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Executive Stock Options - Alternatives to the Proprietary Option Doctrine

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EXECUTIVE STOCK OPTIONS—ALTERNATIVES TO THE PROPRIETARY OPTION DOCTRINE*

CASE AND REGULATION HISTORY

Stock options have found wide usage since the close of World War I as a means of compensating and granting proprietary interests to key employees. Corporations and executives had by the early 1920's become keenly aware of the tax advantages inherent in the use of these stock options. Appropriately, it was at this time that the Treasury took its initial action on the subject whereby it recognized only compensatory stock options. The policy was enunciated in a Treasury Decision[1] which required the inclusion in gross income of the difference between cost and fair market value of any property sold by a corporation to a shareholder. The courts did not readily accept the Treasury's policy with regard to all transfers between corporations and shareholders.[2] This reluctance to apply the Treasury's policy with full force extended to cases involving a corporation's own stock.[3] The courts in the early cases did not express their decisions in terms of proprietorship or compensation, but spoke rather in terms of bargain and purchase.[4] In all cases, however, the courts, where appropriate, were careful to point out that the purpose of the option was to make the executive a stockholder rather than to compensate him. It remained for the courts at a later date to articulate the proprietary interests doctrine as the real reason behind their decisions.[5] In 1939 the Treasury issued T.D. 4879 in which it acceded to judicial holdings, and stated that the excess value of property transferred over the purchase price is includible in gross income

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* ED. NOTE: See also the Leading Article in this issue by Tom B. Rhodes, *Unrestricted Stock Options*. The Leading Article and this Comment constitute a complementary presentation of the subject of stock options in their various aspects. The two views expressed cover somewhat different areas of the same problem and should be read together for a more comprehensive coverage of the field.

[1] T.D. 3435, II-1 CUM. BULL. 50 (1923).

[2] Commissioner v. Van Vorst, 59 F. 2d 677 (9th Cir. 1932); Taplin v. Commissioner, 41 F. 2d 454 (6th Cir. 1930); see also cases cited note 3 *infra*.

[3] Rossheim v. Commissioner, 92 F. 2d 247 (3d Cir. 1937); Omaha-National Bank v. Commissioner, 75 F. 2d 434 (8th Cir. 1935); Schaefer v. Bowers, 41 F. 2d 803 (S.D.N.Y. 1930); Charles E. Adams, 39 B.T.A. 387 (1939); Gordon M. Evans, 38 B.T.A. 1406 (1938); Delbert G. Geeseman, 38 B.T.A. 258 (1938).

[4] Cases cited note 3 *supra*.

[5] Commissioner v. LoBue, 223 F. 2d 367 (3d Cir. 1955), *rev'd*, 351 U.S. 243 (1956); Commissioner v. Straus, 208 F. 2d 325 (7th Cir. 1953); Abraham Rosenberg, 20 T.C. 5 (1953).

to the extent that it is "in the nature of compensation for services rendered or to be rendered. . . ."[6]

In 1945 the Supreme Court rendered its decision in *Commissioner v. Smith*[7] sustaining the Tax Court in its finding that a stock option was received by taxpayer *as compensation for services.* The decision was in line with previous judicial authority and the current regulation, and held that the grant of the options, on the facts, was in the nature of compensation. As a result of the *Smith* case, T.D. 5507[8] was promulgated by the Treasury and became effective the day the *Smith* decision was rendered. It dictated that "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."[9] (Italics added) This precluded the possibility of a proprietary option and precipitated a spontaneous burst of protest that the Treasury had, in T.D. 5507, gone beyond the holdings and facts in the *Smith* case.[10] The question whether the regulation would be upheld in the face of prior contrary judicial decisions appeared to be a valid one. For several years after issuance of T.D. 5507 the courts were involved only with options granted prior to February 26, 1946. In these cases the courts continued to hold that such options were not necessarily to be taxed as compensation,[11] but did not decide the collateral issue of the validity of the regulations under T.D. 5507.

THE LOBUE CASE

Eight years later, in 1954, the Commissioner of Internal Revenue and a taxpayer named LoBue contested the basic validity of the Treasury's position. Taxpayer was granted options in 1945, 1946 and 1947 (the first two options were granted before the effective date of T.D. 5507). Though new options were granted in each year, they were all at the price established in 1945 which was above the then market value but below that of subsequent years. I.T. 3795[12] issued pursuant to T.D. 5507 provided that options granted before February 26, 1946, would not be subject to T.D. 5507 *if* they were granted

[6] 1939-1, CUM. BULL. 159.
[7] 324 U.S. 177 (1945).
[8] 1946, CUM. BULL. 18, amending U.S. Treas. Regs. 111, § 29.22(a)-1 (1946).
[9] See note 8 *supra.*
[10] *E.g.*, Landman, *Executive Stock Options*, 31 TAXES 735 (1953); Seghers, *Stock Purchase Options and the New T.D.* 5507, 41 N.Y. CERT. PUBLIC ACCOUNTANT 250 (1946).
[11] Commissioner v. Straus, 208 F. 2d 325 (7th Cir. 1953); Abraham Rosenberg, 20 T.C. 5 (1953); Norman G. Nicolson, 13 T.C. 690 (1949).
[12] 1946, CUM. BULL. 15, amending U.S. Treas. Regs. 111, § 29.22(a)-1 (1946).

at prices not substantially below the then fair market value of the stock. The Commissioner thus contended that the options granted in 1946 and 1947 must be treated as compensatory options in accordance with I.T. 3795 and T.D. 5507, respectively, without a factual determination of whether the options were granted as compensation.

