Michigan Law Review

Volume 50 | Issue 3

1952

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Recommended Citation
Reece A. Gardner, *EMPLOYEE STOCK OPTIONS*, 50 MICH. L. REV. 409 (1952).
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EMPLOYEE STOCK OPTIONS*

Reece A. Gardner†

THE taxation to an employee of the difference between the fair market value of a share of stock transferred to him by a corporate employer, pursuant to the employee's exercise of an option to acquire it at a price below the value of the share, has for years been a matter of dispute between taxpayers and the Commissioner of Internal Revenue. This dispute has involved not merely, as in the case of many of the hardy tax perennials such as reasonableness of compensation, a question as to the application of facts to a well-defined principle of law, but rather a question of the correct legal concept.[1] The deductibility of such difference by the corporate employer has been viewed as a corollary of the employee's tax liability and hence in that field the same controversy has prevailed.[2] That conflict has been in part, although only in part, resolved by the enactment of section 130A of the Internal Revenue Code,[3] which under certain circumstances exempts income which might be derived by the employee from the exercise of a stock option, but at the sacrifice by the corporation of any deduction it might otherwise have. In cases where the corporation's objective is to induce its employees to make an investment of their own funds in the stock of the corporation, in the belief that a proprietary interest in the enterprise will stimulate their efficiency and productivity, it will undoubtedly find it advantageous to devise a plan meeting all of the requirements of the new statutory provisions. On the other

* Paper delivered at the Institute on the Taxation of Business Enterprise, sponsored by the University of Michigan Law School, June 25-28, 1951.—Ed.

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[1] Rose v. Trust Company of Georgia, (D.C. Ga. 1928) 25 F. (2d) 997, affd. (5th Cir. 1928) 28 F. (2d) 767; Durkee v. Welch, (D.C. Cal. 1931) 49 F. (2d) 339; Bothwell v. Commissioner, (10th Cir. 1935) 77 F. (2d) 35; Merhengood Corp. v. Helvering, (D.C. Cir. 1937) 89 F. (2d) 972, cert. den. 302 U.S. 714, 58 S.Ct. 33 (1937); Rossheim v. Commissioner, (3d Cir. 1937) 92 F. (2d) 247; Delbert B. Geeseman, 38 B.T.A. 258 (1938); Gordon M. Evans, 38 B.T.A. 1406 (1938); Charles E. Adams, 39 B.T.A. 387 (1939); William B. Gillies, P-H B.T.A. Memo. Dec. ¶39,161 (1939); Hawke v. Commissioner, (9th Cir. 1940) 109 F. (2d) 946; Herbert H. Springford, 41 B.T.A. 1001 (1940); Clarence L. Landen, P-H T.C. Memo. Dec. ¶43,019 (1943); James M. Lamond, P-H T.C. Memo. Dec. ¶46023 (1946); Norman G. Nicolson, 13 T.C. 690 (1949); Malcolm S. Clark, P-H T.C. Memo. Dec. ¶50,210 (1950); Albert Russel Erskine, 26 B.T.A. 147 (1932); Edward J. Epsen, 44 B.T.A. 322 (1941); Connolly's Estate v. Commissioner, (6th Cir. 1943) 135 F. (2d) 64; Commissioner v. Smith, 324 U.S. 177, 65 S.Ct. 591 (1945); Van Dusen v. Commissioner, (9th Cir. 1948) 166 F. (2d) 647.

[2] Gardner-Denver Co. v. Commissioner, (7th Cir. 1935) 75 F. (2d) 38, cert. den. 295 U.S. 763, 55 S.Ct. 922 (1935); Electric Storage Battery Co., 39 B.T.A. 121 (1939); Commercial Investment Trust Corp., 28 B.T.A. 143 (1933); W. M. Ritter Lumber Co., 30 B.T.A. 231 (1934).

[3] Revenue Act of 1950, §218.

hand, if the arrangement is avowedly compensatory and a corporation in a 77 or 82 per cent tax bracket is more interested in securing a deduction than in protecting the employee from the realization of taxable income upon exercise of the option, it will have to be certain that the new statute will not apply. In either event, a full understanding of the statutory provisions is necessary. All of the implications of the statute, however, cannot be seen without an understanding of the evolution and status of the law as it existed prior to the enactment of the statute. Many able discussions[4] have been written on the case law of employee stock options and, accordingly, only a relatively brief summary will be presented here.

The Case Law on Employee Stock Options

In T.D. 3435,[5] published in 1923, the Treasury Department first formally announced its position with respect to employee stock options by stating unconditionally that when property is sold by an employer to an employee for an amount less than its fair market value, the difference between the amount paid for the property and the amount of its fair market value should be included in the employee's gross

