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Unrestricted Stock Options

Tom B. Rhodes
UNRESTRICTED STOCK OPTIONS†

by

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FOR the past two decades one of the most popular devices for compensating executives, for providing them with an incentive to render their best efforts in behalf of their corporate employer, and of assuring their loyalty to this employer has been the stock option. In 1950, with the enactment of Section 130A of the Internal Revenue Code of 1939, Congress added its blessing to this type of device in a limited statutory area by providing for the "restricted stock option," and the benefits of the "restricted stock option" continue to be available through Section 421 of the Internal Revenue Code of 1954. Somewhat the same benefits have been available to the corporation and its employees without specific sanction in the Internal Revenue Code through the use of the so-called non-statutory or unrestricted stock option. On February 26, 1945, the Supreme Court of the United States in the case of Commissioner v. Smith handed down its landmark opinion on the question of unrestricted stock options. After a silence of approximately eleven years, this question has once again been passed upon by the Supreme Court of the United States in Commissioner v. LoBue, thus adding to the required reading of anyone concerned with the problem of unrestricted stock options.

BACKGROUND

At the time the Smith case was decided by the Supreme Court

† Ed. NOTE: See also the Comment in this issue, Executive Stock Options—Alternatives to the Proprietary Option Doctrine, which complements this article in presenting some additional alternatives to the late "proprietary option" doctrine.

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3 The term "unrestricted stock option" will be used in this paper to mean any option other than the restricted stock option is defined in Int. Rev. Code of 1954, § 421, and Int. Rev. Code of 1939, § 130A, added by 64 Stat. 942 (1950), as amended, 65 Stat. 506 (1951).


of the United States in 1945, the portion of the Commissioner's Regulations dealing with the subject of unrestricted stock options read as follows:

If property is transferred by a corporation to a shareholder, or by an employer to an employee, for an amount substantially less than its fair market value, regardless of whether the transfer is in the guise of a sale or exchange, such shareholder or employee 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. . . .

These Regulations were based on prior decisional authority, which had established the rule that when an employee was granted a stock option in order to acquire a proprietary interest in the employer corporation the receipt or exercise of this option, while not constituting a gift to the employee, would still not constitute compensation to him. As can be seen the Regulations quoted above indirectly recognized this proprietary-compensatory distinction by stating that income would be realized on the spread between the option price and the cost of the stock when such difference was in the nature of compensation for services rendered.

The Smith Case

The Supreme Court in the Smith case held that the option exercised therein was compensatory in spite of the fact that there was no spread between the option price and fair market value of the stock at the date of the grant of the option. At the time the options were exercised (three and four years after the date of the grant), there was a considerable spread between the option price and the fair market value, and the Court held that this spread constituted ordinary income to the employee at the date of exercise. Since, however, the option was admittedly given to Smith as compensation for services rendered, the validity of the distinction between a proprietary option and a compensatory option was not directly at issue. By way of dictum the Court also recognized that the granting of an option to an employee could constitute income to the employee at the date of the grant, stating:

When the option price is less than the market price of the property
for the purchase of which the option is given, it may have present
value and may be found to be itself compensation for services rendered.7

As a result of this opinion, the Commissioner promptly amended
his Regulations8 to delete any reference to the spread between the
option price and market value constituting income "to the extent
that such difference is in the nature of (1) compensation for ser-
vices rendered," in an attempt to eliminate any distinction between
the so-called proprietary and compensatory option. Principally be-
cause of the fact that this proprietary-compensatory option issue was
not directly involved in the Smith case, subsequent cases have de-
clined to follow these Regulations as amended and have been
decided, more often than not, on the basis of whether the intention
was to grant the employee a proprietary interest in the corpora-
tion9 or was to compensate the employee.10 Intent being the elusive
thing that it is, and courts recognizing that to some extent any
option is both proprietary and compensatory,11 there was little basis
for predicting whether the court would find a particular option
to be compensatory or proprietary. Such was the state of the law
when the Supreme Court decided the LoBue case on May 28, 1956.

The LoBue Case

In the LoBue case, the taxpayer was employed from 1941 to 1947
by Michigan Chemical Corporation. In March 1944, the cor-
poration announced a stock option plan permitting certain key
employees to buy its stock over a three year period at $5 per share.
At the time of this announcement the stock was worth $4.50 per
share. In its general announcement of the plan in 1944, the cor-
poration stated that its purpose was to provide an incentive to key
employees and to permit them to participate in the success of the
company. On January 18, 1945, petitioner was notified of the
grant to him of a non-transferable option to purchase 150 shares
on June 30 of that year. In May 1945, LoBue gave the corporation

7 324 U.S. at 182.
8 T.D. 5507, 1946-1 CUM. BULL. 18.
9 Typical cases holding the option to be a nontaxable proprietary option are: Philip J.
LoBue, 22 T.C. 440 (1954); Martin L. Straus, II, 11 T.C.M. 786 (1952), aff'd, 208 F. 2d
325 (7th Cir. 1953); Robert A. Bowen, 13 T.C.M. 668 (1954).
10 Typical cases holding the option to be a taxable compensatory option are: Charles E.
Sorensen, 22 T.C. 321 (1954); John C. Wahl, 19 T.C. 651 (1953); Wanda V. Van
Dusen, 8 T.C. 388 (1947), aff'd, 166 F. 2d 647 (9th Cir. 1948).
11 For example, the Tax Court in the LoBue case noted, "that in practically all such
cases as the one before us, both the element of additional compensation and the granting of
a proprietary interest are present." 22 T.C. at 445. See also Delbert B. Geeseman, 38 B.T.A.
258, 263 (1938).
his note for $750; he paid off this note in May 1946, receiving his stock. The corporation took no deduction for the difference in the spread between the option price and market value of the stock. The second option granted LoBue was granted to him in January 1946, by letter advising him of his right to buy 150 shares of the stock. During this same month, taxpayer gave his note to the corporation for $750, and this note was paid off in May 1946, at which time taxpayer received his stock. The corporation took a deduction for the excess of the market value over the option price of the stock. The final option granted LoBue was granted to him in January 1947, by letter advising him of his right to buy 40 shares of stock of the company. LoBue paid cash for and received this stock in February of that year, the corporation taking a deduction for the spread between the option price and market value of this stock.

