30 T.C. 1244 (1958)

The relinquishment of a stock option in a divorce settlement can be considered a taxable event, generating a capital gain when the value of the option can be determined and when the transaction is not a mere division of property.

Summary

The U.S. Tax Court considered whether the surrender of a stock option as part of a divorce settlement constituted a taxable event, leading to a capital gain for the taxpayer. Gordon Stouffer had an option to purchase his wife's stock. In their divorce settlement, he relinquished this option. The IRS argued this was a taxable gain, measured by the difference between the option's value and the consideration recited in the option agreement. The court agreed, holding that the release of the option, which had a determinable fair market value based on the underlying stock's worth, resulted in a long-term capital gain. The court rejected the argument that the transaction was merely a division of property and that it was impossible to value what Gordon received for his release of the option.

Facts

In 1937, Gordon Stouffer granted his wife, Ina Mae, 2,000 shares of class B stock in Stouffer Corporation. Simultaneously, Ina Mae gave Gordon an option to purchase those shares at $20 per share. After stock splits and dividends, the 2,000 shares became 20,000 shares of common stock. In 1951, the Stouffers divorced. As part of the settlement, Gordon agreed to terminate any interest in the shares registered in Ina Mae's name, including his stock option. The fair market value of the 20,000 shares at the time was $20 per share.

Procedural History

The Commissioner of Internal Revenue determined a deficiency in Gordon Stouffer's income tax for 1951. The Tax Court addressed the questions of whether Gordon realized a gain by surrendering the option and whether the gain was long-term or short-term capital gain. The Tax Court ruled in favor of the Commissioner on the key issue of whether there was a taxable gain.

Issue(s)

1. Whether Gordon Stouffer realized a taxable gain when he surrendered his stock option in the divorce settlement.

2. Whether, if a gain was realized, it should be classified as a long-term or short-term capital gain.

Holding

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1. Yes, Gordon Stouffer realized a taxable gain because the relinquishment of the option constituted a disposition of property.

2. The gain was a long-term capital gain because the gain was not due to the failure to exercise an option, but rather from its termination by court decree.

Court's Reasoning

The court relied on the precedent established in *Commissioner v. Mesta*, 123 F.2d 986 (3d Cir. 1941), which held that a taxpayer realized a capital gain when he transferred stock to his wife in a divorce settlement. The court reasoned that, although Gordon did not transfer stock itself, he surrendered a valuable option. The court concluded that the option had a fair market value, as evidenced by the value of the underlying stock. Furthermore, the Court stated, "It is entirely proper for parties to a contract to make their own estimates of values; and if they are dealing at arms length and there is no reason to question the bona fides of the transaction, their valuations may be accepted as correct."

The court rejected the argument that the transaction was merely a division of property, noting that Gordon received consideration for releasing the option and that this consideration had a calculable value. The court applied the principle that the value of what the husband received was the fair market value of the stock. The court distinguished this case from cases involving the failure to exercise an option, concluding that the gain resulted from the court decree terminating the option, which took place during the divorce proceedings.

Practical Implications

This case establishes that the surrender of a stock option in a divorce settlement is a taxable event. When advising clients, attorneys should analyze similar situations to determine if the value of surrendered options can be established. Tax practitioners and attorneys specializing in divorce settlements should carefully consider the tax implications of transferring assets, including stock options, during property division. The case underscores that the tax consequences depend on the specifics of the agreement and the fair market value of the assets involved. The court's emphasis on the fair market value of the stock at the time of the divorce and the characterization of the settlement as an arm's-length transaction between the parties are critical factors.

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