Johnson v. Commissioner, 74 T. C. 89 (1980)

The fair market value of stock options is determined by the mean price on the exercise date, even if corporate officers misrepresented financial conditions.

Summary

George and Sylvia Johnson exercised stock options from Mattel, Inc. in 1971. They contested the IRS's valuation of the stock, arguing that Mattel's officers had misrepresented financial data, inflating stock prices. The Tax Court, following precedent from *Horwith v. Commissioner*, ruled that the fair market value of the stock should be based on the mean price on the New York Stock Exchange on the exercise dates, despite later revelations of corporate misconduct. The court also upheld a negligence penalty against the Johnsons for failing to report income from the stock options.

Facts

George E. Johnson, a former senior vice president at Audio Magnetics Corp. , exercised stock options granted by Mattel, Inc. on January 5 and February 8, 1971, after Mattel acquired Audio. The stock prices on those dates were $35. 6875 and $43. 25 respectively. Subsequently, it was revealed that Mattel's officers had misrepresented the company's financial condition, leading to indictments and nolo contendere pleas. The Johnsons did not report the income from these options on their 1971 tax return.

Procedural History

The Commissioner of Internal Revenue assessed a deficiency and negligence penalty against the Johnsons for the 1971 tax year. The Johnsons petitioned the U. S. Tax Court, arguing that the stock's fair market value should not be based on the exchange prices due to Mattel's financial misrepresentations. The Tax Court upheld the Commissioner's determination.

Issue(s)

1. Whether the fair market value of Mattel stock, for purposes of calculating income from exercised stock options, should be based on the mean price on the New York Stock Exchange on the exercise dates, despite later discoveries of corporate misconduct.
2. Whether the Johnsons are liable for a negligence penalty under section 6653(a) for failing to report income from the exercise of the stock options.

Holding

1. Yes, because the mean price on the exercise date reflects the best evidence of what a willing buyer would pay a willing seller, even if corporate misconduct was

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later discovered.
2. Yes, because the Johnsons failed to provide their accountants with necessary information about the exercised options, resulting in a negligent failure to report the income.

Court’s Reasoning

The court applied the long-established principle that the fair market value of stock traded on a national exchange is the price at which it is sold. This approach was upheld despite the misrepresentations by Mattel’s officers, as the court followed the rationale in *Estate of Wright* and *Horwith*, emphasizing that the market price reflects the value at which the stock could have been sold on the exercise dates. The court also noted that considering undisclosed facts known later would create administrative and judicial difficulties. Regarding the negligence penalty, the court found that the Johnsons did not provide their accountants with information about the exercised options, thus failing to meet their responsibility to report the income.

Practical Implications

This decision reinforces that the fair market value of stock options is determined by the exchange price on the exercise date, regardless of later-discovered corporate misconduct. It impacts how stock options are valued for tax purposes, emphasizing the importance of contemporaneous market conditions over subsequent events. Practitioners must advise clients to report income from stock options accurately, as failure to do so may result in negligence penalties. The ruling also affects corporate governance, highlighting the need for transparency to maintain investor trust and the integrity of market prices. Subsequent cases, such as *Horwith*, have continued to apply this principle, solidifying its place in tax law.

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