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EXECUTIVE COMPENSATION: THE TAXATION OF STOCK OPTIONS

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The popularity of the stock option as a method of executive compensation results primarily from its favorable tax consequences. Under present law, an executive's ordinary income may be converted into capital gain. These discriminatory provisions provide a fertile field for tax avoidance.

The first portion of this paper deals with the history of stock option taxation to date. Much of the earlier law remains applicable. The historical perspective shows the wide latitude for avoidance and the faulty assumptions in which tax treatment has been grounded. The second part deals with the present tax treatment of stock options.

I. THE DEVELOPMENT OF STOCK OPTION TAXATION

A. Options Before 1950

The history of stock option taxation is the history of a battle between Congress[1] and the lower courts,[2] on one side, against the Treasury, with occasional support from the Supreme Court.[3] Considering the odds against it, the Treasury has been remarkably successful in the struggle, but it has not been able to limit the option to reasonable proportions as an incentive device.

Many different kinds of stock options have been used, but they usually follow this pattern: corporation *C* gives executive *E* an option for a limited time to buy stock in *C*. The price will generally be near the market value, or slightly above it. A gain will accrue to *E* if the market value of the stock rises above the option price during the option period, and he exercises his option at that time. The anticipated gain, then, is the future rise in the value of the stock.

If *E* does make a profit, the tax problem appears. How much of the increment should be taxed? When should it be taxed? Should it be taxed as ordinary income or as a capital gain?

Taxpayers have argued that options are not compensation, but merely sound methods of bringing executives into equity ownership.

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1. The role of a militant Congressman is well-played by Representative Knutson at 93 CONG. REC. A4060-66 (1947).
2. The extent to which some lower courts have taken up the fight is indicated by the Tax Court decision in Philip J. LoBue, 22 T.C. 440 (1954). See note 66 *infra*.
3. Commissioner v. LoBue, 351 U.S. 243 (1956); Commissioner v. Smith, 324 U.S. 177 (1945).

They have argued further that since stock options are excluded from the statutory definition of ordinary assets,[4] they must be given capital gain treatment. The Treasury has consistently believed that ordinary income rates should apply to the difference between what the employee pays for his stock and the fair market value at the time he receives the stock. This is based on the assumption that the gain represents compensation to the executive. The regulations have taken that position except when court decisions have forced a temporary retreat. These have been the general lines of battle.

The first Treasury statement on the subject in 1923 announced that the Treasury intended to tax any option which had a "substantial" spread at the time of exercise, and that the amount of ordinary income would be measured by that spread.[5] This regulation was repeated, with minor variation, until 1938. During this period from 1923 to 1938, the cases seem to have gone in all directions, with the circuit courts of appeal destroying any semblance of uniformity in the area. As the Board of Tax Appeals viewed it: "We do not think it is possible to harmonize the cases which have been decided."[6] Most of the cases appear to have been decided in favor of capital gain treatment for the taxpayers. Preferential treatment was denied where there was a clear element of compensation. The latter was determined by the motivation of the employer.[7]

Geeseman v. Commissioner,[8] the earliest important case, was decided in 1938. In 1931 the Continental Can Company gave the taxpayer an option to buy stock at $30 per share; the market value at that time was $36. In 1933 he purchased 640 shares when the market value was about $70 per share. The Commissioner proposed to tax him on the difference between the market value of $70 and the purchase price of $30, as ordinary income. The court found little help in the precedents. It said that to hold for the taxpayer on the ground that this was solely the purchase of an asset would be unrealistic; to hold for the Commissioner because this was a simple matter of compensation would be equally unrealistic. Since both elements are always present courts must look to see which aspect is dominant. But at this point the court loaded the scales heavily on the side of capital gain treatment. The option would be characterized as compensation only (1) when the parties had a definite understanding that the option price would be fixed or controlled by services rendered, or (2) when it would be absurd and unreasonable to say

4. INT. REV. CODE OF 1954, § 1221. Sections of the 1954 Code will hereinafter be cited only by section number.
5. T.D. 3435, 1923-II-1 CUM. BULL. 50 (1923).
6. Edward J. Connally, 45 B.T.A. 374, 376 (1941).
7. For a collection of cases, see Annot., 146 A.L.R. 1391 (1943).
8. 38 B.T.A. 258 (1938).

that the option was not compensation. Guided by these principles, the court had no difficulty in finding for the taxpayer, since he had made no promise to remain with the company, and consequently there was no firm agreement as to compensation for future services to be rendered.

After the *Geeseman* decision, the Treasury reluctantly retreated. The regulations under the Revenue Act of 1934[9] and the Revenue Act of 1936[10] were amended by T.D. 4879.[11] This provided that any gain resulting from exercise or sale of the option would be taxable only when the option was in the nature of compensation.[12] It does not appear that *Geeseman* and the resulting regulations had much effect on subsequent court decisions. A later decision of the same court said that the new regulation was merely the statement of a rule already settled by the cases.[13] If there was any effect at all, it was to render even more difficult the task of the Treasury in trying to tax options with elements of compensation.

In 1945, the Supreme Court contributed to the confusion with its opinion in *Smith v. Commissioner*.[14] The taxpayer was employed by Western Cooperage Company, which had taken over the management of the Hawley Pulp and Paper Company under a reorganization plan. When Hawley's indebtedness was reduced by a certain amount, Western was to receive Hawley stock in payment for services. Prior to the receipt of any stock, Western gave the taxpayer an option to purchase Hawley stock if and when it was received. There was a finding of fact that the option had no value at the time of grant, because the market value of the stock did not exceed the option price. Since there was no value to the option when given, and since the arrangement was clearly intended to be compensation, the Supreme Court affirmed the Tax Court in holding that the intended compensation must have been the spread at the time of exercise. The result seems correct, but the logic is hardly satisfying. If an option will probably be financially advantageous in the future, doesn't it have present value even though it cannot be converted into cash at the present time? A future interest in land, to use a simple example, clearly has present value.

9. 48 Stat. 680 (1934).
10. 49 Stat. 1648 (1936).
11. "[A taxpayer exercising an option shall include in gross income] the difference between the amount paid for the property and the amount of its fair market value to the extent that such difference is in the nature of (1) compensation for services rendered or to be rendered . . . ." T.D. 4879, 1939-1 CUM. BULL. 159.
12. The courts considered many factors in determining whether the intention was primarily compensatory or proprietary. See Rudick, *Compensation of Executives Under the 1954 Code*, 33 TAXES 7, 26 (1955).
13. Springfield v. Commissioner, 41 B.T.A. 1001, 1009 (1940).
14. 324 U.S. 177 (1945).

