# THE VALUATION OF OPTION STOCK SUBJECT TO REPURCHASE OPTIONS AND RESTRAINTS ON SALE: A NEW TAX BONANZA IN EXECUTIVE COMPENSATION*

CORPORATE officers or employees frequently are given options to purchase the corporation's stock at a price below market value.[1] Since market value generally mirrors the worth of total rights conveyed by the stock, a party exercising one of these "bargain" options receives concrete economic gain to the extent of the spread between market and option price. And, as a general rule, when the economic benefit is considered "compensation," and hence taxable as ordinary income to the employee, the tax is determined by reference to the spread at the time the option is exercised.[2] In some situations, however, ostensibly for the purpose of retaining a party in the corporation's employ, or perhaps for other reasons, the corporation may place special restrictions on stock purchased through its bargain options.[3] There may be temporary prohibitions against sale of the stock by the optionee.[4] Or the corporation may retain a right—either temporary or permanent—to repurchase the stock, at a given price, at will [5] or on the occurrence of some specified event such as termination of employment.[6] Here, there is no public market

*Harold H. Kuchman, 18 T.C. 154 (1952); Robert Lehman, 17 T.C. 652 (1951).

1. For a comprehensive and penetrating analysis of the option device, see generally, Lyon, *Employee Stock Options Under the Revenue Act of 1950,* 51 COL. L. REV. 1 (1951). See also Alexander, *Employee Stock Options and the 1950 Revenue Act,* 6 TAX L. REV. 165 (1951); Comment, 34 MARQ. L. REV. 211 (1951).

2. U.S. Treas. Reg. 111, § 29.22(a)-1 (1946).

3. Restrictions may be used to retain an employee, to keep the company's shares off the market for a limited period, to preserve the sanctity of a closed corporation, or, as in Robert Lehman, 17 T.C. 652 (1951), see note 30 *infra,* to keep the shares available to the majority stockholders in case they wish to include these shares in a sale of their own interests. For a general discussion of various types of restrictions and the tax treatment they receive, see Molloy, *Restraints on Alienation and the Internal Revenue Code,* 7 TAX L. REV. 439 (1952); Note, *Valuation of Restricted Shares for Tax Purposes,* 90 U. OF PA. L. REV. 346 (1942).

4. See, *e.g.,* Propper v. Commissioner, 89 F.2d 617, 618 (2d Cir. 1937); Morris D. Kopple, 35 B.T.A. 1056, 1057-8 (1937).

5. *Cf.* Lomb v. Sugden, 82 F.2d 166 (2d Cir. 1936); Helen S. Delone, 6 T.C. 1188, 1189 (1946).

6. See, *e.g.,* Spitzer v. Commissioner, 153 F.2d 967, 968-70 (8th Cir. 1946) (subject to repurchase if employee terminates his employment or dies); Kline v. Commissioner, 130 F.2d 742, 743 (3d Cir. 1942) (subject to repurchase if the employee desires to sell, terminates his employment, or dies); Halsted James, 3 T.C. 1260, 1261 (1944), *aff'd per curiam,* 148 F.2d 236 (2d Cir. 1945) (same); Fostoria Glass Co. v. Yoke, 45 F. Supp. 962, 963 (N.D.W. Va. 1942) (subject to repurchase if participant in pooling arrangement wishes to sell).

for the restricted shares themselves, and market value of unrestricted shares may be a totally unreliable index of the value of the restricted shares. Therefore, if the optionee is to be taxed on the amount of his gain when he exercises the option, some index must be developed for appraising the value of the restricted shares.

Courts have adopted different methods, depending on the nature of the restrictions, to value restricted stock for tax purposes.[7] Where a corporation retains the right to repurchase the stock at will, courts hold the value of the restricted stock to be equivalent to the repurchase price.[8] When the corporation's right to repurchase is contingent upon some event such as the employee's desire to sell or the termination of employment, or when the option stock cannot be sold by the stockholder for a specified time period, the value of restricted stock is set by reducing the market value of similar unrestricted shares presumably to reflect impairment of value due to the restriction.[9] There is, however, no precise test for calculating the amount of the reduction.[10] Finally, when restrictions are imposed on stock which is otherwise "highly specula-

7. At one time, the courts refused to recognize the effect of restrictions in valuing the stock, and the recipient of the stock was taxed on the spread between option price and fair market price. G & K Mfg. Co. v. Commissioner, 76 F.2d 454, 456 (4th Cir.), *rev'd on other grounds*, 296 U.S. 389 (1935); *cf.* Wright v. Commissioner, 50 F.2d 727, 729-30 (4th Cir.), *cert. denied*, 284 U.S. 652 (1931).

8. Helvering v. Salvage, 297 U.S. 106 (1935); *cf.* Wilson v. Bowers, 57 F.2d 682, 684 (2d Cir. 1932); and cases cited note 5 *supra*.