All options were exercised by LoBue paying $5 therefor and at all times other than the announcement date in 1944, the stock was worth considerably more than $5.\(^\text{12}\) LoBue thus paid $1,700 for stock having a fair market value when delivered of $9,930. The Commissioner sought to tax the spread to LoBue as ordinary income in 1946, the year in which the notes were paid, and in 1947, when the cash was paid, relying upon the definition of gross income within the meaning of Section 22(a) of the Internal Revenue Code of 1939. The Tax Court held that the options were designed to give LoBue a proprietary interest in the business and that he had not received income from either the granting or exercise of the option. The Court of Appeals for the Third Circuit affirmed, and the Supreme Court, recognizing the long-standing dispute over the taxability of stock options, granted certiorari “to consider whether the Tax Court and the Court of Appeals had given §22(a) too narrow an interpretation.”

In holding that LoBue realized ordinary income when he purchased the stock, the Supreme Court expressly declined to recognize any twilight zone existing between ordinary income status and gift status simply because the intention was to give the employee a

\(^{12}\) The fair market value of the corporations’ stock at certain times during the 3-year period, 1944-1947, was as follows:

<table>
<thead>
<tr>
<th>Year</th>
<th>Fair Market Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>March 1944</td>
<td>$4.50</td>
</tr>
<tr>
<td>January 1945</td>
<td>8.69</td>
</tr>
<tr>
<td>May 1945</td>
<td>13.25</td>
</tr>
<tr>
<td>June 1945</td>
<td>14.38</td>
</tr>
<tr>
<td>March 1946</td>
<td>$19.25</td>
</tr>
<tr>
<td>April 1946</td>
<td>21.25</td>
</tr>
<tr>
<td>May 1946</td>
<td>30.50</td>
</tr>
<tr>
<td>February 1947</td>
<td>19.50</td>
</tr>
</tbody>
</table>

\(^{13}\) Actually the Commissioner asserted a deficiency of $8,100 in 1946 and $580 in 1947. The record figures indicate a spread of $7,650 in 1946 ($25.50 x 300) and the Supreme Court noted that no explanation for this discrepancy appears in the record.
proprietary interest in the business." No gift was involved because the company "was not giving away something for nothing." The Court further stated:

...it seems impossible to say that it was not compensation. ... When assets are transferred by an employer to an employee to secure better services they are plainly compensation. It makes no difference that the compensation is paid in stock rather than in money. Section 22(a) taxes income derived from compensation "in whatever form paid."

While recognizing that it is possible for the recipient of a stock option to realize immediate taxable gain where the option has a readily ascertainable market value and the recipient is free to sell his option, the Court held that this was not such a case. Since, however, "a bona fide delivery of a binding promissory note could mark the completion of the stock purchase and that gain should be measured as of that date," the Court remanded the case to the Tax Court to pass upon the question of whether or not the taxpayer realized ordinary income at the time the promissory notes were given or at the time the promissory notes were paid off. Justices Harlan and Burton in an opinion concurring in part and dissenting in part took the position that the last two options granted LoBue were "unconditional and immediately exercisable" and, therefore, constituted income to LoBue at the date of the grant, while the first option should constitute income to LoBue at the time of the satisfaction of the conditions contained in the option.

**Unrestricted Stock Option as Income**

**Where Employer-Employee Relationship Exists**

The LoBue case almost certainly settles the long-standing controversy over whether an employee realizes taxable income when he exercises a stock option designed to give him a "proprietary

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14 The Supreme Court did not pass upon the question of whether or not restrictions on the disposition of stock may render its value unascertainable so as to preclude the realization of any income on exercise of the option, but it did recognize that no income would be realized at the grant of the option where the option was not transferable and it did not have a readily ascertainable market value.

15 351 U.S. at 247.

16 The majority opinion stated, "These three options were not transferable and LoBue's right to buy stock under them was contingent upon his remaining an employee of the company until they were exercised." 351 U.S. at 249.

17 For brevity, referred to hereinafter as the Dissenting Opinion.

18 The discussion under this heading is limited to situations not involving restrictions on the disposition of either the option or the stock itself. The effect of restrictions on disposition is discussed later under the heading of "Time of Realization of Income." Whether restrictions on disposition render the market value unascertainable thereby causing the realized income to equal zero or simply cause no realization of income is not clearly spelled out in the cases.
interest” in the employer’s business. The Court found it unnecessary to rely on Treasury Regulations in holding that such options constitute ordinary income to the employee. It preferred, however, to rest its case on the comprehensive definition of taxable income contained in Section 22(a) of the Internal Revenue Code of 1939. It stated that the “only exemption Congress provided from this very comprehensive definition of taxable income that could possibly have application here is the gift exemption of Section 22(b)(3)” of the 1939 Code. Since the company “was not giving away something for nothing” this gift exemption had no bearing. The only other classification into which the option could, therefore, fall was the gross income classification. While recognizing that an arm’s length purchase of property even at a bargain price ordinarily does not give rise to taxable income in the year of purchase, the Court stated that this was “not to say that when a transfer which is in reality compensation is given the form of a purchase the Government cannot tax the gain under §22(a).” In this language the Supreme Court thus sounded the death knell of the proprietary-compensatory distinction in respect to stock options in the employer-employee field.

