Abraham L. Johnson v. Commissioner, 8 T.C. 378 (1947)

When an employee purchases stock from their employer at a discount, the transaction is treated as additional compensation taxable to the employee if the opportunity to purchase the stock at below market value is part of the bargain for their services.

Summary

The Tax Court determined that stock purchased by Abraham L. Johnson, an operating vice president, from his employer was additional compensation, not a dividend. Johnson purchased stock at a favorable price. The court reasoned that the stock was offered to Johnson as an employee to secure his continued service and increase his stake in the company, and not as a distribution of profits to a stockholder. Therefore, the bargain purchase constituted compensation income to Johnson.

Facts

Abraham L. Johnson was an operating vice president of a company. The company sold stock to Johnson at a price below market value. The company intended to incentivize Johnson by giving him a larger participation in the company and thereby securing his continued employment. Other stockholders waived their rights, which limited the sale to Johnson alone.

Procedural History

The Commissioner of Internal Revenue determined that the stock purchase was taxable income to Johnson. Johnson petitioned the Tax Court for a redetermination of the deficiency.

Issue(s)

Whether the purchase of stock by an employee from their employer at a price below market value constitutes additional compensation taxable to the employee, or a non-taxable bargain purchase?

Holding

Yes, because the opportunity to purchase the stock at below market value was part of the bargain by which the employee's services were secured and his compensation was paid.

Court's Reasoning

The court reasoned that the stock was offered to Johnson in his capacity as an employee, not as a stockholder. The court distinguished between a dividend (a distribution of profits to stockholders) and compensation (payment for services rendered). Applying the test of whether the opportunity to purchase stock at below market is part of the bargain by which the employee's services are secured, the court noted that the parties agreed there was no issue with respect to receipt of this stock as compensation. The court relied on precedent like *Delbert B. Geeseman, 38 B. T. A. 258*, indicating that the employee's continued employment was not dependent on the stock purchase. The court stated: "The substance of the plan rather than its form must be ascertained." Even though the transaction resembled a stock dividend, the court found that it was primarily intended to incentivize and compensate Johnson for his services. No effort was apparently made by the employer to take any deduction for compensation paid on account of the transaction in controversy.

Practical Implications

This case clarifies that bargain purchases of stock by employees from their employers can be treated as taxable compensation. The key factor is the intent behind the transaction. If the discount is offered to incentivize the employee and secure their services, it is likely to be considered compensation, regardless of the technical form of the transaction. Employers should be aware that offering stock options or discounts to employees may create a taxable event for the employee, requiring proper reporting and withholding. Later cases applying this ruling would need to analyze the specific facts to determine the true intent behind the stock offering, examining factors such as employment contracts, company policies, and the reasons given for offering the stock at a discount.