Encouraged by the *Smith* case, the Treasury returned to a stricter policy in dealing with options. T.D. 5507[15] reverted to the position of the earlier regulations in providing that all options would be considered compensation and would be taxed on the spread at the time of exercise. It went further than the early regulations in eliminating the "substantial" spread requirement. T.D. 5507 applied only to options granted after Feb. 26, 1945, the date of the *Smith* decision. I.T. 3795[16] was released at the same time, providing that options granted prior to that time would not be taxed as compensation unless (1) there was a substantial spread at the time of grant, or (2) compensation was found under the old formula.

The new regulation and ruling were not very significant in their effect on the case law. The second part of I.T. 3795 was intended to cover options granted prior to *Smith*. In *Otto C. Schultz*,[17] the court carefully described the two possible bases of liability under I.T. 3795, but didn't have to worry about the ruling because it found compensation under the old regulations. In *Abraham Rosenberg*,[18] the court did not mention the first basis of taxability (*i.e.*, a substantial spread at the time of grant), though it would not have affected the result in that case. But in *Commissioner v. Straus*,[19] the court ignored I.T. 3795 completely, finding no deficiency. Since the option price in that case was $6 per share and the fair market value at the time of grant was $23.75 per share, an application of I.T. 3795 would certainly have reversed the result.

While those who were litigating past cases went along as usual, those who were planning for the future were faced with T.D. 5507, taxing all options as ordinary income upon their exercise. Most people felt the regulation was not valid and would not be upheld. It was often ignored. One taxpayer added insult by using the regulation as a major premise in his argument.[20] Regardless of what else it accomplished, this attack by the Treasury must have had a considerable *in terrorem* effect.[21] Since there still was doubt as to what the state of

15. 1946-1 CUM. BULL. 18.
16. 1946-1 CUM. BULL. 15.
17. 17 T.C. 695 (1951).
18. 20 T.C. 5 (1953).
19. 208 F.2d 325 (7th Cir. 1953).
20. Commissioner v. Stone's Estate, 210 F.2d 33 (3rd Cir. 1954). The taxpayer purchased 100 warrants from his employer, paying $1,000 for the warrants. Each warrant permitted the purchase of 100 shares of stock. He estimated that he received $5,000 compensation in this transaction, and he paid a tax on that amount. The market price of the stock was below the option price when the warrants were purchased. Later the price went up, and the taxpayer sold 89 of the warrants for $82,680. He argued that T.D. 5507 requires the recognition of ordinary income when property is transferred; since he had reported $5,000 when the warrants were transferred, the remainder of the gain must be a capital gain. The argument was sustained.
21. See the cries of anguish relayed by Rep. Knutson to his fellow legislators, 93 CONG. REC. A4060-66 (1947).

the law was, the taxpayers moved to Congress for support.

B. Options Since 1950

Stock options branched into two families in 1950. Pressure on Congress for more favorable treatment resulted in an amendment to the Internal Revenue Code of 1939, section 130A,[22] which is carried forward, with some modifications, in the present law.[23] Options qualifying under this provision were labeled restricted stock options. Other options are often referred to as non-restricted stock options.[24]

1. *Restricted Stock Options Under Section 421.*—[25]The basic purpose of section 421 is to provide capital gain treatment (*i.e.*, preferential rates and a tax only at the time of disposition of the stock) for options which are considered to be incentive devices. To insure the fact that the option is truly "incentive," and to prevent abuse, several restrictions must be placed on it. They may be summarized as follows:[26]

(a) The option price must be at least 85% of the fair market value at the time of grant.[27] Under a variable pricing provision, the option will qualify if (1) the purchase price varies only with the value of the stock, and (2) the option price is at least 85% of the fair market value when the option is granted.[28]

(b) The option must be non-transferable, except on death.[29]

(c) The recipient cannot hold more than 10% of the voting stock in the corporation when the option is granted.[30] This requirement is waived if the option price is 110% of the fair market value at grant, and the option is exercisable for only 5 years, or was exercised by Aug. 16, 1955.

(d) The option must not be exercisable more than 10 years from the time it is granted.[31]

(e) The recipient must be an employee when the option is granted;

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22. Int. Rev. Code of 1939, § 130A, added by 64 Stat. 942 (1950).
23. § 421.
24. This seems an unfortunate name since many "non-restricted" options are severely restricted. To prevent confusion, this paper refers to all options which do not qualify under § 421 as "non-statutory" options.
25. This is a cursory glance at § 421, which, of course, is extremely important; it has been amply commented upon in various writings. See Rudick, *supra* note 12.
26. For simplicity all numbers in this section are from the INT. REV. CODE OF 1954. For an excellent treatment of the minor changes made in 1954, see Rudick, *supra* note 12.
27. § 421(d)(1)(A)(i).
28. § 421(d)(1)(A)(ii).
29. § 421(d)(1)(B).
30. § 421(d)(1)(C).
31. § 421(d)(1)(D).

and it must be exercised while he is an employee or within three months thereafter.[32]

If an option qualifies as a restricted stock option, it will be treated as a capital asset, and given preferential treatment, subject to the following conditions:

(a) No disposition of the shares may be made within two years of the grant of the options or six months of exercise.[33]

(b) If the option price is between 85% and 95% of the fair market value at the time the option is granted, there will be ordinary income to the extent of the option price subtracted from the lesser of (1) the fair market value of the shares when the option was granted, or (2) the fair market value of the shares upon their disposition.[34]

These are the basic provisions of section 421. It is quite detailed, covering modifications of the option, exercise by an estate,[35] and effects of options received pursuant to certain corporate transactions. The regulations under section 421 are long and cover the possible problems in even finer detail. This paper will not deal with the various considerations involved in setting up such a plan.