Where No Employer-Employee Relationship Exists

While the LoBue case, no doubt, puts to rest the proprietary-compensatory issue in the employer-employee situation, there remains always the problem of delineating properly the scope and effect of such a decision. What, for example, is the effect of the LoBue case as to options granted where no employer-employee relationship exists between the grantor and grantee of the option?

(1) Principal stockholder and others as grantor of option.

A variety of reasons may make it necessary that if an employee of a particular corporation is to be granted an option to acquire some of its stock, the grantor of this option must be one of the principal stockholders, an officer, or perhaps an underwriter assisting with a refinancing. This can be brought about because of the unavailability of unissued or treasury shares, or because of the fact that it is oftentimes desirable to have stockholder approval of any stock option and for some reason this approval may not be forthcoming.

As far back as 1923 the Treasury Department ruled that when, in connection with a reorganization, stock was given to a corporate
employee by the stockholders, the receipt of this stock constituted income to the employee. The Department ruled that this was not a gift because the transfer was made in recognition of past services rendered to the corporate employer and therefore rendered, indirectly, to the stockholders themselves. Since the pertinent Regulations under Section 22(a) of the Internal Revenue Code of 1939 cover only employer-employee situations, the Commissioner has urged and courts have adopted a variety of reasons for taxing the spread on stock options to employees even though the grantor of the option was not technically the employer of the employee in question. In Batterman v. Commissioner the Court relied upon the broad language in Section 22(a) of the Internal Revenue Code of 1939 to hold that the spread on the stock received came within the meaning of "gains or profits from whatever source derived." It stated that whether the transferor of the stock, in this case the principal stockholder of the corporation, was looked on as a temporary employer or as making a contribution to the capital of the company so that it in turn could transfer the stock was an issue that it did not have to decide. Similarly, in Van Dusen v. Commissioner, a case involving stock purchased under an option granted by the president of the corporation personally, the Court of Appeals pointed to the inclusive language in Section 22(a) of the Internal Revenue Code of 1939 as containing no requirements that remuneration emanate solely from the employer, but rather referring to compensation of whatever kind and in whatever form paid. This language is not dissimilar from language used by the Supreme Court in the LoBue case.

Taxpayers, in turn, in non-employer-employee situations have attempted to avoid the imposition of income tax upon the grant or exercise of the option on the ground either that the intent was to confer upon them a proprietary interest or that the spread in the option price and market value constituted a gift. Among the cases often cited by taxpayers faced with such a problem is Bogardus v. Commissioner, wherein the Supreme Court held in a case involving a payment of money designated a gift or honorarium by a holding

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20 The Regulations covering the corresponding section under the Int. Rev. Code of 1954, namely § 61, have not yet been issued.
21 142 F. 2d 448 (6th Cir. 1944), cert. denied, 322 U.S. 756 (1944). This case, as does A.R.R. 2895, supra, involves a direct transfer of stock to the corporate employee, rather than receipt of stock upon the exercise of an option. The cases make no distinction in the two situations, nor does there appear to be any basis for so doing.
22 166 F. 2d 647 (9th Cir. 1948), affirming 8 T.C. 388 (1947).
23 302 U.S. 34 (1937). It should be noted, however, that the parties to the action stipulated that the payment was not made for services.
company to a former employee of an operating company, that the payment was a gift and not compensation. Taxpayers have also urged that while a grantor may intend to induce action on the part of the grantee by conferring a benefit on him, it does not follow that compensation is intended so as to make the benefit taxable income to the grantee. In view of the holding of the Supreme Court in the LoBue case, it would seem that in the future taxpayers in this area also will be denied the benefit of the argument that they have received no income because the option was granted to them in order for them to have a proprietary interest in the company. It may be, however, that in this area a gift will be somewhat easier to establish than in the employer-employee situation. Particularly may this be so where the grantor of the option is the father of the grantee or a person who has taken an unusual interest in a particular employee. While it is true that classifying a payment as income to the payee does not automatically assure a deduction to the payor, the fact that the payor in this area may have considerable difficulty in obtaining a deduction for the payment may, consciously or unconsciously, influence the opinion of the courts. For example, in the recent case of Neville v. Broderick, the court found that the transfer of stock to a key employee, his wife, and son by two owners of the company, where the key employee was not aware of this plan until its consummation, constituted a gift. The court found it significant that none of the parties had claimed a tax deduction as a result of the transfer.

(2) Grantee Not an Employee of Corporation.

Some of the unrestricted stock option cases have involved situations wherein an option to acquire stock was granted to parties who are not employees of the corporation in question. These cases have generally classified close relatives, such as wives and children of key employees, in the same category with the key employee to whom they are related and treated the stock in the same manner as though granted to the key employee in question. Other cases
have involved the grant of an option to purchase stock to brokers as compensation for services rendered in connection with a sale of stock to the public.\textsuperscript{7} Again, no distinction is made merely because the grantee of the option may not technically be an employee of the corporation whose stock he has an option to purchase. It would, therefore, appear that the repercussions of \textit{LoBue} will also be felt by optionees who are not corporate employees, and they must overcome the contention that they have received ordinary income on some ground other than the ground that the option was intended to confer on them a proprietary interest in the corporation.

