Bagley v. Commissioner, 85 T. C. 663 (1985)

Payments received for the termination of stock options granted in connection with employment are treated as ordinary income, not capital gains, and consulting fees must be taxed to the individual who performed the services, not their corporation.

Summary

Hughes Bagley received $70,000 for terminating a stock option granted by his employer, Spencer Foods, and a $50,000 consulting fee. The Tax Court held that the $70,000 was taxable as ordinary income under Section 83 of the Internal Revenue Code, as it was compensation for services. The consulting fee was also taxable to Bagley personally, not to his wholly-owned corporation, under the assignment of income doctrine. The decision clarifies the tax treatment of terminated stock options and reinforces the principle that income from personal services cannot be shifted to a corporation without proper control and contractual recognition.

Facts

Hughes Bagley was employed by Spencer Foods and granted an option to purchase 10,000 shares of stock in 1975. In 1978, Spencer Foods was acquired, and Bagley's option was terminated in exchange for $70,000. Concurrently, Bagley agreed to provide consulting services for one year and received $50,000, which he reported as income for his corporation, Hereford Trading. Bagley reported the $70,000 as a long-term capital gain on his personal tax return.

Procedural History

The Commissioner of Internal Revenue determined a deficiency in Bagley's 1978 tax return and asserted that the $70,000 should be treated as ordinary income and the $50,000 should be taxed to Bagley, not Hereford Trading. Bagley petitioned the U. S. Tax Court for a redetermination of the deficiency. The Tax Court held for the Commissioner on both issues.

Issue(s)

1. Whether the $70,000 received by Bagley in exchange for the termination of his stock option is taxable as capital gain or as ordinary income?
2. Whether the $50,000 consulting fee received by Bagley is taxable to him or to his wholly-owned corporation, Hereford Trading?

Holding

1. No, because the $70,000 is treated as compensation under Section 83 of the Internal Revenue Code and thus is taxable as ordinary income.
2. No, because the $50,000 consulting fee is taxable to Bagley personally under the assignment of income doctrine, as there was no evidence that Hereford Trading

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controlled the earning of the income.

Court’s Reasoning

The court applied Section 83, which governs property transferred in connection with the performance of services, to the $70,000 payment. The option was granted to Bagley in connection with his employment, and its termination before exercise meant it was not subject to Section 421’s capital gain treatment. Since the option lacked a readily ascertainable fair market value at grant, the $70,000 received upon termination was treated as ordinary income. For the consulting fee, the court relied on the assignment of income doctrine, requiring that income be taxed to the earner. Bagley failed to show that Hereford Trading controlled his consulting services or that Spencer Foods recognized the corporation in any agreement. Thus, the fee was taxable to Bagley personally.

Practical Implications

This decision clarifies that payments for terminated stock options linked to employment are ordinary income, not capital gains, affecting how employers and employees structure such options and report their termination. It also reinforces the assignment of income doctrine, requiring careful structuring of service agreements with corporations to shift income tax liability. Practitioners must ensure clear contractual recognition and control by the corporation over services rendered to avoid personal tax liability for their clients. Subsequent cases have applied this ruling to similar situations, emphasizing the need for adherence to Section 83’s requirements and proper corporate structuring to achieve desired tax outcomes.

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