Taxation of Nonstatutory Stock Options - A Proposed Answer to a Continuing Problem

Thomas C. Riley

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TAXATION OF NONSTATUTORY STOCK OPTIONS — A PROPOSED ANSWER TO A CONTINUING DILEMMA

I. INTRODUCTION

For many years stock options have presented corporations with a lucrative and opportune method of compensating highly paid key employees and officers and throughout this period the Commissioner of Internal Revenue and the courts have sought to devise a fair and equitable method of taxing these options. Part of the problem has been solved by sections 422 and 423 of the Internal Revenue Code which grant favorable tax treatment to those options which fall within their provisions. With respect to those options not qualifying under the Code, generally called "non-statutory stock options," the difficulty in devising a taxing scheme centers around the two-fold purpose of granting stock options. First, the option is a means of compensating the highly paid employee with the advantage of deferring the taxation of such compensation to a later and possibly more advantageous time, while the corporation has the benefit of not having to make a cash disbursement to such employee either at the time the services are rendered or later when the option is exercised. Second, the stock option acts as a stimulus to the employee by making him a potential investor and proprietor of the corporation.

Because of this dichotomy in purpose, the taxing authorities and courts are faced with the problem of pinpointing the time when the compensatory aspect of the option subsides, and the investor-proprietary aspect becomes the dominant factor. This transition can occur at any one of three times in the life of an option. They are: (1) when the option has a readily ascertainable market value; (2) when the option is exercised; and (3)

1. Treas. Reg. § 1.421-6(b)(1) (1959), defines an option as "the right or privilege of a person to purchase property from any person by virtue of an offer continuing for a stated period of time, whether or not irrevocable, to sell such property at a stated price, such person being under no obligation to purchase."


6. Obviously, this difficulty has arisen from the employee's desire to realize and retain a maximum amount of dollars from his option which necessarily will depend on the time when the gain arises and whether any gain accruing to him via the option is taxed at ordinary income rates.


when the option is sold.\textsuperscript{9} If restrictions are placed on the stock when the option is exercised, the recognition of income by the employee will be deferred until such restrictions lapse or the stock is sold in an arm's length transaction.\textsuperscript{10} The transition will have occurred, however, when the option is exercised.

The determination of when the transition to investor occurs is relevant for two reasons. First, such a decision will determine when and to what extent the employee will realize and recognize ordinary income,\textsuperscript{11} and second, it will determine when and to what extent the corporation may deduct such compensation on its federal tax return.\textsuperscript{12} In an attempt to resolve this problem, the Commissioner has set forth criteria in his Regulation and, more recently, in his proposed amendments to that Regulation. This Regulation and the proposed amendments are, in essence, a mixture of past cases and prior Regulations with an attempt to give new answers to some of the perplexing problems which have arisen in the past. It is the purpose of this Comment to analyze the Commissioner's Regulation and proposed amendments as they relate to the transition of the option, and to discuss briefly the deductibility to the corporation of the compensation recognized by the employee.

\section*{II. History}

Initially, it was the Commissioner's position that "[w]here property is sold . . . by an employer to an employee, for an amount substantially less than its fair market value . . . such employee shall include in gross income the difference between the amount paid for the property and the amount of its fair market value."\textsuperscript{13} Thus, when an employee exercised his option to purchase stock of the employer-corporation\textsuperscript{14} he was treated as having made a bargain-purchase resulting in the recognition of ordinary income to the extent of the spread between the option price and fair market value of the stock. The courts, however, formulated a test of taxability which limited the scope of the Commissioner's Regulation solely...

\textsuperscript{9} Treas. Reg. § 1.421-6(d)(3).
\textsuperscript{10} Proposed Treas. Reg. § 1.421-6(d)(2)(i).
\textsuperscript{11} Once the transition occurs, all gains or losses accruing to the employee from the option or the stock acquired under the option will be considered capital gains. However, when restrictions on the stock are employed such gains or losses may thereby become ordinary. See pp. 316-17 infra. An unresolved question is whether the employee will realize a capital loss if the transition occurs at the date of grant of the option and the employee allows the option to terminate. It would appear that since the option is not then "in the nature of compensation" (see pp. 305-08 infra), that it would not be precluded from the treatment afforded by section 1234 of the Internal Revenue Code of 1954, allowing a capital loss in such situations. See pp. 305-08 infra.
\textsuperscript{12} Treas. Reg. § 1.421-6(f).
\textsuperscript{13} T.D. 3435, II-1 Cum. Bull. 50 (1923).
\textsuperscript{14} Although Treas. Reg. § 1.421-6(a)(1) speaks of an option "to purchase stock of the employer," it will also cover an option to purchase stock of a parent or subsidiary or stock of another corporation under the "or other property" language of the Regulation. For a discussion of the scope of this Regulation, see pp. 305-08 infra.
to those options initially intended as compensation, thereby eliminating those options which were, in the court's view, granted for the purpose of creating a proprietary interest in the optionee.\textsuperscript{15} The Commissioner acquiesced in these decisions\textsuperscript{16} and amended his Regulation by limiting the amount to be included in gross income at the time the option is exercised "to the extent that such difference is in the nature of (1) compensation for services rendered or to be rendered . . . ."\textsuperscript{17}

This apparent agreement between the Commissioner and the courts was, however, short-lived. In 1945 the Supreme Court held in \textit{Commissioner v. Smith}\textsuperscript{18} that the petitioner-optionee was to include in gross income the spread between the option price and the fair market value of the stock on the date the petitioner exercised his option. The important aspect of this holding arose from the fact that the Court did not discuss whether the option was intended to be compensation or to create a proprietary interest in the employer-corporation. Rather, it based its decision on the theory that "[s]ection 22(a) of the Revenue Act is broad enough to include in taxable income any economic or financial benefit conferred on the employee as compensation, whatever the form or mode by which it is effected."\textsuperscript{19} Because of this all-inclusive language, the Commissioner concluded that the compensatory-proprietary intent test had no continuing vitality. Accordingly, he issued T.D. 5507\textsuperscript{20} and I.T. 3795,\textsuperscript{21} reverting to his initial position that all options involving the employment relationship are compensatory and that the spread at the date of exercise was to be included in gross income. In subsequent cases, however, the courts were unwilling to follow the Commissioner's lead and to abandon the compensatory-proprietary intent test, but rather continued to grant favorable tax treatment to those options which were granted to the optionee for the purpose of creating a proprietary interest in the corporation.\textsuperscript{22}

The \textit{Smith} Court created another problem when it stated in dictum: "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."\textsuperscript{23} Arising from this after-thought was the proposition that the option, rather than the stock underlying the option, was the intended form of compensation. Therefore, the optionee may be required to include as compensatory income the value of the option at the time of grant and not the gain at the time of any subsequent exercise of the option. This exclusion from ordinary income

