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A TALE OF TWO DICTA: THE NON-RESTRICTED STOCK OPTION

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ABOUT THE VIEWPOINT OF THE AUTHOR

Capital gains are taxed less than ordinary income,[1] and the greater part of the tax law concerning stock options flows from that simple proposition. Congress has seen fit to assure capital gains treatment for certain "restricted" stock options granted to employees;[2] the richly-deserved criticism of that legislation will be left to others[3]—our concern is with those whom Congress has not seen fit to bless.

It is the position of this author that the courts and administrative officials should not permit capital gains treatment to the optionee, or to his transferees at less than arm's length, until the non-restricted[4] stock option transaction is "closed" in a comprehensive sense, *i.e.*, until the optionee has no further interest in the option, or the optionee has irrevocably made the complete investment called for by the option and all conditions affecting value, which arise at or from the grant or exercise of the option, have terminated. Implicit in such a proposal is the possibility of taxing each event which increases the value of the option until the transaction is thus closed, even if the same transaction consequently results in ordinary income to the optionee on two or more occasions. Thereby, these gains from performing services will be taxed as ordinary income, as are other forms of compensation for services, congressional largesse aside; this is as it should be.

I. DEATH OF AN ANCESTOR

Once upon a time—but these words, "once upon a time," are the very heart of our story, and we shall return to them in due course. First, let us go back to a tax distinction of yesteryear, for today's quest to secure capital gains treatment from stock option transactions had an illustrious ancestor, a hardy one whose death required two decisions of the United States Supreme Court. Since those Supreme Court decisions also gave birth to the two dicta which people our tale, we shall not go astray with a brief biography of that ancestor—the proprietary stock option.

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1. INT. REV. CODE OF 1954, §§ 1201-02.

2. INT. REV. CODE OF 1954, § 421.

3. *E.g.*, Griswold, *The Mysterious Stock Option*, in 2 TAX REVISION COMPENDIUM 1327 (1959).

4. References in the text after this point to stock options will mean non-restricted stock options unless otherwise indicated.

The early life of this stock option, beset by a generally unfriendly Commissioner and Board of Tax Appeals, but protected by the federal circuit courts, has been narrated elsewhere.[5] In 1938, the Board of Tax Appeals itself recognized a distinction between an option given as compensation and an option given to afford the employee a "proprietary interest" in the business of the employer; it was held that the amount of the spread[6] at exercise was not automatically compensation.[7] Not only did the Commissioner acquiesce in this decision,[8] but the regulations were amended to recognize the distinction:

> If property is transferred . . . by an employer to an employee, for an amount substantially less than its fair market value, regardless of whether the transfer is in the guise of a sale or exchange, such . . . employee shall include in gross income the difference between the amount paid for the property and the amount of its fair market value *to the extent that such difference is in the nature of (1) compensation for services rendered or to be rendered* . . . .[9]

Of course, a distinction implies two possibilities, and on occasion the courts found as a matter of fact that the controlling intention was to give additional compensation.[10] It was the case of *Commissioner v. Smith*[11] that first brought the distinction to the attention of its ultimate dispatcher, the Supreme Court.

Smith received from his employer an option to acquire stock of another corporation at the fair market value at the time of the grant. The Tax Court applied the distinction between proprietary and compensatory options and found that the option was intended as compensation; the Court of Appeals for the Ninth Circuit reversed. Reversing the Court of Appeals and upholding the Tax Court, the Supreme Court found that the intended compensation was as of the time of exercise of the option, since there was apparently no benefit at the time of grant.

The implication was that there must be compensation at some time, and the Commissioner seized the opportunity to let the proprietary stock option have "both barrels." The regulations quoted above were amended significantly: "[t]he difference between the amount paid for the property and the amount of its fair market value *is in the nature of compensa-*

5. See generally Leake & Gleeson, *The Unrestricted Stock Option*, in TAXATION OF DEFERRED EMPLOYEE AND EXECUTIVE COMPENSATION 621, 623-24 (Sellin ed. 1960).

6. The difference between the option price and the market value.

7. Delbert B. Geeseman, 38 B.T.A. 258 (1938).

8. 1939-1 CUM. BULL. 13.

9. T.D. 4879, 1939-1 CUM. BULL. 159, as incorporated in Treas. Reg. 111, § 29.22(a)-1 (1943). (Emphasis added.)

10. *E.g.*, Connolly's Estate v. Commissioner, 135 F.2d 64 (6th Cir. 1943) (grant of options accompanied by reduction of salaries).

11. 324 U.S. 177, *rehearing denied*, 324 U.S. 695 (1945).

tion and shall be included in the gross income of the employee . . . ."[12] A simultaneous ruling on employee stock options announced that all such options were taxable on the spread when exercised or transferred.[13]

At least one court recognized that the proprietary stock option was a condemned distinction.[14] Other decisions, however, breathed life into the champion of capital gains.[15] Again, the victories were Pyrrhic, leading only to the Supreme Court and the final denouement there, in *Commissioner v. LoBue.*[16]

LoBue received from his employer a non-transferable option to buy stock at five dollars per share; it was worth more when he exercised it and his employer deducted the spread at the time of exercise. However, the Tax Court found a proprietary option not taxable to the employee at exercise, and the Court of Appeals for the Third Circuit affirmed. In reversing, the Supreme Court pronounced the distinction between proprietary and compensatory stock options dead for lack of statutory support.[17] Neither legal technicality[18] nor equitable plea[19] has been sufficient to revive the ghost.

II. An Introduction to the Times

Having buried the proprietary stock option, we turn again to the classical opening words of the storyteller, "once upon a time." These words have a special significance in this tale, however; by splitting the phrase thus:

Once
Upon a time,

12. T.D. 5507, 1946-1 Cum. Bull. 18. (Emphasis added.) The regulations as amended, subsequently became Treas. Reg. 118, § 39.22(a)-1(c) (1953).