9. The question has arisen primarily in gift tax cases which hold that the shares' value need not be limited to repurchase price, but that the presence of the restriction must be considered when making the valuation. This rule has been applied in cases where the repurchase price is fixed but the exercise of the option is conditional, see Halsted James, 3 T.C. 1260 (1944), *aff'd*, 148 F.2d 236 (2d Cir. 1945), and in cases where exercise is conditional and the repurchase price is conditional (for instance, where the repurchase price is to be a given percentage of book value at the time the repurchase option is exercised). See Commissioner v. McCann, 146 F.2d 385 (2d Cir. 1944); Krauss v. United States, 51 F. Supp. 388 (1943), *aff'd*, 140 F.2d 510 (5th Cir. 1944); Charles T. Kline, 44 B.T.A. 1052 (1941), *aff'd*, 130 F.2d 742 (3d Cir. 1942). The same result is reached where the sale of shares is temporarily forbidden, and the shares are not highly speculative in nature. Heiner v. Gwinner, 114 F.2d 723 (3d Cir.), *cert. denied*, 311 U.S. 714 (1940) (one year restraint on sale).

10. When valuing restricted shares, courts have looked to all relevant factors. See Commissioner v. McCann, 146 F.2d 385, 386 (2d Cir. 1944), where the court cited as relevant factors: "the prospective earnings, the likelihood that the donor would not retire; his expectancy in life; his power to change the by-laws; his opportunity to sell to another employee—with the director's consent—; and any other factor. . . ." And see Rose Spitzer, P-H 1947 TC Mem. Dec. ¶ 47,076 (1947) (shares in finance company), where the court considered: "the company's net worth, its earning power, dividend-paying capacity, the war conditions, the government credit restrictions on installment buying, the declining market on the basic date, and the testimony of the expert witnesses. . . ." On remand, in Harrison K. McCann, P-H 1946 TC Mem. Dec. ¶ 46,042 (1946), the Tax Court simply stated, "We have considered all of the evidence as directed by the Circuit Court and upon that evidence we find as a fact that the value of the 2,500 shares . . . was $117,500. . . ."

tive" courts have refused to set any value at all for the restricted stock on grounds that value is simply unascertainable.[11] Because restrictions imposed on shares either reduce their value, with the result that taxable spread is decreased, or render value unascertainable, in which case no tax is levied at all at the time an option is exercised, placing the restrictions on stock purchased through bargain options provides a potential tax avoidance device.[12] Any amount which escapes taxation when the option is exercised will then be taxed when stock is sold.[13] But this tax will be at capital gains rather than higher ordinary income rates, the taxpayer may select a favorable year for incurring the tax by postponing sale, and the tax may be avoided entirely if the taxpayer does not sell during his lifetime.[14]

In the past, however, restrictions have been used rarely since their use presented several disadvantages. Taxpayers were reluctant to replace cash compensation with bargain shares subject to repurchase at the will of the

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Similarly, in *Spitzer,* after listing the relevant factors, the Tax Court stated, "[W]e conclude . . . the stock had a value of $120 a share."

The variance in "relevant" factors, as well as the abrupt transition from factors to conclusion, indicate that translation of restrictions into cash value is a mystery best described as case by case *ad hoc* determinations. See also Nee v. Katz, 163 F.2d 256 (8th Cir. 1947), where the Court of Appeals, in remanding for the lower court's failure to state that all relevant factors had been considered, conceded that after consideration of these factors, the lower court might affirm its former decision. On remand, this is what the lower court did. Katz v. Nee, 74 F. Supp. 783 (W.D. Mo. 1947).

11. Helvering v. Tex-Penn Oil Co., 300 U.S. 481, 499 (1937); United States v. State Street Trust Co., 124 F.2d 948 (1st Cir. 1942), *affirming* 37 F. Supp. 846 (D. Mass. 1941); and cases cited note 4 *supra.* See Molloy, *Restraints on Alienation and the Internal Revenue Code,* 7 TAX L. REV. 439 (1952); Note, 90 U. OF PA. L. REV. 346, 354-6 (1942).

12. See, *e.g.,* Halsted James, 3 T.C. 1260 (1944), *aff'd,* James v. Commissioner, 148 F.2d 236 (2d Cir. 1945) (reduced value resulting in lower taxable spread); and cases cited note 9 *supra.* Helvering v. Tex-Penn Oil Co., 300 U.S. 481, 499 (1937) (where shares' value unascertainable, receipt of such shares gives rise to no taxable income); *cf.* Helvering v. Salvage, 297 U.S. 106 (1935) (shares' basis for capital gain purposes limited to cost where corporation might repurchase shares at will at a price equal to the employee's option price).

13. Since the basis for capital gain purposes is the cost of stock plus the taxed spread, see U.S. Treas. Reg. 111, § 29.22(a)-1 (1946), any portion of the spread which escapes taxation at the time the option is exercised will not be included in the basis figure. Therefore, the difference between selling price and basis will be increased, and the capital gain will be greater.