\textbf{Time of Realization of Income}

\textit{Realization of Income at Grant of Option}

The Supreme Court of the United States in the \textit{LoBue} case expressly recognized that it is possible for the recipient of a stock option to realize an immediate taxable gain, citing the \textit{Smith} case.\textsuperscript{8} The Court stated that, although such did not obtain in the case at hand,\textsuperscript{9} "the option might have a readily ascertainable market value and the recipient might be free to sell his option." Since, in the opinion of the majority of the Court, \textit{LoBue} could not sell the options, there was no reason to depart from the uniform Treasury practice of measuring the compensation to employees given stock options subject to this type of contingency by the spread between the option price and market value \textit{at the time the option is exercised}. The Court also pointed out that the "restricted stock option plans" covered by Section 421 of the Internal Revenue Code of 1954 uses the same measurement of value.

The dissenting opinion of Justices Harlan and Burton makes out an even stronger case for the realization of income on unrestricted stock options at the time of the grant of the option, pointing out that it was at the time of the grant of the option that the corporation conferred a benefit upon \textit{LoBue}. In the opinion of the dissenting Justices, "At the exercise of the option, the corporation 'gave' the respondent nothing; it simply satisfied a previously-created legal obligation." The dissenting opinion went on to state:

The option should be taxable as income when given, and any subsequent gain through appreciation of the stock, whether realized by the

\textsuperscript{7} Robert Lehman, 17 T.C. 652 (1951), acq. on this issue, 1952-1 CUM. BULL. 3.

\textsuperscript{8} In the \textit{Smith} case, the Supreme Court by way of dictum stated: "It of course does not follow that in other circumstances not here present the option itself, rather than the proceeds of its exercise, could not be found to be the only intended compensation." 324 U.S. at 182.

\textsuperscript{9} See note 16 supra.
sale of the option, if transferable, or by sale of the stock acquired by its exercise, is attributable to the sale of a capital asset and, if the other requirements are satisfied, should be taxed as a capital gain. Any other result makes the division of the total gains between ordinary income (compensation) and capital gain (sale of an asset) dependent solely upon the fortuitous circumstance of when the employee exercises his option.\textsuperscript{29}

The minority opinion thus points up the problem which has harassed courts since they were first presented with the matter of the proper tax treatment of stock options, namely, what portion of the gain realized is ordinary income and what portion should be taxed as capital gain due to appreciation in value of the asset acquired. Logically there is much to be said for the position of the dissenting Justices, namely, that employees should be taxed at ordinary income rates on the value of the unconditional option at the time of its receipt. Undoubtedly, adoption of such a rule will entail problems as to the proper valuation of the option at the date of the grant; for example, an option to acquire stock at $5 at any time during the next two years might well have value even though the stock was selling for $5 at the date of the grant.\textsuperscript{30}

Perhaps there is not much difference between the majority and dissenting opinions on this point, the chief difference being in their interpretation of the facts. The majority opinion stated that the three options were not transferable, while the dissenting opinion stated that the last two options were unconditional, freely transferable and immediately exercisable.\textsuperscript{31} Clearly, however, the dissenting opinion attaches more significance to the date of the granting of the option as the key date for the realization of income. In any event, the dictum in the Smith case to the effect that there can be an immediate realization of income at the grant of a stock option is reinforced by the dictum in the LoBue case. The net result is to strengthen as authority such cases as Commissioner v. Estate of Lauson Stone\textsuperscript{32} and McNamara v. Commissioner,\textsuperscript{33} wherein the Third

\textsuperscript{29} 351 U.S. at 251.
\textsuperscript{30} Such an option on listed securities clearly has value in the marketplace. For example, on June 28, 1956, an option (a call) to purchase 100 shares of General Motors at its then market price of 46 1/2 at any time within six months cost $410; on the same date an option (a call) to purchase 100 shares of du Pont at its then market price of 193 at any time within six months cost $2,250. Similar calls for a shorter period cost less. These options or calls are not generally available for periods in excess of six months.
\textsuperscript{31} The dissenting opinion would tax conditional options as ordinary income at the time the stated conditions are satisfied since until then the right to purchase stock did not vest. Cf. Robert Lehman, 17 T.C. 652 (1951), \textit{acq.}, 1952-1 \textit{CUM. BULL.} 3.
\textsuperscript{32} 210 F. 2d 33 (3d Cir. 1954), \textit{affirming} 19 T.C. 872 (1953).
\textsuperscript{33} 210 F. 2d 305 (7th Cir. 1954), \textit{reversing} 19 T.C. 1001 (1953).
Circuit and the Seventh Circuit, respectively, found that the taxable event was the grant of the option and that no income was realized on the exercise of the option. These cases also point up the problem of properly evaluating the option at the date of the grant.

In the Stone case, Stone’s employer sold to him in 1947 100 fully transferable warrants at $10 per warrant, each warrant entitling Stone to purchase 100 shares of the company’s stock at $21 per share. At the time the warrants were sold to Stone, the stock was selling at $19.75 per share. Stone in 1947 reported the difference between the value he placed on the warrants of $6,000 and the $1,000 paid for them, or $5,000, as additional compensation, and his employer claimed the same deduction. In 1948 Stone sold 89 warrants for $82,680 and reported the increment as capital gain. The Commissioner attempted to tax to Stone in 1948 as ordinary income the difference between the $890 paid for the 89 warrants and $82,680 received on their sale. At the trial qualified stockbrokers testified that the warrants were worth at least the $6,000 value Stone placed upon them. The Court of Appeals affirmed the Tax Court in holding that the taxable event was the granting of the option, relying on the dictum in the Smith case, and consequently held that the gain realized in 1948 was capital gain.

