Simmonds Precision Products, Inc. v. Commissioner, 75 T. C. 103 (1980)

When stock options are issued in non-arm's length transactions and cannot be valued with fair certainty, the transaction may be held open until the options are exercised.

Summary

Simmonds Precision Products, Inc. terminated agreements with its founder's corporations and acquired patents in exchange for stock and options. The key issue was whether these options had a readily ascertainable fair market value at the time of issuance. The U. S. Tax Court held that due to numerous uncertainties, including the options' long-term nature and restrictions on transferability, their value could not be determined with fair certainty in 1960. Therefore, the transaction was held open until the options were exercised in 1968, allowing Simmonds to amortize the cost of the patents over their useful life ending in 1969.

Facts

Simmonds Precision Products, Inc. (Simmonds) needed to terminate royalty and sales commission agreements with corporations controlled by its founder, Sir Oliver Simmonds, to go public. On May 20, 1960, Simmonds terminated these agreements and acquired the patents in exchange for 61,358 shares of unregistered stock and options to purchase 29,165 additional shares at the public offering price. The options were exercisable in stages starting in 1960 and fully exercisable by 1964, expiring in 1970. They were exercised in 1968 when the stock had appreciated significantly.

Procedural History

The Commissioner of Internal Revenue determined deficiencies in Simmonds' income tax for 1967, 1968, and 1969, related to the amortization of the patents and terminated agreements. Simmonds filed a petition with the U. S. Tax Court. The court denied Simmonds' motion for partial summary judgment on the issue of patent amortization deductions and proceeded to a full trial.

Issue(s)

1. Whether the stock options issued by Simmonds on May 20, 1960, had a readily ascertainable fair market value at that time.
2. If not, when should the transaction be valued for tax purposes?
3. Over what period should the cost of the acquired patents and terminated agreements be amortized?

Holding

1. No, because the options could not be valued with fair certainty due to numerous

uncertainties including their long-term nature, restrictions on transferability, and the speculative nature of the underlying stock's value.
2. The transaction should be valued when the options were exercised in 1968, as the cost became fixed at that time.
3. The cost should be amortized over the useful life of the agreements and the most significant patent acquired, ending on January 15, 1969.

Court's Reasoning

The court applied the "open transaction" doctrine from *Burnet v. Logan*, holding that the options' value was too uncertain to determine with fair certainty in 1960. Factors considered included the options' long-term nature, restrictions on transferability, the speculative nature of the underlying stock, and the lack of an established market for the options. The court rejected the Commissioner's argument that the options could be valued based on the value of the rights transferred, as those rights' future value was also uncertain. The court also found that the transaction was analogous to compensatory stock options, where valuation is often deferred until exercise. The cost basis for the patents and terminated agreements was determined to be the value of the stock and options given up in the exchange, as per *Pittsburgh Terminal Corp. v. Commissioner*. The amortization period was set to end on January 15, 1969, following the expiration of the most significant patent and the licensing agreement.

Practical Implications

This decision clarifies that in non-arm's length transactions involving stock options, if the options' value cannot be determined with fair certainty at issuance, the transaction may be held open until exercise. This impacts how similar transactions should be valued for tax purposes, allowing taxpayers to defer recognition of income until the options are exercised. It also affects how the cost basis of acquired assets in such transactions is determined and amortized. The ruling may influence how companies structure compensation and acquisition agreements involving stock options, particularly in closely held or family-controlled businesses. Later cases, such as *Frank v. Commissioner*, have applied similar reasoning to compensatory options, further solidifying this approach.