[4] 2 MERTENS, FEDERAL INCOME TAXATION 58 (1942); WASHINGTON, CORPORATE EXECUTIVES' COMPENSATION 90 (1942); Ahern, "Aiding Top Executives to Make Advantageous Deferred Compensation and Business Expense Arrangements," N.Y.U. 7TH ANN. INST. ON FEDERAL TAXATION 858 (1949); Alexander, "Employee Stock Options and the 1950 Revenue Act," 6 TAX L. REV. 165 (1951); Baker, "Stock Options for Executives," 19 HARV. BUS. REV. 106 (1940); Bastedo, "Taxing Employees on Stock 'Purchases,'" 41 COL. L. REV. 239 (1941); Blodgett, "Deferred Compensation of Executives," N.Y.U. 6TH ANN. INST. ON FEDERAL TAXATION 764 (1948); Blodgett, "Recent Developments Concerning Deferred Compensation Plans," N.Y.U. 7TH ANN. INST. ON FEDERAL TAXATION 1093 (1949); Boland, "Employee Options Under The Federal Income Tax," 28 TAXES 415 (1950); Canary, "How An Employee May Seek to Raise Real Salary Without Increasing His Compensation," N.Y.U. 8TH ANN. INST. ON FEDERAL TAXATION 1043 (1950); Dann, "Employee Stock Options Under H.R. 6712," 37 GEO. L.J. 242 (1949); Dillavou, "Employee Stock Options," 20 ACCOUNTING REV. 320 (1945); Durant, "Deferred Compensation and Related Arrangements," AMER. U. TAX INST. LECTURES 265 (1949); Freedman, "A Restatement of Tax Incentives in Compensating High-Salaried Executives," 4 RUTGERS L. REV. 617 (1950); Friedman and Silbert, "Stock Option and Stock Purchase Plans," N.Y.U. 8TH ANN. INST. ON FEDERAL TAXATION 433 (1950); Hirsch, "Basis Problems in Employee Stock Option Transactions," 2 INTRAMURAL L. REV. 24 (1946); Lyon, "Employee Stock Options Under The Revenue Act of 1950," 51 COL. L. REV. 1 (1951); Ross, "Tax Consequences of Employee's Stock Option Plans," 26 TAXES 137 (1948); Sax, "Stock Options," 23 TAXES 505 (1945); Seghers, "Stock Purchase Options Under the New Treasury Rules," 81 J. of ACCOUNT. 452 (1946); Schneider, "Taxation—Employee Stock Options Under The Revenue Act of 1950—A Return to the Bargain-Purchase Concept," 34 MARQ. L. REV. 211 (1951); Schwenk, "Disguised Compensation and Dividends as Taxable Income," 60 HARV. L. REV. 44 (1946); Tyler, "Stock Options," 24 TAXES 611 (1946); note, 2 TAX L. REV. 85 (1946); note, 1 TAX L. REV. 225 (1946); comment, 56 YALE L.J. 706 (1947); note, 50 HARV. L. REV. 500 (1937).

[5] II-1 Cum. Bul. 50 (1923).

income. That provision was incorporated in article 31 of Treasury Regulations 65 promulgated under the Revenue Act of 1924 and, with immaterial changes in phraseology, it was carried forward into the regulations promulgated under the Revenue Acts of 1928, 1932, 1934 and 1936.[6] The United States Tax Court and the courts of appeals refused, however, to go as far as the regulations and ultimately evolved a rule that the difference between the option price and the value of the stock acquired under the option would be regarded as taxable income to the employee only if it appeared that the parties intended that the difference be compensation to the employee. If it appeared from the agreement and the circumstances that the option was not intended as a means of compensating the employee, it was held to result merely in the purchase of property at a bargain price from which no income would be derived until sale of the stock.[7]

The Commissioner thereupon conceded the issue and in January 1939, in T.D. 4879,[8] he amended the income tax regulations to provide that if property is sold or transferred by an employer to an employee for an amount "substantially" less than its fair market value, the employee would be required to report the difference as taxable income "to the extent that such difference is in the nature of compensation for services rendered or to be rendered."[9] That appeared to settle the rule of law, and the question of the taxability of the exercise of stock options thereby became merely one of fact as to whether the option was or was not intended as a means of compensating the employee. In 1943, however, there came before the Tax Court the case of *John H. Smith v. Commissioner*[10] in which Smith's corporate employer, which was entitled to receive stock of another corporation for services in the mangement of that corporation under a reorganization plan, gave him an option to acquire part of that stock for services which he performed in negotiating the plan of reorganization. The fair market value of the stock did not exceed the option price at the time the option was granted, but was greatly in excess of it at the time Smith exercised the option and at the time the shares were delivered to him. Both the documentary

[6] Art. 31, Regulations 69 (1926 Act); Art. 51, Regulations 74 (1928 Act) and 77 (1932 Act); Art. 22(a)-1, Regulations 86 (1934 Act) and 94 (1936 Act).

[7] See decisions cited in notes 1 and 2 supra.

[8] 1939-1 (Part 1) Cum. Bul. 159.

[9] As so amended the provision appeared in Art. 22(a)-1, Regulations 101, promulgated under the Revenue Act of 1938, and until again amended in T.D. 5507, 1946-1 Cum. Bul. 18, it so appeared in §29.22(a)-1 of Regulations 103 and 111, promulgated under the Internal Revenue Code.

[10] P-H T.C. Memo. Dec. ¶43,101 (1943).

evidence and Smith's own testimony clearly established the fact that the option was given to him as compensation for his services. Although it was the first case in which the court held that taxable income resulted when the option price was equal to the fair market value of the stock at the time the option was granted, the compensatory character of the option was so clear that the court decided against the taxpayer in a memorandum decision. The Court of Appeals for the Ninth Circuit,[11] however, reversed the Tax Court on the ground that since the option price was equal to the value of the stock at the time the option was granted, there was no bargain purchase and no basis for holding that the subsequent differential was compensation for services or income to the taxpayer.

