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NOTES

Stock Options and the Tax Reform Act of 1969: The Question of Continued Utility*

Prior to the Tax Reform Act of 1969, stock options were very useful devices for transferring economic benefits from corporate coffers to executive pockets without overly burdensome treatment by the Internal Revenue Service. In 1969, however, Congress enacted five new Internal Revenue Code sections and modified a sixth[1] in an effort to dampen the affluent American's enthusiasm for tax loopholes. Since the Act's passage, there has been much discussion about the effects of the new provisions on stock option arrangements, with commentators divided on the question whether stock options remain worthwhile as compensation devices.[2]

This Note attempts its own exploration of the compensatory utility of stock options, beginning with brief sketches of the early tax law relating to options; the developing legislative, regulatory, and judicial refinements; and, the state of the law immediately prior to the Tax Reform Act. The basic operating provisions of the new Act and the proposed regulations are then examined as they relate to both statutory and nonstatutory stock options. After outlining the goals that employers and employees seek by using stock options, the Note's conclusion attempts to analyze the degree to which those goals may still be attained in light of the tax consequences of option arrangements under the 1969 Act.

I. Stock Options Prior to the Tax Reform Act of 1969

A. *Early Treatment*

The initially enacted federal tax statutes did not deal specifi-

* This Note was awarded the Edmund Morgan Prize, given for the best student writing submitted to the *Vanderbilt Law Review* during the 1972-73 academic year.

1. The new Code sections are: (1) §§ 56-58 (imposing a minimum tax of 10% on specified items of tax preference, including tbe difference between fair market value and option price for qualified options, and the deductible one-half of long term capital gains); (2) § 83 (setting out new rules to govern the transfer of propery in connection with employment); and, (3) § 1348 (limiting the maximum tax rate on "earned income" to 50%). All were added by: Act of Dec. 30, 1969, Pub. L. No. 91-172, 83 Stat. 487. The amended section is § 1201 (elimination of the 25% alternative capital gains rate in favor of taxation at one-half the ordinary income rate beyond the first $50,000 of capital gains). Act of Dec. 30, 1969, Pub. L. No. 91-172, § 511(b), 83 Stat. 635.

2. *See, e.g.*, Bachelder, *Executive Compensation After the Tax Reform Act of 1969*, 48 Taxes 652 (1970); Childs, *Compensating the Executive After the Tax Reform Act with Stock Options, Restricted Stock, Deferred Pay—and Even Cash*, 48 Taxes 801 (1970); Rendell, *Qualified Stock Options: Post-1969 Use Hinges Upon Careful Planning*, 32 J. Tax 356 (1970).

cally with the tax consequences of corporate use of stock options as devices to secure optimum executive performance. This lack of specific statutory guidance, however, did not deter the Commissioner from claiming, under the broad language of section 22(a),[3] that all transfers of stock from an employer to an employee for substantially less than the stock's fair market value at the date of transfer constituted taxable "compensation for personal services" in the amount equal to the difference between option price and current value.[4] Since options confer an economic benefit and clearly are not gifts from disinterested sources, logic seems to have favored the Commissioner's stance, at least to the extent that compensation seems to have occurred at some point; courts, however, did not respond favorably. Under the view that stock options that were intended by the employer simply to instill in the employee a sense of ownership and proprietary concern for corporate welfare did not constitute the sort of compensation contemplated by the statute, the circuit courts and, eventually the Board of Tax Appeals, came to apply a "compensatory-proprietary" test.[5] Under this test courts would examine the total factual situation in each case, including such indicia as the contractual language[6] and the size of the exercise "spread"[7]—the difference between the option price and the fair market value of the stock—to determine the intention of the parties. If the parties were found to have intended only the granting of a proprietary interest, the employee was not taxed upon receipt or exercise of the option and the corporation was not allowed a deduction for the option's cost[8] to it.[9] When, on the other hand, a compensatory intent was found, the spread at exercise was taxed as ordinary income to the employee and the corporation was allowed a corresponding "ordinary and necessary" expense deduction in the year of exercise. In either event, gain realized upon the employee's ultimate disposition of the optioned stock was treated as capital gain.[10]

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3. "'Gross income' includes . . . compensation for personal service of whatever kind and in whatever form paid . . . ." Act of Feb. 10, 1939, ch. 1, § 22(a), 53 Stat. 9.

4. *See* Treas. Reg. 94, Art. 22(a)-1 (1936); Treas. Reg. 77, Art. 51 (1932); Treas. Reg. 74, Art. 51 (1928); Treas. Reg. 69, Art. 31 (1926); Treas. Reg. 65, Art. 31 (1924).

5. *See* Lyon, *Employee Stock Options Under the Revenue Act of 1950,* 51 COLUM. L. REV. 1, 5-10 (1951).

6. *See, e.g.,* Clarence L. Landen, 1 CCH TAX CT. MEM. 411 (1943).

7. *See, e.g.,* Gordon M. Evans, 38 B.T.A. 1406 (1938); Wm. B. Gillies, 8 P-H B.T.A. MEM. 39-286 (1939).

8. *See* text accompanying notes 167-69 *infra.*

9. *See* Lyon, *supra* note 5, at 6.

10. *Id.*

In *Commissioner v. Smith*,[11] however, in an otherwise unremarkable opinion holding that an option granted by the employer corporation to purchase stock in a *third corporation* at approximately the grant-date fair market value was "compensatory," the Supreme Court went on to state that "[s]ection 22(a) of the Revenue Act 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."[12] Amidst a storm of protest from the bar,[13] and despite the Court's apparently qualifying use of the "as compensation" phrase, the Commissioner relied upon the *Smith* case as authority for prospective application of the proposition that the "economic benefit" necessarily obtained by purchasing stock at an option price below its fair market value—the spread at exercise—should be taxable in every instance, regardless of the parties' intent.[14] In 1946, the regulations were amended to reflect this position,[15] and critics of the Treasury view appealed to Congress for relief.[16]

1. *Legislative Reaction.*—Criticism of the Commissioner's all inclusive post-*Smith* approach led ultimately to the inclusion of provisions in the Revenue Act of 1950[17] explicitly preserving favorable tax treatment for certain stock options. Although the legislative history of the Act does not reveal a precise statement of the policy bases underlying the congressional action, the Senate Finance Committee's Report on the Bill disapprovingly referred to the impediment to use of stock options for "incentive purposes" raised by the Commissioner's approach, and cited the "uncertainty as to whether the regulations [were] in accordance with the law" as an additional reason for the Bill's passage.[18] Regardless of the exact rationale behind its enactment, the Act's addition of new section 130A to the 1939 Code manifested a congressional intent to provide a safe harbor from the rigors of ordinary income treatment for arrangements meeting the requirements of the newly created classifications of

11. 324 U.S. 177, *rehearing denied with supplementary opinion*, 324 U.S. 695 (1945).
12. 324 U.S. at 181.
13. Lyon, *supra* note 5, at 11.
14. *Id.*
15. T.D. 5507, 1946-1 CUM. BULL. 18.
16. The United States Chamber of Commerce and the Association of the Bar of the City of New York, *inter alia*, presented proposals for legislative action to restore the possibility of favorable tax treatment. *See Hearings on Revenue Revisions Before Comm. on Ways and Means*, 80th Cong., 1st Sess., 1492 (1947-48).
17. Act of Sept. 23, 1950, ch. 994, § 218, 64 Stat. 942.
18. S. REP. No. 2375, 81st Cong., 2d. Sess. 59-60 (1950).

"restricted" stock options.

Under the new provision, an employee not already a substantial shareholder who received a nonassignable option with an option price at least 85 percent of the fair market value of the underlying stock at date of grant was able to escape all taxation upon grant and exercise of the option, provided he neither disposed of the stock within two years of grant or six months of exercise nor failed to satisfy the requirements of employee status within three months prior to exercise.[19] As a corollary to this "noncompensation" treatment, the employer was allowed no business expense deduction.[20] When the employee subsequently disposed of the stock thus acquired, he was entitled to capital gain treatment on all post-grant appreciation in the stock's value, although any bargain element in excess of five percent of fair market value at time of grant was taxed as ordinary income in the year of disposition.[21] The statutory holding period and spread-limitation conditions imposed by the new statute were obviously designed to ensure that the employee's tax-favored status would be, in at least some measure, tied to his continuing economic stake in the successful operation of the corporate enterprise. These facets of the statute, therefore, could be viewed as an implied legislative disapproval of the Commissioner's attempts to disregard the intent of the parties and classify all spreads at exercise as compensation income.

2. *The Continued Common Law.*—Although new section 130A purportedly was designed to relieve uncertainty about the validity of invariably classifying the spread between option price and fair market value at exercise as compensation income, the statute did not have that effect. Because the tax-consequence provisions of the statute reached only stock options that were properly "restricted," the tax treatment of all other option arrangements was necessarily still dependent upon the confusing prior case law, which had prompted the new legislation in the first place.

In 1956, the Supreme Court laid to rest at least some of the doubt surrounding nonstatutory option tax treatment by holding, in *Commissioner v. LoBue,*[22] that an assertedly "proprietary" stock

19. INT. REV. CODE OF 1939, § 130A. For a full description of the requirements for restricted stock option status imposed by § 130A see Lyon, *supra* note 5.

20. INT. REV. CODE OF 1939, § 130A, 64 Stat. 942.

21. *Id.* § 130A(b). Capital gain treatment on disposition resulted, not from any express provision in § 130A, but from the fact that the stock was a capital asset in the employee's hands.

22. 351 U.S. 243 (1956).

option nonetheless resulted in ordinary income treatment for the spread at exercise. The Court stated that "there 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."[23] This judicial endorsement of the Commissioner's antipathy to the proprietary-compensatory doctrine, however, fell short of wholesale approval of the Commissioner's total approach. The Court expressly reserved the possibility that a transferable option with a readily ascertainable fair market value might properly be taxed at the time of grant, rather than the time of exercise,[24] thus shielding from ordinary income treatment any post-grant appreciation in stock value.

Despite the normal IRS preference for early taxation, the Commissioner's desire to focus upon the time of exercise as the trigger for ordinary income treatment is easy to appreciate—if one assumes a substantially rising market, the resulting revenues are likely to be substantially greater than would be the case if the possibly minimal spread at grant were the governing criterion, even allowing for a "present value" discount. It is not, however, so easy to justify the Commissioner's approach using the concepts that underlie our taxation system as a whole. It seems clear that the elements of compensation inherent in stock-option schemes—the "bargain" resulting from a chance to purchase the stock at less than its current market value, and the opportunity to participate in any subsequent appreciation without exposure to investment risks—are in fact obtained by the employee at the date of grant. Common sense would seem to indicate, in the case of the latter element, that it is the opportunity to exercise, rather than the exercise itself, that constitutes compensation. In unremittingly advancing a theory of exercise as compensation, the Treasury approach seems to have been more opportunistic than principled—a situation that should not be considered altogether healthy, even in a society more or less committed to an adversary system of taxation. Justification for deferring taxation until exercise is perhaps best provided under the familiar rationale that when the value of an economic benefit conferred cannot be determined until a later time, the transaction will be considered

23. *Id.* at 247.

24. "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." *Id.* at 249 (citation omitted).

"open" until that time at which the gain can be measured and the tax imposed.[25] This seems to be the position the Treasury finally has adopted, as reflected by the regulations promulgated pursuant to the Internal Revenue Code of 1954.[26]

B. The 1954 Code

1. *Evolution of the Qualified Stock Option.*—The Internal Revenue Code of 1954 in large measure re-enacted the 1939 Code's restricted option provisions in the new section 421, with some changes designed to clarify previous requirements and to enhance the usefulness of the restricted stock option as a management incentive device.[27] Despite the presumably greater certainty and utility occasioned by these and subsequent changes,[28] the restricted option provisions came under increasing fire from commentators, chiefly because they accorded strikingly favorable tax treatment to highly compensated executives, often at the cost of severe dilution of shareholder equity, and because of doubts that these options were even in theory satisfactorily efficient incentive devices.[29] The rising tide of criticism reached its flood in the Kennedy administration's recommendation to Congress that the restricted stock option provisions be repealed in their entirety, on the ground that stock options were compensatory in nature and therefore should not be treated differently than wages or salaries.[30] The House Ways and Means Commit-

25. *See, e.g.*, Burnet v. Logan, 283 U.S. 404 (1931). Normally, however, the receipt of "property" is a taxable event, even though its valuation might not be exact. *See* Rev. Rul. 58-402, 1958-2 CUM. BULL. 15.

26. Treas. Reg. § 1.421-6(c), T.D. 6540, 1961-1 CUM. BULL. 161, 162-63.

27. INT. REV. CODE OF 1954, § 421 (as originally enacted). *See* MERTENS, LAW OF FEDERAL INCOME TAXATION, Code Commentary §§ 421-25:3 (J. Malone ed. 1971). Specific changes included broadening the scope of the section to cover variable price options (§ 421(d) (1) (A) (ii)), clarifying the rules governing exercise of the option after the death of the employee (§ 421(d) (6)), and providing for corporate rearrangements (§ 421(g)). *See id.*

28. Subsequent changes included the provision for a stepped-up basis in the event of exercise following the employee's death (§ 421(d) (1958)); the definition of "employer corporation" to encompass a parent or subsidiary of the grantor (§ 421(a)); and, restrictions upon the scope available for fixing the price under a variable price option (§ 421(d) (7)). *See* MERTENS, *supra* note 27, at §§ 421-25:3.

