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The Mysterious Stock Option*

By Erwin N. Griswold†

Everyone who deals with the field of federal taxes in any sort of a professional way is aware of the fact that the basic statute—the Internal Revenue Code of 1954, as amended—is extraordinarily complicated. It has long since passed the place where the ordinary citizen can be expected to understand even a small part of it. And there are many passages which perplex those who spend their lives working with the law, and bring intricate problems to the courts, and often much uncertainty into their decisions.

A considerable portion of the difficulty with the statute arises from many provisions which deal in one way or another with capital gains. Many of the complicated provisions are designed to frustrate efforts to convert ordinary income into capital gains. Perhaps a leading illustration of this is section 341, dealing with collapsible corporations. Here we have six and a half pages of fine print in one popular edition of the code, designed to frustrate attempts to convert income derived from personal services or from the sale of inventory property into capital gains taxed at favorable rates. Numerous other provisions with a similar objective could be cited.

To an outsider, therefore, it would be something of a surprise to learn that there is one very complicated provision in the statute, which is designed to relax the tax on compensation for personal services, and to provide that in certain very special circumstances such compensation will be taxed as a capital gain —and, in many cases, will never be taxed as income at all. This provision of the statute is the one relating to stock options, now found in section 421 of the 1954 code, as amended in 1958. This provision, too, is extremely complex, occupying more than six pages in a well-known edition of the code. Its complexity, how-

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* Originally published as *Are Stock Options Getting Out of Hand?*, 38 Harv. Bus. Rev. 49 (1960).

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ever, is not an appreciable barrier to its very considerable use by a relatively small number of taxpayers.

Most people know nothing about stock options, and care less. This is not one of the complexities that bothers the ordinary taxpayer in making out his return. Nevertheless, the provisions of the tax law with respect to stock options are of substantial benefit to a very few taxpayers. The fact that these provisions are obscure and rarely used may enhance their attractiveness to those who use them; for economic gain that one can obtain for his efforts without much specific publicity and without paying any tax can be very satisfactory indeed.

There are few things in the tax law that are as vague and intangible as the provisions relating to stock options. This may seem a surprising statement in view of the great extent of the statutory language on this subject. Nevertheless, despite the care with which the statute has been put together, it is hard to put one's finger on most problems relating to stock options. A recent commentator on the problems in this area has summarized the matter in the following conclusion to his article:

> The following quotation, usually attributed to Lincoln, best appears to sum up the policies for and against the restricted stock option provisions of the Internal Revenue Code: "People who like this sort of thing will find this the sort of thing they like."[1]

In a sense, "employee stock options" are related to pension, profit-sharing, and stock-bonus plans, covered by sections 401-04 of the code. All are designed to make it possible to provide incentives for persons in corporate employ, on a favorable tax basis. But there are many differences. The stock option provision is really something different in kind. Indeed, when examined closely, this is one of the most strange and wonderful areas of our tax law, less thought out and less justified than almost any of the many provisions of the tax law granting special benefits.

Let us look at some aspects of stock options in the tax law

1. They are inherently discriminatory.

The provisions granting tax benefits to pension, profit-sharing, and stock-bonus plans, must, by the terms of the statute, and

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[1] Schlesinger, *Selected Problems in the Use of Restricted Stock Options*, 36 Taxes 709, 756 (1958).

within limits fixed by Congress, be nondiscriminatory—that is, they must be proportionately available to a substantial number of the employees of an enterprise, reasonably classified and all within the Treasury's rules for an approved pension plan. In technical terms, they must "qualify" under the mildly stringent terms provided in the statute for such plans. But the provision of stock options, by sharp contrast, may be as discriminatory as the employer wants. They can be limited to one employee, or to a few employees, and ordinarily are. Even among the group of employees who are granted options, some may receive options for a large number of shares, and others for a small number. In the case of pensions, Congress sought to assure that the plan would be a genuine plan for pensions by requiring that the plan be nondiscriminatory In the case of stock options, there is no such assurance at all.

Thus we see that stock options fall outside the general safeguards provided in the case of other employee-benefits plans. They are in a special class, though just why this should be is far from clear, and has never been stated by the congressional committees which developed these provisions. In a tax law which seeks generally to impose taxes on a basis of equality and fairness, it seems odd that there should be this special provision which stimulates discrimination, and on a rather grand scale.

