19 T.C. 872 (1953)

When an employee purchases stock warrants from their employer at a price less than their fair market value, the difference is taxable as compensation, and the employee's basis for determining gain or loss upon a subsequent sale of the warrants is the price paid, increased by the amount previously reported as compensation.

Summary

Lauson Stone, president of Follansbee Steel, purchased stock warrants from the company in 1947. He reported the difference between the warrants' fair market value and his purchase price as income. In 1948, Stone sold the warrants. The IRS argued the entire sale proceeds were taxable as additional compensation. The Tax Court held that the warrants were capital assets, and Stone's basis for calculating capital gains was the original purchase price plus the amount already taxed as income in 1947, rejecting the IRS's argument that the warrants had no value when issued and the entire profit should be taxed as compensation.

Facts

Lauson Stone was the president of Follansbee Steel Corporation. In 1947, Follansbee Steel sold him stock purchase warrants for $1,000, which allowed him to purchase 100 shares of stock per warrant at $21 per share. The warrants were immediately negotiable and exercisable after October 31, 1947, and before May 1, 1952. Stone reported $5,000 as additional compensation in 1947, representing the difference between the $6,000 fair market value he assigned to the warrants and the $1,000 he paid. In 1948, Stone sold 89 of these warrants for $82,680.50.

Procedural History

The Commissioner of Internal Revenue determined a deficiency in Stone's income tax, arguing that the entire proceeds from the sale of the warrants in 1948 should be taxed as additional compensation. Stone petitioned the Tax Court, contesting this determination.

Issue(s)

Whether the proceeds from the sale of stock purchase warrants, acquired by an employee from their employer, are taxable as additional compensation or as capital gains, and what is the proper basis for calculating such gains.

Holding

No, the proceeds are not fully taxable as additional compensation. The warrants were capital assets, and Stone's basis for determining gain was the amount he paid for them, increased by the amount he included as additional compensation in the

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year he purchased the warrants.

Court’s Reasoning

The court reasoned that the stock purchase warrants were capital assets under Section 117(a)(1) of the Internal Revenue Code. The court distinguished these warrants from typical employee stock options, noting that Stone paid a valuable consideration for the warrants, they were negotiable from the date of issue, protected against dilution, and not contingent upon his continued employment. The court relied on Treasury Regulation 111, Section 29.22(a)-1, as amended by T.D. 5507, which states that if an employee purchases property from an employer for less than its fair market value, the difference is compensation, and the basis for subsequent sale is the purchase price plus the amount included in gross income. The court found that the warrants had a determinable market value when issued. The court stated, “In computing the gain or loss from the subsequent sale of such property its basis shall be the amount paid for the property, increased by the amount of such difference included in gross income.” The court rejected the IRS’s reliance on I.T. 3795, which argued for taxing the entire sale amount as compensation, finding it inapplicable to purchased warrants with a determinable fair market value at the time of purchase.

Practical Implications

This case clarifies the tax treatment of stock purchase warrants acquired by employees for less than their fair market value. It establishes that such warrants are capital assets and that the employee’s basis includes the amount already taxed as compensation. Attorneys should use this case to advise clients on structuring stock warrant transactions to ensure proper tax treatment. This case also highlights the importance of establishing the fair market value of warrants at the time of issuance. Later cases will likely distinguish this ruling based on whether the warrants were truly purchased at fair market value, or whether the transaction was structured primarily for tax avoidance.

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