29. Griswold, *The Mysterious Stock Option*, 51 KY. L. J. 246 (1962) (originally prepared at the request of the House Ways and Means Committee, 2 HOUSE COMM. ON WAYS AND MEANS, 86th Cong., 1st Sess., *Tax Revision Compendium* 1327 (Comm. Print 1959)). *See also* Wallace, *Should We Continue to Encourage the Use of Restricted Stock Options?*, 39 TAXES 785 (1961).

30. *See* President Kennedy's 1963 Tax Message as cited in 1 HEARINGS BEFORE THE HOUSE COMM. ON WAYS AND MEANS, 88th Cong., 1st Sess., PRESIDENT'S 1963 TAX MESSAGE 25 (Comm. Print 1963).

tee, however, elected to retain favorable tax treatment for statutory stock options, although it recognized that "abuses" had made the previous statutory scheme unsatisfactory.[31] The Committee reasoned that increased profitability in individual businesses was good for the economy as a whole and that, since management's having a stake in the successful operation of business "provides important incentives to expand and improve the profit positions of the companies involved,"[32] the stock option provisions should be continued.

The Committee's curative recommendations, which were subsequently enacted into sections 421-25 of the Code,[33] involved the creation of two new statutory categories of stock options,[34] and the prospective elimination of the old "restricted" category.[35] The direct successor to the restricted option, the "qualified"[36] option, was the product of major corrective surgery on the restricted option scheme. To ensure that recipients of these new options would in fact be acquiring a "stake in the business," favorable tax treatment was conditioned upon the underlying stock's having been held by the employee for a minimum period of three years.[37] To lessen the probability that gain under the option agreement would follow automatically from participation in the plan, rather than depend upon the individual proprietary efforts of employees, the maximum period for which an option could remain outstanding was reduced to five years,[38] no bargain element was allowed at the time of grant,[39] and the corporation's ability to grant new qualified options at lower prices under declining market conditions was eliminated.[40] Further,

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31. H.R. REP. No. 749, 88th Cong., 1st Sess. 63-64 (1963).

32. *Id.* at 64.

33. Act of Feb. 26, 1964, Pub. L. No. 88-272, 78 Stat. 63-73.

34. The two categories of newly created options were the "qualified stock option," defined in § 422, and the "employee stock purchase plan," defined in § 423. The employee stock purchase plan was designed to encourage nondiscriminatory methods of raising capital by allowing discount purchases of stock by employees when the statutory conditions are met. H. R. REP. No. 749, *supra* note 31, at 69-71. Since this Note deals with the problems of executive compensation via stock options, and since the nondiscrimination requirements of § 423 make it an impractical executive incentive tool, the section will not be discussed further.

35. INT. REV. CODE OF 1954, § 424(b), defines restricted stock option to include only such options granted prior to January 1, 1964. Section 424(c) (3), however, provides a special "extension" for options granted pursuant to pre-1964 binding written contracts and certain pre-existing nondiscriminatory arrangements.

36. INT. REV. CODE OF 1954, § 422.

37. H.R. REP. No. 749, *supra* note 31, at 67; INT. REV. CODE OF 1954, § 422(a) (1).

38. H.R. REP. No. 749, *supra* note 31, at 67; INT. REV. CODE OF 1954, § 422(b) (3).

39. H.R. REP. No. 749, *supra* note 31, at 68; INT. REV. CODE OF 1954, § 422(b) (4).

40. H.R. REP. No. 749, *supra* note 31, at 68; INT. REV. CODE OF 1954, § 422(b).

a continuous employment requirement was added;[41] shareholder approval was required for qualified option plans,[42] presumably because shareholders directly bear the cost in terms of equity dilution; and a provision was inserted to preserve substantially all of the section's benefits for employees of close corporations that miscalculate market value, which by definition is undeterminable, in good faith attempts to set option prices.[43]

Upon satisfaction of the qualified option conditions, the same tax treatment formerly afforded restricted options followed—no tax upon grant[44] or exercise[45] of the option, and capital gain treatment upon disposition of the underlying stock.[46] As under previous law, no deduction was allowed the employer corporation.[47] In the event of a disqualifying disposition, for example one that occured less than three years from exercise of the option, the amount of the spread at exercise was treated as ordinary income to the employee in the year of disposition, with a corresponding deduction to the employer.[48]

Although the statutory requirements were clearly much more restrictive than under former law, the statutory stock option remained a highly attractive device for highly compensated employees. Given the disparity between the alternative capital gains rate of 25 percent and the maximum marginal rate on ordinary income of 70 percent, and the normal attractiveness of tax deferral, the more exacting requirements of section 422 apparently were well worth the trouble.[49]

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41. H.R. REP. No. 749, *supra* note 31, at 67; INT. REV. CODE OF 1954, § 422(a) (2).

42. H.R. REP. No. 749, *supra* note 31, at 67; INT. REV. CODE OF 1954, § 422(b) (1).

43. INT. REV. CODE OF 1954, § 422(c) (1).

44. The Code provisions do not refer to the possibility of taxation upon grant; presumably, the drafters assumed that existing law made such reference unnecessary. *See* BNA TAX MGT. PORTFOLIO 183-2d, *Stock Options (Statutory)—Taxation,* at A-16.

45. § 421(a) (1) specifically provides that "no income shall result" (with the exception of the good faith provision, *see* note 43 *supra* and accompanying text) from the exercise of an option that meets the requirements of section 422(a).

46. Although, the stock option sections do not expressly provide for capital gain treatment, such treatment necessarily attends disposition because the stock is a capital asset in the employee's hands.

47. INT. REV. CODE OF 1954, § 421(a) (2).

48. *Id.* § 421(b).

49. FORTUNE, July 1970, at 100, indicates that qualified stock options were offered (pre-1969 tax reform act) by more than 75% of *"Fortune's* 500." For more complete analyses of the provisions of the 1964 amendments see Baker, *Employee Stock Option Plans Under The Revenue Act of 1964,* 20 TAX L. REV. 77, 78 (1964); Frei, *Stock Options in the Light of the 1964 Revenue Act,* 42 TAXES 872 (1964); Wilf, *One Year of the New Stock Option Rules (or 'Trying to Make a Silk Purse Out of a Sow's Ear'),* N.Y.U. 24TH INST. ON FED. TAX. 755 (1966). Sources are collected in BNA TAX MGT. PORTFOLIO 183-2d, *Stock Options (Statutory)—Taxation,* at C-9.

2. *Nonstatutory Options Under the Treasury Regulations.*—The congressional efforts to shape satisfactory legislative treatment for classes of tax-favored options perhaps overshadowed, but certainly did not hinder, developments in the area of nonstatutory options. Faced with judicial decisions that apparently attempted to resolve the continuing uncertainty about the proper time for option taxation by offering an avenue of unfettered access to tax avoidance through the use of restrictions affecting fair market value,[50] the Treasury proposed comprehensive regulations that centered upon exercise of the option as the taxable event.[51] After an extensive period of review, the final version of the regulation was approved in 1961.[52] The final Treasury position, perhaps on the strength of the Supreme Court's "readily ascertainable" dictum in *Commissioner v. LoBue,*[53] recognized that the grant of an option having "readily ascertainable" fair market value was the proper occasion for taxation, but defined the quoted term so restrictively that any option not actively traded on an established market had little chance of being found to have "readily ascertainable" value.[54] In the unlikely event that a nonstatutory option should be found susceptible to valuation under these rules, the Treasury Regulation provided that the employee would realize compensation—and the employer would be allowed a deduction—in the year of grant, in an amount equal to the difference between the fair market value of the

50. In Harold H. Kuchman, 18 T.C. 154 (1952), the Tax Court held that, because restrictions on use and sale of stock received pursuant to the exercise of an option prevented its having any ascertainable market value, no tax would be incurred upon its transfer to the optionee. The same court, in Robert Lehman, 17 T.C. 652 (1951), held no income was realized when similar restrictions had lapsed on the ground that the value of the stock on the date of restriction lapse "might be out of all proportion to the compensation involved in the original acquisition of the shares." *Id.* at 654. In McNamara v. Commissioner, 210 F.2d 505 (7th Cir. 1954), *rev'g* 19 T.C. 1001 (1953), and Commissioner v. Stone's Estate, 210 F.2d 33 (3d Cir. 1954), *aff'g* 19 T.C. 872 (1953), the courts found that receipt of a stock option having ascertainable value was a taxable event.

51. 21 Fed. Reg. 8774 (1956).

52. Treas. Reg. § 1.421-6(c) (1956), *as amended,* T.D. 6540, 1961-1 CUM. BULL. 161.

53. *See* text accompanying note 23 *supra.*

54. Spiegel, *Development and Current Status of Nonstatutory Stock Options,* 19 U. So. CAL. TAX INST. 217, 227 (1967). If an option is not actively traded on an established market, to have "readily ascertainable" value it must he (1) freely transferable, (2) immediately exercisable in full, and (3) free of any restriction having a significant effect on fair market value (the option stock must be similarly free). In addition, the value of the "option" privilege (i.e. the opportunity to profit from future appreciation in the option stock without undertaking the risk of investment) must be readily ascertainable after considering factors specified in the regulations. Treas. Reg. § 1.421-6(c)(3) (1959), *as amended,* T.D. 6540, 1961-1 CUM. BULL. 880.

option and its cost to the employee,[55] with no compensation income resulting from exercise of the option.[56]

When, as usually will be the case, the option itself has no readily ascertainable fair market value, the new regulations provided that compensation income would be realized in an amount equal to the spread between the option price and the stock's fair market value—and a deduction available to the employer[57]—at the time the employee acquires an unconditional right to receive the stock, provided the stock was not subject to a restriction having a significant effect on its value.[58] In the event that the optioned stock was subject to such a restriction at the time of exercise, the Treasury took the position that compensation income would not result until the restriction lapsed or the stock was sold or exchanged, whichever occurred first.[59] The amount of compensation was set at the lesser of the spread at exercise—determined as though the restriction had not existed—or the difference between the option price and the stock's value at the time of taxation.[60] Under all of these regulatory alternatives, the employee's basis for the optioned stock was increased by any amount included in gross income as a consequence of the regulations' operation.[61]

Although the element of ordinary income and the unavailability of complete tax deferral until disposition of the stock[62] made the tax consequences of nonstatutory options less attractive than those of qualified options, the former category of options was not necessarily inferior as an executive incentive device. The inapplicability of the statutory restrictions imposed upon qualified options afforded nonstatutory options a valuable advantage in flexibility. The absence of a five-year grant-to-exercise limit, for example, allowed the participant in a nonqualified arrangement to benefit from an unlimited time period in which to retain the opportunity to profit from

55. *Id.* § 1.421-6(c)(1) (employee's deduction), § 1.421-6(f) (employer's deduction).

56. Treas. Reg. § 1.421-6(a)(3) (1959), *as amended,* T.D. 6540, 1961-1 CUM. BULL. 880.

57. *Id.* § 1.421-6(f).

58. *Id.* § 1.421-6(d)(1).

59. *Id.* § 1.421-6(d)(2)(1).

60. *Id.*

61. *Id.* § 1.421-6(e).

62. Although the attachment of restrictions that significantly affect the market value of the underlying stock may result in income tax deferral for a holder of nonstatutory optioned stock, the deferral is not so complete as that available under the statutory option provisions, because the nonstatutory option regulations provide that the employee's death will trigger compensation treatment. *Id.* § 1.421-6(d)(5). The statute, on the other hand, provides for a stepped-up basis for the option stock upon the employee's death. INT. REV. CODE OF 1954, § 1014(a).

appreciation in the underlying stock's value while incurring no down-side risk, and the lack of a holding-period requirement permitted the employee to finance his stock purchases by concurrent resale of a portion of the stock so acquired.[63] Moreover, by judicious use of such "significant restrictions on value" as book-value buy-out agreements,[64] taxation on the spread at exercise could be deferred indefinitely and any post-exercise appreciation of the stock's value could be enjoyed at capital gains rates.

II. THE TAX REFORM ACT OF 1969

A. Legislative History

1. *Evolution of Specific Legislation.*—The Tax Reform Act of 1969[65] was the product of a climate of dissatisfaction with an existing tax structure that enabled many persons with huge economic incomes and carefully designed tax shelters to pay little or no tax, leaving the less affluent to shoulder the revenue burden.[66] The exact role that statutory stock options were thought to have played in the creation and maintenance of these undesirable conditions is not clear. In any event, the movement for reform took a focus broad enough to bypass any detailed examination of the effectiveness of sections 421-25 in the context of national tax policy. Its own analysis of the current state of affairs led the Treasury Department to recommend to Congress that relatively drastic reform measures be undertaken, including minimum[67] and maximum[68] taxes designed to operate upon an expanded tax base that would include economic income from sources that were sheltered from taxation under pre-1969 law. The minimum tax was designed to apply a graduated rate to "total income"—a concept that entailed taking into account what the Treasury viewed as the otherwise "unacceptable tax abuses or advantages" stemming from capital gains, interest received on state and local government bonds, percentage depletion in excess of capital invested, and deductions offsetting appreciation on charitable gifts.[69] For purposes of the maximum tax, which was to ensure that

63. *See* Henry, *Financing Executive Purchases Under Stock Option Plans,* N.Y.U. 24TH INST. ON FED. TAX. 789 (1966).

64. *See* Treas. Reg. § 1.421-6(d)(2)(ii) (*example* (3)), *as amended,* T.D. 6540, 1961-1 CUM. BULL. 880.

65. Act of December 30, 1969, Pub. L. No. 91-172, 83 Stat. 487.

66. *See* H.R. Rep. No. 91-413 (Part 1), 91st Cong., 1st Sess. 78 (1969).

