

FEDERAL TAXATION: BARTER-EQUATION TECHNIQUE
EMPLOYED TO VALUE TRANSFERRED SECURITIES
DESPITE PRESENCE OF ACTIVE MARKET

IN *Seas Shipping Co. v. Commissioner*¹ the Second Circuit cautiously affirmed the Tax Court's utilization² of the barter-equation method³ to determine the value of stock received as partial consideration in a sales transaction, despite the presence of an active market in the transferred stock. In March 1957, the taxpayer, Seas Shipping Co., sold ten ships to Moore-McCormack Lines for cash, notes, and 300,000 shares of Moore-McCormack stock. In the year of the exchange, 166,000 shares of Moore-McCormack stock were traded on the New York Stock Exchange at an average annual price of slightly less than twenty-three dollars. However, when Moore-McCormack subsequently sold two of the ships that year, it computed the value of the stock at thirty dollars per share for capital gains purposes.⁴ In contrast, Seas Shipping, in computing the amount realized from the sale of the ten ships, estimated a fair market value of approximately twenty dollars per share, based upon the trading price adjusted for blockage. To remedy this disparity, the Commissioner assessed deficiencies against both taxpayers and computed the stock's value to be thirty dollars per share for the purpose of measuring Seas Shipping's gain.⁵ This determination was made by subtracting from the total of the individual ship values enumerated in the sales contract the amount of cash and notes received and equating the result—nine million dollars—with the total value of the 300,000 shares. The Second Circuit upheld this rejection of the trading price and the substitution of the barter-equation method on the basis of the Tax Court's apparent factual finding that an annual market of 166,000 shares was too sparse a basis upon which to value a block of 300,000 shares.

¹ 371 F.2d 528 (2d Cir. 1967).

² See *Seas Shipping Co.*, 34 P-H Tax Ct. Mem. 1337 (1965).

³ See *United States v. Davis*, 370 U.S. 65, 72 (1965) (values of properties exchanged in arm's length transaction presumed equal); 371 F.2d at 529 n.2 (collecting cases).

⁴ *Id.* at 529.

⁵ See *Seas Shipping Co.*, 34 P-H Tax Ct. Mem. 1337 (1965). See also *Moore-McCormack Lines, Inc.*, 44 T.C. 745 (1965) (sustaining the thirty dollars per share computation).

Valuation of stock is necessitated when a capital asset is exchanged for stock, because the purchaser of the property must value the stock to establish a basis for future capital gains⁶ and the present depreciation of the asset,⁷ while the seller must make a similar determination to compute his gain or loss from the sale.⁸ This valuation process occurs in one of three situations. If the stock has an established market for which quotations are available at the critical time, the prices actually paid for the stock on an established exchange on or around the valuation date are generally regarded as the best evidence of the stock's fair market value as of that date.⁹ However, if the stock has no established market or if the market quotations are either unavailable or so scarce that they do not reflect fair market value,¹⁰ then other evidence of value, such as dividend record, book value, capitalization of earnings, type of management, and general economic conditions are factors considered in the computation of value.¹¹ Between these two categorical positions lie the less predictable cases wherein independent factors may render the quotation price unreliable, and consequently, the exchange quotation is not accepted as determinative of the stock's fair market value.

This third situation may occur when there is a lack of confidence in market prices, deriving from the manner in which an exchange operates. Thus when the quotation price is the result of a controlled market, the trading price will be rejected.¹² A similar approach was

⁶ See INT. REV. CODE OF 1954, §§ 1001 (a), (b).

⁷ See INT. REV. CODE OF 1954, § 167 (g); *Fox River Paper Corp. v. United States*, 65 F. Supp. 605 (E.D. Wis. 1946), *aff'd*, 165 F.2d 639 (7th Cir. 1948).

⁸ See INT. REV. CODE OF 1954, §§ 1001 (a), (b).

