Case Western Reserve Law Review

Volume 8 | Issue 2 Article 9

1957

Restricted-Stock Option Plans--A Windfall to Corporate Officers

Clifford M. Lytle

a setback. On the other hand, a rigid application of *respondeat superior* in the area of hospital employers would lead to a reestablishment of the immunity concept. If the future questions of charitable immunity are determined in the same enlightened manner as was the *Avellone* decision, the problems herein referred to will be properly solved.

DAVID FREED

Restricted-Stock Option Plans — A Windfall To Corporate Officers

INTRODUCTION

Significant advances have been made recently in securing for corporate executives additional financial benefits. Two of the more important developments deal with the tax advantages emanating from stock option and restricted-stock option plans, and the increased opportunity for corporate executives to realize "short swing" profits through the purchase and sale of securities. Examination of these developments reveals that the restricted-stock option plan plays a primary role in securing for corporate executives "just compensation."

Tax advantages which at one time could be obtained under stock option plans were effectively eliminated by the United States Supreme Court's decision in *Comm'r v. LoBue*.[1] This decision placed the restricted-stock option plan, which already had become the predominant means of securing tax advantages for the executive, in such position that it became the sole method for obtaining such benefits. The importance of the restricted-stock option plan is further manifested by a new ruling from the Securities and Exchange Commission, which includes this type of option within an exemption to section 16(b) of the Exchange Act prohibiting executives from obtaining "short swing" profits from the purchase and sale of securities.[2] A thorough understanding of these two developments should prove to be of great service to counsel assisting the corporate executive in the administration of his financial affairs.

THE TAX ASPECT

One of the most perplexing problems confronting corporate officers and employees today is the problem of income taxation. Progressive tax rates have had a stifling effect upon increased raises in salary. As a re-

[1] 351 U.S. 243 (1956).
[2] 17 C.F.R. § 240.16b-3 (1956).

sult, much time and effort has been spent in devising plans under which employees might secure certain tax benefits. This policy does not emanate from an intent to circumvent the tax laws, but rather is predicated upon the belief that there is a real need to preserve officer and employee incentive through increased financial compensation. One device found to be effective in securing tax advantages for employees was the stock option plan.

Stock Option Plans

A stock option plan provides an executive with the privilege of purchasing shares of the company's stock at a future date and at a specific price, usually the price of the stock at the time the option is granted. Basically, its purpose is to induce executives to sign long term contracts and to provide incentive for better management. The benefit of a stock option is reaped by the executive when the price of the stock rises, presumably through this better management, at which time the executive may exercise his option. The benefit is the difference between the option price paid by the executive and the fair market value of the stock at the time the option is exercised.[3]

The employee is now confronted with the problem of how this benefit realized from the exercise of the option is to be treated for purposes of taxation. Historically, the gain could be viewed from two standpoints: (1) the gain could be interpreted as compensation for services rendered; in this case it would be taxed immediately upon the exercise of the option as ordinary income derived within the taxable year;[4] (2) the gain could be interpreted as conferring upon the recipient a "proprietary" interest in the corporation; in this case the profit would be treated as a capital gain and taxed as such upon disposition.[5] The primary test used by the

[3] INT. REV. CODE OF 1954 § 61(a).

[4] To illustrate: the Ames Corporation, on January 1, 1954, grants to its employee Brown, a five year option to buy one share of its stock at $100 per share (the existing fair market value). On January 1, 1956, the price of the stock has risen to $150 and so Brown exercises his option buying one share at the price of the stock at the time the option was granted. Brown has realized a benefit of $50; the difference between the option price ($100 per share) and the fair market value of the stock at the time the option was exercised ($150 per share).

[5] To illustrate: The Ames Corporation granted Brown a 2 year option to buy one share of stock at $100 per share on January 10, 1954. On January 10, 1955, the stock having risen to $150, Brown exercises his option reaping a benefit of $50. If the option is considered "compensatory" in nature, the $50 benefit will be considered as part of Brown's taxable gross income for 1955 under section 61(a) of the 1954 Code. If interpreted as "proprietary" in nature, then the share of stock will be interpreted as a capital gain and not taxed until Brown disposes of the stock. For the taxation of a capital gain, see INT. REV. CODE OF 1954 § 1201-22.

courts in determining which of the above two interpretations should prevail was the intention of the parties.[6]

