



12-1-1956

Taxation -- Federal Income -- Nonrestricted Stock Options -- Proprietary and Compensatory Options -- Taxability of Options upon Receipt

Douglas O. Tice Jr.

Follow this and additional works at: <http://scholarship.law.unc.edu/nclr>



Part of the [Law Commons](#)

Recommended Citation

Douglas O. Tice Jr., *Taxation -- Federal Income -- Nonrestricted Stock Options -- Proprietary and Compensatory Options -- Taxability of Options upon Receipt*, 35 N.C. L. REV. 160 (1956).

Available at: <http://scholarship.law.unc.edu/nclr/vol35/iss1/24>

This Note is brought to you for free and open access by Carolina Law Scholarship Repository. It has been accepted for inclusion in North Carolina Law Review by an authorized editor of Carolina Law Scholarship Repository. For more information, please contact law_repository@unc.edu.

a grant of such authority to a military court, in lieu thereof, will be termed an encroachment on the federal court's jurisdiction.²³

The present status of the law seems to be that ex-servicemen cannot be tried by the military or civil courts for crimes committed while on active duty overseas, unless charges are brought prior to discharge.²⁴ In respect to civilian dependents and civilians working for and with the armed forces, the military courts continue to exercise jurisdiction. It also seems reasonable that the Supreme Court will extend the *Toth* ruling to exempt civilians subject to the U. C. M. J., who return to the United States before charges are preferred by the military authorities for crimes committed overseas.²⁵

J. N. GOLDING

Taxation—Federal Income—Nonrestricted Stock Options—Proprietary and Compensatory Options—Taxability of Options upon Receipt¹

In a recent Supreme Court decision, a serious blow was dealt taxpayers seeking to avoid income taxation arising out of certain employer-employee stock option plans. In *Commissioner v. LoBue*² the Court decided against a distinction supported in the Tax Court³ and Courts of Appeals⁴ which, for income tax purposes, divided employee stock option plans into two types.

The basic problem involved may be illustrated simply. *TP*, a key employee of *X Corporation*, is given an option by the corporation to

²³ It is likely that Congress will now give the federal courts jurisdiction over ex-servicemen and ex-dependents; such would be constitutional. U. S. CONST. art. III, § 2; *Skiriotes v. Florida*, 313 U. S. 69 (1941); *United States v. Bowman*, 260 U. S. 94 (1923); *Jones v. United States*, 137 U. S. 202 (1890).

²⁴ Military jurisdiction is not retroactive in regard to crimes committed prior to induction, although servicemen are presently on active duty; *United States v. Logan*, C. M. 248867, 31 B. R. 363 (1944); nor can it be revived as to crimes committed during the first enlistment, even though a second enlistment immediately follows; *United States ex rel Herschberg v. Cooke*, 336 U. S. 210 (1949). However, military jurisdiction does *not* cease while a discharged serviceman is serving his sentence; *Kohn v. Anderson*, 255 U. S. 1 (1921); and if charges are brought before discharge, military jurisdiction continues after said discharge; *Carter v. McCloughry*, 183 U. S. 365 (1902).

²⁵ 351 U. S. 487, 490.

¹ In 1950 Congress enacted what is now INT. REV. CODE OF 1954, § 421, which provides for capital gains treatment of certain "restricted stock options." If an option complies with § 421 the employee has to report no income until he sells the stock; and, then, any excess over the option price is taxed as a capital gain. However, any stock option plan which does not come within the restrictions of § 421 will not receive the special capital gains treatment. The taxability of these so-called nonrestricted options is the subject of this note.

² 351 U. S. 243 (1956).

³ Malcolm S. Clark, P-H 1950 T. C. Mem. Dec. ¶ 50210; Norman G. Nicholson, 13 T. C. 690 (1949); Delbert B. Geeseman, 38 B. T. A. 258 (1938).

⁴ *Commissioner v. LoBue*, 223 F. 2d 367 (3d Cir. 1955), *rev'd*, 351 U. S. 243 (1956); *Commissioner v. Smith*, 142 F. 2d 818 (9th Cir. 1944), *rev'd*, 324 U. S. 177 (1945).

buy a number of its shares of stock. On the date the option is given the option price may be about the same as the fair market value of the stock.⁵ Later when *TP* exercises the option the fair market value of the stock has risen and *TP* purchases at a considerable saving. *TP*'s preference is to report no income upon receipt or exercise of the option and, upon subsequent sale or exchange of the stock, to report any profit as capital gains.