Because of an asserted conflict between that decision and the decision of the Court of Appeals for the Sixth Circuit in *Connolly's Estate v. Commissioner*,[12] the Supreme Court of the United States granted certiorari and, with Justice Roberts dissenting for the reasons stated by the court of appeals, the majority of the Court held that the option itself could not be regarded as the intended compensation by reason of the fact that it had no fair market value at the time it was granted and, consequently, the compensation which the parties contemplated was not confined to the mere delivery of the option, but included the compensation obtainable by the exercise of the option given for that purpose.[13] It found that the terms of the applicable revenue act relating to the definition of gross income were broad enough to include in taxable income any economic or financial benefit conferred on an employee as compensation, whatever the form or mode by which it is effected. In the course of the decision, the Court stated that when the option price is less than the market price of the property for the purchase of which the option is given, the option itself rather than the proceeds of its exercise might be found to be the "only intended compensation."

[11] Smith v. Commissioner, (9th Cir. 1944) 142 F. (2d) 818.

[12] (6th Cir. 1943) 135 F. (2d) 64. In that case the decedent's corporate employer, pursuant to a resolution of its board of directors reciting that the compensation previously paid him was disproportionate to the value of his services and that he should be given adjusted compensation in the form of an option to purchase stock, granted him an option at a price which was substantially below the market value of the stock on the New York Stock Exchange, both at the time the option was granted and when he exercised it. The court of appeals affirmed a decision of the Tax Court (45 B.T.A. 374) that taxable income was realized upon exercise of the option. The fact that a difference existed between the option price and the value of the stock at the time of grant would probably have led the Court of Appeals for the Ninth Circuit to decide this case in the same way.

[13] Commissioner v. Smith, 324 U.S. 177, 65 S.Ct. 594 (1945).

The *Smith* case was not generally regarded as an extension of the rule applied by the lower courts, except possibly in so far as it ended any question that income from the exercise of a stock option could not under any circumstances be derived if the option price was equal to the fair market value of the stock at the time the option was granted.[14] Nevertheless, on April 12, 1946, the Commissioner again amended the regulations[15] to provide unqualifiedly that any difference between the value of property transferred by an employer to an employee and the price paid by the employee, whether or not substantial, is in the nature of compensation and shall be included in the gross income of the employee.

As a result, the assertion of a tax liability on a favorable purchase of stock became inevitable even in circumstances where the option clearly was not intended as compensation and the option price was the exact equivalent of the value of the stock at the time the option was granted. Thus, let us assume that a corporation believes that production will be increased and labor relations substantially improved if it can persuade its employees to purchase stock and thereby acquire a proprietary interest in the success of the business. It recognizes that those purposes can be better accomplished if the employees actually have an investment in the stock rather than having it handed gratuitously to them, but it also realizes that the employees are not going to subscribe to the stock without some material inducement. It therefore grants an option to acquire the stock at a fixed price in order that the employees will find it advantageous to purchase if the value of the stock does, in fact, increase. Under the decisions of the courts, an option granted under such circumstances clearly would not give rise to taxable income, but under the regulations taxable income would result if the value of the stock did exceed the option price at the time of exercise. Obviously, the possibility that an employee would have to pay not only the purchase price of the stock but also an additional tax liability would substantially reduce the attractiveness of the option and the likelihood that he would exercise it.

[14] Accordingly the decisions in Rose v. Trust Co. of Georgia, Durkee v. Welch, Bothwell v. Commissioner, Merhengood Corp. v. Helvering, Rossheim v. Commissioner, and Hawke v. Commissioner, cited in note 1 supra, appear to be of doubtful authority at the present time. See Van Dusen v. Commissioner, 8 T.C. 388 at 393 (1947). In each of those cases the option arrangement appeared to be of a compensatory character and the courts relied principally on the fact that the option price and the value of the stock were substantially equal at the time the option was granted.

[15] T.D. 5507, 1946-1 Cum. Bul. 18.

Accordingly, to overcome the deterrent effect of the regulations on the use of an employee stock option as an incentive device, section 130A was devised.[16] With this background, we may turn to a study of its provisions.

Statutory Provisions Applicable to Stock Options

Restricted Stock Options. The keystone of the new section is a "restricted stock option" as defined in subsection (d) (1). The elements of the statutory definition are as follows:

(1) *Stock subject to the option.* The option must provide for the purchase of stock of either the employer corporation or its parent or subsidiary. The term "parent corporation" is defined to mean any corporation other than the employer corporation in an unbroken chain of corporations ending with the employer corporation, each of which at the time of the granting of the option owns stock possessing more than 50 per cent of the total combined voting power of all classes of stock in one of the other corporations in such chain. The term "subsidiary corporation" means a similar chain of corporations beginning with the employer corporation. The statute does not define what is meant by stock. There is nothing to indicate that it could not be preferred stock or any other class of nonvoting stock,[17] but it is questionable whether voting trust certificates would qualify.

(2) *Date of grant.* The option must be granted after February 26, 1945, which is the date the Supreme Court announced its decision in *Commissioner v. Smith.* The selection of that date is not explained in the committee reports,[18] but it is probably due to the fact that subject to certain conditions, the Commissioner announced that the amended regulations would not be applied to options granted prior to that date.[19]

(3) *Purpose.* The option must be granted for some reason connected with the individual's employment by a corporation. This pro-

[16] S. Rep. No. 2375, 81st Cong., 2d sess., 1950-2 Cum. Bul. 483 at 526.

