Choosing between Stock Options and Outright Sales

Warren E. Hacker

Selected Close Corporation Problems

I

CHOOSING BETWEEN STOCK OPTIONS AND OUTRIGHT SALES

Warren E. Hacker

The Problem

Stock ownership in the employer corporation by its executives is generally recognized as a desirable business objective.[1] In part, this derives from the belief that an executive who owns shares in his employer company has a greater feeling of belonging and that he is working for himself and his family in contributing to the success of the corporation. Stock ownership permits him to share in the company's growth in a direct tangible way: he or his estate eventually realizes on that share without income tax or at capital gains rates rather than at the steeply graduated rates applicable to ordinary compensation.

These factors are especially important in a close corporation. Because it generally has fewer key people, the outlook and attitude of each one of them is relatively more important to the enterprise than that of his counterpart in a large publicly held corporation, and his relative contribution to the success of the venture is greater and more clearly identifiable in a close corporation. Moreover, except by offering a proprietary interest, the small close corporation rarely can approach either the security or the opportunity which the large corporation can offer to management. Therefore, arranging for stock purchases by key people is more important in the close corporation to attract and keep able management. Yet both the non-tax and tax problems of doing so are immensely more difficult for the close corporation than for the publicly-held company.

Non-Tax Elements of the Problem

Frequently, the key man lacks substantial capital to invest in stock of his employer corporation. If he has capital available, he generally is reluctant to commit all or a substantial part of it to purchasing stock. He may be willing to risk his time and effort on the close corporation's success. Sometimes he may be willing to commit his future earnings. But, of course, he prefers that the stock purchase arrangement be on a no-risk or limited-risk basis to the extent this is possible. Thus, the employee will prefer a stock option where he can wait and see before committing

1. See generally WASHINGTON & ROTHSCHILD, COMPENSATING THE CORPORATE EXECUTIVE 121 (Rev. ed. 1961).

capital, rather than a stock purchase plan where he commits capital from the outset. Sometimes he will demand that the company or its other shareholders be obligated to repurchase his stock should he die or leave the employ of the company, voluntarily or involuntarily, with or without cause. On the other hand, the corporation's desire is generally to have the key man and his capital as completely committed as possible. If the executive has a substantial part of his estate at risk in the venture, he has an additional motive to perform to his utmost and is less likely to leave the company's employ voluntarily. From the corporation's viewpoint, the stock purchase arrangement has less incentive value if it is on a no-risk or limited-risk basis to the employee.

It is hard enough to find a mutually satisfactory basis for reconciling these points of view when the corporation is publicly-held and its stock readily salable. It is even harder where the corporation is closely held. Generally, the dividend yield on a close corporation's shares is small because it is growing and needs to retain its earnings. Sale transactions in its shares are infrequent. The market is generally limited to the company itself and to other shareholders. Indeed, in many instances, there will be legal restrictions in the articles of incorporation or by contract among the shareholders limiting transfer to persons within that group. As a consequence, the fair market value of close corporation shares is a matter of judgment as to which opinions may vary widely.

Basic Tax Elements of the Problem

Difficulty in determining fair market value is by far and away the principal problem from the tax viewpoint in arranging for employee purchase of close corporation stock. Transfer by the corporation of its shares to the employee for cash, for services, or both does not result in income to it.[2] The problems which arise are the amount of and time when income if any is realized by the purchasing employee and the correlative questions as to the deduction allowable to the corporation. All of these depend in the first instance on whether the corporation sells shares to the employee at less than their fair market value, and, if so, the extent of the bargain.

Thus, the basic income tax problem in employee stock purchases is whether and the extent to which the employee purchases the stock at a

2. Unless otherwise noted, all CODE § references herein are to the Internal Revenue Code of 1954, as amended by the Revenue Act of 1964 (Pub. L. No. 88-272, 88th Cong., 2d Sess. (Feb. 26, 1964)) and all Reg. § references are to the Income Tax Regulations (1957), as amended to date. CODE § 1032(a) provides that no gain is recognized to a corporation on the receipt of money for its stock (including treasury stock). Reg. § 1.1932-1(a) provides that a transfer by a corporation of its stock as compensation for services is considered for this purpose as a disposition of such stock for money.

bargain price. The Income Tax Regulations have since 1923[3] provided that if an employer transfers any property to an employee for an amount less than its fair market value at the time of transfer, the employee realizes compensation in the amount of the bargain at that time.[4] The present Regulations contain one important and quite new exception to this rule, *viz.*, if the property transferred is "subject to a restriction which has a significant effect on its value," then the *time* the compensation is realized is postponed until the restriction lapses, and the *amount* of the bargain purchase is then determined.[5] This exception is discussed in some detail below. However, it is important here to observe that it applies to *any* bargain sale to an employee.