In the first decision rendered squarely on point, the Tax Court held that the language of the *Smith* case did not support the amendment to the regulations, and that the question of "whether a stock option is granted to an employee as additional compensation, or to give him a proprietary interest in the corporation, thus remains a question of fact."[13] As a matter of fact the court found that the option in this instance was given for a proprietary interest and was not compensatory in nature. In the Court of Appeals for the Third Circuit, the Commissioner dropped his contention that T.D. 5507 was supported by the decision in the *Smith* case and argued that the amendment did not go beyond §22(a) of the Internal Revenue Code of 1939.[14] The court declined to accept the Commissioner's position, stating that it felt the 1939 regulation and not the 1946 one was in accord with the statute. The Supreme Court granted certiorari[15] "to consider whether the Tax Court and the Court of Appeals had given §22(a) too narrow an interpretation."[16]

The Supreme Court did not choose to make a frontal attack on the proprietary doctrine of stock options. Rather it chose to eliminate the possibility of a proprietary interest by ascribing to §22(a) a sweeping coverage of "all gains" as gross income excepting only those specifically exempted, none of which were appropriate to this case. The Court dichotomized all transfers between corporate employer and employee into either an "arm's length transaction between strangers" on the one hand or a transfer of compensation on the other. It must be one of these two, the Court reasoned, for there are no other alternatives under §22(a). Thus, with apparent ease, and for the first time in a quarter of a century, a court stated that all option bargains given to employees are compensation.

The Court did not consider that §22(a) defines gross income as "*gains, profits,* and income derived from . . . compensation *for* personal service. . ." (italics added) and that if the alleged compensation were in fact "gains" or "profits" rather than compensation it

[13] Philip J. LoBue, 22 T.C. 440, 444 (1954).
[14] 53 STAT. 9.
[15] Commissioner v. LoBue, 350 U.S. 893 (1955).
[16] Commissioner v. LoBue, 351 U.S. 243, 246 (1956).

would not be necessary to search the exemptions to arrive at the result desired by taxpayer. This result would be provided for in the sections relating to capital gains. The Court stated that "there 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."[17] Obviously *if* the alleged compensation is included in *gains* or *profits*, even at a later date, from sales of stock reflecting as a basis the option price paid for the stock, then the statutory definition of gross income is not being narrowed in any sense.

The big question then is, should the difference between the option price and the fair market value come under the "gains" or "profits" provision of §22(a)? The very basis of the employer-employee relationship is that of payment *for* work done or to be done. Though §22(a) has been interpreted as not requiring a legal obligation where the consideration is past,[18] it has never been interpreted, to the writer's knowledge, as negating the requirement that the compensation be given *for* some service of the employee, past, present or future. What, then, is the option bargain given *for* in terms of personal service and what type of service is rendered by the employee in return *for* this bargain?[19] The answer in a strong factual case would seem to be that the bargain is given for nothing in the way of personal services, and that no personal services are rendered in return *for* the option. It can hardly be denied that the immediate purpose of the option is to induce the employee to acquire the stock. Certainly the acquisition of stock is not a personal service. Factual cases would seem

[17] Commissioner v. LoBue, *supra* note 16, at 247.

[18] Old Colony Trust Co. v. Commissioner, 279 U.S. 716 (1929); Poorman v. Commissioner, 131 F. 2d 946 (9th Cir. 1942); Bass v. Hawley, 62 F. 2d 721 (5th Cir. 1933); Weagant v. Bowers, 57 F. 2d 679 (2d Cir. 1932).

[19] In Charles E. Adams, 39 B.T.A. 387 (1939), the court said that the stock option, though expressly subject to cancellation by corporation, was not in fact subject to an arbitrary withdrawal. Traditionally an option has been termed "a contract to keep an offer open" as in Warner Bros. Theatres v. Proffitt, 32 Pa. 316, 198 Atl. 56 (1938). From these cases it might be reasoned that an executive stock option is in fact a contract which is binding, that if it is binding there is mutual consideration, and that if there is mutual consideration, the option must be given *for* some service of the employee.

