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UNITARY THEORY OF STOCK OWNERSHIP *FINK v. COMMISSIONER*

In *Commissioner v. Fink*,¹ the Supreme Court held that a dominant shareholder who voluntarily surrenders a portion of his shares to the corporation, while retaining control, does not sustain an immediate loss deductible for income tax purposes. Such a surrender of stock must be treated as a contribution to capital, the basis of the surrendered shares being reallocated to the remaining shares held and loss or gain recognized only when the shareholder disposes of the remaining shares.²

Stock surrenders generally occur in the context of a failing corporation. The dominant shareholder hopes, by surrendering stock, to assist the corporation in attracting new capital, motivating key employees, or improving the balance sheet by reducing the number of shares outstanding.³ Peter and Karla Fink sought just such a result in 1976 and 1977 when they surrendered shares in Travco, their financially troubled Michigan manufacturer of motor homes. The Finks, in a non-pro-rata surrender,⁴ reduced their holding in the company from 72.5% to 68.5% in an ultimately unsuccessful attempt to attract new capital. They received no compensation for the surrendered shares. Based on a long line of court cases,⁵ the Finks took ordinary loss deductions equal to their basis in the surrendered shares.

The issue presented in *Fink* appeared to be well-settled. The basis of the surrendered stock, since there was no "sale or exchange" requiring capital asset treatment under Internal Revenue Code Section 1222,⁶ was treated as an ordinary loss pursuant to Code Section 165.⁷ Then, in 1977, the Internal Revenue Service

¹107 S. Ct. 2729 (1987), *rev'g* 789 F.2d427 (6th Cir. 1986), *rev'g* 53T.C.M. (P-H) ¶84,418 (T.C. 1984).

²*Fink*, 107 S. Ct. at 2734.

³The Tax Court in *Downer v. Commissioner*, 48 T.C. 86 (1967), considered the treatment of a shareholder's uncompensated stock transfers to a third party to benefit the corporation, and determined that they also resulted in an immediate loss. Two years later Congress added I.R.C. § 83, which, together with the Regulations (particularly Treas. Reg. § 1.83-6(d)), require the transfer of stock to third persons to be treated as a contribution to capital. The Regulations were upheld in *Tilford v. Commissioner*, 705 F.2d 828 (6th Cir. 1983) *cert. denied*, 464 U.S. 992 (1983).

⁴Where surrender of shares is on a pro rata basis, no taxable event occurs as a proportional surrender leaves every shareholder with the same respective interest in the corporation..

⁵*Estate of Foster v. Commissioner*, 9 T.C. 930 (1947); *Miller v. Commissioner*, 45 B.T.A. 292 (1947); *Budd International Corp. v. Commissioner*, 45 B.T.A. 737 (1941), *rev'd on other grounds*, 143 F.2d 784 (3rd Cir. 1944). In *Smith v. Commissioner*, 66 T.C. 622 (1976), *rev'd sub nom.*, *Schleppy v. Commissioner*, 601 F.2d 196 (5th Cir. 1979), the Fifth Circuit reversed the Tax Court primarily because a non pro rata surrender of only 2% interest in the controlled corporation was too insignificant to trigger a loss.

⁶As amended by The Tax Reform Act of 1986 (TRA 86), Pub. L. No. 99-514, §§ 301 and 311, 100 Stat. 2216, 2219 (1986).

⁷Although the Tax Reform Act of 1986 eliminated the tax rate differential between ordinary and capital transactions, the difference between an ordinary loss and a capital loss remains important as individuals are permitted to deduct only \$3,000 of capital losses against ordinary income in each year, whereas all ordinary losses may generally be deducted.

⁷As amended by TRA 86, Pub. L. No. 99-514, § 905(a) and 1004(a), 100 Stat. 2385, 2388 (1986).

withdrew its acquiescence to such treatment⁸ and took the issue into the Tax Court in *Fink*, and in *Frantz v. Commissioner*.⁹

In the *Frantz* decision, the Tax Court first reviewed its long history of approving ordinary loss treatment.¹⁰ The court then abandoned its earlier adoption of the "fragmentary" theory of stock ownership and adopted the "unitary" theory.¹¹ The fragmentary theory of stock ownership views each share of stock as a separate asset, therefore a sale of any share of stock is a closed transaction giving rise to immediate tax consequences. The unitary theory of stock ownership views a shareholder's interest in a corporation as a unit. Transactions of partial stock holdings remain open transactions until the shareholder's entire interest is transferred.¹² The shareholder is viewed as surrendering stock only to benefit the shares of stock retained.

This unitary view permits the court to find that partial surrender is more akin to a contribution to capital than a disposition of a property interest. A partial surrender is, under this view, an open nontaxable transaction with the basis of surrendered shares reallocated to increase the basis of retained shares. The transaction becomes a closed, taxable event only on final disposition of all corporate holdings.