In typical fashion, the Regulations are not nearly so explicit as to the corporation's deduction. However, it seems clear that if the employee realizes income under the bargain purchase rule, the corporation has a deduction in the same amount and at the same time,[6] subject, of course, to the usual limitations that the compensation be reasonable in amount, and the like.

The problem of ascertaining fair market value of the stock is present whether the stock is sold to the employee outright or is sold to him pursuant to his exercise of an option granted to him, and, in the latter event, whether the option is a "qualified stock option"[7] or a "non-qualified stock

3. Regulations 62, Article 31, promulgated under the Revenue Act of 1921 (T.D. 3435, approved Feb. 7, 1923).

4. Reg. § 1.61-2(d)(2) (1957), as amended, T.D. 6416, 1958-2 CUM. BULL. 126 provides this generally: "Except as otherwise provided in [CODE] section 421 and the regulations thereunder. . . ." Reg. § 1.61-2(d)(4) (1957), as amended, T.D. 6416, 1959-2 CUM. BULL. 126 deals specifically with transfer by a corporation of its own stock as compensation. The attempted distinction between "compensatory" and "proprietary" options is no longer possible. Commissioner v. LoBue, 351 U.S. 243 (1956); Commissioner v. Smith 324 U.S. 177 (1945).

5. Reg. § 1.61-2(d)(5) (1957), as amended, T.D. 6416, 1959-2 CUM. BULL. 126, makes the rules of Reg. § 1.421-6 (1959), as amended, T.D. 6481, 1960-2 CUM. BULL. 159, applicable in determining the time and amount of compensation to be included in the employee's income "notwithstanding any other provision of this paragraph . . ." of the Regulations dealing with bargain purchases generally.

6. See Reg. § 1.162-9 (1958) as to deductibility of bonuses to employees paid in kind rather than cash. See also Reg. § 1.421-6(d)(6)(f) (1959), as amended, T.D. 6481, 1960-2 CUM. BULL. 159, that the employer "is considered to have *paid* compensation . . . at the same time and in the same amount" as the employer is considered to have realized compensation where the bargain purchase is pursuant to a non-qualified stock option. (Emphasis supplied.) It is believed that an accrual method employer will be entitled to the deduction in that year notwithstanding the reference to "paid" in the Regulation. It is also believed that the same rule will be applied for any bargain sale to an employee and not limited to those made pursuant to a non-qualified stock option. Note, however, that Reg. § 1.61-2(d)(5) (1957), as amended, T.D. 6416, 1959-2 CUM. BULL. 126, in terms relates only to the employee's income and does not incorporate the rules of Reg. § 1.421-6 as to time and amount of the employer's deduction.

7. As defined by CODE § 422(b). CODE § 423 provides for stock options granted under employee stock purchase plans which meet very strict requirements. CODE § 424, with minor exceptions, deals with restricted stock options granted before January 1964 and, therefore, is not a planning tool. "Non-qualified stock option" refers to any other employee stock option.

option." In the case of close corporation stock, it is impossible to know the fair market value until the Internal Revenue Service or a court has acted. Accordingly, this problem persists so long as the statute of limitations is open for the year or years when the bargain purchase occurs. The Service is, of course, at liberty to second-guess the value of the stock with the benefit of hindsight. The question here considered is whether and how this risk can be avoided or reduced while still satisfying the non-tax elements of the problem.

Basically, there are two methods by which the close corporation may sell shares of its stock to employees: first, pursuant to a stock option and, secondly, by a sale and transfer without intervention of an option. We shall consider these alternative routes in that order.

STOCK OPTIONS

The principal difference between this route and an outright sale of the stock to the employee is that it gives the employee some time before he is required to commit his capital. It permits him to accumulate some capital during that period, *e.g.*, from salary and bonus. But more importantly, the employee is not committed to buy during the option period even though the corporation is committed to sell. This gives the employee the opportunity to decide whether to invest. If the value of the stock goes up he can exercise the option and obtain a bargain purchase. If it goes down, he can allow the option to lapse and keep his capital, this even though the failure of the business to prosper and grow may be directly due to his own mismanagement. This limited-risk arrangement is fine for the executive but, as stated above, does not entirely suit the interests of the corporation. It is not unusual for the option to be exercisable in installments over a period of years, sometimes with a provision for lapse of the option as to any annual installment not then purchased.

