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CORPORATE PAYMENTS TO STOCKHOLDERS AND EMPLOYEES UNDER THE REVENUE ACT OF 1950

LEO A. DIAMOND*

For a number of years it has become virtually commonplace that federal revenue laws, required under the Constitution of the United States to originate in the House of Representatives,¹ are nearly always enacted substantially as rewritten in the Senate. The Revenue Act of 1950²—the twenty-fifth major revenue revision since the enactment of the Sixteenth Amendment in 1913—is the most recent outstanding and surprising example of the vagaries of the federal legislative process. Introduced on June 22, 1950, with administration support as a bill primarily to reduce excises,³ the Revenue Act of 1950, enacted only three months later on September 23, 1950, wiped out all excise tax reductions proposed by the House of Representatives and substantially increased individual and corporation income tax liabilities. The shift in legislative approach between June and September of 1950 was due entirely to sudden adverse international developments, especially those arising out of the Korean crisis. That crisis had so developed into a threat to the maintenance of world peace that enactment of a bill to reduce excises would have been sheer folly. It is not startling, therefore, that when the Senate version of the Revenue Act of 1950 was introduced on August 22, 1950, the measure was no longer one to reduce excises but, on the contrary, was one to provide substantial additional revenue for the costs of military action in Korea and related defense expenditures. Great as was the popular support for repeal or reduction of most excises left over from World War II,⁴ there was no major opposition to postponement of such repeal or reduction or to the increase in income tax liabilities of both individuals and corporations.⁵

The enactment of the Revenue Act of 1950 constituted a solemn and unmistakable warning that more and heavier tax burdens were to be imposed. That warning was to be found not only in the circumstances which

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1. U.S. CONST. Art. I, § 7.

2. Pub. L. No. 814, 81st Cong., 2d Sess. § 994 (Sept. 23, 1950); 64 STAT. 906.

3. H.R. 8920, 81st Cong., 2d Sess. (1950).

4. In his statement of February 5, 1951, before the Committee on Ways and Means of the House of Representatives, Secretary of the Treasury Snyder said the following:

I know the Committee has special reason to regret the necessity for this action [i.e., of increasing excise taxes]. Only a year ago you were considering the President's recommendation for excise tax reductions. This reversal of the situation is one more measure of the price we must pay for our defense requirements.

5. On the contrary, newspaper and editorial comment generally was surprisingly favorable to delay in excise tax reduction. This is significant since many of these same sources of public opinion were virtually uniformly in favor, in June, 1950, of immediate and substantial excise tax reduction.

gave rise to the final version of the enacted measure but also in a specific mandate contained therein that the Congress was to consider the enactment of an excess profits tax.⁶ That tax has now been imposed by the enactment of the Excess Profits Tax Act of 1950⁷ through the acceleration of the legislative process which surprised everyone, including the legislators themselves. In his Budget message of January 15, 1951, President Truman requested the imposition of further taxes to help produce a budget of \$71½ billions for the fiscal year 1952.⁸ In 1951 there will undoubtedly be a new revenue law embodying a substantial part, if not all, of the presidential recommendation.⁹

To the extent that schedules of tax rates provided for by the Revenue Act of 1950 have already been superseded by subsequent legislation, that Act will have become of historical interest in a surprisingly short period of time. The Revenue Act of 1950 contains in addition, however, many significant changes in substantive provisions which will undoubtedly become permanent features in the administration of federal income tax laws.¹⁰ Some of the changes were made to remove tax deterrents from otherwise orderly sales and liquidations,¹¹ whereas others were effected to prevent

6. Title VII of the Revenue Act of 1950 reads as follows:

§ 701. Excess Profits Tax

(a) The House Committee on Ways and Means and the Senate Committee on Finance are hereby directed to report to the respective Houses of Congress a bill for raising revenue by the levying, collection, and payment of corporate excess profits taxes with retroactive effect to October 1, or July 1, 1950, said bill to originate as required by article I, section 7, of the Constitution. Said bill shall be reported as early as practicable during the Eighty-first Congress after November 15, 1950, if the Congress is in session in 1950 after such date; and if the Congress is not in session in 1950 after November 15, 1950, said bill shall be reported during the first session of the Eighty-second Congress, and as early as practicable during said session.

(b) The Joint Committee on Internal Revenue Taxation, or any duly authorized subcommittee thereof, is hereby authorized and directed to make a full and complete study of the problems involved in the taxation of excess profits accruing to corporations as the result of the national defense program in which the United States is now engaged. The joint committee shall report the results of its study to the House Committee on Ways and Means and the Senate Committee on Finance as soon as practicable.

Until H.R. 9827, 81st Cong., 2d Sess. was introduced on December 2, 1950 as a bill to impose a corporate excess profits tax, there was great uncertainty whether the mandate of Section 701 of the Revenue Act of 1950 would be obeyed by the Congress. Considerable controversy raged in the press and in hearings before the Committee on Ways and Means as to the scope of such mandate, there being much argument, that enactment of an excess profits tax was not automatically and inevitably required. Enactment of the Excess Profits Tax Act of 1950 stilled all such argument.

7. Pub. L. No. 909, 81st Cong., 2d Sess. § 1199 (Jan. 3, 1951.)

8. Daily Report for Executives, January 15, 1951, Bureau of National Affairs, Inc., Washington, D. C.

9. In March, 1951, it is not certain whether all of the \$10 billion increase in taxes requested by the President will be voted by the Congress. International tensions may again be the determining factor.

10. See e.g., Title III of the Act, "Treatment of income of, and gifts and bequests to, certain tax exempt organizations," accentuated by business activities described in Cary, *Corporate Financing Through the Sale and Lease-Back of Property: Business, Tax, and Policy Considerations*, 62 HARV. L. REV. 1 (1948); Cf. *C. F. Mueller Co. v. Comm'r*, 14 T.C. 922 (1950), on taxpayer's appeal to Court of Appeals, 3rd Circuit.

11. E.g., INT. REV. CODE § 207, amending § 112(b) (7) (liquidations); INT. REV.

the draining off of revenue through various forms of tax saving schemes and devices.¹² Consequently, that Act, as a major legislative expansion of federal income tax concepts, will be of lasting importance, despite succeeding revenue enactments. This paper is limited to a summary analysis of some of the more important of such changes, dealing with corporate distributions and stock options to employees.

I. CORPORATE DISTRIBUTIONS

Dividends-Received Credit

Corporations, both foreign and domestic, have been permitted for many years a dividends-received credit of 85% of dividends received from domestic corporations but not in excess of 85% of the recipient's adjusted net income.¹³ The dividends-received credit was founded on congressional policy to refrain from taxing, at least in part, as income to the recipient corporation dividends received from domestic corporations—a form of relief from so-called double taxation of corporate earnings.¹⁴ Permitted originally as a tax-relieving measure, the dividends-received credit was found, however, to open up a loophole,¹⁵ resulting in clearly unjustified tax advantages in the case of certain distributions of property other than cash.

For example, if Corporation A, owning stock in Corporation B, received a cash dividend from B, no problem of tax avoidance is involved if A is permitted a dividends-received credit of 85% of the cash distribution, sub-

CODE § 209, adding § 115(g) (3) (redemption to pay death taxes); INT. REV. CODE § 210, amending § 117(a) (capital gain treatment of artistic property); INT. REV. CODE § 216, adding § 124A (amortization of war facilities).

