Tanner v. Commissioner, 119 T. C. 254 (U. S. Tax Court 2002)

In Tanner v. Commissioner, the U. S. Tax Court ruled that income from exercising a nonstatutory stock option must be reported as taxable income, even if a lockup agreement restricts the sale of the acquired shares. The court clarified that the six-month period under Section 16(b) of the Securities Exchange Act of 1934, which could exempt the option from immediate taxation, starts upon the grant of the option, not its exercise. This decision impacts how the timing of stock option taxation is determined and extends the statute of limitations for tax assessments when substantial income is omitted.

Parties

Petitioners: Paul Tanner and Beverly Tanner, residing in Dallas, Texas, at the time of filing the petition. Respondent: Commissioner of Internal Revenue.

Facts

Paul Tanner, a 70-year-old retiree at the time of trial, had previously engaged in buying, selling, and investing in companies. In 1992, he planned to acquire control of Polyphase Corp. (Polyphase), and signed a lockup agreement that restricted his ability to dispose of any Polyphase stock for two years while he owned more than 5% of the corporation. On July 9, 1993, Polyphase granted Tanner a nonstatutory employee stock option, which he exercised on September 7, 1994, acquiring 182,000 shares at $0. 75 each, financed by a loan from a friend. In 1994, Tanner reported income from wages of $161,067 but did not report the income from exercising the option. Polyphase initially reported the income on a Form 1099 for 1995 but later corrected it to 1994.

Procedural History

The Commissioner of Internal Revenue determined a deficiency of $286,659 in the Tanners' 1994 federal income tax, asserting that Tanner had unreported income of $728,000 from exercising the stock option. On April 7, 2000, the Commissioner issued a notice of deficiency for the 1994 taxable year, relying solely on the Form 1099 issued by Polyphase. Tanner filed a petition with the U. S. Tax Court on May 22, 2000, disputing the additional income. The Tax Court considered the case under a preponderance of evidence standard and did not find the resolution dependent on the burden of proof.

Issue(s)

1. Whether the exercise of the nonstatutory employee stock option by Paul Tanner on September 7, 1994, was subject to taxation under section 83(a) of the Internal Revenue Code.
2. Whether the Commissioner proved a substantial omission of income under section 6501(e) to extend the statute of limitations to six years.

Rule(s) of Law

1. Under section 83(a) of the Internal Revenue Code, when property is transferred to a taxpayer in connection with the performance of services, the fair market value of the property at the first time the taxpayer's rights in the property are transferable or not subject to a substantial risk of forfeiture, less the amount paid for the property, is includable in the taxpayer's gross income.
2. Section 83(c)(3) provides an exception to section 83(a) if the sale of the property at a profit could subject a person to suit under section 16(b) of the Securities Exchange Act of 1934, treating the person's rights in the property as subject to a substantial risk of forfeiture and not transferable.
3. Section 16(b) of the Securities Exchange Act of 1934 requires that any profit realized by a corporate insider from a purchase and sale, or sale and purchase, of any equity security of the issuer within any period of less than six months must be returned to the issuer.
4. Under section 6501(e)(1)(A) of the Internal Revenue Code, the statute of limitations for assessing a deficiency is extended to six years if the taxpayer omits from gross income an amount properly includable therein which is in excess of 25 percent of the amount of gross income stated in the return.

Holding

1. The exercise of the stock option by Paul Tanner on September 7, 1994, was subject to taxation under section 83(a) because the six-month period under section 16(b) commenced at the grant of the option on July 9, 1993, and had expired by the time of exercise, rendering section 83(c)(3) inapplicable.
2. The Commissioner proved a substantial omission of income under section 6501(e), extending the statute of limitations to six years, as the unreported income of $728,000 from the stock option exercise exceeded 25 percent of the gross income reported on Tanner's return.

Reasoning

The court reasoned that the six-month period under section 16(b) starts upon the grant of the option, not its exercise, as clarified by 1991 SEC amendments which treat the grant of an option as functionally equivalent to purchasing the underlying security. Therefore, Tanner's rights in the stock were not subject to a substantial risk of forfeiture under section 83(c)(3) at the time of exercise, as the section 16(b) period had expired. The lockup agreement, which extended the restriction period to two years, could not extend the statutory six-month period under section 16(b). The court also found that Tanner realized compensation income upon exercising the option, calculated as the difference between the fair market value of the shares received and the exercise price. The court addressed Tanner's argument that the burden of proof should be on the Commissioner but concluded that the evidence supported the Commissioner's position regardless of the burden. Regarding the statute of limitations, the court found that the unreported income from the option exercise exceeded 25 percent of the reported gross income, justifying the extension to six years under section 6501(e).

Disposition

The Tax Court entered a decision in favor of the Commissioner, affirming the deficiency determination for the 1994 taxable year.

Significance/Impact

Tanner v. Commissioner clarifies the timing of taxation for nonstatutory stock options, establishing that the six-month period under section 16(b) begins at the grant of the option. This ruling impacts how taxpayers and corporations structure and report stock option compensation. The decision also underscores the importance of accurately reporting income from stock options to avoid extended statute of limitations under section 6501(e). Subsequent cases have referenced Tanner to interpret similar issues of stock option taxation and the applicability of section 16(b). This case serves as a critical precedent for tax practitioners advising clients on the tax implications of stock options, particularly in the context of lockup agreements and insider trading regulations.

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