13. I.T. 3795, 1946-1 Cum. Bull. 15. Both regulations and the ruling were made applicable to options granted on or after February 26, 1945, the date of the *Smith* decision. Options granted earlier were excluded by the ruling if the spread at grant was "substantial" (a term further defined in the ruling) or if the grant was clearly income under prior regulations, and the employee and employer promptly consented to limit the employee's basis to the amount paid for the stock and to forego any deduction by the employer. There was some doubt that requiring consent was within the power of the Commissioner. Malcolm S. Clark, 9 CCH Tax Ct. Mem. 719 (1950) (dictum).

14. Van Dusen v. Commissioner, 166 F.2d 647 (9th Cir. 1948).

15. Commissioner v. Straus, 208 F.2d 325 (7th Cir. 1953); Robert A. Bowen, 13 CCH Tax Ct. Mem. 668 (1954); Malcolm S. Clark, 9 CCH Tax Ct. Mem. 719 (1950).

16. 351 U.S. 243 (1956).

17. The statute interpreted by the Court, Int. Rev. Code of 1939, § 22(a), 53 Stat. 9, included in gross income "gains or profits and income derived from any source whatever." The Court, noting that the definition is broad, found no applicable exemption, "gifts" being the only exemption conceivably relevant. There appears to be no reason to draw a different conclusion from the present statute, which includes in gross income "all income from whatever source derived." Int. Rev. Code of 1954, § 61(a).

18. *E.g.*, Robert C. Enos, 31 T.C. 100 (1958) (compensation to employee upon cancellation effected by repurchase from employee and related transferee).

19. *E.g.*, William S. Thornhill, 37 T.C. 988 (1962) (compensation to original owner-employees upon exercise of option granted to permit acquisition of control after repayment of investors).

we analyze at a stroke the current quest for capital gains via stock options.[20] For if the transactions involving the transfer of stock to the employee can be taxable as compensation only once, and if the time of taxability can be controlled by the taxpayer, the stock option remains a vehicle for tax avoidance by capital gains treatment.

Our story is not concerned with the avoidance by an employee whose employer deducted the spread at time of exercise and is now apparently protected by the statute of limitations[21] or by a change in the applicable law.[22] Nor do we bother with taxpayers who have successfully claimed taxability in an earlier year in which they did not report the compensation.[23] Rather, presuming proper application of the law, we will describe and evaluate the history of the law determining the time of taxing the compensation element; as we will see, the extent of the compensation element has generally been dependent on the timing.

III. *Smith*—The First Dictum

Even before the *Smith* decision[24] cast a funereal pallor over the visage of the proprietary stock option, the issue of timing the taxability of any compensation element had reared its elusive head. The Commissioner had long and steadfastly taxed as compensation the spread at time of exercise, if any.[25] Courts which found proprietary stock options

20. There was some concern that § 53, Technical Amendments Act of 1958, 72 Stat. 1644, was intended to reject out of hand capital gains treatment of the disposition of an option by adding § 1234(c) to the 1954 Internal Revenue Code, reading in part as follows (§ 1234 generally accords options the same treatment as the property to which they relate):

> (c) Non-Application of Section.—This section shall not apply to . . . (2) in the case of gain attributable to the sale or exchange of a privilege or option, any income derived in connection with such privilege or option which, without regard to this section, is treated as other than gain from the sale or exchange of a capital asset.

Helping to engender the concern was the general explanation in a committee report: "As a result, the section will not apply to gain from the sale of an employee stock option which is in the nature of compensation to the employee." S. Rep. No. 1983, 85th Cong. (1958) (comment on § 57 of H.R. 8381).

However, the technical explanation in the same report is less alarming:

> Under this exception, for example, *to the extent that* gain on the sale or exchange of an option to purchase stock is in the nature of compensation to an employee, such gain is not to be treated as capital gain *merely because the stock, if acquired, would be a capital asset in his hands.* (Emphasis added.)

The regulations apparently concede that the law otherwise in effect has remained unchanged:

> Section 1234 does not apply to gain resulting from the sale or exchange of an option . . . . To the extent that the gain is in the nature of compensation (see sections 61 and 421, and the regulations thereunder, relating to employee stock options). Treas. Reg. § 1.1234-1(e)(1) (1959).

21. *E.g.*, Robert A. Bowen, 13 CCH Tax Ct. Mem. 668 (1954).

22. *E.g.*, Union Chem. & Materials Corp. v. United States, 296 F.2d 221 (Ct. Cl. 1961). See note 60 *infra* and accompanying text.

23. *E.g.*, Colton v. Williams, 209 F. Supp. 381 (N.D. Ohio 1962) (option taxable at grant); Commissioner v. Estate of Ogsbury, 258 F.2d 294 (2d Cir. 1958) (option exercised on giving prepayable note); *cf.* Commissioner v. LoBue, 351 U.S. 243 (1956) (remanded to determine whether or not option was exercised upon giving note).

24. Note 11 *supra.*

25. Commissioner v. LoBue, 351 U.S. 243, 249 & n.9 (1956).

tended to tax any compensation element at the time of grant to the extent of the spread at that time;[26] but a compensatory stock option was taxed as the Commissioner had proposed.[27] In a rising stock market, the effects of such timing and of the proprietary distinction were parallel and not always clearly separated.

But the separate factor of timing drew new strength from the setbacks dealt proprietary stock options by *Smith* and by the Commissioner's rulings following *Smith.* True, Congress reacted to afford some protection for capital gains treatment of employee stock options,[28] but this was limited to certain "restricted" non-transferable options granted to employees at a price of at least eighty-five per cent of market value at the time of the grant and with no deduction for the employer.[29] Those who could not work within these limitations, those who still attributed validity to the "proprietary" distinction, and those who were saddled with existing options (or the stock or proceeds thereof) continued to litigate.

Commissioner v. Smith has been described earlier; so much for its holding. Today, however, it looms larger for one dictum: "It of course does not follow that in other circumstances not here present the option itself, rather than the proceeds of its exercise, could not be found to be the only intended compensation."[30] It will be recalled from the facts of the *Smith* case that the option price was equal to the market value at the time of grant; also, as reflected in the opinion denying rehearing,[31] it appears that the stock could not be delivered until certain indebtedness of the issuing corporation to third parties was paid. There was room to infer that a freely exercisable option, with a spread at grant, would have been taxed as compensation at grant, and at grant only.