12. E.g., INT. REV. CODE § 208, adding § 115(g) (2) (redemption of stock by controlled company); INT. REV. CODE § 217, amending § 125 (amortization of premium on convertible bond); INT. REV. CODE § 211, amending § 117 (short sales of capital assets); INT. REV. CODE § 212, amending § 117 (treatment of gain to shareholders of collapsible corporations); INT. REV. CODE § 213, amending § 211 (capital gains of nonresident aliens).

13. Beginning with the Revenue Act of 1921 and continuing through the Revenue Act of 1934, dividends received by a corporation from a domestic corporation were deductible in full from gross income. Section 234(a) (6), Revenue Acts of 1921, 1924, 1926; Section 23(p), Revenue Acts of 1928, 1932, 1934. Beginning with the Revenue Act of 1936 and continuing down to date, the full deduction was disallowed and an 85% credit substituted. See INT. REV. CODE § 26(b), before amendment by Section 122(a) of the Revenue Act of 1950 discussed *infra*. The credit is not available with respect to dividends received from so-called China Trade Act Corporations or Section 251 corporations.

14. The shift from deduction to credit was occasioned in the Revenue Act of 1936 because of the imposition by that Act of the short-lived surtax on undistributed profits tax. Pub. L. No. 740, 74th Cong. The credit for dividends received was available only against normal tax and not against such surtax, there being no other ordinary corporate surtax. SEN. FIN. COMM. REP. No. 2156, 74th Cong., 2d Sess. (1936), at p. 15. The credit has been available against corporation surtax since 1941. Section 104, Revenue Act of 1941, Pub. L. 250, 77th Cong., 1st Sess. § 412.

15. "The term 'loophole,' although widely used in polemic discussions of tax statutes and in the more scholarly treatments of tax subjects, is often employed rather loosely. In its narrower and primary meaning, it is used to denote tax savings which the legislative body enacting the statute did not realize would be made possible by the law. At times the term apparently refers also to special tax advantages available to limited groups which the legislative body intended to confer or permit. In its broader meaning, the term seems to connote absence of justification." Lyon, *Employee Stock Options*, 51 COL. L. REV. 1, 3, n. 3 (1951).

ject to the limitation of 85% of its own adjusted net income. If, however, A were to receive property other than cash, tax avoidance may result if the property has appreciated substantially between the time it was acquired by Corporation B and the time it was received by Corporation A.¹⁶ Under the Internal Revenue Code,¹⁷ a dividend is to be taken into the income of the recipient at its fair market value. Thus, Corporation B, receiving a dividend in kind would be required to report as gross income the fair market value of such dividend and presumably would be entitled to use that fair market value as its own tax basis in determining gain or loss on subsequent disposition or in determining depreciation or depletion allowances. At the same time, it would be permitted to enjoy the benefits of a dividends-received credit on the amount of the fair market value of the dividend in kind. In the case of a parent and subsidiary relationship, there thus could be opened a substantial avenue of tax avoidance in that the subsidiary could distribute a dividend in kind to the parent and the parent could subsequently dispose of it with no more than a tax on 15% of the value of such dividend, notwithstanding that the economic gain may have been greatly in excess of 15% of the fair market value of such dividend in kind.

The existence of the loophole was known, of course, for many years but, for one reason or another, there was insufficient momentum prior to 1950¹⁸ to obtain enactment for a correction of the situation. Such momentum, apparently at the insistence of the Treasury Department, was developed in the consideration of the Revenue Act of 1950 to close the possible loopholes of distributions in kind. Under Section 26(b) of the Internal Revenue Code, as presently amended,¹⁹ the dividends-received credit, in the case of a dividend in property other than money, is limited to 85% of the adjusted basis of that property in the hands of the distributing corporation, increased in the amount of any gain or decreased in the amount of any loss recognized to the distributing corporation by virtue of such distribution. A

16. See Section 120, H.R. 6712, Revenue Revision Bill of 1948 (unenacted); H.R. WAYS AND MEANS COMM. REP. No. 2087, 80th Cong., 2d Sess. (1948), Item No. 18, p. 22.

17. Section 115(j) requires that if all or a "part" of a dividend is paid to a shareholder in any medium other than money, the property received other than money shall be included in gross income at its fair market value at the time as of which it becomes income to the shareholder. A dividend "becomes income to the shareholder" when it is received (actually or constructively) by the shareholder, irrespective of the method of reporting income used by the recipient. *American Light & Traction Co. v. Comm'r*, 3 T.C. 1048, *aff'd*, 156 F.2d 398 (7th Cir. 1946); *Tar Products Corp. v. Comm'r*, 130 F.2d 866, (3rd Cir. 1942).

18. Actually, in the unenacted Revenue Revision Bill of 1948, (see n.16) the first move was made legislatively to plug the loophole.

19. Revenue Act of 1950, § 122(a). The textual discussion is limited to dividends received from domestic corporations generally. The Revenue Act of 1950 added dividends-received on preferred stock of public utilities subject to federal income tax. The credit is 57% for the calendar year 1950 and 59% for any taxable year beginning on July 1, 1950, and thereafter. The public utility must come within the definition found in Section 26(h)(1) and the preferred stock must be of the kind and amount described in Section 26(h)(2). The limitation on the credit for dividends in kind applies also to distributions on public utility preferred stock; as a practical matter, such distributions in kind would rarely, if at all, be made in the case of public utility preferred stock dividends.

further limitation is imposed so that the dividends-received credit cannot exceed 85% of the adjusted net income computed without regard to the net operating loss deduction. The amendment is applicable only to dividends received after August 31, 1950; if the amendment were made retroactive to earlier open years, it would have caused considerable administrative confusion wholly disproportionate to abstract tax equity and increased revenue.²⁰

The amendment was not designed to produce substantial additional revenue²¹ but was occasioned chiefly by the need for removing, prospectively, distortion in the logical pattern of dividends-received credit. It is significant that the amendment does not, at least according to congressional statement,²² purport to affect the income tax consequences to the distributing corporation of a distribution in kind. Hence, there is still left for further litigation, if the Treasury Department is so inclined,²³ the tax consequences to the distributing corporation of distributions in kind which have appreciated or declined in value between the date of original acquisition and the date of distribution. That area may well be the subject of future legislation.²⁴

The limitation on the dividends-received credit for dividends in kind now has excess profits tax consequences of no mean significance. Under the new subchapter D of the Internal Revenue Code,²⁵ no part of a dividend is subject to excess profits tax except the portion of the dividend which is not eliminated from net income because of the application of the limitation on the dividends-received credit to dividends in kind.²⁶ Thus, if

20. In addition, there are always doubts as to constitutionality of retroactive increase of tax burdens. But see *Welch v. Henry*, 305 U.S. 134 (1938); *Wisconsin v. Penney*, 311 U.S. 435 (1940); *Wisconsin v. Minnesota Mining & Mfg. Co.*, 311 U.S. 452 (1940).

21. H.R. WAYS AND MEANS COMM. REP. NO. 2319, 81st Cong., 2d Sess. (1950); SEN. FIN. COMM. REP. NO. 2375, 81st Cong., 2d Sess. (1950). Both Committees estimated revenues would be increased \$6 million a year by the amendment to Section 26(b).

22. See note 21 *supra*. If the dividend in kind has an adjusted basis to the distributing corporation in excess of its fair market value when received by the shareholder, the credit cannot exceed 85% of such fair market value. H.R. WAYS AND MEANS COMM. REP. NO. 2087, *supra* note 16 at p. 22.

