Kunsman v. Commissioner, 49 T. C. 62 (1967)

Gain from surrendering restricted stock options issued as compensation is taxable as ordinary income, not as capital gains.

Summary

Donald Kunsman, an RCA executive, received $67,700 upon resigning, including $40,439. 10 for surrendering his restricted stock options. The Tax Court ruled that this sum was taxable as ordinary income, not as capital gains as Kunsman claimed. The court also disallowed a 1962 casualty loss deduction for a swimming pool damaged in 1959, stating that the loss should have been claimed in the year it was known to be total, not when the pool was replaced.

Facts

Donald Kunsman, a key employee at RCA, received stock options as part of his compensation. These options were issued on various dates between 1957 and 1961, with different exercise prices and numbers of shares. Kunsman resigned from RCA on October 31, 1961, due to dissatisfaction with certain employment circumstances. Upon resignation, he entered into an agreement with RCA to surrender his stock options in exchange for $67,700, of which $40,439. 10 was specifically allocated to the options. Kunsman reported this amount as long-term capital gain on his 1962 tax return, while the IRS classified it as ordinary income.

Separately, Kunsman's swimming pool was damaged by a storm in 1959. He attempted repairs but eventually replaced the pool in 1962. He claimed a casualty loss deduction for the replacement cost in his 1962 tax return.

Procedural History

The IRS issued a notice of deficiency to Kunsman for the tax year 1962, reclassifying the $40,439. 10 as ordinary income and disallowing the casualty loss deduction for the swimming pool. Kunsman petitioned the Tax Court, which upheld the IRS's position on both issues.

Issue(s)

1. Whether the $40,439. 10 received by Kunsman for surrendering his restricted stock options is taxable as ordinary income or as capital gain.
2. Whether Kunsman is entitled to a casualty loss deduction in 1962 for the replacement of his swimming pool, which was damaged in a 1959 storm.

Holding

1. Yes, because the gain from surrendering the options is considered compensation for services rendered and thus taxable as ordinary income.

2. No, because the casualty loss occurred in 1959, and the deduction cannot be postponed to 1962 merely because that was the year the pool was replaced.

Court's Reasoning

The Tax Court applied section 1234(c)(2) of the Internal Revenue Code, which states that section 1234(a) does not apply to gain from the sale or exchange of an option if the income is compensatory in nature. The court emphasized that the options were issued as compensation and, therefore, the gain upon their surrender was also compensatory. The court cited *Rank v. United States* and *Dugan v. United States* to support its conclusion that the compensatory nature of the options at issuance determines their tax treatment upon surrender, regardless of the parties' motives at the time of surrender.

Regarding the casualty loss, the court noted that a deduction must be taken in the year the loss is sustained, not necessarily the year of the casualty. Kunsman knew by 1961 that the pool was a total loss, so the court ruled that any casualty loss deduction should have been claimed in 1961 at the latest, not in 1962 when the pool was replaced.

Practical Implications

This decision clarifies that gains from surrendering compensatory stock options are taxable as ordinary income, impacting how executives and companies structure compensation packages and report income. It emphasizes that the tax treatment is determined by the initial nature of the options as compensation, not by any subsequent agreements or intentions at the time of surrender. For casualty losses, the ruling reinforces that deductions must be claimed in the year the loss is known to be total, affecting how taxpayers handle and report such losses. Subsequent cases like *Rank* and *Dugan* have followed this precedent, and it remains relevant for determining the tax treatment of similar compensation arrangements and casualty loss claims.

