Buffalo Law Review

Volume 3 | Number 2 Article 17

4-1-1954

Income Tax—Exercise of Employee's Stock Options

Jules Gordon

Follow this and additional works at: https://digitalcommons.law.buffalo.edu/buffalolawreview

Part of the Taxation-Federal Commons

Recommended Citation

Jules Gordon, *Income Tax—Exercise of Employee's Stock Options*, 3 Buff. L. Rev. 321 (1954).
Available at: https://digitalcommons.law.buffalo.edu/buffalolawreview/vol3/iss2/17

This Recent Decision is brought to you for free and open access by the Law Journals at Digital Commons @ University at Buffalo School of Law. It has been accepted for inclusion in Buffalo Law Review by an authorized editor of Digital Commons @ University at Buffalo School of Law. For more information, please contact lawscholar@buffalo.edu.

Code § 24 (a). The court states that the presumption can only be overcome by detailed evidence that each expenditure is different from, or in excess of, the amount the taxpayer would otherwise spend for his own personal purposes. Therefore if the taxpayer is able to show that the portion of an expenditure for entertainment which he has spent for himself is in excess of his normal personal expenditures, the difference between what was spent and what he would have normally spent will be deductible.

The court sets a standard by which it ascertains the incidental benefit which an individual receives from a business expenditure, and declares that part to be a personal expense because of the fact that the taxpayers participates in, and benefits from, the activity for which the expenditure is incurred and is not in excess of his usual personal expenditure. This is in addition to the burden the taxpayer has always had, *i. e.*, showing that the reason for the expenditure was to directly benefit his business. Although the court in the instant case speaks only of food and entertainment, this new approach could logically be extended to all business expenses, a portion of which inures as an incidental benefit to the taxpayer as a result of his participation in the incurring of such expense. The basis for the apportionment is founded on the nondeductibility of personal expenditures under Int. Rev. Code § 24 (a). Application of this rule to business trips which result in partial vacation to the taxpayer, and other similar types of expenditures is not beyond a strict application of this decision.

Rudolph F. De Fazio.

INCOME TAX — EXERCISE OF EMPLOYEE'S STOCK OPTIONS

In August of 1945, at the same time that the taxpayer joined his employer corporation, he received an option to purchase shares of the corporation's stock at a price below the then market value. The option was freely assignable and was not dependent upon the continued employment of the taxpayer. The corporation spoke of the option as "additional compensation for the current year" (1945).

When the taxpayer exercised the option in 1946 and 1947 the stock was selling at a much higher price. The Commissioner assessed a deficiency on the excess of the market value at the time of exercise over the option price. *Held,* reversing the Tax Court: No income accrued to the taxpayer by reason of the exercise of the option in 1946 and 1947 since the only compensation intended was in the grant of the option in 1945. *McNamara v. Commissioner,* 210 F. 2d 505 (7th Cir. 1954).

Prior to 1945, judicial decisions on the taxibility of employee stock option plans had depended on findings of fact as to whether the grant of the option was intended as compensation or to give the employee "a proprietary interest" in the corporation. Where there was intention to "compensate" this was found to be in the *exercise* of the option, with ordinary income accruing to the extent of the difference between the fair market value of the stock at date of exercise and the option price. *Albert Erskine,* 26 B. T. A. 147 (1932); *Edward Connolly,* 45 B. T. A. 374 (1941), *aff'd,* 135 F. 2d 64 (6th Cir. 1943). For the rationale of the proprietary interest finding, see *Delbert Geeseman,* 38 B. T. A. 258 (1938).

Before the *Geeseman* case, *supra,* the Treasury Regulations took the position that the difference between market value and option price, if substantial, was ordinary income. T. D. 3435 II-1 CUM. BULL. 50 (1923). After that case the Regulations were changed to the position that the difference, if substantial, would be income only to the extent it was in the nature of compensation for services. U. S. Treas. Reg. 111, § 29.22 (a)-1 (1943).

In a 1945 case, the Supreme Court held that the excess of market value at the date of exercise over the option price was ordinary income where there was no spread between option and market price when the option was granted and it was found that the parties contemplated compensation to the taxpayer. *Commissioner v. Smith,* 324 U. S. 177 (1945). Dictum in the *Smith* case suggested that were there a spread at the time the option was granted so that the option itself had a present marketable value, the option might be found to be the only compensation intended. *supra* at 179.

Despite this dictum, shortly after the *Smith* decision the Treasury amended its Regulations in T. D. 5507, 1946-1 CUM. BULL. 18, which provided that if property is transferred by an employer to an employee for an amount less than its fair market value, the difference *is in the nature of compensation.* At the same time the Treasury issued I. T. 3795, 1946-1 CUM. BULL. 15 which provided that:

> [I]f an employee receives an option on or after Feb. 26, 1945 (the date of the *Smith* decision) to purchase stock of an employer corporation, . . . and he *exercises* such option, [he] realizes . . . income . . . on the date . . . he receives the stock to the extent of the difference between the fair market value of the stock when received and the price paid therefor.
>
> If the employee *transfers* such option for consideration . . . [he] realizes taxable income by way of compensation on the date he receives such consideration to the extent of the value of the consideration. (Emphasis added.)

The scope of this last section of I. T. 3795 was severely restricted in a subsequent case where the taxpaper *purchased* stock options from his employer corporation and later *sold* them at a profit. The Tax Court, relying on the dictum in the *Smith* case, held that the spread between the sale and purchase price of the options was not ordinary income and that I. T. 3795 did not apply. *Lauson Stone,* 19 T. C. 872 (1953), *aff'd,* 210 F. 2d 33 (1954).

Although in the instant case the employee exercised, rather than sold the options, which he received in connection with an employment contract rather than by purchase, the court reached the same result as in the *Stone* case, *supra.* The court here relies heavily on the manifest intent of the corporation that the option be considered compensation for the year in which it was granted, and the finding that the option could have been sold for a substantial sum in the year of its receipt.

By holding that, despite the subsequent exercise, the value of the option at the time of grant was the only compensation involved, the *McNamara* case has now completely vitiated I. T. 3795, *supra,* and its rigid objective criteria.

Since the court did find that the grant of the option was intended to be compensation, T. D. 5507 is not yet squarely controverted if the option, rather than the stock purchased pursuant to it be considered the "property transferred." However, there seems to be little doubt that the courts have not departed from their position that what is compensation under the code is determined by the action and intention of the parties and not by Treasury Regulations.

Jules Gordon

INTERPLEADER — TEST OF MUTUALLY EXCLUSIVE CLAIMS

A and B are brokers. In an action by A to recover commissions from vendor, B was interpleaded. In the contract of sale between vendor and purchaser, the latter designated B as procuring broker and agreed to deliver to vendor an agreement indemnifying him against loss by reason of any claim by any other broker for commissions. Simultaneously, another agreement was made between vendor and B reciting the contents of the above contract and stating that vendor was to pay $90,000 to B. *Held* (4-1): B can rest on his agreement with vendor; A's claim for commissions earned is not affected thereby; therefore, interpleader should not have been granted. *Norman v. Oakland Golf Club,* 282 App. Div. 960, 125 N. Y. S. 2d 859 (2d Dep't 1953).