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The key difficulty however is the requirement that the investor be an individual. Subsidization of an inventor's activity would seem to be the best means of promoting inventive activity particularly in view of the fact that an inventor's income, before the product of his efforts is realized, may often be meager.[58] Such subsidization represents a deterring risk to an individual which could more easily be absorbed by entities desirous of fostering inventive activity from other than charitable motives.

Be this as it may, the concrete result of the intricate mechanism of section 1235, and the alternative possibilities under the prior law, is that practitioners must carefully evaluate the circumstances of the inventor and investor client. While capital gain benefits may ostensibly be easier to obtain under section 1235, the expansive possibilities of the prior law may be more advantageous.

George M. Gibson

CURRENT VIEWS ON THE TAXATION OF STOCK OPTIONS

The most effective means of compensating the corporate executive and other valuable employees in light of our present taxing structure is a problem which constantly commands the attention of corporate employers throughout the country. The ideal form of compensation of course is one which provides a maximum, non-taxable, economic benefit for the employee, and at the same time, allows a maximum deductible expense to the employer. Since absolute realization of this ideal is usually impossible under our present income tax code the problem becomes one of formulating compensation plans which most nearly approach it.

One of the most popular methods of tax-free compensation is the use of fringe benefits. These often include such items as country club memberships, various types of insurance benefits,[1] company cars, interest free loans,[2] expense accounts, and the like. In general this type of compensation is non-taxable to the employee, and at the same time it may be fully deducted by the employer. However, the economic benefits which may be conferred by this method are usually not substantial, and these plans are often subject to close scrutiny by the

58. The income spreading provisions of the 1954 Code are beyond the scope of this paper but should be consulted if there is a chance that a transaction will not qualify for capital gain benefits.

1. INT. REV. CODE OF 1954, §§105-06. These sections deal with health and accident insurance plans and provide that, generally premiums paid by the employer as well as most benefit payments received by the employee are excludable from the employee's gross income.

2. Rev. Rul. 713, 1955—2 CUM. BULL. 23. Here the Commissioner ruled that interest free loans from the employer to the employee do not constitute taxable income to the latter.

Commissioner. Generally, some business purpose must be shown to justify this type of plan, for if the benefits are found to be of a purely personal nature there is a great likelihood that they will be treated as ordinary income to the employee thus resulting in full taxability to him and at the same time causing the complete loss of a deduction for the employer.

Another device in this area which is popular especially where substantial economic benefits are sought to be conferred is the stock option plan. Section 421 of the Internal Revenue Code of 1954 defines a "restricted stock option" and provides that the gains which result from the issuance of such an option to employees shall be taxed at capital gains rates. At the same time "unrestricted" options which do not meet the requirements of this section are left to be taxed according to the general rules in conjunction with section 61 of the Code.

If a stock option qualifies under section 421 the general rule is that no taxable gain is realized either when the option is granted or when it is subsequently exercised. In the eyes of the taxing powers income accrues to the taxpayer only to the extent of the gain on the subsequent sale of the stock acquired by the exercise of the option, and this income is liable only to tax at capital gains rates.

The possibility of realizing only a capital gain on the profits from a stock option transaction at first seems extremely appealing. However, it should be observed that substantial restrictions must be complied with before an option plan can qualify for special treatment under section 421. Often, then, the operation of these restrictions serves to substantially lessen many of the advantages which would otherwise be inherent in such favorable tax treatment. For example, the section requires that the spread between the option price of the stock and its fair market value at the time the option is granted be limited to fifteen per cent of the value of the stock at the time. Also, where the amount of this spread is greater than five per cent of the value of the stock at the time of the granting of the option, certain elements of ordinary income are present. Further, there are various time limitations on the exercise of the option and the disposition of the stock acquired thereby. And finally the section is extremely difficult to apply in the case of closely held corporations whose stock does not possess a readily ascertainable market value.

Thus, while statutory restrictive stock option treatment is advantageous to a degree, it still has sufficient shortcomings to motivate the taxpayer to seek more desirable substitutes.