To the writer this is a *non sequitur*. Where an option is granted voluntarily by an employer other than in an employment contract, it would seem that this is a mere promise by the employer and is revocable at that time. At some point, after the executive has expended efforts in reliance upon the promise, the promise itself becomes irrevocable. See RESTATEMENT, CONTRACTS § 90 (1932). The fact that the option becomes irrevocable does not supply the missing *for*. The basic objective of granting the option has not changed. It was a promise by which the corporation sought an ultimate benefit. The fact that the corporation, because of the executive's change of position, is estopped to revoke its promise still does not mean that the promise was given for the change of position. The purpose of the option remains primarily that of fostering ownership. The fact that employee rights attach in the meantime is wholly irrelevant.

to exist where the option is not granted *for* past or present services. What of the contention that the option is given, as phrased by the Supreme Court in this case, "to secure better services," in the future? Admittedly the option is given with the hope that it will result in increased incentive, but it is not given with the idea that the increased incentive will be in return *for* that option.[20] The option bargain is a means to an end. It does by a "proprietary interest in fact" what mere compensation *for* personal services cannot do. It increases incentive. To say that the option is compensation *for* the increased incentive is to ignore the purpose and reason behind stock ownership. It is contemplated by the company that the increased effort will be born of the desire of the employee to increase his income from stock ownership. This is the heart and core of the doctrine of proprietary interest which has been recognized by the Tax Court[21] and courts of appeals[22] for many years, and which has never been contradicted by contrary Congressional action.[23] This interpretation

[20] Compare Helvering v. American Dental, 318 U.S. 322 at 331 (1943), where the court said "the fact that the motives leading to the cancellations were those of business or even selfish... is not significant" in determining whether a gift had been made to a customer.

[21] Philip J. LoBue, 22 T.C. 440 (1954); Abraham Rosenberg, 20 T.C. 5 (1953); Norman G. Nicolson, 13 T.C. 690 (1949); Herbert H. Springford, 41 B.T.A. 1001 (1940); Charles E. Adams, 39 B.T.A. 387 (1939); Gordon M. Evans, 38 B.T.A. 1406 (1938); Delbert G. Gesseman, 38 B.T.A. 258 (1938).

[22] Commissioner v. LoBue, 223 F. 2d 367 (3d Cir. 1955); Commissioner v. Straus, 208 F. 2d 325 (7th Cir. 1953); Rossheim v. Commissioner, 92 F. 2d 247 (3d Cir. 1937); Merhengood Corporation v. Helvering, 89 F. 2d 972 (D.C. Cir. 1937).

[23] A review of the Senate's report on § 130A of the INT. REV. CODE OF 1939 casts some doubt as to the real intent behind its passage. The following passages from the report, S. REP. No. 2375, 81st Cong., 2d Sess. 59 (1950), are pertinent:

> At the present time the taxation of these options is governed by regulations which impede the use of the employee stock option for incentive purposes. Moreover, your committee believes these regulations go beyond the decision of the Supreme Court in *Commissioner v. Smith*, 324 U.S. 177 (1945). The resulting uncertainty as to whether these regulations are in accordance with the law is an additional reason for legislative action at the present time....
>
> Under your committee's bill no tax will be imposed at the time of exercise of a "restricted stock option" or at the time the option is granted and the gain realized by the sale of the stock acquired through the exercise of the option will be taxed as a long term capital gain. Such treatment is limited to the "restricted stock option" *for the purpose of excluding cases where the option is not a true incentive device.* Options which do not qualify as "restricted stock options" will continue to be *taxed as under existing law.* (Italics added)

The doubt reflected in the quoted passages above as to the validity of T.D. 5507 appears to be one of the moving factors behind the passage of the "restricted stock option" legislation. The italicized words in the second quoted paragraph indicate that the beneficial treatment is given to none except qualifying options because it is desired not to include compensatory options any further. An inspection will reveal that there is no limitation even on compensatory options which qualify. The cited purpose of the limitation would seem to indicate that incentive type or proprietary type options should still be accorded capital gain treatment. Indeed, no other meaning would appear warranted from the statement that nonqualifying options "will continue to be taxed as under existing law," proprietary options being recognized under the law existing at that time.

of proprietary interests does no violence to §22(a). That section does not require that income be ordinary income rather than capital gains, nor current income rather than deferred until sale of stock. It only requires that at some time such a benefit as is here bestowed be recognized. The section is broad in this respect. The proprietary interest concept does nothing to narrow it. For some reason the Supreme Court seems to think it does and bases its decision upon that ground. Whether the Supreme Court's decision in the *LoBue* case is good law or not, it is nevertheless the law at this juncture. The *LoBue* doctrine must, henceforth, fit into the tax planner's scheme, and his attention must be directed to its limitations and alternatives.

Restricted Stock Options—An Alternative

The first question raised with respect to restricted stock options as an alternative is, are they really an alternative? The Senate Finance Committee in its report on restricted stock options stated, "Ordinarily when an option is used as an incentive device, the option price approximates the fair market value of the stock at the time the option is granted."[24] The committee's observation is correct. In the majority of cases where courts have held options to be capital or proprietary in nature, the fair market value at the time of the grant approximated the option price.[25] One must not too readily conclude from this similarity that restricted stock options will fulfill the calling of proprietary options as used before the *LoBue* decision, however. The statutory options are hedged in with restrictions such as stock ownership and date of exercise and many other disadvantages which render a thorough review of all circumstances and alternatives imperative for the prudent selection of a system of executive stock ownership. This Comment can do no more than point up the problem and suggest some areas for consideration.

