T.C. Memo. 1967-247

Gains from the surrender of employee stock options, initially granted as compensation, are taxed as ordinary income, not capital gains, regardless of whether the payment for surrender is explicitly labeled as compensation at the time of surrender.

Summary

The petitioner surrendered stock options, initially granted as compensation, and received payment. The Tax Court addressed whether this payment should be taxed as ordinary income or capital gains. The court held that because the options were granted as compensation, the income from their surrender was ordinary income, irrespective of the petitioner's argument that the payment was not explicitly intended as compensation at the time of surrender. Additionally, the court addressed the timing of a casualty loss deduction for storm damage to a pool, ruling that the deduction could not be taken in the year of replacement but should have been taken in the year the loss was sustained or ascertainable.

Facts

1. Petitioner received stock options from RCA as compensation for services.
2. In 1962, petitioner surrendered these stock options to RCA and received $40,439.10 for their surrender.
3. Petitioner claimed this gain should be taxed at capital gains rates under Section 1234(a) of the Internal Revenue Code.
4. In 1959, a storm damaged petitioner's pool. Petitioner made repairs that year.
5. In 1961, petitioner determined the pool was a total loss.
6. In 1962, petitioner replaced the pool and claimed a casualty loss deduction for $5,411.95 in his 1962 tax return.

Procedural History

The Commissioner of Internal Revenue determined that the $40,439.10 received for the stock options was taxable as ordinary income and disallowed the casualty loss deduction in 1962, stating the loss occurred in 1959. The petitioner challenged these determinations in Tax Court.

Issue(s)

1. Whether the gain realized from the surrender of employee stock options, initially granted as compensation, is taxable as ordinary income or capital gains under Section 1234 of the Internal Revenue Code.
2. Whether the casualty loss deduction for damage to the petitioner's pool, sustained in 1959, was properly deductible in 1962 when the pool was replaced.

Holding

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1. No. The gain from the surrender of the stock options is taxable as ordinary income because Section 1234(c)(2) explicitly excludes from capital gains treatment any income that is otherwise treated as ordinary income, such as compensation.
2. No. The casualty loss deduction was not properly taken in 1962 because casualty losses are deductible in the year the loss is sustained, not in a subsequent year when the damaged property is replaced, especially when the extent of the loss was known in a prior year (1961).

Court's Reasoning

Stock Options Issue:

– The court relied on Section 1234(c)(2) of the Internal Revenue Code, which states that Section 1234 (regarding capital gains treatment for options) does not apply to income from options that is otherwise treated as ordinary income.

– The court cited legislative history indicating that Section 1234(c)(2) was intended to prevent capital gains treatment for gains from employee stock options that are compensatory in nature.

– The court referenced *Commissioner v. LoBue*, 351 U.S. 243 (1956), and *Commissioner v. Smith*, 324 U.S. 177, affirming that compensation for services is taxed as ordinary income, even if provided in the form of stock options.

– Quoting from Senate Report No. 1983, the court emphasized that Section 1234(c)(2) clarifies that the section

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