Qualified Stock Options

The stock option may be either a "qualified stock option" under the statute[8] or a "non-qualified stock option." The principal difference in the income tax treatment of the two is that, properly handled, the qualified stock option permits avoidance of the bargain purchase rule upon acquisition of the stock for less than its then fair market value at the time of exercise. Making the employee option a "qualified stock option" is a relatively simple drafting matter for an informed lawyer[9] where the stock is quoted on a stock exchange or its fair market value can otherwise be

8. *Ibid.*

9. See Bergen, *Restricted Stock Options for Executives of Closely Held Corporations*, N.Y.U. 11TH INST. ON FED. TAX 145 (1953); Vesely, *Compensation Arrangements in Smaller Corporations: Compensation Through Use of Corporation Stock*, 29 U. CINC. L. REV. 52 (1960). The more stringent requirements of CODE § 422 pose no more difficult problems for the draftsman than did those of CODE § 421 prior to the Revenue Act of 1964.

ascertained with reasonable certainty.[10] However, a prime requirement is that the option price be not less than the fair market value of the stock at the time the option is granted.[11] Where the fair market value of the stock cannot be ascertained with reasonable certainty, there can be no certainty that the option will be a "qualified stock option."

That uncertainty persists until the stock acquired pursuant to the restricted stock option has been disposed of. The statute provides that if the employee does not dispose of the stock within three years and one day from the date the stock was acquired, then his entire gain on disposition is taxed at capital gain rates.[12] In no event will the corporation have a deduction[13] unless the employee disposes of his stock within that period. In that event, the employee realizes ordinary income and the corporation is entitled to claim a deduction in the year the disqualifying disposition occurred.[14] Generally, the amount of both the employee's income and the corporation's deduction is the excess of fair market value of the stock over the option price at the time the option was exercised.[15] Thus, the question of fair market value is important not only to assure that the option is a "qualified stock option;" it is also important when the employee disposes of the stock acquired by him pursuant to exercise of the option.

The importance of ascertaining fair market value and the inherent difficulty of doing so present a real challenge to the ingenuity of lawyers advising close corporations. An advance ruling on value is not possible because the Internal Revenue Service refuses to rule in advance on factual matters generally.[16] One possibility would be to specify a price in the option but include an escalator clause, *i.e.,* that should the Internal Revenue Service or a court later determine that the specified option price was less than the fair market value of the shares at the time of grant, the option price should be appropriately increased. This would have completely solved the problem. However, the Service has ruled that inclusion of any such provision disqualifies the option.[17]

10. Reg. § 1.421-2(a)(5) (1957), as amended, T.D. 6527, 1961-1 CUM. BULL. 153, provides: "Any reasonable valuation methods may be used" to determine whether the option price is at least 85% of fair market value in determining whether the option is a "restricted stock option" and refers to the methods described in Estate Tax Reg. § 20.2031-2. It may be assumed that the same principles will be applied under CODE § 422 to determine whether an option is a "qualified stock option."

11. CODE § 422(b)(4).

12. CODE §§ 422(a)(1), 421(a)(1).

13. CODE §§ 422(a)(1), 421(a)(2).

14. CODE § 421(b).

15. *Ibid. But see* CODE §§ 422(c)(4), (5) for exceptions where the amount realized on such dispositions is less than the value of the stock at exercise and where the disposition is by or for the benefit of an insolvent individual.

16. Rev. Proc. 62-32, 1962-2 CUM. BULL. 527.

17. Rev. Rul. 59-243, 1959-2 CUM. BULL. 123. Reg. § 1.421-1(d)(2)(i)(a) (1957), as

Another possibility is to impose such restrictions on the transfer and sale of the shares acquired upon exercise of the option as will fix the fair market value of the stock. This possible solution, the only one remaining in the present posture of the authorities, is discussed in detail below. But even this solution still leaves much room for expensive, time-consuming dispute and litigation with the Service as to whether the restrictions imposed on the shares had the desired effect. And if the option is exercised in installments, the possibility of dispute arises each time some stock is purchased.

Non-Qualified Stock Options

There is no statute governing non-qualified stock options. The principal authority at the present time are Regulations adopted in 1961.[18] These Regulations go beyond the decided cases and, indeed, in some respects appear to be contrary to them.[19] For present purposes, it is sufficient to note that a question exists as to whether the Regulations are valid.