In the McNamara case, McNamara, as a result of negotiations as to his compensation upon a change of employment, was granted an option in 1945 to purchase 12,500 shares of the stock of his new employer, National Tea Company, for $16 a share plus a salary and a percentage of the net profit. At that time the stock was selling for $19 a share and the options ran to August 1947. The options were exercisable as to one-quarter immediately, and the remaining three-quarters after February 1946, August 1946, and February 1947, respectively. McNamara exercised one-half of his options in 1946 and the other one-half in 1947, at a time when the National Tea stock was selling at approximately $28 per share. In his 1945 return McNamara in addition to his salary included in income as compensation received $16,375 on the theory that this was the value of the options issued to him in that year. National Tea took a corresponding deduction on its 1945 return. In its 1945 report to the Securities and Exchange Commission, National Tea stated that the consideration for the granting of the option was “services rendered and to be rendered.” The Commissioner determined a deficiency for each of the years 1946 and 1947 on the theory that the difference between the option price and the fair market value of the stock
at the time of the exercise of the options represented ordinary income. The Tax Court sustained the Commissioner and rejected McNamara's argument that the options constituted income at the time of the grant. The Tax Court felt it was plain that no assignment of the options was contemplated even though there was no provision in the option prohibiting assignment. The Court of Appeals reversed the Tax Court, finding the grant of the option to be the compensation intended. The Court of Appeals found it significant that the option was granted “to the petitioner and his heirs, executors, administrators and assigns” and that it was not conditioned upon petitioner’s remaining in the employ of National Tea. The Court of Appeals made no reference to the fact that the options were not immediately exercisable, and the Tax Court placed no emphasis on the point although it referred to the option as “of a restrictive type” because it was not immediately exercisable.

As a result of the LoBue case, it seems safe to predict that in the future the Commissioner will inspect more carefully the tax return of the grantee of the option in the year of the grant. Future Stones may be more interested in proving that the option was worth a maximum of $6,000 in the year of the grant rather than showing that the option was worth at least $6,000. Future McNamaras may encounter difficulty in establishing that an unconditional option to purchase 12,500 shares at $3 under the market is not worth at least $37,500 plus some reasonable amount because of the right to purchase stock which may appreciate in value.\(^5\) It will be recalled that in neither the Stone case nor the McNamara case was the year of the issue of the grant of the option before the court.

The McNamara case also points up one of the ambiguities in the LoBue opinion, namely—what effect is to be given to the fact that a transferable option not conditioned on continuing employment is not immediately exercisable.\(^6\) The dissenting Justices apparently would postpone taxability until the permissible exercise date on the ground that until that date the option has not vested. As pointed out above, the majority opinion in indecisive language alludes only

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\(^5\) See discussion of value of six-month options to purchase listed stocks at market in note 31 supra.

\(^6\) In Van Dusen v. Comm'r., 166 F. 2d 647 (9th Cir. 1948), the court of appeals found the option to have only nominal value at the date of grant where the employee had the option to purchase fifty shares of stock a month so long as he was employed. See also John G. Wahl, 19 T.C. 651 (1953), wherein the Tax Court declined to hold the taxpayer realized income at the time of the grant of the option where the taxpayer had a present option to only one-half of the stock and a corporate resolution forbade assignment of any of the options except to other corporate employees with the consent of the corporation.
to immediate transferability not contingent on continued employment and "readily ascertainable market value" as perhaps necessary requirements for taxing an option at the date of grant. Does the fact that an option is not immediately exercisable cause it to have no "readily ascertainable market value"? It can be seen that future litigation (or possibly legislation) must clarify just what effect will be given to options, otherwise unconditional, that are not immediately exercisable.

Realization of Income on Exercise of Option.

In the LoBue case in holding LoBue taxable at the time of the exercise of the option, the Supreme Court relied strongly on the "uniform Treasury practice since 1923" of measuring "the compensation to employees given stock options subject to contingencies of this sort by the difference between the option price and the market value of the shares at the time the option is exercised." Since options are exercised more frequently on a rising market, taxation at the time of the exercise of the option has inured to the benefit of the Commissioner. Since many options contain restrictions of one type or another, the Commissioner, reinforced by the LoBue decision, will continue, no doubt, to urge that no income was realized at the grant of the option and the case at issue falls within the general rule of taxation at the time of exercise of the option.

Here again, however, certain cases have carved out an exception to the general rule of taxability at date of exercise in situations where, because of restrictions on the disposition of the stock received on exercise of the option, the stock itself has no fair market value. While some of the early cases refused to recognize the effect of restrictions on disposition in valuing stock, and cases holding that there was no realization of income on exercise of the option because of restrictions on disposition have been criticized by law review writers, the more recent decisions recognize that restrictions on disposition may render the value of the stock so uncertain as not to justify charging a taxpayer with income at the time of the exercise of the option.

For example, in MacDonald v. Commissioner, the taxpayer was given an option to buy 10,000 shares of Household Finance stock

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37 See, for example, G&K Mfg. Co. v. Helvering, 76 F. 2d 434 (4th Cir. 1935), rev'd other grounds, 296 U.S. 389 (1935); and Newman v. Comm'r., 40 F. 2d 225 (10th Cir. 1930).
38 Note, The Valuation of Option Stock Subject to Repurchase Options and Restraints on Sales, 62 YALE L.J. 832 (1953).
39 230 F. 2d 534 (7th Cir. 1956), reversing 23 T.C. 227 (1954).
at $18.70 at a time when the price of the stock was $33.87. At the
time of the exercise of the option in 1949, the price was $33.75.
The Tax Court found the spread between option price and market
value to be ordinary income at the time of exercise of the option in
1949. In reversing, the Court of Appeals for the Seventh Circuit
found that the oral agreement of MacDonald not to sell the stock
while he was in the employ of Household Finance made unascertain-
able the fair market value of the stock and, therefore, MacDonald
realized no income at the date of exercise of the option. The court
believed, but did not decide, that Section 16(b) of the Securities
Exchange Act of 1934 (covering insiders’ profits within six months
of purchase) would be applicable, and accordingly any profit realized
by MacDonald from the sale of stock would have to be turned over
to the corporation.