Faced with the loss of the proprietary stock option, taxpayers found much solace in the dictum and, for a while, some help. Even a court applying *Smith* broadly to wipe out proprietary stock options paid enough deference to the dictum only to find it inapplicable.[32] Then, in *McNamara v. Commissioner,*[33] the court limited compensation to the spread at grant

26. Omaha Nat'l Bank v. Commissioner, 75 F.2d 434 (8th Cir. 1935); *cf.* Merhengood Corp. v. Helvering, 89 F.2d 972 (D.C. Cir.), *cert. denied,* 302 U.S. 714 (1937) (presumption of no income at grant from failure to report on return); Rossheim v. Commissioner, 92 F.2d 247 (3d Cir. 1937) (option price approximately equal to value at grant).

27. Connolly's Estate v. Commissioner, 135 F.2d 64 (6th Cir. 1943).

28. Int. Rev. Code of 1939, § 130A, as added by Revenue Act of 1950, § 218(a), 64 Stat. 942 (now INT. REV. CODE OF 1954, § 421).

29. *Ibid.* The 1954 provision allows a variable price, within somewhat complex limits. See generally Schlesinger, *Selected Problems in the Use of Restricted Stock Options,* 36 TAXES 709 (1958).

Another limitation prohibits any substantial restriction on the ownership of stock transferred to an employee. *Cf.* Rev. Rul. 54-467, 1954-2 CUM. BULL. 207.

30. 324 U.S. 177, 182 (1945).

31. 324 U.S. 695.

32. Van Dusen v. Commissioner, 166 F.2d 647 (9th Cir. 1948).

33. 210 F.2d 505 (7th Cir. 1954).

of an assignable option priced below market; the *Smith* dictum was relied on squarely. In *Commissioner v. Stone's Estate*,[34] the court gave the taxpayer capital gains treatment on the appreciation from the time of the grant to the sale of warrants by finding compensation at the grant of transferable warrants priced a little above market; the *Smith* dictum again was relied upon squarely.[35] In both cases, the employer deducted and the employee reported as income the value, as they saw it, of the rights at the time of grant; this was no doubt of special importance in *Stone's Estate*, since there was no spread at the time of grant on which to base value. Thus, although *Smith* was a victory for the Commissioner, an imposing body of law favoring the taxpayer was built upon the dictum in *Smith*; but it was only the first dictum of our tale.

IV. *LoBue*—The Second Dictum

LoBue[36] represented another big victory for the Commissioner in the stock option area. Proprietary stock options were no more. Taxation as ordinary income of the spread at the time of exercise was upheld, at least in the case at bar.[37] But in the midst of ordinary income, we find capital gain possibilities, by virtue of this dictum:

> It is of course possible for the recipient of a stock option to realize an immediate taxable gain. See Commissioner v. Smith, 324 U.S. 177, 181-182. The option might have a readily ascertainable market value and the recipient might be free to sell his option. But this is not such a case. These three options were not transferable[8] [8. Cf. McNamara v. Commissioner, 210 F.2d 505.] and LoBue's right to buy stock under them was contingent upon his remaining an employee of the company until they were exercised.[38]

While the last sentence of text quoted is not part of the dictum, it is included to show the puzzling citation of *McNamara*; that case did not limit taxability at grant to options having "a readily ascertainable market value." Neither did *Smith*, cited in the *LoBue* dictum; and the *Smith* dictum apparently cited refers to the possibility of compensation taxable at the grant being the *only* compensation.

Two justices dissenting[39] in *LoBue* argued that the taxable event was the grant with respect to two of the options which the dissent under-

34. 210 F.2d 33 (3d Cir. 1954).

35. Nevertheless, the Court of Claims recently characterized *Stone* as a decision based upon principles rejected by the Supreme Court in *LoBue*. Union Chem. & Materials Corp. v. United States, 296 F.2d 221 (Ct. Cl. 1961) (granting Stone's employer a deduction for the appreciation from grant to sale).

36. Commissioner v. LoBue, 351 U.S. 243 (1956).

37. However, the case was remanded to determine when the option was exercised in light of the fact that a note was given sometime before the transfer of the stock.

38. Commissioner v. LoBue, 351 U.S. 243, 249 (1956).

39. *Id.* at 250.

stood to be unconditional.[40] The taxation at grant was said to prevent a division of the total profit between ordinary income and capital gain "dependent solely upon the fortuitous circumstances of when the employee exercises his option."[41] This example was given:

> Suppose two employees are given unconditional options to buy stock at $5, the current market value. The first exercises the option immediately and sells the stock a year later at $15. The second holds the option a year, exercises it, and sells the stock immediately at $15. Admittedly the $10 gain would be taxed to the first as capital gain; under the Court's view, it would be taxed to the second as ordinary income because it is "compensation" for services. I fail to see how the gain can be any more "compensation" to one than it is to the other.[42]

The contention and the example failed to note an important distinction—the second employee did not make his commitment until the stock reached fifteen dollars.[43]

Such law as was initially created on the basis of the *LoBue* dictum was mostly non-judicial. However, in one case taxing the exercise of an unassignable stock option, although delivery of the stock was delayed until it was paid for, the court likened the right to secure the delivery of the stock to the receipt of an assignable stock option, terming each the "unrestricted use of a valuable economic right."[44] More predictably, it was held that an option requiring six months' employment before exercise had no ascertainable value at grant.[45]

Meanwhile, in November of 1956, the Commissioner proposed regulations which made no provision for options taxable as compensation at grant.[46] After more than two years and some changes in other respects, these became final regulations.[47] However, since then, possibly in response to vigorous criticism,[48] the regulations were amended to provide that an employee has compensation at grant if the option has "a readily ascertainable market value."[49] We recognize, of course, that the phrase quoted is from the *LoBue* dictum, and it is about this phrase that the battle presently rages.