Under these Regulations, the time when the employee realizes income and the corporation has a deduction, as well as the amount of such income and deduction, depends in the first instance upon whether the non-qualified stock option has a "readily ascertainable" fair market value. If it does, both the employee's income and the corporation's deduction occur at the date when the option is granted, not when it is exercised.[20] The amount in both instances is the excess of the fair market value *of the option* at that time and the amount, if any, paid for it.[21]

Under the Regulations, the option will have a "readily ascertainable" fair market value if such options are traded on an established market, otherwise only if certain stringent requirements are met.[22] Even options

amended, T.D. 6527, 1961-1 CUM. BULL. 153 provides: "The option price must be fixed or determinable *at the time the option is granted.*" (Emphasis supplied.) Again, it may be assumed that the same principles will be applied under CODE § 422.

18. Reg § 1.421-6, (1959), as amended, T.D. 6481, 1960-2 CUM. BULL. 159.

19. Hawkins, *Employer Stock Options,* 100 TRUSTS & ESTATES 516 (1961); LeFevre, *Non-Restricted Stock Options,* N.Y.U. 20TH INST. ON FED. TAX 353 (1962); Zarkey, *The Tax Incidents of Non-Restricted Stock Options,* U. SO. CAL. 1962 TAX INST.; Alfred, *Fair Market Value Concept: Current Problem Areas in Income Taxation,* 14 W. RES. L. REV. 217, 225 (1963). The Regulations have been criticized in Colton v. Williams, 209 F. Supp. 381 (N.D. Ohio 1962).

20. Reg. § 1.421-6(a)(3), (c)(1), (f) (1959), as amended, T.D. 6481, 1960-2 CUM. BULL. 159. The possibility that the option itself may have value and represent compensation when *granted* rather than or in addition to the bargain purchase when *exercised* was recognized by dictum in Commissioner v. LoBue, 351 U.S. 243, 249 (1956); Commissioner v. Smith, 324 U.S. 177, 181 (1945).

21. Reg. § 1.421-6(a)(3), (c)(1), (f).

22. This will occur only (a) if the option is freely transferable, (b) if it is exercisable immediately in full, (c) if neither the option nor the optioned property are subject to restrictions or conditions which have "a significant effect" on fair market value, and (d) if the fair market value of the "option privilege" is readily ascertainable. Reg. § 1.421-6(c)(3).

of *publicly held* corporations will rarely qualify if these Regulations are valid. The possibility that an option on *close* corporation stock may have a "readily ascertainable" fair market value under these tests is so slight as to be completely disregarded.[23] Accordingly, the employee's income and the corporation's deduction do not occur at the time the option is granted. Both are deferred until the time the option is exercised, or still later than that. Ordinarily, the option will not be exercised unless the value of the stock increases after the date that the option is granted. This means that the amount of income to be realized by the employee and the amount of the corporation's correlative deduction will be greater than if it were determined as of the date the option was granted.

Under the Regulations,[24] where the option does not have a "readily ascertainable" fair market value, the employee's income and the corporation's deduction may occur and be measured as of the date the option is exercised or a still later date, with the possibility of a still greater amount of income to the employee and correlative corporate deduction. If the stock is not subject to restrictions when transferred or, in any event, not subject to restrictions which "significantly affect" its value, the employee realizes income and the corporation is entitled to a deduction at the time the option is exercised, sold, or exchanged. In that case, the amount of the income and deduction is the excess of the amount realized over the option price. However, where stock acquired pursuant to exercise of an option is subject to a restriction which "significantly affects" its value, then the employee realizes income and the corporation becomes entitled to a deduction on the date the restriction lapses or the stock is sold or exchanged.[25] In the latter case, the amount of both the employee's income and the corporation's deduction is the *lesser* of (a) the excess of value of the stock at that time (or the amount realized) over the price paid, or (b) the excess of the non-restricted value of the stock over the option price at the time the option was exercised.[26]

Thus, the fair market value question is essentially the same whether a qualified or a non-qualified stock option is used. In both cases, it arises in the year the option is exercised if the stock acquired is not subject to a restriction which significantly affects its value. In both cases, it arises each time some of the stock is purchased if the option is exercised in installments. However, again assuming that there is no restriction which

23. *But see* Colton v. Williams, 209 F. Supp. 381 (N.D. Ohio 1962), where the court twisted the Regulations to avoid holding them invalid.

24. Reg. § 1.421-6(d) (1) (1959), as amended, T.D. 6481, 1960-2 CUM. BULL 159.

25. Reg. § 1.421-6(d) (2) (i) (1959), as amended, T.D. 6481, 1960-2 CUM. BULL. 159. This is contrary to Robert H. Lehman, 17 T.C. 652 (1951), *gov't appeal dismissed,* Second Circuit, June 8, 1952; *acq.,* 1951-1 CUM. BULL. 3; *acq. withdrawn and non-acq.,* 1962-2 CUM. BULL. 7. See Kempler, *Non-Restricted Stock Option Plans — Kuchman and Lehman Cases,* 16 TAX L. REV. 339 (1961).