14. If the spread is taxed at capital gains rates, the tax rate will not exceed 26%, see INT. REV. CODE § 117(c)(2); whereas if the tax were at ordinary rates, a high salaried corporate executive would be taxed at a far higher rate. Since a capital gains tax is not imposed until the shares are disposed of, see INT. REV. CODE § 112(a), taxpayer can postpone payment of the tax until a year in which he has offsetting capital losses, with the result that he actually may pay no tax. Furthermore, if the taxpayer does not sell within his lifetime, tax is never imposed on the original spread since the taxpayer's heirs receive as a basis for the stock its fair market value at the date of the taxpayer's death. INT. REV. CODE § 113(a)(5).

corporation since the bargain could be withdrawn at any time [15] and the stock could not be sold for more than the price of the corporation's repurchase option.[16] And of course, conditionally exercisable repurchase options and restraints on sale also limited the use of the shares to the stockholder. Moreover, the precise amount of tax benefit to be obtained by placing restrictions on stock was not readily ascertainable in advance,[17] and the uncertainty in valuation opened the way for possible litigation between the taxpayer and the Commissioner. In the light of these disadvantages it was patently more practical until 1946 to use "proprietary" options, *i.e.*, options designed to give an employee a stake in the business rather than compensate him, since the spread on stock purchased under a "proprietary" option was not taxed until stockholder sold the shares and then was taxed at capital gains rates.[18] When the usefulness of "proprietary" options was left in doubt by the 1946 Supreme Court decision in *Commissioner v. Smith* [19] and subsequent Treasury Regulations,[20] attention focused on invalidating the Regulations or obtaining special

15. But the corporation, in the interest of good employer-employee relations, may not exercise its rights. See Helvering v. Salvage, 297 U.S. 106 (1935), where the option to repurchase at $100 was not exercised even though the unrestricted value of the stock was $1,164.70. However, if the company is not a closed corporation, a stockholder's derivative suit might lie to force exercise of the repurchase option or to hold directors liable for failure to exercise it. In any event, the employee would probably prefer a safer form of compensation.

16. No purchaser will pay more than the repurchase price because if the employee no longer holds the shares there is nothing, not even considerations of employee morale, to prevent the corporation from exercising its rights.

17. Since the manner in which courts gave cash value to the restriction was a mystery, see note 10 *supra*, taxpayers could not readily determine the tax benefit they would receive when restrictions were used.

18. Omaha Nat. Bank v. Commissioner, 75 F.2d 434 (8th Cir. 1935); Delbert B. Geeseman, 38 B.T.A. 258, 263-4 (1938); Gordon M. Evans, 38 B.T.A. 1406, 1412-13 (1938); see also Herbert H. Springford, 41 B.T.A. 1001 (1940). In distinguishing between compensatory and proprietary options, the courts looked to the intent of the parties. For discussion of the problems involved in ascertaining intention, see Sax, *Stock Options*, 23 TAXES 505 (1945) (listing 38 factors which indicate intent to compensate and 30 which indicate intent to grant a proprietary option); Bastedo, *Taxing Employees on Stock "Purchases,"* 41 COL. L. REV. 239 (1941); Note, 50 HARV. L. REV. 500 (1937). A clever draftsman could easily create an option which would be held proprietary. See Sax, *supra*, at 510.

19. 324 U.S. 177 (1945), *rehearing denied*, 324 U.S. 695 (1945).

20. The amended Regulation, U.S. Treas. Reg. 111, §29.22(a)-1 (1946), attempted to do away with the proprietary option concept by declaring that the spread between cost and market price is, in all cases, compensation. Presumably the regulation was based on dicta in the *Smith* case which suggested that any economic benefit accruing to an employee where employee-employer relations are involved is compensation. Commissioner v. Smith, 324 U.S. 177, 181 (1945).

The change in the Regulations has been criticized as being an unwarranted extension of the *Smith* holding. See, *e.g.*, SEN. REP. No. 2375, 81st Cong., 2d Sess. 59 (1950). The attitude of the courts on this question is unclear. *Compare* Van Dusen v. Commissioner, legislative treatment for stock options;[21] the possibility of using restrictions on stock to obtain tax benefits was apparently ignored. With the passage of Section 130A of the Internal Revenue Code, under which qualified options are given substantial tax benefits,[22] option plans have been drawn primarily with an eye to qualify under 130A. But two recent decisions in the Tax Court may vault into prominence the use of restrictions on stock in bargain options.