The regulations purport to describe "readily ascertainable market value." Ordinarily, there shall be none "unless the option is actively traded

40. *Id.* at 252.
41. *Id.* at 251.
42. *Id.* at 251-52, n.2.
43. See *Grisswold, supra* note 3, at 1330-31.
44. Commissioner v. Estate of Ogsbury, 258 F.2d 294 (2d Cir. 1958).
45. Robert C. Enos, 31 T.C. 100 (1958).
46. Proposed Treas. Reg. § 1.421-6, 21 Fed. Reg. 8774.
47. T.D. 6416, 1959-2 CUM. BULL. 126.
48. *E.g.*, Leake & Gleeson, *op. cit. supra* note 5, at 635-36.
49. Treas. Reg. § 1.421-6 (1961), as amended, T.D. 6540, 1961-1 CUM. BULL. 161.

on an established market."[50] If the option is not so traded, the taxpayer must show that the option is freely transferable, exercisable immediately in full, free of restrictions having a significant effect on its value (other than liens or conditions to secure its price[51]) and accurately valued.[52] Accurate valuation requires ascertaining the value of the property optioned, the length of the period the option is in force, and the probability of increase or decrease in the value of the property.[53]

Time factors enter into the valuation "irrespective of whether there is a right to make an immediate bargain purchase of the property."[54] This is explained as follows:

> The option privilege is the opportunity to benefit at any time during the period the option may be exercised from any appreciation during such period in the value of the property subject to the option without risking any capital. Therefore, the fair market value of an option is not merely the difference which may exist at a particular time between the option price and the value of the property subject to the option but also includes the value of the option privilege.[55]

It has been urged that the regulations are invalid in requiring that the non-traded option be exercisable immediately in order for there to be compensation at grant.[56] Perhaps this requirement was designed to discourage employers by facing them with the prospect of immediate dilution of stock at a price somewhere below market while having no hold on the employee (and, in many cases, the immediate cost of at least a simplified registration under the Securities Act of 1933); however, the regulations quoted above indicate that a spread at grant is not necessary to valuation at grant and the cases bear this out.[57] Often, the employer can risk immediate exercise if the option price is at or above market value at the time of the grant.

50. Treas. Reg. § 1.421-6(c)(2) (1961).

51. Presumably any restrictions dischargeable at will by the transferee are also irrelevant. See Commissioner v. Estate of Ogsbury, 258 F.2d 294 (2d Cir. 1958).

52. Treas. Reg. § 1.421-6(c)(3) (1961).

53. *Ibid.*

54. Treas. Reg. § 1.421-6(c)(3)(ii) (1961).

55. *Ibid.*

56. Lefevre, *Nonrestricted Stock Options*, N.Y.U. 20TH INST. ON FED. TAX. 353, 364 (1962); Zarky, *The Tax Incidents of Non-Restricted Stock Options*, U. SO. CAL. 1962 TAX INST. 625, 632-33.

57. Commissioner v. Stone's Estate, 210 F.2d 33 (3d Cir. 1954) (warrants at price over market held to have value at grant); Colton v. Williams, 209 F. Supp. 381 (N.D. Ohio 1961) (value includes "lead" value of option). *Contra*, Union Chem. & Materials Corp. v. United States, 296 F.2d 221 (Ct. Cl. 1961) (testimony on value insufficient in face of market value below option price); see Willie L. McNatt, 31 P-H Tax Ct. Mem. 600 (1962), *aff'd on other grounds sub nom.* Frank v. Commissioner, 321 F.2d 143 (8th Cir. 1963) (lack of value indicated by contemporaneous sales below option price). See also Fleischer & Meyer, *Tax Treatment of Securities Compensation: Problem of Underwriters*, 16 TAX L. REV. 119, 145 n.133 (1960).

Since the promulgation of the regulations based on the *LoBue* dictum, some cases have continued to turn on market value,[58] but two relevant decisions have been handed down.[59] They both deal with proof of value of the option at grant; they seem to apply different tests, as well as reaching different results. The opinions are extensive and some discussion of each is warranted, at least until the passage of time relegates them to historical importance.

First was *Union Chem. & Materials Corp. v. United States*,[60] a 1961 Court of Claims decision. Earlier we discussed *Commissioner v. Stone's Estate*,[61] in which the court found compensation at the time of the grant and capital gains on the appreciation thereafter. In *Union Chem.*, the issue was whether or not Stone's employer was entitled to a deduction at the time Stone sold the warrants based on their value then. Recognizing that the rule in *Stone's Estate* would require disallowance of the deduction, the Court of Claims reasoned that *LoBue* had changed the law and established a new test—"readily ascertainable market value." Furthermore, the new test was strictly applied. Direct testimony of experts as to the approximate value of the warrants at grant was held to prove only that the warrants were valuable but not that they had readily ascertainable market value; the deduction was allowed as of the sale of the warrants. Such technical strictness was bound to incur criticism;[62] but, although the regulations were not mentioned, their tough requirements gained strong support.[63]

In 1962, a federal district court in Ohio decided the second case, *Colton v. Williams*.[64] After finding that the option itself was intended as compensation, and citing *McNamara*[65] as authority for rejecting a theory of estoppel based on the failure to report compensation in the year of grant,[66] the court moved to the question of value—"present value." A recent public offering had sold at three dollars per share while the option price was three dollars and twenty-five cents; but the court noted that the offering was oversubscribed and chose to believe testimony that the

58. *E.g.*, Champion v. Commissioner, 303 F.2d 887 (5th Cir. 1962) (remanded to determine fair market value applying blockage rule); Elsie L. Dees, 31 P-H Tax Ct. Mem. 915, 928 (1962) (Issue 2).

59. Union Chem. & Materials Corp. v. United States, 296 F.2d 221 (Ct. Cl. 1961); Colton v. Williams, 209 F. Supp. 381 (N.D. Ohio 1961).

60. Union Chem. & Materials Corp. v. United States, *supra* note 59.

61. 210 F.2d 33 (3d Cir. 1954).

62. Comment, *Taxation of the Stock Option as Intended Compensation*, 9 U.C.L.A. L. REV. 703, 716-18 (1962). The commentator found the decision "irreconcilable" with *LoBue* since the warrants were freely transferable and their value was "calculated." *Id.* at 717. Of course, as this entire tale is designed to emphasize, the conflict, if any, is with the *LoBue dictum*, not with its *holding*.

