Kolom v. Commissioner, 71 T. C. 979 (1979)

The fair market value of stock acquired through qualified stock options, even when subject to Section 16(b) of the Securities Exchange Act, is determined by the mean price of the stock on the date of exercise, not the option price.

Summary

Aaron L. Kolom exercised qualified stock options in Tool Research & Engineering Corp. in 1972. The IRS determined a tax deficiency based on the difference between the stock's fair market value at exercise and the option price, treating it as a tax preference item subject to the minimum tax. Kolom argued that due to Section 16(b) restrictions, the fair market value should be the option price. The Tax Court held that the fair market value was the mean price on the New York Stock Exchange on the exercise date, rejecting Kolom's argument that Section 16(b) affected the stock's value. The court also upheld the constitutionality of the minimum tax provisions and found no prohibited second examination by the IRS.

Facts

In 1972, Aaron L. Kolom, an officer and director of Tool Research & Engineering Corp. , exercised qualified stock options. The options were granted in 1968, 1970, and 1971, with varying exercise dates and prices. The IRS assessed a tax deficiency of $43,792, including an increased deficiency of $1,303, based on the difference between the stock's fair market value at exercise and the option price as a tax preference item subject to the minimum tax. Kolom argued that Section 16(b) of the Securities Exchange Act of 1934, which requires insiders to return short-swing profits to the corporation, should reduce the stock's fair market value to the option price. The IRS used the mean price of the stock on the New York Stock Exchange on the date of exercise to determine the fair market value.

Procedural History

The IRS initially determined a tax deficiency of $42,489 for Kolom's 1972 income tax, later increasing it by $1,303. Kolom contested this deficiency in the Tax Court, arguing the fair market value should be the option price due to Section 16(b) restrictions. The Tax Court reviewed the case and upheld the IRS's determination, ruling that the fair market value was the mean price on the New York Stock Exchange at the time of exercise.

Issue(s)

1. Whether the fair market value of stock acquired by Kolom through qualified stock options is the mean price of the stock on the New York Stock Exchange at the date of exercise or the option price due to the applicability of Section 16(b) of the Securities Exchange Act.
2. Whether the minimum tax provisions of sections 56 and 57(a)(6) are

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unconstitutional as applied to the exercise of qualified stock options by a person subject to Section 16(b).
3. Whether the deficiency was determined as a result of a prohibited second examination of Kolom's records under section 7605(b).
4. Whether the IRS should be required to pay Kolom's attorney's fees incurred in connection with this case.

Holding

1. No, because the court determined that the fair market value is the mean price on the New York Stock Exchange at the date of exercise, not the option price, as Section 16(b) does not affect the stock's value to a willing buyer.
2. No, because the court found that the minimum tax provisions are constitutional, as they apply to economic income realized upon the exercise of the options, even if the gain cannot be immediately converted to cash due to Section 16(b).
3. No, because the court held that the examination resulting in the deficiency did not involve a second examination of Kolom's books and records, but rather followed an examination of the corporation's records and was approved by supervisors.
4. No, because the court lacks jurisdiction to award attorney's fees to Kolom.

Court's Reasoning

The court applied the definition of fair market value as the price at which property would change hands between a willing buyer and a willing seller, both informed and not under compulsion. It rejected Kolom's argument that Section 16(b) restrictions should reduce the stock's value to the option price, emphasizing that these restrictions do not affect the stock's value to a willing buyer. The court cited United States v. Cartwright and Estate of Reynolds v. Commissioner to support its definition of fair market value. It also distinguished cases like MacDonald v. Commissioner, which involved different types of restrictions, and clarified that Section 16(b) does not constitute a nonlapse restriction under Section 83(a)(1). The court upheld the constitutionality of the minimum tax provisions, reasoning that economic income is realized upon the exercise of the options, regardless of the timing of cash realization. Regarding the second examination issue, the court found that the IRS's actions did not violate section 7605(b), as they were based on the examination of the corporation's records and followed proper approval procedures. Finally, the court noted its lack of jurisdiction to award attorney's fees.

Practical Implications

This decision clarifies that the fair market value of stock acquired through qualified stock options, even for insiders subject to Section 16(b), is the stock's mean price on the exchange at the time of exercise. Attorneys advising clients on stock options must consider this ruling when calculating potential tax liabilities, especially under the minimum tax provisions. The decision reinforces the IRS's ability to reassess tax liabilities based on corporate records without violating prohibitions on second examinations. This case may influence future tax planning strategies for corporate insiders and the valuation of stock options in similar circumstances.

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