In an eight-to-one decision the Supreme Court in *Fink*¹³ sided with the Commissioner, the Tax Court and the Second Circuit. The decision was grounded on three points. First the Court viewed the surrender of stock as essentially similar to a shareholder's forgiveness of debt owed to him by the corporation.¹⁴ Debt forgiveness is treated as a capital contribution. The Court recognized, but was not swayed, by the Finks' arguments that a surrender of stock is not recorded as a capital contribution for accounting purposes and results in a reduction of the surrendering shareholder's proportionate interest in the corporation.¹⁵

⁸The I.R.S. acquiesced in the cases of *Miller*, 45 B.T.A. 292 and *Budd*, 45 B.T.A. 737, at Rev. Rul. 52-11299, 1942-2 C.B. 3 and 13. Acquiescence was withdrawn in 1977, after the *Fink* transactions, Rev. Rul. at 1977-1 C.B. 2. While the I.R.S. publicly acquiesced to these decisions, it sometimes took a contrary position in litigation and Revenue Rulings. See footnote 3 of the Supreme Court's decision in *Fink*, 107 S. Ct. at 2731.

⁹83 T.C. 162(1984), *aff'd*, 784 F.2d 119 (2d Cir. 1986), *cert. denied*, 107 S. Ct. 3262 (1986). In *Frantz*, the Second Circuit affirmed the Tax Court's decision, but limited the Tax Court holding. *Frantz*, 784 F.2d at 126. However, the court stressed that it was not ruling on whether a shareholder surrendering a more substantial equity interest might sustain an immediate loss. *Id.* In *Fink*, the Tax Court specifically refused to abandon the historical fragmentary view of stock ownership. *Fink*, 53 T.C.M. (P-H) §§84,418. The U.S. Supreme Court granted certiorari to settle the dispute between the circuits. *Fink*, 107 S. Ct. 454 (1986).

¹⁰The Tax Court's decision in *Frantz*, 83 T.C. 162, was a regular decision issued by the Court with four judges dissenting. The decision in *Fink* was issued by the court on the same day in a Memorandum Decision which referred to the reasoning in *Frantz*. *Fink*, 53 T.C.M. (P-H) § 84,418.

¹¹*Frantz*, 83 T.C. at 174.

¹²For further discussion of the unitary and fragmentary theory of stock ownership, see "Frantz or Fink: Unitary or Fractional View of Non-Prorata Stock Surrenders," 48 *U. Pitt. L. Rev.*, 905 (1987).

¹³*Fink*, 107 S. Ct. 2729 (Syllabus). Justice Stevens dissented from the majority decision on the basis that the law had been long-settled when the *Fink* transactions occurred. Any change of established precedent should be undertaken by Congress and not the courts. *Id.* at 2736 (Stevens, J., dissenting).

¹⁴*Id.* at 2732.

¹⁵*Id.* at 2734.

It is sufficient, as the Court found in its second analytical premise, that the Finks were motivated by a desire to enhance the value of their remaining shares of stock.¹⁶ The Court adopted the unitary theory of stock ownership in determining that the motive of enhancing the value of stock holdings retained, causes the surrender of a partial interest to be an inappropriate time to recognize gain or loss.¹⁷ The Finks must await final disposition of their corporate interest to determine ultimate gain or loss.¹⁸

Finally, the Court commented that the immediate recognition of ordinary loss to a surrendering shareholder could result in a convenient method for shareholders in failing corporations to convert capital to ordinary losses.¹⁹

The decision in *Fink* will not end litigation in the area. The Supreme Court left open the question of whether non-pro-rata surrenders by a nondominate shareholder or surrenders reducing a controlling shareholder's position to non-controlling would result in immediate, ordinary loss.²⁰

The unitary theory of stock ownership will spawn new legal issues. For example, will the Internal Revenue Service be content to follow the unitary theory when a dominant shareholder sells a block of stock for a profit; or, to what extent will the unitary view be followed in publically traded corporations. For that matter, what level of stock ownership is required to be "dominant" or "controlling" in a publically traded corporation.²¹ There are estate tax implications in the area of corporate asset freezes and gifting programs utilizing shares of stock. If a donor gifts corporate stock but retains control has there been, under the unitary theory, a completed gift or has there been a retention of some lifetime interest.

A theory, such as unitary stock ownership, approved by the Supreme Court and imposed on a complex tax system will have a long and litigated life.

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¹⁶ *Id.* at 2732.

¹⁷ The Court found precedent in I.R.C. §§ 83 and 302 for adoption of the unitary view of stock ownership. *Id.* at 2735.

¹⁸ *Id.*

¹⁹ The Sixth Circuit in *Fink*, 789 F.2d 427 (6th Cir. 1986), also noted the abuse potential, but asserted that the tax law provided other means — substance over form, sham transaction, step transaction, and the business purpose rule — to avoid abuse. *Id.* at 432.

²⁰ Justice White wrote a concurring opinion in *Fink*, in which he extended the majority's opinion to cover a surrender of stock which *did* cause loss of control by the surrendering shareholder. *Fink*, 107 S.Ct. at 2735 (White, J., concurring).

²¹ The Supreme Court, in footnote 15, implies that while "loss of control" in the instant case means less than 50 percent ownership, such definition might not apply to a publicly traded company where control may exist with less than majority ownership. *Id.*