67. HOUSE COMM. ON WAYS AND MEANS AND SENATE COMM. ON FINANCE, 91st Cong., 1st Sess., TAX REFORM STUDIES AND PROPOSALS (Part 1) 13-15 (Comm. Print 1969).

68. *Id* at 17-18.

69. *Id.* at 14.

no person paid an effective rate on his total income greater than 50 percent,[70] the Department recommended that total income include, in addition to the preference items included in the minimum tax proposal, the spread between option price and fair market value on "any stock options"[71] exercised during the year, under the rationale that

> stock options represent a major component of executive compensation which—although eventually taxable when the stock is sold—should nevertheless be included in the year in which exercised to obtain a realistic measure of the relationship between an individual's total income and his tax payments and thereby the appropriateness of applying the maximum ceiling.[72]

This treatment proposed by the Treasury Department would seem to reflect a view that stock options occupy something of a middle ground in the war against tax avoidance. They apparently were not deemed productive of sufficient abuse to merit inclusion in the minimum tax scheme; yet their tax-sheltering aspects were thought real enough to warrant inclusion in the broad base called for by the maximum tax proposal. Whatever the analytical merit of this brief Treasury statement may be, it is apparently the closest that the legislative history of the Tax Reform Act comes to an express consideration of the specific policy bases underlying the Act's treatment of statutory stock options.

The Department's broad recommendations were not enacted. The House transformed[73] the minimum tax proposal into a complex provision designed to limit those tax preferences previously condemned by the Treasury proposal.[74] This Bill did not refer to statutory stock options. The Senate, however, rejected the House's approach in favor of a simpler design that entailed a relatively straightforward tax on the tax preference items listed in the House Bill, with an unexplained addition of several items, including the "bargain element" in qualified (and restricted) stock options.[75] The Senate amendments provided the basic structure for the minimum

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70. *Id.* at 18.

71. *Id.* Presumably, the Treasury intended to refer only to statutory stock options, since it is difficult to see why the spread at exercise on nonstatutory options, already included in ordinary income under existing law, should be again singled out for inclusion in "total income."

72. *Id.*

73. For an explanation of the Treasury's position on the evolution of its original proposal see *Statement of Edwin S. Cohen, Assistant Secretary of the Treasury for Tax Policy, Hearings on H.R. 13270 Before the Senate Finance Committee,* 91st Cong., 1st Sess. pt. 1, at 547 (1969).

74. *See* H.R. REP. No. 91-413 (Part 1), 91st Cong., 1st Sess. 77-83 (1969).

75. S. REP. No. 91-552, 91st Cong., 1st Sess. 114 (1969).

tax as ultimately enacted.[76]

The House also rejected the Treasury's broad maximum-tax proposal, and instead adopted a 50 percent maximum rate on earned income.[77] The stated purpose of this maximum rate on earned income was not tax relief, but rather was "reduc[ing] pressure for the use of tax loopholes," and lowering the "incentive to engage in otherwise unprofitable operations" and spend "time and effort on 'tax planning' at the expense of pursuing normal business operations."[78] The House version apparently limited its anti-loophole effect to earned income on the theory that the disincentive effect of high tax rates was greatest in the case of earnings.[79] Although the Senate opposed the maximum tax measure on the ground that it offended the principle of progressivity,[80] the Bill was passed as reported by the Joint Committee with the addition of a provision that offset a taxpayer's eligibility for the 50 percent maximum rate by the excess of his tax-preference items over 30,000 dollars. This provision again reflects the theory that reduction of the incentive to use tax avoidance devices is inappropriate when the taxpayer already has sheltered a substantial part of his income through preferred tax treatment.[81]

2. *Policy considerations.*—The legislative history of the 1969 Tax Reform Act, only a small portion of which has just been discussed,[82] offers scant comfort to one who looks for guidelines to aid interpretation of the Act's provisions as they affect the tax consequences of using stock options as employee-incentive devices. The legislative history does serve to emphasize a basic thrust of the Act—reduction of opportunities for escape from the general rate structure—but the absence of specific delineation of policy goals that relate to the Act's effect upon transactions governed by sections 421-25 and the regulations thereunder prevent the sort of conclusions about congressional intent that would be most helpful in as-

76. *See* H.R. REP. No. 91-782, 91st Cong., 1st Sess. 301-02 (1969).

77. H.R. REP. No. 91-413 (Part 1), 91st Cong., 1st Sess. 208 (1969).

78. *Id.*

79. *See* H.R. REP. No. 91-782, 91st Cong., 1st Sess. 224 (1969) (Joint Committee general explanation of the Act).

80. *See* S. REP. No. 91-552, 91st Cong., 1st Sess. 133 (1969). The deletion received strong support from Senator Gore (D. Tenn.). *See id.* at 333.

81. *See* H.R. REP. No. 91-782, 91st Cong., 1st Sess., 224 (1969) (Joint Committee general explanation of the Act).

82. Considerations of space necessitate the omission of the legislative background of the remaining Tax Reform Act provisions that bear upon stock option arrangements (the reduction of the tax advantages of capital gains and the new rules for restricted property). The hroad range of other Reform Act topics has been disregarded for lack of direct relevance.

sessing the sometimes woefully vague language used in the operative provisions of the new law.

B. Specific Provisions of the Tax Reform Act

Although, as previously pointed out, the Tax Reform Act did not modify directly the existing Code provisions that govern tax treatment of stock option arrangements, it indirectly affects the tax consequences of these arrangements in a number of ways. The introduction of a minimum tax on tax preference items,[83] the setting of a maximum marginal rate for earned income,[84] the increase of the tax rate upon long term capital gains,[85] and the new rules governing restricted property[86] all have at least potentially significant effect on the continued utility of stock options as executive incentive devices.

1. *Sections 56-58: The Minimum Tax for Tax Preference.*—The minimum tax sections provide generally for a tax of ten percent on the total annual amount of a taxpayer's "items of tax preference"[87] in excess of: (1) the sum of 30,000 dollars, (2) the taxpayer's otherwise applicable tax liability for the current year,[88] and (3) any unused portion of the latter item for the previous seven years.[89] The two items of tax preference that directly affect stock option arrangements are the amounts represented by the spread at exercise of qualified stock options[90] and one-half of the amount by which the taxpayer's net long-term capital gain exceeds his short-term capital loss.[91] Thus an employee who holds a qualified stock

83. INT. REV. CODE OF 1954, §§ 56-58.

84. *Id.* § 1348.

85. *Id.* § 1201(b), (c).

86. *Id.* § 83.

87. *Id.* § 57(a). The complete listing of tax preference items is comprised of: (1) excess investment interest (this item was designed to remain a tax preference item through 1971 only, via the "phasing in" of § 163(d), *see* Olsen, BNA TAX MGT. PORTFOLIO 269, *Minimum Tax- Items of Tax Preference*, at A-4); (2) accelerated depreciation (in excess of straight-line) on real property; (3) accelerated depreciation (in excess of straight-line) on § 1245 property subject to a net lease; (4) "excess" deductions attributable to amortization of certified pollution control facilities; (5) "excess" deductions attributable to amortization of railroad rolling stock; (6) the exercise spread on qualified and restricted stock options; (7) "excess" reserves for losses on bad debts of certain financial institutions; (8) "excess" depletion deductions; and (9) an amount equal to one-half the excess of an individual's net long term capital gain over his short term capital loss and a formula percentage of the excess of net corporate long-term capital gain over short-term capital loss. *Id.*

88. INT. REV. CODE OF 1954, § 56(a). Section 56(a) also provides that the computation should be made without regard to the taxes imposed by §§ 531 and 541, and that the tax so computed will be reduced by the sum of the credits allowable under §§ 33,37, and 38.

89. *Id.* § 56(a)(2)(B), § 56(c).

90. The spread at exercise on a restricted stock option is also included. *Id.* § 57(a)(6).

91. *Id.* § 57(a)(9).

option is faced with the possibility not only of paying a tax equal to ten percent of the "paper profit" he receives from exercising an option to acquire stock that he may not dispose of for three years,[92] but also with the prospect of an additional ten percent tax on one-half of the capital gain he realizes upon ultimate disposition of the stock. To add insult to injury, the proposed regulations provide that the employee's stock basis will not be increased to reflect the initial preference tax paid.[93] In effect, these sections result in the imposition of three taxes—the "stock-option" preference tax, the normal capital gain tax as it applies to the "spread" element of his ultimate gain, and the "capital gain" preference tax—upon the employee's gain from the spread at exercise. Moreover, under the terms of the statutes involved,[94] the unfortunate taxpayer would appear vulnerable to tax-preference treatment for an exercise spread that subsequently is accorded compensation income treatment as the result of a disqualifying disposition. The proposed regulations, however, temper this possibility by setting out a "tax benefit" rule, which nullifies the operation of section 57(a)(6) if the disqualifying disposition occurs in the year of exercise.[95] This minimal largess by the Treasury, however, may be attacked on at least two perhaps fundamentally inconsistent grounds. First, the terms of the statute afforded no explicit basis upon which to rest the authority necessary to effect such a dispensation—under sections 421-22, a "qualified

92. The employee must hold his stock for 3 years in order to meet the qualified-stock-option requirements of § 422(a)(1). In this situation, he is unable, without incurring the penalties of a disqualifying disposition, to raise the money to pay the 10% tax by selling a portion of the stock received pursuant to the option.

93. Proposed Treas. Reg. § 1.57-1(f)(7), 35 Fed. Reg. 19765 (1970).

94. The holding-period and employment requirements of § 422(a) are conditions upon the applicability of the favorable tax treatment offered by § 421; they are not, however, listed by § 422 among the conditions that must be met to fall within the definition of "qualified stock option." Thus, although a disqualifying disposition ends an employee's tax-favored treatment, it does not affect the "qualified" status of the option when exercised. Since § 57(a)(6) merely refers to "a qualified stock option" in defining the spread at exercise as a tax preference item, the statutory language would appear to call for imposition of the minimum tax regardless of whether the option's favorable treatment under § 421 is later ended by the operation of § 422 (a)(1) upon a disqualifying disposition.

95. Proposed Treas. Reg. § 1.57-1(f)(5)(i), 35 Fed. Reg. 19764 (1970), provides: "Section 57(a)(6) is inapplicable if, in the taxable year of the transfer, there is a disposition of the stock or a modification of the stock option plan which disposition or modification renders section 421(a) inapplicable or applicable solely by reason of section 423." Thus, the proposed regulation is also intended to provide for modifications, which under the terms of § 425(h) are equivalent to the granting of new (and possibly unqualified) options. A failure by the employee to satisfy the employment requirements of § 422(a) results, under the proposed regulations, in application of its "tax benefit rule" without qualification. Proposed Treas. Reg. § 1.57-1(f)(5)(i), 35 Fed. Reg. 19764 (1970).

stock option" remains qualified regardless of any subsequent disqualifying disposition, and section 56(a)(6) applies, without hint of exception, to qualified stock options. Secondly, even if the letter of the law is properly to be disregarded in pursuit of the section's underlying policy by penalizing only those transactions which actually result in the sort of preferred tax treatment that the statutorily described preference items would ordinarily entail, there appears to be little justification for truncating this policy at the end of one year.[96]

2. *Section 1348: The Fifty-Percent Maximum Rate on Earned Income.*—(a) *The Basic Statutory Scheme.*—Section 1348 provides for a maximum marginal rate of 50 percent on "earned taxable income."[97] Earned taxable income is that amount of income "earned" within the meaning of sections 401(c)(2)(C) or 911(b) which bears the same ratio to taxable income as such earned income less deductions properly allocated to it under section 162 ("earned net income")[98] bears to adjusted gross income—but less the amount by which the larger of the taxpayer's current tax preference items,[99] or the average of his tax preference items over the past five years, exceeds 30,000 dollars. Section 1348(b) excludes certain classes of income, one of which is "deferred compensation within the meaning of section 404," from its definition of earned income. For at least three reasons the maximum rate limitation does not reduce loophole pressure to the extent that a casual glance at the section's title might indicate. First, the statutory scheme for applying the 50 percent maximum rate ensures that the marginal rates applicable to a taxpayer's unearned ordinary income will not be lowered because of the maximum tax.[100] Secondly, the method of reaching taxable

96. Two possible, though certainly not compelling, justifications exist for the Treasury's one-year limit on the tax benefit principle's operation. The first is that the taxpayer has indeed secured a tax benefit, in the form of a tax deferral, when he waits until after the year of exercise to make a disqualifying disposition, although this benefit is not nearly so substantial as the "deferral plus transposition to capital-gains rate" benefit apparently aimed at by Congress. Second, allowing retroactive inapplicability of the minimum tax would add an additional note of complexity to the statute.

97. INT. REV. CODE OF 1954, § 1348(a).

98. "Earned net income" is defined in the statute as follows: "the term 'earned net income' means the excess of earned income (as defined in § 1.1348-3(a)) over any deductions which are required to be taken into account under section 62 in determining adjusted gross income and are properly allocable to or chargeable against earned income." Proposed Treas. Reg. § 1.1348-2(d)(2), 36 Fed Reg. 23815 (1971).

99. *See* INT. REV. CODE OF 1954 § 57(b); notes 87-91 *supra* and accompanying text.

100. Section 1348(a) provides that earned taxable income will be taxed under the ordinary rate structure until the 50% bracket is reached, and that the tax on this amount, plus

earned income requires allocation of a portion of the taxpayer's personal and other deductions to earned income.[101] Finally, a large tax-preference item from a preceding year may return to haunt the taxpayer under the "average" tax preference offset.