As early as 1923⁶ the Commissioner urged that the spread or difference between the option price for the stock and the fair market value of the stock is taxable income to the employee exercising the option. The Board of Tax Appeals originally supported the Commissioner's contention.⁷ Some Courts of Appeals, however, did not agree.⁸

The Board decided in 1938 that there were two types of employee stock option plans.⁹ According to the Board's theory, one type of option is compensatory in nature and in fact intended as compensation to the employee.¹⁰ The second type is proprietary in nature and intended only to give the employee a bargain purchase of the stock so that he might acquire an ownership interest in the corporation.¹¹ Only where the option is compensation to the employee would he be taxed on the spread between the option price and the fair market value of the stock. The Commissioner acquiesced¹² in this reasoning until 1945 when the Supreme Court in *Commissioner v. Smith*¹³ gave him new hope that his original determination had been valid. In this decision the Supreme Court reinstated a finding of the Tax Court that an option was compensatory because of the intent of the parties, ignoring the proprietary option theory on which the Court of Appeals had reversed.

Following the *Smith* case the Commissioner ruled in T. D. 5507.¹⁴

⁵ The relationship of the option price to the market value of the stock on the date the option is granted has been and will continue to be an important factor in employee stock option cases. *Rosshiem v. Commissioner*, 92 F. 2d 247 (3d Cir. 1937); *Omaha Nat'l Bank v. Commissioner*, 75 F. 2d 434 (8th Cir. 1935); *Wanda V. Van Dusen*, 8 T. C. 388 (1947), *aff'd*, 166 F. 2d 647 (9th Cir. 1948); *Albert R. Erskine*, 26 B. T. A. 147 (1932).

⁶ T. D. 3435, II-1 CUM. BULL. 50 (1923).

⁷ *Albert R. Erskine*, 26 B. T. A. 147 (1932).

⁸ *Omaha Nat'l Bank v. Commissioner*, 75 F. 2d 434 (8th Cir. 1935), *reversing* 29 B. T. A. 817 (1934); *Rosshiem v. Commissioner*, 92 F. 2d 247 (3d Cir. 1937), *reversing* 31 B. T. A. 857 (1934).

⁹ *Delbert B. Geeseman*, 38 B. T. A. 258 (1938).

¹⁰ *Van Dusen v. Commissioner*, 166 F. 2d 647 (9th Cir. 1938); *Connelly's Estate v. Commissioner*, 135 F. 2d 64 (6th Cir. 1943); *Edward J. Epsen*, 44 B. T. A. 322 (1941).

¹¹ *Malcolm S. Clark*, P-H 1950 T. C. Mem. Dec. ¶ 50210; *Norman G. Nicholson*, 13 T. C. 690 (1949); *James M. Lamond*, P-H 1946 T. C. Mem. Dec. ¶ 46023.

¹² 1939-1 CUM. BULL. 13. The Commissioner also amended the regulations to conform with the Board's holding. The difference between the option price and the market price was to be taxable to the employee "to the extent that such difference is in the nature of (1) compensation for services rendered or to be rendered . . ." T. D. 4879, 1939-1 CUM. BULL. 159.

¹³ 324 U. S. 177 (1945).

¹⁴ 1946-1 CUM. BULL. 18.

"If property is transferred by an employer to an employee for an amount less than its fair market value, regardless of whether the transfer is in the form of a sale or exchange, the difference between the amount paid for the property and the amount of its fair market value is in the nature of compensation and shall be included in the gross income of the employee."