It appears that prior to 1939 the Tax Commissioner did not readily accept this dual interpretation of gains derived from exercising an option. Instead, the Commissioner viewed all profits arising under employee stock option plans as compensatory in nature.[7] This resulted in taxation of the officer or employee immediately upon the exercise of his option. At first the Commissioner's position was viewed with favor by the Board of Tax Appeals, but after several reversals in the circuit courts,[8] the Board was moved to adopt the distinction between "compensatory" and "proprietary" interests.[9] In view of this, the Commissioner acquiesced and amended the regulations to provide for such a distinction.[10]

It was not long before the law was again thrown into a state of confusion. In 1945, the Supreme Court decided the controversial case of *Comm'r v. Smith*,[11] which ultimately had an adverse effect upon the "proprietary" interpretation. The facts of this case were such that the stock could only have been received as compensation. A "proprietary" interpretation was obviously out of the question since Smith was given an option to buy stock in *another corporation*.

The Court stated that section 22(a) of the Revenue Act, pertaining to taxable gross income, was broad enough to include any economic or financial benefit conferred on the employee "as compensation," regardless of the form or mode by which it is effected.[12] In view of the particular facts of this case, it is clear that the Court was merely applying existing tax principles pertaining to compensatory options. The Commissioner, however, interpreted this decision as holding that every benefit received, including "proprietary" interests, was compensatory in nature.[13] Subsequent decisions to the *Smith* case have not been uniform in application. Some cases have followed the Commissioner's "compensatory" interpreta-

---

[6] Hawke v. Commissioner, 109 F.2d 946 (9th Cir. 1940).

[7] U.S. Treas. Reg. 94, Art. 22(a) -1 (1936).

[8] Rossheim v. Commissioners, 92 F.2d 247 (3rd Cir. 1937); Merhengood Corp. v. Commissioner, 89 F.2d 972 (D.C. Cir. 1937); Bothwell v. Commissioner, 77 F.2d 35 (10th Cir. 1935); Omaha Nat'l Bank v. Commissioner, 75 F.2d 434 (8th Cir. 1935); for a thorough examination of the history of stock option plans, see Lyon, *Employee Stock Options Under the Revenue Act of 1950*, 51 COLUM. L. R. 1 (1951).

[9] Delbert B. Geeseman, 38 B.T.A. 258 (1938).

[10] T.D. 4879, 1938-1 CUM. BULL. 159.

[11] 324 U.S. 177 (1945).

[12] *Ibid.*

[13] This view was formally expressed by the Commissioner in T.D. 5507, 1946-1 CUM. BULL. 18. This regulation does not apply to options granted to an employee prior to February 26, 1945.

tion and others have continued to utilize the old test based upon the intent of the grantor of the option.[14]

In 1950, Congress recognized that the Commissioner's interpretation of the *Smith* case was impeding the incentive purposes of the stock option plan. As a matter of fact, the Finance Committee reported that, in its opinion, the Commissioner's regulations went beyond the Supreme Court's decision in *Comm'r v. Smith*.[15] Because of the resulting uncertainty as to whether these regulations were in accordance with the law, Congress was moved to clarify the problem through legislation and did so by creating the restricted-stock option.[16]

Restricted-Stock Option Plans

Essentially, a restricted-stock option plan is the same as a stock option plan with one very important exception; it must meet the requirements imposed by section 421 of the 1954 Revenue Code. The exercise of the restricted-stock option may result in an employee deriving a handsome tax-free benefit. For purposes of taxation, part of this gain — the difference between the option price and the fair market value of the stock at the time the option was granted — is tax free. The balance, however, is taxable as a capital gain. To qualify for this tax advantage, the option price, at the time the option is granted, must be 95% of the existing fair market value of the stock subject to the option.[17] If the option price of the stock is less than 95%, but not less than 85% of the fair market value at the time the option is granted, then the employee is taxed only upon disposition of the stock. The general nature and purpose of this new option statute was to insure non-compensatory treatment of options which meet the specified conditions of the statute. However, if at the time the option is granted the option price is between 85% and 95% of the fair

[14] *James M. Lamond*, P-H 1946 T.C. Mem. Dec. § 46023, held that the *Smith* case did not eliminate the question of intention, but *Wanda V Van Dusen*, 8 T.C. 388 (1947) held the option was treated as commensatory. *Norman C. Nicholson*, 13 T.C. 690 (1949), and *Malcolm C. Clark*, P-H 1950 T.C. Mem. Dec. § 50210 seem to have swung the pendulum away from a literal reading in the *Van Dusen* option.

[15] S. REP. NO. 2375, 81st Cong., 2d Sess. 59-60 (1950).