There have been no court decisions dealing with section 421 thus far. It may be expected that they will not arise frequently; since the success of a 421 plan is assured, a person in a high tax bracket is not encouraged to leave the friendly confines of capital gain treatment in order to test the fringe areas of section 421. If he wants to gamble, a non-statutory option with no pretence of qualifying under section 421 is a more likely windfall.[36]

2. *Non-Statutory Options.*—The cases since 1950 have involved options exercised prior to 1950. Various factors determined their outcome, and the cases might be grouped as follows:

(a) Some options were taxed on the spread which existed at the

32. § 421(a).
33. § 421(a).
34. § 421(b).
35. § 1014(d) provided that the basis of a restricted stock option would not be stepped up at the death of the holder if he had not exercised the option by that time. This made it desirable to exercise the option before death. This provision has recently been deleted, so there is a step-up regardless of exercise. 72 Stat. 4 (1958). There is a continuing drive to liberalize tax treatment upon the employee's death. Under a proposed amendment to § 421, any ordinary income arising from the exercise of an option by an employee will not be due until the death of his spouse, assuming she receives the stock. The proposed change has been passed by the House of Representatives. H.R. 6777, 86th Cong., 1st Sess., 105 CONG. REC. 15541-42 (daily ed. Aug. 25, 1959).
36. This is indicated by the names of recent articles: *The Non-Restricted Employee Stock Option—An Executive's Delight,* 11 TAX L. REV. 179 (1956); *The Valuation of Option Stock Subject to Repurchase Options and Restraints on Sale: A New Tax Bonanza in Executive Compensation,* 62 YALE L.J. 832 (1952).

time the option was granted. In *McNamara v. Commissioner*,[37] the Court of Appeals for the 7th Circuit taxed the spread at time of grant instead of the spread at time of exercise, basing its decision on the intention of the parties. The stock had an ascertainable spread of $3 at grant and about four times as much at exercise. The court seemed confused about the economics of the situation.

> But it seems equally clear to us that if we say, from this evidence, that it was the intention of the parties that the grant of the option was to constitute compensation, we must also say that the parties intended it as additional compensation for petitioner's services for the year in which the option was granted.[38]

Just because the option was intended to be compensation in the year it was granted does not mean that the spread at that time determines the amount of gain. It seems clear that there might be value received, and hence compensation, even where there was no spread whatsoever at the time of grant. There was no reason to limit the gain in this case to the spread when the option was granted.

The taxpayer also prevailed in *Commissioner v. Stone's Estate*.[39] He purchased warrants from his employer corporation. Each warrant was an option to buy 100 shares of stock. He paid tax on the warrants when he received them, estimating the gain at $5,000. He later sold the warrants for $82,680, and claimed a capital gain. The court upheld his claim and here again the decision seems unwise. The Commissioner has much the better of the argument in pointing out that the transaction between the corporation and the taxpayer was not in the nature of a sale, and that ordinary income should not be converted into capital gain through this sham.

(b) Some cases held no income at either grant or exercise on the basis of the old compensatory-proprietary approach. While it has been suggested that proprietary options were gaining increasing favor with the courts during this period,[40] this would seem hard to support. No clear judicial attitude is discernible. The option in *Robert A. Bowen*[41] had a spread of $33 per share at the time of grant, and yet was held proprietary. This result is difficult to understand, in view of the large element of immediate gain. *Abraham Rosenberg*,[42] on the other hand, was a strong case for the proprietary argument. The employer corporation was closely held, and the only way for the taxpayer to assure himself of an equity interest was by way of

37. 210 F.2d 505 (7th Cir. 1954).
38. *Id.* at 508.
39. 210 F.2d 33 (3rd Cir. 1954).
40. Lentz, *Stock Ownership Plans—Options, Warrants, Leverage Stock*, N.Y.U. 13TH INST. ON FED. TAX. 499, 519 (1955).
41. 13 T.C.M. 668 (1954).
42. 20 T.C. 5 (1953).

an option. Furthermore, the stock had a fair market value of about $3.00 or $3.25 when the option was given at $5.40. Several other cases lie somewhere between *Bowen* and *Rosenberg,* with regard to the element of compensation contained in the bonus.[43]

(c) Many cases found ordinary income at the time of exercise because the options were compensatory. In *Charles E. Sorenson,*[44] Willys Motor Co. gave the taxpayer very lucrative options to lure him into its management. The options were an important part of his demands in the pre-employment negotiations. These facts tended to show compensation. An additional factor which hurt the taxpayer's case was his desire to sell the options, rather than exercise them, and a failure to show that he had ever intended to buy and retain an equity interest in the firm. Once the court decided that the intention was compensatory, it followed the reasoning of *Commissioner v. Smith:* compensation was intended, but restrictions on the option prevented its having an ascertainable market value at the time it was granted, so the spread at exercise must have been the intended compensation.

In *Joseph Kane,*[45] the option was given to the wife of the taxpayer when he started working for his new employer. The court had little difficulty in treating the option as one belonging to the husband. Though the option price was above fair market value at grant, the price rose sharply so that considerable gain resulted upon exercise of the option.

The option in *Dean Babbitt*[46] was subject to restrictions which prevented valuation at the time of grant. The court found the intention compensatory, and measured the gain by the spread at exercise. The case also illustrates the computation problem involved in bloc sales. Since there was very little trading in the stock, a large bloc thrown on the market would have depressed prices. Consequently, the market value of the bloc was not determined by the quoted market price but rather the estimated price of the entire bloc had been offered.

Other cases during this period took the same approach, and found ordinary income at exercise of the option.[47]

(d) Some cases refused to tax the option at exercise because restrictions prevented valuation. The leading case here is *Harold H. Kuchman.*[48] At the time of both grant and exercise in this case,

43. Commissioner v. Straus, 208 F.2d 325 (7th Cir. 1953); Donald B. Bradner, 11 T.C.M. 566 (1952), *aff'd per curiam,* 209 F.2d 956 (6th Cir. 1953); James C. Hazleton, 12 T.C.M. 398 (1953).
44. 22 T.C. 321 (1954).
45. 25 T.C. 1112 (1956).
46. 23 T.C. 850 (1955).
47. John C. Wahl, 19 T.C. 651 (1953); Otto C. Schultz, 17 T.C. 695 (1951).
48. 18 T.C. 154 (1952).

there was a complicated reorganization taking place. The terms of the option prohibited resale by the taxpayer for a year and gave the vendors the first right of repurchase. The latter right ran for two years. The Tax Court found that the fair market value of the stock at the time of exercise could not be ascertained and consequently it found there was no tax due at that time. It did not consider if and when a tax might be due. The difficulties in this holding will be discussed later.

In *Phil Kalech*,[49] the court did sustain a tax at exercise, but used book value rather than market value to compute gain, because of restrictions on the option.