Two recent cases decided by the Tax Court and acquiesced in
by the Commissioner announce this same rule. In Kuchman v.
Commissioner," Kuchman in connection with a reorganization,
got an option from the underwriters handling the reorganiza-
tion to acquire stock at $5, which, if unrestricted, was worth
about $25. In connection with the option agreement Kuch-
man agreed that any shares received by him on exercise of the option
would not be sold for one year; that if he quit to work elsewhere
within one year, he would sell the stock back to the underwriters
at $5 per share; that any sale within two years would be made to the
underwriters at the market price; and that he would exercise no
pre-emptive right for one year. The Tax Court found that because
of these restrictions the stock had no ascertainable fair market
value in the hands of Kuchman at the time purchased by him and,
therefore, the acquisition of stock did "not justify charging Kuch-
man in the year of receipt with income in any amount." In Lehman
v. Commissioner," Lehman was one of the partners in an under-
writing firm that received an option to buy certain shares for ser-

40 In so holding the Court of Appeals for the Seventh Circuit relied on the following
cases as authority for the proposition that restrictions on the disposition of stock may cause
it to have no market value ascertainable with reasonable certainty: Helvering v. Tex-Penn
Oil Co., 300 U.S. 481, 499 (1937); Schuh Trading Co. v. Comm’r., 95 F. 2d 404 (7th
Cir. 1938); and Propper v. Comm’r., 89 F. 2d 617 (2d Cir. 1937). But see Batterman v.
Comm’r., supra note 21, wherein the Court of Appeals for the Sixth Circuit held that a
gentleman’s agreement not to sell more than 1/6 of the shares purchased in any one year
did not constitute a sufficient restriction on disposition to render the market value un-
ascertainable.

41 18 T.C. 154 (1952), acq., 1952-2 CUM. BULL. 2.
42 17 T.C. 652 (1951), acq. on this issue, 1952-1 CUM. BULL. 3.
cause of restrictions upon disposition, the shares had no fair market value when purchased by the partnership in 1943 pursuant to the option and that there was no realization of income at that time. The restrictions on disposition expired on December 41, 1943, and in 1944 the shares were sold by the firm, the individual partners reporting the excess of proceeds received over purchase price as capital gain. The Commissioner attempted to tax the partners at the time of termination of restrictions and the court decided against the Commissioner, stating:

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.\(^4\)

Various writers have warned against undue reliance on the Kuchman and Lehman cases.\(^4\) In spite of the fact that both of these cases were acquiesced in by the Commissioner, acquiescences can be withdrawn and a reappraisal by the Commissioner of the stock option field may be in order because of the LoBue victory. This issue was not passed upon in the LoBue case since there were no restrictions on the sale of stock once in the hands of LoBue. However, since the LoBue case did recognize the restrictions on transferability of the option itself may prevent realization of income at the time of grant of an option, the argument will, no doubt, be advanced that indirectly the Supreme Court has endorsed the rule that restrictions on disposition of the stock may preclude realization of income at the time of exercise of the option. Furthermore, the Supreme Court in 1937 announced the rule, in connection with a reorganization, that the speculative quality of shares and restrictions making sale of the shares impossible render the market value incapable of being ascertained with reasonable certainty so that no income can be realized on receipt of the shares.\(^4\)

One of the questions raised in the LoBue case and the reason the case was remanded to the Tax Court was the question of the exact time of the exercise of the option. As pointed out above, LoBue

\(^{43}\) Id. at 654.


\(^{45}\) Helvering v. Tex-Penn Oil Co., 300 U.S. 481 (1937). Both the Tax Court in the Kuchman case and the Court of Appeals for the Seventh Circuit in the MacDonald case relied upon the Tex-Penn Oil case.
gave his note for the first 150 shares on May 1, 1945, and this note was not paid off until May 24, 1946, at which time he received his stock; similarly as to the second option for 150 shares, he gave his note on January 3, 1946, and this note was paid off on May 24, 1946, at which time the stock was also delivered to him. Since the market value of the shares was lower at the time the notes were given, than at the time the notes were paid, LoBue contended that if he was to be taxed at the exercise date, that the proper date was the date of delivery by him of the notes to the company. The court pointed out that:

It is possible that a bona fide delivery of a binding promissory note could mark the completion of the stock purchase and that gain should be measured as of that date. Since neither the Tax Court nor the Court of Appeals passed on this question the judgment is reversed and the case is remanded to the Tax Court.44

The usual rule in determining receipt of income in situations of this type is that negotiable interest-bearing notes representing unconditional promises to pay and given in full payment of the amount due will constitute income in the amount of their face value.45 A somewhat similar rule applies to payments, namely, whether a note constitutes payment depends upon whether the parties intended the note to evidence a promise to pay or serve as security for payment.46 In other words, the giving of a promissory note sets the time of the taxable event when it constitutes payment “in cash or its equivalent.”47 No doubt these principles will serve on the remand of the LoBue case as a guide in the difficult factual determination of the exact time of the exercise of the option.

