Morris v. Commissioner, 70 T. C. 959 (1978)

The fair market value of stock at the grant date and the correct date of grant are crucial for determining the tax treatment of stock options.

Summary

In Morris v. Commissioner, the court addressed the tax implications of stock options granted by Information Storage Systems, Inc. (ISS) to its employees. The key issues were whether the stock's fair market value (FMV) exceeded the option price on the grant dates and the determination of those grant dates. The court found that the FMV did not exceed the option price from January to June 1968, and the grant date was the date of state permit issuance. The court also ruled on the FMV at exercise dates and invalidated a regulation concerning the calculation of stock ownership for disqualifying options. The decision impacts how stock options are valued and when they are considered granted for tax purposes.

Facts

ISS, a startup in the computer industry, granted stock options to its employees in 1968. The options were part of a plan intended to qualify under IRC section 422. The plan required a permit from the California Corporation Commission, which was obtained on March 14, 1968. The options were granted at various times from January to June 1968, with an exercise price of $4. 57 per share. ISS faced significant challenges, including market uncertainty and technical issues, which affected the stock's value. Employees exercised their options between 1969 and 1972, and the company underwent multiple rounds of financing, with stock prices ranging from $20 to $30 per share.

Procedural History

The Commissioner determined deficiencies in the petitioners' income taxes, arguing that the options were not qualified because the FMV exceeded the option price at grant and the options were granted after the state permit was issued. The cases were consolidated for trial, and the Tax Court held hearings to determine the FMV at the grant and exercise dates, the grant dates, and the validity of certain regulations concerning stock ownership calculations.

Issue(s)

1. Whether, on the dates the stock options were granted, the fair market value of the stock exceeded the option price of $4. 57 per share?
2. What was the fair market value of the optioned stock on the various dates when petitioners exercised their options?
3. What were the controlling dates that stock options were granted to petitioners or their predecessors in interest?
4. To what extent did petitioners Brunner, Crouch, Halfhill, Harmon, and Woo each

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own more than 10 percent of the outstanding stock of ISS within the meaning of IRC section 422(b)(7)?
5. Is section 1. 422-2(h)(1)(ii) of the Income Tax Regulations valid?
6. Was there a modification of the terms of the stock option granted to Steven J. MacArthur by permitting the purchase price to be paid by a promissory note instead of cash?

Holding

1. No, because the court found that the FMV of ISS stock did not exceed $4. 57 per share from January 11, 1968, to June 27, 1968.
2. The court determined specific FMV values for the stock on various exercise dates, ranging from $30. 00 in 1969 to $9. 00 in 1972.
3. The grant date was March 14, 1968, the date the state permit was issued.
4. The court invalidated the regulation and calculated that petitioners owned more than 10 percent of ISS stock, disqualifying portions of their options.
5. No, because the court held that section 1. 422-2(h)(1)(ii) of the regulations was invalid as it conflicted with the statute by excluding optioned shares from the denominator in calculating ownership percentages.
6. Yes, because the arrangement allowing payment by promissory note was a modification, and on the modification date (April 15, 1971), the FMV exceeded the option price, disqualifying the option.

Court’s Reasoning

The court applied the willing buyer-willing seller standard for FMV and used actual sales as the best evidence. It found that ISS’s financial situation and market conditions supported the conclusion that the FMV did not exceed the option price at grant. The court determined the grant date as the date of state permit issuance, reflecting corporate intent. In calculating ownership percentages under IRC section 422(b)(7), the court rejected the regulation’s approach, ruling that shares covered by options should be included in both the numerator and denominator. The court also found that allowing payment by promissory note was a modification of the option terms, triggering tax consequences at the modification date.

Practical Implications

This decision underscores the importance of accurately determining the FMV of stock at the grant and exercise dates of options. It also clarifies that the grant date is when corporate action is complete, including obtaining necessary permits. The ruling on the invalidity of the regulation affects how companies and employees calculate ownership for purposes of disqualifying stock options. Legal practitioners must consider these factors when drafting and administering stock option plans to ensure compliance with tax laws. The decision may influence future cases involving the timing of stock option grants and the calculation of ownership percentages for tax purposes.

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