\textsuperscript{15} See Delbert B. Geeseman, 38 B.T.A. 258 (1938).
\textsuperscript{16} 1939–1 \textit{CUM. BULL.} 13 (part 1).
\textsuperscript{17} T.D. 4879, 1939–1 \textit{CUM. BULL.} 159 (part 1).
\textsuperscript{18} 324 U.S. 177 (1945).
\textsuperscript{19} Id. at 181.
\textsuperscript{20} T.D. 5507, 1946–1 \textit{CUM. BULL.} 18.
\textsuperscript{21} I.T. 3795, 1946–1 \textit{CUM. BULL.} 15.
\textsuperscript{22} \textit{E.g.}, Malcolm S. Clark, 9 CCH Tax Ct. Mem. 719 (1950); Norman G. Nicolson, 13 T.C. 690 (1949).
\textsuperscript{23} 324 U.S. at 182.
of the spread at the time of exercise would be based on the theory that the compensatory aspect of the option has been completed and taxed, and that any gain he may realize from the subsequent exercise of the option would flow from his status as an investor or owner of a capital asset.24

Prior to Smith, the only event considered to give rise to ordinary income was the sale or exercise of the option by the optionee. As a result of the Smith dictum, however, the granting of the option was added as another date in the life of an option which may, under the proper circumstances, be considered as the appropriate date for the purposes of determining the amount of compensation the employee has realized from his option.25

In 1950, Congress attempted to eliminate the compensatory-proprietary intent problem by creating a statutory exception to existing stock option rules in the form of a “restricted stock option.” An option which met the new standards received favorable tax treatment because no gain would be recognized by the employee until he sold the stock acquired under the option and that gain would be taxed as a long term capital gain.26 The courts, however, ignored the possibility that this section preempted any similar tax treatment to other options, and thus continued to exclude from the operation of T.D. 5507 and I.T. 3795 those options which were granted with the intention of creating a proprietary interest in the corporation.27

This practice continued until the Supreme Court’s decision in Commissioner v. LoBue,28 where the Court stated:

[T]here is not a word in § 22(a) which indicates that its broad coverage should be narrowed because of an employer’s intention to enlist more efficient service from his employees by making them part proprietors of his business. In our view there is no statutory basis for the [compensatory-proprietary intent] test established by the courts below. When assets are transferred by an employer to an employee to secure better services they are plainly compensation.29

With the rejection of the compensatory-proprietary intent test, and the recognition that all nonstatutory stock options granted to an employee were to some extent compensatory, the only questions left for determination

24. See McNamara v. Commissioner, 210 F.2d 505 (7th Cir. 1954), rev’d 19 T.C. 1001 (1953); Estate of Lauson Stone, 19 T.C. 872 (1953), aff’d, 210 F.2d 33 (3d Cir. 1954).

25. See pp. 308-13 infra for a discussion of how the Regulation determines whether the optionee realizes compensation income from the grant of the option and the criteria used for such a determination.


29. Id. at 247.
were when and to what extent the employee realized ordinary income in the form of compensation.\textsuperscript{30}

After \textit{LoBue}, one of three possible events during the life of an option could be chosen as the time when the optionee-employee was compensated by the optionor.\textsuperscript{31} It could be at the time the option was granted, or when the option was exercised, or when it was sold.\textsuperscript{32} However, in the situation where the date of exercise was the time of compensation, the employee may have been able to defer\textsuperscript{33} or possibly even avoid\textsuperscript{34} recognition of any ordinary income in the form of compensation by the placing of restrictions on the stock acquired under the option.

This deferral or avoidance of ordinary income was made possible by the cases of \textit{Robert Lehman}\textsuperscript{35} and \textit{Harold H. Kuchman}.\textsuperscript{36} Kuchman held that the placing of certain restrictions on stock acquired under an option would prevent the ascribing of any fair market value to the stock thereby preventing any determination of the amount of ordinary income realized by the optionee at the time of exercise. The \textit{Lehman} case went further, holding that the subsequent lapsing of those restrictions was not a taxable event which would give rise to income and that when the stock acquired under the option was sold, the taxpayer received no compensation but only capital gain.

The Commissioner subsequently issued his nonacquiescence\textsuperscript{37} with the \textit{Lehman} decision and in 1959, in an attempt to clarify his position, adopted Treas. Reg. § 1.421–6 setting forth definite standards as to when an option gives rise to compensatory income and what will be the amount of that income. The Commissioner, in the process of conforming his Regulation to the prior case law, retreated from his previous stand\textsuperscript{38} that all compensatory options give rise to ordinary income at the time of exercise. The Regulation and its proposed amendments now recognize that, in addition to the date of exercise, other events such as (1) when the option has a readily ascertainable fair market value,\textsuperscript{39} (2) when the

\begin{footnotesize}
\textsuperscript{30} The following dictum in the \textit{LoBue} case also added weight to the argument that an employee may realize compensatory income on the date of grant:

\begin{itemize}
  \item It is of course possible for the recipient of a stock option to realize an immediate taxable gain. See \textit{Commissioner of Internal Revenue v. Smith}, 324 U.S. 177, 181–182. The option might have a readily ascertainable market value and the recipient might be free to sell his option. But this is not such a case. \textit{Id.} at 249 (emphasis added).
\end{itemize}

\textsuperscript{31} The option need not be given by the employer to give rise to compensatory income nor must the employee be the optionee. See pp. 306–07 infra.

\textsuperscript{32} See pp. 308–16 infra.

\textsuperscript{33} Under Proposed Treas. Reg. § 1.421–6(d) (2) (i), the recognition of compensation-income will occur only upon the lapsing of restrictions on the stock already acquired under the option.

\textsuperscript{34} See pp. 316–17 infra for a discussion of this possibility under the decision of the Tax Court in Robert Lehman, 17 T.C. 652 (1951).


\textsuperscript{39} Proposed Treas. Reg. § 1.421–6(d) (1) (i).
\end{footnotesize}
option is sold, or (3) when any existing restrictions lapse, may also be points in the life of an option where the full measure of compensation has been received by the employee. The question now is whether the Commissioner’s Regulation and his newly proposed amendments reflect the prior case law and whether any discrepancies between the two are justified.

III. Scope of the Regulation

All options falling within the scope of Treas. Reg. § 1.421-6 will, in accordance with its provisions, give rise to the realization of ordinary income in the form of compensation at one time or another. Treas. Reg. § 1.61-15(a) provides for the recognition of such income by the following language: "[A]n option in payment of an amount constituting compensation of such person . . . is subject to the rules contained in § 1.421-6 for purposes of determining when income is realized in connection with such option and the amount of such income." If the option does not fall within the Regulation, then it would appear that the option would be considered a capital asset and that the subsequent sale or exercise of the option would be taxed in accordance with section 1234 of the 1954 Internal Revenue Code.

Treas. Reg. § 1.421-6(a) (1) uses the following language to define the scope of its coverage: "If an employer or other person grants to an employee or other person for any reason connected with the employment of such employee an option to purchase stock of the employer or other property . . . then this section shall apply . . . ." Obviously, the critical factor in determining whether an option falls within this definition will be whether the person receiving the option would have received it notwithstanding the employment relationship. Where an employer grants an option to an employee there would appear to be little room to argue

   (i) An option which is subject to the rules contained in section 421; and
   (ii) An option which is not granted as the payment of an amount constituting compensation, such as an option which is acquired solely as an investment, or as part of an investment unit described in paragraph (b) of § 1.1232-3.
45. Treas. Reg. § 1.421-6(a)(1) purports to include options for the purchase of any property which includes an option to purchase stock. This Comment, however, is limited to the stock option although the principles considered in this analysis would necessarily apply to options to purchase property other than stock.
46. Treas. Reg. § 1.421-6(a)(1).
47. The terms employee and employer are defined by Treas. Reg. § 1.421-6(b)(3)(i) as: "The term 'employee' includes the person who provided the consideration resulting in the grant of the option, the term 'employer' includes the person to whom, or for whom, such consideration was provided, and the term 'employment' includes the providing of such consideration."
that the option was not in some way “connected with the employment of such employee.”