(b) *Section 1348 and Qualified Stock Options.*—The 50 percent maximum rate on earned income has two significant consequences in the qualified stock option area. First, if the taxpayer has tax-preference items in excess of 30,000 dollars, each dollar of qualified-option spread at exercise, because it is a tax preference item under section 57(a)(6), will remove a dollar of earned income from the relatively comforting 50 percent bracket and place it in the less desirable environs of the tax rates applicable to other ordinary income. Assuming the worst, the tax rate will be increased from 50 to 70 percent[102] on an amount of the taxpayer's other income equal to his paper profit on exercise of a qualified option—a situation equivalent to a direct tax of twenty percent on the qualified option spread.[103] In addition, this situation causes the taxpayer to worry that the size of his qualified option tax preference will, through the averaging provisions, affect his eligibility for the maximum earned income rate over the next four years, but also, assuming his current high income and tax preference situation continues, he must expect a substantial repetition of the twenty percent increase in his tax bracket and four-year eligibility effect upon realization of capital gain when he disposes of the optioned stock.[104] Secondly, section 1348 will concern the employee who has made a disqualifying disposition of his option stock. Although the gain recognized upon a disqualifying disposition is considered to be compensation[105] for the employee's services, and although section 911(b), through which section 1348 derives its definition of earned income, defines earned income to include "compensation for personal services actually ren-

50% of any remaining amount of earned income, will be subtracted from what would otherwise be the total tax (computed under § 1 as though the earned income provisions did not exist) to reach the actual tax due.

101. *See* Johnson, *Minimum and Maximum Taxes After Two Years—A Survey and General Evaluation*, 50 TAXES 68, 78 (1972).

102. Under current income tax rates, a married taxpayer filing a joint return would need a taxable income of over $52,000 in order to benefit from the maximum tax rate, and a taxable income of over $200,000 to be exposed to the 70% marginal rate on ordinary income.

103. *See* Asimow, *The Maximum Tax on Earned Income: Tax Planning for the Seventies*, 23 U. SO. CAL. TAX INST. 19, 96 (1971).

104. The 20% increase in tax bracket, however, would apply only to a dollar amount equivalent to one-half the gain realized, since only one-half is a tax preference item under § 57 (a)(9), making the situation the equivalent of a direct tax of 10% on the gain realized.

105. *Cf.* Treas. Reg. 1.61-2(d)(4) (1966).

dered," the statutory exclusion of "deferred compensation" from earned income[106] creates some doubt that the terms of the Code permit an employee's gain from a disqualifying disposition to qualify for the 50 percent rate on earned income. This doubt exists because section 404, from which section 1348 draws its definition of "deferred compensation," refers to plans or methods for deferring *receipt* of compensation and existing law looks to the time of exercise[107] in measuring compensation income that is treated as "received" in the year of the disqualifying disposition.[108] The proposed regulations, however, resolve this problem in favor of earned-income treatment, and taxpayer challenges do not seem likely.

(c) *Section 1348 and Nonstatutory Options.*—Concern about the earned-unearned status of income realized on the exercise of nonstatutory stock options is likely to raise problems of statutory interpretation glossed over by the proposed regulations in the case of disqualifying dispositions. Since unqualified stock option arrangements do not involve tax preference items, the danger attendant to qualified plans of penalizing earned income does not arise. Thus, the effect of section 1348 upon unqualified options turns on the deceptively simple question whether the income required to be recognized upon exercise is "earned." Again, there seems to be little doubt that the income constitutes "compensation for personal services" within the meaning of section 911(b); the problem is whether it is "deferred compensation" and thus ineligible for the maximum rate limitation. When a nonqualified option is exercised within the year following the taxable year of grant, the spread will qualify as earned income under section 1348(b), which excludes from deferred compensation "any amount received before the end of the taxable year following the first taxable year of the recipient in which his right to receive such amount is not subject to a substantial risk of forfeiture (within the meaning of section 83(c) (1))." Under a regulation proposed pursuant to the same provision, the device of attaching a substantial risk of forfeiture to the option stock may operate to ensure qualification for the maximum rate.[109]

When the risk of forfeiture is not involved, however, exercise of a nonqualified option in a year subsequent to the year following the

106. INT. REV. CODE OF 1954 § 1348(b).

107. *Id.* § 421(b).

108. *Id.* Treas. Reg. § 1.421-8(b) provides that "[t]he income attributable to such [disqualifying] transfer shall be treated . . . as income *received* in the taxable year in which such disposition occurs."

109. *See* Proposed Treas. Reg. § 1.1348-3(b)(2), 36 Fed. Reg. 23817 (1971).

year of grant raises problems that the Code sections do not clearly resolve. Because of the essentially vague character of the statutory language,[110] and the somewhat elusive nature of the concepts involved, the combinations and permutations of arguments and theories are practically endless, and the legislative history provides scant guidance.[111] For example, it is possible to reason that compensation by means of nonqualified options does not come "within the meaning" of section 404, which governs the deductibility of compensation under deferred payment plans or methods, because the deductibility of stock option compensation is specifically governed by the Regulations under a different section, section 421.[112] On a more theoretical level, section 404's reference to plans "deferring the receipt" of compensation can be used to argue that the spread at exercise is not deferred compensation because compensation is in fact "received" under stock-option arrangements at the time of grant, and only the taxation of it is deferred to a later time.[113]

On the other hand, it is possible to argue that the term "within the meaning of section 404" does not mean that the compensation at issue must be subject to the provisions of section 404, but rather that such compensation must only be within the general concept of deferred compensation embodied in that section.[114] There are substantial difficulties with this argument, since section 404 purports to reach all transactions to which its "deferred compensation" lan-

110. For example, the term "deferred compensation" standing alone could hardly be said to have a precise objective content. By referring the taxpayer to § 404 for the "meaning" of deferred compensation, § 1348 does little to remedy this lack of precision, since § 404 does not explain the term, and the body of precedential interpretation thereunder provides minimal additional assistance. *See* Watts, *The Maximum Tax on Earned Income: Section 1348*, 26 TAX L. REV. 1, 25 (1970).

111. The Ways and Means Committee Report spoke merely of "deferred compensation," without further explanation, H.R. REP. No. 91-413 (Part 1), 91st Cong., 1st Sess. (1969), and the Bill as reported contained the unadorned phrase "deferred compensation payment." H.R. 13270, 91st Cong., 1st Sess., § 802 (1969). The reference to § 404 was added by the Conference Committee, for reasons apparently known only to that body. JOINT CONF. REP. No. 91-782, 91st Cong., 1st Sess., § 804 (1969). A possible indication of legislative intent may he the references in the Committee reports concerning tbe enactment of § 83 of the Code to stock option arrangements as "deferred compensation arrangements." H.R. REP. No. 91-413 (Part 1), 91st Cong., 1st Sess., 86-87 (1969). The context of the discussion must be kept in mind, however.

112. *See* Treas. Reg. § 1.421-6 (1966). *See also* Proposed Treas. Reg. § 1.421-6(a)(2), 36 Fed. Reg. 10787 (1971). This argument necessarily views the Conference Committee's insertion of the reference to § 404 as designed to limit the meaning of "deferred compensation" to deferred payments by an employer, the deductibility of which is governed directly by § 404.

113. *See* Watts, *supra* note 110, at 22-23.

114. *See* Asimow, *supra* note 103.

guage refers, but it apparently represents the position that the Treasury adopted in the Proposed Regulations under section 1348.[115] In reply to the theory that the exercise of a nonqualified option represents, at most, delayed taxation, rather than deferred receipt of compensation, a substantial argument may be offered that the policy underlying both section 1348 and section 404 requires that "deferral" be deemed to refer to tax consequences, not metaphysical concepts or technical legal distinctions. This, too, is apparently the position taken by the Treasury.[116]

Although the Treasury positions on the meaning of deferred compensation within section 1348 would seem logically to suggest that the exercise of a nonqualified option should result in deferred compensation[117] ineligible for the 50 percent maximum rate, the Proposed Regulations, without explanation, take a different stance. The proposed rule opts for earned income, and not deferred compensation, but only if the terms of the option in question do not allow exercise more than three months after termination of employment.[118] There appears to be no satisfactory theoretical explanation for the Treasury's position on this point. If the "all or nothing" arguments previously suggested are rejected, then the only remaining alternative with substantial support in principle would seem to be some version of the rationale previously offered in Revenue Ruling 69-118.[119] In that ruling the measure of deferred compensation upon option exercise was apparently held to turn upon the year in which services were performed to which an amount of the compensation received would be properly attributable. This rationale, however, would require proration of exercise compensation according to the years to which various portions would be attributable—a consequence that the Treasury would understandably be reluctant to endorse under section 1348.

115. Proposed Treas. Reg. § 1.1348-3(b)(1), 36 Fed. Reg. 23817 (1971).

116. *Id.*

117. It is conceivable, though not entirely logical, that one could espouse both positions and still maintain that the spread at exercise on a nonqualified stock option does not represent deferred compensation, on the theory that, since existing law taxes the spread as though it were current compensation, it should be so treated for the purposes of § 1348. This apparently was the Treasury's initial line of thought on the subject. *See* Address by Hon. John S. Nolan, University of Pennsylvania Tenth Annual Tax Conference, Oct. 14, 1970 (reprinted in BNA DAILY TAX REP. No. 207 (Oct. 23, 1970)). *See also* Childs, *Compensating the Executive After the Tax Reform Act with Stock Options, Restricted Stock, Deferred Pay—and Even Cash*, 48 TAXES 801 (1970).

118. Proposed Treas. Reg. § 1.1348-3(b)(3)(iii)(b), 36 Fed. Reg. 23818 (1971). Of course, any exercise within one year following the year of grant will qualify as earned income. *Id.*

119. 1969-1 CUM. BULL. 135.

Whatever may be the ultimate resolution of the problems surrounding the concept of deferred compensation in the context of stock option arrangements, an employee who wishes to plan under the guidance of the Proposed Regulations can maximize his chances of securing earned income treatment by ensuring that the option agreement negates the possibility of exercise after three months from termination of employment. In any event, employees holding nonstatutory options will not suffer affirmatively adverse consequences from the enactment of section 1348.[120] At worst, ineligibility for the maximum rate on earned income will leave them precisely where they were before 1969—with the difference between option price and fair market value at exercise taxed at ordinary income rates.

3. *Section 1201: The Increased Alternative Capital Gain Rate.*—Again motivated by the realization that many high-income taxpayers were structuring their transactions to take advantage of the pre-1969 25 percent maximum rate on long term capital gain—often thereby reducing their effective tax rates below those incurred by less affluent taxpayers and arguably violating the intent behind the progressive rate structure[121]—Congress, in 1969, amended section 1201 to provide in essence that such long term gain in excess of 50,000 dollars would be taxed at one-half the ordinary rate structure, or a maximum marginal rate of 35 percent.[122] The impact of this amendment on qualified stock option arrangements lies in its reduction of the incentive for employees to seek an escape from the tax rates upon compensation income. Before the Tax Reform Act, a highly compensated employee suffering under a 70 percent marginal tax rate might have been irresistibly tempted by the opportunity afforded by a qualified stock option plan, not only to defer taxation, but also to reduce his tax rate by approximately 64 percent. Under current law, the deferral possibility is still available, but the tax rate reduction opportunity has been reduced, given the applicability of section 1348's maximum 50 percent rate on earned income to the employee's current compensation, to fifteen percentage points (50 percent less 35 percent), a 30 percent reduction from the earned income rate.[123]

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120. Indirectly, of course, employees with large tax preference items could suffer from the displacement of what would otherwise constitute earned income provided in § 1348(b)(2). *See* text accompanying notes 102-04 *supra*.

121. H.R. REP. No. 91-413 (Part 1), 91st Cong., 1st Sess. 14 (1969).

122. Act of Dec. 30, 1969, Pub. L. No. 91-172, § 511(b), 83 Stat. 635.

123. This assumes that the employee has sufficient capital gains from other sources to

4. *Section 83: Property Transferred in Connection With Performance of Services.*—Section 83, added to the Code in 1969[124] in response to Treasury recommendations for statutory recognition of the problems incident to schemes for using restricted property as compensation for services,[125] is a broad and fairly complex section[126] that sets out rules to govern transfers of property in connection with the performance of services. By virtue of a specific exclusion,[127] the section does not apply to statutory stock options, but nonstatutory options are exposed to the full impact of its provisions. Section 83 provides generally that, when property is transferred in connection with the performance of services, the difference between its fair market value and the amount paid for it will be included in the gross income of the person who performed the services, in the first taxable year in which the property becomes either transferable or free from a substantial risk of forfeiture.[128] The fair market value is determined without regard to any restriction other than a restriction that by its terms will never lapse, and at the earliest time the rights of the transferee become transferable or free from the risk of forfeiture. A deduction in an amount equal to that included in the recipient's income is allowed to the employer in the tax year that encompasses the end of that year in which the person performing the services was taxed.[129]

Alternatively, the section provides that the person who performs the services may elect to include in his income for the year of transfer the excess of the property's fair market value—determined without reference to lapsable restrictions—over the amount paid for it,[130] with the employer receiving a concomitant deduction.[131] This

offset the $50,000 that remains eligible for a 25% tax rate under § 1201(b).

124. Act of Dec. 30, 1969, Pub. L. No. 91-172, § 321(a), 83 Stat. 588.

125. *See* BNA TAX MGT. PORTFOLIO 262, *Restricted Property—Section 83,* at A-1.

126. Section 83's complexity and scope create problems of interpretation and application that are beyond the scope of this Note. Consequently, only some of the questions raised by its application to stock option compensation will be considered here. For fuller discussions of the section see Blake, *Compensatory Property (Restricted and Unrestricted) Under Section 83 of the Code,* N.Y.U. 29TH INST. ON FED. TAX. 1273 (1971); Koppel, *Restricted Stock: What's Left After the Tax Reform Act of 1969?,* 48 TAXES 558 (1970); sources cited in BNA TAX MGT. PORTFOLIO 262, *supra* note 125, at C-3.