23. Cf. *Raum, Dividends in Kind: Their Tax Aspect*, 63 HARV. L. REV. 593 (1950); *Tye, Corporate Distributions—Some Current Trends*, 4 TAX L. REV. 459 (1949); *Johnson, Corporation and Stockholder—Dividends in Kind*, 1 TAX L. REV. 86 (1945); *Wallace, Corporation and Stockholder—Dividends in Kind: A Dissent*, 1 TAX L. REV. 93 (1945).

24. Present omens forbode no early legislative treatment.

25. Added by Section 101, Excess Profits Tax Act of 1950 and containing Sections 430 to 472 of the INT. REV. CODE.

26. INT. REV. CODE § 433(a), dealing with excess profits net income of the taxable year, reads in part as follows:

§ 433. Excess Profits Net Income.

(a) Taxable Years Ending After June 30, 1950.—The excess profits net income for any taxable year ending after June 30, 1950, shall be the normal-tax net income, as defined in Section 13(a)(2), for such year increased or decreased by the following adjustments:

(1) Adjustments.—

(a) Dividends received.—The credit for dividends received shall apply, without limitation (except the limitation relating to dividends in kind), to all dividends on stock of all corporations, except that no credit for dividends received shall be allowed with respect to dividends (actual or constructive) on stock of

after August 31, 1950, Corporation A were to receive a cash dividend of \$100, the entire amount would be eliminated from excess profits net income. If, however, Corporation A were to receive a dividend in property (other than cash) having a fair market value of \$100 but having a basis to the distributing corporation of only \$80, \$20 would be included in excess profits net income and subject to excess profits tax.²⁷

Although, as indicated above, for income tax purposes generally the new limitation on the dividends-received credit is applicable only to dividends received after August 31, 1950, that limitation has now been given effect for excess profits tax purposes to the calendar years 1946 to 1949, inclusive. For corporations using the earnings credit in computing excess profits tax liability, the rule described in the preceding paragraph applies in determining the income of the taxable years in the base period, *i.e.*, calendar years 1946 to 1949.²⁸ Such a situation may result in substantial tax savings,²⁹ especially where the taxpayer corporation, computing its excess profits tax liability, may have received distributions in kind during the calendar years 1946 to 1949 but not during a taxable year subject to excess profits tax. It is only right, however, that if the limitation on the dividends-received credit for dividends in kind is applicable to excess profits tax years, it should be equally applicable in the base period years, even though in particular cases fortuitous tax savings may accrue.³⁰

foreign personal holding companies or dividends on stock which is not a capital asset:

27. Official specific instructions prescribed by the Commissioner of Internal Revenue, for filling out Schedule EP (Form 1120) in computation of Corporation Excess Profits Tax reads in part as follows (Item 9, p. 3):

9. Dividends received.—The purpose of this adjustment is to exclude dividends, except dividends (actual or constructive) on stock of foreign personal holding companies and dividends on stock which is not a capital asset. In the case of a dividend in kind, received after August 31, 1950, the amount to be excluded shall not exceed the adjusted basis of the property so distributed in the hands of the distributing corporation at the time of the distribution, increased in the amount of gain or decreased in the amount of loss recognized to the distributing corporation by reason of such distribution.

Under such instruction the amount excluded cannot exceed, in the example described in the text, the adjusted basis of the dividend in kind, namely, \$80.

28. INT. REV. CODE § 433(G), dealing with earnings of taxable years in base period for excess profits tax purposes, reads in part as follows:

(b) Taxable Years in Base Period.—For the purposes of computing the average base period net income, the excess profits net income for any taxable year shall be the normal-tax net income, as defined in Section 13(a)(2) as in effect for such taxable year, increased or decreased by the following adjustments (for additional adjustments in case of certain reorganizations, see part II of this subchapter):

(6) Dividends received.—The credit for dividends received shall apply, without limitation (except the limitation relating to dividends in kind), to all dividends on stock of all corporations, except that no credit for dividends received shall be allowed with respect to dividends (actual or constructive) on stock of foreign personal holding companies or dividends on stock which is not a capital asset;

29. This possibility of tax saving was not present under World War II excess profits tax. C. 2, Subchapter E, INT. REV. CODE repealed by Section 122(a) of the Revenue Act of 1945, Pub. L. No. 214, 79th Cong., 1st Sess. § 453.

30. Taxpayers, whose excess profits credit is computed on the invested capital method, are, of course, not affected by adjustments to income during the base period years 1946 to 1949.

Stock Redemptions

Thirty-one years ago in *Eisner v. Macomber*,³¹ the Supreme Court of the United States held that Congress did not have power under the Sixteenth Amendment to tax as income a dividend in its own common stock paid by Standard Oil Company of California on its own common stock.³² Congress was not slow in recognizing that unless there were a statutory bar, such a stock dividend could be easily redeemed tax free into cash. The Revenue Act of 1921 thus provided in substance that redemption of a stock dividend might result in having the redemption proceeds taxed as a dividend.³³ Later, statutory successors of that provision (now embodied in Section 115(g) of the Internal Revenue Code) were broadened to cover all redemptions whether or not the stock redeemed had originally been issued as a stock dividend in whole or in part.³⁴

During the past three decades there has been considerable litigation on the extent to which Section 115(g) and its earlier counterparts are an effective bar to the distribution of cash or the equivalent of cash through the redemption of stock free from tax as ordinary dividend income. From time to time numerous suggestions were heard for the amendment of Section 115(g) but none seemed to be appealing to the Congress until after the 1949 decision of the Court of Appeals for the Third Circuit in *Commissioner*

31. 252 U.S. 189 (1920).

32. Following the decision in *Eisner v. Macomber*, referred to in the text, Congress specifically provided that a stock dividend should not be subject to income tax. That prohibition persisted until 1936 when, by Section 115(f) of the Revenue Act of 1936, it was provided that "A distribution made by a corporation to its shareholders in its stock or in rights to acquire its stock shall not be treated as a dividend to the extent that it does not constitute income to the shareholders within the meaning of the Sixteenth Amendment to the Constitution." Pub. L. No. 740, 74th Cong. In *Helvering v. Grifiths*, 318 U.S. 371 (1943), the Supreme Court held that Section 115(f) of the Revenue Act of 1936 did not in effect overrule *Eisner v. Macomber* but that, on the contrary, the legislative history surrounding the enactment of that section indicated the Congress still thought a dividend, such as that issued in *Eisner v. Macomber*, should not be subject to tax. See also, *Helvering v. Spruce*, 318 U.S. 604 (1943), and *Strassburger v. Comm'r*, 318 U.S. 604 (1943), Section 115(f) of the INT. REV. CODE, a direct successor of Section 115(f) of the Revenue Act of 1936, does not therefore authorize the taxation of so-called common on common stock dividends.

33. Section 201(d) of the Revenue Act of 1921 provided that "A stock dividend shall not be subject to tax but if after the distribution of any such dividend the corporation proceeds to cancel or redeem its stock at such time and in such manner as to make the distribution and cancellation or redemption essentially equivalent to the distribution of a taxable dividend, the amount received in redemption or cancellation of the stock shall be treated as a taxable dividend to the extent of the earnings or profits accumulated by such corporation after February 28, 1913, shall be treated as a taxable dividend."