In *Harold H. Kuchman*,[23] the taxpayer exercised an option to purchase shares of the corporation which employed him. Under the option, he paid $5 per share for stock which, if unrestricted, would have had an approximate value of $25.[24] The stock was subject to a one year restraint on alienation and to an option, held by the corporation, to repurchase at $5 per share if the taxpayer left the company within the next year.[25] Kuchman argued that his option was "proprietary" and, consequently, that no tax should be levied on exercise of the option.[26] But the court did not decide this issue. Instead, the court reasoned that because of the restrictions no buyer would pay more than $5 per share and because of the future value of the stock and the temporary

166 F.2d 647 (9th Cir. 1948), *affirming* 8 T.C. 388 (1947) (*Smith* dicta followed, old regulation ignored), *with* Norman G. Nicolson, 13 T.C. 690 (1949) (amended regulation ignored). The opinions of the commentators as to the validity of the regulations are similarly divergent. *Compare* Boland, *Employee Options Under the Federal Income Tax*, 28 TAXES 415, 418-20 (1950), *with* Alexander, *Employee Stock Options and the 1950 Revenue Act*, 6 TAX L. REV. 165, 172-3 (1951). For argument that newly created § 130A of the Internal Revenue Code, containing special treatment for qualifying stock options, precludes the proprietary option from constituting any legitimate basis for tax treatment different from the Treasury Regulations, see Alexander, *supra*, at 202-3.

21. For discussion of attempts to obtain remedial legislation, see Lyon, *Employee Stock Options Under the Revenue Act of 1950*, 51 COL. L. REV. 1, 15-16 (1951). In 1948, an option law was passed by the House of Representatives, but it was never voted on in the Senate. For discussion of this bill, see Dann, *Employee Stock Options Under H.R. 6712*, 37 GEO. L.J. 242 (1949). For discussion regarding the validity of the amended Regulation, see articles cited note 20 *supra*.

22. INT. REV. CODE § 130A. For the requirements of this section, see note 39 *infra*. For the tax benefits obtainable under this section, see notes 40-1 *infra*.

23. 18 T.C. 154 (1952).

24. This is the value the Commissioner placed on the shares. *Id.* at 162. It is also the price at which the shares were being offered to the public. *Id.* at 161. Although this valuation may be open to criticism, there is little doubt that the shares were worth far more than $5.

25. *Id.* at 159. The repurchase option probably could be exercised only if the *employee* chose to leave the company during the following year. The stock was subject to the further restriction that if the taxpayer wished to sell during the first two years after the restraint on sale had lapsed, he was required first to offer the shares to the company at the then market price. This last restriction would have no effect on the shares' market value. See James Couzens, 11 B.T.A. 1040, 1163-4 (1928); Jay N. Darling, 4 B.T.A. 499, 502 (1926).

26. See Briefs for Petitioner and Respondent, Harold H. Kuchman, 18 T.C. 154 (1952) *passim*.

nature of the restrictions no seller would sell for $5. Thus, the court concluded that it was impossible to ascertain the value of the restricted shares.[27] As a result, no tax was levied on the spread between option price and an estimate as to what the stock might have been worth, even though after one year the value of the stock would have increased almost 500 percent. The Commissioner acquiesced in the decision.[28]

In *Robert Lehman*,[29] another Tax Court case just prior to *Kuchman*, the taxpayer received, as compensation for services, a bargain option which he exercised two years later. The stock purchased under the option could not be sold for eleven months from the purchase date. Moreover, if within the eleven months the majority stockholders sold their interest in the company, they could include in the sale the shares held by Lehman, provided they paid him the same price they were receiving for their own stock.[30] Shortly after the restrictions terminated, Lehman sold the shares and reported the profit as capital gain. On the ground that the restrictions made value unascertainable, the Commissioner had imposed no tax at the time the option to purchase the shares was exercised.[31] But the Commissioner did assert that income was realized and thus tax was due in the year the restrictions terminated. Accordingly, he attempted to include in the taxpayer's ordinary income the difference between the cost of the stock and its value immediately after the restrictions expired; only the increase in value that occurred between the time of expiration and the time of sale was treated as capital gain. But the Tax Court held that the expiration of restrictions was not a taxable event and thus treated the entire gain as capital gain.[32] Again, the Commissioner acquiesced.[33]

Read together, the *Kuchman* and *Lehman* cases remove the major practical difficulties in the use of bargain option stock with restrictions as an attractive device for compensating officers and employees. As a result of *Kuchman*, it is simple to create restrictions that will make value unascertainable. The corporation need only retain a one-year option to repurchase stock at its cost to the employee, and condition the repurchase option on the employee's

27. Harold H. Kuchman, 18 T.C. 154, 162-3 (1952). This determination is not in line with prior decisions. See notes 9, 11 *supra*.

28. 1952 INT. REV. BULL. No. 18 at 1 (1952).

29. 17 T.C. 652 (1951).

30. Brief for Petitioner, p. 3; Brief for Respondent, pp. 10-11, Robert Lehman, 17 T.C. 652 (1951). The provisions were to last for three years from the time the option was granted. At the time the option was exercised, all but eleven months of this period had expired.

31. In this, the Commissioner was probably in error. Since restraint on sale and the repurchase restriction were to remain in effect only a short time, and since repurchase would have resulted in bringing close to the shares' market value to Lehman, these restrictions probably should not have rendered value unascertainable under the existing law unless the value of the shares unrestricted was "speculative." See notes, 9, 11 *supra*.

