Hirsch v. Commissioner, 51 T. C. 121 (1968)

Income from nonstatutory stock options is not taxable if the stock is subject to restrictions significantly affecting its value.

Summary

Ira Hirsch exercised nonstatutory stock options to acquire Pacific Vitamin Corp. stock, agreeing not to sell it for six months and facing potential Securities Act violations if sold. The Tax Court held that these restrictions significantly affected the stock's value, deferring taxable income recognition until the restrictions lapsed. Additionally, a $33,000 payment from David Vickter to Hirsch was ruled as ordinary income for services rendered, not a capital gain from asset sale, despite Hirsch's claim of a property interest in Vickter's stock.

Facts

Ira Hirsch, employed by Pacific Vitamin Corp. , received stock options as part of his employment agreement. On July 3, 1961, he exercised an option to buy 8,750 shares, agreeing not to sell them for six months. The SEC indicated that selling the shares without registration could violate the Securities Act of 1933. In 1962, after David Vickter sold a majority interest in Pacific to Nutrilite Products, Inc. , Hirsch received $33,000 from Vickter, which he reported as a long-term capital gain.

Procedural History

The Commissioner of Internal Revenue determined deficiencies in Hirsch's income taxes for 1961-1963, asserting that the stock option exercise and the $33,000 payment should be taxed as ordinary income. The case was appealed to the U. S. Tax Court, which heard arguments on both issues.

Issue(s)

1. Whether Hirsch realized taxable income upon the exercise of nonstatutory stock options when the stock was subject to restrictions significantly affecting its value.
2. Whether the $33,000 payment from Vickter to Hirsch constituted ordinary income or an amount received from the sale or exchange of a capital asset.

Holding

1. No, because the stock was subject to restrictions that significantly affected its value, deferring income recognition until the restrictions lapsed.
2. No, because the payment was for past and future services, constituting ordinary income, not proceeds from the sale of a capital asset.

Court's Reasoning

The court applied Section 1. 421-6(d)(2)(i) of the Income Tax Regulations, which states that income from nonstatutory stock options is not recognized if the stock is subject to a restriction significantly affecting its value. The six-month non-sale agreement and potential Securities Act violations were deemed significant restrictions. The court rejected the Commissioner’s argument that Hirsch could have avoided these restrictions, emphasizing that the restrictions were in place at the time of option exercise. For the $33,000 payment, the court found no binding agreement for Hirsch to receive a share of Vickter’s stock proceeds, classifying the payment as compensation for services, not a capital gain. The court cited precedent that such payments for services are ordinary income.

Practical Implications

This decision clarifies that nonstatutory stock options subject to significant restrictions do not trigger immediate taxable income, impacting how companies structure stock option plans and how employees report income from such options. Legal practitioners must consider potential restrictions under securities laws when advising on stock option taxation. The ruling on the $33,000 payment reinforces that payments tied to employment services are taxed as ordinary income, guiding the classification of similar future payments. Subsequent cases like *Rev. Rul. 68-86* have applied this principle, distinguishing between restricted and unrestricted stock for tax purposes.