[17] Compare I.R.C., §141(d).

[18] In the bill as reported by the Senate Committee on Finance the date selected was December 31, 1946. The Senate changed the date but no reference to that fact was made in the report of the Committee on Conference. H. Rep. No. 3124, 81st Cong., 2d sess., 1950-2 Cum. Bul. 580.

[19] I.T. 3795, 1946-1 Cum. Bul. 15. The condition was that on or before July 1, 1946, all taxpayers concerned file with the Commissioner written consents agreeing that the basis of the stock would be the option price and that no deduction would be claimed, attributable to any aspect of the option arrangement, under §23(a)(1) or any other subsection of the Internal Revenue Code, and indemnifying the Commissioner against any action by any taxpayer concerned inconsistent with the consents filed.

vision is not, strictly speaking, a limiting condition but it indicates that the application of secton 130A is not dependent in any way upon the compensatory or noncompensatory character of the option.

(4) *Grantor of the option.* The option must be granted by the employer corporation or by its parent or subsidiary.

(5) *Option Price.* The option price must be not less than 85 per cent of the fair market value, at the time the option is granted, of the stock subject to the option. The determination of fair market value will, of course, be one of the most troublesome factors in applying the statute. As previously stated, the purpose of the enactment of section 130A was to permit the use of stock options as an incentive for greater productivity which would normally be reflected in an increase in the value of the stock after the date of the option. Accordingly, a requirement that the option price be exactly equivalent to the fair market value of the stock would have been consistent with that purpose. The Senate Committee on Finance, however, recognized the difficulties in ascertaining accurately the fair market value of the stock of many corporations and, consequently, gave the 15 per cent leeway.[20] In the case, however, of stock not having a readily ascertainable market value, the valuation can be a matter of a wide divergence of opinion. Even an agreement as to value between the employer and employees would probably not be accorded the weight ordinarily given to arm's length transactions because their interests are so nearly akin. In the case of stocks listed on an exchange, the fair market value on a particular day is usually taken as the average of the high and low prices at which the stock sold on that day. The statute, however, does not refer to the day on which the option is given but refers to the "time" it is given. If an option is actually made known to the employees after the close of the exchange and the market closed high, it is obvious that an option price fixed at exactly 85 per cent of the average of the high and low sales during the day could be too low. In the case of listed stock, that difficulty can be avoided by using the high quotation of the day for the purpose of measuring the option price. With respect to unlisted stocks, it may not be possible to do more than make a bona fide effort to fix a price at 100 per cent of the value of the stock, letting the 15 per cent safety margin take care of differences of opinion on the valuation question. That, of course, was all Congress intended.

(6) *Transfer and Exercise.* The option must by its terms affirmatively provide that the employee may not transfer it otherwise than by

[20]S. Rep. No. 2375, 81st Cong., 2d sess., 1950-2 Cum. Bul. 483 at 526.

will or by the laws of descent and distribution and, furthermore, that during his lifetime it can be exercised only by him.

(7) *Options to shareholders.* The optionee may not at the time the option is granted own stock possessing more than 10 per cent of the total combined voting power of all classes of stock of the employer corporation or of its parent or subsidiary corporation. For this purpose, the individual is considered as owning the stock owned directly or indirectly by or for his brothers, sisters, spouse, ancestors and lineal descendants, and likewise, his proportionate share of stock owned by a corporation, partnership, estate or trust in which he has an interest. It is clear that ownership of more than 10 per cent of the stock of any one of the corporations in the parent-subsidiary chain will defeat the option whether or not the option is granted by the corporation in which the employee already owns stock. This limitation was considered necessary to preclude the shareholders of a corporation from distributing the corporation's earnings in the form of capital gains.[21]

(8) *Modifications, extensions and renewals.* Under subsection (e), for the purpose of determining whether the option is a restricted stock option, as defined in subsection (d), any modification, extension, or renewal of the option is considered as the granting of a new option and the option price must be at least 85 per cent of the fair market value of the stock on the date of the original granting of the option, on the date of the making of such modification, extension, or renewal, or on the date of the making of any intervening modification, extension, or renewal, whichever of those dates reflects the highest value. Similarly, the employee could not on the date of the modification, extension, or renewal, own more than 10 per cent of the voting stock of the corporation or of its parent or subsidiary even though he owned less than that percentage at the time the original option was granted.

Tax Effect of a Restricted Stock Option. If the option qualifies as a restricted stock option, subsection (a) provides for the tax effect of its exercise upon the employee and the employer. It, in turn, imposes substantial restrictions upon the exercise of the option and with respect to the disposition of the stock acquired upon the exercise of the option, but if those restrictions are observed it provides that no income shall result at the time of the transfer of such share to the individual upon his exercise of the option with respect to such share; that no deduction under section 23(a) (relating to ordinary and necessary business expenses) shall be allowable at any time to the employer corporation of such individual or its parent or subsidiary corporation with respect to

[21] Id. at 527.

the share so transferred; and that no amount other than the option price shall be considered as received by either of such corporations for the share so transferred.

