

Taxation - Stock Option Given as Compensation Held Income Upon Granting

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general advertising or an occasional presence of a delivery truck in the taxing state. It must be admitted, however, that the activities described, especially the entrance of the delivery truck into the taxing state, present a borderline situation. That fact, plus the ratio between the majority and minority of the court, leads to the observation that perhaps little more activity in the taxing state was necessary to give Maryland jurisdiction. However, due to the great emphasis on factual situations, future cases concerning the collection of use taxes from nonresident merchants might be easily distinguished.

TAXATION—STOCK OPTION GIVEN AS COMPENSATION HELD INCOME UPON GRANTING

Petitioner entered into a two-year employment contract and was granted a stock option as part of the contract, to be exercised within the two-year period. Although the option was exercised in part the first year, and the remainder the second year, both the petitioner and his employer treated the option as "compensation" for services rendered the first year, using the difference between the fair market value of the stock at the time the option was granted and the option price as the basis for their income tax return. The Tax Court agreed that the option was intended as additional "compensation" but held that the dates of exercise determined the income to be reported. On review, the Court of Appeals reversed the lower court, holding that the option was intended as additional compensation for services for the year in which the option was granted and thus it was taxable in that year only. *McNamara v. Commissioner of Internal Revenue*, 210 F. 2d 505 (C.A. 7th, 1954).

The petitioner, on August 24, 1945, entered into an employment contract with the National Tea Company for a term of two years beginning March 21, 1945, which, among other things, contained a provision to the effect that he was to receive a stated salary of \$27,500 with additional annual compensation of two per cent of the net profits over \$300,000. In addition the petitioner was granted the following option by National on August 24, 1945:

. . . this certifies that an option is hereby extended to said HARLEY V. MC-NAMARA, his heirs, . . . and assigns, to expire on August 24, 1947, to purchase 12,500 shares of the common stock of this corporation, . . . at such times prior to August 24, 1947, as he or they shall elect, upon the payment to this corporation of the cash sum of \$16.00 for each share so purchased. . . .

On the same day the board of directors of National, at a special meeting, adopted the following resolution:

WHEREAS, the Executive Committee of this corporation has recommended that, in addition to the stated cash payments on account of salary and such

additional contingent compensation as is now in effect, the compensations of Harley V. McNamara . . . for the current year shall include the options hereinafter specified;

NOW, THEREFORE, BE IT RESOLVED that the compensation of said officers for the present fiscal year shall be and the same are hereby fixed at cash salaries of \$27,500 for said Harley V. McNamara . . . , and in addition thereto stock options, as provided for in the succeeding paragraph.

The petitioner accepted the option and signed the agreement on September 12, 1945. The market price of the stock on August 24, 1945, and September 12, 1945, was \$19.00 and \$20.00 per share respectively. The option was exercised on March 12, 1946, and March 6, 1947, petitioner purchasing 6,250 shares each time. The fair market value of the stock on these dates was \$28.50 and \$27.00 per share respectively. National in its 1945 federal income tax return claimed a deduction of \$16,374 in respect to the option granted, as compensation to petitioner; similarly, the petitioner included this amount as additional compensation received from National in his 1945 income tax return.

The primary question here is whether, upon the exercise of a stock option, the petitioner realized income in the form of compensation measured by the difference between the option price paid and the fair market value of the stock acquired and, if the petitioner realized income, whether it was taxable in the year 1945 when the option was granted, or in the years 1946 and 1947 when the option was exercised. The Internal Revenue Code broadly defines gross income,¹ and such all inclusive terms indicate a legislative intent that income should be taxed comprehensively. The regulations state that compensation results when property is transferred by an employer to an employee for an amount less than its fair market value.² The Internal Revenue Service has ruled that if an employee receives a stock option on or after February 26, 1945, he realizes taxable income by way of compensation on the date upon which he receives the stock to the extent of the difference between the fair market value of the stock when it is received and the price paid therefore, or if the employee transfers such option for consideration, he realizes taxable income by way of compensation on the date he receives such consideration to the extent of the value of such consideration.³ For many years the law has been very confused as to the tax treatment to be accorded stock options, some courts treating them as compensation while others as merely a proprietary interest. In all cases the intention of the parties has been held to be the controlling factor in determining

¹ Int. Rev. Code § 22 (a), 26 U.S.C.A. § 22 (a) (1949).

