***Lo Bue v. Commissioner, 22 T.C. 440 (1954)***

Whether the grant of a stock option to an employee results in taxable compensation depends on whether the option was intended as compensation or to give the employee a proprietary interest in the business.

**Summary**

The U.S. Tax Court addressed whether the exercise of stock options by an employee resulted in taxable compensation. The Commissioner argued that Treasury regulations automatically treated the difference between the option price and fair market value as compensation. The court disagreed, holding that the determination of whether the options were compensation or a means to give the employee a proprietary interest was a question of fact. After reviewing the facts and the company's intentions, the court determined that the options were granted to give the employee a proprietary interest, thus not triggering taxable compensation upon their exercise.

**Facts**

Philip J. Lo Bue was employed by Michigan Chemical Corporation. From 1945 to 1947, he was granted options to purchase the company's stock at a set price. The options were granted to key employees, including Lo Bue, as part of a plan to give them a proprietary interest in the corporation. The company's communications to Lo Bue emphasized the goal of employee ownership and participation in the company's success. The options were offered at a price equal to or slightly below the market value of the stock at the time of the grant. In 1946 and 1947, Lo Bue exercised his options, and the fair market value of the stock exceeded the option price. The corporation deducted, on its tax returns for 1946 and 1947, the difference between the market value and option price of the shares sold to employees. The IRS determined that Lo Bue received unreported compensation in these years because of his exercise of the options.

**Procedural History**

The Commissioner of Internal Revenue determined deficiencies in Lo Bue's income tax for 1946 and 1947, arguing that the exercise of stock options resulted in taxable compensation. Lo Bue challenged this determination in the U.S. Tax Court. The Tax Court considered the case and issued its opinion, deciding in favor of Lo Bue and against the Commissioner.

**Issue(s)**

1. Whether the exercise of stock options by Lo Bue resulted in taxable compensation in 1946 and 1947.

2. If so, in what amounts?

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## Holding

1. No, because the court found that the options were granted to give Lo Bue a proprietary interest in the corporation, not as compensation for his services.

2. Not applicable, because the court ruled that there was no taxable compensation.

## Court's Reasoning

The court began by noting that the central issue was a question of fact: whether the stock options were intended as additional compensation or to give Lo Bue a proprietary interest in the company. The Commissioner argued that Treasury regulations, based on the Supreme Court's decision in *Commissioner v. Smith*, mandated that the difference between the option price and market value was taxable compensation. The court disagreed, stating that the Supreme Court in *Smith* did not hold that every economic benefit conferred on an employee constitutes compensation. The court emphasized that the language in *Smith* stated, "Section 22 (a) of the Revenue Act is broad enough to include in taxable income any economic or financial benefit conferred on the employee as compensation, whatever the form or mode by which it is effected…"

The court examined the corporation's intent in granting the options. Based on the evidence, including letters sent to Lo Bue, the court determined that the options were primarily intended to incentivize key employees and give them a stake in the company's success. The court noted the growth in the number of shareholders after the plan was implemented and the company's emphasis on the value of employee ownership. The court considered the fact that the purchase price initially specified by the directors in granting the option rights slightly exceeded the then fair market value of the stock, which negated the idea that the rights were authorized with compensation in mind. Furthermore, the court stated, "Here it "definitely and clearly" appears that the granting of the options to petitioner in 1945, 1946, and 1947 was not intended as additional compensation for his services." The court found that the deduction taken by the corporation on its income tax returns did not alter the essential purpose of granting the options.

## Practical Implications

This case highlights the importance of considering the intent behind stock option grants. To determine if a stock option constitutes compensation, one must examine the substance of the transaction. The court's emphasis on the intention of the company and the nature of the communication around the grant has significant implications for structuring and documenting equity compensation plans. When counseling clients, this case suggests that the options must be framed to create a sense of ownership. If the intention is to offer stock options as an incentive to motivate employees or as a way to offer a bonus, then the difference between the market price and option price is more likely to be considered compensation and thus

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taxable income. The court also clarified that the Commissioner's interpretation of *Commissioner v. Smith* was too broad. This case provided the basis for a legislative response in 1950 establishing new rules for the tax treatment of employees' stock options, which was meant to encourage the use of stock options for incentive purposes. Later cases have cited *Lo Bue* on the matter of discerning whether an option was compensatory or proprietary.

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