The Regulation, however, covers other transactions in addition to such direct grants from the employer to the employee, and the justification for expanding the scope of the section can be found in several cases. For example, in *Wanda V. VanDusen*, the Tax Court held that the optionee-employee realized ordinary income upon the exercise of an option granted to him by the shareholder-president of the corporation on the basis that the option was granted as an inducement for the impending employment relationship between the corporation and the optionee. In *Robert C. Enos*, the Tax Court also refused to ignore the employment relationship where an optionee-employee assigned the rights under his option contract to his wife. Similarly, in *Joseph Kane* the Tax Court found that the employment relationship was the critical factor in the granting of an option even though neither the employer nor the employee was a party to the option contract. The optionor was a major shareholder of the employer-corporation and the optionee was the wife of the employee. The deciding factor in the case was the provision in the option contract that the option’s existence was contingent upon the husband’s continued employment with the employer-corporation.

The Commissioner and the courts, in going beyond the direct employer-employee transaction, have established what amounts to a “but for” test of taxability. In other words, if it is decided that but for the employment relationship the option would not have been granted, then the option will be considered as a means of compensating the employee, thereby bringing it within the provisions of Treas. Reg. § 1.421-6. It should be kept in mind that the test of taxability is not based on whether the parties intended the option as compensation to the employee, but it would appear that intent would be relevant only where the optionee argues that the option was intended as a gift, and not as compensation. Of course, where there is some correlation between the employment relationship and the granting of the option, the burden of proving that the option was intended as a gift would be almost insurmountable.

48. 8 T.C. 388 (1947), aff’d, 166 F.2d 647 (9th Cir. 1948).
49. 31 T.C. 100 (1958).
50. 25 T.C. 1112 (1956), aff’d per curiam, 238 F.2d 624 (2d Cir. 1956), cert. denied, 353 U.S. 931 (1957).
51. 25 T.C. at 1125.
52. Intent becomes relevant when the issue is at what point during the option’s life did the employee realize compensation income. See pp. 312-13 infra for a discussion of this issue.
53. Indicative of this is the statement made by the Court in Commissioner v. LoBue, 351 U.S. 243 (1956):

The only exemption Congress provided from this very comprehensive definition of taxable income that could possibly have application here is the gift exemption of § 22(b)(3). But there was not the slightest indication of the kind of detached and disinterested generosity which might evidence a “gift” in the statutory sense. These transfers of stock bore none of the earmarks of a gift. They were made by a company engaged in operating a business for profit, and the Tax Court found that the stock option plan was designed to achieve more profitable operations.
From a practical standpoint, the majority of options which are subject to Treas. Reg. § 1.421-6 are those in which the employer is the optionor and the employee is the optionee and, for one reason or another, the option fails to meet the tests necessary to qualify for favorable tax treatment under sections 422 or 423 of the 1954 Internal Revenue Code. For example, an option may not qualify under sections 422 or 423 where the employer is not the optionor. The various other situations in which an option may be subject to Treas. Reg. § 1.421-6 are too numerous to set forth. It is sufficient to state that Treas. Reg. § 1.421-6, by the use of such broad language as "any person" or "any property," has effectively included within its scope any option which in any way may be related to the payment of compensation to someone in the employment relationship and which does not qualify under sections 422 or 423.

Once it is determined that the option does fall within the scope of Treas. Reg. § 1.421-6, the next question to confront the optionee is when and to what extent income will be recognized under that Regulation. As mentioned previously, the Commissioner has indicated in Treas. Reg. § 1.421-6 and the proposed amendments to that Regulation that several possible events in the life of an option may give rise to the realization of ordinary income, with recognition being deferred to a later time, or to both the simultaneous realization and recognition of ordinary income. They are: (1) the date when the option has a readily ascertainable fair market value; (2) the date when the option is exercised; (3) the date when the option is sold; or (4) the date of the lapse of any existing restrictions having a significant effect on the value of the stock. It is by providing the employees "with an incentive to promote the growth of the company by permitting them to participate in its success."

*Id.* at 246 (emphasis added).

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54. Treas. Reg. § 1.421-6(a) (1) states:
This section will apply, for example, when an option is not a qualified [section 422] or restricted [section 423] stock option at the time it is granted or an option granted or when ... an option is modified so that it no longer qualifies as such an option, or when there is a disqualifying disposition of stock acquired by the exercise of such an option so that section 421 does not apply.

55. Under section 422(b) of the Code only those options granted by the employer-corporation or its parent or subsidiary corporation, to purchase stock of any such corporations will qualify for favorable tax treatment.

56. But see pp. 315-16 infra. The operation of Treas. Reg. § 1.421-6 is restricted to those options granted on or after February 26, 1945 (the date of the Supreme Court's decision in Commissioner v. Smith, 324 U.S. 177 (1945)). Treas. Reg. 1.421-6(a) (2). Also, Treas. Reg. § 1.421-6(a) (2) excludes:
(i) Property transferred pursuant to an option exercised before September 25, 1959, if the property is transferred subject to a restriction which has a significant effect on its value, or
(ii) Property transferred pursuant to an option granted before September 25, 1959, and exercised on or after such date, if under the terms of the contract granting such option, the property to be transferred upon exercise of the option is to be subject to a restriction which has a significant effect on its value and if such property is actually transferred subject to such restriction.

57. See pp. 300-01 supra.

58. Proposed Treas. Reg. § 1.421-6(d) (1) (i).

59. Treas. Reg. § 1.421-6(d) (1).

60. Treas. Reg. § 1.421-6(d) (3).

61. Proposed Treas. Reg. § 1.421-6(d) (2) (i).
quite clear, however, that the Commissioner is not ready to accept the court's criteria for establishing which event will be used as the date when the employee has been fully compensated and becomes an investor.

IV. RECEIPT OF THE OPTION AS THE TRANSITIONAL EVENT

In Commissioner v. LoBue, the Supreme Court, in dictum, made the following observation:

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, 181-182. The option might have a readily ascertainable market value and the recipient might be free to sell his option.

Obviously borrowing the language in LoBue, the Commissioner, in Treas. Reg. § 1.421-6(c), established that an employee would realize and recognize compensation at the time of grant if that option had a "readily ascertainable fair market value." The proposed amendment to Treas. Reg. § 1.421-6(d)(1) now allows the employee to realize and recognize ordinary income from the option at a time subsequent to its grant but before it is exercised or sold by providing:

In the case of an option granted after October 26, 1968, which has a readily ascertainable fair market value prior to its exercise or transfer in an arm's length transaction, the employee includes compensation in gross income only at the time the option first has a readily ascertainable fair market value.