On the same day a statement amplifying and interpreting T. D. 5507 was issued:

"If an employee receives an option . . . to purchase stock of the employer corporation, . . . and the employee exercises such option, the employee realizes taxable income by way of compensation on the date upon which he receives the stock to the extent of the difference between the fair market value of the stock when it is received and the price paid therefor."¹⁵

The Commissioner thus, in effect, revived his 1923 ruling; again, all options were taxable to the employee on the spread between the option price and market value of the stock when the stock is received.¹⁶ The Commissioner's determinations, however, did not end the idea of proprietary stock options.¹⁷

In *Commissioner v. LoBue* the stock option had been awarded LoBue in recognition of his "contribution and efforts in making the operation of the company successful."¹⁸ The Tax Court and Court of Appeals had both held that the option was proprietary.¹⁹ In holding that the distinction between proprietary and compensatory stock options does not exist for income taxation purposes and that both should be taxed alike, the Supreme Court said:

". . . [T]here is not a word in section 22(a) which indicates that its broad coverage should be narrowed because of an employer's intention to enlist more efficient service from his employees by making them part proprietors of his business. In our view there is no statutory basis for the test established by the courts below. . . . Section 22(a) taxes income derived from compensation 'in whatever form paid.' And in another stock

¹⁵ I. T. 3795, 1946-1 CUM. BULL. 15, 16.

¹⁶ Usually the stock will be received at the same time the option is exercised. However, when the stock is received at a date later than the exercise the Supreme Court has held the spread to be taxable at the later time. *Commissioner v. Smith*, 324 U. S. 695, *denying rehearing of* 324 U. S. 177 (1945).

¹⁷ Phillip J. LoBue, 22 T. C. 440 (1954), *aff'd* 223 F. 2d 367 (3d Cir. 1955), *rev'd* 351 U. S. 243 (1956); Robert A. Bowen, P-H 1954 T. C. Mem. Dec. ¶ 54206.

¹⁸ *Commissioner v. LoBue*, 351 U. S. 243, 244 (1956).

¹⁹ Phillip J. LoBue, 22 T. C. 440 (1954), *aff'd* 223 F. 2d 367 (3d Cir. 1955), *rev'd* 351 U. S. 243 (1956).

option case we said that section 22(a) 'is broad enough to include in taxable income any economic or financial benefit conferred on the employee as compensation, whatever the form or mode by which it is effected.'"²⁰

Thus the Court in *LoBue* has abolished a complicated tax doctrine of eighteen years' standing²¹ by taking a more realistic view than had the Courts below of the actual economic benefits derived by employees receiving options. Now that the Court has ruled that all nonrestricted²² stock options are compensatory, the question remains as to when and at what valuation the gain should be reported.

TREATING THE RECEIPT OF THE OPTION ITSELF AS COMPENSATION

That the option itself may be the only intended compensation has been recognized, at least in dicta, by the Supreme Court. In *Commissioner v. Smith* the option involved had no value when received by the taxpayer. However, the Court stated: ". . . It of course does not follow that in other circumstances not here present the option itself, rather than the proceeds of its exercise, could not be found to be the only intended compensation."²³ The Court had in the opinion previously given an indication of what kind of option it might consider as compensation to the employee:

" . . . When the option price is less than the market price of the property for the purchase of which the option is given, it may have present value and may be found to be itself compensation for services rendered. . . . The option could operate to compensate the taxpayer only as it might be the means of securing the transfer of the shares of stock from the employer to the employee at a price less than their market value, or possibly, which we do not decide, as the option might be sold when that disparity in value existed. . . ."²⁴

If an employee successfully contends that his option is compensation when received his tax saving might be substantial. He would

²⁰ *Commissioner v. LoBue*, 351 U. S. 243, 247 (1956). The "another stock option case" was *Commissioner v. Smith*, 324 U. S. 177, 181 (1945). Note that the Court based its decision on INT. REV. CODE OF 1939, § 22(a), 52 STAT. 457 and not T. D. 5507 or I. T. 3795. Section 22(a) defined gross income as including "gains, profits, and income derived from . . . compensation for personal service . . . of whatever kind and in whatever form paid."

²¹ For further discussion of the problems involved in determining whether an option is compensatory or proprietary, see Dillavou, *Employee Stock Options*, 20 ACCOUNTING REV. 320 (1945); Comment, 56 YALE L. J. 706 (1947); Note, 11 TAX L. REV. 179 (1956).

²² See note 1 *supra*.

²³ *Commissioner v. Smith*, 324 U. S. 177, 182 (1945).

