

Taxation - Employee Stock Options Under the Revenue Act of 1950

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TAXATION — EMPLOYEE STOCK OPTIONS UNDER THE REVENUE ACT OF 1950 — A RETURN TO THE BARGAIN-PURCHASE CONCEPT

Business experience has revealed that employees work harder when they can acquire an owner's interest in the enterprise. One problem has been the cost to the employee who is often not in a financial position to buy company stock. To meet this problem employers have often granted options to deserving employees to buy the company stock at a bargain price. The plan, as hopefully conceived by the parties, would allow the employee to acquire the stock within his means and to realize taxable income only when and if he chose to resell, and then only at capital gains rates on the difference between the sales price and what he had paid for the stock.

However, the Treasury was quick to dampen these hopes by its first regulations in 1923 which required the employee to include in his gross income "the difference between the amount paid for the property and the amount of its fair market value."¹ The practical result of the Treasury position was to levy a tax at ordinary rates on the *spread* (difference between the purchase price of the stock and the fair market value of the stock) at the time of the exercise of the option by the employee. Although this afforded the employee a higher basis for resale purposes, it imposed an additional acquisition cost on the employee.

Since the 1923 Regulations employee stock options have received more than a fair share of the litigation and confusion that surrounds important tax issues. Section 218 of the Revenue Act of 1950² is designed to remove that confusion and to provide a defined method whereby the employee can buy in without tax cost and postpone such problems until the time for resale.

The new law, however, protects only restricted stock options which comply with its conditions. There are at least three types of options which are left to the vagaries of the earlier developments in the field:

1. options granted before February 27, 1945;³
2. options exercised before January 1, 1950;⁴
3. non-complying options.

If an employee or employer is faced with an option in one of these three categories, he must familiarize himself with the history of employee stock options and evaluate his case under the earlier law.

¹ Reg. 65, Art. 31 (1923).

² PUBLIC LAW 814, 81ST CONGRESS, CHAPTER 994, 2D SESSION, H.R. 8920; cited as "Revenue Act of 1950." Section 218 of the Act adds amending Section 130A to the Internal Revenue Code.

³ Section 130A (d) (1): "RESTRICTED STOCK OPTION.—The term 'restricted stock option' means an option granted after February 26, 1945, . . ."

⁴ Section 218 (b): "EFFECTIVE DATE.—The amendment made by this section shall be applicable with respect to taxable years ending after December 31, 1949."

Prior to 1923, the Treasury Regulations made no reference to employee stock options or purchase agreements. From 1923 to 1939, the Treasury Regulations set up a conclusive presumption of compensation where an employer sold any property to an employee "for an amount substantially less than its fair market value." The employee in such case was required to include in his gross income "the difference between the amount paid for the property and the amount of its fair market value."⁵

However, in 1938 in the *Geeseman* case,⁶ which involved an employee incentive plan, the Board of Tax Appeals rejected a deficiency assessment and held that compensation had not been intended, thereby making the intention of the parties an important factor in determining the question of compensation. In cases subsequent to the *Geeseman* case, the Board of Tax Appeals ignored other factors and found there was no intention to compensate where there was no substantial initial spread at the time the option was issued.⁷ This doctrine was followed even where the option had been termed as "additional and separate consideration" for services.⁸

As a result of these adverse decisions and other earlier adverse appellate decisions,⁹ the Treasury, in 1939, amended its regulations so as to tax the spread at the time of exercise of the option to the extent that it was "in the nature of" compensation.¹⁰ The 1939 Regulations opened the door to Treasury-taxpayer litigation over the questions of intention of the parties and the substantiality of the initial option spread. The Treasury prevailed in the courts only in those cases where substantial initial spreads had existed.¹¹

The *intention of the parties* and the *substantiality of initial spread* doctrines continued down to 1945 when the Supreme Court in the *Smith* case¹² indicated that a substantial initial spread was no longer required as a prior condition to the compensation concept.¹³ Following the

⁵ T.D. 3435, II-I Cum. Bull. 50; Reg. 65, Art. 31; Reg. 69, Art. 31; Reg. 74, Art. 51; Reg. 77, Art. 51; Reg. 86, Art. 22 (a) 1; Reg. 94, Art. 22 (a) 1.

⁶ *Geeseman v. Commissioner*, 38 B.T.A. 258 (1938).