It will be seen that that provision does not expressly prohibit the recognition of income upon the receipt of the option itself, which the Supreme Court in *Commissioner v. Smith* said could under some circumstances be found to be the only intended compensation. The committee report, however, makes it clear that no income is to be recognized either upon the receipt of the option or upon its exercise.[22] This section is also silent as to the treatment for tax purposes of the gain derived by the employee upon the sale or exchange of the stock acquired under the option,[23] nor does it expressly provide what amount shall be considered as the employee's basis for determining gain or loss upon the sale or exchange of the stock. In subsection (b) such rules are partially provided where the option price is less than 95 per cent of the value of the stock on the date the option is granted. There appears to be no question, however, that section 117 will apply to any gain or loss realized on the sale or exchange of the stock and it is manifest that no one could successfully argue that his basis exceeded the actual purchase price of the stock except as otherwise expressly provided in subsection (b).

With respect to the corporation, a deduction is prohibited under section 23(a) relating to ordinary and necessary business expenses, but if treasury stock is sold at below the corporation's cost and the corporation would otherwise be entitled to take such loss into account, nothing in section 130A appears to defeat its right to do so. Similarly, nothing in the section protects it from the recognition of gain, and it is possible that that gain will be measured not by the option price but by the actual fair market value of the stock. That question will depend upon whether the value of the services received by the corporation in exchange for the stock was equal to the value of the stock on the date of transfer.[24] It may also depend upon whether the option was or was not intended to be compensatory although it is possible that the courts could hold that stock issued pursuant to an option which was merely an incentive device produced economic benefits to the corporation equal to the fair market value of the stock it transferred. If gain is

[22] Id. at 526. The Finance Committee said, "Under your committee's bill no tax will be imposed at the time of exercise of a 'restricted stock option' or at the time the option is granted and the gain realized by the sale of the stock required through the exercise of the option will be taxed as a long-term capital gain."

[23] This omission is likewise supplied in the Committee Report. See note 22 supra.

[24] International Freighting Corp. v. Commissioner, (2d Cir. 1943) 135 F. (2d) 310.

recognized in excess of the difference between the corporation's cost of the stock and the option price, the corporation, nevertheless, would appear to be precluded from claiming any offsetting deduction under section 23(a). The provision that no amount other than the option price shall be considered as received by the corporation appears to be designed to prohibit the corporation from claiming any greater addition to its paid-in capital for the purposes of the excess profits tax.

Limitations on Tax Exemption under Subsection (a). This brings us to a consideration of the restrictions that are imposed upon the exercise of the option and disposition of the stock.

(1) *Exercise of the option.* With respect to exercise, the requirement that the option be exercised after 1949 presents no difficulty. The second requirement is that at the time of the exercise of the option the individual must be an employee of the corporation granting such option, or of a parent or subsidiary corporation of such corporation or it must be exercised by him within three months after the date he ceases to be an employee of any of such corporations.

It is interesting to note that in this connection the language refers to "a" parent or subsidiary and makes it clear that employment by any of the corporations within the chain, up or down, from the employer corporation will satisfy the employment requirement. In subsection (d)(1) relating to the stock which may be the subject of the option, in subparagraph (d)(1)(C) relating to the 10 per cent stock ownership rule, and again in subparagraph (a) (1) (2) relating to the corporate deductions, the statute speaks of the employer corporation or "its" parent or subsidiary. It is unlikely that those provisions were intended to be limited to the employer corporation and the corporations immediately above and below it, but the difference in the language should not be overlooked if corporations more remote in the chain are brought into the option plan.

The term "employee" is not defined and, consequently, will probably be interpreted in the light of the common law rule of employer-employee relationship.

It will be noted that if the option is not exercised by the optionee while he is employed, it must be exercised "by him" after the termination of his employment. As we have seen, the definition of a restricted stock option does not prohibit transferability of the option, if unexercised at the time of the employee's death, by his will or by the laws of descent and distribution; and with respect to the exercise of the option, it requires only that it be exercised by him during his lifetime and does not require that the option expire at his death. Accordingly,

it is clear that the option may be exercised after the employee's death, but there is a substantial question whether the benefits of subsection (a) can be obtained upon an exercise other than by the employee himself. Nothing in the committee reports clarifies this question. As will be brought out in subsequent discussion, when the option price is less than 95 per cent of the value of the stock at the time the option is granted, the statute requires that upon the sale, exchange, gift, or other transfer of legal title of the stock, or upon the death of the employee, there be treated as ordinary income and not as a capital gain the difference between the option price and the fair market value of the stock either at the time of such disposition or at the time the option was granted, whichever is the lesser. If the benefits of subsection (a) were to be extended to cover the exercise of the option after the date of the employee's death, the provisions of subsection (b) would have to be amplified to cover the subsequent disposition of the shares by the person who exercised the option. On the other hand, if the option did not fall within the 95 per cent rule and was exercised by the employee prior to his death, no amount would ever be taxable as ordinary income and it would appear to be highly unfortunate to tax the beneficiaries of his estate upon income which would have been tax-free to the decedent. The apparent conflict between the definition of a restricted stock option and the limitation in subsection (a) that the option be exercised by the employee would justify the Commissioner in interpreting subsection (a) to apply to the decedent's beneficiary, but absent such an interpretation the question will probably have to be resolved by the courts.