2. *Are they taxable or aren't they?*

A stock option allows the holder of the option to buy shares of stock at the price stated in the option. Obviously, the option is attractive only if the option price is lower than the fair market value of the stock at the time of exercise. Thus, when the stock option is useful it enables the employee to make a bargain purchase of the stock.

Ordinarily, bargain purchases made by an employee from his employer result in income, taxable at ordinary rates. They are simply a form of compensation for services rendered. When most people receive something of substantial economic vaule as compensation, they have to pay tax on the value of the benefit received, regardless of its form.

In the case of stock options, however, Congress has provided a peculiarly complex scheme. If the option price is at least ninety-

five percent of the market value—at the time the option is granted —then no income is realized on the exercise of the option. Thus a substantial economic benefit may be obtained, and retained indefinitely, without the payment of any tax. The economic benefit —often substantial—obtained on the exercise of the option is wholly free. If the stock is sold, then there may be tax, but income realized on the sale of the stock is taxed as a capital gain. If the stock is simply held until death, though, there is no income tax at all, at any time, no matter how much the actual gain may have been. The stock, in such event, as in the case of other property, passes to the estate or beneficiary, taking as its basis in the new owner's hands the fair market value at the time of death.

Where the option price is between eighty-five and ninety-five percent of the fair market value of the stock—at the time the option is granted—a more complicated rule becomes applicable. In such cases, no income is realized on the exercise of the option, but the spread between the option price and the fair market value at the time of grant is taxable as ordinary income on any disposition of the stock—though not before. The death of the holder of the stock is treated as a disposition, so this amount—the spread up to the fair market value at the time of grant—does become taxable as ordinary income on a sale or in the event of the death of the holder of the stock. As a matter of fact, there is now going through Congress an amendment to the stock-option provisions under which the transfer of stock on death to the widow of the employee will not be treated as a disposition, so that no tax will be due not only while the employee is living but while his wife is living, too. For some reason it seems to be fairly easy to get legislation extending tax benefits in this area. It is of course not surprising that there does not seem to be a very effective lobby against stock options.

There are further complexities in the case of a person who possesses more than ten percent of the stock of his employer. In this case he gets the benefit only if the option price is at least 110 percent of the fair market value on the date when the option is granted. In such a case, the option can be exercised only within a period of 5 years.

In cases of employees with lesser stock interest, though, the

option can be exercised over a period of ten years. In all cases, the benefits cannot be obtained unless the stock is held until at least two years after the date the option was granted, and for at least six months after the option was exercised.

These time limits were obviously designed to insure that the employee would have some stake as a shareholder for at least an appreciable period of time. However, there is often a way around requirements of this sort, and there appears to be one in this case. The Treasury has recently ruled[2] that a person who has exercised a stock option may purchase a "put"—that is, a right to sell the stock at a fixed price at a future date—and that this purchase of a "put" will not constitute a "disposition" of the stock he has acquired on his option. Thus, at relatively small expense, he may in many cases completely hedge his position, and assure himself that he will not suffer from future declines in the price of the stock.

There is no thought of criticism of the Treasury Department in the reference to this ruling. It is difficult to see how they could have come to any other conclusion as the statute is now worded. The ruling does show, though, that an employee may effectively get the benefit of a stock option, without taking any risk after he has purchased the stock of his employer at a specially favorable price.

Truly, this is a fairyland. The ground is strewn with quite a bit of gold. But, this is only for a select few, and in somewhat special cases. With care, though, and in a sufficiently stable and prosperous company, the benefits can be very great. The benefits can be received without any present income tax, and often without any income tax at all, in cases where the stock received is held by the employee until his death.

3. *Stock options are least useful in small companies where they are most justified.*

Because of the limits to ninety-five or eighty-five percent of market value—in some cases, 110 percent—a curious consequence develops. It is in small and closely held companies that the stock option device may have its clearest justification. It is in such companies, perhaps, in need of better management, that an out-

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[2] Rev. Rul. 59-242, 1959-2 Cum. Bul. 125.

sider can be brought in and given the real incentive through a stock option of sharing in the improvement of the company It is in such companies, too, that the efforts of an individual can have some impact on the value of the stock.

Yet, it is in just these smaller companies that the determination of the fair market value of the stock at any particular date is most difficult and uncertain. The Treasury has recently ruled, and quite properly, that it will not undertake to fix the value of stock in order that a stock option may qualify as a restricted stock option.[3] For this reason, it is extremely difficult to use stock options in the case of a closely held company If the stock goes up in value, the employee is always subject to the risk that it will be eventually determined that the value of his stock when the option was granted was higher than was then contemplated, with the result that the option price is outside the charmed circles of eighty-five or ninety-five percent.