[16] INT. REV. CODE OF 1954 § 421.

[17] To illustrate: if at the time the option is granted, the option price of the stock is $95 and the fair market value is $100, then the option would qualify under the 95% rule. If the option is exercised and the price of the stock later rises to $150, upon disposition the holder receives a tax free benefit as to $5 (the difference between the option price and the fair market value of the stock at the time the option was granted). But, the taxpayer is *not* relieved of the capital gain tax for the residue of the profit realized by the stock rising to $150. The $5 tax free benefit, however, does not increase the cost basis of the share to $100 and thus there is a $55 capital gain tax that must be paid.

market value, then *upon disposition* the formula gain will be taxed as ordinary income. Of course if the option price is below the 85% minimum, it cannot qualify as a restricted-stock option.

In order to qualify as a restricted-stock option, all of the following conditions must be met:

(1) The option must be granted to an employee by an employing corporation for any reason connected with his employment. Legislative history makes it quite clear that "employee" is to be construed broadly enough to include the executive officers.[18] It is not clear, however, whether directors fall within the category. Since the term "employee" is not defined in section 421, this must be determined by examining the individual state statutes. Ohio interprets the term "employee" as including directors.[19]

(2) The option price must be at least 85% of the fair market value of the stock subject to the option at the time the option is granted.

(3) The option must be exercised during the employee's lifetime and by the employee himself.

(4) The option is not transferable except by will or descent. There appears to be a latent inconsistency between this requirement and the previous condition relating to the personal exercise of the option. But it should be noted that this personal exercise requirement applies only during the employee's lifetime. Upon his death, Congress intended the the benefits of restricted-stock option to inure to the employee's heirs or estate as well as to the employee.

(5) The option must be exercised during the employment or not later than three months subsequent to its termination.

(6) The stock subject to the option must not be sold until two years or more after the option has been granted.

(7) The stock subject to the option must not be sold until six months or more after the option has been exercised.

(8) At the time the option is granted, the optionee must not control more than 10% of the voting power of the employer corporation or its parent or subsidiary corporations. This limitation does not apply, however, if the option price at the time the option is granted is at least 110% of the fair market value of the stock. Under this exception to the 10% limitation, the option is exercisable over a period of not more than five years.[20]

Examination of the restricted-stock option plan discloses substantial

---

[18] S. REP. NO. 2375, 81st Cong., 2d Sess. 59-60 (1950).

[19] 1 DAVIES, OHIO CORPORATION CODE 621 (1942)

[20] The legislation applied only to restricted-stock options granted after February 26, 1945, and exercised after 1949.

tax benefits which may be reaped by an employee. If the option price of the stock at the time of the grant is 95% of the fair market value, then upon exercise of the option, part of the gain derived by the employee is tax free.

If taxed because the option falls within the 85% to 95% range, the employee will be taxed only upon *disposition* or *death*. This enables the taxpayer to spread his tax obligations over a period of his own choosing. All other conditions being equal, if his taxable gross income is high for a given year, then it would be wise to retain the stock in its present form. If, however, his taxable gross income is low, then it would benefit the taxpayer to dispose of the stock so as to reduce his tax liability. The term "disposition" includes a sale, exchange, gift or any transfer of legal title, but does not include a transfer from a decedent to his estate or a transfer by bequest or inheritance.[21] In view of this, it would appear that the wise employee would hold his stock until death. By doing this he would never pay a capital gain tax on the increased value of the security. Upon the death of an optionee, after the formula gain is taxed as ordinary income, the stock is given a new tax basis and is subject only to estate taxation.[22]

The tax spread on *disposition* greatly favors the executive. The Internal Revenue Code provides that the amount treated as compensation shall be the amount by which the option price is exceeded by the lesser of —

(1) the fair market value of the share at the time of such disposition or death, or
(2) the fair market value of the share at the time the option was granted.

Thus, if the fair market value at the time of disposition or death is less than the option price, there will never be any ordinary income tax on the spread at the time the option is exercised.

Though there are significant benefits inherent in a restricted-stock option plan, there are certain limitations which should not be overlooked. Many states have statutes granting "pre-emptive rights" to the shareholders of a corporation which has declared a new issuance of stock.[23] Each stat-

[21] INT. REV. CODE OF 1954 § 421 (d) (4).

[22] To illustrate: assume in January, 1954, Brown exercises his option to buy one share of stock at $85 per share when the fair market value of the stock is $100 per share. In January, 1956, Brown dies. The fair market value of the stock has risen to $150 per share. Brown's estate must include the formula gain ($15) within his taxable gross income for that year. But no capital gain tax need be paid. Upon death, the stock is given a new tax basis (the existing fair market value of the stock — $150) and is subject only to estate taxation.

