20 T.C. 5 (1953)

When an employee exercises a stock option granted before February 26, 1945, the difference between the option price and the market value of the stock is not taxable income if the option was granted to enable the employee to acquire a proprietary interest in the corporation, rather than as compensation for services.

Summary

Abraham Rosenberg received a stock option from his employer, Alexander's Department Stores, Inc., in 1938. He exercised part of the option in 1943 and the remainder in 1946. The Commissioner of Internal Revenue argued that the difference between the option price and the market value of the stock when the option was exercised in 1946 constituted taxable income to Rosenberg. The Tax Court held that the option was granted to enable Rosenberg to acquire a proprietary interest in the corporation, not as compensation; therefore, the difference was not taxable income. The decision hinged on the intent behind the granting of the option and the regulations in place before February 26, 1945.

Facts

Rosenberg was hired by Alexander's in 1938 after working for another department store. His employment contract included a salary, a percentage of sales and profits, and a stock option to purchase 3,000 shares at $5.40 per share. Rosenberg expressed a desire to own stock in the company, leading to the inclusion of the stock option in his contract. He exercised the option partially in 1943 and fully in 1946, while still employed. At the time the option was granted, the stock's market value was approximately $3.00 – $3.25 per share. In 1946, when Rosenberg exercised the remainder of his option, the market value was $11 per share.

Procedural History

The Commissioner determined a deficiency in Rosenberg's 1946 income tax, arguing that the difference between the option price and market value of the stock was taxable income. Rosenberg contested the deficiency in the Tax Court. The Tax Court ruled in favor of Rosenberg, finding that the stock option was intended to provide him with a proprietary interest, not as compensation.

Issue(s)

Whether the stock option granted to Rosenberg before February 26, 1945, was intended as compensation for services or to enable him to acquire a proprietary interest in the corporation.

Holding

No, because the Tax Court found that the stock option was granted to enable

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Rosenberg to acquire a proprietary interest in Alexander’s, not as compensation for his services.

Court’s Reasoning

The Tax Court emphasized that the key question was the intent behind granting the stock option. The court considered several factors: the full compensation package (salary plus percentage of sales and profits) was already agreed upon before the stock option was introduced; at the time of the grant in 1938, the option price was higher than the market value; the terms of Rosenberg’s employment were not altered by the granting of the option, and the option did not replace a prior bonus agreement. The court noted, “The evidence convinces us that the option was granted because the employer and the employee both believed that it was desirable that the employee be given immediate assurance that the stock of the employer corporation, which it seems was closely held by a family, could be purchased by him.” The court also stated that the employer’s treatment of the option as a deduction on its tax return for 1946 was not binding on the petitioner. The Tax Court applied Regulations 111, section 29.22(a)-1 as it existed before amendment by T.D. 5507, which governed options granted before February 26, 1945.

Practical Implications

This case illustrates the importance of determining the intent behind granting stock options, particularly for options granted before the 1945 amendment to tax regulations. It highlights factors courts consider when distinguishing between compensatory options and those intended to provide a proprietary interest. This case is relevant for understanding the tax treatment of employee stock options granted prior to February 26, 1945, and serves as a guide for analyzing similar cases based on their specific facts. It emphasizes that the employer’s accounting treatment of the option is not determinative of the employee’s tax liability. This case clarifies that language such as "In order to induce you to enter into this agreement" is not conclusive evidence that the option was granted as compensation.

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