Schulman v. Commissioner, 93 T. C. 623 (1989)

Restricted stock options become taxable when transferable or no longer subject to substantial risk of forfeiture, at their fair market value minus any amount paid.

Summary

Seymour Schulman, under his employment contract with Valley Hospital, exercised an option to purchase partnership units at a fixed price. The units became transferable when the hospital was sold to Universal Health Services in July 1979, triggering ordinary income taxation based on their fair market value of $274. 54 per unit minus the option price of $39. 90. Schulman later sold the units in 1980, realizing a short-term capital gain. The court also ruled that the statute of limitations for assessing 1979 taxes remained open, and Schulman was liable for negligence penalties due to attempts to manipulate the timing of the transactions for tax benefits.

Facts

Seymour Schulman was employed as the administrator of Valley Hospital Medical Center and was granted an option to purchase 2,887 partnership units at $39. 90 per unit over a 4-year period starting January 1, 1979. The options were subject to restrictions, including repurchase by Valley Hospital if Schulman's employment ended before December 31, 1982. Schulman exercised the option in January 1979 and pledged the units to secure a bank loan on March 31, 1979. Unbeknownst to Schulman, Valley Hospital was negotiating its sale to Universal Health Services (Universal). In June 1979, Valley agreed to lift resale restrictions on Schulman's units contingent on the sale to Universal, which was backdated to March 31. The sale to Universal was completed in late July 1979, and Schulman sold his units in April 1980 for $285. 61 per unit.

Procedural History

The Commissioner of Internal Revenue determined deficiencies in Schulman's 1979 and 1980 income taxes, asserting that the option transaction should have been reported in 1980. Schulman contested this, arguing that the option became taxable in 1979 but that the statute of limitations for assessing 1979 taxes had expired. The Tax Court held that the units became taxable in 1979 when they became transferable, and the statute of limitations remained open due to an unrestricted consent form signed by Schulman. The court also found Schulman liable for negligence penalties.

Issue(s)

1. Whether the partnership units became taxable under Section 83 of the Internal Revenue Code when Schulman exercised the option in 1979 or when he sold the units in 1980.

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2. Whether Schulman realized income from the promissory notes received as part of the sale of his partnership units.
3. Whether the statutory period of limitations on assessment for 1979 had expired regarding the partnership sale issues.
4. Whether Schulman was liable for additions to tax under Section 6653(a) for negligence in 1979 or 1980.

Holding

1. Yes, because the partnership units became transferable in July 1979 when the sale to Universal was completed, and Schulman realized ordinary compensation income in that year based on the fair market value of the units minus the option price.
2. Yes, because the promissory notes received as part of the sale of the partnership units had fair market value and were includable in income.
3. No, because the consent form signed by Schulman was unrestricted, keeping the statutory period of limitations open for assessing 1979 taxes.
4. Yes, because Schulman's attempts to manipulate the timing of the transactions to achieve tax benefits constituted negligence under Section 6653(a).

Court's Reasoning

The court applied Section 83 of the Internal Revenue Code, which taxes the excess of the fair market value of property transferred in connection with the performance of services over the amount paid, when the property becomes transferable or no longer subject to a substantial risk of forfeiture. The court determined that Schulman's units became transferable in July 1979 when the sale to Universal was completed, as this event triggered the lifting of resale restrictions. The fair market value was established by the arm's-length sale of other units to Universal at $274. 54 per unit. The court rejected Schulman's argument that the units became transferable when pledged for a loan in March 1979, as the pledge was subject to forfeiture if Schulman's employment ended. The court also found that the consent form extending the statute of limitations was unrestricted, despite a transmittal letter mentioning a specific issue, because the consent itself contained no limitations. Finally, the court imposed negligence penalties due to Schulman's attempts to backdate documents to achieve tax benefits, finding these actions were not in good faith.

Practical Implications

This decision clarifies the timing and valuation of taxable events for restricted stock options under Section 83, emphasizing that transferability, not just the exercise of an option, triggers taxation. Legal practitioners should advise clients that the fair market value at the time of transferability, not the option price, determines the taxable amount. The ruling also underscores the importance of ensuring that any consents extending the statute of limitations are clearly drafted to avoid ambiguity.

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Businesses granting restricted stock options must be aware of the tax implications for employees when options become transferable, especially in the context of corporate transactions. Subsequent cases, such as Bagley v. Commissioner, have applied this principle, confirming that the timing of taxation under Section 83 hinges on transferability and risk of forfeiture.

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