⁷ *Evans v. Commissioner*, 38 B.T.A. 1406 (1938); *Adams v. Commissioner*, 39 B.T.A. 387 (1939); *Springford v. Commissioner*, 41 B.T.A. 1001 (1940).

⁸ *Evans v. Commissioner*, 38 B.T.A. 1406 (1938).

⁹ *Bothwell v. Commissioner*, 77 F. (2d) 35 (C.C.A. 10th 1935); *Merhengood Corporation v. Helvering*, 89 F. (2d) 972 (App. D.C., 1937), *cert. denied*, 302 U.S. 714 (1937); *Rosshelm v. Commissioner*, 92 F. (2d) 247 (C.C.A. 3d 1937).

¹⁰ T.D. 4879, 1939-1 Cum. Bull. 159, Reg. 101, Art. 22 (a) 1; Reg. 103, Sec. 1922 (a) -1, Reg. 111, Sec. 29.22 (a) 1.

¹¹ *Hawke v. Commissioner*, 109 F. (2d) 946 (C.C.A. 9th 1940), *cert. denied*, 311 U.S. 657 (1940); *Mason v. Commissioner*, 125 F. (2d) 540 (C.C.A. 6th 1942), *cert. denied*, 317 U.S. 657 (1942); *Connolly's Estate v. Commissioner*, 135 F. (2d) 64 (C.C.A. 6th 1943).

¹² *Commissioner v. Smith*, 324 U.S. 177 (1945).

¹³ The Tax Court in the *Smith* case had conceded that compensation was intended but held, nevertheless, that the spread was taxable at the date of exercise even though no substantial spread had existed when the option was

Smith decision, the Treasury not only amended its regulations to conform with that decision,¹⁴ but also put forth a ruling in 1946¹⁵ in which it has been thought to have gone beyond the *Smith* decision in stating that the Treasury need no longer prove an intention that the option was given as compensation, which proof had been made in the *Smith* case and was a factor in that decision.¹⁶

The *Smith* decision and the Treasury regulations and rulings following in its wake were criticized as destructive of legitimate incentive option or stock purchase plans.¹⁷ The claim was made that the employee might be forced to sell a portion of his newly-acquired stock to pay the tax assessed upon its purchase and that taxing of the stock option upon its exercise was contrary to the *bargain-purchase* concept of the *Palmer* case.¹⁸ On the other hand, it was suggested that such sale of a portion of the newly-acquired stock was not necessary, if the employee-stockholder wished to retain the stock for voting purposes, since the tax could be paid out of current income or the stock could be pledged to raise a loan which could be repaid out of dividends.¹⁹

As to employee stock options under the new law, an examination of Section 218 of the 1950 Act reveals that the bona fide incentive plan is well-protected from the rigors of the *Smith* decision. To qualify as a restricted stock option *all* of the following more important conditions must be met:

1. It must be an option granted after February 26, 1945, to an individual, for any reason connected with his employment.
2. It must be exercised after December 31, 1949.
3. It must be granted by either the employer, parent, or subsidiary corporation, to purchase stock of any of such corporations.

granted. The Supreme Court in upholding the Tax Court said: "Section 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."

¹⁴ "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." Reg. 111, Sec. 29.22 (a) -1 as amended by T.D. 5507 (1946), I.T. 3795, Int. Rev. Bull. 1946-8-12296.

¹⁵ T.D. 5507, 1946-1 Cum. Bull. 18.

¹⁶ Tyler, 24 Taxes, *The Tax Magazine*, 611 (July 1946).

¹⁷ *Ibid.*

¹⁸ Profit, if any, accrues to the purchaser of property only upon sale or disposition, and the taxable income is the difference between the amount thus *realized* and its cost, less allowed deductions. One does not subject himself to income tax by the mere purchase of property even if at less than its true value and taxable gain does not accrue to him before he sells or otherwise disposes of it. *Palmer v. Commissioner*, 302 U.S. 63, 69 (1937).

¹⁹ "THE TREASURY PROPOSAL TO TAX EMPLOYEE'S BARGAIN PURCHASES: T.D. 5507," 56 *Yale L.J.* 706 (1947).