In view of the turbulent history of executive compensation and its taxation in the last thirty five years, it is perhaps a discrete move to seek the shelter of a statute in the hope of obtaining certainty of treatment for stock options granted key employees. This move cannot, of course, be finally judged sound unless it meets the need

[24] S. Rep. No. 2375, 81st Cong., 2d Sess. 59, 60 (1950).

[25] Commissioner v. Straus, 208 F. 2d 325 (7th Cir. 1953); Rossheim v. Commissioner, 92 F. 2d 247 (3d Cir. 1937); Philip J. LoBue, 22 T.C. 440 (1954), *aff'd*, 223 F. 2d 367 (3d Cir. 1955), *rev'd*, 351 U.S. 243 (1956); Abraham Rosenberg, 20 T.C. 5 (1953); Norman G. Nicolson, 13 T.C. 690 (1949); Herbert H. Springford, 41 B.T.A. 1001 (1940); Charles E. Adams, 39 B.T.A. 387 (1939); Gordon M. Evans, 38 B.T.A. 1406 (1938). One case where the option was below the fair market value of the stock was Delbert G. Geeseman, 38 B.T.A. 258 (1938).

of the corporation concerned in the most economic manner available. The use of restricted stock options under §421 of the Internal Revenue Code of 1954 is such a move. Statutory options can be used most ideally by a corporation whose stock has a readily ascertainable market value at a time when its stock is low or moderately priced, whose future appears promising, when granted to executives other than large stockholders and which executives have fairly substantial income subject to tax. From this optimum situation, the gradations of usfulness of statutory options diminish to the point where they are less beneficial than regular compensatory options (including those formerly termed proprietary). A corporation operating under all or most of the circumstances above will do well to give serious consideration to the use of statutory options. Such a corporation can easily adapt its option price to conform with either the 85% or 95% of market value limitation as desired. The presence of a depressed market gives it additional flavor because of the lure of capital rather than ordinary income treatment of future market increases. The fact that the executive is in a high income bracket makes the exemption from taxation of the option-market spread relatively more valuable to him than the deduction for compensation would be to the corporation.

Probably the greatest restriction upon the use of the statutory option is the requirement that the option price must be a certain percent of the fair market value of the stock at date of grant. The vast majority of corporations in this country are not listed on a stock exchange, and the greater number are not traded with sufficient frequency over-the-counter to establish a reliable market value. It is thus inevitable that a market value must be established by evidence of isolated sales, book value, earning power and other facts of probative value.[26] In spite of the corporation's objective efforts to set the option price at market values the road is open for evidence of higher market value from the Commissioner. Obviously the uncertainty of such a course is a strong deterrent to the use of statutory options where the tax benefits of such options are the primary reason for their use. It is believed, however, that a conservative application of generally accepted standards of valuation in an objective spirit will not be lightly considered by the court where it is obvious that an honest effort was made by the corporation to comply with the statute. The court should be reminded of the patent injustice to small

[26] Compare use of formula based on earnings as described in Robertson v. Routzahn, 75 F. 2d 537 (6th Cir. 1935), and A.R.M. 34, 2 CUM. BULL. 31 (1920).

corporations of exacting and after-the-fact determinations of market value which thwart them in their bona fide attempt to comply with the statute, especially where reasonable men might differ on such a determination..

For companies with listed stocks and readily ascertainable market values, the statutory option presents an opportunity undoubtedly out of line with the basic purpose behind such options. In view of the fact that the statute permits option prices to be as low as 85% of the fair market value of the stock, it is clear that a system of deferred compensation can be effected quite readily. The grant can be made effective as of a date to be set by an appointed committee at 85% of the price set by such committee. The committee can simultaneously purchase stock at market on the exchange and set the option price at 85% of cost. The effect of such transaction is to compensate the executive to the extent of 15% of the market value, which compensation will not be recognized until its realization by sale at some future date when lower tax rates are enjoyed by the executive. This morsel is not so delectable as it first appears in view of the fact that the corporation loses the right to take a deduction for the amount of compensation so granted either in the year of the grant or the year of recognition by the recipient. It becomes important to consider whether the tax benefit to the executive more than balances the tax loss to the corporation. If the effect of the double taxation of corporate earnings is weighed, it is quite conceivable that what appeared to be a tax plum is little more than an illusion.

A slight variation might make the statutory option more attractive. If the committee grants the option at 95% of market value, the 5% spread will be taxed at capital gain rates rather than compensation rates upon realization. This arrangement would require three times as large a volume of financing as the 15% spread. If, however, the corporation is able, under state law, to finance its own executives' purchase, the corporate dividends will probably exceed the corporate interest rate, and the larger volume of financing will not be an insuperable burden.

The illusionary aspect of restricted stock options is perhaps best presented by the use of hypothetical situations. The relative advantage or disadvantage of statutory options is measured in the following illustrations by the combined dollar benefits to both the corporation and the executive. In a few circumstances, the relation between corporation and executive might render the unilateral rather than the consolidated effect a more desirable and expedient criterion. Using the combined effect as our standard, three principal variables must be determined.