26. Reg. § 1.421-6(d)(2) (i) (1959), as amended, T.D. 6481, 1960-2 CUM. BULL. 159.

significantly affects the stock's value, at least this important difference between the two exists:[27] where a non-qualified stock option is used, it is only for the year or years of exercise that the fair market value question can be raised. Once these years are barred under the statute of limitations, the question is no longer an issue and the employee is assured of favorable capital gains treatment upon later sale.[28]

OUTRIGHT PURCHASE

The risk of dispute over fair market value is still less where the stock is transferred to the employee without the intervention of an option. And outright sale can accomplish substantially everything which the option arrangement accomplishes with one notable exception. For example, suppose the employee is permitted to subscribe for authorized but unissued shares of an Ohio corporation, obligating himself to pay the subscription price in installments (say, equal amounts over five years) with interest at a fair rate and the right to prepay the balance without penalty. The corporate legislation and form of subscription agreement provide that as each installment is paid, a certificate for the appropriate number of shares will be issued.[29] Under this arrangement, the employee becomes a shareholder of the corporation immediately[30] with all of the rights of a shareholder, with the exception that he will be entitled to vote the shares rep-

27. There is possibly a further advantage to using a non-qualified rather than a qualified stock option, *viz.,* use of an escalator clause to minimize the risk of dispute as to fair market value. If, for example, the option price is specified at the figure the parties believe to be the fair market value with a proviso that should the Commissioner determine a higher value, the employee is obligated to pay the difference, there would never be a bargain purchase and, hence, never any income if it were effective. The escalator clause, if effective, would eliminate any motive for the Service to raise the fair market value issue. While the Service takes the position that this disqualifies an option under the Regulations on restricted or qualified stock options (see note 17 *supra*), this Regulation does not apply to non-qualified stock options. Rev. Rul. 59-243, 1959-2 CUM. BULL. 123, asserts as additional support for this position that "the parties to an option contract are not competent to confer upon [the Commissioner] any function of making such value determinations or to subject him to any duty to make them," citing Frederic W. Procter, 142 F.2d 824 (4th Cir. 1944), *cert. denied,* 327 U.S. 785 (1944). That case holds void as against public policy a condition on a gift that if it were held subject to gift tax, it should be deemed not included in the conveyance. It is not at all clear that *Procter* would apply to an escalator provision in a qualified stock option, particularly if it were made to depend upon a determination by the Service rather than by the courts. There would then not be the "trifling with the judicial process" which *Procter* condemns. However, it seems probable that the Service would dispute the effectiveness of such an escalator provision in light of Rev. Rul. 59-243, 1959-2 CUM. BULL. 123. Furthermore, the employee might well prefer to take his chances on the dispute with the Service, rather than undertake this sort of obligation. It costs more to pay the excess to the company than to pay income on the excess.

28. Stock acquired pursuant to a non-qualified stock option can be disposed of after the usual six month holding period with capital gain consequences even though within three years after the stock was acquired.

29. OHIO REV. CODE § 1701.24(B) prohibits issuance of the certificate until the subscription for the shares represented by it has been paid.

30. OHIO REV. CODE § 1701.03(E).

resented by the unpaid portion of his subscription only so long as his subscription is not in default.[31] If the interest rate charged does not exceed the rate of dividends paid on the shares while the subscription is outstanding, this arrangement accomplishes generally what a stock option exercisable in installments would accomplish, except that the employee is committed from the outset to make the purchase and is personally liable for the subscription price. This is not the limited-risk arrangement which the employee usually would prefer. Accordingly, the option route must be used in some cases. However, in other situations, the employee may not be so insistent on an option, particularly if he understands the recurrent risks inherent in the fair market value problem and the possibility of reducing those risks if the outright purchase route is followed.

Of course, outright purchase does not avoid these risks completely. If the subscription price is less than fair market value at the time the subscription agreement is made, the employee has income and the corporation can claim a deduction equal to the bargain in that year, unless the stock acquired is subject to a restriction which significantly affects its value.[32] But the outright purchase has the distinct advantage over the option route of considerably reducing the risk of dispute with the Service over fair market value. *First,* it is so much simpler in concept and execution, and it is less likely to attract inquiry from the Service as a practical matter.[33] *Secondly,* since there is only *one* decisive date for valuation — that when the subscription agreement is executed — the Service has only that one opportunity to dispute the value used by the parties. *Thirdly,* the amount of the bargain, if any, usually is smaller at the date the arrangement is made than it is later when the installments are paid (or the option installments are exercised). Accordingly, the amount of the employees' exposure to ordinary income is limited to the smallest amount possible in the circumstances, if as assumed throughout, the values increase over the years. Moreover, in contrast to qualified stock options, the corporation's right to claim a deduction corresponding to the amount taxed to the employee as compensation does not depend upon what the employee does with his stock.