The treatment of non-restricted stock options, that is those which do not qualify for special treatment under section 421, has been in a state of constant

unrest for quite some time and particularly so in recent years. The original approach to the problem, adopted by both the lower courts and the Treasury Department was to distinguish between "compensatory" and "proprietary" options for the purpose of determining whether ordinary income had been realized by an employee on the transaction.[3] This determination turned primarily on the intent of the parties to the plan.[4] As a consequence, if the option was found to be in the nature of compensation, that is "compensatory," ordinary income was held to have been realized when the option was exercised to the full extent of the spread between the option price of the stock, and its fair market value at the time of exercise.[5] The purchase price of the stock so acquired then became its basis, and subsequent gains and losses received capital gain or loss treatment.

In contrast to the above treatment, if it was determined that the purpose of the option in question was to secure a share in the ownership of the business for the employee, the option was characterized as "proprietary," with the result that no ordinary income was realized by the employee on the transaction no matter how large the spread.[6] Thus, here again the purchase price of the stock would be its basis for determining subsequent gain and loss, but aside from a capital gains tax on income from a subsequent sale, no other tax was levied on this type of transaction.

The first major inroads made by the Treasury upon this doctrine appeared to have occurred in 1945 beginning with the case of *Commissioner v. Smith.*[7] In that case, an employee was granted an option to purchase shares of a corporation held by the employer. The option was admittedly compensatory in nature, but it was assumed that it had no value at the time it was issued. The Court held that even here the measure of income was the spread between the option price and the fair market value of the stock at the time the option was exercised, and in so doing stated in sweeping terms that, "Section 22(a) of the Reveneu Act (of 1939) is broad enought to include any economic or financial benefit conferred on the employee as compensation, whatever the form or mode by which it is effected . . . ."

With this encouragement the Treasury Department announced an amendment to its regulations to the effect that all transfers of property by an employer to an employee for less than its fair market value should result in fully taxable

3. Connolly's Estate v. Commissioner, 135 F.2d 64 (6th Cir. 1943); Clarence L. Landen, 1 T.C.M. 411 (1943).
4. Connolly's Estate v. Commissioner, *supra* note 3; Rossheim v. Commissioner, 92 F.2d 247 (3d Cir. 1937).
5. Rossheim v. Commissioner, *supra* note 4; Larkin v. United States, 78 F.2d 951 (8th Cir. 1935).
6. Rossheim v. Commissioner, *supra* note 4; Clarence L. Landen, *supra* note 3.
7. 324 U.S. 177 (1945).

compensation to the extent of the savings to the employee.[8] The apparent purpose of this amendment so far as is pertinent to the field of stock options was to eliminate the effect of the distinction between compensatory and proprietary options, and render both types fully taxable at ordinary income rates according to the formula laid down by the Supreme Court in the *Smith* case. However, in the cases which followed the lower courts ignored the effect of this regulation on the stock option transaction,[9] and the distinction between proprietary and compensatory options was to persist for another decade.

This conflict between the lower courts and the Treasury continued until 1956 at which time the ruling of the Supreme Court in the case of *Commissioner v. LoBue*[10] represented a complete victory for the Treasury. In this case the Tax Court held that the taxpayer had realized no income by virtue of his exercise of a stock option given him by his employer, since the option was issued for the purpose of giving the employee a proprietary interest in the business.[11] The Court of Appeals affirmed.[12] The Supreme Court reversed[13] and held (7-2)[14] that the spread was fully taxable. The reasoning was that under section 22(a) of the Internal Revenue Code of 1939 Congress had intended to tax all gains which were not specifically exempted, and that since this type of a transaction did not fall within any exemption (the Court ruled out the possibility of a gift) the resulting gain was fully taxable. Thus this decision resulted in a twofold victory for the Treasury in that the Court abolished the proprietary-compensatory distinction that had persisted in the lower courts, and also lent its approval to the long standing practice of the Treasury of computing the gain at the time the option is exercised.[15]