According to the Regulation, an option will have a readily ascertainable fair market value only when the "option is actively traded on an established market" or, if the option is not traded on an established market, when its market value "can be measured with reasonable accuracy." Whether an option's value can be measured with reasonable accuracy in turn depends upon an affirmative showing that:

a) The option is freely transferrable by the optionee;
b) The option is exercisable immediately in full by the optionee;
c) The option or the property subject to the option is not subject to any restriction or condition which has a significant effect upon the fair market value of the option or such property; and
d) The fair market value of the option privilege is readily ascertainable...
Determining the existence of the first three conditions will normally be possible after a brief review of the provisions of the option contract. However, whether the privilege of acquiring property under the option has a readily ascertainable value will, according to the Regulation, necessitate the consideration of the following factors:

a) Whether the value of the property subject to the option can be ascertained;

b) The probability of any ascertainable value of such property increasing or decreasing; and

c) The length of the period during which the option can be exercised.

Because of this multiple set of criteria, the practical effect of the Regulation is to deny the realization of compensation to the optionee from the receipt of the option unless the option is traded on an established market. Whether the criteria established by the Regulation can be supported by prior case law is certainly subject to question. The Estate of Lauson Stone and McNamara v. Commissioner were the first two cases in which a court held that the granting of the option was the intended means of compensating the employee, rather than its subsequent sale or exercise. In Stone, the optionee was issued 100 freely negotiable warrant certificates, each of which represented a right to purchase 100 shares of the employer-corporation, Follansbee Steel Corporation. The certificates were not exercisable until 6 months after the date of grant. The purchase price for the stock was set at $21 per share by the warrants, and the fair market value ascribed to the stock at the date of grant was $19.75 per share. One year later, the petitioner sold 89

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69. Treas. Reg. § 1.421-6(c) (3) (ii) defines option privilege as: "[T]he opportunity to benefit at any time during the period the option may be exercised from any appreciation during such period in the value of the property subject to the option without risking any capital."

70. Treas. Reg. § 1.421-6(c) (3) (ii) (a), (b), (c).


72. 19 T.C. 872 (1953), aff'd, 210 F.2d 33 (3d Cir. 1954), nonacquiescence in, 1953-1 Cum. Bull. 1. But see Union Chems. & Materials Corp. v. United States, 296 F.2d 221 (Cl. Ct. 1961), where the court was faced with the question as to the extent of the deduction allowed to the optionor and found that the option in the Stone case had no readily ascertainable market value at the date of the grant.


74. For a discussion of the Stone-McNamara cases, see Comment, Taxation of the Stock Option as Intended Compensation, 9 U.C.L.A.L. Rev. 703 (1962).

75. Initially, it was believed that an upward spread between the option price and market value was necessary in order for the option to have a readily ascertainable market value at the date of grant. See Commissioner v. Smith, 324 U.S. 177, 181 (1945), where the Court said: "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." See also Estate of Lauson Stone, 19 T.C. 872, 878 (1953). Treas. Reg. § 1.421-6(c), however, does not include such a requirement.
of the warrants for $82,680, reporting the transfer as a sale of a capital asset resulting in a long term capital gain of $76,790. The Commissioner assessed a deficiency on the basis that the gain on the sale of the warrants was the intended mode of compensation to the optionee and therefore was ordinary income. The Tax Court, in rejecting the Commissioner's position, stated that:

[T]he [only] reasonable inference to be drawn from the facts presented is that the parties were dealing in stock warrants and not the shares of stock that could be acquired thereunder. The following facts lend support to such a view, i.e., the decedent paid a valuable consideration for their issuance; the warrants were negotiable from their date; they were protected against dilution in value; and they were not contingent upon his continued employment.76

Conspicuously absent from the facts considered critical in the eyes of the court was that the warrants were not exercisable in full at the time of grant,77 as required by Treas. Reg. § 1.421–6(c) (3) (i) (b). Therefore, ascribing a compensatory value to an option at the date of grant may not necessitate that the option be exercisable in full when received by the optionee, despite such a requirement in the Regulation.

This position is corroborated by the seventh circuit's decision in the McNamara case. In McNamara the petitioner was given a 2-year unconditional, assignable option with semi-annual exercise dates. The circuit court agreed with the Tax Court that the "intention of the parties is the controlling factor in determining this question"78 of whether the value of the option or the bargain-purchase of the stock underlying the option was the amount of compensation involved. However, the circuit court reversed the Tax Court's decision that the employee realized compensation upon the exercise of the option because the circuit court found that the parties intended that the option was to be the vehicle of compensating the employee. Notwithstanding the fact that the options were not immediately exercisable in full, the court found that the option had a fair market value on the basis that the option was assignable and that there existed a spread79 between the option price and the market value at the date of grant. These cases, however, did make it clear that the options must be alienable to have a market value,80 as is now required by Treas. Reg. § 1.421–6(c) (3) (i) (a).

In addition to the two factors mentioned above, the Commissioner has also included two other conditions before the value of the option can be determined.81 Treas. Reg. § 1.421–6(c) (3) (i) (c) requires the option

(N.D. Ohio 1962), where the court, in dictum, criticized the rule that a spread must exist at the date of grant between the option price and fair market value of the stock in order for it to have a readily ascertainable market value.

76. Estate of Lauson Stone, 19 T.C. 872, 877 (1953).
77. The warrants were exercisable 6 months after the date of grant. Id. at 874.
78. McNamara v. Commissioner, 210 F.2d 505, 508 (7th Cir. 1954).
79. See note 75 supra.
81. See pp. 308-09 supra.
or the stock to be acquired under the option to be devoid of any conditions or restrictions.82 This requirement would appear to be consistent with the Kuchman-Lehman83 decisions of the Tax Court which held that the imposition of restrictions on stock acquired under an option prevented the ascertainment of its fair market value at the date of acquisition.84 However, the placing of "conditions" on the same plane with "restrictions" with respect to the effect each has on the market value of the option85 is an extension of the holdings in these two cases. The Tax Court, in holding that restrictions on the sale of the stock acquired under the option prevented the valuation of the stock, noted:

Since fair market value is defined as the price at which the property to be valued with all its attributes would change hands between a willing buyer and a willing seller generally [citation omitted] and not as the sale might be limited to one specific purchaser [citations omitted] we have concluded that the ascertainment of fair market value cannot be founded on this testimony [that a purchaser could not be found for this stock under such contractual restrictions].86

It is submitted that conditions on the exercise of the option which may be fulfilled by the individual at any time do not necessarily prevent the valuation of the option in the same manner as contractually agreed upon restraints on alienation, as existed in the Kuchman-Lehman cases. Therefore, it would seem that a very plausible argument could be made that conditions, such as the one mentioned above, will not prevent valuation of the option but will only reduce its value.87

The Commissioner's fourth requirement88 in determining whether an option's value can be measured with "reasonable accuracy" relates to the value of the option privilege, more commonly referred to as the "percentage lead." In Colton v. Williams,89 the court, in valuing the option granted to an employee, expressly included the percentage lead factor, using Treas. Reg. § 1.421-6(c)(3)(i)(d) as support for the adoption of this factor as part of its valuation method.90 However, in ascribing a value for percentage lead, the court did not use the three criteria

82. For a very good discussion of the differences between conditions and restrictions under Treas. Reg. § 1.421–6, see Bromberg, Opportunities Open up for Tax Planning Under New Regulations on Non-statutory Stock Options, 12 J. TAXATION 297 (1960).
83. Harold H. Kuchman, 18 T.C. 154 (1952); Robert Lehman, 17 T.C. 652 (1951).
84. For a discussion of the results following the use of restrictions on stock acquired under an option, see pp. 316–19 infra.
85. Notably, the lapsing of conditions on stock acquired under an option are treated differently than the lapsing of restrictions. Compare Treas. Reg. § 1.421–6(d)(1) with Treas. Reg. § 1.421–6(d)(2)(i).
86. Harold H. Kuchman, 18 T.C. 154, 163 (1952).
87. The Tax Court until recently has held that investment letter stock does not deprive the stock of a fair market value but merely reduces that value. The Tax Court has also found a stock's value to be less than market if blockage principles are in operation.
90. Id. at 384.
which Treas. Reg. § 1.421-6(c)(3)(ii) established explicitly for that purpose. Instead, the court based its decision on expert testimony, which it regarded as the only "reliable means of proof." It would be pure speculation to state that the expert considered the three factors delineated in the Regulation.