127. INT. REV. CODE OF 1954, § 83(e)(1). Section 83(e) also excludes transfers in respect of § 401(a) trusts or § 404(a)(2) annuities, transfers of options without readily ascertainable market value, and transfers of property pursuant to options that had readily ascertainable fair market values at grant.

128. *Id.* § 83(a).

129. *Id.* § 83(h). The deduction is allowed only to the extent that it qualifies under § 162.

130. *Id.* § 83(b).

131. *Id.* § 83(h).

election procedure entails an element of risk when possible forfeiture is involved, because a subsequent forfeiture of the property will not give rise to a deduction for the tax previously paid.[132] Finally, section 83 provides that any increase in the fair market value of transferred property from the cancellation of a restriction that by its terms will never lapse will be treated as compensation, to the extent not offset by any consideration paid for the cancellation, in the year in which cancellation occurs.[133]

Translated into the language of nonstatutory options, the section's provisions mean that when an employee receives, upon exercise of his option, transferable stock that is not subject to a substantial risk of forfeiture, he must include the exercise spread in his taxable income, no matter how many or how severe the restrictions that otherwise affect the market value of the stock received. Nonlapsable restrictions, however, are allowed to be considered in determining fair market value. Moreover, when a substantial risk of forfeiture is present and the employee does not elect early taxation, with the result that taxation is deferred to a later date, any intervening appreciation in the stock's market value will be figured into the spread for determining compensation income at the time the risk lapses, rather than receiving the benefit of capital gain rates. Thus, in sharp contrast to prior law governing the exercise of nonstatutory options to receive stock subject to a substantial risk of forfeiture,[134] deferral of taxation can be gained only when there is a substantial risk of losing the stock altogether, and even then at a cost of foregoing the benefits of capital gain treatment for any deferral-period appreciation.

Substantial questions remain about the effect of section 83 on nonstatutory stock options, even in view of the explanation and interpretation offered by the proposed Treasury regulations.[135] For example, the term "substantial risk of forfeiture," because it governs the timing of taxation, is central to the operation of the statute. Section 83(c)(1) states that "[t]he rights of a person in property are subject to a substantial risk of forfeiture if such person's rights to full enjoyment of such property are conditioned upon the future performance of substantial services by any individual."[136] Unless the

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132. *Id.* § 83(b).

133. *Id.* § 83(d)(2).

134. *See* text accompanying notes 58-61 *supra*.

135. Proposed Treas. Reg. § 1.83, 36 Fed Reg. 10788 (1971).

136. Section 83(c) also defines "transferability" as follows: "The rights of a person in

hoary maxim *expressio unius* is brought to bear, this statement would seem to allow the existence of other kinds of substantial forfeiture risks. Indeed, the legislative history of section 83 discloses the House Committee's position that the question depends upon the facts and circumstances surrounding each restriction involved.[137] The proposed regulations, however, define such a risk only in terms of forfeiture conditioned upon performing or refraining from performing substantial services, with the element of substantiality becoming a question of fact to be decided in each case under general regulatory guidelines.[138] Under those guidelines, for example, the traditionally employed noncompetition and consulting-services agreements will not be considered as involving "substantial" services unless specific facts and circumstances indicate to the contrary.[139] The question of how great the risk of forfeiture must be to come within the statutory requirement of substantiality is itself to a large degree unresolved. The proposed regulations make it clear that a major shareholder will experience difficulty in convincing the Commissioner that he may fail to satisfy the required restrictions, since they make control of the corporation a significant factor in establishing a lack of a "substantial risk of forfeiture."[140] The question is one of fact, however, and the development of concrete standards will have to await future cases and rulings.

The interpretation of a second key phrase, "a restriction which by its terms will never lapse," raises questions about section 83's effect, since it is the only kind of restriction whose effect on the fair market value of the stock will be taken into account in determining the spread to be taxed under either the general rule or special election provision of the section.[141] Subsection 83(d) and the proposed regulations indicate that a restriction that limits all future transfers of the stock to sales under a formula-fixed price is a nonlapsable restriction,[142] and the proposed regulations further indicate that limitations on disposition imposed by securities law or mandatory fair market value buy-out provisions are not nonlapsable.[143] The Treas-

property are transferable only if the rights in such property of any transferee are not subject to a substantial risk of forfeiture." INT. REV. CODE OF 1954, § 83(c)(2). Although this is something of an Alice-in-Wonderland definition, it does not appear to raise any problems in applying the statute.

137. H.R. REP. No. 91-413 (Part 2), 91st Cong., 1st Sess. 88 (1969).

138. Proposed Treas. Reg. § 1.83-3(c)(1), 36 Fed. Reg. 10790-91 (1971).

139. *Id.* at 10791.

140. *Id.*

141. *See* INT. REV. CODE OF 1954, § 83(a)(1).

142. Proposed Treas. Reg. § 1.83-5(a), 36 Fed. Reg. 10792 (1971).

143. *Id.*

ury's view on securities law restrictions—and presumably any other restrictions imposed by law—is likely to be challenged by an employee who receives a sizeable block of unregistered stock upon exercise of his option, and finds himself facing a substantial tax liability based upon the unrestricted fair market value of the stock, while the strictures of Rule 144[144] leave him with the possibility of realizing only a fraction of that value in the foreseeable future. If, for example, one supposes a case in which the only current available avenue of disposition for the employee's "lettered" stock entails a discount of over 50 percent, the tax due upon receipt of the stock under the 50 percent maximum rate of section 1348 would exceed the amount the employee could realize upon it; hence, in real terms, its economic value rests in his hands.[145] In such a situation, the employee would be likely to argue, first, that the securities-law restrictions upon resale of his stock are restrictions which by their terms will never lapse, and, secondly, that any contrary interpretation of the statute would result in a tax on an amount in excess of his income, in violation of the sixteenth amendment. Even if the employee could succeed in characterizing Rule 144's perpetual restrictions as "nonlapsing," the Commissioner might nevertheless prevail on the interpretation point by advancing the argument that the statutory language contemplates only restrictions imposed by agreement be-

144. SEC Rule 144, adopted effective April 15, 1972, SEC Release No. 33-5223. Rule 144 itself is not a "restriction," since it in essence merely provides a purportedly nonexclusive means by which a security holder may dispose of his stock without violating the Securities Act's basic prohibition against selling unregistered stock. A holder of restricted securities may dispose of them in an amount up to 1% of the shares outstanding every 6 months under Rule 144 after a 2-year holding period, but only if the requirements of the section are met. Despite the apparent nonexclusivity of the section, however, there is every indication that efforts to "free" the shares outside of Rule 144 will prove unavailing, and inducing the company to register the stock may not, as a practical matter, be possible. Thus Rule 144, in effect, imposes a perpetual "taint" upon restricted stock; whether this taint is sufficient to constitute a restriction that by its terms will never lapse seems open to question, in view of the Rule's allowance for a sale at fair market value of an amount up to 1% of the issuing company's outstanding shares of that class—a percentage that is likely to be greater than the percentage that a typical employee will receive upon exercise of a nonqualified stock option. When, as in the hypothetical situation in text, the issuer is a nonreporting company, it may prove virtually impossible to comply with the information-availability requirements of the Rule, and the security holder with a large block of stock will thus be, for all practical purposes, a prisoner of the Rule, although he may be free to effect a second-tier private placement at the cost of a very substantial discount from the fair market value of his stock. For a similar hypothetical problem see Helpern, *The Unexpected Impact of New Section 83—The Restricted Property Provisions*, 24 TAX LAW. 365, 369-70 (1970).

145. This, of course, assumes that the taxpayer has income in an amount sufficient to make the 50% rate applicable, and that the spread at exercise is earned income, which it would be under the proposed regulations. *See* text accompanying notes 118-20 *supra*.

tween the parties and that the lapsing or nonlapsing characteristics of restrictions imposed by law are immaterial. This position is perhaps supported by the fact that Congress, in enacting section 83, omitted without comment a portion of the original Treasury proposal that had provided for value adjustments for restrictions imposed by securities law and restrictions which by their terms will never lapse.[146] In view of the congressional power to define income,[147] and the singular inability of recent plaintiffs to succeed in arguments constructed under the sixteenth amendment,[148] the hypothetical employee-plaintiff seems even more likely to lose on his second point than on his first.

As a logical matter, the problems surrounding interpretation of the "nonlapse" rules of subsections 83(a) and (b) appear virtually unresolvable. Conceptually, if a restriction upon the use of property is *never* to lapse, then it must bind the owner and his transferees or successors forever. It is difficult to think why such a perpetual restriction would not violate the ancient rule against unreasonable restraints on alienation. It seems certain that neither Congress nor the Treasury contemplated such a result, although the proposed regulations do require that the restriction "will continue to apply to, and to be enforced against, any subsequent holder . . . ."[149] Perhaps the most that can be said is that a final resolution of the problems surrounding the concept of a restriction which by its terms will never lapse will have to come from the courts. Although the problems discussed above do not begin to exhaust the interpretative difficulties that section 83 may raise, they do indicate that the section is certain to make life considerably more difficult for employees who wish to defer taxation through the use of restricted stock.

C. *The Apparent Disutility of Stock-Option Compensation After the Tax Reform Act of 1969*

Even if a substantial number of the previously described questions that have arisen in the wake of the 1969 Act and the regulations proposed thereunder are ultimately resolved in favor of taxpayers, it seems clear that substantial questions remain about the

146. House Comm. on Ways and Means, 91st Cong., 1st Sess., Tax Reform Proposals Contained in the Message from the President of April 21, 1969, H.R. Doc. No. 91-103 (Comm. Print 1969).

147. *See* Helpern, *supra* note 139, at 370.

148. *See* J. Chommie, Federal Income Taxation 3 (1968).

149. Proposed Treas. Reg. 1.83-5(a)(3), 36 Fed. Reg. 10792 (1971).

continued utility of stock option arrangements as employee incentive devices. Prior to 1969, a highly compensated employee[150] could, through a qualified stock option plan, avoid the 70 percent maximum rate on compensation income and postpone taxation indefinitely, with the promise of a 25 percent capital gain rate when he ultimately decided to incur tax liability. After 1969, the employee can use qualified stock options to accomplish precisely these same objectives—deferral of taxation and transition to the capital gain rate structure—but the incentives to do so are less and the newly created potential costs are infinitely[151] greater. The employee's incentives are reduced because the tax rate that he is seeking to avoid has dropped to 50 percent, while the rate that he seeks to gain has risen to 35 percent. His potential costs, which did not exist before the Tax Reform Act, now include a ten percent tax upon the exercise spread that he had hoped to see taxed only in later years,[152] an additional ten percent tax on one-half of his ultimate gain, and the return to the 70 percent ordinary income bracket of an amount of otherwise earned income equal to the spread at exercise.[153] To use a numerical example, a pre-1969 taxpayer who received a share of stock worth 200 dollars pursuant to the exercise of a qualified option for a price of 100 dollars would pay no current tax; assuming that he sold the stock when its value had increased by 50 percent four years later,[154] he would take home 150 after-tax dollars of gain, as compared to the 79 dollars he could have obtained by taking his

150. For purposes of this example, "highly compensated" means that the employee's taxable income is eligible for the 70% bracket on ordinary income, that he has sufficient current earned compensation income to suffer the full effect of any reduction in earned taxable income resulting from excess tax preference items, and that the benefits of § 1201(b)'s 25% tax on the first $50,000 of capital gain have been applied elsewhere.

151. The potential costs are "infinitely" greater, not necessarily because costs may be substantial, but because any cost at all is infinitely greater than zero. These potential costs spring from the operation of the minimum tax on "excess" tax preference items imposed by § 56 and the disqualification of earned income by reason of "excess" tax preference mandated by § 1348. For a taxpayer whose tax preference items have not recently exceeded $30,000, however, these "costs" will not apply at all. They are therefore only potentially detrimental to a taxpayer, depending upon the amount of tax preference items that he has. *See* notes 88-89 *supra* and accompanying text; notes 102-04 *supra* and accompanying text.

152. Thus, the 10% minimum tax on the exercise spread in effect results in partial impairment of the taxpayer's ability to defer current income, despite the provisions of § 421, when the employee has tax preference items that exceed $30,000 plus current income tax.

153. This results from the operation of § 1348(b), which reduces earned taxable income by the excess of current or averaged tax preference items over $30,000, thus ending the eligibility of that amount of otherwise earned income for the 50% maximum rate and exposing it to the ordinary income structure, which may call for a marginal rate as high as 70%. *See* note 102 *supra* and accompanying text.

154. This assumes a growth rate in the value of the stock of 10% per annum.

original 100-dollar spread as direct compensation income and investing, at ten percent, the after-tax proceeds, along with the 100 dollars he would have otherwise spent in exercising the option.[155] The post-1969 taxpayer in the same situation faces the possibility of paying a ten-dollar minimum tax and an additional twenty dollars of tax on his compensation income from section 1348 rate displacement in the year of exercise;[156] and, after a 70-dollar capital gains tax, a possible three-dollar minimum tax, and an additional potential twenty-dollar tax payment from displacement of earned income upon disposition of the stock eight years later, the taxpayer might take home a gain of only 107 dollars. Had he simply taken the amount of his stock option spread as cash compensation in the original year, the 50 percent post-tax remnant, the 100 dollars that otherwise would have supplied the option price, and the money represented by the tax savings from avoiding the tax-preference consequences of qualified option use, and applied the total sum to a market purchase of the employer company's stock, the taxpayer would have realized a net benefit of 128.50 dollars.[157] When the possible adverse effects of the minimum and maximum taxes are fully encountered, the passage of the 1969 Act would seem to have

155. If, in lieu of the stock-option arrangement, the highly compensated taxpayer had received the $100 spread amount as additional salary, he would have paid $70 in tax on it, and could have used the $30 remaining after taxes, with the $100 he would otherwise have expended for the option exercise, to purchase stock in the employer corporation. When the stock increased in value by 150% 4 years later, the taxpayer would pay a 25% tax on his capital gain of $65, leaving him with a net economic gain of $79.

