Cohu v. Commissioner, 8 T.C. 798 (1947)

A taxpayer realizes income from stock received as compensation when the stock is issued and the restrictions on its transferability are lifted, not when the right to receive the stock is granted, especially when conditions precedent to issuance remain unfulfilled.

Summary

The Tax Court addressed when income was realized by petitioners who received promotional stock in a company. The court held that the income was realized in 1940, when the stock was issued and restrictions were lifted, not in 1939 when the right to receive the stock was granted. Key to the court's decision was that conditions precedent to the stock's issuance (approval by the Corporation Commissioner and execution of waivers) were not met in 1939. The court also determined the fair market value of the stock and addressed whether stock received by one petitioner was separate or community property.

Facts

Petitioners Cohu and Ryan performed promotional services for Pacific Airmotive Corporation. As compensation, they entered into contracts in 1939 to receive promotional stock. The stock issuance was subject to conditions imposed by the California Corporation Commissioner, including approval of an escrow holder and petitioners executing waivers of dividend and asset distribution rights. These conditions were not met in 1939 but were satisfied by March 4, 1940, when the stock was issued and placed in escrow. Unrestricted Class A shares sold in 1940 for between $5 and $8. In an isolated transaction, some promotional shares were transferred for approximately $4.50 per share.

Procedural History

The Commissioner of Internal Revenue determined that the petitioners realized income in 1940 based on the fair market value of the promotional shares. The petitioners contested this determination, arguing that income, if any, was realized in 1939. The Tax Court heard the case to determine the tax year and value of the stock, and to resolve a community property question.

Issue(s)

1. Whether the petitioners realized income from the promotional shares in 1939, before the conditions precedent to issuance were satisfied?
2. If the income was not realized in 1939, what was the fair market value of the promotional shares on March 4, 1940, when they were issued and placed in escrow?
3. Whether the promotional shares received by petitioner Cohu constituted his separate property or community property?

Holding

1. No, because the conditions precedent to the issuance of the stock were not met in 1939, meaning the company had no authority to bestow a proprietary interest in the stock to the petitioners.
2. The fair market value was $4 per share, because that value appropriately reflected the restrictions placed on the promotional shares and a somewhat isolated sale of shares.
3. The shares were community property, because Cohu was domiciled in California before he entered into the contract to receive the shares.

Court’s Reasoning

The court reasoned that the petitioners did not acquire a proprietary interest in the company in 1939 because the Corporation Commissioner’s approval and the execution of waivers were conditions precedent to the company’s authority to issue the shares. The court stated, “The company’s authority to issue shares or create proprietary interests derives from the state and is not an inherent corporate power which can be exercised by contract independently of sovereign control.” The court rejected the constructive receipt and cash equivalent arguments. As to valuation, the court found that the unrestricted share price did not adequately account for the restrictions on promotional stock. The court gave significant weight to an arms-length transaction of similar shares.

Finally, the court looked at the domicile of Cohu. The court stated, “We have found as a fact that La Motte decided to make California his home early in June 1939, and this fact, coupled with his presence in California and the other attendant circumstances of the situation, satisfies us that he became domiciled in California at that time.” Because he was domiciled in California before entering the agreement to receive the stock, the stock was community property.

Practical Implications

Cohu clarifies that the timing of income recognition for stock compensation is tied to the satisfaction of conditions precedent to issuance, not merely the contractual right to receive the stock. It highlights the importance of regulatory approvals and restrictions on stock when determining the year of income realization. This case serves as a reminder to legal practitioners and businesses to carefully consider all restrictions and conditions surrounding stock compensation when determining tax liabilities. The case also serves as a reminder to look to real transactions in determining value.