On the other hand, in the case of a publicly held company, whose stock is listed on the big board, there is no such problem. The fair market value of the stock can always be determined with considerable accuracy, from day to day As a result, it would appear that stock options are most widely used with respect to employees of such publicly held companies. Yet, these are the very companies where the use of stock options is least justified, where the contribution of any individual employee has much less to do with the value of the stock than do general market conditions, and where the option benefit is most clearly a form of compensation.

4. The gain prior to the exercise of the option is not really a capital gain.

In any event, there is no real justification for treating the spread between the option price and the fair market value on the date of exercise of the option as a capital gain. Capital gains are taxed at a special rate for a variety of reasons. One of these is that a person holding a capital asset has made a capital investment which is at risk during the period he has held it. He takes a chance that the value will go down, in which case he will suffer a loss. Such losses are not fully deductible from income

[3] Rev. Rul. 59-242, 1959-2 Cum. Bul. 123.

taxes, and one recompense is that capital gains, when realized, are taxable at special rates.

But the employee who has a stock option has no capital investment before the option is exercised. He has nothing to risk. He loses nothing if the stock goes down. He is on a one-way street. If things go well, he gains. If things go badly, he loses nothing. There is not here a true justification for the allowance of capital gain rates. Capital gain rates should be applicable to people who have capital at risk. An employee with an unexercised stock option has nothing at risk. He has made no investment. He has hopes for profit, but no risk of loss. It is a very happy situation, which hardly seems entitled to special tax treatment as well.

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 But this is not applicable to the gain inherent in the stock at the time he receives it through the exercise of a favorable stock option.

5. *Incentives.*

The basic reason given for the allowance of tax benefits in the case of stock options is that they will provide incentives to corporate employees. There is little doubt that tax free income is highly attractive to anyone, including persons who are not employees of corporations, or persons who are employees but do not have the benefit of stock options, or even to persons who do have stock options, but where the price of the stock does not go up enough to make the option attractive.

Nevertheless, there are real difficulties in the way of realizing on this incentive. Where an employee has a stock option, he must, in some way, provide the funds to meet the option price in order to take up the option. From gossip in the luncheon clubs, one gets the impression that this sometimes presents a real problem. Indeed, a number of instances have appeared in the papers where an employee had to sell stock he already owned in his employer company in order to raise the money needed to take up stock at a favorable price under a stock option. Consid-

ering that one of the arguments presented in favor of stock options is that they enable an employee to acquire a stake in his company, this is surely an odd result. Nevertheless, it seems likely that a considerable amount of the sales of shares by "insiders" reported to the Securities and Exchange Commission may actually be sales which are made in order to raise cash to take up stock options. If this is true, it serves to emphasize the essentially compensatory nature of the stock option scheme.

In other cases, apparently employees have real difficulty in taking up their options with cash, because they are allowed to pay for the stock by giving a note. It may even be that in some cases such notes are canceled if the market value of the shares goes down. This may involve returning the shares, but the net result is favorable to the employee.

All of this emphasizes the fact that the incentive involved in stock options tends to be very uncertain and haphazard. If we are really seeking to provide incentive, it would seem that there are at least two things that we might do: (1) We might learn a lot more about what really are the incentives which lead people to engage in productive and useful work, and (2) we might find a tax device which would provide financial incentive in a far less discriminatory and haphazard form.

It is no doubt generally true that men are acquisitive, and that they like to acquire economic benefit. It is perhaps less clearly true that men will work harder to acquire a greater economic benefit after they are already fairly well paid. It is far from clear, though, that economic gain is the only objective for which men will work, or work hard. Large segments of our population work, and devotedly, for relatively small economic benefit. This would include Members of Congress, and the clergy, to mention only two groups. It is obvious that other incentives are active in their cases. It is also far from clear that the economic incentive is effective on a man who already has substantial means, say, many millions of dollars. Yet, if investigation were made, it might be surprising what a large proportion of the benefit from stock options goes to people who are already very well off in economic terms.

It is hard to investigate matters of this sort, and particularly hard for the private citizen. About all that he can do is to rely

a good deal on instinct and general feeling. The basic fact remains that we know virtually nothing about stock options, who gets them, who exercises them, the amount of the benefit which is thus obtained without current tax, and often without any tax at all, the relation of this benefit to the person's other income and wealth, and the actual amount of "incentive" which is provided by the stock option.