156. The additional $20 tax might result from the effects of § 1348 (b)'s reduction in earned taxable income for excess preference items. If the highly compensated taxpayer has $30,000 of other tax preference items, the $100 spread at exercise will reduce earned taxable income for the current year by $100, thereby increasing the applicable tax rate on that $100 from 50% to 70%. Since a 50% tax rate applied to a $100 base results in $50 of tax, and a 70% rate results in $70 of tax, the application of § 1348 has cost the taxpayer $20 in tax that he would otherwise not have had to pay.

157. Had the post-1969 highly paid taxpayer received an additional $100 in salary rather than the $100 spread on his qualified option, he would have had to pay $50 in tax upon the additional earned income, leaving him with $50 after taxes. Additionally, assuming that § 56's minimum tax on tax preference items would have had their full adverse effect if the taxpayer had been compensated by means of a qualified stock option, the taxpayer will have an additional $30 in tax savings from the use of current direct compensation. These sums, together with the $100 no longer needed for option exercise, will in 4 years produce a capital gain of $90, upon which the alternative tax will be $31.50. If the worst possible § 56 and § 1348 consequences operate upon the taxpayer's $45 tax preference in this later year, he will incur a minimum tax of $1.35—10% x ($45 tax preference less $31.50 capital gain tax paid)—and will have $45 of earned income transformed into ordinary income, at a tax cost of $9.00. Thus the taxpayer's total after-tax capital gain is $48.15, which, together with his original after-tax compensation and tax savings of $80 in the original year, will leave him with a net gain of $128.50.

destroyed the tax minimization advantages of qualified stock options.

In the area of nonqualified options, the same sort of questions about continued tax advantages may be raised. Prior to 1969, unrestricted nonstatutory options occupied an essentially neutral position regarding taxpayer goals of tax deferral and minimization. By paying a tax at ordinary income rates upon the spread at exercise of his option, the highly compensated employee incurred exactly the same tax liabilities—a 70 percent tax on the amount of compensation and a 25 percent tax on the ultimate capital gain—that he would have incurred had he received the amount of the spread as direct cash compensation and invested the after-tax remainder in his employer's stock at current fair market value. After the Tax Reform Act, however, this previously neutral device now involves a possible tax penalty. If the proposed regulation's position—that the exercise spread on nonqualified options whose terms permit exercise more than three months after employment terminates will constitute deferred compensation—[158] is endorsed by the courts, the compensation income realized upon exercise of such options will fail to qualify for the 50 percent maximum rate of section 1348, and the highly compensated taxpayer will therefore suffer an increased tax of 20 dollars for every 100 dollars by which the market value of his option stock exceeds the option price.

Ineligibility for the maximum rate on earned income may also affect nonstatutory stock option arrangements that involve the use of restrictions upon the optioned stock. In addition to the penalty of ineligibility for the maximum rate on earned income, other tax consequences occasioned by the 1969 Act have considerably more far-reaching effect on restricted stock arrangements. Prior to the Tax Reform Act, affluent executives were able to achieve deferral of taxation on the exercise spread of nonqualified options and to secure the advantages of capital gain treatment for post-exercise appreciation in the option stock's value by participating in option arrangements that called for restrictions substantially affecting the value of the stock. After the 1969 enactment of section 83, tax deferral is still possible, but it can be achieved only at a cost of incurring a substantial risk of forfeiture, rather than by a restriction that merely affects value. Similarly, capital gain treatment, at the increased 35 percent rate, can still be obtained for post-exercise appreciation only at the price of current compensation income treatment

158. Proposed Treas. Reg. 1.1348-3(b)(3)(iii)(*b*), 36 Fed. Reg. 23819 (1971).

for the spread at exercise.[159]

Thus, prior to 1969, a highly compensated employee who paid an option price of twenty dollars for stock with a fair market value of 100 dollars and a book value of 50 dollars that was subject to a mandatory book-value buy-out provision for a period of eight years would have paid no current tax. Assuming that both the fair market value of the stock and the net worth of the company had doubled eight years later, the employee at that time would have paid 56 dollars in tax on the 80-dollar spread at exercise (computed without reference to the restriction), and would have a potential capital gain of 100 dollars, which would ultimately result in 25 dollars of tax at pre-1969 rates. Thus, upon disposition of the stock, the employee would take home 99 dollars of after-tax gain. In addition, the employee would have enjoyed a tax savings in the exercise year of 56 dollars, an amount that could have been invested in company stock which could have been disposed of for 98 after-tax dollars eight years later. When this advantage to the taxpayer from the opportunity of tax deferral is counted in, his total after-tax gain on the transaction would have amounted to 197 dollars. Under the terms of the 1969 Act, however, an employee in the same situation would, at best,[160] pay a 40-dollar tax at the time of exercise upon the difference between the option price and the fair market value of the stock (computed without regard to the buy-back restriction, since it will lapse by its terms in eight years), and will have a potential capital gain of 100 dollars, promising an eventual tax of 35 dollars. If the penalties of sections 56 and 1348 are applicable, there will be an additional tax of 21.50 dollars upon disposition of the stock, and the post-1969 employee will thus have 83.50 dollars of after-tax gain, apparently a much less advantageous situation than that which confronted his pre-Reform Act counterpart.

Similarly, if the restriction in the example above is changed to one requiring forfeiture of the stock upon termination of employment within eight years, a pre-1969 employee who exercised such an option would pay no tax upon exercise, would pay a tax of 56 dollars upon lapse of the restriction, and would take home 99 dollars of after-tax post-disposition gain. The post-1969 employee also is able

159. *See* note 156 *supra* and accompanying text.

160. At best, the exercise would be considered earned income. Under the proposed regulations, however, the exercise of a nonstatutory option whose terms permit exercise more than 3 months after termination of employment will result in "deferred compensation" and thus in ineligibility for the 50% rate on earned income. Proposed Treas. Reg. § 1.1348-3(b)(3)(iii)(*b*), 36 Fed. Reg. 23819 (1971).

to defer taxation, since the restriction now imposes a substantial risk of forfeiture, but upon the restriction's lapsing in the eighth year he will have to take into his compensation income the entire difference between the 200-dollar appreciated fair market value of the stock and the twenty-dollar option price. This will entail a 90-dollar tax payment under the 50 percent maximum rate on earned income[161] and will leave the employee with an after-tax gain of 90 dollars if the stock is sold; a result again reflecting a less favorable situation after 1969.

Finally, if the restriction is changed to a nonlapsable book-value buy-out provision, which is cancelled under circumstances suggesting compensation in the eighth year, the pre-1969 employee would have paid no tax at exercise, would presumably have paid a 56-dollar ordinary income tax upon cancellation, and would have had an ultimate after-tax gain of 99 dollars. The employee also would have saved 21 dollars in the year of exercise by deferring taxation on the 30-dollar economic value of his gain at that time, a savings that could have grown to 36.75 after-tax dollars by the time of cancellation, if invested at ten percent. The post-1969 employee, however, would pay a fifteen dollar earned-income tax on the 30-dollar difference between book value and option price (the restriction is taken into account since by its terms it never lapses), and, when the restriction is cancelled, a 50-dollar tax upon the 100-dollar resulting increase in the stock's value.[162] The 50 dollars of untaxed appreciation presumably will receive capital gain treatment upon disposition of the stock, resulting in a tax of 17.50 dollars, a possible preference tax of 75 cents, and a possible increase in tax from displacement of earned income of five dollars.[163] Thus the employee would have a total after-tax gain of 92.25 dollars, a result appreciably less advantageous than under pre-1969 law, even when the value of the tax saving occasioned by the pre-1969 employee's ability to defer taxation completely is not considered.[164]

161. The 50% maximum rate offered by § 1348 would clearly apply here, since the compensation is received less than one year following the year the substantial risk of forfeiture terminated. *See* INT. REV. CODE OF 1954, § 1348(b)(1).

162. The $50 tax assumes that the 50% maximum tax rate on earned income will apply. *See* note 160 *supra*.

163. These effects from the minimum and maximum tax provisions will take place only if the highly compensated employee has tax preference items in the year of disposition of over $30,000 plus taxes paid.

164. The pre-1969 employee in this situation had $56 in the year of exercise that would have gone to pay taxes had taxation not been deferred. If the employee had invested this amount in company stock, its value would have been increased to $112 by the year of cancellation, at which time he could have disposed of it and collected $98 in after-tax proceeds.

III. Analysis of the Continued Utility of Option Arrangements Under The 1969 Act

A. *Questions That Must Be Answered To Analyze the Ultimate Impact of the 1969 Changes*

As the preceding section demonstrates, it is easy to show that the full adverse effects of the 1969 Tax Reform Act, when compared to the results under prior law, can operate to limit severely the utility of stock option arrangements as a means of attracting and holding key employees. Extreme examples of comparative disutility do not, however, support a conclusion that stock options are moribund as executive compensation devices, although some commentators have apparently taken this stance.[165] First, to say that stock options are less desirable now than in 1968 is not to say that stock options are presently undesirable. Secondly, the Reform Act provisions' design to affect adversely high-income taxpayers who have structured their transactions to receive substantial amounts of income through congressionally disfavored sources does not automatically mean that every taxpayer who dares to exercise a stock option will suffer disastrous tax consequences. Finally, although the tax consequences of compensation are undeniably important, nontax considerations should not be ignored in analyzing the utility of compensation arrangements.

It is impossible to evaluate accurately the impact of the 1969 changes on stock option arrangements without first identifying precisely the goals that option arrangements are designed to achieve, for it is only to the extent that the Reform Act thwarts realization of those goals that it diminishes the utility of option compensation, regardless how horrific its consequences may seem in the abstract. Clearly, the goals sought through option arrangements are shaped with the desires of two separate parties in mind—employer corporations and employees. For purposes of analysis, perhaps it is more helpful to examine the parties' goals separately before proceeding to evaluate the chances of their attainment under the provisions of the Tax Reform Act.

1. *The Employer's Objectives.*—There are at least four identifiable goals that employer corporations may wish to attain through the use of option arrangements. First, the employer corporation may desire to imbue its employers with a sense of proprietary concern, so that they will identify the corporate welfare as tantamount to

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165. *See, e.g.*, Childs, *supra* note 2, at 818.

their own. Secondly, the employer may wish to place the employee in a position such that he will receive a direct financial advantage to the extent his own job efforts increase the profitability of the company's operations. Thirdly, the corporation must couch its offer of participation in terms attractive enough to secure and retain desirable employees—a presumably scarce commodity, sought after by many potential employers. Finally, the corporation will want to achieve the preceding objectives at the least possible cost.

2. *The Employee's Objectives.*—While employees may have genuine desires to become shareholders of the corporation, presumably they are concerned primarily with maximizing their own financial returns. Thus, the overriding employee goal in any compensation arrangement would seem to be the realization of maximum after-tax economic benefit. Depending upon his total income situation, an employee obviously will be interested in deferring taxation, securing a lower tax rate, or combining these techniques to maximize his economic gain from a given amount of compensation. Although stock option arrangements, even after the 1969 Act, can be used to achieve both deferral and rate reduction to some extent, defining employee goals only in terms of the possible operation of these tax planning techniques upon a given compensation "amount" would result in incomplete analysis.

In addition to weighing the tax consequences attendant to the various forms that his compensation might take, the employee must be concerned about the absolute amount that he will receive before taxes. Obviously the employee who succeeds in securing from his employer the "perfect" tax minimization compensation arrangement will do little to accomplish his underlying objective of maximum economic benefit if his pretax income is insubstantial; conversely, an employee who unthinkingly exposes his satisfactorily high compensation to the most massive tax bite possible has also failed to achieve his ultimate goal. Realization of that goal necessarily entails receipt of an optimum package of pretax compensation with some tax-limiting form.

An employee might maximize his economic gain through stock options because of their pretax benefits as well as their tax incidents, because an employer should logically be willing to place a more substantial pretax gain in the employee's hands through stock options than through alternative forms of compensation. This nontax advantage of option arrangements arises, first, because granting a stock option costs the employer corporation very little in comparison to the benefit it affords the employee. In the absence of a spread

at grant, there is no charge against corporate earnings,[166] and the employee still receives a valuable (and usually tax-free) right to benefit from any appreciation in the stock's value without assuming any investment risk.[167] Secondly, the corporation would seem to incur only minimal later costs. If the employee does not exercise his option, the corporation cannot be said to have suffered any great option-related economic detriment. Even when the employee realizes a significant economic gain through exercising an option on appreciated stock, the spread at exercise is not a charge against earnings for financial reporting purposes,[168] and any real cost involved, such as the economic cost of foregoing the sale of stock at a higher price or that of a dilution in earnings per share, is borne by individual shareholders.[169] Finally, since the employer may affirmatively desire that key employees acquire a proprietary stake in the business, he may thus be willing to incur a greater cost in providing employees with company stock than in supplying economic benefits that carry no such intrinsic advantage to the corporation. In short, the employer is likely to feel that he can spend less but get more by using stock options.