32. For the facts and holding of the decision, see Robert Lehman, 17 T.C. 652, 653-4 (1951).

33. 1952-1 CUM. BULL. 3.

leaving the corporation.[34] Since this condition is largely within the employee's control, he is not receiving a bargain that may readily be withdrawn.[35] Moreover, by the end of the year, he will hold stock free of restraints. At the same time, bolstered by the Commissioner's acquiescence, the taxpayer faces little uncertainty in the tax benefit to be derived: since value of the restricted shares is unascertainable and not merely reduced, he cannot be taxed at all when he exercises the option;[36] and the *Lehman* case at least implies that any later tax assessment must be at capital gains rates and only when the stock is sold.[37]

The Kuchman type option compares favorably with any other available form of stock option compensation. While a proprietary option might confer the same tax benefits as does an option falling within *Kuchman*, current Treasury Regulations indicate that the Commissioner, at least, views the proprietary option as defunct.[38] Consequently, attempts to establish proprietary options simply invite litigation and the danger that courts may support the Regulations and thus tax the optionee at ordinary income rates on the spread between market and option price. Section 130A of the Internal Revenue Code also offers favored treatment for qualifying bargain options.[39] Under 130A, if option

34. See Harold H. Kuchman, 18 T.C. 154, 159 (1952). It is possible that the same result can be obtained by using restrictions other than those used in *Kuchman*. Short term repurchase options conditioned on the employee's desire to sell or on his death, or long term options conditioned on the same factors may invoke similar tax treatment. While in most situations, all three conditions: desire to sell, death, and termination of employment have been present, the *Kuchman* case involved only the latter condition. Consequently, whether either of the former conditions, alone or together, will make value unascertainable is problematical, although the *Kuchman* rationale seems equally applicable to all three.

The *Lehman* restriction (repurchase contingent on sale by majority stockholders of their interests) suggests the possibility that value may be held unascertainable even where the occurrence of the condition enabling repurchase is unlikely. In *Lehman*, there is no evidence that the Commissioner investigated the possibilities of a sale by the stockholders, so that actually there may have been little chance that such a sale would have been made. It is conceivable that repurchase can be conditioned on a merger or consolidation within a short period when, in fact, there is almost no possibility of the event taking place. If the Commissioner does not look behind such a restriction, its presence should, by analogy to *Lehman*, prevent the ascertainment of value.

35. Since the opportunity to exercise a repurchase option will probably not induce a corporation to discharge a competent employee, the exercise of a repurchase option which is conditioned on termination of employment is largely within control of the employee. Moreover, in the *Kuchman* case, the wording of the repurchase option indicates that it would become operative only if the employee resigned voluntarily. See Harold H. Kuchman, 18 T.C. 154, 159 (1952).

36. See *id.* at 162-3; and cases cited note 11 *supra*.

37. The court, in stating that the profit was properly reported as capital gain when the shares were sold, used broad language stating that any attempt to tax at ordinary income rates on the expiration of restrictions would not succeed. Robert Lehman, 17 T.C. 652, 654 (1951). But see note 49 *infra*.

38. See note 20 *supra*.

39. The requirements that must be met for an option to qualify under § 130A are: the option must be granted to an employee, INT. REV. CODE § 130A(a); the spread cannot

price is 95% of market price, the optionee will obtain tax benefits similar to Kuchman's.[40] However, the obvious virtue of the Kuchman type option is the larger spread that can be used. The 95%-130A option offers the employee a bargain with only a 5% margin of safety. Consequently, any shift in the market may eliminate the entire gain. Under *Kuchman*, the same bargain might be obtained by the purchase of fewer shares at larger discounts, and thus minor market changes may reduce but will not eliminate the bargain. Section 130A also offers some favored tax treatment for stock purchased under options at 85% to 95% of market price: tax on the spread is at ordinary income rates; but the tax may be postponed until the stock is sold, or, if the stock remains unsold, until the stockholder's death.[41] Here, a Kuchman type option can provide not only a larger spread, but also a tax at capital gains rates and the possibility that the tax can be entirely avoided if the taxpayer never sells his stock. Additionally, a Kuchman type option can secure favored tax treatment in situations which do not qualify at all under 130A. The option may be used to compensate parties other than employees (as in the *Lehman* case where it was granted to compensate an investment banker); or it may be given to an individual even if he owns or controls more than 10% of the corporation's voting stock. And a corporation need not confine its bargain offer to its own shares or those of its parent or subsidiaries; favored tax treatment will be accorded where a company is disposing of its holdings in any other corporation.[42]

Placing restrictions on option stock provides such a generous and obvious tax avoidance device that future attempts to take advantage of the Kuchman type option may be unsuccessful despite the Commissioner's acquiescence in

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exceed 15%, *id.* § 130A(b); the option cannot be transferable, *id.* § 130A(d)(1)(B); the recipient of the option must not own or control more than 10% of the employing company's voting stock, *id.* § 130A(d)(1)(C); the shares offered must be those of the employing company or of its parent or subsidiary, *id.* § 130A(d)(1); and the shares may not be disposed of by the employee for two years from the time the option was granted, nor for six months from the time the option was exercised, *id.* §§ 130A (a), (b).