(e) In a final group of cases, the question was whether the taxpayer had received ordinary income at the time when restrictions on the stock lapsed. In these cases, no tax had been assessed at the time of exercise, presumably on the ground that no valuation was possible because of the restrictions. The courts rejected the Commissioner's position that the lapse of restrictions might be a taxable event.

In *Robert Lehman*,[50] the taxpayer was a partner in Lehman Bros. The partnership received options for certain services rendered, and exercised them on Feb. 1, 1943. There were certain restrictions, not described in the option, attached to the stock. The restrictions lapsed at the end of that year. The partnership did not include as income the gain resulting from exercise of the option. The Commissioner asserted a deficiency against the taxpayer for his share of the profits, claiming ordinary income was received when the restrictions lapsed. The court held for the taxpayer, saying:

> Termination of the restrictions was not a taxable event such as the receipt of compensation for services or the disposition of property. Values fluctuate from time to time and the value on a later date might be out of all proportion to the compensation involved in the original acquisition of the shares. The gain was properly reported as a long term capital gain from the subsequent sale of the shares.[51]

In this case, stock restrictions lasting only 11 months turned ordinary income into capital gain. It would take a greedy taxpayer to complain about that sort of bargain.

The *Kuchman* and *Lehman* cases combine to form a possible road, albeit a winding road, to avoidance of all tax at ordinary income rates. *Kuchman* said no tax was due at exercise if restrictions prevented valuation. Lehman held there was no tax liability upon lapse of restrictions. The apparent result of the transaction is no tax until

49. 23 T.C. 672 (1955).
50. 17 T.C. 652 (1951).
51. *Id.* at 654.

sale of the stock and a capital gain at that time. If the short-term restrictions which worked the magic in *Lehman* are found to be sufficient in the future, the arrangement is not at all burdensome to the taxpayer.[52]

Another case dealing with the *Kuchman* problem has recently spent several years in the courts. Household Finance Corporation offered a stock option plan to the taxpayer. The Tax Court held it was compensatory.[53] In doing so, it rejected two claims that valuation was impossible: (1) The taxpayer argued he had promised not to sell the stock as long as he was employed by the corporation, but the court found there was no binding agreement, and consequently no diminution in value. (2) It was argued that there was possible liability under section 16(b) of the Securities Exchange Act of 1934.[54] If the taxpayer might later be forced to disgorge his entire profit pursuant to that statute, it would not be fair to tax this profit when it is only temporarily realized. The Tax Court decided that no profits were vulnerable under that statute. Consequently, the deficiency asserted was upheld. Upon petition for review, the Court of Appeals for the Seventh Circuit reversed.[55] It said a binding agreement not to sell did exist, and liability under section 16(b) of the Securities Exchange Act of 1934 was likely if the stock had been sold within six months.[56] This prevented valuation and no tax could be levied.

The *MacDonald* case then started its second round in the Tax Court.[57] On motion for additional hearing, counsel for the Commissioner offered some possible bases upon which economic gain could be measured, though he stated that there was no intention to limit the government's proof at retrial. He suggested: (1) The corporation gave the taxpayer a fifteen year interest-free loan to the extent of the purchase price of the stock, plus any tax due on the purchase. The economic gain involved in this preferential treatment was taxable compensation.[58] (2) The taxpayer supplied enough money to buy

52. Of course the restrictions might be burdensome for non-tax reasons.
53. Harold E. MacDonald, 23 T.C. 227 (1954).
54. 48 Stat. 896 (1934), 15 U.S.C. § 78(p) (1952).
55. 210 F.2d 505 (7th Cir. 1954).
56. At the present time, it is clear that option profits are not within the reach of § 16(b) of the Securities Exchange Act of 1934, provided the options are non-transferable and meet certain procedural safeguards. 17 C.F.R. § 240.16(b) (1949).
57. 16 T.C.M. 208 (1956).
58. Transcript of Record, p. 6, reproduced in Appendix A of Brief for the Petitioner, p. 25, Commissioner v. MacDonald, 248 F.2d 558 (7th Cir. 1957). A similar argument was made on appeal. Brief for the Petitioner, p. 17, Commissioner v. MacDonald, *supra*. The taxpayer argued that this type of gain was too speculative, and the interest-free aspect of the note was not something that could be sold, so no ascertainable value was present. Transcript of Record, p. 17, reproduced in Appendix A of Brief for the Petitioner, p. 33, Commissioner v. MacDonald, *supra*. The argument of the taxpayer is not persuasive. On petition for review, Brief for Respondents, p. 37, Com-

5,541 shares at market price. The other 4,459 shares represented gain realized because of the spread between purchase price and market price. Dividend yield was about $2 per share. Capitalizing this expected return would give a value in excess of $150,000. This is taxable gain.[59]

Judge Rice in the Tax Court was clearly unhappy with both the Seventh Circuit holding,[60] and the attempts to find different methods of valuation.[61] He denied a new hearing.[62]

On petition for review, the Court of Appeals for the Seventh Circuit again reversed.[63] It said the previous decision which it had rendered gave the Commissioner a chance to use other methods of valuation. Consequently, the Tax Court was required to hear the possible methods. A third Tax Court decision has not been given.

The *MacDonald* litigation may reinforce conflicting positions. It buttresses the *Kuchman-Lehman* avoidance plan insofar as it holds that the option restrictions prevent ordinary income at exercise. On the other hand, it indicates that the courts are worried about possible tax-avoidance. It also emphasizes that the Commissioner is not conceding the battle. As the executive plans his future forms of income, he may not be encouraged by the taxpayer's success in *MacDonald*.

3. *Philip J. LoBue.*—[64] This case has been the most important judi-

missioner v. MacDonald, *supra*, the taxpayer emphasized Rev. Rul. 55-713, 1955-2 CUM. BULL. 23. This states that where an employer provides an interest-free loan for premiums on an employee's life insurance policy, no taxable income is received by the employee. But the Treasury is careful to limit revenue rulings to similar facts, and an extension of the ruling to this situation could not be justified. Furthermore, the issue in the ruling concerns whether or not there was any gain. But here the two courts have agreed that there was an economic gain in the transaction; the problem is one of valuation, and whether or not the interest-free loan is relevant to that determination.

