Jacob M. Kaplan v. Commissioner, 26 T.C. 98 (1956)

Stock issued to an individual as compensation for services is taxable at its fair market value when received, and corporate distributions are taxed as dividends only if they are out of earnings or profits.

Summary

This case concerns the tax treatment of stock received by a promoter, redemptions of stock, and the application of the collapsible corporation provisions of the Internal Revenue Code. The Tax Court addressed whether stock received by the petitioner as compensation for services should be taxed at the time of receipt or later, and whether stock redemptions were essentially equivalent to taxable dividends. The court also examined the applicability of the collapsible corporation rules to the sales and redemptions of the petitioner's stock. The court held that the stock was taxable when received, the redemptions were not equivalent to dividends due to a lack of earnings and profits, and the Commissioner failed to prove the applicability of the collapsible corporation provisions.

Facts

Jacob M. Kaplan, the petitioner, was a promoter who hired an architect for building projects. As part of the architect's compensation, the corporations issued stock to the architect, which was immediately assigned to Kaplan. The Commissioner determined that the stock constituted compensation for services. The stock was issued in four controlled building corporations. Kaplan sold and redeemed some of the stock. The key factual dispute concerned the value of the stock, whether the redemptions were essentially equivalent to dividends, and whether the corporation was a collapsible corporation.

Procedural History

The Commissioner of Internal Revenue determined deficiencies in Kaplan's income tax for 1949. The case was brought before the Tax Court. The Commissioner asserted that the stock was compensation, the redemptions were taxable dividends, and that the collapsible corporation provisions applied. The Tax Court ruled in favor of the taxpayer on all the primary issues, rejecting the Commissioner's assessments.

Issue(s)

1. Whether the stock received by Kaplan constituted taxable income at the time of receipt.

2. Whether the redemptions of Kaplan's stock were essentially equivalent to a taxable dividend.

3. Whether the corporation was a collapsible corporation under Section 117(m) of

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the 1939 Internal Revenue Code.

Holding

1. Yes, because the stock represented ordinary income to Kaplan as compensation for services, valued at par when received.

2. No, because the distributions were not made out of earnings or profits.

3. No, because the Commissioner failed to prove that more than 70 percent of the gain was attributable to the construction of property as required under section 117(m).

Court's Reasoning

The Court determined that the stock received by Kaplan was income when received, representing payment for services rendered. The court found the stock had a fair market value at the time it was received, and the restrictions on its redemption did not diminish its value to a nominal amount. The court cited to Robert Lehman, 17 T. C. 652, which supported the holding that the stock was income when received.

Regarding the redemptions, the court found that the distributions were not taxable dividends because the corporations did not have sufficient earnings and profits. The court emphasized that the absence of earnings and profits was a critical consideration. The court noted that Section 115(a) requires that a distribution must come out of "earnings or profits" to be considered a dividend. The court further stated that Section 22(a) is qualified by section 22(e), which references section 115 for the taxation of corporate distributions. The court stated, "[A]bsence of the latter is hence a critical consideration."

The court addressed the collapsible corporation issue. The court found that the Commissioner had the burden of proving that the conditions of section 117(m) were met. The court determined that the Commissioner had not provided sufficient evidence to establish that more than 70% of the gain was attributable to the property constructed by the corporation. As the court pointed out, "[W]e can only say that respondent has not, in our view, performed the requisite task of showing here that section 117(m) is applicable." The court noted that while Kaplan would ordinarily have the burden of disproving the fact, the court could not assume that here.

Practical Implications

This case is important for tax practitioners as it clarifies the tax treatment of stock compensation and the importance of earnings and profits in determining whether a corporate distribution is a dividend. The case emphasizes the timing of when compensation is taxed (at receipt, not when it is sold or redeemed). The decision also underscores the Commissioner's burden of proof in applying the collapsible

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corporation rules. Practitioners should carefully analyze the facts to determine when stock is income to the taxpayer and whether a distribution comes out of earnings and profits.

Practitioners should take note of the court's discussion regarding the burden of proof and the specific requirements of section 117(m). The case illustrates the need to have proper documentation when it comes to the attribution of gain to constructed property. This case could influence how the IRS and courts analyze similar situations where stock is received for services, particularly in real estate or construction contexts. It reinforces the necessity for corporations and shareholders to maintain accurate records of earnings and profits to determine the tax consequences of distributions and redemptions.

Later cases continue to cite to Kaplan on the proper timing of when compensation is taxed.

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