Sale of Option as Contrasted with Exercise of Option

Broadly speaking, it makes little difference in an employer-employee situation whether the employee exercises the option or sells the option. The Treasury Department in I.T. 379548 takes the position that an employee realizes ordinary income by way of compensation on the sale of the option just as he would on its exercise. In Soren-

44 351 U.S. at 250.
45 2 MERTENS, FEDERAL INCOME TAXATION § 11.07, and cases cited therein.
46 2 MERTENS, op. cit. supra, §§ 12.52-12.54, and cases cited therein.
47 Ibid.
48 1946-1 CUM. BULL. 15. The pertinent part of this I.T. provides “if an employee receives an option on or after February 26, 1945, to purchase stock of the employer corporation... and the employee exercises such option, the employee realizes taxable income by way of compensation on the date on which he receives the stock... If the employee transfers such option for consideration in an arm’s length transaction, the employee realizes taxable income by way of compensation on the date he receives such consideration...”
sen v. Commissioner,\(^{81}\) the Commissioner relied upon I.T. 3795 to tax Sorensen with ordinary income upon the sale of the option just as though he had exercised such option. It would seem, however, that even in an employer-employee situation, since the sale of an option has more of the attributes of a capital transaction than the exercise of an option, there is some psychological advantage to having made a sale of the option rather than exercising it. For example, in the Stone case the Tax Court felt that I.T. 3795 was not intended to cover stock warrants acquired by purchase and attempted to limit its effect solely to stock options; the Tax Court also pointed out that the parties were *dealing in stock warrants* and not the shares of stock that could be acquired thereunder in holding that Stone had not realized ordinary income on the sale of the warrants in question. In affirming, the Court of Appeals for the Third Circuit stated that when Stone “received this thing of value in 1947 and turned it into cash in 1948 that, it being a ‘capital transaction,’ he should be treated as in any other capital transaction.”\(^{82}\)

Where there is no employer-employee relationship involved, G.C.M. 23677\(^{83}\) states broadly that the gain or loss arising from the sale of an option to acquire stock constitutes long term capital gain and loss, providing the option is a capital asset held for more than six months. No case has been found involving the sale of an option by an employee in a semi-employee status to the grantor of the option, that is, an option granted by a principal officer of a company or large stockholder of a company to an employee of that company. However, in the case of Ben F. Reid v. Commissioner,\(^{84}\) the situation closely approaches this semi-employee situation in that one Knox and Reid owned an option to purchase approximately 1254 shares of Texmass Corporation. The stock option was granted to Knox by Snowden in November 1946, the only determination as to employee status being that in December 1946 Knox was an officer and director of Texmass. In May 1947, Knox gave to Reid \(\frac{1}{2}\) of this option and in August 1947, Reid became a mem-

\(^{81}\) 22 T.C. 321 (1954).
\(^{82}\) 210 F. 2d at 34.
\(^{83}\) 1943 Cum. Bull. 370. “Section 1234 of the Internal Revenue Code of 1954 among other things provides for capital gain or loss on the sale or exchange of an ‘option to buy or sell property which in the hands of the taxpayer constitutes (or if acquired would constitute) a capital asset.’ This section of the 1954 Code presents no problem when the receipt of the option itself is held to be income, since realizing capital gain on a subsequent sale of the option in such a situation is in line with the decided cases. What effect, if any, this section of the Code will have in cases where no income is realized upon receipt of the option, remains to be seen.”
\(^{84}\) 13 T.C.M. 123 (1954).
ber of the board of directors. Upon the subsequent sale of this option back to Texmass the Tax Court held that the sale of the option was the sale of a capital asset, citing G.C.M. 23677. Since this issue was not presented in the LoBue case, it may be expected that taxpayers will continue to urge that the sale of an option is one of the helpful facts supporting their claim that the gain on sale of an option constitutes a capital transaction rather than realization of ordinary income by way of compensation.

Deduction Allowable Grantor of the Option

Employer-Employee Situations

Where an employer-employee relationship exists the announced policy of the Treasury Department is to permit a deduction to the employer of the amount of spread between the cost of the option and the value of the stock at the time of the exercise of the option. I. T. 3795 states:

If such option is granted to the employee by the employer corporation, the amount of compensation realized by the employee under the foregoing principles is deductible by the employer corporation, in the year in which the employee realizes such compensation, to the extent set forth in Section 23(a) (1) of the Internal Revenue Code.

Court decisions indicate a similar deduction is allowable to employers in the year the option is granted if compensation is realized by the employee at the date of the grant of the option. Congress has followed an opposite pattern in providing for restricted stock options by allowing the employer no deduction for the spread between the option price and the market value of the stock at the date of exercise in return for the employee not including any amount in his income at the time of the exercise of the option. The general pattern, however, in unrestricted option situations is to permit the employee to deduct the amount includible in the income of the employee even though in other fields of income taxation there is no exact correlation between income on the one hand and deduction on the other.

56 Although the issue was not directly involved, the Commissioner apparently took no exception to the employer's taking a deduction for the amount reported by the employee as income at the time of the grant of the option in the cases of Comm'r. v. Estate of Lawson Stone, 210 F. 2d 33 (3d Cir. 1954), affirming 19 T.C. 872 (1953), and McNamara v. Comm'r., 210 F. 2d 505 (7th Cir. 1954), reversing 19 T.C. 1001 (1953). In the Stone case the corporation even took a deduction in its 1948 return for at least the amount reported by Stone as capital gain for that year.