It would be a very fruitful thing, it seems to me, if Congress through an appropriate committee, or the Treasury, were to investigate this matter, on a calm, dispassionate, and unprejudiced basis, simply for the purpose of developing the facts as to the extent to which stock options have been used, the extent of the benefit which has been obtained, or is potentially realizable, and the amount of incentive which the gain provided by the options has produced which would not have been available without the options, without the tax benefit, or from some other source. It might even be the conclusion that the acquisitive instinct in Americans is not the one which should be encouraged by substantial tax benefits. If stock options actually encourage and stimulate businessmen to run more efficient business, they may be worth the price. On the other hand, if it should appear that there is some sort of connection between the type of persons who are stimulated by the provision of stock options and the type of management that has given us so much of fins and chrome on our oversized, unduly expensive, and wasteful automobiles, we may indeed have been paying a price far greater than the tax loss involved in untaxed compensation through stock options.

A related aspect of the problem was referred to in a recent article in a business journal.[4] This is *Can Capitalism Win the Intellectuals?* by Calvin B. Hoover. This is the relevant passage:

> Even more concretely, the area of managerial practices needs to be reexamined and defined. The exposure of reprehensible corporate actions which led to the establishment of the Securities and Exchange Commission in the early 1930's did much to discredit modern capitalism in the eyes of the intelligentsia, and even small investors. There is serious danger that some of the current practices may cause mushrooming hostility toward corporate management

[4] Hoover, *Can Capitalism Win the Intellectuals?* 37 Harv. Bus. Rev. 47 (1959).

reminiscent of earlier years. Consider the following examples:

> The bestowal of stock options by corporate management on itself, permitting the dilution of stockholder equities in the name of executive incentives, is a widely accepted practice. When their value depends largely on the demand for the products of the industry and the level of the stock market at the time the options are bestowed—as compared with the level when they are exercised—it is difficult to present these stock options as simple incentives.[5]

6. Heads I win, tails you lose.

The basic and appealing theory behind the stock option provision is the thought that a man might come into a company and by his own ability and efforts improve the company's business so that its stock would greatly increase in value. In such a case, there is something to be said for the proposition that the man whose efforts have produced such a desirable result should share in the gain. Whether that share should be on a specially favorable tax basis is another matter. However, it might be that there should be tax concessions where it is clear that the employee's efforts have contributed substantially to the increase of the value of the company's stock.

In certain special, relatively small cases, one man's efforts may directly affect the value of his employer's stock. But, as has already been pointed out, many or most options are granted by very large corporations where general business conditions have far more to do with the value of the stock than do the efforts of one man or any group of men.

As an incentive device, stock options have a very large element of lottery in them. We have stringent provisions in our tax law aimed against gambling. Yet we also find the stock option provision, which turns to a very large extent on what amounts to a gamble. When the market value of the stock goes up, it is very nice and interesting, and stock options may lead to very large amounts of economic gain, without any present tax, and the real possibility that there may never be any income tax at all. What happens, though, when the market value of the stock goes down, as it did in the case of many companies during 1957-58?

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[5] *Id.* at 54.

As a matter of fact, this may merely increase the incentive. It tends to become a heads I win, tails you lose, lottery For when the market goes down, the old options may be canceled, and new options may be issued at the lower price. Thus, the employee may get the maximum incentive if the price of the stock is first depreciated. As a columnist in the Washington Post and Times Herald said, on April 4, 1958:[6]

> Stockholders of the Aluminum Co. of America, who suffered the humiliation of watching their stock drop from more than $120 a share to less than $70 in the last two years, may have read with mixed emotions the decision of the corporation s top executives to spare themselves and some 300 other officers and employees a similar indignity
>
> A fairy godmother stock option committee, consisting of the 6 highest paid directors and officers voted to cancel options on 193,000 shares of Alcoa stock at $117.25 and to reissue options share for share at $68.50. This put all optionees (a) even with the current price of Aluminum stock and (b) 48¾ points up on the patient stockholders who held their shares without benefit of a fairy godmother committee to bail them out of their investment venture.

Now it was undoubtedly not essentially the fault of employees holding stock options that the fair market value of the stock of most companies went down in 1957-58. This was due to general market conditions, and to forces quite beyond the influence of corporate employees generally In this respect, the decline in value was not much different from the increase in value which occurs in boom periods. Yet the employee with a stock option is really sitting very well. When prices go up, he can exercise his option and get a substantial benefit without current tax, and very likely without ever paying any income tax. On the other hand, when prices go down, he can, with a little difficulty, get a new option at the lower price, and thus have the prospect of a much larger gain at a later date, likewise without current tax, and with the prospect of no income tax at all.