Since this decision has permanently deprived the taxpayer of his favorite device for obtaining favored tax treatment in this area, namely that of the proprietary option, recourse must be had to other possibilities. It appears at present that there exist only three alternatives worthy of any note. First, the transaction may be a gift in which case no income would be realized by the employee. Secondly, the market value of the stock purchased by exercise of the

8. U.S. Treas. Reg. 118, §39.22(a)-1 (1946).
9. Commissioner v. Straus, 208 F.2d 325 (7th Cir. 1953); Van Dusen v. Commissioner, 135 F.2d 64 (6th Cir. 1943).
10. 351 U.S. 243 (1956).
11. 22 T.C. 440 (1954).
12. 223 F.2d 367 (3d Cir. 1955).
13. The Court relied especially on Commissioner v. Glenshaw Glass Co., 348 U.S. 426 (1955); and Commissioner v. Smith, *supra* note 7.
14. Justices Harlan and Burton dissented on the ground that the option itself was compensation, and that the proper time to compute the gain was when the option was received.
15. In Joseph Kane, 25 T.C. 1112 (1956), *aff'd per curiam,* 238 F.2d 624 (2d Cir. 1956), *cert. denied,* 353 U.S. 931 (1957), this same rule was applied where the option in question was given to the employee's wife and was exercised by her. The Court found that the option was granted as compensation to the employee and as such was taxable as income to him when his wife exercised it.

option might be so impaired by various restrictions that there would be no "spread" between the option price and the fair market value. Finally, under certain circumstances it may be apparent that the option itself was intended as the compensation, in which case the appropriate tax could be paid when the option was granted, thus rendering future gain liable only to capital gains tax.

First as to the possibility of a gift, the *LoBue* decision points out that where an employer-employee relationship exists such treatment is highly unlikely, but it is not impossible. In *Neville v. Brodrick*,[16] shares of stock were given to the taxpayer who for twenty-nine years had been employed by the small, closely held corporation. The Court of Appeals held that the District Court's findings to the effect that the taxpayer had failed to rebut the presumption of compensation were clearly erroneous. This case involved stock rather than options, but its reasoning should be equally applicable to the latter transactions. However, the facts of this case are quite peculiar, and the burden of proof on the taxpayer is so immense that the classification of the option as a gift is generally not a satifactory solution to the taxing problem.

A second, and more practical device is one which effiectively eliminates income upon exercise of the option. This is accomplished by relying on the rule in the *LoBue* case that compensation upon exercise of the option is measured by the spread between the option price and the fair market value of the stock at the time of the exercise. The procedure is to place a sufficient number of restrictions upon the stock obtained by exercising the option so that it has no appreciable fair market value when it is received. Support for this device is found primarily in two Tax Court cases.

First, in *Harold H. Kuchman*,[17] an employee was offered an opportunity to purchase, at five dollars per share, stock which was subsequently offered to the public at twenty-five dollars per share. However, the stock purchased by Kuchman was restricted to the extent that he could not sell it for one year without the consent of the underwriters who had issued it, and, in the event that he terminated his employment within one year for the purpose of accepting another job or going into business for himself, he was required to offer the shares back to the underwriters at the price which he had paid for them. Because of these restrictions, the Court held that the stock had no reasonable ascertainable market value when it was issued. In conjunction with this case, in *Robert Lehman*,[18] the taxpayer, by exercise of a compensatory option, obtained certaain shares which contained a large number of restrictions. The government stipulated that the shares had no ascertainable market value at the time the option was exercised. Upon expiration

16. 235 F.2d 263 (10th Cir. 1956), *reversing*, 133 F.Supp. 716 (D. C. Kan. 1955).
17. 18 T.C. 154 (1952 *acq.*).
18. 17 T.C. 652 (1952 *acq. on pertinent point)*.

of the restrictions the stock was sold and the income reported as a capital gain. The Tax Court upheld the taxpayer's treatment, rejecting the government's contention that ordinary income was realized when the restrictions on the stock expired.