59. Transcript of Record, pp. 7-8, reproduced in Appendix A of Brief for the Petitioner, p. 26, Commissioner v. MacDonald, *supra* note 58. On appeal, the Commissioner either put the argument in extremely general terms, or abandoned it. Brief for the Petitioner, pp. 17-18, Commissioner v. MacDonald, *supra* note 58. This method of measuring gain does not seem acceptable. The argument is, in effect, that 5,541 shares represent basis, and 4,459 shares represent gain. The gain is then capitalized on the basis of expected earnings. Were the restrictions taken into consideration when the rate of capitalization was determined? If not, then it seems the Commissioner has changed the method, but retained the basic flaw. If the restrictions were taken into account in some manner, the capitalization rate of about 16.8 (a return of less than 6%) seems much too high.

60. He commented at the hearing: "It does seem to me though, that the 7th Circuit has opened up a pretty big loop-hole in the law here." Transcript of Record, p. 9, Commissioner v. MacDonald, *supra* note 58.

61. "We are unable to find that there is any method of computation, other than the one used in our original opinion, which is proper or meritorious and the respondent's motion for an additional hearing in this cause is hereby denied." Harold E. MacDonald, 16 T.C.M. 208, 209 (1956).

62. *Id.* at 208.

63. 248 F.2d 552 (7th Cir. 1957).

64. 22 T.C. 440 (1954).

cial pronouncement in the stock option area. It began as a typical proprietary-compensatory controversy. The Michigan Chemical Corporation gave the taxpayer options in 1945, 1946, and 1947. The options were not restricted. The options were exercised in 1945 and 1946 for the grants given in those years, and the Commissioner asserted a deficiency. The only witness at the hearing before the Tax Court was a Colonel Davis, who had been the chief executive officer of the corporation during the years in question, and had drawn up the option plan. He indicated on direct examination that the plan was purely an incentive measure.[65] On cross-examination, however, a portion of a letter of Colonel Davis to the taxpayer was placed in the record, and it sounded very much like a salary bonus plan.[66] The Tax Court rejected the validity of T.D. 5507. It then held that the option was an incentive device and denied the deficiency. On petition for review, the Court of Appeals for the Third Circuit affirmed.

The long-standing controversy was then placed before the Supreme Court.[67] The result was a victory for the Commissioner's patience and persistence.[68] Mr. Justice Black, for the majority said:

> But there is not a word in Sec. 22(2) [of the Int. Rev. Code of 1939] which indicates that its broad coverage should be narrowed because of an employer's intention to enlist more efficient service from his employees by making them part proprietors of his business. In our view there is no statutory basis for the test established by the court below. When assets are transferred by an employer to an employee to secure better services they are plainly compensation. It makes no difference that the compen-

65. "Q: In these discussions with the directors and with the officers of the company, prior to the passing of the resolutions of March 21, 1944, was there any characterization of the plan in your recollection as being intended as compensation to the employees?"
"A: Not the slightest." Transcript of Record, p. 129, Commissioner v. LoBue, 351 U.S. 243 (1956).

66. One paragraph read: "The Committee's selection of the names of our employees to receive the right to purchase stock and the number of shares assigned to each selectee is determined by the Committee after a careful appraisal of the individual's contributions to the company in the way of job performances during the past year. In other words, the extent of your participation in the plan is based on how well you handled your job during the year. Outstanding service to the company is given added recognition in determining the number of shares assigned. In this connection I would like to point out to you it is but natural to expect a more rigid comparative appraisal of your efforts in the future." Transcript of Record, pp. 135-136, Commissioner v. LoBue, *supra* note 65. And one of the letters in exhibit contained this sentence: "This allotment of stock was made by the committee and is in recognition of your contribution and efforts in making the operation of the company successful." *Id.* at 19. Yet in the Tax Court opinion, Judge Rice said: "Here it definitely and clearly appears that the granting of the options to petitioner in 1945, 1946 and 1947 was not intended as additional compensation for his services." 22 T.C. 440, 445 (1954).

67. 351 U.S. 243 (1956).

68. "Its victory in the now famous LoBue decision can well be characterized as a situation where the Treasury lost every battle but won the war." Cohen, *The Stock Option Picture Since LoBue; Supreme Court's Views Turn Up in New Regs.*, 6 J. Taxation 17 (1957).

sation is paid in stock rather than in money.[69]

This quite clearly closed the case against the proprietary theory. Until that point, the Supreme Court had responded well. But then Mr. Justice Black discussed the time when the gain should be measured, and the result was less satisfactory. In this case, the gain was measured at exercise because at the time of grant there were certain restrictions on the option preventing valuation.[70] But Mr. Justice Black said:

> It is of course possible for the recipient of a stock option to realize an immediate taxable gain. See *Commissioner v. Smith,* 324 U.S. 177, 181-82. The option might have a readily ascertainable market value and the recipient might be free to sell his option.[71]

Here the court gave a boost to the *McNamara* approach[72] for converting ordinary income to capital gain. If a corporation is careful to make the option transferable, and to eliminate all other restrictions so as to give the option an ascertainable market value, only the spread at the time when the option is granted will be taxed. Thus the amount of ordinary income can be completely controlled, and all appreciation from that point until exercise will be capital gain.[73] Once again, as in the *Smith* case, the Supreme Court lost a good opportunity to eliminate much of the difficulty in this area.[74]

69. 351 U.S. 243, 247 (1956).

70. Mr. Justice Black said that the stock was not transferable, and the right to buy was contingent on his remaining an employee until exercise of the options, 351 U.S. 243, 249 (1956). The second restriction is not clear on the record. Transcript of Record, pp. 18-22, Commissioner v. LoBue, *supra* note 65.

71. 351 U.S. 243, 249 (1956) (dictum).

72. See text accompanying note 37 *supra*.

73. It is interesting to note that this is almost the reverse of the *Kuchman-Lehman* device (see text accompanying notes 48-52 *supra*). Under that plan, the taxpayer attempts to place such restrictions on the option and the resulting allocation of stock that valuation becomes impossible. If both of these methods gain the approval of the courts, the tax law will be doubly beneficent—it not only will give capital gain treatment to most or all of the gain, but will give a choice of plans to fit the needs of the corporation.