B. Limits on the Degree to Which the 1969 Act Can Affect the Achievement of Stock Option Objectives

1. *No Impact on Nontax Objectives.*—By definition, the Tax Reform Act of 1969 could hardly have affected the nontax goals that stock option arrangements are designed to achieve. It is still important, however, to emphasize that the employer objectives of instilling proprietary attitudes and providing incentives for profit-making performance are left untouched by the Act. Similarly, there is no impairment of the employee's ability to realize maximum pretax

166. *See* Anderson, *Traditional Forms of Compensation (Options, Stock and Cash) After the Tax Reform Act*, 24 U. So. CAL. TAX INST. 547, 550 (1972).

167. Cash compensation, on the other hand, entails a charge against corporate income, in the amount of the compensation. Even though the corporation may, through its ability to deduct the same amount from its taxable income, incur an actual cost of little more than half the compensation paid out, it is a cost nonetheless. *See* Bachelder, *Tax and Accounting Aspects of Costs of Nonqualified Compensation Plans*, N.Y.U. 30TH INST. ON FED. TAX. 443 (1972).

168. Anderson, *supra* note 166, at 550.

169. Although the corporation and its owners (shareholders) are separate legal entities, and the shareholders' costs are not those of the corporation, it may seem sophistic to assert that option exercise thereby costs the corporation nothing. It is possible, however, that shareholders, at least in a publicly held corporation, will not suffer the full adverse economic effects of dilution, since it may not, due to other factors that influence the market, be reflected in the market price of their stock.

economic gain through the employer's willingness to provide larger absolute benefits in option form. The relative importance of these nontax objectives of option compensation vis-a-vis tax-related goals is difficult to assess, since each is in large part a product of the employer's subjective judgment. Nevertheless, it seems possible that some employers and employees might conclude that stock option arrangements have substantial continued utility, regardless of the possibility of severely reduced tax advantages under the 1969 Act.

2. *Narrow Scope of Impact on Tax Related Objectives.*—Tax considerations obviously bear heavily on the capability of employees to achieve maximization of after-tax compensation, and, to a lesser extent, upon the employer's objective of reducing compensation costs.[170] Thus, to the extent that the 1969 Act substantially impairs the ability of employers and employees to accomplish these goals through the use of stock options, it has impaired the general utility of stock option arrangements. None of the potentially adverse provisions of the Reform Act, however, applies to all stock options. To the extent that these provisions do not apply, the utility of stock option arrangements will, again by definition, be as great as under prior law.

Generally, the 1969 Act can be said to have little or no effect on the ability of employers and employees to use qualified options for achieving tax-minimization objectives unless the employee is relatively highly compensated; the position of an employee whose purchase or disposition of option stock does not remove him from the category of persons with salaries less than 52,000 dollars and tax preference items not exceeding 30,000 dollars is not changed by the Tax Reform Act. Similarly, the tax treatment of nonqualified options that do not involve restrictions remains unaffected by the Act, unless the employee has a sufficiently high amount of earned income to make "deferred compensation" disqualification of such income applicable.

(a) *The Minimum Tax.*—The minimum tax has no effect on employer deductions or nonqualifying options; it may have virtually no impact on qualified option use by middle-income employees and highly paid executives who receive substantially all their income

170. The significance of tax law on employer cost reduction goals lies in the question of whether the employer will receive a deduction as the result of the transaction. Since, with respect to stock options, the Tax Reform Act has changed the law in this area only in the context of restricted property, this consideration is considerably less critical than the question of the employee's tax treatment.

through salaries and options. The ten percent tax on items of tax preference imposed by section 56 applies only when the taxpayer's preference items for the current year exceed 30,000 dollars plus both his current income tax liability and his tax carryovers from the previous seven years. Thus, middle-income employees have little to fear from the minimum tax; even an employee with a taxable income of 100,000 dollars could absorb a 72,000-dollar spread on exercise or a 144,120-dollar capital gain on disposition without incurring the minimum tax if he has no other tax preferences for the current year. If the employee had not received tax preference items exceeding 30,000 dollars per year in the recent past, those amounts could increase enormously.[171] Furthermore, since the income tax generated by each marginal dollar of salary can shield up to 50 cents worth of tax preference items from the minimum tax, even a very highly compensated executive need not worry about the minimum tax, as long as his current compensation income remains at least 18,000 dollars above two-thirds of his total income.[172] In the event the employee should suffer the catastrophe of having his tax preference items exceed the generous offsets provided by the Code, he still may not feel the brunt of the full ten percent tax. If the offending preference item is capital gain from the disposition of his option stock, the 35-percent alternative tax due will increase the allowed offset, resulting in an effective rate of only three percent on the preference amount.[173] Only when the offending item is the exercise spread on a qualified option, which itself generates no offsetting tax liability,[174] will the full minimum tax impact be felt.

(b) *The Maximum Tax.*—The maximum tax has relevance only for relatively highly compensated employees. Although the maximum 50-percent rate on earned income affects qualified stock op-

171. The increase comes from the carryover provisions of § 56(c), which allow "unused" amounts of tax liability to be applied against preference items over the following 7 years. *See* notes 87-89 *supra* and accompanying text.

172. The $18,000 figure represents the tax paid on the first $52,000 of the employee's income, before the 50% rate becomes applicable. The example assumes that the 50% maximum rate on earned income applies. To the extent that the employee is taxed at the higher rates of § 1, the sheltering ratio would be correspondingly greater.

173. For example, a $100 capital gain represents a "prima facie" preference item of $50. The offsetting tax ($35) generated, however, reduces the preference item to $15, 10% of which is $1.50. $1.50 is 3% of the original preference item.

174. Even the exercise spread can generate offsetting tax in one situation. When the employee suffers from displacement of earned income as a result of the tax preference represented by an option spread in excess of $30,000, the transposition to the ordinary income rate schedule can increase the employee's taxes by an amount equal to 20% of the spread, thus doubly shielding the spread from the minimum tax.

tion arrangements by reducing the disparity between the maximum rates applicable to current salary and capital gains, this effect is not felt unless the taxpayer has earned income in excess of 52,000 dollars.[175] Similarly, section 1348's earned income disqualification penalty for tax preferences will not become significant until the employer has taxable income over 52,000 dollars and current or averaged tax preference items in excess of 30,000 dollars. Thus, a highly compensated employee can absorb 130,000 dollars of exercise spread or capital gain preference over the five-year period during which a qualified option is allowed to remain outstanding without experiencing any adverse effect under section 1348.[176] Finally, the maximum tax provisions cannot affect the exercise of nonqualified options unless the employee receives in excess of 52,000 dollars in earned income. The maximum tax has no effect on employer deductions.

(c) *Capital Gain Rate.*—The Reform Act's increase in the section 1201 alternative tax rate has no effect on employees whose ordinary income plus capital gain not deductible under section 1202 is less than 52,000 dollars.[177] Even for high-income taxpayers, the first 50,000 dollars of capital gain is taxed only at 25 percent. Thus at least 50,000 dollars of post-1969 gain can be received each year without experiencing the effects of the 1969 Act.

(d) *Section 83.*—Although section 83 does not apply to qualified stock options, it reaches nonqualified option arrangements regardless of the amount involved. The section changes pre-1969 law, however, only when restrictions are imposed upon the option stock, thus leaving nonrestricted, nonqualified option devices unaffected by the Tax Reform Act.

C. *Effects of the Reform Act Upon the Tax-Related Goals of High-Income Taxpayers*

As previously indicated,[178] when the full adverse effects of its provisions are felt, the Tax Reform Act can substantially diminish the opportunity of maximizing after-tax gain through the use of

175. Since the ordinary income rates of § 1 do not exceed 50% until taxable income goes above $52,000, the maximum tax has no effect prior to that point, and thus cannot be accused of reducing the disparity. It should be noted here that the first $50,000 of capital gain is taxed only at 25% by the alternate tax of § 1201(b).

176. This assumes that the taxpayer has no other tax preferences.

177. Taxpayers with smaller "total" incomes will obtain an effective tax rate of 25% or less through the graduated rates of § 1.

178. *See* text accompanying notes 150-64 *supra*.

option arrangements. The full adverse effects of the 1969 Act are not, however, inexorably visited upon even the high-income employee. When the employee's economic status exposes him to the possibility that the 1969 provisions will become operative, it is by no means certain that all provisions will apply, or that the tax consequences of the applicable provisions warrant an automatic conclusion that stock options are no longer viable tax-saving devices. To the extent that the provisions of the Act do apply, it can be assumed that the results will be less favorable than under prior law, and the question becomes whether option arrangements retain tax utility as compared with existing compensation alternatives. Since space does not permit individual consideration of the plethora of currently possible compensation devices, the utility of stock option compensation will be compared with that of compensation in cash for two reasons. First, the availability of the 50 percent maximum tax suggests that cash may now be a relatively desirable form of compensation; hence, insofar as stock options can improve upon the after-tax results produced by earned income, they certainly can be said to have retained tax minimization utility. Secondly, cash compensation represents a convenient standard against which to measure relative utility; since other forms of compensation are likely to be described utilizing comparison with traditional salary arrangements, a similar analysis here may provide something of a common denominator.

1. *The Qualified Option, the Highly Compensated Executive, and the 1969 Act.*—Regardless of the heights to which an employee's income may rise, the minimum tax provisions of section 56 and the increased alternative capital gain rate of section 1201 are not likely to impinge substantially upon his ability to achieve the tax minimization goals of qualified option arrangements. Although the fifteen percentage point differential between the alternative capital gain rate and the earned-income rate under the 1969 Act is much less than the 45 point differential that existed under prior law, the capital gain rate is still lower, hence more advantageous. Superficially, it might seem that the addition of a ten percent minimum tax on the exercise spread and what amounts to a five percent minimum tax on the capital gain at disposition[179] would exactly cancel out any advantage from the transition to the alternative rate structure of-

179. The minimum tax is 10% of the preference item (less offsets). Since the preference item here is ½ the capital gain, the 10% preference tax on that is equal to a 5% tax on the entire gain.

fered by qualified options; this is by no means the case, however, for three reasons. First, the alternative and "preference" capital gain taxes are applied only after the employee has had the opportunity to defer taxation for as long as he wishes, thus gaining for himself any pre-tax appreciation on the portion of the option spread that was sheltered from direct taxation at exercise.[180] Thus, even assuming that the full adverse effects of the minimum tax apply, the employee whose option stock doubles in value between exercise and disposition will enjoy an ultimate after-tax gain that is 135 percent greater than the gain he would have achieved by taking an amount equal to the spread at exercise as direct cash compensation and investing the sum remaining after taxes in the employer's stock.[181] The substantiality of this tax advantage, however, is clearly dependent upon continued growth in the market value of the employer corporation's stock. Secondly, even when the value of the employer's stock remains constant, the total of the ten percent preference tax at exercise and the five percent rate applicable at disposition will not totally eradicate the fifteen point rate differential between the capital gain and earned-income taxes, because the tax generated by the capital gain itself will reduce the effective rate at disposition.[182] Finally, it seems quite likely that the tax penalties from preference items will not affect most employees, since the higher the employee's current compensation, the more likely it is that the offsetting tax thereby generated will completely shelter his

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180. There is something of a semantic problem in analyzing the tax effects of the preference taxes. Thus, the minimum tax is "on" the amount represented by the preference item, but the maximum tax displacement penalty is not really a tax "on" anything; it's simply a disqualification of an amount of "earned income" for the earned income rate. For purposes of a more descriptive analysis, both the minimum tax and the maximum tax penalties will be treated as separate "costs."

181. This example, of course, involves assuming either that the maximum tax does not apply, or that the taxpayer has no earned income available to suffer from displacement. The example also involves assuming that the capital gain realized upon disposition would somehow not generate offsetting tax. It does, however, show the benefits of deferral. On exercise, the option-compensated employee would have a $10 tax cost, and on disposition, would pay a $10 tax, in addition to his $70 capital gains tax, for an after-tax gain of $120. The cash-compensated employee would have $50 after taxes, plus $10 saved from not paying a preference tax. Invested in company stock, this $60 will grow to $120, which, after taxes of $21 for capital gains, and $6 for preference, will leave a net gain of $93, of which $120 is approximately 129%.

182. The offset amounts to the tax paid on the tax preference item. Since the preference item is equal to 50% of the entire capital gain, and since the tax amounts to 35% of the gain, only 15% of the total gain is left as a preference item. Thus, the preference tax rate of high-bracket capital gains is 1.5% of the entire gain, or 3% of the pre-offset preference item, and the sum of the 2 preference rates on the spread (assuming no growth in the stock), would be 11.5%, not 15%.

preference items from the minimum tax.[183] Moreover, in the unlikely event that his option prospects are so overwhelmingly lucrative that they threaten exhaustion of available tax offsets, the employee can arrange for option terms allowing installment exercise, in order to ensure that tax carryover from up to seven years prior to grant can be brought into play. In view of the ease with which preference items may be sheltered, it seems safe to conclude that the minimum tax may be largely disregarded for the purpose of subsequent analysis.

Post-1969 survival of the qualified option's potential for tax minimization under sections 56 and 1201, however, does not mean that the erstwhile optionee is home free. The antipreference reach of section 1348 is broad enough to impair severely the tax utility of option arrangements for high-income taxpayers. Like the other provisions of the Reform Act, however, section 1348 does not impose a blanket penalty on qualified option use. As previously noted,[184] section 1348 does not affect employees who earn less than 52,000 dollars a year; conversely, it will not reach employees whose preference items remain below 30,000 dollars a year, regardless of how much they earn. For employees who do not fit within either of the above situations, the displacement-of-earned-income penalties of section 1348 are incurred only gradually, as the employee moves from 52,000 to 200,000 dollars of otherwise earned taxable income per year.[185] More importantly, even the full adverse effects of the maximum rate provisions may not wipe out entirely the ability of employees to maximize after-tax gain through qualified option arrangements, because of the opportunity for appreciation in the option stock's value prior to taxation that such arrangements afford.