40. *Id.* § 130A(a). If an option qualifies under this section, no tax is imposed when the option is exercised and only a capital gains tax is paid when the shares are sold. See Ivins, *What Is New in Employee Stock Options*, 10 N.Y.U. INSTIT. FED. TAX 121, 129-30 (1952).

41. INT. REV. CODE § 130A(b). This tax is measured by the lesser of the difference between either cost and fair market value at the time the option was granted, or cost and fair market value at the time of sale or death.

42. Since *Kuchman* and *Lehman* were decided on a rationale of unascertainability, the existence of 130A qualifications is irrelevant for obtaining a favored treatment under these cases. In fact, both cases involved situations which would not fall under § 130A: in *Lehman* the option was granted to an independent contractor, rather than to an employee, Robert Lehman, 17 T.C. 652, 653 (1951), and in *Kuchman* the offering was made by an underwriter, with the result that the shares were not those of the issuing company or its parent or subsidiary. Harold H. Kuchman, 18 T.C. 152, 158 (1952).

the *Kuchman* and *Lehman* decisions. Section 130A of the Internal Revenue Code contains special legislation permitting favored treatment for stock option plans, but only in limited circumstances which pose requirements that both the taxpayer and corporation must meet. *Kuchman* and *Lehman*, if completely followed, undermine congressional choice of the type of favored treatment and the limitations imposed by Congress on situations in which such treatment should be available.[43] Thus, when restrictions are placed on option stock in the future, the Commissioner may attack, or at least distinguish, the *Kuchman* and *Lehman* holdings. Of course, any major reversion to prior law may make the Kuchman type option unattractive once again and may endanger benefits from plans drafted to fall within *Kuchman*.[44]

Aside from argument based on congressional intent, there are doctrinal grounds to buttress an attack against a Kuchman type option. The *Kuchman* case, for example, represents a substantial change of prior law. Before the decision, the value of restricted shares was unascertainable only where the value of the stock without restrictions would have been "highly speculative."[45] Thus *Kuchman* may be directly attacked as erroneous, since courts would have previously evaluated the restricted shares when the option was exercised. To attack in this way, however, the Commissioner's acquiescence would have to be withdrawn. But even if the decision is accepted, future situations may readily be designated as falling outside its scope. Restrictions on Kuchman's stock were imposed, apparently without regard to tax motives, because of the company's dire need to retain his services in a period of reorganization.[46] Where circumstances indicate that restrictions are imposed to obtain tax benefits rather than for any urgent necessity to retain the employee's services,[47] *Kuchman* can conceivably be held inapplicable and the restrictions ignored as an attempt to avoid the limitations of Section 130A. At the same time, the *Lehman* case does not necessarily preclude an attempt to assess the total bargain, *i.e.*, the spread between option price and the original market price of unrestricted shares, at ordinary income rates when restrictions expire. In *Lehman*, the court dismissed the Commissioner's attempt to tax at ordinary

43. For § 130A requirements, see note 39 *supra*. At least one commentator has argued on identical grounds that § 130A precludes favored treatment for proprietary options. See Alexander, *Employee Stock Options and the 1950 Revenue Act*, 6 TAX L. REV. 165, 202-3 (1951).

44. Under prior law, the *Kuchman* restrictions would have caused a reduction in value thus creating considerable uncertainty as to the precise tax effect of any restriction, see notes 9, 10 *supra*. This uncertainty alone would deprive the *Kuchman* option of much of its utility for tax avoidance. And, of course, if the reduction is not substantial, tax benefits may be greatly limited.

45. See notes 9, 11 *supra*.

46. Harold H. Kuchman, 18 T.C. 154, 158 (1952).

47. The distinction might rest on the presence of some urgent business purpose. But such a test will invite litigation since it will be difficult to draw the line between urgent and ordinary business purposes.

rates the spread between option price and *market price when restrictions expired.* And its conclusion that expiration of restrictions is not a taxable event was predicated in response to the Commissioner's argument that income was realized by the lifting of restrictions.[48] Acquiescence may be interpreted as an assent only to the court's conclusion regarding the particular spread litigated and the fact that no income was realized. Then it may be urged that the year of realization of income is irrelevant since, whenever income may have been realized, it cannot as a practical matter be assessed until restrictions do lift.[49] The situation is analogous to others where practical reasons result in assessment of tax in a year in which gain or loss did not occur, as for example, in the tax treatment of a recipient of blocked currency.[50]

But the possibility of attack on future Kuchman type options should not deter taxpayers from using them, especially since some options may be drafted to guarantee some tax benefits regardless of attack. On the strength of the

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48. See Robert Lehman, 17 T.C. 652, 654 (1951).