Recently, the Tax Court has shown a definite inclination to use the four standards of valuation set forth in Treas. Reg. § 1.421-6(c)(3)(i). Therefore, it would appear that all options now falling within the scope of Treas. Reg. § 1.421-6 will be required to satisfy these criteria, in order for the option to have a readily ascertainable fair market value. It should be noted, however, that the valuation structure established by the Regulation conflicts with the Internal Revenue Service's general policy of valuing property when received except under extremely unusual circumstances. Furthermore, the question here is not whether the employee realizes compensatory income, but only what amount he receives, because after the LoBue decision it was recognized that all nonstatutory employment stock options, at one time or another, give rise to ordinary income. Therefore, there is no justification for the Commissioner's stringent criteria except that of raising additional tax dollars. Moreover, more leniency in this area would not appreciably diminish the revenue now forthcoming because the amount of compensation generally expected by the parties is the spread at the date of exercise and it is at that time that the employee will normally consider himself as an investor and proprietor.

Generally, there appears to be two logical approaches to the question of whether the employee realizes and recognizes compensation before the sale or exercise of an option. Under the Regulation and proposed amendments to the Regulation, it would appear that the intent to compensate the employee by means of the option itself is a question of fact, with the critical question being whether the option has any fair market value at some date prior to its sale or exercise. That is, if an option has no fair market value at a date prior to its sale or exercise, then there could be no intent to compensate the employee by means of the option, as nothing of value has been given to the employee.

The second approach would be to determine first, as a question of fact, whether the parties intended the option or the stock underlying the

91. Id. at 385.
94. Under the compensatory-proprietary intent test the optionee could completely avoid the realization of compensatory income. See pp. 301-03 supra. After LoBue, however, this is not possible. But see pp. 316-17 infra.
95. See Rhodes, Unrestricted Stock Options, 11 Sw. L.J. 39 (1957).
97. See note 75 supra.
option to be the mode of compensation. If the option was found to be the intended method of compensating the employee then the next question would be whether the option had an ascertainable value. Absent an ascertainable value, the transaction would be treated as an "open transaction" under the theory of Burnet v. Logan,98 and compensation would result to the employee upon some subsequent event when the value could be ascertained.

It is submitted that, contrary to the proposed amendments to Treas. Reg. § 1.421-6(d)(1)(i), the test for determining whether the employee realizes income before the option is sold or exercised should be based on the intent of the parties to the option. More specifically, the critical question is whether the parties intended to compensate the employee by the granting of the option or by the stock underlying the option. Therefore, the stringent valuation requirements contained in Treas. Reg. § 1.421-6 could be eliminated in favor of the general policy of valuation set forth in Rev. Rul. 58-402.99 The point in time at which the parties intended the compensation to occur should be a question of fact. The critical factors in determining this intent should be the three criteria set forth in Treas. Reg. § 1.421-6(c)(3)(ii)(a), (b), and (c).100 This method of determining the taxable event would appear to be more consistent with the case law101 and would eliminate the existing conflict between the Regulation and the general valuing policy previously established by the Commissioner. In addition, this position would not, to any large degree, affect decisions which might be obtained under the proposed amendments to the Regulation. Furthermore, by adopting this "open transaction" concept, the Regulation would maintain an internally consistent position.102


100. Whether the option is subject to conditions or restrictions or exercisable immediately, or whether the parties expect the market value of the stock to appreciate substantially during the term of the option would be the critical factors in determining whether the optionor intended to presently compensate the employee. Restraints on alienation would affect the determination of whether the option had a fair market value. However, notations in the minutes of the corporation or within the option itself that the optionor intends to currently compensate the employee should be given little weight. But see McNamara v. Commissioner, 210 F.2d 505 (7th Cir. 1954), rev'd 19 T.C. 1001 (1953).

101. E.g., McNamara v. Commissioner, 210 F.2d 505 (7th Cir. 1954); Estate of Laison Stone, 19 T.C. 872 (1953).

102. It should be apparent that the Regulation was inconsistent as to its approach to the lapsing of restrictions or conditions. That is, that if restrictions or conditions were placed on the option at the date of grant, the lapsing of those restrictions or conditions will not result in the recognition of compensatory income. However, if the conditions or restrictions were placed on the stock acquired under the option, he will recognize ordinary income when they lapse. See Aidinoff, Employee and Non-Employee Stock Options: Recent Developments, N.Y.U. 22d INST. ON FED. TAX. 167, 162. However, this inconsistency has been removed by the Proposed Regulation in that if restrictions on the sale of an option lapse before the option is exercised it may then be valued. See Commissioner v. Ogsbury, 258 F.2d 294, 296-97 (2d Cir. 1958), aff'd 28 T.C. 93 (1957), where such a result was indicated.
VII. THE SALE OR EXERCISE OF THE OPTION AS THE TRANSITIONAL EVENT

If the transitional event is not the grant of the option, then it must occur either when the option is sold\textsuperscript{103} or when it is exercised.\textsuperscript{104} Of course, if the employee allows the option to lapse, no compensation will be received by the employee, as he will have received nothing of value.

If the option is not sold but is exercised by the optionee, then the employee will realize income at that time and to the extent of the difference between the option price and the fair market value of the stock on the date of exercise.\textsuperscript{105} However, in accordance with Treas. Reg. § 1.421-6(d)(1), the optionee must, at the date of exercise, have "an unconditional right to receive the property subject to the option" or the determination of the amount to be included in gross income as compensation will be deferred until such right exists.\textsuperscript{106} \"[C]onditions that may be performed by him at any time,\"\textsuperscript{107} such as making payment for the stock when he so desires, are excluded from those which may make the employee's right to receive the stock a conditional right. An example of a conditional right to receive stock would be where the optionee is to receive the stock only if and when it is received by the optionor.\textsuperscript{108}

With respect to sales of options, Treas. Reg. § 1.421-6(d)(3) provides that if the option is "transferred in an arm's length transaction, the employee realizes compensation in the amount of the gain resulting from such transfer of the option . . . .\"\textsuperscript{109} The recognition of compensatory income upon the sale of an option which is in the nature of compensation is not a concept new to tax law.\textsuperscript{110} The Technical Amendments Act of 1958\textsuperscript{111} specifically amended section 1234 of the Code to provide for the recognition of ordinary income upon the sale of a compensatory stock option. Section 1234(d) now states:

