5 T.C. 104 (1945)

When an employee purchases stock from their employer at a discount, the difference between the market price and the purchase price is taxable income to the employee if the purchase is considered compensation for services.

Summary

The petitioner, an operating vice president, purchased company stock at a discount. The Commissioner argued that the stock was received as a taxable dividend. The Tax Court held that the stock was sold to the petitioner as an employee, not as a stockholder, and thus was a bargain purchase related to his employment. The court determined that the discount was intended as compensation and therefore constituted taxable income to the employee. The key factor was that the purchase was tied to his employment status and intended to incentivize him as an employee.

Facts

The petitioner was the operating vice president of a company. The company sold stock to the petitioner at a price below its market value. The company stated it was in its best interest that the employee be satisfied and have a larger stake in the company. Other stockholders waived their rights to purchase, effectively limiting the sale to the petitioner.

Procedural History

The Commissioner determined that the stock purchase constituted a taxable dividend. The petitioner challenged the Commissioner's determination in the Tax Court.

Issue(s)

Whether the difference between the market price and the purchase price of stock acquired by an employee from their employer constitutes taxable income, when the purchase is made available because of the employee's position within the company.

Holding

Yes, because the opportunity to purchase the stock at a discount was considered part of the bargain by which the employee's services were secured and his compensation was paid. The employee's continued employment was not necessarily dependent on receiving the right to purchase stock at less than market price.

Court's Reasoning

The court reasoned that the stock was offered to the petitioner in his capacity as an employee, not as a stockholder. The court relied on prior precedent, including

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Delbert B. Geeseman, 38 B. T. A. 258, to establish that bargain purchases offered to employees can be considered compensation. The court stated, “the test of whether options to purchase stock exercised by employees are additional compensation and so taxable or are mere bargain purchases not giving rise to taxable income until final disposition is whether the arrangements between employer and employee lead to the conclusion that by express contract, or necessary implication from the surrounding facts, the opportunity to purchase stock at below the market is a part of the bargain by which the employee’s services are secured and his compensation is paid.”

The court acknowledged the transaction had aspects resembling a stock dividend but emphasized that the substance of the plan should be prioritized over its form. The assurance that other stockholders would waive their subscription rights indicated an intention to sell the stock specifically to the petitioner as an employee, not to distribute profits to stockholders generally.

Practical Implications

This case illustrates the importance of examining the substance of a transaction when determining its tax implications. The critical takeaway is that stock options or purchases offered to employees at a discount are likely to be treated as taxable compensation if they are tied to the employment relationship. This ruling requires careful structuring of employee stock option plans to clarify whether a bargain purchase is intended as additional compensation. Employers should be aware that offering discounted stock to employees might not always be treated as a tax-free benefit. Subsequent cases and IRS guidance further refine the rules for determining when employee stock options trigger taxable events.

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