profit is realized, at which time the computed capital increment should be reported as capital gain, the remainder as ordinary income. This proposal would give the employee the benefits of bargain treatment for capital gains to the extent that these are ascertainable, but not insofar as the profit is merely earned income in disguise. While this may lead to the taxation of some legitimate capital gains as ordinary income, it is the most desirable alternative to total disregard of the overriding element of compensation in employee stock purchase plans.

[55] Where a taxable event such as a purchase or sale occurs, and that part of the asset which is not capital is ascertainable at the time of the taxable event, apportionment is possible and ordinary income and capital gain will be segregated. Thus, the sale of past partnership profits as part of the sale of the whole partnership interest results in ordinary income to the extent of the undistributed profits. Estate of William T. Jones, 3 T.C.M. 97 (1944). See A. B. Culbertson, 14 T.C. 1421 (1950), for the reporting of receipts above the market value of a deferred obligation.

[56] Where stock was received as compensation, the subsequent sale more than two years later resulted in an ordinary loss, the court determining that the contractor-owner held the stock primarily for resale. Gilbert v. Commissioner, 56 F. 2d 361 (C.A. 1st, 1932).

[57] This apportionment problem is analogous to that problem presented by the interest factor in the annual payments. A sum paid in one installment would differ from an equivalent amount paid in annual installments due to the earning capacity of funds. This implicit interest has been taxed as ordinary income in two ways. The present value of the annual payments may be subtracted from the total of such payments, the difference being spread ratably over the period payments are received. Eldredge v. United States, 31 F. 2d 924 (C.A. 6th, 1929); Julia Andrews Bruce, 5 B.T.A. 300 (1926). In another method, each payment may be discounted, thus the greater the length of time, the greater the discount, the greater the return of ordinary income. Ruth Iron Co. v. Commissioner, 26 F. 2d 30 (C.A. 8th, 1928). The total number of payments need not be known for this solution. Either of these solutions is dependent upon an arbitrary and possibly inequitable interest rate. The modern cases have not allowed this implicit interest computation. Westover v. Smith, 173 F. 2d 90 (C.A. 9th, 1949); Commissioner v. Carter, 170 F. 2d 911 (C.A. 2d, 1948).