34. "If a corporation cancels or redeems its stock (whether or not such stock was issued as a stock dividend) at such time and in such manner as to make the distribution and cancellation or redemption in whole or in part essentially equivalent to the distribution of a taxable dividend, the amount so distributed in redemption or cancellation of the stock, to the extent that it represents a distribution of earnings or profits accumulated after February 28, 1913, shall be treated as a taxable dividend." INT. REV. CODE § 115(g)(1). Cutkin and Beck, *Stock Redemptions as Taxable Events Under Section 115(g)*, 24 TAXES 1172 (1946). Murphy, *Partial Liquidations and the New Look*, 5 TAX L. REV. 73 (1949); Miller, *Stock Redemptions*, PROCEEDINGS OF NEW YORK UNIVERSITY SIXTH ANNUAL INSTITUTE ON FEDERAL TAXATION 307 (1948); Drye, *Earned Surplus and Its Tax Problems for the Stockholder*, 1 TAX L. REV. 421 (1949).

v. *Wanamaker*.³⁵ In that case the taxpayers (trustees of a testamentary trust) owned stock in Corporation P which was the parent of a subsidiary corporation, S. Corporation S bought P stock from the taxpayers during the years 1942, 1943 and 1944. The Commissioner asserted that the purchase of the P stock by S was tantamount to a redemption of the P stock calling for the application of Section 115(g) of the Internal Revenue Code, so that the proceeds should be taxed as a dividend. The Court of Appeals, affirming the Tax Court, thought otherwise and held that Section 115(g) was applicable only to the situation where a corporation redeems or cancels its own stock and not the stock of any other company, irrespective of the relationship of that company to the corporation acquiring the stock.³⁶

Fully cognizant of the fact that to amend Section 115(g) to bar any further so-called *Wanamaker* redemptions would yield immediately only insignificant additional revenue,³⁷ the Congress, in the Revenue Act of 1950, added a new subdivision (2) to Section 115(g) to prevent future reliance on the *Wanamaker* decision. Effective as to taxable years ending after August 31, 1950, and to amounts received after that date, redemption of stock through use of a subsidiary corporation may (but not necessarily) result in the realization of ordinary dividend income, subject to progressive surtax rates, as distinguished from either capital gain or capital loss.³⁸

The new provision is applicable if the corporation issuing the stock has control of the corporation acquiring the stock. "Control" is defined as ownership of stock possessing either at least 50% of the total combined voting power of all classes of stock entitled to vote or, in the alternative, at least 50% of the total value of shares of all classes of stock of the acquiring corporation.³⁹ Inasmuch as "control" not only covers direct but indirect ownership as well, the provision would be applicable, for example, where Corporation X acquires shares of stock of Corporation Z and the latter owns 100% of the stock of Corporation W, which in turn owns 50% of the stock of Corporation X. The new provision, however, would not be applicable to the acquisition by Corporation R of stock of Corporation S even though both are wholly owned subsidiaries of Corporation T.⁴⁰

35. *Comm'r v. Trustees*, 178 F.2d 10 (3rd Cir. 1949), *affirming* 11 T.C. 365 (1948).

36. See Note, 63 HARV. L. REV. 1275 (1950).

37. "Your Committee's amendment will yield a small amount of additional revenue, and prevent substantial loss through the utilization of this loophole in future years." H.R. WAYS AND MEANS COMM. REP. NO. 2319, 81st Cong., 2d Sess. 53 (1950); SEN. FIN. COMM. REP. NO. 2375, 81st Cong., 2d Sess. 43 (1950).

38. Revenue Act of 1950, § 208. A distribution may be taxed as a dividend under Section 115(g) irrespective of whether the amount thereof is equal to, in excess of, or less than the adjusted basis of the redeemed or cancelled stock.

39. Care must be taken to distinguish the concept of "control" under Section 115(g)(2) from the concept of "control" under Section 112(h). Aside from the differences in percentages of total combined voting power necessary, the former section has the additional requirement of ownership of 50% of total value of shares whereas the latter section requires 80% of the total number of shares of nonvoting stock.

40. There would seem to be little economic justification in many instances for distinguishing between the purchase of a parent corporation's stock by a subsidiary corpora-

The new subdivision (2) of Section 115(g) does not automatically come into play merely because a so-called "controlled" corporation acquires the stock of the issuing corporation. The basic test is whether, if the amount paid for the stock by the acquiring "controlled" corporation had been distributed to the issuing corporation and that amount had in turn been applied by the latter in redemption of the stock, such amount would, under subdivision (1) of Section 115(g), be treated as essentially equivalent to a taxable dividend. Thus, it is still necessary, even under the new provision, to determine from all the facts and circumstances of the acquisition of stock whether a dividend had in fact been distributed. While plugging a so-called loophole "discovered" as a result of the *Wanamaker* decision, or, at least, filling in a *casus omissus*, the new subdivision (2) will not necessarily cut down the amount of litigation under Section 115(g) generally. That litigation will continue as long as there are differences in opinion as to what constitutes, "in effect," a dividend.⁴¹

While attempting to strengthen the effectiveness of Section 115(g) through the addition of the new subdivision (2), the Congress, interestingly enough, gave ear to representations that some relief from the impact of the fundamental premise of Section 115(g) should be afforded in the case of redemptions of stock to pay death taxes. Under a new subdivision (3) of that section,⁴² stock may now be redeemed automatically free from tax on the proceeds as ordinary dividend income under all (but not less than all) the conditions described presently.

The stock to be redeemed must be stock which is part of some de-

tion and the purchase by one corporation of stock of a so-called brother or sister corporation. In both situations the recipient of the redemption proceeds might be getting his money out at capital gains rates which otherwise should be subjected to surtax rates. The justification for the distinction, however, is real because in the parent and subsidiary situation the recipient shareholder could be deemed in effect to have received a dividend from the parent by means of a payment made on its behalf by the subsidiary. If, for example, the subsidiary had distributed earnings to its parent and the parent had redeemed its stock, Section 115(g), before amendment in 1950, might well have been considered applicable; a so-called indirect payment by the parent through its subsidiary should logically, therefore, not escape the impact of Section 115(g). Where, however, the purchasing corporation is not a subsidiary of the corporation issuing the stock, there cannot be any legal basis for attributing to the purchase proceeds the character of a dividend since in fact neither corporation owes the duty to pay dividends to the other.

41. DeWind, *Preferred Stock "Bail-Outs" and the Income Tax*, 62 HARV. L. REV. 1126 (1950); Darrell, *Recent Developments in Nontaxable Reorganizations and Stock Dividends*, 61 HARV. L. REV. 958 (1948).

42. As added by Revenue Act of 1950, § 209, effective as to taxable years ending after September 22, 1950 but only to amounts distributed after that date:

(3) Redemption of stock to pay death taxes.—The provisions of this subsection shall not apply to such part of any amount so distributed with respect to stock the value of which is included in determining the value of the gross estate of a decedent in accordance with section 811, as is distributed after such decedent's death and within the period of limitations for the assessment of estate tax provided in section 874(a) (determined without the application of section 875) or within 90 days after the expiration of such period, and as is not in excess of the estate, inheritance, legacy, and succession taxes (including any interest collected as a part of such taxes) imposed because of such decedent's death: Provided, that the value of the stock in such corporation for estate tax purposes comprises more than 50 per centum of the value of the net estate of such decedent.

cedent's gross estate for federal estate tax purposes. The value of the redeemed stock must be more than 50% of the value of the decedent's net estate for similar purposes. Redemption proceeds must be actually distributed after decedent's death⁴³ but, in any event, not later than three years and ninety days from the actual filing (timely or otherwise) of the federal estate tax return.⁴⁴ The amount of the redemption proceeds must not be in excess of all federal, state, and foreign estate, inheritance, legacy and succession taxes, including interest collected as part thereof, due and owing by virtue of the decedent's death.⁴⁵