It is possible to view section 1348's maximum rate-displacement effects as imposing an additional twenty percent tax on the spread at exercise of a qualified option and an additional ten percent tax on the appreciated spread at disposition of the underlying stock,[186] thus resulting in an effective tax rate of 65 percent, as

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183. *See* notes 171-72 *supra* and accompanying text.

184. *See* notes 175-76 *supra* and accompanying text.

185. This means the employee is moving from the 53% bracket, in which displacement of $100 of earned income will result in only a $3 increase in tax, to the 70% bracket, where displacement of the same amount results in a $20 increase.

186. In analyzing the effects of § 1348 earned income displacement on qualified options, it is important to distinguish between capital gain generated by appreciation on the option spread, and capital gain generated by the amount actually invested, i.e. the option price. The former is the distinguishing attribute of qualified option treatment; the latter would follow from any investment, and is not pertinent to analysis of option versus alternative compensation.

compared to the 50 percent rate that would have applied had the employee taken the same amount of compensation in cash. Under this kind of analysis, qualified options would lose all tax advantage once the section 1348 vulnerable employee passed the 60 percent marginal rate on ordinary income. Compensation in the form of a 100-dollar option spread to an employee in the 60 percent bracket would result in a ten-dollar tax increase from displacement of earned income on exercise, and upon disposition a 35-dollar capital gain tax, coupled with an additional five-dollar tax increase from the displacement effects of section 1348. The tax effect of straight cash compensation in the same amount would be an immediate tax of 50 dollars. Since the total tax would be equal to 50 dollars in each case, and since any increase in the employee's marginal tax rate would result in additional penalty effect under the option arrangement but would not alter the tax effect of the cash compensation scheme, the qualified stock option invariably would be declared disadvantageous for employees whose taxable incomes exceed 100,000 dollars.[187]

Although the above analysis is based upon the undeniably correct premise that the total tax burden upon a given amount of qualified option compensation begins to exceed the total tax burden on cash compensation after applicability of the 60 percent ordinary income rate, the analysis itself is unsound, because it does not allow for the effects of stock appreciation and tax deferral. It is not sufficient merely to sum up the tax rates that are effectively applied to the stock option spread. This will distort the actual impact of the individual rates because they are applied at different times between which the amount to which they apply can appreciate in value. For example, even in the most unfavorable section 1348 situation, the exercise of a qualified stock option will entail a current tax penalty equal only to twenty percent of the spread, while the receipt of an equal amount of current cash compensation will result in the immediate imposition of a 50 percent tax. Assuming the amount in question is 100 dollars, the employee who exercised his option has paid the government twenty dollars, thereby foregoing any future productive use of that money; but he has retained, in the form of stock, the entire 100-dollar gain from the exercise spread, and may look forward to an intervening period during which that amount may

187. That is, those employees whose marginal rates exceed 60%, and for whom (under this analysis) each additional dollar of tax preference items would increase their total effective tax rates.

grow, before it becomes subject to taxation at an effective rate of 45 percent.[188] On the other hand, although a similarly situated employee who received cash would have only 50 dollars left from his 100-dollar paycheck, he would have twenty more after-tax dollars than his option-compensated counterpart, because he would not have had to suffer a 20 percent penalty from sacrificing 100 dollars of earned income to the ordinary rate structure. The employee would therefore have 70 after-tax dollars as a result of choosing cash in lieu of option compensation, and would, as a rational high-income individual, presumably invest the amount in productive assets. For the purpose of eliminating analytical complications,[189] it may be assumed that these assets will appreciate in value at the same rate as the company stock. With the tax effects of the initial compensatory transactions accounted for, the situation now presents an adequate framework for analysis of the effects of deferral and appreciation. The cash recipient can, like the option holder, expect an intervening period of asset growth before the gain on his 70-dollar investment will be taxed at the same 45 percent effective rate that will apply to his counterpart's gain, since both employees are equally affluent, hence vulnerable to displacement of earned income by capital gain. The difference between the two is that the option-compensated employee has 100 dollars worth of assets, which, together with additional gains from growth, will be taxed in the future at 45 percent, while the cash-compensated employee has 70 dollars in assets, only the subsequent *gain* from which will be exposed to the 45 percent tax. In any future year, the first employee's ultimate economic gain will therefore be equal to 55 percent of the amount to which his 100 dollar spread has grown, while that of the second employee will be 70 dollars plus his after-tax gain—55 percent of the amount by which the appreciated value of his investment exceeds 70 dollars. Thus, if the value of the option spread has grown to an amount X, the value of the cash investment, since both grow at the same rate, will have grown to $.7X$, and the ultimate economic benefit to be derived will be $.55X$[190] for the first employee,

188. This 45% figure is comprised of the 35% capital gains rate and the effective 10% penalty from an amount of earned income equal to the preference element of the appreciated spread, and since the tax increase from displacement is 20% of that amount, the amount of displacement penalty is equal to 20% of 50%, or 10% of the appreciated spread.

189. Although different investments in reality will likely grow at different rates, no one can tell beforehand what the rate will be. Since this analysis is confined to tax effects, the intrusion of elements of "betting on the market" would not be helpful or analytically sound.

190. The effective tax rate on disposition is 45%, *see* note 188 *supra*, and the tax due on disposition is thus $.45X$, and the after-tax gain, by subtraction, is $.55X$.

and \$70.00 + .55(.7*X*-\$70.00), or \$31.50 + .385*X*, for the second. Clearly, as the employer's stock increases in value, the amount of the difference between .55*X* and .385*X* will grow larger and larger. Just as clearly, once the amount of that difference exceeds \$31.50, the employee who utilized the stock option arrangement will have the larger ultimate economic gain. That difference (.165*X*) here equals \$31.50 when the value of the original option spread has grown to \$190.91, thus promising the option-compensated employee that he will maximize his after-tax economic gain by holding on to his optioned stock until its value rises to approximately 191 percent of the market price at exercise.

Similarly, since the dollar figures in the above example may be directly transposed to generally applicable percentages, any employee can be certain that qualified option arrangements will offer greater tax advantages than cash compensation whenever the option stock has a substantial growth potential. Assuming that a ten percent annual growth rate is likely to be typical, the "magic" 191.1 percent appreciation figure is reached in around seven years;[191] since qualified arrangements retain tax utility even in the absence of deferral and appreciation considerations for taxpayers below the 60 percent bracket, those taxpayers for whom the 191.1 percent figure is relevant would seem well able to afford the wait. For taxpayers above the 60 percent tax bracket who find it necessary to dispose of optioned stock before it has approximately doubled in value, however, there seems to be no escape from the penalizing effects of section 1348. The absence of any tax-generated preference-item offset and the presence of the five year averaging provision leave the taxpayer no apparent means of circumventing the 30,000-dollar limit on penalty-free qualified option exercise or capital gain receipt. Except as to these taxpayers, the previously described insubstantiality of the threat posed by the minimum tax provision and the preceding analysis would seem to warrant the conclusion that qualified stock option arrangements, even after the 1969 Act, remain capable of advancing the tax-related objectives of employees.

2. *The Nonqualified Option and the 1969 Act.*—The Tax Reform Act changes impinge upon unrestricted nonqualified option arrangements since the capital gain rate, upon eventual disposition of the optioned stock, is increased and the capital gain itself may generate tax-preference and earned-income displacement penalties. These adverse tax consequences are, in the absence of appreciation

191. At the end of 7 years, the percentage figure would he 194.87%.

in the optioned stock's value, effectively compensated for by the twenty percent decrease in the tax burden on exercise as a result of the maximum rate on earned income.[192] Any post-exercise appreciation, however, by increasing the amount of after-tax gain represented by the disparity between the 25 percent alternative rate under prior law and the 45 percent effective rate on disposition that is now likely to be encountered by high income taxpayers on disposition, will render nonqualified options less advantageous after 1969 than before. Nevertheless, given the availability of earned income treatment for the spread at exercise, nonstatutory options are equally as effective as cash in achieving tax minimization goals, and should not, therefore, be ruled out as compensation devices.

Similarly, the adverse consequences attending the realization of capital gains under the 1969 Act operate to reduce the tax advantages of nonqualified option arrangements involving restricted stock. The additional tax effects resulting from section 83's application to these arrangements, however, make analysis somewhat more difficult. Although section 83 allows employees to defer taxation, the section 83 deferral opportunity is not as attractive as the deferral opportunity presented under prior law for two reasons. First, section 83 deferral is conditioned upon the imposition of a substantial risk of forfeiture. While it seems clear, for example, that incurring a twenty percent probability of losing one's stock is economically equivalent to suffering a twenty percent tax on that stock's value, degrees of risk are probably not susceptible to such a percentage definition. The impact of the forfeiture requirement of section 83 is therefore not quantifiable, and will depend upon the subjective judgment of the individual employee. Secondly, section 83 requires that any deferral-period appreciation in the optioned stock's value be taxed as compensation, rather than as capital gain. As compared to pre-1969 law, this requirement actually decreases the tax rate that is applied at the time of restriction lapse from 70 percent to 50 percent[193] (assuming the stock is not sold at lapse), but it potentially increases the amount subject to taxation by the amount of post-

192. The 1969 Act's reduction of the rate on exercise (assuming the exercise qualifies for earned income treatment) is equal to 20% of the spread. Assuming the stock does not appreciate, the same amount will be taxed at the increased post-1969 rates on disposition. The effective rate on disposition is 45% (assuming that the disposition is completely sheltered from the minimum tax), a 20% increase over the pre-1969 25% capital gain rate, and the 2 changes cancel each other out.

193. There is no problem here with the availability of earned income treatment for the spread, since § 1348 specifically excludes amounts received upon the lapse of substantial risks of forfeiture. INT. REV. CODE OF 1954, § 1348(b)(1).

exercise appreciation. Depending on the growth of the underlying stock, an employee who sells his stock upon lapse of the restriction could actually benefit more under section 83 than under prior law. Since the pre-1969 employee's advantage from the 25 percentage point rate differential on appreciation will not offset the section 83 employee's twenty point advantage on initial spread until the value of the underlying stock increases to 180 percent of its value at the date of exercise, section 83 would seem to present possibilities of tax advantage to the recipient of restricted stock whose risk of forfeiture terminates before the 180 percent appreciation point is reached. This analysis, however, does not account for the economic detriment from incurring a substantial forfeiture risk, nor does it account for the fact that a pre-1969 taxpayer could put off taxation on post-exercise appreciation until he decided to sell the stock, rather than having the rate applied at the time of restriction lapse, so that he could maximize his gain by holding the stock well beyond the 180 percent point.

Although the foregoing analysis would seem to indicate that the use of restricted stock in nonstatutory option arrangements would be substantially less advantageous after the Tax Reform Act than before, such arrangements nevertheless provide tax advantages over current cash compensation and may therefore have continued utility as tax minimization devices. This continued utility derives from the probability of appreciation and the tax benefits of deferral. For example, if one employee receives 100 dollars of spread by exercising a nonstatutory option on restricted stock, and a second employee receives the same amount in direct cash compensation and then invests the after-tax remainder in assets that will grow at the same rate as the restricted stock, the first employee is in a more favorable position to maximize after-tax gain. If the growth rate is zero, both employees will have 50 dollars of net economic gain. For each one-percent increase of growth above zero, however, the first employee will have 50 cents of potential after-tax gain, while the second, even assuming that none of the preference-related penalties apply, will have a potential post-tax gain of only 32.5 cents.[194] In the first case, the employee is receiving the benefit of all his productive resources;

194. For the first employee, each 1% increase in his $100 investment will represent a potential $1 gain, which will be taxed at the 50% maximum rate, *see* note 118 *supra* and accompanying text, leaving him 50¢ of after-tax gain. Each 1% increase in the second employee's $50 investment will bring him 50¢, which represents a potential gain that will be taxed at the 35% rate for capital gains, resulting in a tax of 07.5¢, and 32.5¢ of after-tax gain.

in the second, the employee has donated one-half of his gain-generating ability to the government.

IV. Conclusion

The Tax Reform Act of 1969 has not ended the utility of stock option arrangements as a means of achieving the goals that stock options were presumably designed to secure. Most of those goals are not incompatible with the congressional purpose of discouraging attempts at tax avoidance through disfavored "preference" avenues; yet to the extent that the employee's goal of maximizing economic gain through minimizing taxation appears to conflict with the legislative aim, substantial questions arise. Nevertheless, the greater number of these questions disappear upon analysis, because (1) the adverse effects of the applicable new Code sections have relevance only to relatively highly paid employees, and (2) most highly compensated employees, despite the fullest application of the antipreference penalties the Code can muster, will still find that stock option arrangements continue to provide tax advantages, although those advantages are likely to be smaller than under prior law. Only employees with taxable incomes over 100,000 dollars seem inextricably hampered by the Act, and then only with reference to qualified options, and only to the extent that their items of tax preference exceed 30,000 dollars.

To say that stock option arrangements retain tax advantages, of course, is not to say that stock options represent the most efficient means available for tax minimization. Just as option compensation generally is more effective than cash in advancing employee tax objectives, other forms of compensation may be superior to options as tax minimization devices. The point, however, is that when the completely unimpaired nontax attributes of option compensation are considered, the conclusion seems inescapable that stock options have continued usefulness as tax-planning devices for the foreseeable future.

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