Cohu v. Commissioner, 8 T.C. 796 (1947)

Restricted stock received as compensation for services is taxable as income in the year the restrictions lapse and the stock is freely transferable; the value of the stock is determined at that time.

Summary

The Tax Court addressed the timing and valuation of income recognition for promotional shares of stock received as compensation. Petitioners received shares in 1940 that were subject to restrictions, including escrow requirements and waivers of dividends. The court held that the shares were not constructively received in 1939 because conditions precedent for issuance had not been met. The shares were income in 1940 when the restrictions were lifted. The court determined the fair market value of the restricted stock to be $4 per share, considering the restrictions and an arm's-length transaction. Finally, the court determined that the shares received by one petitioner were community property as he had established domicile in California prior to the contract date.

Facts

- Petitioners Cohu and Moore performed promotional services for a new company, Northwest Airlines.
- As compensation, the company promised them shares of its stock (Class A and Class B).
- The stock was subject to restrictions, including being held in escrow and waivers of dividend rights.
- The company's permit required the approval of an escrow holder by the Commissioner of Corporations, and execution of waivers of dividend rights by the petitioners, before the stock could be issued.
- The escrow agent was not approved nor waivers executed in 1939.
- In March 1940, the restrictions were lifted, and the shares were issued and placed in escrow.
- Unrestricted Class A shares were sold in 1940 at an average price of $6.50.
- Ellsworth-Smith transfer, an arm's length transaction, indicated a price of $4.50 per restricted share.
- Cohu moved to California in June 1939.

Procedural History

The Commissioner of Internal Revenue determined that the petitioners had received taxable income in 1940 due to the receipt of the promotional shares and assessed deficiencies. The petitioners contested this determination in the Tax Court.

Issue(s)

1. Whether the petitioners realized income in 1939, when the public sales

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determining their interests were made, or in 1940, when the shares were actually issued?
2. What was the fair market value of the promotional shares on March 4, 1940?
3. Whether the shares received by petitioner Cohu constituted his separate property or community property?

Holding

1. No, because the conditions precedent to the company's authority to issue the shares (approval of the escrow agent and execution of waivers) were not met in 1939.
2. The fair market value was $4 per share, because the restrictions on the promotional shares significantly reduced their value compared to unrestricted shares; the Ellsworth-Smith transfer being a reasonable proxy.
3. The shares were community property, because Cohu had established domicile in California prior to entering the contract for the shares.

Court's Reasoning

The court reasoned that the company's authority to issue shares derived from the state and was subject to the Commissioner of Corporations' approval. Because the necessary approvals and waivers were not in place in 1939, the petitioners did not acquire a proprietary interest in the company that year. The court rejected the arguments of constructive receipt and equivalent of cash. The court stated that the contracts "were merely evidence of the company's undertaking and, while undoubtedly valuable and transferable with the Corporation Commissioner's permission, they were not given or accepted as payment." The court relied on the Ellsworth-Smith transfer as the best indication of value and discounted the value of unrestricted shares due to the limitations. It also considered the managerial relationship of petitioners to the company and the unproven position of the company. Regarding community property, the court found that Cohu established domicile in California prior to the date of the contract entitling him to the shares. Therefore, under California community property law, the shares were community property.

Practical Implications

This case highlights the importance of considering restrictions on stock when determining its fair market value for tax purposes. It also clarifies that mere contractual rights to stock do not necessarily equate to taxable income until the conditions for issuance are met and the restrictions are lifted. Attorneys should carefully analyze the terms of stock agreements and relevant state laws to determine the proper timing of income recognition. This case remains relevant for determining when an employee or service provider recognizes income from stock options or restricted stock units. It is an example of applying valuation principles and community property laws in the context of executive compensation and closely-

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held businesses. Later cases cite this for the principle that restrictions on stock impact its value. The case is also a clear illustration that the power to issue stock is derived from the state.

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