74. The other question in the case concerned the determination of the year of exercise. The taxpayer gave notes to the corporation in 1945 and 1946; he paid them in 1947 and received the stock at that time. The Tax Court stated that he received the "economic benefit" from the options when the notes were given, so that was held to be the time of exercise. 28 T.C. 1317 (1957). The court relied on James S. Ogsbury, 28 T.C. 93 (1957). In that case the taxpayer gave notice in 1945 that he elected to exercise the option. The terms of the option permitted him to delay payment indefinitely, provided he remained employed by the corporation. In 1948 he tendered payment and received the stock. The Tax Court held that 1945 was the year of exercise, and should provide the measure for taxation. In the *Smith* case, the option was given by Western Cooperage Company for shares in Hawley Pulp and Paper Co. which Western was managing under a reorganization plan. The taxpayer paid for the shares in 1938 and received them in 1939. The Supreme Court held that 1939 was the year of exercise. It stated that since Western did not have an unconditional right to the Hawley stock, the taxpayer did not have an unconditional right to the fruits of the option.

The limits of the *LoBue* holding have not yet been tested. In *James S. Ogsbury,*[75] which was pending when *LoBue* was handed down, the taxpayer abandoned his argument that no compensation was involved. As to the dictum in *LoBue* concerning taxation at the time the option is granted, it has not been at issue in any case since that decision.

II. Stock Option Taxation for the Future

A. The Difficulties with Present Treatment

Certain forms of income are treated as capital gains and are given a highly preferential rate. Several reasons have been advanced to justify this preferential treatment. Each reason is highly controversial. The following section will assume the validity of the major reasons and will consider their application to stock options.

It has been suggested that capital transactions are given preferential treatment because frequently there is no gain or loss in terms of real income, in spite of a sale price which differs from the cost basis. This is the case where a change in interest rates or price levels has occurred.[76] This reason for preferential treatment does not apply to stock options, since the outlay for the investment is not due until the stock is actually received. In those few cases where the receipt of the stock is delayed, the amount of time elapsed will not be a significant factor.

A second suggested reason stems from the fact that capital gains are realized only when the taxpayer elects to realize them. He may decline to realize a gain because his relative position would not be improved after the realization of the gain and the payment of a tax on that gain. Thus the tax on these gains must be favorable or it will tend to freeze realization.[77] This problem is not present in the stock option situation. No investment is made until the option is exercised, so there is no "locked-in" effect. If the stock is later resold by the optionee for a price exceeding the value at the time when the option was exercised, then this justification for preferential treatment may become relevant as to the difference between value at

The taxpayer won in *LoBue* and *Ogsbury,* but lost in *Smith.* Yet it seems that *Smith* is the strongest case for the taxpayer. There he actually paid out cash at the earlier time, and his investment was complete regardless of when he received the stock. In *LoBue* and *Ogsbury,* on the other hand, there was only a promise to pay. Since enforcement of the promise depends on action by the corporation against the executive, the firmness of the obligation is somewhat doubtful.

75. 28 T.C. 93 (1957).

76. Seltzer, The Nature and Tax Treatment of Capital Gains and Losses, 93 (1951).

77. Testimony of Walter W. Heller, *Hearings Before The Subcommittee on Tax Policy of the Joint Committee on the Economic Report,* 84th Cong., 1st Sess. 318 (1955).

time of exercise and value at time of resale. It is not relevant, however, to the gain arising from exercise of the option.

A third reason for preferential treatment, closely related to the reason just presented, is that a sensitive area of incentive is involved, and the financial world demands a tax law which does not throw roadblocks in the way of investors.[78] Preferential treatment encourages the investment of money in new and expanding industries, according to the argument. Here again, stock options simply do not fit the rationale. Options are a method of executive compensation, and incentive is built into the option device regardless of tax aspects. When the value of the stock rises above the option price, it becomes profitable to exercise the option in nearly every case. Tax incentive will do little to encourage exercise of options, nor will disincentive have much effect in discouraging exercise.[79]

A fourth reason advanced for preferential handling of capital gains is that the gain accrues over several years, but is realized in one year, and the bunching effect increases the tax liability.[80] This is certainly a problem, but with regard to stock options two factors tend to mitigate this apparent inequity. First, the taxpayer has complete control over realization of the gain, and can exercise his options in a way that will prevent too much bunching. Second, options may be given for several years, so that the gains will tend to average out over the years.

If these are the reasons for preferential treatment in capital transactions,[81] that treatment is not justified when applied to stock options.

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78. Testimony of J. Keith Butters, *Hearings, supra* note 77 at 316-17.

79. The case for preferential treatment in order to promote incentive is strongest where the goal is not executive compensation, but the sale of stock to a large number of stockholders for the purpose of equity financing. For example, it has been asserted that this form of financing is essential to large, rapidly-expanding corporations, and that a spread at the time the option is granted is necessary to insure the success of the offering. *Hearings Before the House Ways and Means Committee*, 83rd Cong., 1st Sess., pt. 1, topic 15, at 409 (1953). It was argued that the lack of preferential treatment would severely hamper the sale of the issue. This presents the strongest case for advocates of capital gain treatment. Whether or not this form of equity financing is as necessary as the argument suggests is a difficult economic question. A recent study of private investment capacity would seem to cut against the argument. See generally BUTTERS, THOMPSON & BOLLINGER, INVESTMENTS BY INDIVIDUALS (1953). And Dr. Butters has pointed to the drive by the income-minded and security-minded for less risky investments—which would describe American Telephone & Telegraph, the corporation in the above situation. *Hearings, supra* note 77, at 316. In any event, the option for equity financing would seem fairly rare, when compared to compensation options, and any incentive advantage involved in preferential treatment for the former would be far outweighed by the disadvantages when applied to the latter.

80. Testimony of Walter W. Heller, *Hearings, supra* note 77 at 318-19. But see the testimony of Stanley S. Surrey, *Hearings, supra* note 77, at 320, arguing that the averaging problem is largely irrelevant in determining whether or not a preferential rate is justified.

81. For the view that preferential treatment is based on no ecomonic

These general economic considerations may be stated more specifically in terms of horizontal equity. The failure to include option profits in ordinary income is discrimination in favor of the managing class. The income tax is intended to be a "neutral" tax in the sense that all people with the same amount of income shall have an equal tax liability. This principle is violated when a segment of the taxpaying public can claim preferential treatment for part of its earnings.[82] The argument is made that stock option gains are really different from the usual salary gain. But a tax on the spread at the time of exercise is levied only on gain actually received in the form of stock value, and not potential gain; the tax is on the equivalent of dollars received. The taxpayer has no funds invested until the time of exercise. From the tax standpoint, any difference between value received under an option and value received under a straight salary would not seem significant. Under present law, an executive may receive a large tax benefit by shifting the form of his compensation.