(2) *Required retention of the stock.* The benefits of subsection (a) cannot be obtained if any disposition of the share is made within two years after the date of the granting of the option or within six months after the transfer of the share of stock to the employee. Subsection (d) (4) defines the term "disposition" to include a sale, exchange, gift, or any transfer of legal title except a transfer from a decedent to his estate, a transfer by bequest or inheritance, an exchange which is within the provisions of sections 112 (b) (2) or (3), or a mere pledge or hypothecation.

It will be noted that the statute refers in terms of a share of stock, and the legislative history makes it clear that the provisions of subsection (a) will apply to any shares with respect to which the requirements are met even though those benefits are denied with respect to other shares acquired upon the exercise of the same option.[25] Thus, if

[25] H. Rep. No. 3124, 81st Cong., 2d sess., 1950-2 Cum. Bul. 580 at 587.

an employee acquires some shares while he is still employed, or within three months after his employment is terminated, or if he holds some of the stock for the full two years from the date of the granting of the option and for six months after the transfer of the shares to him, he will realize no income upon the exercise of his option with respect to those shares even though other shares acquired under the same option are purchased more than three months after he has ceased to be an employee or are disposed of before the end of the prescribed holding period.

Thus, it will be seen that if all of the requirements of a restricted stock option are met and all of the rules as to the exercise of the option and retention of the stock are observed, no taxable income will result to the employee as a result of the receipt of the stock. Moreover, if the option price is at least 95 per cent of the fair market value of the stock at the time the option is granted, any income derived from the sale or exchange of the stock will be treated as a long-term capital gain.[26] A special rule is provided under subsection (b), however, if the option price is less than 95 per cent of the value of the stock on the date the option is granted.

Special Rule Where Option Price Is Between 85 Per Cent and 95 Per Cent of Value of Stock. Subsection (b) provides that upon the death of the employee or in the event of a disposition of the stock by him, "there shall be included as compensation (and not as gain upon the sale or exchange of a capital asset) in his gross income" the amount by which the option price is exceeded by the lesser of the fair market value of the share at the time of such disposition, or death, or the fair market value of the share at the time the option was granted. Again, presumptively, any gain realized by sale or exchange in excess of the amount so taxable as ordinary income would be taxed as a capital gain. As stated above, the term "disposition" is defined in subsection (d)(4) to include a sale, exchange, gift, or transfer of legal title except a transfer from a decedent to his estate or by bequest or inheritance, an exchange for stock or securities in a tax-free reorganization, or a mere pledge or hypothecation. If the requirements of subsection (a) are met, the denial of a deduction to the corporation applies to any amounts treated as ordinary income under subsection (b).[27]

[26] Since subsection (a) requires the stock to be held at least six months, gain derived upon the sale of stock held in conformity with that requirement will necessarily be a long-term gain under the present provisions of I.R.C., § 117(a)(4). If the holding requirement under the latter section should be extended without a corresponding amendment of §130A(a), sale of the stock could result in a short-term gain.

[27] H. Rep. No. 3124, 81st Cong., 2d sess., 1950-2 Cum. Bul. 580 at 587.

Insofar as this section purports to include in the employee's gross income "as compensation," the difference between the option price and the fair market value of the stock at the time of the employee's death or any disposition of the stock without consideration, it appears to be of doubtful validity in cases where the option was granted under circumstances which would have led the courts to hold that it was not compensatory and that no taxable income was derived from its exercise. If the gain is realized by sale or exchange, the Congress could unquestionably deny to the taxpayer the benefit of subsections (b) and (c) of section 117 of the code which permit a taxpayer to take into account only 50 per cent of the gain and to compute his tax at a rate not in excess of 50 per cent of the amount so taken into account. As applied to gain on a sale or exchange, it is probable that the courts will construe the phrase "as compensation" merely as surplusage and treat the provisions of subsection (b) of section 130A as merely a limitation upon section 117. The objection is more fundamental, however, insofar as the statute attempts to create taxable income by reason of the death of the optionee, or of a gift or other transfer of legal title without consideration. As we have seen, the courts have held that where a stock option is not intended as compensation, the optionee derives no taxable income from the transaction until he actually realizes the gain by sale or exchange. An unrealized increment in value is not income[28] and Congress, therefore, has no power to tax it without apportionment.[29] Mindful of the fact that no provision of the income tax law, except the attempt to tax stock dividends,[30] has yet succumbed to an attack on constitutional grounds, no one can hazard a guess as to what the attitude of the courts will be when this question comes before them. If, however, they give full effect to subsection (b), they will be forced to overrule the decisions which hold that no income is derived from the exercise of a noncompensatory stock option. Accordingly, the employee or his transferee, in appropriate cases, should protect his right to a refund of any tax paid

[28] Lynch v. Turrish, 247 U.S. 221, 38 S.Ct. 537 (1918); General Utilities and Operating Co. v. Helvering, 296 U.S. 200, 56 S.Ct. 594 (1935); Treas. Reg. 111, §29.41-2; MERTENS, FEDERAL INCOME TAXATION 169 (1942).

[29] In Alexander, "Employee Stock Options and The Revenue Act of 1950" 6 TAX L. REV. 165 at 177, 178 (1951), the author takes the view that "there can be little doubt that Congress could have supported the Treasury position by the passage of an appropriate law adopting the theory of the amended regulation." If Congress could have wholeheartedly adopted the Treasury position, clearly it could do so to the limited extent provided in §130A(b). However, if a bargain purchase under some circumstances is not "income," it is difficult to see how Congress can change its character by so naming it. Section 22 of the code was broad enough to reach it where income did in fact result from the exercise of a stock option.

