***Pagel, Inc. v. Commissioner, 91 T. C. 200 (1988)***

The gain from the sale of a nonqualified stock option received in connection with services is taxable as ordinary income when the option is sold, if it did not have a readily ascertainable fair market value at the time of grant.

**Summary**

Pagel, Inc. , a brokerage firm, received a warrant to purchase stock from Immuno Nuclear Corp. as compensation for underwriting services. The warrant was sold to Pagel's sole shareholder years later, and the IRS recharacterized the gain as ordinary income, not capital gain. The Tax Court upheld this, ruling that the warrant did not have a readily ascertainable value when granted due to restrictions on transferability and exercise. Thus, under Section 83 and its regulations, the gain was taxable as ordinary income upon sale. This decision emphasizes the importance of determining when nonqualified stock options have a readily ascertainable value for tax purposes.

**Facts**

In September 1977, Pagel, Inc. served as underwriter for a stock offering by Immuno Nuclear Corp. , receiving $42,300 in commissions and a warrant to purchase 23,500 Immuno shares for $10. The warrant could not be transferred or exercised until 13 months after its issuance and was not actively traded on any market. In October 1981, Pagel sold the warrant to its sole shareholder, Jack W. Pagel, for $314,900. Pagel reported this as a capital gain, but the IRS recharacterized it as ordinary income.

**Procedural History**

The IRS issued a notice of deficiency for Pagel's 1982 tax year, recharacterizing the gain from the warrant sale as ordinary income. Pagel challenged this in the U. S. Tax Court. After a trial where all but two issues were settled, the court focused on the tax treatment of the Immuno warrant. The IRS later conceded the tax treatment of another warrant (FilmTec) but not the Immuno warrant, which remained the central issue.

**Issue(s)**

1. Whether Section 83 of the Internal Revenue Code applies to the gain from the sale of the Immuno warrant by Pagel, Inc. ?
2. Whether the Immuno warrant had a readily ascertainable fair market value at the time it was granted to Pagel, Inc. ?
3. Whether Section 1. 83-7 of the Income Tax Regulations is valid and applicable to the Immuno warrant?

**Holding**

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1. Yes, because Section 83 governs the taxation of property transferred in connection with the performance of services, which includes the warrant received by Pagel, Inc. for its underwriting services.
2. No, because the warrant was not transferable or exercisable until 13 months after its grant, thus lacking a readily ascertainable fair market value at the time of grant under Section 1. 83-7(b)(1) and (2).
3. Yes, because Section 1. 83-7 is a valid regulation consistent with the statutory purpose of Section 83 and has been upheld in prior cases.

**Court's Reasoning**

The court applied Section 83 and its regulations to determine that the gain from the sale of the warrant was taxable as ordinary income. The warrant did not have a readily ascertainable fair market value at the time of grant due to its non-transferability and non-exercisability for 13 months, as per Section 1. 83-7(b). The court rejected Pagel's argument that the warrant's value was nominal at grant, noting that even speculative value formulas suggested a higher value. The court also upheld the retroactive application of Section 1. 83-7, citing precedent that such regulations are presumed retroactively effective unless an abuse of discretion is shown. The court emphasized the policy of requiring reasonable accuracy in the valuation of nonpublicly traded options, a policy not altered by Section 83's enactment. The decision was supported by consistent case law upholding similar regulatory schemes.

**Practical Implications**

This decision clarifies that nonqualified stock options or warrants received in connection with services, which do not have a readily ascertainable fair market value at the time of grant, are taxed as ordinary income when sold. Legal practitioners must carefully analyze the terms of any option or warrant, particularly restrictions on transferability and exercise, to determine the timing of tax recognition. The ruling impacts how businesses structure compensation arrangements involving options, as the potential tax liability could be significant upon sale. Subsequent cases have followed this precedent, reinforcing the need for accurate valuation methods for nonpublicly traded options and the importance of Section 83 regulations in tax planning.

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