4. Its price must be at least 85% of the fair market value of the stock at the time the option was granted.
5. It is not transferable otherwise than by will or the laws of descent and distribution.
6. At the time it is granted, the individual grantee must not own, directly or indirectly, more than 10% of the total combined voting power of all classes of stock of the employer corporation or of its parent or subsidiary corporation.
7. It must be exercised while the grantee is an employee of the employer, parent, or subsidiary corporation, or within three months after the date he ceases to be such employee.
8. The stock must not be disposed of within two years from the date of the granting of the option nor within six months after the transfer of the stock to the grantee.
9. No deduction under section 23(a) of the I.R.C. is allowable at any time to the employer, parent, or subsidiary corporation with respect to stock transferred under the restricted stock option plan.

Under Section 218 of the 1950 Act, while the employee-stockholder is given capital-gains treatment on resale for any increase in value of the stock over its fair market value at the date of the option grant,²⁰ the employee-stockholder nevertheless remains taxable for ordinary income to the extent of the initial spread at the time of the option grant where the option price was less than 95% of the fair market value of the stock. However, such taxation as ordinary income is deferred to the year of disposition or the year closing with the death of the holder of such stock and the amount taxed as compensation is measured "by the amount (if any) by which the option price is exceeded by the lesser of—

"(1) the fair market value of the share at the time of such disposition or death, or

"(2) the fair market value of the share at the time the option was granted."²¹

²⁰ Sec. 130A (a) (1) of the I.R.C. as added by Sec. 218 of the Revenue Act of 1950 provides: "TREATMENT OF RESTRICTED STOCK OPTIONS.—If a share of stock is transferred to an individual pursuant to his exercise after 1949 of a restricted stock option, and no disposition of such share is made by him within two years from the date of the granting of the option nor within six months after the transfer of such share to him—

"(1) no income shall result at the time of the transfer of such share to the individual upon his exercise of the option with respect to such share;"

²¹ The 1950 Act Conference Report furnishes the following example illustrative of the SPECIAL RULE WHERE OPTION PRICE IS BETWEEN 85% AND 95% OF THE VALUE OF STOCK of Sec. 218 of the 1950 Act:

"On January 1, 1951, Jones an employee of the M Corporation, receives

In the event of a disposition of stock by the individual, the amount taxable as ordinary income is added to his cost basis for future capital-gains computation.²² The death of an individual while he owns the stock is considered a disposition in the taxable year closing with his death.²³

By setting up a fixed category of restricted stock options *not* subject to income tax upon their exercise, the 1950 Act extends the benefits of capital-gains tax treatment to the employee-stockholder under a bona fide incentive plan, and it keeps the *Smith* case plug in the capital-gains loophole as regards the use of stock options by employers who seek to convert corporate earnings from ordinary income into capital gains.

The 1950 Act places the employee-stockholder, who meets the requisites of Section 218, upon an equal footing as to capital-gains treatment with the ordinary investor who heretofore has had the advantage of having the *bargain-purchase*²⁴ or *realization of income*²⁵ concepts applied in his favor. Thus as to the bona fide employee incentive device, Section 218 marks a retreat from the prior *compensation* concept and a return to the *bargain-purchase* concept.

In the final analysis, the advantages forthcoming to the employee-stockholder under an incentive plan protected by Section 218 of the Revenue Act of 1950 are substantial. Bargain shares may be held as permanent investments and instruments of control, although the latter function is rather nebulous since restricted stock options are limited to holders of less than 10% of the total voting stock. The most important advantage is that the employee-stockholder is now able to time the taking of a capital gain for his own tax advantage and need pay no more than a flat 25% maximum effective rate on long term gains.

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a restricted stock option to purchase a share of stock of M Corporation for \$85. The fair market value on that date is \$100. On January 1, 1953, Jones exercises the option, the fair market value on that date being \$125. On January 1, 1954, Jones sells the share for \$150. The difference between the fair market value at the date the option was granted and the option price was \$15. Therefore, \$15 is included as ordinary income in Jones' gross income for 1954. This \$15 increases the \$85 cost basis of the share to Jones, thus giving him a basis for determining gain or loss on the sale of the share of stock of \$100. Having sold the share for \$150, Jones has a gain on the sale of \$50, of which \$25 is taken into account as long-term capital gain."

²² Sec. 130A (b) of the I.R.C. as added by Sec. 218 of the Revenue Act of 1950.

²³ *Ibid.*

²⁴ In the case of a bargain purchase, the gain accrues when the transaction is completed, and is not due to an increase in the value of an investment already held. Under the ordinary case of bargain purchase at less than market value, the difference is not taxable as income. *Eisner v. Macomber*, 252 U.S. 189 (1920).

²⁵ *Supra*, note 18.