In many respects the new subdivision (3) is a curious provision. The stock to be redeemed need not be part of the estate of the decedent which comes into the hands of the executor or administrator as property owned by the decedent at his death. For federal estate tax purposes, property may be included in the gross estate of a decedent for reasons other than outright ownership, such as, for example, property transferred in contemplation of death, property as to which possession or enjoyment thereof is delayed until the decedent's death⁴⁶ and property transferred, subject to rights of revocation, amendments and alterations by the decedent.⁴⁷ Furthermore, the new subdivision (3) may afford relief if the stock, owned outright at date of death by the decedent, was distributed in due course to legatees prior to redemption. It is apparent, however, that the section will not apply if the person redeeming the stock is a bona fide purchaser for value, notwithstanding that because of a prior transfer the stock is included in the gross estate of a decedent.⁴⁸

Although the title of subdivision (3)—"Redemption of Stock to Pay Taxes"—implies a suggestion that the subdivision covers only situations where redemption occurs for the purpose of paying death taxes, nowhere in that subdivision is there any requirement that the proceeds of the re-

43. Subdivision (3) of Section 115(g) would be applicable even though the corporation effecting the redemption carried on negotiations with the owner of the stock prior to the death of the individual in whose gross estate the stock is included. As stated in the text, the test is the actual date of the payment of the redemption proceeds.

44. Section 276 of the Internal Revenue Code provides for the execution of waivers of the period of limitation on assessment of income tax. There is no comparable provision for waivers in federal estate tax cases. Section 875 of the Internal Revenue Code provides, however, for the suspension of the running of the statute of limitation on assessment of estate tax where a deficiency notice has been sent. The three years and ninety day period described in the text is unaffected by any suspension of statute of limitations occurring under Section 875.

45. If the redemption proceeds are in excess of all death taxes described in the text, the benefits of Section 115(g)(3) are inapplicable only to such excess. H.R. WAYS AND MEANS COMM. REP. NO. 2319, 81st Cong., 2d Sess. 64 (1950); SEN. FIN. COMM. REP. NO. 2375, 81st Cong., 2d Sess. 55 (1950).

46. INT. REV. CODE § 811(c).

47. *Id.* at § 811(d).

48. There would seem to be no justification for extending the benefits to redemption proceeds received by a bona fide purchaser of stock included in some decedent's gross estate. SEN. FIN. COMM. REP. NO. 2375, 81st Cong., 2d Sess. 83 (1950).

demption need be actually utilized for payment of any such taxes.⁴⁹ As a corollary, it follows that likewise there is no requirement that the estate of the decedent or anyone else be in need of cash. Assume, for example, all death taxes to have been paid out of ample liquid funds. Later, and within three years and ninety days from the filing of the federal estate tax return, stock is redeemed by a person to whom the property had been transferred in contemplation of death six months prior to decedent's death. The new amendment would be applicable (assuming, of course, the value of that stock is included in the gross estate), even though the owner of the stock did not in fact contribute to the payment of any part of the death taxes because of a provision in the decedent's will having the effect of absolving the stock owner from contribution for any part of the death taxes.

The foregoing requirements of subdivision (3), relating to time of redemption, amount of redemption and value of stock redeemed, are specific and unequivocal. Consequently, because the value of the decedent's gross estate may be the subject of litigation extending over many years and the value of the stock to be redeemed may also be in question, considerable uncertainty can well develop as to whether redemption proceeds will ultimately be "protected" under subdivision (3). As previously indicated, for example, the value of the stock redeemed must be more than 50% of the net estate,⁵⁰ but that does not mean, of course, that the person owning such stock is necessarily in control, actual or otherwise, of the corporation⁵¹ which redeems such stock. Hence, absent such control, redemption may be forced upon the stock owner when he is at least not certain that he wants the proceeds because of the inapplicability of subdivision (3). Where, however, for example, the estate is the stock owner and is in control of the redeeming corporation, great responsibility is placed on the executor whether or not to redeem during the course of litigation extending beyond three years and ninety days from the filing of the federal estate tax return. It is natural, ordinarily, for the fiduciary to contend for as low a value as possible in death tax proceedings. To be successful in such a case might mean that the advantages of subdivision (3) of Section 115(g) would be forfeited.⁵²

49. The title of new subdivision (3) is in a sense merely generally descriptive of the purposes of the subdivision but it is not legally controlling in so far as the subdivision itself, aside from the title, covers situations where the redemption proceeds are not used to pay death taxes.

50. There is some question as to what was meant by "net estate" in subdivision (3). For purposes of the basic estate tax, the net estate is determined in part by deducting from the value of the gross estate an exemption of \$100,000. INT. REV. CODE § 812(a). For purposes of additional estate tax, the exemption is \$60,000. INT. REV. CODE § 935(c). It would appear that the net estate under subdivision (3) of Section 115(g) refers to the net estate as determined for additional estate tax purposes. In any event, the marital deduction, provided for by Section 812(e) of the Internal Revenue Code, would be taken into account in determining the net estate.

51. The corporation referred to in the text would include a subsidiary corporation described in subdivision (2) of Section 115(g).

52. Subdivision (3) normally will apply in so-called close family corporations. If a person other than the decedent's estate is the recipient of the redemption proceeds and such person does not control the estate, the success of the fiduciary in obtaining a low

Subdivision (3) of Section 115(g) should itself be the subject of comparatively little litigation.⁵³ Its effect on the overall interpretation of Section 115(g)(1) may, however, give rise to litigation involving any redemption of stock (which is included in some decedent's gross estate) that does not technically qualify under subdivision (3). On the one hand, it may be argued that inasmuch as Congress specifically dealt with redemption of stock included in some decedent's gross estate, any such case not technically falling within subdivision (3) should automatically come within subdivision (1). In opposition to such a contention, it may be argued that subdivision (3) merely removes beyond the pale of contention the cases falling within its scope and that the taxability of any redemption of stock included in some decedent's gross estate, not coming within subdivision (3), must be construed as if subdivision (3) had never been enacted. What the trend of future litigation will be is difficult to tell but it is believed that the latter view will ultimately prevail.

Collapsible Corporations

The treatment of corporate distributions was subjected in the Revenue Act of 1950 to a radical change in the case of sales and liquidations effected for tax purposes primarily. For some time prior to 1950, the Congress was made aware that, notably in the movie and building construction industries, one or more persons would organize a corporation for the production, construction or manufacture of property and before such corporation would normally realize any significant amount of income from such production, construction or manufacture it would be liquidated and the property distributed to shareholders. The purpose was, of course, to "set the stage" for the argument that any gain realized on the disposition of such property should be capital gain.⁵⁴ The disparity between the capital-gain rate (*i.e.*, maximum of 25%) and high surtax rates made such a technique, if successful, most inviting and attractive.⁵⁵ To meet that problem for the future (but necessarily to preclude disposition of issues for earlier years),⁵⁶ Congress added a new subsection (m) to Section 117⁶⁷ which has the effect of transforming any gain, otherwise long-term, realized from the sale or exchange—in liquidation or otherwise—of stock of a so-called "collapsible"

valuation may also destroy the effectiveness of subdivision (3) for such person. This is but another instance of the peculiar manner in which subdivision (3) may operate.

53. The observation in the text is made with full realization that prognostication in this field is dangerous.

54. INT. REV. CODE § 115 (c).

55. Blum, *The Decline and Fall of Capital Gains*, 28 TAXES 838; Miller, *The "Capital Asset Concept": Critique of Capital Gains Taxation*, 59 YALE L.J. 837, 882 (1950).