The first variable, in question form, is "At what price will the option be exercised?" The second is "What will the differential in the executive's tax rate be between the date of exercise and the date of disposition or sale?" The third variable is presented in the question "What percentage price option is being considered as an alternative to the statutory option?"

The following situations illustrate the effect of these variables:

Situation 1—Smith who files a joint return, has $20,000 taxable income and is given a 75% option to purchase for $3,750 stock with a market value of $5,000. Jones, who also files a joint return and has the same taxable income, is offered an 85% restricted stock option. He can buy for $4,250 stock worth $5,000. Both immediately exercise their options, acquire stock worth $5,000. Later when their taxable income is still $20,000 they sell the stock for $7,000.[27]

Situation 2—Same as situation 1 except that Smith and Jones both exercise the option at a time when the stock is selling for $7,000, and subsequently sell it for $7,000.

Situations 3 and 4—Same, respectively, as situations 1 and 2 except that both executives have a taxable income of $40,000 in year of exercise and year of sale.

Situation 5 and 6—Same, respectively, as situations 1 and 2 except that Smith's option is granted at 65% rather than 75% of market value at date of grant.

Situations 7 and 8—Same, respectively, as situations 5 and 6 except that both executives had a taxable income of $40,000 at date of exercise and date of sale.

Situations 9 and 10—Same, respectively, as situations 1 and 2 except that both executives had a taxable income in year of exercise of $64,000 and a taxable income in year of sale of $8,000.

Situations 11 and 12—Same, respectively, as situations 5 and 6 except that both executives had a taxable income at date of exercise of $64,000 and a taxable income in the year of sale of $8,000.

The above situations can be tested on the following basis to determine which method will result in a lower combined cost:

[27] This fact situation was used by J. K. Lasser in the June 15, 1956 special supplement to his TAX REPORT.

SITUATION 1

	SMITH	JONES
COST TO CORPORATION:		
Value of stock at date of grant	$5,000	$5,000
Option price received	3,750	4,250
Tax deduction value of spread (52% rate)	650	-0-
Value received by corporation	4,400	4,250
Net cost to corporation	600	750
COST TO EXECUTIVE:		
Purchase price of stock	3,750	4,250
Tax on spread of $1,250 at 38%	475	-0-
Capital gain tax on subsequent sale 38% X 50% of $7,000 less $5,000.	380	380
Ordinary income tax on subsequent sale $5,000 less basis X 38%	-0-	285
Net cost to executive	4,605	4,915
NET CONSOLIDATED COST	$5,205	$5,665

Situations 2 through 12 tested on the above basis give the following net consolidated costs:

SITUATION	*SMITH*	*JONES*	*EXCESS COST OF R.S.O. OVER NON-QUALIFYING S.O.*
2	$4,545.00	$5,665.00	$1,120.00
3	5,610.00	5,980.00	370.00
4	5,130,00	5,980.00	850.00
5	5,135.00	5,665.00	530.00
6	4,475.00	5,665.00	1,190.00
7	5,630.00	5,980.00	350.00
8	5,150.00	5,980.00	830.00
9	5,422.50	5,455.50	33.00
10	5,422.50	5,455.50	33.00
11	5,487.50	5,455.50	(32.00)
12	5,487.50	5,455.50	(32.00)

The above illustration indicates that the maximum benefits under a restricted stock option will be derived where the second variable is the greatest. The illustration is, of course, general and serves but to point up the necessity for a realistic estimate of the circumstances surrounding each prospective stock option. Maximum benefits to both corporation and executive can be accomplished by giving meticulous attention to the probable facts of a prospective option and projecting the total cost based upon these facts in the manner described above.

NON-STATUTORY ALTERNATIVES

Treat Value of Option as Consideration

In the *Smith* case, the Supreme Court stated:

> Since the Tax Court found that the market price of the stock on the date of the option did not exceed the option price, it is evident that its finding that the option was given as compensation for respondent's services, had reference to the compensation to be derived from exercise of the option after the anticipated advance in market price of the stock.[28]

But the court in that case, though speaking at dictum, pointed out that:

> When the option 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.[29]

This dictum was followed in *McNamara v. Commissioner.*[30] In that case the option was granted at a price below the fair market value of the stock. The option was freely assignable, and was exercisable whether or not the grantee continued as an employee. The resolution granting the option stated that the executive's compensation for the year included the option. The corporation deducted and taxpayer included the value of the option in their returns for the year. The Court of Appeals for the Seventh Circuit held that the option itself had a present value when granted, was intended as compensation, and was in fact compensation. It seems rasonable to expect that the *McNamara* case will be followed where the following factors are established:

1. That there are no restrictions within the option period upon the assignment or exercise of the option.
2. That the option be granted at a price appreciably lower than the fair market value of the stock at date of grant.
3. That evidence in the contemporary papers establishes the intent of the parties that the option itself be compensation.
4. That the parties make an honest attempt to arrive at a fair market value for the options and that such value be reported by both parties as compensation.