63. Tyre, *Non-restricted Stock Option "Loophole" Spotlighted by Recent Decision*, 16 J. TAXATION 272 (1962).

64. 209 F. Supp. 381 (N.D. Ohio 1961).

65. Commissioner v. McNamara, 210 F.2d 505 (7th Cir. 1954).

66. See note 23 *supra* and accompanying text.

actual value at grant, two months after the offering, was three dollars and seventy-five cents and that the value of the option privilege itself, the "lead," was an additional fifty cents. In passing, the court disapproved of the arbitrary effect of limiting the value to the spread, if any, at the time of grant.[67] *Smith* was cited,[68] but not *LoBue*; but it is really the *LoBue* dictum that was given its most recent judicial treatment in the following passage discussing the regulations (quoted at length because of its current interest):

> Moreover, Treasury Regulation § 1.421-6(c)(3)(ii) provides that the fair market value of an option includes the value attributable to the option privilege irrespective of whether there is a right to make an immediate bargain purchase. We are not presently concerned with whether this provision dispenses with the present value theory (supra). We cite the section to support our finding that the option at the time of its granting had a value per share of $1.00, which includes the factor of percentage "lead."
>
> The Government repeatedly calls our attention to this Treasury Regulation, and insists that the option has no value includible in income for the year of 1951 because it does not have a readily ascertainable fair market value. It is quite true as the plaintiff contends that the Regulation does not find specific support in the case law in all its particularities, but we do not find it necessary to express a disinclination to follow the Regulation. The option under consideration appears to conform to a reasonable interpretation of the conditions imposed by the Regulation.
>
> First, we note that there is no requirement that the stock be actively traded on an established market, indicating, it would seem, that the benefits of the section are not to be limited to the larger corporations. Under Section 1.421-6(c)(3)(i), the sole requirement is that the option have a readily ascertainable fair market value, which means that it can be measured with reasonable accuracy. Now, unless the previous dispensation that the stock need not be actively traded on an exchange means nothing, there would appear to be no other reliable means of proof except the sort of testimony heard in this trial. We have the objective fact that the taxpayer was to receive this option "in lieu of all present incentive payments." In addition, there was the evidence of the successful public offering. Finally, there was the expert testimony of an informed broker. More evidence would border on being merely cumulative, especially when any evidence against the fact of the option having a value was absent.
>
> Therefore, consequent to our finding that the option had value

67. Colton v. Williams, 209 F. Supp. 381 (N.D. Ohio 1961) (dictum).
68. *Ibid.*

> and was income in the year of 1951, we find that Regulation 1.421-6 supports the position of the plaintiff taxpayer.[69]

V. A SHORT INTERLUDE ABOUT TWO HOLDINGS

Now we digress from the apparent mainstream of our story to a matter which, to this author, seems completely bound up with the same quest for capital gains treatment. This is the matter of restricted stock, *i.e.*, stock subject to restrictions affecting its transfer or the realization of its value.

It was early held that restrictions on the stock acquired would reduce its value, and therefore, the compensation at acquisition of the shares.[70] Aside from compensation, there are a number of cases that have decided whether or not particular restrictions prevented determination of fair market value.[71] In the field of compensatory stock options, however, two cases stand out.[72]

In *Robert Lehman*,[73] the taxpayer and the Commissioner agreed that the restrictions on the shares acquired by the taxpayer prevented the ascertainment of fair market value. The Commissioner sought to tax as ordinary income the spread between cost and market value when the restrictions lapsed. The Tax Court squarely rejected that proposal with this comment:

> [The Commissioner] cites a number of cases holding that no income is realized when the shares are received subject to restrictions which preclude ascertainment of fair market value but none holding that compensation is received or a taxable event

69. *Id.* at 382. The unreported conclusions of law of the district court indicate that the four requirements of the regulations (transferability, immediate full availability, lack of significant restrictions and readily ascertainable value) were considered fulfilled. Alfred, *Current Problem Areas in Income Taxation*, 14 W. RES. L. REV. 217, 227 n.54 (1963).

70. Helvering v. Salvage, 297 U.S. 106 (1936), *affirming*, 76 F.2d 112 (2d Cir. 1935). Some of the shares acquired at $100 per share, a price far below their value, were subject to an option of the employer to repurchase at the same low price. Both courts used strong language with respect to the valuation of these shares:

> Until the option expired in subsequent years, the market value of the shares subject to it could scarcely exceed the price at which the company could repurchase them . . . . 76 F.2d at 114.
>
> Considering the option to repurchase at par, outstanding in 1922, there could be no proper finding of fair market value at that time in excess of $100 per share. 297 U.S. at 109.

71. See generally Kempler, *Non-Restricted Stock Option Plans: Kuchman and Lehman Cases*, 16 TAX L. REV. 339, 341 (1961). For two recent cases on restricted securities, see Arc Realty Co. v. Commissioner, 295 F.2d 98 (8th Cir. 1961) (Issue 1) (securities valued despite restrictions) and Mailloux v. Commissioner, 320 F.2d 60 (5th Cir. 1963) (valuation of speculative stock required to reflect restriction).

72. Harold H. Kuchman, 18 T.C. 154 (1952); Robert Lehman, 17 T.C. 652 (1951). A third case, MacDonald v. Commissioner, 230 F.2d 534 (7th Cir. 1956), suggests two types of restrictions: an understanding that retention of stock is required to retain one's job, and a liability under the Securities Exchange Act of 1934 to return to the corporation any profits on sale of the stock.