49. It must be noted, however, that under certain circumstances, courts may find that lifting of restrictions does result in realization of income by the stockholder. If, for instance, stock is subject to a permanent repurchase option which is exercisable at the termination of employment, the employee should anticipate repurchase upon retirement. But, if at any later time, the company waives its right to repurchase, the employee then possesses completely unrestricted shares. Any difference between the repurchase price and the market value of unrestricted shares at the time of waiver is analogous to a bonus for the employee and consequently might be taxed at ordinary rates at that time. *But cf.* Frances Elliott Clark, 28 B.T.A. 1225, 1230-1 (1933), *aff'd*, 77 F.2d 89 (3d Cir. 1935) (the removal of restrictions by the employer was held to give rise to no taxable income whatsoever). If the courts hold a contrary view, then corporations can always safely provide for tax-favored compensation to its employees by granting stock subject to repurchase options and later lifting the restrictions long before the condition may occur.

50. When a taxpayer earns income in a foreign country, and that money is subject to restrictions which limit its use, the taxpayer may defer reporting this income until the restrictions are lifted, in which case he receives income in the later year to the extent of the value of the money in that year. See Mim. 6475, 1950-1 CUM. BULL. 50.

A similar result is reached in cases where an employee is promised a stock bonus, on the condition that he remain with the corporation for a specific period of time. In Fred C. Hall, 15 T.C. 195 (1950), the shares were issued to the employee when the bonus agreement was signed. He immediately indorsed the certificates in blank and turned them over to the corporation's treasurer, who held them until the employee had remained with the corporation the required time. The court held that the employee received the bonus in the later years after the required services had been performed and tax was based on the shares' value in the later year. The same result is reached even though the employee receives dividends on the shares during the escrow period, see Roscoe H. Aldrich, 3 B.T.A. 911 (1926), or he is able to borrow from the company, using the stock as collateral, during the escrow period. See Phillip W. Haberman, 31 B.T.A. 75 (1934), *aff'd*, 79 F.2d 995 (2d Cir. 1935).

Both the blocked currency and the defeasible bonus situations are support for overruling the *Lehman* decision, since in both cases the tax is based on value in the year when restrictions end. But they also are precedent for distinguishing *Lehman*, and taxing the original spread when restrictions lift, since they permit tax to be levied at a more practical time when value is not ascertainable in the year of receipt.

Commissioner's acquiescence alone, corporations and employees may find it worthwhile to adopt Kuchman type options—most probably where requirements of 130A cannot be met or where large spreads are particularly desirable. Indeed, since acquiescence is not to be taken lightly [51] and tax benefits are substantial, there is considerable justification for gambling with a Kuchman type option in almost any circumstance except where parties desire and are able to fall within the 95% provisions of 130A. Use of the Kuchman type option, however, is made especially attractive by the possibility of drafting an option which will qualify under the 85% to 95% provisions of 130A and, at the same time, contain restrictions bringing the option stock within *Kuchman*.[52] As a result, the taxpayer may use up to a 15% spread and be assured that he will not be taxed until stock is sold or until his death, and, if Kuchman type options remain unassailed, he can receive the additional benefits made available by the *Kuchman* and *Lehman* cases.

The Commissioner and the courts should plug up the huge loophole created by the *Kuchman* and *Lehman* cases. When restrictions are placed on stock it is undoubtedly difficult, if not impossible, to value the shares accurately in order to tax the stockholder. But the solution provided by the two recent Tax Court decisions resolves the difficulty only at the expense of undermining congressional intent and creating favored tax treatment for a special class of taxpayers.[53] Alternative to the Tax Court's position lies a whole range of possibilities for tax treatment. Illustrative are the approaches of: taxing at the expiration of restrictions the original spread or spread at expiration; evaluating the stock at reduced amount when the option is exercised; limiting the *Kuchman* doctrine to restrictions which serve urgent "business purposes." These

51. "Acquiescence by the Commissioner in a Tax Court decision usually means that the decision will be accepted by the Commissioner as a precedent in closing similar cases. However, the Commissioner has, in a few instances, revoked or withdrawn his acquiescence. . . ." 3 P-H 1953 FED. TAX SERV. ¶ 28,405 (1953).

52. The addition of *Kuchman* restrictions to a 130A option would not be burdensome. Under § 130A, the employee cannot sell for six months from the time of purchase. The addition of *Kuchman* restrictions increases that period to one year, but under *Kuchman*, when the employee exercises his option immediately, one year is the longest time he will be kept from selling; whereas under § 130A if the employee exercises the option immediately he must hold the shares for two years since § 130A also requires the shares to be held for two years from the time of grant. Therefore, it is only where the employee, under a 130A option, does not exercise the option for at least a year that the *Kuchman* sale restraint will add to his burdens. The addition of the one-year repurchase option does increase the burdens on the employee, but the increase is slight, and it should not make the 130A option unattractive. For discussion of non-*Kuchman* restrictions which may receive the same treatment as Mr. Kuchman's, see note 34 *supra*.