56 See note 2 supra.

57 For example, INT. REV. CODE OF 1954, § 101, excludes from the income of beneficiaries or the estate of an employee up to $5,000 paid by the employer by reason of the death of the employee. INT. REV. CODE OF 1939, § 22(b) (1), as amended, 65 STAT. 483.
Where No Employer-Employee Relationship Exists

Where no employer-employee relationship exists, for example, where the option is granted by the principal stockholder or officer of a corporation, there is considerable uncertainty as to the exact nature of the benefit flowing from the principal stockholder or officer and what tax treatment should be given by him to this benefit conferred upon the grantee of the option. Since the deduction sections of the Internal Revenue Code are considerably more restrictive than the broad definition of gross income contained in the Code, non-employers may encounter considerable difficulty in claiming a deduction for the option granted. In the Van Dusen case the Court of Appeals for the Ninth Circuit pointed out that it was not of compelling significance that the principal stockholder did not take a deduction for compensation paid on account of the sales made under the option, implying perhaps that the principal stockholder had some right to take such a deduction. In the Batterman case, the appellate court pointed out that it was not necessary to decide whether or not the principal stockholder and grantor of the option was the temporary employer of the grantee of the option or made a contribution to the capital of the company so that it could pay stock to the employee in question. Of course, it would make a considerable difference to the grantor of the option whether or not he was looked upon as an employer entitled to deduct compensation paid or whether he was looked upon solely as making a contribution to the capital of the corporation which might increase his cost basis in his stock. In the Neville case, the Court of Appeals for the Tenth Circuit found that the principal stockholders had intended to make a gift to the grantee of the option and found it significant that none of the parties had claimed any tax deduction as a result of the transfer. Query: If the grantor has made a gift, might a gift tax return be due under the circumstances? Since practically all of the litigation has involved the grantee of the option rather than the grantor, the problem here involved will have to await clarification by future court decisions.

Does “Restricted Stock Option” Legislation Preempt the Field?

The question of whether restricted stock option legislation preempts the field has not been passed upon to date by the courts. Since Sec-

(1951), provided a somewhat similar exclusion. These payments, however, are deductible to the employer. J. Putnam, Inc., 15 T.C. 86 (1950) acq. 1950-2 CUM. BULL. 4; U.S. Treas. Reg. 111, § 29.23 (a)-9 (1943).
tion 130(A) was added to the Internal Revenue Code of 1939 by the Revenue Act of 1950 effective for taxable years ending after December 31, 1949, cases involving these years have for the most part not yet reached decisional stage. In the LoBue case, for example, all the options were granted in years prior to 1950, and the Supreme Court held that since the transactions in question all occurred prior to 1950, the restricted stock option legislation had no relevance to the case at hand. Since the Senate Finance Committee in 1950 stated, "Options which do not qualify as 'restricted stock options' will continue to be taxed as under existing law," it seems very doubtful even in the employer-employee situation that the courts will take the position that an employee realizes ordinary income on grant or exercise of an option simply because he failed to make out a case under the restricted stock option statutes. It would appear to be even more certain where no strict employer-employee relationship exists that the courts will continue to pass upon unrestricted stock options as a matter not controlled by strict statutory law.

**CONCLUSION**

One might conclude that the LoBue case will have the following effect in the unrestricted stock option field:

1. It rejects, perhaps with finality, the view that an employee will recognize no income on the exercise of a stock option where the stock option is "proprietary" in nature. Employees are thus given an added inducement to take the statutory restricted stock option in preference to the less predictable unrestricted stock option.

2. It will supply added ammunition to those taxpayers who, for one reason or another, desire to contend that the grant of an unconditional, fully transferable option marks the taxable event.

3. It will lend support, albeit indirect, to those taxpayers who wish to contend that because of restrictions on disposition, the stock received on exercise of the option in question had no fair market value and, therefore, there is no realization of income to the optionee.

It is felt, however, that the Supreme Court skirts rather than solves the main problem. This problem is the problem which has traditionally existed in the unrestricted option field, namely: what portion of the profit realized upon the exercise of an option by an employee constitutes ordinary income in the nature of compensation and what portion is due to appreciation in value of stock which has traditionally been taxed as capital gain income.

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It is at once apparent that the courts have not been pleased with the Treasury solution of taxing the entire amount realized on exercise of the option as ordinary income in the nature of compensation, regardless of how long the option has been held or how much the price of the stock has gone up in the interim period. The courts recognize that these problems do not arise when there is a falling market. There is much to be said for the position of the Supreme Court minority opinion that the taxable event is the grant of each option and not its exercise; that at the exercise of the option the corporation gives the grantee of the option nothing, but simply satisfies a previously created legal obligation. Such a position, of course, requires a realistic appraisal of the depressing effects of restrictions imposed upon the disposition of the option or upon the stock itself. It would seem that the position taken by the Court of Appeals for the Seventh Circuit in the *MacDonald* case, gives undue emphasis to an oral agreement on the part of the employee not to sell and to SEC restrictions on insider profits, when there existed an eighteen point spread at the time of the grant of the option between the option price and the price of the stock. Some recognition should also be given to the fact that the duration of the option is an important factor in arriving at its value. For example, a ten year option to buy General Motors at the present market price has real value. While the difficulty in accurately evaluating options at the date of the grant is recognized, taxing unconditional transferable options at the date of grant would avoid taxing as ordinary income in the nature of compensation the amount of appreciation in value of the stock. A subsequent appreciation in value of the stock should not be taxed any differently from any other capital transaction, and the grantor of the option should be limited in his deduction to the amount of compensation included in income of grantee of the option at the date of the grant. The net result might then be to place people who, for some reason, cannot qualify for the statutory restricted stock option in approximately the same position as those who do so qualify.