56. H.R. WAYS AND MEANS COMM. REP. NO. 2319, 81st Cong., 2d Sess. 56, 96 (1950); SEN. FIN. COMM. REP. NO. 2375, 81st Cong., 2d Sess. 45, 88 (1950). Revenue Act of 1950, § 212(b), specifically provides that determination of tax treatment of any gains realized before 1950 is to be made if Section 117(m) had not been added to the Code and without any inferences that the addition of that section was not expressly made applicable to pre-1950 gains and without inferences drawn from the specific limitations contained in Section 117(m). To what extent this legislative mandate will be observed will never be known.

corporation into ordinary income, subject to the full impact of surtax rates.

A "collapsible" corporation is in substance defined as a corporation which is formed or availed of principally for the production, construction or manufacture of property or for the holding of stock in a corporation so formed or availed of "with a view" to the following two purposes: *First*, a sale or exchange of stock of such corporation by its shareholders or a distribution to such shareholders before (not after) the realization by such corporation of a substantial part of the net income to be derived from such property and, *second*, the ultimate realization by the shareholders of gain which is "attributable" to such property.

Notwithstanding the existence of both proscribed purposes, the special treatment under Section 117(m) of gain realized by a shareholder on his stock in a "collapsible" corporation does not apply if any one of the three following limitations is not met: if, after commencement of the manufacture, construction or production of property, the shareholder did not own, actually or constructively, more than 10% in value of the outstanding stock of the "collapsible" corporation; if not more than 70% of the gain recognized in the taxable year is attributable to the property manufactured, constructed or produced; and if the gain is realized more than three years following the completion of such manufacture, construction or production of property.

Section 117(m) abounds with latent, as well as patent, ambiguities. Space does not permit an extended analysis of such ambiguities, but it is obvious that for some time to come there will be considerable opportunities for extended litigation. Among the more important difficulties in Section 117(m) is the problem of whether a subjective or objective test is to be applied in determining when a corporation is "formed or availed"⁵⁷ of "with a view"⁵⁸ to the proscribed purposes. In this connection, whether the corporation was formed before or after the enactment of the Revenue Act of 1950 might have a factual (as distinguished from a legal) bearing on assumed motive. Furthermore, how many stockholders must have participated in formulating the proscribed purposes is a troublesome uncertainty. Who can say when a corporation has engaged in the manufacture, construction or production of property "to any extent" as set forth in the statute? Also, there is the substantial necessity of determining when gain realized by the

57. Revenue Act of 1950, § 212, effective for taxable years ending after December 31, 1949, with respect to gain realized after that date. Consequently, the collapsible corporation treatment is applicable to corporations formed either before or after January 1, 1950.

58. The experience gained under Section 102 of the Code, relating to surtax on corporations formed or availed of for the purpose of preventing surtax on shareholders, may be of value in the construction of the "formed or availed of" test in the new Section 117(m).

59. Presumably, the words "with a view" imply a test in which an important, but not necessarily primary, purpose is to anticipate gain by shareholders before realization of income by the corporation. To what extent any such anticipation will be treated as *de minimis* remains to be seen.

shareholders is in fact attributable to the property manufactured, constructed or produced by the so-called "collapsible" corporation.⁶⁰

Section 117(m), like Sections 26(b) and 115(g) (2), was not enacted for the revenue it would produce.⁶¹ It was brought into the law to preserve the logical effectiveness of progressive surtax rates. If it acts as a deterrent to easy avoidance of such rates, it will have justified its existence. If, however, because of the numerous troublesome areas which might conceivably restrain orderly liquidations—not primarily connected with tax-saving motives—one may question the ultimate utility of such legislative prohibitions, especially in view of the relatively insignificant expected revenue yield.

Section 112(b) (7) Liquidations

The Revenue Act of 1950 revived for the calendar year 1951 an opportunity to effect a complete cancellation or redemption of all the stock of a corporation without the recognition of gain.⁶² That substantial tax privilege is limited to complete liquidations fitting the conditions set forth in Section 112(b) (7) of the Internal Revenue Code. In 1938,⁶³ and again in 1944,⁶⁴ Congress was impressed with the argument that many personal holding companies, whose existence was no longer justified, could not completely liquidate without substantial tax liability incurred by their stockholders because of appreciation in the values of the corporate assets.

To accelerate and induce the liquidation of such companies in the years mentioned, Congress provided roughly that corporations, whose shareholders elect to have Section 112(b) (7) apply,⁶⁵ could liquidate with the following tax consequence to shareholders generally. In the case of non-corporate shareholders, gain, not in excess of their ratable share of earnings and profits accumulated after February 28, 1913, would be treated as a

60. An interesting facet of the difficulties involved in determining when gain is attributable to property is illustrated by the following situation. Assume that a mortgage has been obtained for building construction under Section 608 of the National Housing Act, c. 319, 56 STAT. 303 (1942), 59 STAT. 47 (1945), 60 STAT. 214 (1946), 12 U.S.C. § 1743. Prior to realization of substantial income by the corporation obtaining the mortgage and constructing the housing development either a liquidation occurs or shareholders sell their stock. Is any gain which they may realize in whole or in part attributable to the construction or to the mortgage, especially if the mortgage should be a favorable one? At present, the answer is in doubt.

61. Both the House Ways and Means Committee and the Senate Finance Committee estimated that the "closing of the collapsible corporation loophole" would produce about \$3,000,000 additional revenue each year. H.R. WAYS AND MEANS COMM. REP. NO. 2319, 81st Cong., 2d Sess. 57 (1950); SEN. FIN. COMM. REP. NO. 2375, 81st Cong., 2d Sess. 46 (1950).

62. Revenue Act of 1950, § 206.

63. Revenue Act of 1938, § 112(g) (7), Pub. L. No. 554, 75th Cong., 3rd Sess. § 289. The transfer of all property under the liquidation had to occur within December, 1938.

64. Revenue Act of 1943, § 120, Pub. L. No. 235, 78th Cong., 2d Sess. § 63. The transfer of all property under the liquidation had to be within any one calendar month of 1944. Delivery of more than 94% in book value of the assets during the month picked by the shareholders for complete liquidation has been held to be compliance with Section 112(b) (7) of the Code, as amended by Section 120 of the 1943 Act. Estate of Lewis B. Meyer v. Comm'r, 15 T.C. 109 (1950).

65. The Tax Court has held that an election made under Section 112(b) (7) is binding. Estate of Lewis B. Meyer, *supra* note 64.

dividend; gain attributable to the receipt of money or recently acquired stock or securities would be taxed as capital gain; no part of the gain otherwise realized on the liquidation would be taxed but, subject to adjustments, the basis of the assets acquired on liquidation would be the basis of the stock cancelled or redeemed. In the case of corporate shareholders, gain would be recognized only to the extent of the greater of (a) the portion of the assets received consisting of money or of property recently acquired, or (b) ratable share of earnings and profits accumulated after February 28, 1913.

