Mitchell v. Commissioner, 65 T. C. 1099 (1976)

Nonstatutory stock options received as compensation, whether in exchange for other options or salary reduction, are taxed as ordinary income upon sale.

Summary

Raymond Mitchell received a nonstatutory stock option from Royal Industries, Inc. , in exchange for his restricted Amerco stock option and a reduction in salary. Upon selling this option in installments, the IRS treated the proceeds as ordinary income. The Tax Court held that the option was compensatory, thus subject to ordinary income tax upon sale. The court also determined that the option lacked a readily ascertainable fair market value at the time of grant, so no taxable event occurred until its sale. This decision underscores the tax implications of stock options granted as compensation.

Facts

In 1961, Raymond Mitchell, an employee and shareholder of Western Rubber Corp. , received a restricted stock option. Following corporate changes, this option was exchanged for an Amerco option. In 1966, Royal Industries acquired Amerco, and Mitchell exchanged his Amerco option for a nonstatutory Royal option and accepted a salary reduction. Mitchell sold this Royal option in 1967 and 1968, reporting the proceeds as capital gains. The IRS reclassified these proceeds as ordinary income.

Procedural History

Mitchell petitioned the U. S. Tax Court after receiving a notice of deficiency from the IRS for the tax years 1967 and 1968. The IRS conceded no income was realized in 1967 due to Mitchell’s cash accounting method but maintained the income from the option sales should be treated as ordinary income in 1968. The Tax Court reviewed the case to determine the nature of the Royal option and its tax treatment upon sale.

Issue(s)

1. Whether the nonstatutory stock option granted by Royal was compensatory in nature.
2. Whether the gain from the sale of the Royal option should be treated as ordinary income or capital gain.
3. Whether the Royal option had a readily ascertainable fair market value at the time of grant.

Holding

1. Yes, because the Royal option was granted in exchange for Mitchell’s Amerco option and in lieu of salary, it was compensatory in nature.

2. Yes, because the Royal option was compensatory, the gain from its sale was ordinary income.
3. No, because the Royal option was not actively traded on an established market and had significant restrictions, it did not have a readily ascertainable fair market value at the time of grant.

Court's Reasoning

The court determined that the Royal option was compensatory because it was granted in exchange for Mitchell's Amerco option and as consideration for his salary reduction. The court rejected Mitchell's argument that the option was not compensatory due to its exchange nature, citing *Commissioner v. LoBue* and regulations that classify such options as compensation. The court also found that the option's value could not be accurately determined at the time of grant due to its restrictions and lack of an established market, thus following *LoBue* in holding that the taxable event occurred upon sale, not at grant. The court emphasized that compensation can take the form of stock options, and the exchange of options does not negate their compensatory nature.

Practical Implications

This decision clarifies that nonstatutory stock options granted in exchange for other options or as part of compensation packages are treated as ordinary income upon sale. It emphasizes the importance of determining the compensatory nature of options for tax purposes. Practitioners should be aware that such options do not have a readily ascertainable fair market value unless they are actively traded, which impacts when the taxable event occurs. This ruling has implications for how companies structure compensation and how employees report income from option sales. Subsequent cases have followed this principle, reinforcing the tax treatment of compensatory options.