²⁴ *Id.* at 181.

report as ordinary income the value of the option the year received. Any subsequent gain realized on sale of the option or stock would be taxed under the lower capital gains rates.²⁵

Aside from the dictum of the Supreme Court in the *Smith* case, the taxpayer may find support from two recent Courts of Appeals cases. In *McNamara v. Commissioner*²⁶ the option was assignable and was not conditioned on McNamara's continued employment with the corporation. A present value was indicated by the spread between option price and market value when the option was granted.²⁷ McNamara's uncontroverted evidence showed the intent²⁸ of the employer was that the option itself would be compensation to him in 1945, the year of its grant. For that year the corporation claimed a salary deduction in an amount representing the value it placed on the option, and McNamara reported the same amount as ordinary income.²⁹ The Commissioner, however, disallowed the employer's deduction and ruled that the transaction gave McNamara no income.

When McNamara exercised the option in subsequent years, the Commissioner assessed deficiencies, stating that the spread between option price and fair market value on the date the option was exercised and stock paid for was taxable income.³⁰ The Tax Court decided in favor of the Commissioner.³¹

In reversing the Tax Court, the Seventh Circuit Court of Appeals felt that the facts of the case established a situation such as the Supreme Court had described in the dictum of *Commissioner v. Smith*.³² The

²⁵ Of course, the market price of the stock may decrease. This is the risk that the employee takes in reporting the value of the option as ordinary income. However, presumably the amount so reported would be reflected in the basis of the option and, upon subsequent exercise, the basis of the stock.

²⁶ 210 F. 2d 505 (7th Cir. 1954).

²⁷ The option granted a right to purchase a total of 12,500 shares during a two year period. The option price was \$16 per share. On the date the option was granted the fair market value of the stock was \$19 per share. The taxpayer and the corporation valued the option at \$16,375.

²⁸ A board of directors resolution had stated that the option was "in addition" to the taxpayer's cash salary. In the yearly report to the Securities Exchange Commission, the corporation reported that the option was granted to the taxpayer for "services rendered or to be rendered."

²⁹ If the taxpayer does not report the value of the option as income in the year received, he may be estopped or deemed to have waived the right to claim the amount as income in that year. See *Bothwell v. Commissioner*, 77 F. 2d 35 (10th Cir. 1935).

³⁰ The difference between the option price and the market price of the stock when the option was exercised was \$78,125 in 1946 and \$77,343.75 in 1947.

³¹ *Harley V. McNamara*, 19 T. C. 1001 (1953), *rev'd* 210 F. 2d 505 (7th Cir. 1954). The Tax Court said that the intended compensation was the profit to be derived upon exercise of the option and not the option itself. "This is not a case of the distribution of a stock option or warrant, which has a clearly ascertainable market value or which the employee could readily sell. Although there was no provision in the option forbidding assignment, it is nevertheless plain that no assignment or sale was ever contemplated by either party." *Id.* at 1010.

³² 324 U. S. at 181-82. The finding of the Tax Court that the compensation

facts upon which the court relied were: (a) The taxpayer and the employer intended the option as compensation when granted; (b) the taxpayer and the employer both reported a valuation on the option itself in 1945; (c) the option had value when granted; (d) the option was assignable.

In *Commissioner v. Stone's Estate*³³ the taxpayer, Stone, was allowed to purchase one hundred warrants at a price of \$10 per warrant. Each warrant entitled him to buy one hundred shares of the employer's stock at a certain price. On the date Stone obtained the warrants, the market price of the stock was below the warrant price. However, he reported \$5000 compensation for that year as the total additional value of the one hundred warrants.³⁴ In the next year Stone sold eighty-nine of the warrants for \$82,680, returning the rest to the corporation at the purchase price.

Stone sought to pay capital gain rates on the profit he realized from the sale. The Commissioner determined that the gain was ordinary income, falling within the scope of T. D. 5507 and I. T. 3795. He relied specifically on a part of I. T. 3795:³⁵

"If an employee transfers such option for consideration in an arm's length transaction, the employee realizes taxable income by way of compensation on the date he receives such consideration to the extent of the value of such consideration."