[30] Eisner v. Macomber, 252 U.S. 189, 40 S.Ct. 189 (1920).

at ordinary income rates under the 95 per cent rule until its validity has been determined by the courts. Furthermore, when an option is granted under circumstances and for the purposes which would have made it noncompensatory under the case law, the agreement should be so drawn and a careful record so made that the optionees can establish their immunity from tax.

As an adjunct of subsection (b), subsection (c) provides that if stock transferred to an individual upon his exercise of a restricted stock option is exchanged by him for stock or securities in an exchange within the provisions of section 112(b)(2) or (3), or if new stock, as described in section 113(a)(19), is acquired upon a distribution with respect to such stock, the stock or securities acquired in the exchange and such new stock shall be considered as having been transferred to him upon his exercise of such option. It will be noted that this section by its terms applies only to new shares acquired by the employee after he himself has exercised the option. In most cases under a stock option plan which will have any considerable duration, it will be desirable to provide that the shares which have been allocated to an employee will also carry with them, without any increase in the option price, any stock dividends which may have been issued by the corporation between the date of the granting of the option and the date of the employee's exercise of it. There appears to be no reason to assume that such shares, however, would not be treated as shares received upon the exercise of the option under subsection (a). This situation is not so clear, however, in the event the corporate employer merges into another corporation prior to the exercise of the option. Under those circumstances, if the option agreement is assumed by the surviving corporation, such assumption might be considered as a modification, extension, or renewal of the option.

Options Not Qualifying Under Section 130A

This brings us to the status of those options which do not qualify for exemption under section 130A. That classification includes an option granted on or before February 26, 1945, one granted at a price below 85 per cent of the fair market value of the stock, or one which by its terms does not restrict the transferability of the option nor limit exercise solely to the employee during his lifetime. It also covers an option granted to a person who possesses more than 10 per cent of the voting stock of the employer corporation or its parent or subsidiary corporation, and it includes even a restricted stock option to the extent that the employee exercises the option more than three months after

he ceases to be an employee of any of the corporations in the parent-subsidiary chain, or fails to hold the stock for two years after the date of the granting of the option, or for six months after the transfer of the share to him. As we have heretofore seen, under the old decisions the exercise of the option would result in taxable income to the employee and an allowable deduction to the employer if the option was intended to be compensation. On the other hand, if the option was not intended to be compensatory, no taxable income results to the employee and no deduction is allowable to the employer. The latter rule is expressly contrary to the present regulations, which, however, seem to take unjustified liberties with the decision of the Supreme Court in *Commissioner v. Smith*. Even the Senate Committee on Finance stated that in its belief the regulations go beyond the decision of the Supreme Court and it cited the resulting uncertainty as to whether the regulations are in accordance with the law as an additional reason for taking legislative action.[31] No cases have arisen which have dealt either with options granted after the decision in the *Smith* case or after the change in the regulations. Cases involving options granted prior to those dates have, however, come before the Tax Court after the decision in the *Smith* case, and in some instances after the change in the regulations and the enactment of the Revenue Act of 1950, and the Court has not hesitated to apply the same rule that prevailed prior to 1945.[32]

The Senate Committee on Finance was careful to prevent any inference that the enactment of the new statutory exemption should influence the law with respect to options not covered by its terms. It is true that the committee referred to the new section as according "special treatment" to certain employee stock options, but that, of course, is the fact with respect to those options embraced by its terms which would otherwise have been held to be compensatory. It said, however, that options which do not qualify as restricted stock options "will continue to be taxed as under existing law."[33] Again, it said that the section contains no rules applicable to transactions respecting stock options which are not restricted stock options and, further, that if the employee disposed of his stock within the required holding period, transactions

[31] S. Rep. No. 2375, 81st Cong., 2d sess., 1950-2 Cum. Bul. 483 at 526.

[32] James M. Lamond, P-H T.C. Memo. Dec. ¶46,023 (1946); Norman G. Nicolson, 13 T.C. 690 (1949); Malcolm S. Clark, P-H T.C. Memo. Dec. ¶50,210 (1950) (all holding that no income was realized); and Van Dusen v. Commissioner, 8 T.C. 388 (1947) affd. (9th Cir. 1948) 166 F. (2d) 647 (in which a tax was imposed under circumstances which would have led the court to find a compensatory option prior to the Smith case).

[33] S. Rep. No. 2375, 81st Cong., 2d sess., 1950-2 Cum. Bul. 483 at 526.

respecting the option and such stock revert to their status under existing law.[34] Accordingly, with respect to those options which do not qualify for exemption under the statutory section, the conflict between the unqualified position the Commissioner has taken in his regulations and the more limited rule which has been applied by the courts remains to be resolved in further litigation.