This section [providing that gain or loss on the sale of an option shall take the same character as any gain or loss on a sale of the property underlying the option] shall not apply to—

\begin{itemize}
  \item\textsuperscript{103} Treas. Reg. § 1.421-6(d)(3).
  \item\textsuperscript{104} Treas. Reg. § 1.421-6(d)(1).
  \item\textsuperscript{105} Id.
  \item\textsuperscript{106} See Philip J. LoBue, 28 T.C. 1317 (1957), aff'd, 256 F.2d 735 (3d Cir. 1958); Estate of James S. Ogsbury, 28 T.C. 93 (1957), aff'd, 258 F.2d 294 (2d Cir. 1958).
  \item\textsuperscript{107} Id.
  \item\textsuperscript{108} See also Graney v. United States, 258 F. Supp. 383 (S.D. W.Va. 1966), aff'd per curiam, 377 F.2d 992 (4th Cir. 1967), where the taxpayer unsuccessfully argued that the placing of the optioned stock in escrow with title in his name, such stock to be transferred to him when he made payment, gave him the property interest at the date of grant. Thus, it would appear that an unconditional right to the stock can never be acquired prior to the exercise of the option.
  \item\textsuperscript{109} Treas. Reg. § 1.421-6(d)(3).
  \item\textsuperscript{110} E.g., Commissioner v. Smith, 324 U.S. 177 (1945); Estate of James S. Ogsbury, 28 T.C. 93 (1957), aff'd, 258 F.2d 294 (2d Cir. 1958).
  \item\textsuperscript{111} Act of Sept. 2, 1958, c 1, § 53, 72 Stat. 1644 (1958).
\end{itemize}
(2) in the case of gain attributable to the sale or exchange of a privilege or option, any income derived in connection with such privilege or option which, without regard to this section, is treated as other than gain from the sale or exchange of a capital asset;\textsuperscript{112}

Furthermore, the report of the Senate Committee on Finance\textsuperscript{113} clearly indicates by the following language that this subsection was to apply to the sale of an employee stock option: “As a result [of the addition of subsection (d)(2)] the section [1234(a)] will not apply to gain from the sale of an employee stock option which is \textit{in the nature of compensation to the employee}.”\textsuperscript{114}

Even prior to the amendment of section 1234, the Tax Court had held that the sale of a compensatory stock option resulted in ordinary income rather than capital gains.\textsuperscript{115} Cases rendered subsequent to the amendment have also denied capital gains treatment, now on the basis of section 1234(d)(2). Indicative of these latter cases is \textit{Rank v. United States},\textsuperscript{116} where the employee was the holder of a restricted stock option under section 130A of the 1939 Internal Revenue Code. The optionor-corporation wished to liquidate under section 337, which required that the liquidation be completed within 1 year from the date of the adoption of the plan of liquidation. Because the outstanding options represented a potential barrier to such complete liquidation, the corporation offered to repurchase the options at a price of $11.25 per share. The optionee-employee accepted the offer and the sale was consummated. The employees reported the gain as resulting from the sale of a capital asset. The fifth circuit, however, took a different view of the transaction. The court noted that if the options had been exercised by the optionees and the stock held for the period required by statute, no compensation income would result under section 130A of the 1939 Code. However, the court decided that qualifying the option under section 130A did not mean that the option was not compensatory; it merely meant that if all the requirements set forth in the section were complied with, no ordinary income would result upon the exercise of the option. Because the sale of the option was an act of disqualification, it was relegated to the position of a nonstatutory compensatory stock option, and thus the sale clearly fell within the language of section 1234(c)(2).\textsuperscript{117}

In summation, it should be apparent that the sale of \textit{any} stock option which was granted because of the employment relationship will result in the realization and recognition of ordinary income and that the statement in Treas. Reg. § 1.421–6(d)(3) is merely a reiteration of what was

\textsuperscript{112} \textit{Int. Rev. Code} of 1954, § 1234(d)(2).
\textsuperscript{114} \textit{Id.} (emphasis added).
\textsuperscript{115} \textit{See note} 110 \textit{supra}.
\textsuperscript{116} 345 F.2d 337 (5th Cir. 1965). \textit{See also} \textit{Dugan v. United States}, 237 F. Supp. 7 (S.D.N.Y. 1964); Donald H. Kunsman, 49 T.C. 62 (1967).
\textsuperscript{117} \textit{Int. Rev. Code} of 1954, § 1234(c)(2) is now \textit{Int. Rev. Code} of 1954, § 1234(d)(2).
previously being done by the courts. It is also clear that, absent the intent to compensate and the ability to value the option before its exercise, the transition of an option can occur only when the option is sold or exercised.\textsuperscript{118} Whether there is an intent to compensate at this later date is irrelevant. If the economic or financial benefit received at the time of exercise is incapable of valuation due to the imposition of conditions beyond the employee’s control, the transaction is left open solely for the purposes of determining the value received by the employee and not because he was not compensated at that time. However, whether a similar result is reached when restrictions are placed on the stock acquired under the option is not without question.

VI. RESTRICTED STOCK — IS THE LAPSE OF RESTRICTIONS A TRANSITIONAL EVENT OR A POINT OF VALUATION?

Initially, in Robert Lehman,\textsuperscript{119} the Commissioner took the position that no compensation income is realized when the optionee receives stock subject to restrictions because of the then inability to ascertain a fair market value; however, he reasoned that upon the lapsing of those restrictions, the employee realizes compensation to the extent of the spread on the date of exercise. The Tax Court, however, took a different view, stating that the “[t]ermination of the restrictions was not a taxable event such as the receipt of compensation for services or the disposition of property.”\textsuperscript{120}

With this result in mind, the Commissioner, in the subsequent case of Harold H. Kuchman,\textsuperscript{121} argued that the optionee realized compensation on the date he exercised the options notwithstanding certain contractual restrictions on the sale of the stock acquired under the option. In rejecting the Commissioner’s position, the Tax Court said that “[u]nder these circumstances\textsuperscript{122} acquisition of the stock does not justify charging petitioner

\textsuperscript{118} See Commissioner v. Ogsbury, 258 F.2d 294 (2d Cir. 1958). In Ogsbury, the court posed the following hypothetical:

Thus, assuming that Ogsbury’s employer in 1945 had removed the restriction on assignability from Ogsbury’s option, the economic benefit so conferred upon Ogsbury by such an option would have been identical to the economic benefit conferred upon him after he exercised his right under the within option as it was amended in 1945. Clearly, in the assumed case, Ogsbury would have been in receipt of income in 1945.


\textsuperscript{120} 17 T.C. at 654.

\textsuperscript{121} 18 T.C. 154 (1952), acquiesced in, 1952-1 Cum. Bull. 3. See also MacDonald v. Commissioner, 230 F.2d 534 (7th Cir. 1956), rev’g 23 T.C. 227 (1954). Restrictions preventing the ascertaining of fair market value were first recognized in Helvering v. Tex-Penn Oil Co., 300 U.S. 481 (1937).

\textsuperscript{122} In the Kuchman case the contractual restrictions in question were: (1) that the optionee would not, during the first year after he acquired stock under the option, sell it without the written consent of the underwriter; (2) that if his employment with the Bates Manufacturing Co. should terminate within 1 year from the date he acquired the stock, he would tender the stock to the underwriter for
in the year of its receipt with income in any amount."\textsuperscript{123} As a result of these two decisions, it would seem that, by the use of restrictions having a significant effect on the stock's value, the employee can avoid the recognition of any ordinary income at the time of exercise or when the restrictions lapse.