⁹ See, e.g., *W. T. Grant Co. v. Duggan*, 94 F.2d 859, 861 (2d Cir. 1938); *Hazeltine Corp. v. Commissioner*, 89 F.2d 513, 519-20 (3d Cir. 1937); *Commissioner v. Robertson*, 75 F.2d 540, 541-42 (6th Cir.), *cert. denied*, 295 U.S. 763 (1935); *Estate of Caroline McCulloch Spencer*, 5 T.C. 904, 907-08 (1945). See generally LOWNDES & KRAMER, FEDERAL ESTATE AND GIFT TAXES § 18.25 (2d ed. 1962). *But see* 10 MERTENS, FEDERAL INCOME TAX § 59.14 (Zimet ed. 1964).

¹⁰ See e.g., *Argonaut Consol. Mining Co. v. Anderson*, 52 F.2d 55, 57 (2d Cir. 1931), *cert. denied*, 284 U.S. 682 (1932); *Automatic Transp. Co.*, 3 B.T.A. 505, 508 (1926).

¹¹ See Rev. Rul. 65-192, 1965-2 CUM. BULL. 259 (income tax); Rev. Rul. 59-60, 1959-1 CUM. BULL. 237, *superseding* Rev. Rul. 54-77, 1954-1 CUM. BULL. 187 (estate and gift tax). See generally LOWNDES & KRAMER, *op. cit. supra* note 9, § 18.27; 10 MERTENS, *op. cit. supra* note 9, §§ 59.21-28; Katz, *The Valuation of a Closed Corporation For Estate Tax Purposes*, 29 KAN. CITY L. REV. 1, 7-38 (1961).

¹² See *Andrews v. Commissioner*, 135 F.2d 314, 318-19 (2d Cir.), *cert. denied*, 320 U.S. 748 (1943) (securities issued in payment of bond interest); *Propper v. Commissioner*, 89 F.2d 617 (2d Cir. 1937); *Tex-Penn Oil Co. v. Commissioner*, 83 F.2d 518, 523 (3d Cir. 1936), *aff'd*, 300 U.S. 481 (1937); *Continental Oil Co. v. United States*,

taken during the highly inflationary period of 1929 when the market quotations did not accurately reflect market value because of speculation and the presence of unskilled investors.¹³ Regardless of the reason, once the trading price is discarded, a court may decide that the stock is incapable of valuation and thus that no tax is due¹⁴ or that while the stock has value it must be determined by the consideration of other economic factors.¹⁵ Since rejection of the trading price is rare and the determination that the market is controlled is apparently a factual one, a predictive standard cannot be articulated. In any event, the exchange price is not always totally disregarded. For example, if upon the simultaneous disposition of the number of shares to be valued the taxpayer would receive a value lower than the market price because of the sudden increase in supply, then the trading price may be reduced¹⁶ as a concession to this economic fact. The recognition of this phenomenon, called blockage,¹⁷ is not automatic¹⁸ but rather depends upon the peculiar facts of each case¹⁹ as well as upon the skill with which the taxpayer's counsel dem-

62 F. Supp. 876 (Ct. Cl. 1945), *cert. denied*, 328 U.S. 847 (1946); Wallis Tractor Co., 3 B.T.A. 981, 1002-03 (1926).

¹³ See *Strong v. Roberts*, 14 Am. Fed. Tax R. 1207, 1220, 1224 (D.N.J. 1933), *aff'd*, 72 F.2d 455 (3d Cir.), *cert. denied*, 293 U.S. 621 (1934) (exchange quotation over one hundred dollars, court's valuation sixty-five dollars). *But see Susan T. Freshman*, 33 B.T.A. 394, 402-03 (1935). See generally LOWNDES & KRAMER, *op. cit. supra* note 19, § 18.19.

¹⁴ *E.g.*, *Propper v. Commissioner*, 89 F.2d 617 (2d Cir. 1937); *Harold H. Kuchman*, 18 T.C. 154 (1952); *cf. Society Brand Clothes Inc.*, 18 T.C. 304, 314-18 (1952).