Some further support for this particular approach to the problem may be found in *MacDonald v. Commissioner.*[19] There stock acquired by exercise of a compensatory option could not be sold during the taxpayer's term of employment and further restrictions were imposed by operation of the provisions of the Securities Exchange Act of 1934 governing short swing insider's profits.[20] The Court labeled the Commissioner's contention that the taxpayer could resign from his $75,000 per year position and sell the stock "absurd," and held the restrictions sufficient to destroy the stock's market value. On remand, the Tax Court denied the Commissioner's motion for additional hearing on the ground that there was no other method of computing gain on the transaction.[21]

In the above case it should be noted that the Court seemed to rely primarily on the prohibition against the sale during the term of employment. It is questionable whether the relevant provisions of the Securities Exchange Act would be sufficient to destroy the stock's market value without the aid of some more substantial restrictions. The Supreme Court itself has recognized the possibility that stock of a highly speculative nature could be deprived of an ascertainable fair market value when a restrictive agreement made its sale impossible.[22] However, it appears that the restrictions must be of a substantial nature in order to suffice. A right of first option in the officers and controlling stockholders of the employer corporation has been held insufficient.[23] Also, the Commissioner has ruled that a restriction preventing disposition of the stock for a period of five years did not prevent it from having an ascertainable market value.[24]

Finally, it should be noted that the great majority of the materials relied on in this area antedate the decision in the *LoBue* case, and whether the courts will remain receptive to this view in the face of increased use and also in light of a proposed Treasury regulation which will be discussed at the end of this paper, remains questionable.

The final approach, that of treating the option itself as compensation,

19. 230 F.2d 534 (7th Cir. 1956).
20. SECURITIES EXCHANGE ACT OF 1934, §16(b), 49 STAT. 881 (1934), 15 U.S.C. §78p(b) (1952), provides in substance that any profit realized by a director or officer of a corporation from the sale of stock within a period of less than six months is recoverable in a suit by the issuing corporation, or if it refuses to sue, by a shareholder in its behalf and for its benefit.
21. H. E. MacDonald, 16 T.C.M. 208 (1956).
22. See *e.g.,* Helvering v. Tex.-Penn. Oil Co., 300 U.S. 481 (1937).
23. Jay N. Sarling, 4 B.T.A. 499 (1926).
24. I.T. 2309, V-2 CUM. BULL. 114 (1926).

seems to be the most fruitful for the taxpayer in light of current circumstances. Here, the taxpayer would realize ordinary income only at the time the option was issued, to the extent of its fair market value, and any subsequent gain upon the sale of stock acquired by exercise of the option would be taxable at capital gains rates. In both the *Smith*[25] and the *LoBue*[26] decisions the Supreme Court has recognized the possibility of such treatment, and two Court of Appeals cases lend further support to this approach.

In *Commissioner v. Stone's Estate*,[27] the taxpayer purchased one hundred warrants at ten dollars per warrant. Each could be exercised after six months from the date of purchase to acquire one hundred shares of the employer's stock at twenty one dollars per share. At the time of the issue the stock was selling for $19.75 per share. In their returns for that year both the taxpayer and his employer treated the transaction as a bargain purchase of warrants worth $6,000. Thus the employee reported $5,000 as ordinary income and the corporation deducted a corresponding amount. Subsequently, when the warrants were sold the profit was declared as a capital gain. The Commissioner contended that the excess of the gain over the ten dollars per warrant cost was ordinary income but the Court found for the taxpayer saying that the parties were dealing in the warrants themselves. Reliance was placed on the fact that the warrants were paid for, that they were negotiable from the outset, and that they were not subject to the usual restrictions found in stock options. Also, the Court held the fact that the corporation had deducted an amount at least equal to the capital gain of the taxpayer when the warrants were sold, not to be controlling.