Apparently defeated on both fronts, the Commissioner, in his Regulation, took the position that the optionee was to report as compensation income the lesser of:\textsuperscript{124}

a) The difference between the amount paid for the property and the fair market value of the property (determined without regard to the restriction) at the time of its acquisition, or

b) The difference between the amount paid for the property and either its fair market value at the time the restriction lapses or the consideration received upon the sale or exchange, whichever is applicable.\textsuperscript{125}

By allowing the optionee to use the lesser of these two figures, the Commissioner placed the optionee-employee in the advantageous position of receiving capital gains treatment for any gain accruing to him during the period the restrictions are in force,\textsuperscript{126} whereas any losses would be, in effect, treated as ordinary. This is a result which is not supported by the prior cases.

The initial error made by the Commissioner was his position in Lehman that the lapsing of restrictions was a taxable event resulting in compensation to the optionee-employee. It is submitted that the correct position to be taken by the Commissioner in regard to the lapsing of the restrictions is that taken in the proposed amendments, namely, that the lapsing of restrictions is not a taxable event, but rather that it is the closing or finalizing of an "open transaction" within the rationale of Burnet v. Logan.\textsuperscript{127} In other words, the only possible event\textsuperscript{128} when

\begin{itemize}
  \item the option price; and
  \item that if he wished to sell the stock during the first 2 years after acquisition he would first offer it to the underwriter at the current bid price.
\end{itemize}

\textsuperscript{123} Id. at 163.

\textsuperscript{124} Under Proposed Treas. Reg. § 1.421-6(d) (2) (iii) all options granted before October 26, 1968, and exercised by the person to whom it was granted will be subject to the same rules as those in Treas. Reg. § 1.421-6(d) (2) (i). However, T.I.R. 1006, 7 CCH 1969 STAND. FED. TAX REP. ¶ 6426, at 71,127, extended this period until June 30, 1969.

\textsuperscript{125} Treas. Reg. § 1.421-6(d) (2) (i) (a) (b). If a sale or exchange is consummated before the restrictions lapse and is not at arm's length, then the employee is to recognize ordinary income in the year of sale to the extent of the gain. In addition, he shall include the difference between such gain recognized and that accruing on the date the restrictions lapse or the stock is sold at arm's length. Treas. Reg. § 1.421-6(d) (2) (i).

\textsuperscript{126} Of course, if the stock is sold in an arm's length transaction before the restrictions lapse, he will realize and recognize compensatory income at that time. Treas. Reg. § 1.421-6(d) (2) (i).

\textsuperscript{127} 283 U.S. 404 (1931).

\textsuperscript{128} An argument may, however, be made that since restrictions having a significant effect on the market value of the stock are, in effect, limited to those which

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the transition to investor could occur is when the option is exercised, since it is at this time that the optionee is irrevocably committed to a position as holder of a capital asset and, in such a position, is subject to all the attributes of an investor. All market fluctuations will affect the value of the stock he has received and he will receive all dividends and exercise any voting privilege the stock may possess. However, once the parties place restrictions on the stock acquired under the option in order to defer the valuation of the financial or economic benefit received to a later date, then any gain and loss in the stock occurring during this period, which is normally characterized as capital, will be effectively converted to an ordinary gain or loss as a result of the parties' own agreement. Therefore, the spread at the date the restrictions lapse should be the amount of compensation income regardless of whether the market for the stock increased or decreased during the period when the restrictions were in force.

The Tax Court, in subsequent cases, has limited the effect of the Kuchman-Lehman decisions by limiting restrictions held to have a significant effect on the value of the stock essentially to those which place an absolute restriction on the sale of the stock. The court has recently indicated a retreat from this position as to investment letter stock which had been held to be capable of valuation even though the value would be reduced below market to reflect a discount due to the limited number of potential buyers available. In light of the restricted application of the

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prevents the sale of the stock, Harry Simmons, 23 CCH Tax Ct. Mem. 1423 (1964) and cases cited in note 132 infra, that the lapsing of the restrictions results in the receipt of the intangible right of alienation within the concept of United States v. Davis, 370 U.S. 65 (1962), and that such is a taxable event.

129. See Griswold, The Mysterious Stock Option, 51 Ky. L.J. 246 (1963), where it is stated:

Of course, once the employee exercises his option, he does have capital at risk, assuming he has made bona fide payment. Any fluctuation from the fair market value at the time he acquires the stock is a true capital gain or loss, and should be treated accordingly.

Id. at 252.

130. It is possible to minimize the total tax on the ordinary income realized from the exercise of the option by placing restrictions on the stock and lapsing those restrictions over a period of years.

131. It has been posited that restrictions will not be given operative effect unless there existed a valid business purpose for the use of such restrictions. See Kempler, Non-Restricted Stock Option Plans: Kuchman and Lehman Cases, 16 TAX L. REV. 339 (1961).

132. E.g., Jack I. LeVant, 45 T.C. 185 (1965), aff'd, 376 F.2d 434 (7th Cir. 1967); W.H. Weaver, 25 T.C. 1067 (1956); Rev. Rul. 68-86, 1968-1 CUM. BULL. 184. In Harry Simmons, 23 CCH Tax Ct. Mem. 1423 (1964), the court said:

Where there is an absolute restriction on transfer, it has been held that no ascertainable value can be found. . . . Since it appears from the record before us that at least private sale is possible, we believe an ascertainable fair market value can be found and, therefore, the petitioners realized income from the bargain purchase of Imperial stock in 1958.

Id. at 1426.

133. In the case of Max D. Klahr, 1968-245 CCH Tax Ct. Mem. 7703(m), the Tax Court held that an investment letter did sufficiently restrict the stock to have a significant effect on its value. But see Victorson v. Commissioner, 326 F.2d 264 (2d Cir. 1964), aff'd, 21 CCH Tax Ct. Mem. 1238 (1962); William H. Husted, 47 T.C. 664 (1967). See also cases cited in note 132 supra.
Kuchman-Lehman cases by the Tax Court, it would appear that a direct attack upon their cumulative holdings would meet with some success. 134 Of course, the position could be taken that the amount of compensation realized is the spread on the date of exercise which, due to the imposition of restrictions on the stock, could not be recognized until the restrictions lapse or the stock is sold in an arm's length transaction. This position would, however, conflict with the general valuation policies of the Service that if value can be ascertained, income is then realized and recognizable. Such a conflict should be avoided. In any event, an employee should not be allowed to avoid completely the recognition of ordinary income by the use of restrictions on the stock acquired under the option.