² Treas. Reg. 111, § 29.22 (a)-1 (1949).

³ I.T. 1946-1 Cum. Bull. 15 (1946).

this question.⁴ The courts looked to the intention to determine whether the employer sought to compensate his employee or to give him a proprietary interest. If the former, they held the employee realized taxable income in the form of compensation;⁵ if the latter, they held that the transaction was considered not to have resulted in income to the employee upon the granting or upon the exercise of the option.⁶ On the other hand, an assignable option has been recognized as property in itself,⁷ but where it was found unassignable it has been held that there was no market value at time of issuance,⁸ or that its value was highly speculative,⁹ or that its market value was not established,¹⁰ and thus compensation was realized only upon its exercise.

The contention of the petitioner was that whatever income he received by reason of the option was realized only in 1945 when the option was granted, and consisted merely of the fair market value of the option, or in the alternative, that he realized no income whatever by reason of the option, or its exercise because it represented a proprietary interest. The Commissioner disallowed the deduction claimed by National, assessed a deficiency, and conversely held that petitioner received no taxable income by the receipt of the option in 1945, and determined an overassessment due taxpayer for that year. On the other hand, the Commissioner determined, that under the Internal Revenue Code¹¹ and applicable regulations,¹² the petitioner received additional compensation

⁴ *Bogardus v. Commissioner of Internal Revenue*, 302 U.S. 34 (1937); *Connolly v. Commissioner of Internal Revenue*, 135 F. 2d 64 (C.A. 6th, 1943); *Mason v. Commissioner of Internal Revenue*, 125 F. 2d 540 (C.A. 6th, 1942); *Martin L. Strauss*, 11 T.C.M. 786 (1952); *Donald B. Bradner*, 11 T.C.M. 566 (1952); *Malcolm S. Clark*, 9 T.C.M. 719 (1950); *James M. Lamond*, 5 T.C.M. 51 (1946).

⁵ *Harold H. Kuchman*, 18 T.C. 154 (1952).

⁶ *Rosshiem v. Commissioner of Internal Revenue*, 92 F. 2d 247 (C.A. 3rd, 1937); *Norman G. Nicolson*, 13 T.C. 690 (1949); *Martin L. Strauss*, 11 T.C.M. 786 (1952).

⁷ *Commissioner of Internal Revenue v. Smith*, 324 U.S. 177 (1945); *Helvering v. San Joaquin Fruit & Investment Co.*, 297 U.S. 496 (1936).

⁸ *Harold H. Kuchman*, 18 T.C. 154 (1952).

⁹ *Van Dusen v. Commissioner of Internal Revenue*, 166 F. 2d 647 (C.A. 9th, 1948).

¹⁰ *John C. Wahl*, 19 T.C. 651 (1953).

¹¹ Int. Rev. Code, § 22 (a), 26 U.S.C.A. § 22 (a) (1949). "General definitions. 'Gross income' includes gains, profits, and income derived from salaries, wages, or compensation for personal service . . . of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. . . ."

¹² *Treas. Reg. 111, § 29.22 (a)-1 (1949)*. "If property is transferred by an employer to an employee for an amount less than its fair market value, regardless of whether the transfer is in the form of a sale or exchange, the difference between the amount paid for the property and the amount of its fair market value is in the nature of compensation and shall be included in the gross income of the employee. . . ."

in the years 1946 and 1947 representing the difference between the fair market value of the stock and the option price when the option was exercised. The Tax Court found that the option was intended as compensation and not merely to give the petitioner a proprietary interest in the corporation; that the compensation intended was not the value of the option but was the difference between the fair market value of the stock on the date of exercise and the option price; that the option was not the only intended compensation, and that even though assignable neither party contemplated assignment or sale; and that the option itself did not represent a property interest, which could be disposed of without a sacrifice.