The second case in point is *MacNamara v. Commissioner*.[28] There an option granted to the taxpayer to purchase 12,500 shares of the stock of his employer at sixteen dollars per share was stated in the employment contract to be "in consideration of the employee's acceptance of employment." The market value of the stock at the time was nineteen dollars per share. The option was exercisable one-quarter immediately, and one-quarter at the end of each of three succeeding six month intervals. In returns for the year the taxpayer reported $16,375 as compensation, and employer claimed a commensurate deduction. In upholding this treatment the Court relied on the fact that the options were described as compensation for the year in which they were granted and also pointed to the consistent treatment by both the taxpayer and the employer.

Thus, in light of these decisions, if certain conditions are met, it seems quite likely that the taxpayer will be permitted to treat the option itself as compensation at the time it is granted. The most important requirements here seem to

25. 324 U.S. 177 at 181 (1945).
26. 351 U.S. 243 at 249 (1956).
27. 210 F.2d 33 (3d Cir. 1954), *affirming* 19 T.C. 872 (1953).
28. 210 F.2d 505 (7th Cir. 1954), *reversing* 19 T.C. 1001 (1953).

be that the parties evidence an intent that the option itself be immediate compensation, that the option be immediately negotiable (although its exercise may be restricted to some not too far distant date) and that it have an ascertainable market value in excess of any price which may be paid for it.[29]

The final development in the area of unrestricted options which merits attention is a proposed regulation in which the Commissioner expresses his most recent views on the taxation of such options.[30] This regulation purports to govern the taxability of all options granted for any reason connected with employment, to which section 421 of the Internal Revenue Code of 1954 does not apply, regardless of whether the option is granted by the employer, a parent or subsidiary of the employer, a shareholder of any such companies, or by any other person and regardless of whether the option is granted to an employee, a member of his family, or any other person, and regardless of whether the option is to purchase stock of the employer, parent, subsidiary, or stock of any other corporation or to purchase any other property. First is stated the general rule that as a result of such a transaction ordinary income is realized by the employee to the extent of the spread between the option price and the fair market value of the stock at the time of the exercise. However, the regulation goes on to make two important exceptions. First, it states in substance that if at the time the option is exercised, the property which is obtained thereby bears restrictions which "substantially affects its value" the employee realizes compensation at the time these restrictions lapse, to the extent of the spread between the option price and the market value of the property at that time. Secondly, the regulation goes on to provide that should an option be sold before its exercise the employee realizes compensation to the extent of the gain realized on such a sale.

At first glance then, a future adoption of this regulation would seem to quell any hopes which taxpayers may have of reaping benefits in the form of capital gains by the use of option plans which do not meet the requirements of section 421. However, this is not necessarily true since, although Treasury Regulations must be followed unless they are unreasonable or inconsistent with the revenue statutes, they are not absolutely binding upon the courts.[31]

Obviously, the proposed regulation would have no effect on options which could be classified as gifts, since these are exempt under specific provisions of the Code.[32] Also, the regulation in question will probably have no application to stock options which themselves are intended as compensation. Where an option with a clearly ascertainable market value is granted with the intent that it be

29. See, *e.g.*, Dean Babbitt, 23 T.C. 850 (1955).
30. U.S. Treas. Reg. §421-6, proposed 11-10-56.
31. Commissioner v. So. Texas Lumber Co., 333 U.S. 496 (1947); Burk-Waggoner Oil Ass'n v. Hapkins, 269 U.S. 110 (1925).
32. INT. REV. CODE OF 1954 §102(a).

present compensation it is analogous to income in the form of property and the tax should be computed immediately. In such a case it would seem to be arbitrary and unreasonable to postpone the determination of the tax until some future date where the real income value of the option could be affected only by fortuitous circumstances.

The effect of the proposed regulation will be the greatest where ordinary income is sought to be avoided by placing restrictions on the stock acquired by exercise of an option. If, as the Supreme Court decided in the *LoBue* case, where an option itself is not compensation, the computation of income may be postponed until the option is exercised, it would seem logical also that where the market value of the stock so acquired is impaired by certain restrictions the determination of tax may be further postponed until these restrictions expire and the full income value of the option is realized. The answers to all of these problems must now await final determination by the courts, and the events of the next few years should have a pronounced influence on the taxation of stock option plans.

—*Edwin P. Yaeger*