These things are made even easier by provisions in the statute for options at variable prices. Instead of granting the option to buy stock at a fixed price, the option may provide a formula

[6] Quoted in Schlesinger, *Selected Problems in the Use of Restricted Stock Options*, 36 Taxes 709, 730-31 (1958).

based upon market value when the option is exercised. If this is carefully drafted, it can be an almost foolproof device, allowing an employee the greatest potentiality of gain at the time the price of the stock is lowest. Just how this fits in with the general "incentive" philosophy behind the stock option provisions is far from clear.

It is true that the statute contains provisions dealing with modification of stock options, which were apparently designed to make it impossible to substitute a new lower price for the original higher price specified when the option was granted. But this provision is largely negated by the authority also given in the statute for options with variable prices. It is negated, too, by the simple device of leaving the old option outstanding and granting new options to the favored employees at the new reduced price. This latter arrangement may present certain problems from the point of view of corporation law, but these problems do not seem to have been insuperable in many cases where new options have been granted in recent years.

7 Do they cost anything?

There is a sort of general assumption that stock options do not cost the stockholders anything. No money is paid out by the corporation. Indeed, the corporation receives money, in the amount of the stock option price. To conclude, however, that the benefit received by the employee on the exercise of the options costs nothing to anyone would clearly be most unsophisticated. It does not take much analysis to show that the exercise of the option at a bargain price does necessarily involve a dilution of the stock and thus direct cost for each shareholder in exactly the same amount as in the case of a corresponding salary payment. This cost may in fact be very great in the aggregate.

Indeed, the economic cost to the shareholders as a group may be far more than they would sustain from a direct salary payment in the same amount. Such a salary would, among other things, be deductible by the corporation on its tax return, and would thus reduce the corporation's taxes. But the issuance of stock pursuant to a stock option gives no tax benefit to the corporation, even though the market value of the stock may be far greater than the option price. This is true even in the cases where options are

granted at prices between eighty-five and ninety-five percent of market value where there is a tax due from the holder, at ordinary income rates, on disposition of the stock.

In this respect, stock options may be most insidious, for they may involve a substantial cost to the shareholders of which they are largely unaware. It is true that the granting of stock options is usually authorized by shareholders at a stockholders meeting. But shareholders rarely know much about the exercise of stock options, and in particular, they are given little direct information as to the actual amount of benefit derived from such exercise, either with respect to individual employees, or in the aggregate. There are some corporations whose stock comes to a certain plateau, and rarely rises much above that. Some security analysts believe that this is due to the very large amount of stock options outstanding. In such cases, the costs to the shareholders may be very heavy indeed, and far more than they may ever realize. It seems odd that such hidden costs should be fostered by our tax laws, and tolerated by our properly strict security laws.

Indeed, we should know much more about stock options, and their use, the extent of the benefits derived, and the cost to shareholders. In addition to tax information, the Security and Exchange Commission should require that detailed information about stock options should be furnished to shareholders, not only on the authorization of such options, but on their issue, and, especially, on their exercise.

As a matter of fact, we now have such things as stockless stock options, sometimes called phantom stock options, or "shadow plans." In these arrangements, there is no stock at all, but an account is opened for the employee, and he is credited with a certain amount of stock at an advantageous price. Stock may never be issued; or, it may eventually be issued at the time of retirement or withdrawal from the company These plans do not involve the same consideration as those raised by true stock option plans. Yet, they are direct offspring of the stock option arrangement and show the extent to which developments in this area are possible. When we really know more about stock options, we might find that their use is justified, perhaps on a more limited or less discriminatory basis, particularly with closely held companies, where they are not especially useful now We

might also find that a very large amount of benefit has been going, tax free, to an already relatively wealthy class, and that stock options have in fact been the basis upon which a considerable number of modern great American fortunes are being founded, often at the expense of relatively small stockholders in publicly held companies. The establishment of such fortunes is not necessarily bad in itself. However, if it is sharply discriminatory, it raises questions as to why some segments of the population should have tax free income while others pay high rates of tax on much smaller incomes. It is clear that the problem would be greatly reduced if tax rates generally could be lowered. It might well be that one sound and effective way to achieve that end would be to eliminate the escape from taxation of a large amount of income, essentially compensatory in nature, derived through stock options.