[23] "Pre-emptive rights" are the rights of the holders of the shares of any class of stock (with a few exceptions) to purchase upon the offering of new stock, shares in proportion to their respective holdings.

ute must be individually examined to see if the problem of "pre-emptive rights" applies to restricted-stock options. In Ohio, there seems to be little difficulty. Expressly exempted from "pre-emptive rights" are shares of stock issued or agreed to be issued for considerations other than money.[24] Since corporate officers in many instances are interested in receiving stock for services rendered to the corporation, no "pre-emptive right" to the newly issued shares would exist. If the consideration is monetary, there is still no problem. The Ohio Corporation Code further exempts from "pre-emptive rights" any shares issued or agreed to be issued upon the exercise of options granted and authorized in accordance with section 1701.16 (dealing with options to purchase shares) [25]

Capital impairment statutes have a limiting effect upon restricted-stock options. These statutes generally prohibit stock from being sold below par value so as not to impair the capital of the corporation. The policy against granting an employee unreasonably large compensation must also be considered in drafting a plan.

It is significant to note that no deduction under section 162 of the 1954 Revenue Code (relating to trade or business expenses) is allowed to the corporation with respect to the transfer of stock under a restricted-stock option plan.[26] Since the primary concern of a corporation intent upon attracting capable management has been to safeguard the executive's tax benefits at its own expense, the loss of the deduction is considered well worthwhile.

Thus, prior to 1956, there were two methods by which corporations could compensate their employees and at the same time secure for them significant tax advantages — the stock option plan when interpreted as conferring a "proprietary" interest, and the restricted-stock option plan.

In 1956, however, the Supreme Court of the United States effectively eliminated the usage of the stock option plan as a means by which employees could receive any tax benefits. The Court held in *Comm'r v. LoBue*,[27] that section 22(a) of the 1939 Code, defining taxable gross income, was intended by Congress to tax *all* gains except those specifically exempted. Unless a gain derived from a stock option plan could fall within the gift exemption of section 22(b) (3), it would be taxable as compensation. Such a transfer of stock, which is in reality compensation since it is given to secure better services, must necessarily be taxed as ordinary income. The effect of this decision eliminates the idea of a

---

[24] OHIO REV. CODE § 1701.15.

[25] OHIO REV. CODE § 1701.16.

[26] INT. REV. CODE OF 1954 § 421(a) (2)

[27] 351 U.S. 243 (1956)

"proprietary" interest emanating from a stock option plan, and the tax advantages formerly received are no longer available.

The use of the stock option plan as a device for securing tax advantages is now impractical, since the gain derived cannot be viewed as a "proprietary" interest and thus must be taxed as ordinary income immediately upon exercise of the option. This exclusion leaves only the restricted-stock option plan under which tax benefits may be secured. Corporations which have not as yet modified their incentive plans so as to fall within the restricted-stock option plan according to section 421(e) of the 1954 Code, must now do so or their employees will lose the tax benefits.

THE "SHORT SWING" PROFITS ASPECT

Under the tax aspect, we have examined how corporations may secure for their employees tax advantages by employing the use of a restricted-stock option plan. Recently, an additional method has evolved by which corporate officers and employees may realize a profit through the acquisition of stock. The development contemplates the elimination of a prior restriction rather than the creation of a new right. Essentially, it is the broadening of an exemption to the prohibition of the Securities Exchange Act against realizing "short swing" profits through the purchase and sale of securities.

Section 16(b) of the Securities Exchange Act of 1934 prevents corporate officers from taking advantage of inside information and making profits by the purchase and sale, or sale and purchase of stock. Any profit realized by an executive from such purchase or sale within any 6 month period from the date of the stock purchase shall inure to and be recoverable by the issuer of the security.[28]

Certain transactions have been exempted from section 16(b) under the Exchange Act Regulations.[29] In 1935, Rule X-16B-3 was adopted by the Commission to provide for the exemption of stock options which met several specified conditions. This regulation, however, was seldom used and soon became obsolete. A new regulation was adopted in 1949, but this dealt with an entirely different subject matter. It was limited to profit sharing and similar plans. No reference was made to stock option plans at all. In order to bring the exemptions to section 16(b) into line with the 1950 Revenue Act provision relating to restricted-stock options, Rule X-16B-3 was amended to include both stock options and restricted-stock options. Since the interpretations of the Commission concerning

[28] Securities Exchange Act of 1934 § 16(b).