¹⁵ *E.g.*, *Lincoln Bank & Trust Co. v. Commissioner*, 51 F.2d 78 (6th Cir. 1931), *cert. denied*, 285 U.S. 548 (1932); *Continental Oil Co. v. United States*, 62 F. Supp. 876, 886 (Ct. Cl. 1945), *cert. denied*, 328 U.S. 847 (1946); *Wallis Tractor Co.*, 3 B.T.A. 981, 1003-04 (1926).

¹⁶ See *Helvering v. Maytag*, 125 F.2d 55, 63 (8th Cir.), *cert. denied*, 316 U.S. 689 (1942); *Commissioner v. Shattuck*, 97 F.2d 790, 792 (7th Cir. 1938); *Helvering v. Safe Deposit & Trust Co.*, 95 F.2d 806, 812 (4th Cir. 1938); *Bartol v. McGinnes*, 185 F. Supp. 659, 661-62 (E.D. Pa. 1960); *Havemeyer v. United States*, 59 F. Supp. 537, 548-51 (Ct. Cl.), *cert. denied*, 326 U.S. 759 (1945).

¹⁷ See generally *Badger, Blockage as a Valuation Problem*, N.Y.U. 20TH INST. ON FED. TAX 587 (1962); *Hughes, "Blockage" in Valuation of Assets for Federal Tax Purposes*, 25 FORDHAM L. REV. 702 (1956); *Riecker, Blockage in Federal Estate and Gift Tax Valuation*, Mich. S.B.J., Aug. 1963, p. 24.

¹⁸ See, *e.g.*, *Warner v. Commissioner*, 193 F.2d 328 (2d Cir. 1952) (*per curiam*); *Richardson v. Commissioner*, 151 F.2d 102, 103 (2d Cir. 1945), *cert. denied*, 326 U.S. 796 (1946); *Mott v. Commissioner*, 139 F.2d 317 (6th Cir. 1943); *Robert L. Clause*, 5 T.C. 647, *aff'd mem.*, 154 F.2d 655 (1945); *John J. Newberry*, 39 B.T.A. 1123, 1128-34 (1939); *Archibald M. Chisholm*, 37 B.T.A. 167, 170-71 (1938). See generally LOWNDES & KRAMER, *op. cit. supra* note 9, § 18.26; *Hughes, supra* note 17, at 707.

¹⁹ Compare *Bartol v. McGinnes*, 185 F. Supp. 659, 661 (E.D. Pa. 1960), with *Mott v. Commissioner*, 139 F.2d 317 (6th Cir. 1943).

onstrates that the market will be unable to absorb the number of shares being valued without serious price readjustment.²⁰ Thus, while blockage does yield a price different from the exchange price, the variation results from a modification of the quotation price and not from a rejection of this factor.

The Second Circuit allowed the Tax Court to disregard the market price of the Moore-McCormack stock on the basis of the finding that the market was too sparse for purposes of valuing the large block of stock. It concluded that "there was present, therefore, a necessity for the Tax Court to turn to the barter-equation method,"²¹ a test which has been previously employed to determine the value of inchoate marital rights²² and a passenger railroad franchise extension.²³ The court recognized debilities inherent in the barter-equation technique,²⁴ but it indicated that other indicia of value supporting the result reached by this method. Specifically, the court noted that the stock had a book value in excess of thirty-nine dollars, that it constituted a thirteen per cent ownership of a profitable corporation, and that as a result of a contemporaneous voting trust the taxpayer received control of twenty per cent of the directorships for a five-year period.²⁵ Moreover, the court considered it "highly unlikely" that twenty-three dollars was accepted by the taxpayer as the stock's value since adoption of this figure would have meant that it had sold the ships for two million dollars less than they were worth.²⁶ Acknowledging the lack of any precedent for the use of the barter-equation method in the presence of an active market, the court nonetheless affirmed the Tax Court's decision by emphasizing that the sale was an arm's length transaction between two knowledgeable shipowners who had stipulated in the contract that the value of the stock was thirty dollars per share.²⁷

With the exception of those cases involving a controlled market,²⁸

²⁰ See Badger, *supra* note 17, at 588-90; Hughes, *supra* note 17, at 709-10; Riecker, *supra* note 17, at 26.

²¹ 371 F.2d at 532.

