32 T.C. 853 (1959)

When an executory contract, though not immediately convertible to cash, has an ascertainable fair market value, the present value of the contractual rights is considered taxable income in the year the contract is executed for a taxpayer reporting on a cash basis.

Summary

The U.S. Tax Court considered whether bonus payments received from an oil lease, to be paid in installments over several years, constituted taxable income in the year the lease was executed, even though the taxpayers reported their income on a cash basis. The court found that the agreement for future payments had an ascertainable fair market value equal to the face value of the bonus. Because the oil company was ready, willing, and able to pay the full bonus upfront, but the taxpayers requested a deferred payment schedule, the court held the taxpayers realized taxable income in the year the lease was executed to the extent of the fair market value of the deferred payments.

Facts

In April 1951, Frank Cowden, Sr., and his children (the Cowdens), entered into an oil, gas, and mineral lease with Stanolind Oil and Gas Company. The lease included a "bonus" or "advance royalty" payment totaling $511,192.50, to be paid in installments: a small portion upon execution of the lease, and the remainder in two subsequent years. The parties also executed separate written agreements evidencing Stanolind's obligation to pay the bonus. Stanolind was ready, able, and willing to pay the entire bonus immediately. The Cowdens, however, preferred the deferred payment schedule. The Cowdens assigned the rights to these deferred payments to a bank, which discounted them slightly. The Commissioner of Internal Revenue determined that the present value of the deferred payments was taxable income to the Cowdens in 1951.

Procedural History

The Commissioner of Internal Revenue determined deficiencies in the Cowdens' income tax. The Cowdens challenged these deficiencies, arguing that they were cash-basis taxpayers and should only be taxed when they received the actual payments. The case was heard before the U.S. Tax Court.

Issue(s)

1. Whether, under the lease and accompanying agreements, the Cowdens realized taxable income in 1951 to the extent of the discounted value of the bonus payable in subsequent years.

2. Whether the Cowdens were entitled to deduct the cost of internal revenue

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documentary tax stamps affixed to the mineral lease as a current expense.

Holding

1. Yes, because the agreements for deferred payment had an ascertainable fair market value equal to their face value, and Stanolind was ready, willing, and able to pay the full bonus in 1951. The court held that the Cowdens realized income in 1951 to the extent of the present value of the agreements.

2. No, because the cost of the stamps constituted a capital expenditure, not a deductible current expense.

Court’s Reasoning

The court found that the crucial fact was Stanolind’s willingness and ability to pay the entire bonus immediately. Because of this, the deferred payment agreements had a fair market value equal to their face value. The court distinguished the case from prior ones where executory contracts were not found to have a fair market value, emphasizing that in those cases, the payor was not necessarily ready and able to pay the full amount immediately. The court reasoned that the deferred payments were

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