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EMPLOYEE STOCK OPTIONS: THE EFFECT UPON A CORPORATION'S EARNINGS AND PROFITS

*Harold S. Divine*¹ and *Luckman v. Commissioner*²

In both *Harold S. Divine*³ and *Luckman v. Commissioner*⁴ the taxpayers received dividends from the Rapid American Corporation and claimed that the distribution of cash which they had received should not be taxed as dividends because the corporation had no earnings and profits.

By defining a dividend as a distribution out of earnings and profits,⁵ the Internal Revenue Code⁶ creates the possibility of a

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4. 418 F.2d 381 (7th Cir. 1969).
5. *Int. Rev. Code* of 1954, § 316(a) provides, in part:
   *The term “dividend” means any distribution of property made by a corporation to its shareholders—
   (1) out of its earnings and profits accumulated after February 28, 1913, or
   (2) out of its earnings and profits of the taxable year. . . .

*Int. Rev. Code* of 1954, § 301(c) provides, in part:

1. *Amount Constituting Dividend.*—That portion of the distribution which is a dividend (as defined in section 316) shall be included in gross income.
2. *Amount Applied Against Basis.*—That portion of the distribution which is not a dividend shall be applied against and reduce the adjusted basis of the stock.
3. *Amount In Excess of Basis.*—
   (A) *In General.*—. . . *That portion of the distribution which is not a dividend, to the extent that it exceeds the adjusted basis of the stock, shall be treated as a gain from the sale or exchange of property.*
distribution to shareholders being taxed at other than the ordinary income rates applied to dividends. If the taxpayer is successful in arguing that the distribution exceeded earnings and profits, the portion of the distribution in excess of earnings and profits will be taxed as a return of capital (no tax) or at capital gains rates, either of which is more advantageous to the taxpayer than taxation at ordinary income rates.

During the period January 1, 1957 through January 31, 1963 the Rapid American Corp. granted restricted stock options at a price below market value to certain of its key employees. The recipients' exercise of their options resulted in the purchase of 186,558 shares of authorized but unissued Rapid common stock. Based upon the quoted market price at the date of exercise, the aggregate market value of these shares was $5,671,120.00. Rapid, of course, received only the option price of $2,044,748.00. The difference between these two sums, the option spread at exercise, if subtracted from Rapid's earnings and profits account, would have exhausted it. Subsequent to the exercise of the stock options Rapid paid cash dividends to the shareholders.

*Luckman v. Commissioner* was the first litigation to arise concerning the tax status of these dividends. In *Luckman* the Seventh Circuit Court of Appeals concluded that the spread between the fair market value of the stock and the option price on the date of purchase did reduce earnings and profits. Consequently, the distribution received by Mr. Luckman was not a dividend.

The Commissioner, undaunted by the *Luckman* result, relitigated the issue in *Harold S. Divine*. Mr. Divine was a Rapid shareholder who had received a portion of the cash dividends paid by Rapid after exercise of the stock options. The *Divine* case concerned the same facts as *Luckman*, except for the amounts distributed to each taxpayer and the taxable years involved. In *Divine* the taxpayer argued that the difference between the fair

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8. See note 5 supra.
10. See note 7 supra and accompanying text.
11. The first issue before the Tax Court was whether the Commissioner was collaterally estopped by the *Luckman* decision. The court resolved the estoppel issue in favor of the Commissioner and proceeded to a decision on the merits. The estoppel issue will not be treated in this note.
market value of the stock and the lower option price actually paid by the employees was a compensation expense that reduced the corporation’s earnings and profits. The Tax Court rejected this line of analysis, finding that there was no reduction of earnings and profits, and characterized the distribution to Divine as a dividend.

Rapid did not claim the aggregate difference between the market price of the stock at exercise and the option price (option spread at exercise) as a deduction on its federal income tax returns and did not reduce its balance sheet retained earnings account by that amount. It did advise the taxpayer in Divine not to report any of the distributions to him as dividend income on his federal income tax returns for the years 1961 and 1962, and the taxpayer followed this advice.

At the threshold, the issue was the effect, if any, of the option spread at exercise upon the corporation’s earnings and profits. If, as the taxpayer argued, the option spread at exercise does reduce earnings and profits, then the distribution by Rapid was not a dividend because its earnings and profits account was exhausted by the spread at exercise.

The Tax Court in Divine agreed with the Commissioner and held that the option spread at exercise did not affect Rapid’s earnings and profits. Essential to the Divine rationale was the assumption that the income tax treatment of an item predates that item’s earnings and profits effect. Because restricted stock options provided no income tax deduction to the corporation, the court reasoned, no earnings and profits reduction would be allowed. Thus, the distribution to the taxpayer was a dividend. By implication, non-statutory stock option plans which do provide an income tax deduction to the corporation would reduce

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12. Rapid could have deducted neither the option spread at grant nor the option spread at exercise. Int. Rev. Code of 1954, §§ 424(a), 421(a)(2).
14. The Tax Court in Divine reached the same result it had reached earlier in Luckman. The two cases were similarly disposed of, but on different rationales. In Luckman, the rationale was that the corporation suffered no loss because it received good will from the employee equal to the option spread at exercise.
15. Taxable income is normally the point of departure in computing earnings and profits, but the latter account need not and often does not follow the former. B. Bittker & J. Eustice, ¶7.03, at 7-13. See note 22 infra and accompanying text.
earnings and profits.