Use of Stock Warrants

Closely related to stock options are stock warrants. As the two are

[28] Commissioner v. Smith, 324 U.S. 177, 179 (1945).
[29] Commissioner v. Smith, *supra* note 28, at 181.
[30] 210 F. 2d 505 (7th Cir. 1954).

used with respect to employees the essential difference seems to be that the employee purchases the warrant whereas the option is generally granted without a cash payment by the employee. Where the price paid for the warrants equals their market value, an arm's length transaction occurs. Where, however, the price paid for the warrants is clearly below their market value, the transaction would seem to be in essence the same as the grant of an option which has a fair market value. Such, at any rate, is the result of *Commissioner v. Stone's Estate*,[31] in which taxpayer purchased warrants for less than their value. In that case the Court of Appeals for the Third Circuit held that upon a subsequent sale of the warrants taxpayer recognized capital gain where the value of the warrants had increased. Again there seems to be little reason for this case not to be followed if a market value can be ascribed to the warrants with sufficient certainty and the intent is made clear that the warrant itself is to be treated as compensation.

Sale By Corporation of Restricted Stock

Another method which has been used with some success by tax practitioners is the sale of stock by a corporation to its executives which stock is subject to restrictions preventing its sale or requiring resale to the corporation at some ascertainable amount, *e.g.*, book value, or capitalized earning value. The idea is that the restriction will preclude a market value on the stock at the time of sale to the executive.[32] At a subsequent time the restrictions are removed and the stock is sold or the stock is repurchased by the corporation at an increased valuation. In both cases it is hoped that the full amount of the gain will be treated as capital gain to the executive. There is authority to uphold the desired treatment. Several cases have held that restrictions upon stock prevent it from having an ascertainable market value.[33] A recent tax court case, *Robert Lehman*,[34] held that the subsequent termination of such restrictions on stock which had no fair market value when previously received for services is not an event which gives rise to income for tax purposes. For the present, the acquiescence of the Commmissioner on this point[35] seems to offer some slight degree of shelter. The Treasury's position appears to be

[31] 210 F. 2d 33 (3d Cir. 1954).
[32] Burnet v. Logan, 283 U.S. 404 (1931).
[33] Helvering v. Tex-Penn Oil Co., 300 U.S. 481 (1936); Schuh Trading Co. v. Commissioner, 95 F. 2d 404 (7th Cir. 1938); Propper v. Commissioner, 89 F. 2d 617 (2d Cir. 1937); Harold H. Kuchman, 18 T.C. 154 (1952).
[34] 17 T.C. 652 (1951).
[35] 1952-1 CUM. BULL. 5.

less favorable, however, with the recent proposal of a regulation making the removal of restrictions a taxable event.[36] In connection with the restrictions requiring repurchase by the corporation, there is also authority to support the above practices. In *Estate of Raymond T. Marshall*[37] a closely held corporation sold stock to an officer with the requirement that it be resold to the company upon termination of the officer's employment. The court held that upon resale the officer realized captial gain.[38] It is suggested that such restrictions on stock be used only when the surrounding facts indicate that the procuring of more favorable tax treatment is not the sole purpose for their use. Though the *Lehman* case itself would seem to support the tax free withdrawal of restrictions at any time, it is submitted that where the circumstances surrounding the stock grant and the subsequent restriction withdrawal do not indicate any other bona fide business purpose, a court will have little difficuly in finding the substance of the transaction to have been compensatory in nature and assess ordinary income rates thereto. In such a case the failure of the corporation to amend its return within the time prescribed can render substantial tax loss to the corporation as well as the individual.

Gift

Though there are times when a corporation desires to issue its stock gratuitously to an individual in appreciation for some act of the latter, such situations are not within the scope of this discussion. We are concerned only with the transfer of stock to an executive for the purpose of making the executive an owner and with doing so as economically as possible. The big question is, for tax purposes can a gift of stock be made by a corporation to an executive for the purpose of granting stock ownership to the executive? (Assume corporate power to make the gift.) To the writer's knowledge, the question has not been squarely presented to the courts. The Supreme Court in the *LoBue* case indicated that any transfer by a corporation to an executive must be either compensation or a gift. Thus, in theory, it can be done. However, the courts have not readily found transfers to be gifts where the payment by the corporation is in recognition

[36] U.S. Treas. Reg. 1.421-6(b) (1) (proposed November 10, 1956).

[37] 20 T.C. 979 (1953).

[38] Compare National Clothing Co. of Rochester, 23 T.C. 944 (1955). A closely held corporation sold its stock to an employee under a restriction requiring either resale or corporation's consent to sell. In year of repurchase the corporation deducted the difference between the amount received for the stock and the amount paid to the employee on repurchase as compensation to the employee. The corporation contended that the entire arrangement was compensatory and the court so held.

of past services.[39] Furthermore, "if services have been performed by the recipients, it may well be said the presumption is that the payment is for the services and not a gift.[40] It would seem, as a practical matter, that the use of gifts for the purpose of granting ownership to an executive is today of little value to the tax planner. In almost all instances the executive has rendered past services to the employer. In these instances a presumption of payment for these services automatically arises. This presumption is of course open to rebuttal, but is extremely difficult if not impossible to overcome. Where past services have not been rendered, it is unusual to find a gift being made which is not conditioned upon the future receipt of services.