73. 17 T.C. 652 (1951).

takes place when the restrictions terminate and fair market value can be determined.[74]

In *Harold H. Kuchman*,[75] the taxpayer was an executive and stockholder who received the right to buy shares at five dollars each with the restrictions that he could not sell for one year and, that if his employment terminated within one year, the seller (the underwriter) could repurchase at five dollars per share. The Commissioner contended that the taxpayer was taxable upon exercise of the right, but the Tax Court, four judges dissenting, held there was no ascertainable fair market value at acquisition of the stock and there could be no income on the receipt of stock costing five dollars per share if the only possible sale was at five dollars per share. The Commissioner acquiesced.[76]

When the Commissioner issued the previously mentioned regulations in 1959,[77] he adopted the *Kuchman* case with these special features:

(a) Exercise of the option would not be the taxable event, if the "property is subject to a restriction which has a significant effect on its value"; the taxable event would be the earlier of the lapse of the restriction or the disposition of the property at arm's length.[78]

(b) The amount of compensation in case (a) would be the lesser of the spread at the time of the taxable event or the spread at the time of acquisition of the property (valuing the property without regard to the restriction).[79]

The first feature is an expansion of *Kuchman*, deferring taxation if the restriction merely has a "significant effect on value"; apparently the Commissioner is resigned to having only one bite at the ordinary-income apple and does not want to eat while there is a big restriction running through the fruit.[80] The second feature is probably a response to the concern of the Tax Court in *Lehman* about using fortuitously high values upon lapse of restrictions to measure compensation;[81] since *Lehman* was obviously rejected otherwise,[82] the acquiescence in that decision was withdrawn a few months later.[83]

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74. *Id.* at 654.

75. 18 T.C. 154 (1952).

76. 1952-2 CUM. BULL. 2.

77. Treas. Reg. § 1.421-6 (1959), as added by T.D. 6416, 1959-2 CUM. BULL. 126.

78. Treas. Reg. § 1.421-6(c)(2)(i) (1959), now Treas. Reg. § 1.421-6(d)(2)(i)(1961).

79. *Ibid.*

80. *But cf.* Kempler, *supra* note 71, at 349.

81. Lefevre, *supra* note 56, at 358.

82. Schlesinger, *The Utility and Feasibility of Stock Options in Close Corporations*, in TAXATION OF DEFERRED EMPLOYEE AND EXECUTIVE COMPENSATION 580, 619 (Sellin ed. 1960); Fleischer & Meyer, *supra* note 57, at 138-41.

83. T.I.R. 248, Aug. 29, 1960.

VI. THE CAMP FOLLOWERS

As the quest by employees for capital gains treatment of stock option transactions ran into mounting difficulties, there were vigorous proposals made to disassociate the independent contractors—primarily the underwriters—from the employees,[84] although both may receive stock options as compensation. The treatment of the classification problem by the Commissioner has oscillated unhappily[85] over a period of a little more than seven years.[86] The Commissioner proposed to exclude independent contractors,[87] but then included them[88] and thereafter excluded them.[89] Subsequently, he again proposed to include them[90] but left them excluded.[91] Most recently, and perhaps finally, he has included them.[92] During periods of exclusion, the Commissioner relied on regulations concerning bargain purchases under the general taxing statute[93] mixed with the possibility of future inclusion.[94] Judicial classification has been inclusive in theory but uncertain in practice.[95]

84. Brach & Dixon, *Tax Treatment of Compensatory Stock Options to Non-employees; The Valuation Problem*, 17 J. TAXATION 66 (1962); Fleischer & Meyer *supra* note 57; Webster, *Compensating the Underwriter*, N.Y.U. 21ST INST. ON FED. TAX. 1433 (1963). *Contra*, Tyre, *supra* note 58; see Alexander, *Current Valuation Problems*, U. So. CAL. 1963 TAX INST. 685, 727.

85. See generally Brach & Dixon, *supra* note 84, at 66-68, 70. When announcing the latest proposal, the Commissioner indicated that special efforts would be made to settle pending cases because the law had been so uncertain. T.I.R. 490, July 11, 1963.

86. The first proposal, *infra* note 87, was November 10, 1956; the latest regulations, *infra* note 92, were promulgated December 12, 1963.

87. Proposed Treas. Reg. § 1.421-6, 21 Fed. Reg. 8774 (1956).

88. T.D. 6416, 1959-2 CUM. BULL. 126.

89. T.D. 6481, 1960-2 CUM. BULL. 159.

90. Proposed Treas. Reg. § 1.421-6, 25 Fed. Reg. 12414 (1960).

91. T.D. 6540, 1961-1 CUM. BULL. 161.

92. T.D. 6696, 1963 INT. REV. BULL. No. 52, at 9, adding Treas. Reg. § 1.61-15 (regulations 1.421-6 made applicable to independent contractors). However, lenders will not be affected pending new proposed regulations concerning their options, T.I.R. 526, Dec. 12, 1963, an exception of increased importance because of federal legislation favoring Small Business Investment Companies. See 20 J. TAXATION 79 (1964).

93. Rev. Rul. 2-49, 1962-1 CUM. BULL. 13, relying on Treas. Reg. § 1.61-2(d)(2) (1957). Predecessor regulations go far back. Brach & Dixon, *supra* note 84, at 66-7. The language was essentially the same, except for the *Smith* changes. Note 12 *supra* and accompanying text. However, the 1959 regulations on non-restricted stock options were made applicable to bargain purchases by employees of any property subject to restrictions having a "significant effect" on its value. Treas. Reg. § 1.61-2(d)(5), added by T.D. 6416, 1959-2 CUM. BULL. 126, which also added Treas. Reg. § 1.421-6 (1959).

94. See Tyre, *supra* note 63, at 274; Lefevre, *supra* note 56, at 370.

95. In Victorson v. Commissioner, 13 Am. Fed. Tax R.2d 425 (2d Cir. Jan. 15, 1964), the appellate court noted the employee regulation deferring taxation when a restriction has a significant effect on value, but held it inapplicable to years before issuance of the regulation; nevertheless, the court noted that new regulations, only thirty-five days old on the date of the opinion, extended the rule to underwriters. 13 Am. Fed. Tax R.2d 427, n.2. Judge Raum, in the Tax Court, had expressly indicated that employee rules should apply. 31 P-H Tax Ct. Mem. 1370, 1378 n.1 (1962). In Willie L. McNatt, 31 P-H Tax Ct. Mem. 600 (1962), *aff'd on other grounds sub nom.* Frank v. Commissioner, 321 F.2d 143 (8th Cir. 1963), the court apparently used employee rules since it cited *LoBue* and *Union Chem.* employee cases. But, in fact, *Victorson* merely determines fair market value despite restrictions depressing value, and *McNatt* measures compensation at exercise and finds none in the