As authority for its decision, the Tax Court cited *Connolly's Estate v. Commissioner*.¹³ In that case, the employee was given an option to purchase the company's stock for much less than market value, to be exercised within three years. The market value of the stock at date of option was \$2.35 and at date of purchase was \$5.00. The corporate minutes indicated that it was granted as adjusted compensation for services rendered. The court held that the taxable income was determined on the dates the option was exercised and not as of the date granted. Another case relied on by the Tax Court was *Van Dusen v. Commissioner of Internal Revenue*.¹⁴ The employer in that case gave his employee an option to purchase fifty shares of stock per month at \$5.00 per share, for a period of ten years. The option was conditioned upon both parties to the option living and remaining employees of the corporation. At the time the option was granted, its market value was \$9.00 per share. During the subsequent four years, the employee bought stock for a price much less than the market value of the stock at the time of purchase. The court held that aside from the fact that the employee could exercise the option only so long as he remained an employee of the corporation, there existed no basis for arriving at a value for the option on the date granted. The court held further that the restrictive conditions together with the possibility of decline in market value led logically to the conclusion that the value of the option could scarcely have been more than nominal at the time it was granted, and therefore was intended as compensation when exercised.

In reversing the Tax Court, the instant court does so without citing authorities, basing its decision solely on the distinguishing facts in the case. Although the option had value when it was granted, the court distinguishes the *Connolly* case on two points: (1) there was nothing in the resolutions authorizing an option in that case, nor was there anything in the options indicating that the parties intended the additional compensation to be "for the current year" or "for the fiscal year," and

¹³ 135 F. 2d 64 (C.A. 6th, 1943).

¹⁴ 166 F. 2d 647 (C.A. 9th, 1948).

(2) neither party made any report of the option in his income tax returns in the year the option was granted.

The fact that the disposal value of the option was speculative, coupled with the failure of both the employer and employee to claim any deduction in their income tax returns for the value of the stock when given, was sufficient for the court to distinguish the Van Dusen case from the instant case.

The only authority cited for the holding in the instant case was the dicta contained in the case of *Commissioner of Internal Revenue v. Smith*.¹⁵ Although the court in that case held that the compensation was not confined to the mere delivery of an option of no value, but included the compensation obtainable by the exercise of the option given for that purpose, the court further stated:

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.¹⁶

It is upon this statement that the instant court relies.

This case is significant because it is the first to hold that the value of the option, when granted, is the amount to be reported as income. However, the possibility of other courts following this precedent is slight because none seem to favor the taxpayer as much as the instant court, and since the decisions in such cases rest on the facts involved, courts will have little trouble distinguishing other cases from the instant case.

WORKMEN'S COMPENSATION—HEART ATTACK HELD WITHIN STATUTE

The plaintiff was a police captain whose duties were mainly supervisory. On the day in question, plaintiff led an emergency search for a fugitive, an activity unusual to the normal performance of his duties. Because of the heavy strain of walking three hours over rugged terrain and the digging out of his car, which had become stuck in the sand, the plaintiff suffered a heart attack and was permanently disabled. Action was brought to recover compensation. The court allowed the claim, holding that the disability was a result of strain on the heart due to unusual exertion and was an "accident arising out of and in the course of employment" within the meaning of the Workmen's Compensation Act.¹ *Hathaway v. New Mexico State Police*, 57 N.M. 747, 263 P. 2d 690 (1953).

Generally, when the courts speak of "accident" as used in Workmen's Compensation Acts, they are construing the term liberally and in its

¹⁵ 324 U.S. 177 (1945).

¹⁶ *Ibid.*, at 181.

¹ Workmen's Compensation Act, 1941 Comp. §§ 57-902.