Morrison v. Commissioner, 56 T. C. 1054 (1971)

Stock options received in corporate reorganizations are taxable as compensation if they are granted in exchange for future services and non-compete covenants.

Summary

In Morrison v. Commissioner, Jack F. Morrison received stock options as part of a merger between Sig Laboratories and Intra Products. The key issue was whether these options were taxable as compensation for future services and a non-compete covenant or as part of the stock exchange. The Tax Court held that the options were compensatory, thus taxable under section 61(a)(1) of the Internal Revenue Code. The court reasoned that the options were granted to secure Morrison's future services and non-compete covenant, not as part of the stock exchange. This decision clarifies that stock options in reorganizations are taxable as compensation if linked to future services or non-compete agreements.

Facts

Jack F. Morrison and James C. O'Neal, majority shareholders of Sig Laboratories, Inc. , negotiated a merger with Intra Products, Inc. The merger agreement initially provided for a pro rata distribution of Intra shares to Sig shareholders. However, Morrison and O'Neal proposed an amendment where they would receive options to purchase additional Intra shares at $1 per share, in exchange for their future services and a non-compete covenant. The merger was completed on May 31, 1966, and Morrison exercised his option on October 17, 1966.

Procedural History

The Commissioner of Internal Revenue determined a deficiency in Morrison's income tax for 1966, arguing that the stock options were compensatory and should be taxed upon exercise. Morrison petitioned the Tax Court, which held a trial and subsequently issued an opinion finding the options were compensatory and thus taxable under section 61(a)(1).

Issue(s)

1. Whether the stock options received by Jack F. Morrison were compensatory in nature, taxable under section 61(a)(1)?

2. What was the fair market value of the stock options as of May 31, 1966?

Holding

1. Yes, because the stock options were granted in exchange for Morrison's future services and a non-compete covenant, making them compensatory under section 61(a)(1).

2. The fair market value of the stock options as of May 31, 1966, was $299 per share.

Court's Reasoning

The court applied sections 354 and 356 of the Internal Revenue Code, which govern tax treatment of stock exchanges in reorganizations. The court determined that the stock options were not part of the stock exchange but were compensation for Morrison's future services and non-compete covenant, as evidenced by the negotiations and the terms of the merger agreement. The court rejected Morrison's argument that the options were part of the stock exchange, citing the lack of support in the written agreements and the testimony that the options were a condition for securing Morrison's services. The court used the transactions involving Sig stock to value the Intra stock at $299 per share, rejecting the Commissioner's higher valuation based on speculative negotiations with Revlon. The court also considered the Supreme Court's recognition in Commissioner v. LoBue and Commissioner v. Smith that stock options can have immediate taxable value if they have a readily ascertainable market value.

Practical Implications

This decision impacts how stock options in corporate reorganizations are analyzed for tax purposes. It clarifies that options granted in exchange for future services or non-compete covenants are taxable as compensation, not as part of the stock exchange. Legal practitioners must carefully draft reorganization agreements to distinguish between stock exchanges and compensatory arrangements. Businesses must consider the tax implications of using stock options to secure employee commitments during mergers. This case has been cited in subsequent rulings, such as Philip W. McAbee, to support the taxation of stock options as compensation in similar contexts.