These are substantial advantages. However, heretofore there has been an unfortunate tendency among practitioners to equate employee stock purchases with stock options, particularly restricted stock options,

31. OHIO REV. CODE § 1701.44(B).

32. Reg. § 1.61-2(d)(2), (5) (1957), as amended, T.D. 6416, 1959-2 CUM. BULL. 126. Of course, if such a restriction exists, the same problems under the Regulations arise whether the stock is acquired by outright purchase as by exercise of an option.

33. The new option reporting requirements of CODE § 6039 relate only to transfers of stock pursuant to exercise of a "qualified stock option," a "restricted stock option," or an option described in CODE §§ 423(c) and 424(c)(1). Reg. § 1.61-15(c) as amended by T.D. 6696, approved Dec. 9, 1963 (28 Fed. Reg. 13450, at 13451 1963) requires similar reports as to non-qualified stock options.

and to overlook the merits of outright purchase arrangements. In some cases, an option will be the only arrangement acceptable to the employee. That this is so in some cases should not blind the practitioner to the merits of the outright purchase arrangement in other cases where this alternative is acceptable to the parties.

STOCK RESTRICTIONS

Whether qualified stock options, non-qualified stock options or outright purchase is used, it would be extremely helpful if the fair market value of the shares could be fixed by conditions and restrictions upon the shares acquired by the employee. Certain writers have cautioned that such restrictions may not be effective unless there is a bona fide business purpose for imposing them, as distinguished from tax considerations.[34] This should pose no problem in close corporations where such restrictions are so common and well recognized as desirable wholly aside from tax considerations.

At the same time, it should be recognized that the imposition of certain kinds of conditions and restrictions may completely destroy the effect of the stock purchase arrangement and cause it to be regarded as a sham — as simply a compensation arrangement masquerading as a stock purchase. The conditions and restrictions must not be such as to prevent the employee from having and exercising the substantial rights of stock ownership after exercise of the option or other transfer of the shares.[35] For example, if the employee cannot dispose of the stock to anyone except the corporation, and if the latter is obligated to repurchase on demand on a basis where the employee or his estate cannot possibly lose, there is risk that the employee will be treated as not really a shareholder. The leading cases on this involve outright purchase arrangements.[36] But there is no reason to believe that the same principle does not apply to stock option arrangements as well.[37] In contrast, an arrangement under which

34. See Bergen, *supra* note 9, at 158; Rudick, *Compensation of Executives Under the 1954 Code*, 33 TAXES 7 (1955).

35. Reg. § 1.421-1(f) (1957), as amended, T.D. 6527, 1961-1 CUM. BULL. 153 defines "transfer" as "the transfer of ownership of such share, or the transfer of substantially all the rights of ownership." Reg. § 1.421-6(d)(1) (1959), as amended, T.D. 6481, 1960-2 CUM. BULL. 159 refers to the time the employee has the "unconditional right" to receive the stock.

36. National Clothing Co., 23 T.C. 944 (1955), *acq.*, 1956-1 CUM. BULL. 5 (purchase of stock for a non-interest bearing note payable only from dividends, restrictions on transfer in the meantime); Marts, Inc., 19 CCH Tax Ct. Mem. 669 (1960), *gov't appeal withdrawn*, Third Circuit, 1961 (stock issued below book value, employee never paid or expected to pay, corporation bound to repurchase on termination of employment at book value or difference between compensation paid and $85,000, whichever was greater); Walker v. United States, 62-1 U.S.T.C. ¶ 9347 (W.D. Pa. 1961) (companion case to *Marts, Inc.*). *Contra:* Patent Button Co. v. Commissioner, 11 CCH Tax Ct. Mem. 262 (1952), *aff'd*, 203 F.2d 479 (2d Cir. 1953).

37. Rev. Rul. 54-467, 1954-2 CUM. BULL. 207, is the only authority found involving stock options. It was there held that a transfer of substantially all rights of ownership occurred

the employee is not assured against loss should be treated in substance as a stock purchase with potential capital gain consequences.