The present law particnlarly favors managers of large corporations. Besides discrimination on behalf of the manager class, preferential treatment for stock options results in discrimination within the class. It is much easier for executives of a large corporation to take advantage of capital gains treatment. Small corporations may have a difficult time showing the fair market value of their stock. This determination is essential under section 421.[83] There is always the danger that the Commissioner may come in and dispute the value, which upsets the plan long after it has been relied upon by the corporation and taxpayer. This discourages the use of section 421 by small corporations.

Determination of fair market value is likewise essential under the *McNamara* approach. Where the option had an ascertainable market value at the time of grant, the option was taxed at that time, but the difference between value at grant and value at exercise qualified as capital gain. This may be desirable for the executive under some circumstances. Here, too, the small corporation is at a comparative disadvantage.

The executives of small corporations are also in a less favorable position because restricted options under section 421 are limited to individuals who own not more than 10% of the voting power of the corporation.[84] Where the corporation is small, the same subparagraph

rationale whatsoever, but is merely an uneasy compromise between opposing philosophies, see the testimony of Carl S. Shoup, *Hearings, supra* note 77, at 319.

82. See Paul, *Erosion of the Tax Base and Rate Structure*, 11 TAX L. REV. 203, 213-15 (1956). The article is an excellent discussion of how equity is disappearing from the income tax.

83. § 421(d)(1).

84. § 421(d)(1)(C).

contains an exception to this rule which may become operative; this provides that where the option price is at least 110% of the fair market value when the option is granted, and the option is either limited to five years or actually exercised in one year, capital gain treatment will be given. This may aid the small corporation executive in some cases, but it is not so desirable as the usual section 421 situation.

Finally, the attractiveness of capital gain treatment has encouraged the use of faulty assumptions to justify preferential treatment.[85]

(a) One assumption was apparently put to rest in *LoBue*—that stock options are "proprietary" or "compensatory" and only the latter should be taxed. Prior to *LoBue,* the courts did not say that options are all one or the other,[86] but they did base their decisions on the relative weights of these two "characteristics." Tax treatment should follow from the nature of the taxpayer's receipts and not be based on the motives of his employer.[87] Whether his employer hates him or likes him is not important; a fortiori it is not important whether he likes him retrospectively (compensation) or prospectively (proprietary interest).

(b) A premise which is equally false is the view that the only compensation in the exercise of an option may be the spread at the time of grant. This was the basis for the decision in *McNamara v. Commissioner.*[88] It was given a further boost by the dictum in *Commissioner v. LoBue.*[89] If the *LoBue* case did away with the compensatory-proprietary distinction, as it apparently did, then the important consideration is how much is received by the taxpayer. It seems apparent that an unrestricted option for any term must be worth something more than the spread when it is granted—indeed, the possibility of appreciation is the principal reason for using the stock option device. It does not make sense to fix the value without regard to that factor.

(c) Some courts assume that appreciation between grant and exercise merely indicates a shrewd purchase. Others have accepted the contention that the appreciation reflects an increase in the executive's

85. For a cogent statement of what we know and what we don't know about the use of stock options, see Erwin N. Griswold, "The Mysterious Stock Option," 2 Tax Revision Compendium 1327. These materials were submitted before the House Committee on Ways and Means, 86th Cong., 1st Sess., 1959, on November 16, 1959.

86. Geeseman v. Commissioner, 38 B.T.A. 258, 263 (1938).

87. This distinction has not been carefully recognized in many of the cases already discussed. Confusion can also be seen in much of the testimony before Congress where the problem is frequently analyzed from the point of view of the corporation, instead of the taxpayer.

88. 210 F.2d 505 (7th Cir. 1954); see discussion in text accompanying note 37 *supra*.

89. 351 U.S. 243, 247 (1956).

output resulting from the incentive created by the option. These views seem naive in light of the inside information, and sometimes inside control, which executives have.[90] There may be contracts to buy or sell which are not publicly known. There may be trends in the market or the industry which are discernible only to those with access to company records. There may be lucrative stock splits.[91] To treat a company executive as if he were in the same position as anyone else buying stock of that company is not realistic.

B. Suggested Changes in Option Taxation

It appears that the present taxation of the stock option is neither equitable nor necessary in terms of economic incentive. The following section deals with some possible solutions to the problem.

1. *Statutory Change.*—The most desirable solution of the problem is a statutory revision which would end all preferential treatment for stock options. This would involve the elimination of section 421. In view of the present uncertainty it should be specifically stated that ordinary rates will apply to the gain realized through the exercise of an option. As an alternative, the tax might be levied on the value of the option itself, regardless of whether or not it is exercised, but this would have two major drawbacks. First, the fair market value of an option is frequently impossible to determine. Second, the tax might be due before any gain could be realized; furthermore, the amount of the tax would be quite independent of the taxpayer's actual gain on the total transaction. Gain is best measured by the spread at the time when the option is exercised.

A complete end to preferential treatment for option profits is desirable. Economic considerations do not require preferential treatment. Giving them such treatment does violence to principles of equity, and is an unnecessary drain on treasury receipts.

2. *Judicial Handling.*—Until a statutory change occurs, it is up to the courts to maintain the greatest possible equity within the framework of the statute. *Commissioner v. LoBue* was a big step in the right direction. Two other areas of attack are suggested:

90. The approach in the securities field seems more realistic. Under § 16(b) of the Securities Exchange Act of 1934, 48 Stat. 896, 15 U.S.C. § 78(p) (1952), an insider is liable for short term profits in company stock without regard to motive, intent or knowledge. This is considered necessary because of the insider's extremely advantageous position, and the difficulty of proving his use of that position. While the considerations in the securities field are not strictly analogous to those in the tax law, the latter might profitably incorporate a similar recognition of the economic facts of life.

91. In Joseph Kane, 25 T.C. 1112 (1956), the option price was above the market price when the option was granted. Less than a year later, there was a stock split. Six months after that, the fair market value was twice as much as the option price. While the effect of the split on the market value is not shown, it can be assumed that the split was not harmful.

(a) It has frequently been assumed that section 130A[92] did not affect the treatment of non-statutory options in any way.[93] It is submitted that section 130A and its successor, section 421 should be held to pre-empt the field of preferential treatment for stock options.