Those who advocate early valuation of rights and stock acquired by non-employees have offered much of value with respect to the desirability[96] and practicality[97] of valuing option rights and even, in many cases, restricted stock. This might be a somewhat biased approach designed to limit the amount of ordinary income and maximize the portion of total profit to receive capital gains treatment; the proponents stand firmly behind the regulations limiting the compensation on restricted stock to no more than the spread at acquisition (disregarding the restrictions).[98] On the other hand, the last-mentioned limitation is ingeniously justified by distinguishing the underwriter from the employee because the underwriter has completed the performance of his services by the time he acquires the stock whereas the employee is expected to continue performing services.[99] The allowance of the distinction is probably a matter of policy, but it would seem that the realities of underwriting often continue to require services of at least an informal nature for many years, particularly in the case of the typical small company forced to cough up stock options in order to interest underwriters.[100]

VII. Epilogue for the Practical

Two main areas of capital gains possibilities remain: compensation only at grant, and restricted stock. For the publicly held corporation, with stock having provable market value, the certainty of capital gains treatment under the statutory scheme[101] probably overrides the possibility of a deduction for the employer and any other advantages of a non-restricted stock option arrangement.[102]

absence of a spread, without discussion of restrictions or pure option value. It is interesting to note that the taxpayer lost both cases: Victorson wanted to defer compensation and McNatt lost capital gains treatment on an alternative theory. Yet the Commissioner has cited these two cases, plus *Smith* and *LoBue*, as authority that the employee rules extend to independent contractors. T.I.R. 490, July 11, 1963.

96. Fleischer & Meyer, *supra* note 57, at 144-45; Webster, *supra* note 84, at 1446-48.

97. Brach & Dixon, *supra* note 84, at 72-3.

98. Brach & Dixon, *supra* note 84, at 73-4; Fleischer & Meyer, *supra* note 57, at 138-41. A limit on compensation may not assure capital gains treatment of further profits. In Walter F. Tellier, P-H Tax Ct. Rep. & Mem. Dec. (P-H Tax Ct. Mem.) ¶ 63,212 (Aug. 14, 1963), the court ruled that the warrants and stock held by the taxpayer were inventory rather than investment property. Therefore, the court did not reach the alternative government argument that the gains represented compensation for underwriting services. The taxpayer curiously and unsuccessfully argued that securities received as compensation could not be part of inventory at the time of resale.

99. Brach & Dixon, *supra* note 84, at 73-74; Fleischer & Meyer, *supra* note 57, at 138-41; Webster, *supra* note 84, at 1447.

100. *Cf.* Alexander, *supra* note 84, at 717. See discussion on "Non-cash Compensation" in SEC, *Special Studies of Securities Markets*, H.R. Doc. No. 95, 88th Cong., 1st Sess. ch. IV (1963) (greater frequency in "best-efforts" underwritings and tendency to appear where rate of cash compensation is highest).

101. Int. Rev. Code of 1954, § 421.

102. *But cf.* Leake & Gleeson, *The Unrestricted Stock Option*, in Taxation of Deferred Employee and Executive Compensation 621, at 622-23 (Sellin ed. 1960). As of this writing, some limitations on the use and benefits of § 421 appear to be in the offing. H.R. 8363, 88th Cong., 2d Sess. § 222 (1964).

For the closely held corporation, however, the picture is different. Restricted stock option benefits are relatively unavailable because the stock cannot be valued with sufficient assurance to know whether or not the statutory requirements are being met.[103] It has been suggested that the valuation problem and another problem important to a close corporation, dilution of control, can be avoided by optioning stock restricted by the reservation to the employer of a right of first refusal at book value; under present law, any increase in book value after exercise would receive capital gains treatment.[104] Unfortunately this seems best adapted to young or dormant corporations for which the proportionate growth of equity may be expected to be large; in other situations there apparently would be a dilemma between (1) a substantial commitment at exercise compared to potential capital gains, or (2) a very low option price, reducing the commitment, but increasing the ordinary income element. Of course, the "book value" restriction will serve to defer taxation until sale of the stock,[105] but this could be achieved more easily by the use of "shadow stock."[106]

Another suggestion is that the taxpayer rely on the tale of two dicta.[107] For the publicly held corporation, as stated before, this would be risking uncertainty principally to secure the deduction for the employer; in fact, the very possibility of such a deduction tends to make arrangements relying on the dicta too good to be true—better than Congress's own gift to the executive.[108] On the other hand, the close corporation, largely unable to use the statute, faces the total inability to value its options, let alone the Commissioner's requirement that the option be capable of precise valuation.

It is a third class of corporation, still unheralded in the law, for whom the tale of two dicta seems to hold potential: the semi-close (or semi-public) corporation, an initially closely held corporation which has sold stock to the public but in which the original principals retain a large stock interest, normally effective control. To prevent further dilution of control, and yet compete for executives,[109] the controlling stock-

103. Schlesinger, *supra* note 82, at 600-11. However, proposed legislation would limit the penalty, if market value is underestimated in good faith, to the inclusion in ordinary income of the lesser of one and one-half times the deficiency or the spread at exercise. S. REP. No. 830, 88th Cong., 2d Sess. 91 (1964).

104. Schlesinger, *supra* note 82, at 612-19; *cf.* Willis, *Non-Restricted Stock Options*, 101 TRUSTS & ESTATES 1146, 1205 (1962).

105. *Cf.* Treas. Reg. § 1.421-6(c)(2)(ii), example (4) (1961).

106. See generally Lentz, *Different Kinds of Stock Bonus Plans* in TAXATION OF DEFERRED EMPLOYEE AND EXECUTIVE COMPENSATION 34, 46-52 (Sellin ed. 1960); Note, *Phantom Stock Plans*, 76 HARV. L. REV. 619 (1963).