Conditions and restrictions on shares may leave the employee with substantial rights of stock ownership,[38] but still may have an effect on the fair market value of the shares. If the Regulations are valid, restrictions which have a significant effect on the value of the stock postpone determination of the amount of the employee's compensation (and the corporation's deduction) to the time such restrictions lapse.[39] Obviously, this provision is aimed at restrictions which result in the stock having no ascertainable fair market value or a lesser value than otherwise. Its justification is that otherwise temporary restrictions avoid the bargain purchase rule when the shares are transferred to the employee and ordinary income is completely avoided[40] unless compensation is realized when the restrictions lapse and the value of the shares increases. However, the Regulation goes beyond the necessities of this situation in that it is in terms not limited to *temporary* restrictions, is not limited to restrictions the lapse of which permit the employee to realize a greater amount than otherwise and, hence, is not limited to the tax avoidance device.[41]

The examples in the Regulations shed little light on the kind of restrictions which the Service regards as having a significant effect on value. A binding commitment to resell the stock to the corporation at the below-market price paid for it should employment terminate within two years

even though the stock acquired upon exercise of a restricted stock option could not be transferred for a period (10 years at a maximum) except (a) with consent, (b) by will or inheritance, or (c) sale to an outsider after first refusal to the corporation at its then "current appraised value," and even though the certificates were endorsed and deposited with the corporation to secure the employee's covenant against transfer.

38. Reg. § 1.421-1(f) (1957), as amended, T.D. 6527, 1961-1 CUM. BULL. 153, probably means this. If it means what it literally says, *i.e.*, "substantially all the rights of ownership," it probably goes too far.

39. Reg. §§ 1.421-6(d)(2)(i), (f) (1959), as amended, T.D. 6481, 1960-2 CUM. BULL. 159.

40. This is the combined effect of Harold H. Kuchman, 18 T.C. 154 (1952), holding that stock lacked ascertainable market value where the employee could not sell for a year without consent and the corporation had a first refusal if his employment terminated in that year or the employee wished to sell within two years, on the one hand, and Robert H. Lehman, 17 T.C. 65 (1951), *gov't appeal dismissed*, Second Circuit, June 8, 1952; *acq.*, 1951-1 CUM. BULL. 3, *acq. withdrawn and non-acq.*, 1962-2 CUM. BULL. 7, on the other, holding that lapse of restrictions is not a taxable event. See excellent discussion in Kempler, *Non-Restricted Stock Option Plans — Kuchman and Lehman Cases*, 16 TAX L. REV. 339 (1961).

41. The Regulation relates to restrictions which have a significant effect on the value of the stock when it probably is intended to apply only to those which "significantly *reduce*" the value. Conceivably the "restriction" might result in a fair market value *higher* than the Service would determine for shares not subject to the "restriction." For example, the corporation might be obligated to repurchase in certain events at a price determined by formula, let us say, the same formula which was used in good faith by the parties in determining value and price of the shares when they were originally transferred to him. The Service has no legitimate interest in applying the Regulation in such cases. For this reason, perhaps the term "restriction" in the Regulation should be interpreted as limited to those terms and provisions which are designed to depress the value of the shares temporarily.

for any reason other than death is regarded as having such an effect.[42] The restriction lapses, either at the end of the two year period or on the employee's death within that period and, under the Regulation, compensation income is realized at that time. On the other hand, a restriction providing that if the employee desires to dispose of the stock during his employment, he must offer it to the corporation at fair market value does not significantly affect its value,[43] although the same arrangement using book value rather than fair market value does have this effect.[44] In terms, the Regulation is broad enough to cover any arrangement whereby the employee is prohibited from selling for a period of time,[45] or is obligated during his lifetime or the period of his employment to sell to the corporation or to the other shareholders at a figure which is below fair market value.[46]

The validity of these Regulations is bound to be tested and there appears to be a fair chance that the courts will reaffirm the *Lehman* decision[47] and hold that lapse of restrictions is not a taxable event.[48] The possibility of overturning the Regulations appears to be particularly good where the restrictions on transfer relate to close corporation stock and

---

42. Reg. § 1.421-6(d)(2)(b)(ii) (1959), as amended, T.D. 6481, 1960-2 CUM. BULL. 159, Exs. (1) & (2).

43. *Id.* at Ex. (3).

44. *Id.* at Ex. (4).

