18 T.C. 154 (1952)

When an employee receives stock as compensation through a bargain purchase option, the amount of compensation is measured by the difference between the option price and the fair market value of the stock on the date the option is exercised, not the date the option is authorized.

Summary

This case addresses how to determine the amount of compensation an employee receives from a bargain purchase of their employer's stock. Kuchman argued that the compensation should be measured by the difference between the option price and the market price on the day the option was authorized. The Tax Court held that the compensation is determined by the difference between the option price and the market price on the day the option was exercised. Additionally, the court determined that stock received in lieu of dividends before the option was exercised constituted additional compensation.

Facts

The petitioner, Kuchman, received a stock option from his employer as compensation for services. The corporation authorized the option in 1944, but the option was issued and exercised in 1945. The option allowed Kuchman to purchase stock at $3 per share. When Kuchman exercised the option, the market value of the stock was $33.875 per share. Prior to exercising the option, Kuchman also received 360 shares of stock in lieu of dividends declared on the optioned shares.

Procedural History

The Commissioner of Internal Revenue determined that Kuchman received compensation income based on the difference between the option price and the market value of the stock when the option was exercised, as well as the value of the shares received in lieu of dividends. Kuchman petitioned the Tax Court for a redetermination of the deficiency.

Issue(s)

1. Whether the amount petitioner received as compensation for services rendered by way of a bargain purchase of his employer's stock should be measured by the difference between the option price and the market price on the day the option was authorized or by such difference on the day the option was exercised.
2. Whether stock purchased by the corporation and delivered to petitioner in amounts equivalent to dividends declared on the optioned shares after the option authorization but prior to its exercise represents compensation to petitioner in addition to the optioned shares.

Holding

1. No, because the compensation is realized when the option is exercised and the stock is received at a price below its market value.
2. Yes, because the shares were received in lieu of cash payments and represent additional compensation for services.

Court's Reasoning

The court reasoned that the option itself did not transfer any stock until it was exercised. Relying on Commissioner v. Smith, the court emphasized that even if the option had value when authorized, that value would be income when the option was received, not when it was exercised. The court found no evidence of a binding agreement obligating the corporation to issue the option before it actually did. The court also highlighted restrictions on the option, such as the prohibition of assignment without corporate consent, making it difficult to determine a market value for the option itself. The court stated, "An option carrying such conditions and restrictions, in our opinion, makes impossible a determination of market value." Therefore, the taxable event occurred when Kuchman exercised the option and received the stock at a bargain price. As for the shares received in lieu of dividends, the court found that these were additional compensation because they were received in lieu of an authorized cash payment to stockholders before Kuchman became a stockholder.

Practical Implications

This case clarifies the timing of income recognition for compensatory stock options. The key takeaway is that the taxable event generally occurs when the employee exercises the option and purchases the stock at a discount, not when the option is granted or authorized. This means that the employee will be taxed on the difference between the market value of the stock at the time of exercise and the price they paid for it. Further, any additional benefits, like dividends paid in shares before exercising the option, can be considered additional compensation. This case highlights the importance of considering restrictions on stock options when valuing them and determining when income is recognized.