It appears from the *Senate Report*[94] that the restrictive provisions of section 130A were included in the belief that they were essential elements of an incentive option. The section was elaborately designed to exclude options which were not considered to be given for proprietary purposes. Restricted stock options must meet certain tests involving the spread at time of grant, the periods during which the stock is held, the extent of the executive's interest in the corporation, etc. Non-statutory options do not need any of these restrictions. It would be unwise policy to give the same preferential treatment to non-statutory options, which do not have these safeguards, unless considerations of statutory interpretation require it.[95]

The argument raised against this position is that the legislative history of section 130A[96] will not permit such a view. This is based on *Senate Report* 2375 which states:

> Options which do not qualify as "restricted stock options" will continue to be taxed as under existing law.[97]

It is argued that this means the statutory amendment shall have no effect on non-statutory options. This position does not seem so persuasive as to close the argument.

In the first place, the sentence quoted above must be read in context. The entire paragraph states:

> Under your committee's bill no tax will be imposed at the time of exercise of a "restricted stock option" or at the time the option is granted and the gain realized by the sale of the stock acquired through the exercise of the option will be taxed as a long-term capital gain. Such treatment is limited to the "restricted stock option" for the purpose of excluding cases where the option is not a true incentive device. Options which do not qualify as "restricted stock options" will continue to be taxed as under existing law.[98]

It seems likely that Congress thought all options would be taxed at ordinary rates after the release of T.D. 5507, and that the passage of section 130A marked an area carved out for capital gain treatment. This was a tenable assumption, since no cases under T.D. 5507 had

92. INT. REV. CODE OF 1939, § 130(A), added by 64 Stat. 942 (1950).
93. Lentz, *Stock Ownership Plans—Options, Warrants, Leverage Stock*, N.Y.U. 13TH INST. ON FED. TAX. 499, 513 (1955).
94. S. REP. No. 2375, 81st Cong., 2d Sess. 60 (1950).
95. Note, 62 YALE L. J. 832, 840 (1953).
96. INT. REV. CODE OF 1939, § 130(A), added by 64 Stat. 942 (1950).
97. S. REP. No. 2375, 81st Cong., 2d Sess. 60 (1950).
98. *Ibid.*

arisen prior to 1950. Congress listed all the options which would be considered incentive devices, and which would therefore receive preferential treatment. If this was the assumption, it tends to defeat Congressional policy when non-statutory options are also given preferential treatment.

Secondly, the hearings and debate on the bill also indicate that the provision was written because all stock options were to be taxed as ordinary income. Senator George, introducing the provision on the floor of the Senate, said that the special treatment was intended to be "restricted to true employee incentive options."[99]

The testimony before the House Ways and Means Committee of the 80th Congress, which considered a similar provision, also emphasized the need for preferential treatment because none was available at that time.[100] It seems that the push was to provide for *a* method of preferential relief, not an *additional* method.

It is not asserted that the two arguments above are conclusive. On the other hand, they indicate that the legislative history does not conclusively show that pre-emption was not intended. Where the legislative history is not clear, the strong policy considerations involved should lead to the view that Congress intended to cover the field of preferential treatment when it passed section 130A.[101]

If it is held that the area of preferential treatment has been pre-empted by the specific statutory provision, then the inequities which still exist in the field of non-statutory options would be eliminated. For example, the dictum in *Commissioner v. LoBue* to the effect that some options might be taxable as ordinary income only to the extent of the spread at grant, would not be followed.[102] Similarly, preferential treatment would be denied in situations where restrictions still apply at the time of exercise, as in *Commissioner v. MacDonald.*[103]

(b) Whether or not the pre-emption argument prevails, some of the inequities can be removed.

For example, where the option was freely transferable and had an ascertainable fair market value at the time of grant, it was taxed as ordinary income only to the extent of the spread at the time the option was granted in *McNamara v. Commissioner*. The basis of the decision was the "intention" of the parties to give compensation only to that

99. 96 Cong. Rec. 13276 (1950).

100. "The usefulness of stock options as a means of securing and retaining executive personnel [has] been nullified by court decision and Treasury rulings . . . ." Recommendation of the National Association of Manufacturers, *Hearings on Revenue Revisions, House Ways and Means Committee,* 80th Cong., 1st Sess. at 1473-74 (1947). And see the memorandum filed by the Chamber of Commerce of the United States, *id.* at 1599.

101. Int. Rev. Code of 1939, § 130(A), added by 64 Stat. 942 (1950).

102. See discussion in text of the case of *James S. Ogsbury* at p. 488 *supra.*

103. See discussion in text accompanying notes 53-63 *supra.*

extent. It has been suggested above that this is an irrelevant criterion. The solution appears simple—reject this idea, and tax at the time of exercise.

Another inequity exists where restrictions at the time of exercise prevent valuation. It does not make good sense to allow the complete avoidance of a tax at ordinary rates merely because restrictions complicate the problem of valuation. One approach is to ignore the restrictions and tax on the full value as if unrestricted.[104] This position is supported by the argument that restrictions are nearly always methods of tax avoidance, and that corporations have other devices for insuring incentive and the retention of employees if a non-tax motive is actually present.[105] This seems to be a somewhat harsh result, but may be desirable if the courts will not face the difficult valuation problems which restrictions present.

There are several possibilities for taking restrictions into consideration.[106] Under current treasury regulations,[107] gain is realized when the restrictions lapse, and the amount taxed is the spread at that time. This may be hard on the taxpayer in a rising market; but if it is assumed that restrictions are primarily tax devices, the inequity diminishes. Of the several methods suggested, this one seems to produce the soundest result.

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104. Note, 62 YALE L. J. 832, 843 (1953); *contra,* 51 NW. U. L. REV. 621, 627-28 (1956).

105. Note, 62 YALE L.J. 832, 843-44 (1953); *contra,* Koerber & McDermott, *Employee Stock Purchase Plans,* 46 ILL. B. J. 208, 225 (1957).

106. A case comment at 51 NW. U. L. REV. 621, 624 (1956) suggests three: (1) tax at exercise, allowing for restrictions; (2) tax at ordinary rates upon lapse of the restrictions; (3) tax resale of stock as part income and part capital gain.

107. Treas. Reg. 1.421-6 (1959), adopted by T.D. 6416 on Sept. 24, 1959.