²² United States v. Davis, 370 U.S. 65 (1962), 1963 DUKE L.J. 365.

²³ Philadelphia Park Amusement Co. v. United States, 126 F. Supp. 184 (Ct. Cl. 1954).

²⁴ 371 F.2d at 529-30.

²⁵ *Id.* at 530.

²⁶ *Id.* at 532.

²⁷ *Ibid.*

²⁸ See note 12 *supra* and accompanying text.

Seas Shipping appears to be the only income tax case which has rejected the trading price in the presence of an active market on an established exchange. While there is a trend toward the application of blockage in income tax cases,²⁹ the approach in that situation is distinguishable, for there the trading price is not rejected but merely modified. Here, however, the trading price was completely disregarded because the market was considered "too thin." Yet, neither the Tax Court nor the Second Circuit gave any meaningful indication of how such an assessment is made. The Second Circuit apparently assumed that the issue was a question of fact and thereby foreclosed from further appellate consideration.³⁰ However, the Tax Court had not made any express finding concerning the "thinness" of the market;³¹ rather, it seemed simply to have preferred the barter-equation technique.³² Although the novel employment of this device in the instant case may have reached the "true" value of the stock, the obviousness of the fair market value is a shallow excuse for disregarding what has heretofore been considered to be the determinative factor in the valuation of traded securities, namely, the trading price. The mischief is not the result achieved but rather the method employed, for it creates uncertainty in an area of relative certitude without realizing any offsetting benefits.

Even if it were appropriately found, using articulated standards, that the market was too sparse for the purpose of discerning a fair market value, it does not follow that the Tax Court should immediately resort to the barter-equation device. As the Second Circuit realized, that technique of valuation embodies several infirmities: first, the sides of the barter may be unequal; second, the determination of which side should be valued independently to be used as the standard is arbitrary; and third, the evidence of value on one side may be no more reliable than that on the other.³³ In addition, the barter-equation method has been employed only in a few situations where the *quid pro quo* received was otherwise incapable of valuation. However, there is no suggestion in the opinion that this stock was incapable of valuation by the usual devices. Moreover, the value

²⁹ Hughes, *supra* note 17, at 702-03.

³⁰ See 371 F.2d at 532.

³¹ See *Seas Shipping Co.*, 34 P-H Tax Ct. Mem. 1337, 1339 (1965).

³² See *id.* at 1343-44.

³³ 371 F.2d at 529-30.

of stock for which no market exists has been successfully computed by the Treasury and the courts.³⁴ The decision thus extends the barter-equation method to a situation for which it was not designed, without any discussion of the reason for such an extension other than the conclusory observation that "necessity" required it. Of course, one explanation of this novel result is the obviousness of the thirty-dollar figure, which was readily discernible from the contract. It was this factor of a clearly stated thirty-dollar contract price upon which Judge Friendly relied in his concurring opinion to find an estoppel against Seas Shipping.³⁵ Thus the holding of the instant case might well be limited to situations in which the parties had contractually stipulated the value of the stock³⁶ on the theory that the stipulated figure represents the best evidence of value. However, aside from the "best evidence" rationale, it is doubtful whether the mere clarity of the result justifies abandonment of the accepted systems of stock valuation unless there is some clearly articulated competing reason. No such countervailing analysis was exhibited in *Seas Shipping*. Considering both the rejection of the market price and the utilization of the barter-equation technique, it may be possible to denominate this case as the "obvious" exception rule to the general standards of valuation; yet this exception will engender a new problem—namely, the determination of when a result is sufficiently obvious to warrant a departure from the accepted standards.

³⁴ See Rev. Ruls. cited note 11 *supra*; Mathilde B. Hooper, 41 B.T.A. 114, 129 (1940); Inga Bardahl, 34 P-H Tax Ct. Mem. 918 (1965). See generally 10 MERTENS, *op. cit. supra* note 9, §§ 59.21-.27.

³⁵ 371 F.2d at 533.

³⁶ Cf. *Hamlin's Trust v. Commissioner*, 209 F.2d 761 (10th Cir. 1954).