The conclusion should not be drawn, however, that a stock option plan is valueless unless it immunizes the employee against ordinary tax liability. As stated at the outset of this article, in view of the present high rate of taxation on corporations, it is possible that the employer would be more interested in its deduction than in providing tax-free benefits to the employee. If the option is granted and exercised in strict conformity with all of the rules of section 130A, the deduction will not be available to the employer. Similarly, if the case law continues to be applied as it has been heretofore, a noncompensatory arrangement will not afford a deduction to the employer. Consequently, a compensatory option plan not meeting the requirements of section 130A(d) may be desirable to the employer corporation. Under such a plan, exercise of the option will clearly result in taxable income to the employee. However, the present high tax rates have created increasing interest in plans by which compensation can be deferred so that part of the compensation which the corporation would otherwise be willing to pay an employee currently can be received by him after his retirement, when his income is in lower tax brackets and the portion of such additional compensation which he can actually keep after paying his taxes will be greater than it would have been if he had added it to his other compensation while actively employed. Except where the corporation is willing to provide a pension or profit-sharing plan and trust which qualifies under section 165 of the Internal Revenue Code,[35] the purchase of annuity contracts or an agreement to pay retirement benefits, whether it be funded or unfunded, entails considerable hazards to the employee to some extent under the doctrine of constructive receipt, and to a greater extent under the equivalent-of-cash or economic benefit doctrine.[36] In the case of retirement benefits provided for officer-share-

[34] Id. at 552 and 553.

[35] Under I.R.C., §165(a)(3), a qualifying plan must benefit (1) 70% of all employees, or (2) 80% of all eligible employees if 70% of all employees are eligible, excluding those employed not more than a prescribed period up to five years and part time and temporary employees, or (3) employees qualifying under a classification which does not discriminate in favor of officers, shareholders, or supervisory or highly compensated employees. The latter group are usually the ones for whom deferred compensation plans are desirable.

[36] For an excellent discussion of the dangers of various "non-section 165 arrangements," see Blodgett, "Deferred Compensation of Executives," N.Y.U. 6TH ANN. INST. ON FEDERAL TAXATION 764 (1948).

holders of closely held corporations using the accrual method of accounting, the deduction by the corporation is also jeopardized by section 24(c) of the code.[37] A stock option, however, can provide retirement income without the dangers of a pension agreement. Even though the employee realizes income upon the exercise of the option, he can space that income as he sees fit. There is no danger that the doctrine of constructive receipt would apply because the receipt of the income by the employee is conditioned upon his making out of his own funds a substantial payment for the stock and the doctrine does not apply to such conditional rights.[38] Of course, if the employee wishes to reduce the income to cash, he must sell the stock. In the case of stock having a ready market, that presents no difficulty. In the case of closely held corporations, the other shareholders may be willing to buy the stock, but if the corporation itself should be the only market, section 115(g) of the code[39] will present an obstacle to the full use of the stock option as a deferred compensation plan. Even if the stock is not readily salable, the employee will be enabled to increase his investment portfolio at a much lower rate of tax than he would have paid had he received the compensation during his period of active employment, and if he is willing to sell and the corporation can and will buy his entire holdings

[37] So far as pertinent here, §24(c) provides that "no deduction shall be allowed under §23(a)" for the accrual of liability for compensation to a person on the cash basis who directly or indirectly owns more than 50% in value of the corporation's outstanding stock unless payment is made within two and one-half months after the close of the corporation's taxable year. If a pension agreement matures and is nonforfeitable, the entire obligation of the corporation probably accrues, but if the employee directly or constructively owns more than 50% of the stock, the deduction is lost under §24(c). Of course, the retirement plan would be one deferring the receipt of compensation within the meaning of §23(p), and hence if the deferred compensation payments were deductible under that subsection, they would be deductible in the year in which paid. To be deductible under §23(p), however, the amount must be deductible under §23(a) without regard to §23(p), and in view of the fact that in the circumstances to which it applies, §24(c) provides that no deduction shall be allowed under §23(a), it cannot be said with assurance that §23(p) would save the deductions.

[38] Estate of John J. Hessian, P-H T.C. Memo. Dec. ¶43,203 (1943). See Dillis C. Knapp, 41 B.T.A. 23 (1940); Walter I. Bones, 4 T.C. 415 (1944). U.S. Treas. Reg. 111, §29.42-2 provides: "To constitute receipt [when income is not actually reduced to possession] the income must be credited or set apart to the taxpayer without any substantial limitation or restriction as to the time or manner of payment or condition upon which payment is to be made. . . ."

"An executory limitation is none the less a condition because performance rests with the grantee." Schaefer v. Bowers, (2d Cir. 1931) 50 F. (2d) 689 at 691.

[39] Subsection (1) of §115(g) provides that if a corporation cancels or redeems its stock "at such time and in such manner as to make the distribution and cancellation or redemption in whole or in part essentially equivalent to the distribution of a taxable dividend, the amount so distributed in redemption or cancellation of the stock, to the extent that it represents a distribution of earnings or profits accumulated after February 28, 1913, shall be treated as a taxable dividend."

in the corporation he could do so without risk that any portion of the proceeds would be treated as a taxable dividend.[40] Similarly, upon his death, if the value of his stock comprises more than 50 per cent of the value of his net estate, his stock holdings can be partially liquidated without invoking section 115(g) to the extent that the sale price does not exceed his estate and inheritance tax liabilities.[41] Imperfect as such an arrangement may be, it nevertheless presents under the present uncertain state of the law with respect to deferred compensation, a method which is subject to fewer risks than any other plan yet devised except the section 165 arrangements.

[40] Treas. Reg. 111, §29.115-9.
[41] I.R.C., §115(g)(2).