Issue of Preferred Stock Dividend

Though this Comment is not designed to exhaust the field of possibilities, a rather unique arrangement in corporate financing has been suggested by one writer which illustrates how stock plans can be tailored to particular fact situations. The situation presented in the words of the writer is as follows:

> . . . . (A) closely held corporation may have one class of stock outstanding and a fairly small group of stockholders who desire to give younger executives a chance to buy stock which will cost very little but which will give them an enhanced interest in future growth. In such cases, it may seem desirable to issue a tax-free stock dividend of preferred stock on common stock with a par value of the preferred equal to the present worth of the company and the preferred dividend equal to present earnings. This should have the effect of reducing the common stock to a low value, though there may still be room for argument with the Commissioner over the precise amount. Then the existing stockholders could sell their common stock to employees at a nominal price.[41]

COMPARISON OF ALTERNATIVES

In order to facilitate our comparison of the alternatives presented, it should be useful to determine for each alternative, as was done earlier in our discussion of restricted stock options, the net consolidated cost to the corporation and the executive in effecting a transfer of corporate stock. The different costs can then be compared to

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[39] Held to be compensation in the following cases: Wallace v. Commissioner, 219 F. 2d 855 (5th Cir. 1955); Painter v. Campbell, 110 F. Supp. 503 (N.D. Tex. 1953). Held to be a gift in the following cases: Bogardus v. Commissioner, 302 U.S. 34 (1937); Blair v. Rosseter, 33 F. 2d 286 (9th Cir. 1929).

[40] Wallace v. Commissioner, 219 F. 2d 855, 857 (5th Cir. 1955); see also Carragan v. Commissioner, 197 F. 2d 246 (2d Cir. 1952).

[41] Lyon, *Employee Stock Purchase Arrangements*, 31 TAXES 1021, 1029 (1953).

determine the most economical under each particular set of circumstances. The twelve basic fact situations presented in the section on restricted stock options will be used for each alternative to the extent that the facts are relevant to a particular alternative. In addition, the following facts must be assumed:

1. That in connection with *options having a market value,* the market value of the option (Smith's option) is equal to the difference between the option price of the stock and the fair market value of the stock.

2. That *warrants* having a fair market value of $500 are sold for $200 and entitle the executive to buy for $5,000 stock having a value at the date of issuance of the warrants of $5,000. That the executive exercises the warrants when the stock is selling for $7,000 and subsequently sells it for $7,000. That in situations 9 through 12 the executive had a taxable income of $64,000 in the year he purchased the warrants and a taxable income of $8,000 in the year he sold the stock.

3. That in the *sale of restricted stock* the stock (having a fair market value of $5,000 unrestricted) is sold under restrictions to the executive for the same amount (as the Smith option) as in the basic situations. That between the time of the executive's purchase and sale the restrictions are removed. (Restrictions requiring repurchase by the corporations are not considered.)

The net consolidated cost can be calculated in the same manner as illustrated earlier in this Comment.[42] On that basis the comparative net consolidated costs of the scheduled alternatives for the twelve basic situations are tabulated in Table A.

[42] The form used earlier can be adapted to the present type of stock arrangements. As an illustration, the computation of cost of stock warrants for situation 1 is set forth below:

Situation 1

Cost to Corporation:	
Value of stock and warrant at date of warrant issue	$5,500
Proceeds from warrants	200
Proceeds from sale of stock under warrants	5,000
Tax deduction value of spread (52% rate)	156
Value received by corporation	5,356
Net cost to corporation	144
Cost to Executive:	
Cost of warrant	200
Tax on spread (38% x $300)	114
Cost of stock on exercise of warrants	5,000
Capital gain tax on subsequent sale (38% x 50% x $7,000 less $5,500)	285
Net cost to executive	5,599
Net consolidated cost	$5,743