107. Leake & Gleeson, *supra* note 102.

108. Comment, *Taxation of the Stock Option as Intended Compensation*, 9 U.C.L.A. L. REV. 703, 710-13 (1962).

109. And directors. See Moore, *Stock Options for Directors in Small Corporations*, 11 CLEV.-MAR. L. REV. 396 (1962).

holders may offer, or have the corporation offer, options on stock which, once acquired, can only be retained while the employment continues.[110] This will secure for the executive the capital gains afforded by the "book value" restriction discussed above but without the early investment, provided that the current and unresolved conflict between *Union Chem.* and the regulations, on the one hand, and *Colton v. Williams*, on the other, is resolved by taxing the approximate value of the option as the only compensation.

VIII. Epilogue for the Philosophical

Suppose that the dictum in *Smith* merely said "the option itself . . . found to be intended compensation" rather than, "the option itself . . . found to be *the only* intended compensation."[111]

Suppose that options were valued at grant if at all possible and that the value was taxed at that time as compensation.[112]

Suppose that additional value received upon exercise of the option (or other bargain purchase of shares), or upon disposition of the option, were also taxed as compensation,[113] unless restrictions on acquired stock totally prevented valuation.[114]

Suppose that *Lehman* were overruled and that the additional value added upon the termination of any restrictions (or upon the earlier disposition of the stock) were also taxed as compensation.[115]

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110. Schlesinger, *supra* note 82, at 612.

111. (Emphasis added.) *Compare* Treas. Reg. § 1.61-2(d)(4) (discount on employer's note to be reported as payments collected), *with* Leake & Gleeson, *supra* note 102, at 634-37.

112. Authorities cited notes 96 and 97 *supra*. See generally Rev. Rul. 58-402, 1958-2 Cum. Bull. 15, 16:

> The amount of the fair market value of property is a question of fact, but only in rare and extraordinary cases will property be considered to have no fair market value . . . . Whether value is ascertainable is a reviewable question of law.

The ruling includes many citations and examples, but none in the stock option area.

The Supreme Court, too, has recently indicated the desirability of current valuation, even if rough, in a marital settlement case. United States v. Davis, 370 U.S. 65, 72-73 (1962). However, it has been suggested that the Court was "influenced by the correlative problem of the wife's basis . . . ." Alexander, *supra* note 84, at 688.

113. *Cf.* Commissioner v. LoBue, 351 U.S. 243, 249 (1956):

> Moreover, the uniform Treasury practice since 1923 has been to measure the compensation to employees given stock options subject to contingencies of this sort by the difference between the option price and the market value of the shares at the time the option is exercised. We relied in part upon this practice in Commissioner v. Smith . . . . And in its 1950 Act affording limited tax benefits for "restricted stock option plans" Congress adopted the same kind of standard for measurement of gains. . . . Under these circumstances there is no reason for departing from the Treasury practice.

114. See Kempler, *supra* note 71, at 349.

115. See Alexander, *supra* note 84, at 731-32; Fleischer & Meyer, *Tax Treatment of Securities Compensation: Problem of Underwriters*, 16 Tax L. Rev. 119, 135-37. It has been suggested that Commissioner v. Estate of Ogsbury, 258 F.2d 294 (2d Cir. 1958) weakens *Lehman* considerably. Fleischer & Meyer, *supra* at 136; Leake & Gleeson, *supra* note 93, at 644.

What problems would arise?

The first is the practical problem of many valuations.[116] A comparison of English and American law on stock options led one writer to conclude that economic gain should be taxed as and when it can be administratively valued.[117] Tending to suggest that valuation is a burdensome administrative task is a recent adherence by the Treasury to its policy of not issuing advance rulings as to valuation.[118] However, it would seem to result in more uniform taxation to move the area of dispute from whether or not valuation is proper to the actual valuation itself.[119]

The second problem involves the appreciation of stock acquired subject to restrictions. Aside from the claim of the underwriters, alluded to earlier, that they are finished performing their services when they acquire the stock, there is the general question of whether or not appreciation after investment should be taxed as ordinary income.[120] As was noted in VII, the investment commitment is a practical bar to capital gains in many cases. Yet, have we not returned again to the problem of taxing compensation at the time and to the extent generally intended—to *Smith*, once removed? Instead of letting an optionee play with a stock option, doing nothing until the market rises, he now gets restricted stock. Tax is deferred until the restrictions lapse; if the market has not risen, his ordinary income will be limited to the value of his bargain purchase (and ordinary income will be reduced if the market falls before lapse[121]).

But if the market goes up, shall ordinary income still be so limited and the balance of profit receive capital gains treatment? As in *Smith* and *LoBue*, the usual intent is to compensate for services with the appreciation, documentary mumbo-jumbo notwithstanding; it is like a cash bonus promised as a "return on investment" if the stock goes up.[122] The restrictions are generally created at the time of, and in connection with, the grant of options or bargain sale of stock as payment for services; certainly the lapse of the restrictions is contemplated then, and the harvest at the time of the lapse should relate back to the payment for services and be taxed as ordinary income.

116. For a chart of the present steps in recognizing income on non-restricted stock options, see Robertson, *Stock Options and Bargain Purchases Should be Reviewed in Present Market Picture*, 19 J. TAXATION 88, 91 (1963).

117. Mullock, *Unconditional Nonqualified Stock Options*, 40 TAXES 860 (1962).

118. Rev. Proc. 62-32, 1962-2 CUM. BULL. 527. *But cf.* note 112 *supra*.

119. Consider the quotation from Revenue Ruling 58-402 at note 112 *supra*.

120. It has been pointed out that this problem concerned the Tax Court in *Lehman* and the Treasury in writing the regulations. Note 81 *supra* and accompanying text.

121. Zarky, *The Tax Incidents of Non-Restricted Stock Options*, U. So. CAL. 1962 TAX INST. 625, 641.

122. *Cf.* William J. Haag, 40 T.C. 88 (June 4, 1963); *appeal docketed*, 8th Cir., Sept. 3, 1963. In the *Haag* case, a controlling shareholder, who had been leasing property to the corporation, sold it to the corporation with an option to repurchase at far less than the value (because the corporation improved the property). Upon repurchase, he again leased the property to the corporation. The court treated the spread on exercise of the option as additional rent to the shareholder.