19 T.C. 1001 (1953)

When an employer grants a stock option to an employee as compensation, the employee realizes taxable income at the time the option is exercised, measured by the difference between the stock's fair market value at exercise and the option price.

Summary

Harley McNamara, an executive at National Tea Company, received stock options as part of his compensation package. He exercised these options in 1946 and 1947, when the fair market value of the stock exceeded the option price. The Tax Court held that the difference between the option price and the fair market value of the stock at the time the options were exercised was taxable income to McNamara as compensation. The court reasoned that the options were intended as compensation and not merely to provide a proprietary interest in the company.

Facts

McNamara left Kroger to become Executive Vice President at National Tea Company in March 1945.

As part of his employment agreement, he received an option to purchase 12,500 shares of National Tea Company stock at $16 per share.

The option vested in stages over two years, with limitations on the number of shares he could purchase at different times.

The fair market value of the stock on the grant date was $19-$20 per share.

McNamara exercised the options in 1946 and 1947 when the market price was significantly higher than the option price.

National Tea Company deducted a portion of the option's value as compensation expense in its 1945 tax return.

Procedural History

The Commissioner of Internal Revenue determined deficiencies in McNamara's income tax for 1946 and 1947, asserting that the difference between the fair market value of the stock and the option price was taxable income.

McNamara petitioned the Tax Court for a redetermination of the deficiencies.

Issue(s)

Whether the gain derived from the exercise of the stock options was intended as compensation to McNamara?

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If the gain was intended as compensation, whether the taxable event occurred when the option was granted, or when it was exercised?

What was the fair market value of the stock on the dates the options were exercised?

Holding

Yes, the gain derived from the exercise of the option was intended as compensation to McNamara because the option was part of his employment agreement and was treated as compensation by both McNamara and National Tea Company.

The taxable event occurred when the options were exercised because the option itself was not "the only intended compensation"; the profit derived upon exercise of the option was the intended compensation.

The fair market value was $28.50 per share on March 12, 1946, and $27.50 per share on March 6, 1947, because the court adjusted the Commissioner's determination for 1947 based on evidence of a weaker market.

Court's Reasoning

The court relied on *Commissioner v. Smith*, which held that any economic or financial benefit conferred on an employee as compensation is taxable income. The court found that the option was intended as compensation, noting that McNamara had requested stock options as part of his compensation package when he was recruited.

The court distinguished the case from situations where the option itself is the only intended compensation. It emphasized that the restrictions on when McNamara could exercise the option indicated that his continued employment and the resulting increase in the company's stock value were factors in determining the overall compensation.

The court considered expert testimony on the value of the option but found it unpersuasive. It concluded that the intended compensation was the profit derived from exercising the option, not the value of the option itself.

The court applied the "blockage" principle in determining the fair market value of the stock, adjusting the Commissioner's determination for 1947 to account for the large block of shares and the weaker market conditions at that time.

Practical Implications

This case illustrates that stock options granted to employees are generally treated as compensation and taxed when exercised. The key factor is whether the option was granted as an incentive for performance (compensation) or merely to provide the employee with a proprietary interest in the company.

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The case emphasizes the importance of documenting the intent behind granting stock options to employees.</r

This case highlights the importance of considering the “blockage” principle when valuing large blocks of stock for tax purposes.

This case, while predating current IRC Sec. 83, is still relevant to understanding the foundational principles of taxing stock options as compensation.

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