The operation of Section 112(b) (7), under the amendment made by the Revenue Act of 1950, is limited to liquidations adopted after December 31, 1950, and if the transfer of all property under the liquidation occurs within some one calendar month of 1951. That section is not limited, however, to liquidations of personal holding companies. Any domestic corporation can be liquidated thereunder.⁶⁶

The importance of Section 112(b) (7) in the present discussion lies chiefly in its relevance to the operation of Section 117(7), dealing with the treatment of gain received from so-called "collapsible corporations." If a 1951 liquidation falls within the scope of Section 171(m) and also qualifies as a Section 112(b) (7) liquidation, which of the two sections will govern the treatment of gain to the recipient shareholders? There is nothing in the statute nor in legislative history generally which gives the basis for an unequivocal and categorical reply to such an inquiry. Each section relates to a special type of liquidation transaction, so that the usual rule that a special treatment takes precedence over a general treatment does not obtain here. Analysis of each section reveals, however, that, in a sense, Section 117 merely transmutes what would otherwise have been capital gain into ordinary income, but the basis of the property received is no different in the hands of the recipient stockholder from what it would have been had there been no such transmutation. On the other hand, he who obtains the benefit of a Section 112(b) (7) liquidation must pay a price for the present non-recognition of gain, otherwise taxable, through the use of a substituted basis of the assets received on liquidation. It would seem entirely logical, therefore, that for the year 1951 a Section 112(b) (7) transaction, otherwise

66. Since 1934 so-called personal holding companies have been subject to additional surtax on undistributed earnings. See Revenue Act of 1934, § 351, Pub. L. No. 216, 73rd Cong., INT. REV. CODE § 500. Consequently, except in unusual situations personal holding companies, at least those organized since 1934, have had no appreciable accumulation of earnings and profits. Liquidation under Section 112(b) (7) would, in the case of such companies, therefore, generally result in little income being treated as ordinary dividend income, except possibly as to so-called recently acquired assets of the corporation. In the case of corporations other than personal holding companies which, despite the prohibition against unreasonable accumulation of surplus, have managed to retain substantial accumulated earnings and profits, there would be less impetus for utilization of Section 112(b) (7). Whether or not the shareholders should consent to a liquidation under Section 112(b) (7) will, of course, depend upon individual circumstances. The election is, as previously indicated, a solemn one, not subject to revocation. *Goldman v. Comm'r*, T.C. Memo No. 2205, October 25, 1950, 9 T.C.M. 936.

falling within the scope of Section 117(m), will nevertheless be governed by the terms of the former rather than by the latter section.

If Congress should at a later date again revive Section 112(b) (7), it may well at that time take into account the effect of such revival on the effectiveness of Section 117(m). In the absence, however, of the incorporation of Section 112(b)(7) as a permanent feature of the federal income tax law, the effectiveness of Section 117(m), such as it may be is not materially weakened by the preference given over it to Section 112(b) (7) transactions.

II. STOCK OPTIONS

After nearly four decades of federal income tax administration, Congress moved, in the Revenue Act of 1950,⁶⁷ to legislate specifically on the tax aspects of certain employee stock options. Prior to that legislative move, the tax consequences of stock options were a matter exclusively for administrative and judicial interpretations under the so-called "bargain purchase" theory.⁶⁸ Following the decision of the United States Supreme Court in *Commissioner v. Smith*,⁶⁹ the Commissioner of Internal Revenue in his regulations provided in substance that every so-called "bargain purchase" made (including exercise of stock options) by an employee resulted in compensation to him to the extent of the bargain.⁷⁰ In the unenacted Revenue Revision Bill of 1948⁷¹ which passed the House of Representatives, specific treatment was provided for so-called "restricted stock options."⁷² The House of Representatives, when considering the bill which ultimately became the Revenue Act of 1950, did not see fit to restore to active consideration the matter of a legislative pattern for the treatment taxwise of employee stock options. The Senate revived legislative interest on the subject.⁷³

Whether the fundamental tax philosophy, such as can be discerned, underlying the new employee stock option provisions is sound is beyond the scope of this paper.⁷⁴ The purpose here is merely to summarize the principal aspects of the new stock option treatment for whatever use may be made of it in future employee-employer relationships.

Section 130A of the Code purports to set forth specific rules covering the income tax aspects of so-called "restricted stock options."⁷⁵ In order

67. INT. REV. CODE § 130A as amended by Section 218 of the Revenue Act of 1950.

68. See for comprehensive list of literature in this field. Alexander, *Employee Stock Options and the 1950 Revenue Act*, 6 TAX L. REV. 165, 167, n.10 (1951).

69. 324 U.S. 177 (1945); rehearing denied 324 U.S. 695 (1945).

70. U.S. Treas. Reg. 111, § 29.22(a)-1, as amended by T.D. 5507, 1946-1 CUM. BULL. 18; I.T. 3795, 1946-1 CUM. BULL. 15.

71. H.R. 6712, 80th Cong., 2d Sess.

72. Section 137 of H.R. 6712 *supra*.

73. The details in Section 130 of H.R. 6712 *supra*, differ materially in many respects from Section 130A of the Code, as amended by Section 218 of the Revenue Act of 1950, but the basic mold appeared first in H.R. 6712.

74. For a criticism of the provision as giving unwarranted relief to corporation executives, see Lyon, *Employee Stock Options under the Revenue Act of 1950*, 51 COL. L. REV. 1, 52-58 (1951).

75. These rules are effective only for taxable years ending after December 31, 1949, where the exercise of the option occurs after 1949.

that the section be applicable, the option must not only be a restricted stock option as defined but the stock acquired by virtue of the exercise of the option must not be disposed of within two years after the option was granted nor within six months following acquisition of the stock. There is nothing in Section 130A which provides any rules covering the tax consequences for any taxable periods of: stock options which do not qualify as restricted stock options; so-called restricted stock options exercised prior to 1950; so-called restricted stock options where disposition of the stock acquired as a result of the exercise of the option occurs within the two-year and six-months' periods mentioned above; and any so-called restricted stock options exercised by one who, at the time of the exercise of the option, is not (or was not within three months prior thereto) an employee of the corporation granting the option or of a parent or subsidiary corporation.⁷⁶

The entire field of the taxation of employee stock options which, for one reason or another, do not come within the provisions of Section 130A is still left open for further administrative and judicial development.⁷⁷

Preliminary Definitions

There are five tests⁷⁸ which must be met in their entirety before an option is a restricted stock option within the meaning of Section 130A. *First*, the option must have been granted after February 26, 1945, the date *Commissioner v. Smith, supra*, was decided, to an individual "for any reason connected with his employment by a corporation" by either his employer or by its parent or subsidiary corporation; *second*, only stock of the employer or of its parent or subsidiary corporation must be covered by the option; *third*, the option price cannot be less than 85% of the fair market value of the stock subject to the option at the time the option is granted; *fourth* the option must specifically provide that it cannot be transferable otherwise than by will or by intestacy and is not exercisable during the lifetime of the employee by him alone; and *fifth*, when the option is granted, the employee cannot own more than 10% of the total combined voting power of all classes of stock of his employer corporation or of its parent or subsidiary corporation.⁷⁹

76. Corporate relationship is predicated on ownership of 50% of total combined voting power. INT. REV. CODE § 130A(d) (2) & (3). The 50% ownership test is applied as of the time the option was granted.

77. It is interesting to note what the Senate Finance Committee thought of the Commissioner's interpretation of the Supreme Court's decision in *Comm'r v. Smith*, 324 U.S. 177 (1945). "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 *Comm'r v. Smith*, 324 U.S. 177 (1945)." SEN. FIN. COMM. REP. NO. 2375, 81st Cong., 2d Sess. 59 (1950).

78. INT. REV. CODE § 130A(d) (1).

79. Ownership by the employee includes ownership of stock, directly or indirectly, by brothers and sisters (of the whole or half blood), spouse, ancestors and lineal descendants. Furthermore, stock owner directly or indirectly by or for a corporation, partnership, estate or trust must be considered as being proportionately owner for its shareholders, partners or beneficiaries. INT. REV. CODE § 130A(d) (1) (C).

