Lighthill v. Commissioner, 66 T. C. 940 (1976)

Ordinary income from nonstatutory stock options is realized when restrictions on the stock lapse, not at the time of sale.

Summary

Olaf Lighthill received nonstatutory stock options from his employer as compensation, which he exercised in 1968. The stock was subject to sale restrictions until March 1969. The Tax Court held that Lighthill realized ordinary income when the restrictions lapsed, based on the difference between the stock's fair market value at exercise and its cost. This ruling upheld the validity of IRS regulations, overturning the precedent set by the Robert Lehman case, and clarified the timing of income recognition for restricted stock options.

Facts

Olaf B. Lighthill, employed by Dempsey-Tegeler & Co. , received 500 warrants in 1967 to purchase King Resources Co. stock. He exercised these warrants on June 10, 1968, acquiring 1,500 shares for $7,000, but the shares were restricted from sale due to SEC regulations and an investment letter. The restrictions were lifted on March 14, 1969, and Lighthill sold 500 shares on March 19, 1969, for $41,250. The IRS asserted that Lighthill realized ordinary income when the restrictions lapsed, based on the stock's fair market value at the time of exercise.

Procedural History

The Commissioner of Internal Revenue determined a deficiency in Lighthill's 1969 federal income tax. Lighthill contested this in the U. S. Tax Court, which upheld the IRS's position, applying the regulations under section 1. 421-6(d) of the Income Tax Regulations and finding them valid despite conflicting with the prior ruling in Robert Lehman.

Issue(s)

1. Whether petitioners realized income in 1969 on the lapse of restrictions on stock acquired in 1968 under an option received in a prior year, and if so, the amount of income realized.
2. The amount of capital gain petitioners realized later in 1969 upon the sale of one-third of that stock.

Holding

1. Yes, because the regulations under section 1. 421-6(d) stipulate that income is realized when restrictions on the stock lapse, and this was upheld as a valid interpretation of tax law.
2. The capital gain was properly reduced by the amount of income realized when the

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restrictions lapsed, as the basis of the stock was increased by this amount.

Court’s Reasoning

The Tax Court applied IRS regulations that state income from nonstatutory stock options is realized when restrictions on the stock lapse, not at sale. This was consistent with the Supreme Court’s ruling in Commissioner v. LoBue, which established that compensation from stock options must be taxed at some point. The court rejected the precedent set by Robert Lehman, finding it no longer viable post-LoBue. The court emphasized the regulations’ alignment with the broad scope of section 61 of the tax code, which taxes all gains unless exempted. The court also cited Glenn E. Edgar as supporting the validity of these regulations. The fair market value of the stock at the time of exercise, without restrictions, was used to determine the amount of ordinary income realized.

Practical Implications

This decision clarifies that income from nonstatutory stock options is recognized when restrictions on the stock lapse, impacting how taxpayers and their advisors must account for such income. It reinforces the IRS’s regulatory authority to define the timing of income recognition in these scenarios. Practitioners should note that the basis of the stock is adjusted by the amount of income recognized at the lapse of restrictions, affecting subsequent capital gains calculations. This ruling has been applied in later cases and remains a significant precedent in the taxation of restricted stock options.

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