TABLE A

Situation	(a) Ordinary Stock option	(b) Restricted stock option	(c) Option having market value	(d) Stock warrants	(e) Sale of restricted stock
1. Executive, who files a joint return, and has $20,000 taxable income is offered one of the following alternative methods of buying stock with a present market value of $5,000: (a) a 75% option to purchase for $3,750; (b) an 85% restricted stock option to purchase for $4,250; (c) a 75% option having a market value of $1,250; (d) stock warrants purchase for $200 having a fair market value of $500 and entitle executive to buy stock within certain period for $5,000; (e) option to purchase stock subject to restrictions for $3,750 or 75% of the market value. In (a), (b) and (c) the options are exercised immediately. In (d) the warrants are purchased immediately and are exercised when stock is selling for $7,000. In (e) the stock is purchased immediately and the restrictions are removed prior to executive's sale. In all cases the stock is sold by executive for $7,000 in a year when his taxable income is $20,000.	$\underline{\$5,205}$	$5,665	$\underline{\$5,205}$	$5,743	$5,617.50
2. Same as situation 1 except that in all alternatives the privilege to purchase the stock is exercised when the stock has a market value of $7,000.	$\underline{4,545}$	5,665	5,205	5,743	5,617.50
3. Same as situation 1 except that executive has a taxable income of $40,000 in year of exercise and year of sale (exercise in this particular situation refers to purchase of warrants in alternative (d)).	$\underline{5,610}$	5,980	$\underline{5,610}$	5,932	5,910
4. Same as situation 2 but with the exception which is incorporated in situation 3.	$\underline{5,130}$	5,980	5,610	5,932	5,910
5. Same as situation 1 except that in alternatives (a), (c) and (e) the option is for 65% rather than 75% of the fair market value at date of grant. In alternative (c) the market value of the options is $1,750.	$\underline{5,135}$	5,665	$\underline{5,135}$	5,743	5,712.50
6. Same as situation 2 but with the exception which is incorporated in situation 5.	$\underline{4,475}$	5,665	5,135	5,743	5,712.50
7. Same as situation 5 but with the exception which is incorporated in situation 3.	$\underline{5,630}$	5,980	$\underline{5,630}$	5,932	6,050
8. Same as situation 6 but with the exception which is incorporated in situation 3.	$\underline{5,150}$	5,980	5,630	5,932	6,050
9. Same as situation 1 except that executive had a taxable income of $64,000 in year of exercise (exercise in this particular situation refers to purchase of warrants in alternative (d)) and a taxable income of $8,000 in year of sale.	$\underline{5,422.50}$	5,455	$\underline{5,422.50}$	5,734	$\underline{5,422.50}$
10. Same as situation 2 but with the exception which is incorporated in situation 9.	$\underline{5,422.50}$	5,455	$\underline{5,422.50}$	5,734	$\underline{5,422.50}$
11. Same as situation 5 but with the exception which is incorporated in situation 9.	5,487.50	$\underline{5,455}$	5,487.50	5,734	5,487.50
12. Same as situation 6 but with the exception which is incorporated in situation 9.	5,487.50	$\underline{5,455}$	5,487.50	5,734	5,487.50

(Underlined amounts represent lowest costs for each situation.)

A word of caution must be inserted about accepting the costs calculated in Table A as final for all purposes. For instance, perhaps the primary purpose of an option is to compensate the employee. Obviously the consolidated cost of the option is in itself misleading. If the type alternative which has the lowest net consolidated cost in the particular situation has a relatively low cost to the corporation and a relatively high cost to the individual, the goal of compensating the employee has not been accomplished. In order to compensate the individual as fully as desired, a cash payment must be arranged. The cost of making that cash payment must then be added to the net consolidated cost of the option. This should be done for all the alternatives where compensation is a major factor. The cost of making a cash payment of compensation is calculated as follows:

	Situation X	*Situation Y*
Cost to corporation:		
Amount of payment	$100	$100
Tax deduction (52% rate)	(52)	(52)
Cost to corporation	48	48
Cost to individual:		
Cash received	(100)	(100)
Tax on payment		
(Rates of 38% and 65% resp.)	38	65
Cost to individual	(62)	(35)
Net cost of payment	($14)	13

(Parentheses indicate negative figures).

A glance at the above tabulation will indicate that one alternative will not, so far as cost alone is concerned, be the best one for all occasions. In determining which alternative is most advantageous for his client, the attorney should determine with as much objectivity as possible what the circumstances can reasonably be expected to be on the significant dates involved. On the basis of those circumstances, cost estimates should be worked out, as above, for comparison and selection of the most economical alternative. The attorney should then weigh the cost factor against the reliability factor, (*i.e.*, the degree of reliance that the Commissioner or the courts will uphold the desired method) and select the alternative which has the most favorable balance of these two.

Conclusion

Executive stock options have been and will continue to be an important tool in corporate affairs. There is every reason to believe that they will continue to find large usage both for the purpose of compensating and for the still important purpose of granting proprietary interests to corporate officers. Though the Supreme Court has taken away the advantage of permitting the corporation to deduct the value of proprietary options to the extent that this had in the past been done, it is submitted that the effect of the Court's decision will not be too adverse where corporations did not make a practice of taking such a deduction for the value of proprietary options.

Despite the fact that the Court's decision appears questionable, it is now the law. Tax planners must now consider the alternative courses to the granting of proprietary options. There are several. Many of the alternatives are either not yet fully sanctioned by the courts, or are, though supported, not considered to be of such sterling legal quality as to be above reversal of judicial attitude. The degree of reliability which can be placed upon an alternative being upheld in court is a major consideration in the selection of a method. This factor should be carefully weighed against the cost factor to the corporation and to the executive. It is believed that an attorney, in executing these considerations, will be rendering a service to his client, whether corporation or individual, which will find its fruits in increased corporate efficiency and *esprit de corps.*

Edward R. Smith