45. In addition to Harold H. Kuchman, 18 T.C. 154 (1952), see, *e.g.*, Heiner v. Gwinner, 114 F.2d 723 (3d Cir.), *cert. denied*, 311 U.S. 714 (1940) (no sale for one year); McDonald v. Commissioner, 230 F.2d 534 (7th Cir. 1956), *on remand*, 16 CCH Tax Ct. Mem. 208, *second appeal*, 248 F.2d 552 (7th Cir. 1957) (no sale while employed by corporation); Bassick v. Commissioner, 85 F.2d 8 (2d Cir.), *cert. denied*, 299 U.S. 592 (1936) (no sale until January 1st of the following year); Junior Amusement Co., 15 T.C.M. 577 (1946) (no sale for five years); I.T. 2309, V-2 CUM. BULL. 114 (sell only to corporation for five years).

46. For federal estate tax purposes (and possibly for federal gift tax purposes also), such arrangements have been regarded as fixing fair market value. Lomb v. Sugden, 82 F.2d 166 (2d Cir. 1936); Wilson v. Bowers, 57 F.2d 682 (2d Cir. 1932). See also Estate Tax Reg. § 20.2031-2(h).

47. Robert H. Lehman, 17 T.C. 652 (1951), *gov't appeal dismissed*, Second Circuit, June 8, 1952; *acq.*, 1951-1 CUM. BULL. 3; *acq. withdrawn and non-acq.*, 1952-2 CUM. BULL. 7.

48. There is a possibility that the principle of the Regulations may be completely avoided by creating a separate class of common stock to be sold to employees, including the "restriction" affecting value in the terms of that stock. If the stock is repurchased at the employee's death or other termination of his employment, it is difficult to see how there is any "lapse" of the restrictions where they are inherent in the shares themselves. In addition, if it is intended that the employee's shares be restricted for a definite period of years, the special class of common shares might provide for conversion into or exchange at the end of that period for the other class of common shares, not containing any restrictions. Under CODE § 1036(a), no gain or loss is recognized on the exchange of common for common of the same corporation. A court might find it difficult to hold that an alleged "lapse" of restrictions attributable to such an exchange should be regarded as a taxable event in the face of a statute providing that the exchange of shares shall not be a taxable event. But that result is not entirely impossible. See, *e.g.*, the decisions discussed in Garver, *Liquidations Under Section 337*, 13 W. RES. L. REV. 245, 255-56 (1962), holding that ordinary income is realized upon sales which are in terms within the nonrecognition provisions of CODE § 337(a).

are of the usual kind, not tax motivated. For example, a fairly typical close corporation arrangement is to permit transfer by gift within the employee's family, to provide for an option to the company to repurchase at death or upon termination of his employment, and to restrict sales and other disposition of his shares in the interim to assure the company's right to repurchase. If the repurchase price was clearly fair market value, the Regulation would not apply.[49]

Because the stock of close corporations is difficult to value, the repurchase price is ordinarily determined by a formula, not uncommonly 100% or a higher or lower percentage of book value. The formula value is generally regarded by the parties as an approximation of fair market value. The formula is not used out of any desire temporarily to depress the value of the shares so that the employee will benefit when the restrictions "lapse" at his death or on prior termination of his employment. Indeed, it may be the same formula which was used to determine the price at which the stock was originally sold to the employee.[50] The parties regard restrictions which persist until the employee's death or prior termination of his employment as *permanent* rather than as temporary restrictions. Not infrequently they closely parallel or are the same as the restrictions which also exist on the shares of the company outstanding in the hands of nonemployees. The Regulations apply only if the Service successfully contends that, notwithstanding these facts, the formula yields a figure below fair market value. If the validity of the Regulations is presented to the courts in this context, it is not unlikely that they will be held invalid.

More importantly, sound administration of the tax laws demands that the principle of the Regulations should never be applied to such cases. The Regulations should be modified so as not to impair the legitimate use of restrictions on transfer of close corporation stock. The use of a formula for determining the price at which shares are required to be repurchased or may at the company's option be repurchased from the employee is a practical necessity in a close corporation. The formula may or may not result in what the Service may, with hindsight, later agree is fair market value where the shares have no market, fair or otherwise. But if the parties make an honest effort to approximate fair market value by such a formula, the employee and his estate should not be exposed to the harsh consequences which flow from the Regulations, *viz.*, unexpected

49. Reg. § 1.421-6(a)(2)(ii) (1959), as amended, T.D. 6481, 1960-2 CUM. BULL. 159, Ex. (3).

50. At least one writer suggests that the Regulation will not apply if the employee is required first to offer the stock to the corporation at a price less than its fair market value but in excess of the price which the employer paid for it, even though the restrictions may be for a temporary period. Willis, *Non-Restricted Stock Options*, 101 TRUSTS & ESTATES 1146. 1205 (1962).