[29] S.E.C. Reg. X-16B (1934).

the amended rule were given limited publicity, and in fact were not official determinations of the Commission, an air of confusion still prevailed in this area. To remedy this, a codification of these interpretations was effected to simplify the provisions and afford the investor more protection.

The purpose of the new amendment was to exempt from section 16(b) all acquisitions pursuant to bonus, profit sharing, retirement, stock option, thrift, savings and similar plans. An analysis of the rule may be divided into two basic divisions: conditions under the old regulations which are now eliminated, and conditions required under the new amendment.

Conditions Eliminated

The amended rule eliminates the condition that the persons who are to receive the securities must be selected by a board of directors, the majority of which are not eligible to participate in the plan. This should prove to be quite advantageous to controlling directors of corporations who are also officers and can share in the harvest. In such a situation a problem arises as to state laws which prohibit officers and directors from fixing their own compensation. In Ohio, the problem does not exist. The Ohio Corporation Code permits the directors, irrespective of any personal interest, to establish reasonable compensation for services rendered to the corporation by the directors and officers.[30]

The amended rule also eliminates the requirement of a cash payment as a prerequisite to the transaction falling within the exemption. Previously, this cash requirement had excluded stock acquired through stock options for services rendered.

Conditions Required Under the Amendment

The amendment makes it clear that stock options and restricted-stock options now fall within the exemption. This is in accord with the expressed intention of the Commission, which created the 1952 rule so as to conform to the 1950 Code section pertaining to restricted-stock options.

The plan must be approved by at least a majority of the security holders of the issuer present or represented and entitled to vote at the meeting, or by a charter amendment.

A new subsection was added authorizing successor corporations to qualify for the benefits if their predecessors would have been eligible. The plan or obligation to participate must, however, have been assumed by the issuer in connection with the transaction of succession.

---

[30] OHIO REV. CODE § 1701.60.

A plan may qualify under the amended rule if it limits the funds or securities allocated by establishing limitations for each fiscal year, or for the duration of the plan. The limitation may be determined by fixed amounts of the securities or funds, or by formulas based upon earnings, dividends, compensation received, percentage of outstanding securities or similar factors. Actually this is an administrative task since such a procedure is generally inherent in the creation of a restricted-stock option plan.

The effect of broadening the exemption to section 16(b) should not be interpreted as weakening the section or its purpose. As stated above, the basic purpose is to prevent officers having access to inside corporate information from using this information to their advantage in realizing "short swing" profits from the purchase or sale of securities. Since under Rule X-16B-3 a stock option or restricted-stock option plan must meet the approval of at least a majority of shareholders, sufficient protection is afforded the corporation.

Concluding the examination of the "short swing" profits aspect, it is seen that the broadening of the exemptions to section 16(b) of the Securities Exchange Act has placed the corporate executive in an advantageous position. Under stock option and restricted-stock option plans, officers and employees, upon the exercise of their options, have the opportunity to realize "short swing" profits. Since the recipient of the option under the new exemption need not hold his stock for the 6 month period required under section 16(b), he may dispose of the stock immediately and retain the profit derived without having it inure back to the issuer.

CONCLUSION

The confusion over stock option and restricted-stock option plans has been resolved to a great extent. The *LoBue* case has all but eliminated the stock option plan as a means of bestowing upon a corporate executive any tax advantages. Stock options, unless transferred as gifts, can no longer be interpreted as conferring a "proprietary" interest in the corporation. In view of this situation, the restricted-stock option is elevated to an extremely important position, for it now becomes the only means by which an executive will be able to spread his tax obligations over a desired period of time.

The corporate executive, under a stock option or restricted-stock option plan, may derive "short swing" profits from the purchase or sale of securities. By exercising the option immediately, he may realize a profit without having it inure to the shareholders of the issuing corporation. Of course, the conditions precedent under Rule X-16B-3 must be satisfied, but this poses no great problem since the conditions merely afford the issuer the proper protection against wrongdoing.

In a final appraisal, it would appear that the recent advances made in the areas of taxation and "short swing" profits have had an encouraging effect upon corporate executives. The need for a solution to the executive's tax burden is apparent. Since the congressional attitude toward taxation has always followed a fluctuating pattern, it cannot be foretold whether these recent developments will adequately alleviate this burden. Certainly a move in the right direction has been effected.

CLIFFORD M. LYTLE, JR.