Estate of Ralph B. Campbell, Deceased (Mabel W. Campbell, Administratrix), and Mabel W. Campbell, Petitioners v. Commissioner of Internal Revenue, Respondent, 56 T. C. 1 (1971)

Service stock, unrestricted when first acquired but later subjected to restrictions, can result in capital gain upon sale of the stockholder's rights.

Summary

Ralph B. Campbell received unrestricted service stock in The Oaks, Inc. , as compensation for services. Later, the stock was placed in escrow due to a public offering, but Campbell sold his rights in the stock before the escrow was released. The Tax Court ruled that the gain from these sales was long-term capital gain because the stock was unrestricted when initially acquired. The court also upheld the Commissioner's determination of unreported income from The Oaks and confirmed that a 1964 return, purportedly filed jointly but unsigned by Mabel Campbell, was indeed a joint return due to the couple's history of filing jointly and Mabel's reliance on her husband for financial affairs.

Facts

Ralph B. Campbell, a promoter, received 615 shares of service stock in The Oaks, Inc. , in 1962 for services rendered. These shares were initially unrestricted. Later in 1962, due to a planned public stock offering, the shares were placed in escrow under Kentucky law, restricting their transfer until certain conditions were met. Campbell sold his rights to 1,000 shares in 1963 for $5,000 and the remaining rights in 1964 for $40,000. The 1963 and 1964 tax returns did not report these sales as capital gains. Additionally, the Commissioner determined that Campbell received unreported income of $8,217. 91 from The Oaks in 1963. Mabel Campbell did not sign the 1964 joint return, but it was filed as a joint return.

Procedural History

The Commissioner determined deficiencies and an addition to tax for negligence for the years 1963 and 1964. The petitioners contested these determinations in the U. S. Tax Court. The court ruled on four issues: the classification of gain from the sale of service stock, unreported income, the validity of the 1964 joint return, and the addition to tax for negligence.

Issue(s)

1. Whether the gain realized by Ralph B. Campbell from the sale of his rights in service stock in The Oaks, Inc. , in 1963 and 1964 constituted ordinary income or capital gain.
2. Whether Campbell received unreported compensation in the amount of $8,217. 91 from The Oaks, Inc. , in 1963.
3. Whether the 1964 tax return filed in the names of Ralph B. and Mabel W.

Campbell was a joint return despite Mabel's unsigned signature.
4. Whether petitioners are liable for the addition to tax under section 6653(a) for 1963 due to negligence.

Holding

1. Yes, because the service stock was unrestricted when first acquired by Campbell, making the subsequent sales of his rights in the escrowed stock long-term capital gain.
2. Yes, because petitioners failed to prove that Campbell did not receive the $8,217.91 from The Oaks in 1963.
3. Yes, because the 1964 return was intended to be a joint return given the history of filing joint returns and Mabel's reliance on her husband for financial affairs.
4. Yes, because petitioners did not provide evidence to show that the Commissioner erred in determining the negligence penalty for 1963.

Court's Reasoning

The court determined that Campbell's service stock was unrestricted when he first received it in 1962, before it was placed in escrow due to the planned public offering. Since Campbell's rights in the stock were sold while the stock was still in escrow, the gain was treated as capital gain rather than ordinary income. The court rejected the Commissioner's argument that the stock was restricted from the outset, citing Kentucky law and the timing of the escrow agreement. For the unreported income, the burden of proof was on the petitioners, who failed to provide sufficient evidence to disprove the Commissioner's determination. The 1964 return was deemed a joint return based on the couple's history of filing jointly and Mabel's reliance on her husband for financial matters. The negligence penalty was upheld due to the lack of evidence showing error in the Commissioner's determination related to the unreported income.

Practical Implications

This decision clarifies that service stock, even if later subjected to restrictions, can be treated as a capital asset if it was unrestricted at the time of acquisition. Legal practitioners should carefully document the timing and nature of stock acquisitions to accurately classify gains upon sale. Businesses engaging in public offerings should be aware of the potential tax implications for founders and promoters receiving service stock. This case also underscores the importance of proving unreported income and the impact of a history of joint filing on the validity of tax returns. Subsequent cases may reference this decision when dealing with the taxation of service stock and the validity of joint returns.