In determining whether an option qualifies as a restricted stock option, modification, extension or renewal must be considered.⁸⁰ Modification, extension or renewal will, in effect, be considered as the granting of a new option. Thus, because of modification, extension or renewal, an option may become a restricted stock option or, because thereof, an option may cease being a restricted stock option.⁸¹

If an employee exercises a restricted stock option and exchanges the stock received on the exercise for other stock or securities in a tax-free exchange under either Section 112(b) (2) or Section 112(b) (3) of the Code or if stock is received as a nontaxable dividend on the option stock under Section 113(a) (19) of the Code, the stock or securities acquired in the tax-free exchange or the dividend stock is to be treated as having been transferred to the employee upon exercise of the option. A similar rule is applicable where there are two or more such exchanges or acquisitions.⁸²

Tax Consequences on Exercise of Option

Where the option price is 95% or more of the value of stock at the time the option is granted, the employee will not be deemed to realize income on the happening of any of the following events: The grant of the option, the exercise of the option,⁸³ or receipt of stock following exercise of the option.⁸⁴ If, however, the employee makes a disposition⁸⁵ of the stock within two years from the date the option was granted to him or within six months after he received the stock, Section 130A will not be deemed applicable. If stock acquired on exercise of an option is held for the requisite time, then gain or loss on a subsequent sale or exchange will be treated as long-term gain or loss from the sale or exchange of a capital asset.⁸⁶

Section 130A is applicable if, at the time the option is granted, the optionee is an employee and at the time he exercised the option he was an employee or had been an employee not more than three months before such exercise.⁸⁷ There does not appear to be any requirement that the

80. INT. REV. CODE § 130A(e).

81. Fair market value of the stock at the time of the grant of the option will be deemed to be the highest of the following three values: (1) fair market value on date of original grant; (2) fair market value on date of modification, extension or renewal; and (3) fair market value on date of making any intervening modification, extension or renewal.

82. INT. REV. CODE § 130A(c).

83. This is in contrast to the rule under existing regulations of the Commissioner with respect to stock options generally. U.S. Treas. Reg. 111, § 29.22(a)-1.

84. SEN. FIN. COMM. REP. No. 2375, 81st Cong., 2d Sess. 98 (1950).

85. The term "disposition" includes a sale, exchange or gift or any transfer of legal title; it does not include the passage of title from a deceased employee to his estate or by bequest or inheritance; nor does it cover a tax-free exchange under Sections 112(b) (2) and (3) of the Internal Revenue Code or a mere pledge of hypothecation. INT. REV. CODE § 130A(d) (4).

86. It is clear that no income tax liability would arise should the employee transfer the stock as a gift more than two years from the date the option was granted and more than six months after receipt of the stock. A gift within any one of those periods would, of course, make Section 130A inapplicable.

87. INT. REV. CODE § 130A(a).

optionee must have remained an employee continuously in the period intervening between grant of the option and exercise thereof, as long as the three months' rule is observed. Once the option has been exercised, continued employment is, of course, not necessary.⁸⁸

The statute is silent on the specific question as to whether the new treatment would be applicable in the event an employee were to die before exercising an option previously granted to him. Although there seems to be some difference of opinion,⁸⁹ the unequivocal wording of the statute would appear to require a conclusion that only the employee-optionee can exercise the option. Certainly, where an employee dies after having exercised an option, Section 130A will govern if the fiduciary representative should retain the stock beyond the expiration of both the two-year period following grant of the option and the six months' period following receipt of the stock. There would appear to be not inconsiderable question as to the applicability of Section 130A if such representative were to dispose of the stock before the expiration of either of such periods.⁹⁰

What has been said above with respect to the tax consequences on the grant and exercise of the option is equally applicable to the case where the option price is less than 95% of the value of stock at the time the option was granted. The same comment applies in case of termination of employment. The differences in treatment lie in disposition and on death of the employee.

Where the option price is between 85% and 95% and disposition of the stock is postponed until after the two-year and six-months' periods, respectively, the following rule is applicable. For the taxable year in which the disposition occurs, the employee's gross income is increased by inclusion as compensation (taxed as ordinary income and not as capital gain) of an amount which is equal to the excess (a) of the fair market value of the stock at the time of disposition over the option price, or (b) of the fair market value of the stock on date the option was granted over the option price, whichever yields the lesser amount.⁹¹ Upon the occurrence of a disposition and realization of compensation, the cost basis of the stock to the employee at that time must be increased by the amount of compensation included in gross income. Thus, any amount received on sale or exchange in excess of the cost basis so adjusted is treated as a long-term capital gain.

88. The extent of the employee's stock ownership after granting of the option is immaterial; similarly, extent of stock ownership of the employee on exercise of the option or thereafter is irrelevant to the application of Section 130A.

89. That Section 130A is inapplicable, see Alexander, *op. cit. supra* note 68 at 204; that Section 130A should be applicable, see LYON, *op. cit. supra* note 74 at 48-52.

90. Cost basis of the stock in the hands of the executor or beneficiary, regardless of the application of Section 130A, will be fair market value of stock at the employee's death or, in the case of the optional value for estate tax purposes, one year after death or on earlier disposition. INT. REV. CODE § 113(a) (5).

91. For example, see CONFERENCE COMM. REP. NO. 3124, 81st Cong., 2d Sess. 30-31 (1950).

If the excess amount received on sale or exchange is less than the option price, the difference is treated as a long-term capital loss.

In the case of the death of an employee who had received and exercised an option in the so-called 85% to 95% class, the statute requires the following treatment on disposition of the stock.⁹² In the final income tax return of the decedent, there is to be reported as compensation and not as capital gain an amount equal to the excess (a) of fair market value of the stock at death over the option price, or (b) of fair market value of the stock at the time the option was granted over the option price, whichever yields the smaller amount. This is so regardless of when death occurs, *i.e.*, whether or not within two years from the date the option was granted or within six months following acquisition of the stock.⁹³

In the case of employee stock options not governed by Section 130A, the employee may be subjected to heavy income tax on the mere exercise of an option.⁹⁴ At the same time, however, his corporate employer is permitted to obtain a deduction under Section 23(a) for compensation paid to the extent such compensation is includable in the employee's gross income. Inasmuch as, for purposes of Section 130A, Congress deemed restricted stock options not to be compensatory but incentive devices, it was only natural that, to the extent the tax consequences of an option are governed by Section 130A, no deduction will be allowed to any corporation.⁹⁵

Where the corporate employer grants an option, qualified as a restricted stock option, to only a few employees, it should not normally be difficult for the employer corporation to keep informed as to whether disposition of the stock was postponed beyond the required holding periods. If, however, a large corporate employer should grant such options to many employees, it is possible that in some instances the employer will lose valuable tax deductions, through ignorance of what employees have been doing with their stock. Although there seems to have been considerable activity among larger corporations to grant restricted stock options to top management since the enactment of the Revenue Act of 1950, the question whether any particular corporation should grant such an option is, of course, one which is grounded in corporate policy beyond the scope of this discussion. Stockholder resistance to the grants of any such options cannot, of course, be overlooked.

92. If the employee dies before having exercised the stock option, then what has been said previously in the text applies here.

93. Cost basis of the stock to the fiduciary or beneficiary is the same as that set forth above in the text, regardless of the amount included as compensation in the decedent's final income tax return.

94. The Commissioner has not yet undertaken to tax as income any so-called spread between fair market value and option price at the time the option is granted.

95. INT. REV. CODE § 130A(a) (2).