The Court of Appeals affirmed the Tax Court holding in favor of the taxpayer,³⁶ both courts relying on the dictum in the *Smith* case. The Court reasoned that the warrants had value when obtained by the taxpayer. This was illustrated by the following facts: (a) Stone bought the warrants and reported the amount by which his estimate of their value exceeded the purchase price as income; (b) the warrants were

intended by the parties was not the value of the option itself but the spread between fair market value of the stock on the day of exercise and the option price was held "clearly erroneous" by the Circuit Court because not supported by substantial evidence. "It seems clear to us, from the language of the parties found in the written instruments they executed and from their actions, that they intended the option itself to be the additional compensation by the parties for petitioner's services." *McNamara v. Commissioner*, 210 F. 2d 505, 510 (7th Cir. 1954).

³³ 210 F. 2d 33 (3d Cir. 1954).

³⁴ The taxpayer's burden of proof on the value of the warrants was sustained by two expert witnesses. The Tax Court said it was convinced from the evidence that the 100 warrants were worth \$6000 to Stone when he received them. However, exactly what data this valuation was based upon does not appear.

³⁵ 1946-1 CUM. BULL. at 16.

³⁶ *Estate of Lauson Stone*, 19 T. C. 872 (1953), *aff'd* 210 F. 2d 33 (3d Cir. 1954). The Tax Court reasoned that the warrants involved differed from the usual options given to employees. On this ground it is difficult to reconcile this decision with the Tax Court's decision in the *McNamara* case. However, in *McNamara* the Tax Court had held that the option itself had no ascertainable value; here, the warrants were held to have such a value. Accepting the court's findings of fact the opposite holdings by the Tax Court are reconcilable.

fully assignable by Stone; (c) the holder of the warrants was protected from dilution of his right to purchase stock.

The Supreme Court in *Commissioner v. LoBue* left the road open for further taxpayer arguments that the receipt of the option is compensation.

"It is of course possible for the recipient of a stock option to realize an immediate taxable gain. . . . The option might have a readily ascertainable market value and the recipient might be free to sell his option. . . ." ³⁷

In future option cases the obstacle which employees will have to overcome will be the proving of a "present value" of the option when received, apparently required by the dictum in *Commissioner v. Smith*.³⁸ The Court's dictum can be interpreted to mean that in order to have present value the option price should be less than the market price of the stock. In the *LoBue* case the Court referred to a "readily ascertainable market value" and the right to sell the option. It cited the *McNamara* case as an idea of what it had in mind.³⁹ It may well be that the Supreme Court intended to imply that proof of the existence of both factors is essential for invocation of the *McNamara* rule.

As a summary, the following factors indicate a possibility that an option will be taxed when received: (1) The option has value on the date granted. Value means a present value and will usually be related to the spread between the option price and the fair market value of the stock. (2) The option is freely assignable by the employee.⁴⁰ (3) Circumstances surrounding the granting of the option indicate that the parties intend the option as compensation. (4) The employee includes the value of the option when granted in his tax return for that year.

Problems of valuation will not be too great for the employees of larger corporations whose stock is readily available on the exchanges. However, where a small corporation is involved, the value of the option when received will usually be a matter of some conjecture. In some tax matters the courts have been quite reluctant to evaluate property where its value is a matter of much uncertainty.⁴¹ The Supreme Court

³⁷ *Commissioner v. LoBue*, 351 U. S. 243, 249 (1956).

³⁸ 324 U. S. at 181.

³⁹ The Court made no reference to *Commissioner v. Stone's Estate*, 210 F. 2d 33 (3d Cir. 1954).

⁴⁰ Where the option was not assignable it has been held not to be compensation to the employee at date of grant. *Dean Babbitt*, 23 T. C. No. 108 (Feb. 14, 1955); *John C. Wahl*, 19 T. C. 651 (1953). In *John C. Wahl* one half of the option could not be obtained unless taxpayer was still employed by the corporation. Taxpayer could not assign the option except to other employees. Such restrictions were held to make determination of a value impossible.

⁴¹ In *Burnet v. Logan*, 283 U. S. 404 (1931), the Commissioner attempted to apportion amounts received and to be received by the taxpayer for sale of stock