VII. DEDUCTIBILITY OF COMPENSATION

Treas. Reg. § 1.421–6(f) allows the employer to deduct, as compensation paid to an employee, the amount of income realized and recognized by the employee under subsections (c) and (d). 135 Because the language of the Regulation refers only to the situation in which the employer granted the option, it could be maintained that if someone such as a shareholder or a subsidiary granted the option, a deduction by the employer would not be allowed. 136 On the other hand, a deduction is not expressly denied to the employer in such a situation. 137 In Deputy v. du Pont, 138 the taxpayer, a major stockholder of du Pont, attempted to deduct the cost of transferring 9000 shares of his personal holdings of du Pont stock to key executive employees on the theory that it was an ordinary and necessary expense of his trade or business. The Supreme Court denied the deduction to the taxpayer on the basis that the deduction did not "proximately result . . . from the taxpayer's business but from the business of the du Pont company." 139 More recently, in Walton O. Hewett, 140 the Tax Court denied the petitioner-sole shareholder a deduction he attempted to take under either section 212 or 162 of the Internal Revenue Code of 1954 for the cost of stock transferred from his personal holdings to two salesmen in payment of commissions. The basis of the denial was

134. E.g., Kempler, supra note 131, at 339.
136. The Commissioner has, under Treas. Reg. § 1.404(a)(12), attempted to disallow to the employer a deduction for payments made for the benefit of a non-qualified employee's trust. But see Buttery Stores, Inc. v. United States, 375 F.2d 799 (Ct. Cl. 1967); Mississippi River Fuel Corp. v. United States, 314 F.2d 953 (Ct. Cl. 1963); Russell Mfg. Co. v. United States, 175 F. Supp. 159 (Ct. Cl. 1959).
137. If the income realized by the employee is deductible as compensation, then the employer may have very definite problems complying with the withholding of taxes under INT. REV. CODE of 1954, § 3401. See Lefevre, supra note 135, at 369.
139. Id. at 494.
140. 47 T.C. 483 (1967). See also Bert B. Rand, 35 T.C. 956 (1961); Harry Kahn, 26 T.C. 273 (1956).
that the payments were not an "ordinary" expense for the conservation or enhancing of the value of the petitioner's property, but instead were an ordinary expense proximately related to the corporation's business.

If the transferring stockholder cannot take a deduction for the transfer, then the question necessarily arises as to how the transaction is to be treated. In J. K. Downer,141 the Tax Court answered this question when it held that a transfer of stock from a major stockholder to an employee was a taxable event in that it was a transfer of a capital asset which necessarily resulted in a capital gain or loss to the transferring stockholder. The "measure of such [gain or] loss is the difference between [the transferring stockholder's] adjusted basis in the shares and their fair market value at the time of transfer."142 The court distinguished the situation in which a stockholder transfers cash to the employee as compensation, noting that this would be considered a contribution to the capital of the corporation.143 The court based its distinction between the transfer of cash and the transfer of shares to an employee on the fact that "[i]n the former case, there is no change in his proportionate shareholder interest in the corporation — only his investment has been varied. In the latter case, such a change admittedly takes place."144 Thus, when "a shareholder . . . sells [or transfers] a portion of his shares [he] realizes taxable gain or loss measured by the difference between amount received and his cost basis in those shares even though dollarwise the transaction does not recoup his total investment."145

Having established that the taxpayer in Downer incurred a loss on the transfer, the next question confronting the court was whether the loss was an ordinary or capital loss. The court held that the transfer resulted in a capital loss on the basis that a "sale or exchange" of a capital asset had occurred in that the stockholder had received, in return for the stock transferred, an intangible benefit within the rationale of United States v. Davis,146 namely, the continued rendering of services by the recipient to the corporation.

With it now clear that the transferring stockholder cannot take a deduction for the amount of compensation realized by the employee and that the transfer of stock by the stockholder is a sale or exchange of a capital asset, the question becomes whether the corporation can take a deduction for the compensation paid. There is little authority to the effect

141. 48 T.C. 86 (1967). For a discussion of this question of proportionate versus disproportionate payment by a stockholder to an employee, see O'Brien, Stock Transfers by Shareholders to Outsiders for Nontangible Consideration, 39 TAXES 675 (1961).
142. 48 T.C. at 94.
143. But see Lefevre, supra note 135, at 369.
144. 48 T.C. at 91.
145. Id. (emphasis added).
146. 370 U.S. 65 (1962). In Davis, the Court held that the transfer of stock as a result of a divorce settlement was a sale of a capital asset, the transferor receiving the intangible marital right of the wife. That right was valued at the current fair market value of the stock transferred to her. See also United States v. General Shoe Corp., 282 F.2d 9 (6th Cir. 1960), cert. denied, 365 U.S. 843 (1961).
that the corporation can deduct an amount paid by another to the employee as compensation. However, under the rationale of *Deputy v. du Pont*, it is clear that such payments are ordinary expenses for the corporation's trade or business and, under section 162(a)(2), any ordinary and necessary expenses of the business of a corporation are deductible. In *Heymann Mercantile Co.*, the Tax Court granted a corporation a deduction for compensation paid to its president by a related partnership stating: "Since it was paid for services rendered to the petitioner [corporation], was reasonable in amount, and would have been a necessary expense of petitioner . . . we think it should be allowed as a deduction." This case can be distinguished on the basis that the payment involved was made in cash, not stock. More specifically, because the payment was made in cash, the partnership would have been considered to have made a contribution to capital and not to have entered into a taxable exchange of a capital asset as occurred in *Downer* where stock was transferred. This distinction, however, can be questioned on the basis that, even though a recognizable exchange of stock has occurred in the *Downer* situation, the recognizable amount to the stockholder is not necessarily a loss to the extent of the compensation recognized by the employee as provided under the Regulation. The loss may be greater or less than the amount of compensation realized and recognized by the employee. In fact, the amount realized and recognized by the stockholder may be a capital gain. Furthermore, as the gain or loss to the stockholder is capital in nature, it will necessarily result in different tax consequences than if it were ordinary income or ordinary loss. Therefore, it would appear that, unless the corporation is allowed the deduction, it would be lost.

It is submitted that such a result is not justified because, if the employee receives ordinary income as compensation, the corporation should be allowed a deduction as a necessary counterpart to the disallowance of a deduction to the corporation when there is no ordinary income because the option is qualified. Thus, the corporation should be allowed a deduction in the same amount as is realized and recognized as compensation by the employee.

VIII. Conclusion

In order to maintain consistency both with the case law and within the Regulation itself, it is submitted that the Regulation delineating the procedure for taxing nonstatutory stock options should comport with the following analysis. First, the question should be whether the option, at the date of grant, was intended to be the vehicle of compensating the

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148. 7 CCH *Tax Ct. Mem.* 856 (1948).
149. *Id.* at 869.
employee. In order to answer this question, the critical factors should be those currently used to determine whether the option has a readily ascertainable fair market value. If the option was not found to be the intended vehicle of compensating the employee, then the stock underlying the option necessarily must be the compensatory aspect of the option. Therefore, when the option is exercised the employee will, at that time, have been compensated by the employer. If the value of the compensation to the employee cannot be ascertained in either case, then the transaction should be kept open until such time as the value can be ascertained under general valuation policies established by the Commissioner. Once it is determined when and to what extent the employee is compensated, then the employer should be allowed a deduction under section 162 to the extent of the compensation recognized by the employee regardless of who is the optionor. This approach would be a necessary corollary to the position that the employee will realize compensatory income from any option granted as a result of his employment regardless of who is the optionor. It is submitted that this process of analysis will be more consistent with the optionee's transition to the status of investor and will not, to any large degree, change results which may be obtained under the current Regulation and proposed amendments to that Regulation.

Thomas C. Riley