53. Generally, stock option compensation is used for corporate executives. Indeed, the passage of § 130A giving the stock options favored treatment under *limited* circumstances was vehemently criticized as socially unwise special class legislation. See Lyon, *Employee Stock Options Under the Revenue Act of 1950*, 51 COL. L. REV. 1, 3, 54-7 (1951). *Kuchman* and *Lehman* extend the potentialities for the same group to benefit even further.

alternatives, however, either retain old difficulties, create new litigious questions, leave the tax loophole open, or tax "unfairly."[54] Perhaps the best solution to the problem is to revert to the position of the courts prior to 1935: ignore restrictions for tax purposes.[55] At first blush, this approach may appear unfair to those who use the option for restricted stock for reasons other than tax avoidance, for restrictions do factually reduce value and the taxpayer will thus be assessed on more than he actually receives when he exercises the option. Apart from tax purposes, however, restrictions involved in litigation thus far have been designed primarily to guarantee an employee's services to the corporation, or to stimulate employee incentive while keeping the corporation closed.[56] In fact, the corporation has command of many other devices to exact the same guarantees just as effectively.[57] Thus ignoring restrictions

54. Overruling *Kuchman*, and holding that repurchase options reduce value, might block the loophole because of the uncertainty that would be created. But return to law which is so hard to administer seems unwise and may breed litigation. See notes 9, 11 *supra*. Limiting the *Kuchman* rule to a situation where there is an urgent business necessity will also be unsatisfactory since the question of whether conditions create an urgent or merely an ordinary business necessity is litigious.

Overruling *Lehman*, thereby taxing spread at the time restrictions expire, can be said to be unfair to the taxpayer since gain in market value from the time of exercise until restrictions end will be taxed as ordinary income rather than capital gain. But see note 50 *supra*, where in situations similar to this, a tax has been levied when restrictions expire. On the other hand, this action may not entirely block the loophole. If the restrictions expire or are lifted after many years, at a time when the employee is in a lower income bracket, the taxpayer will obtain postponement benefits similar to those provided by § 130A(b). See note 41 *supra*. Distinguishing *Lehman* so as to make tax on the original spread possible at the restriction's end may also be unfair to the taxpayer, since he will be taxed on his original spread even though the market price may have dropped considerably. Again, the employee may still gain the benefit of postponement of taxation. Of course, to the extent that there is little arm's-length dealing between corporations and recipients of option stock, the postponement possibility becomes even more attractive since the corporation may select the taxpayer's choice of year for lifting restrictions. And see note 49 *supra*.

55. See G & K Mfg. Co. v. Commissioner, 76 F.2d 454, 456 (4th Cir.), *rev'd on other grounds*, 296 U.S. 389 (1935); Newman v. Commissioner, 40 F.2d 225 (10th Cir. 1930); and case cited note 7 *supra*. See also Note, 83 U. OF PA. L. REV. 1028 (1935).

56. For use of restrictions to help retain employees' services, see Kline v. Commissioner, 130 F.2d 742 (3d Cir. 1942) (repurchase price contingent on conditions under which severance of employment takes place); Lloyd D. McDonald, P-H 1944 TC MEM. DEC. SERV. ¶ 44,096 (1944) (company could repurchase if employee retired before age of 60 or if he retired without consent of Board of Directors after reaching age 60); Harold H. Kuchman, 18 T.C. 152 (1952). For use of restrictions in closed corporations, see Spitzer v. Commissioner, 153 F.2d 967 (8th Cir. 1946); Commissioner v. McCann, 146 F.2d 385 (2d Cir. 1944); Halsted James, 3 T.C. 1260 (1944), *aff'd per curiam*, 148 F.2d 236 (2d Cir. 1945).

57. It is true that restrictions may serve some valid purpose, but these purposes can be achieved in other ways. Short-term restrictions do help a corporation retain an employee's services for a specific period of time; but, except for the tax loophole created by such restrictions, the same results can be obtained by contracting either to offer a

hardly seems unfair, since it allows the courts and the Commissioner to cope in a very simple way with what the restriction really seems to be: a tax avoidance device.

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bonus by way of a § 130A option if the emloyee performs the required services, or to deliver a stock bonus to the employee after he has remained the required time. See Fred C. Hall, 15 T.C. 195 (1950); and other cases cited note 50 *supra*. Similarly, long term restrictions provide the employer with an effective weapon for inducing the employee to remain with the company until he reaches retirement age. However, pension plans or annuities, for example, under which the employee's rights are forfeited if he leaves the company before he has reached retirement age are equally powerful devices.

If a closed corporation gives a managing employee stock, subject to repurchase, for voting purposes, the same result can be achieved by making him a voting trustee, under a voting trust which will terminate at the end of his employ. If stock is given so that the employee will share in dividends, the size of which may well depend on his efforts, the same goal can be reached by adopting a plan under which the employee receives a share of the net profit.