In dictum the court stated that if a restricted stock option plan were to have an effect upon the corporation's earnings and profits, that effect would be measured by the option spread at grant.\textsuperscript{18} Under this view, Rapid would have retained sufficient earnings and profits to make the distribution to the taxpayer a dividend.

The \textit{Divine} decision directly conflicts with the result in \textit{Luckman} which reduced the corporation's earnings and profits by the option spread at exercise. The \textit{Luckman} court found that the spread was essentially compensation and, since compensation is an expense, should reduce earnings and profits.\textsuperscript{19} Additionally, the court argued, this compensation expense should reduce earnings and profits because in economic reality the corporation could have paid the employee a cash sum equal to the spread at exercise which the employee could have used to purchase the stock. Because a cash payment would reduce earnings and profits, the court reasoned that a stock option should also reduce that account since the practical effect of both transactions would be the same: the corporation would receive services and the employee would receive stock.\textsuperscript{20}

\textbf{Earnings and Profits}

The meaning of earnings and profits has been the subject of an on-going debate\textsuperscript{21} ever since these words were introduced to the

\begin{itemize}
\item \textsuperscript{18} This alternate measuring point was suggested in Jacoby, \textit{Earnings and Profits: A Not so Theoretical Concept-Some Winds of Change}, N.Y.U. 29TH INST. ON FED. TAX. 649, 665 (1971) [hereinafter cited as Jacoby]. The option spread at grant will always be a lesser sum that the option spread at exercise if the market has risen since the grant. In fact, under this alternate \textit{Divine} view, Rapid would have retained sufficient earnings and profits to render the distribution to the taxpayer a dividend.
\item \textsuperscript{19} With the advent of the qualified stock option in 1964 (see note 85 infra) the existence of a spread at grant, tolerated under the restricted stock option, was made impossible. \textit{Int. Rev. Code} of 1954, § 422(b)(4).
\item \textsuperscript{20} This analogy has been criticized for ignoring the form of the transaction, for understating realized gains by the corporation, and for assuming an improbable bargain—that the corporation would agree to pay a cash sum determined by fortuitous market factors. Jacoby, \textit{ supra} note 18, at 664-65. See notes 99 \textit{et seq. infra} and accompanying text.
federal income tax law in 1916. The first income taxing act, the Revenue Act of 1913, taxed dividends but did not define the term. In *Lynch v. Hornby* the Supreme Court interpreted dividend to include all dividends paid in the ordinary course of business, notwithstanding their source. To prevent the taxation of earnings that accrued prior to enactment of the Revenue Act of 1913 the Revenue Act of 1916 introduced the term earnings and profits. It provided that:

> the term "dividends" as used in this title shall be held to mean any distribution made or ordered to be made by a corporation . . . out of its earnings or profits accrued since March first, nineteen hundred and thirteen. . . .

From the first instance the Code provided no definition for earnings and profits from which its application to specific situations could be reasoned deductively. In their search for a definition the courts apparently accepted the premise that Congress intended to tax the corporation and the shareholder as two separate entities. The corporation was to be taxed on its earnings and profits, and the shareholder was to be taxed on distributions paid by the corporation on his investment, regardless of the funds used to pay the distribution or the date of purchase of the stock. Under this separate entity concept, income exempt from tax to the corporation, such as municipal bond interest, when distributed to the shareholder loses its character and is dividend income. A slightly more anomalous result occurs when the shareholder receives a distribution immediately after purchasing a share of stock. Rather than being a return of capital, the distribution is taxable as a dividend to the shareholder to the extent the corpora-

What is Meant by Earnings and Profits, N.Y.U. 18th Inst. on Fed. Tax. 235 (1960); Jacoby, supra note 18.

25. See B. BITTKER & J. EUSTICE ¶7.03 at 7-11.
27. United States v. Phellis, 257 U.S. 156 (1921). This proposition is intrinsic in all cases applying the requirement of earnings and profits where the character of a distribution as a dividend was at issue. The only recognized exception to the separate entity rule is the Code's treatment of taxable stock dividends. See note 63 infra and accompanying text.
28. Charles F. Ayer, 12 B.T.A. 284, 287 (1928) contains the first judicial utterance on this point. See Treas. Reg. § 1.32-6(b) (1955). That municipal bonds lose their character as tax exempt income upon distribution is a well settled and long established proposition. 1 MERTENS, LAW OF FEDERAL INCOME TAXATION § 9.32 (Malone ed. 1969).
tion has earnings in excess of contributed capital.

Using the separate entity concept as an operating premise for their focus on the corporation the courts have wielded the definition of earnings and profits on a case by case basis with only an occasional statutory reaction. The Internal Revenue Code fails to provide a definition. Most probably the content of earnings and profits eluded the Congress responsible for its introduction to the income tax law. The decisions seem to accept earnings and profits as the measurable amount of realized gain in excess of contributed capital which remains for distribution to the shareholders.

Under this approach the earnings and profits treatment of an item usually follows the income tax treatment since most income and expense items taken into account for taxable income will affect the amount of realized gain available to be distributed. It is for this reason that the computation of earnings and profits begins with taxable income.

30. Int. Rev. Code of 1954, § 301(c) provides that a dividend is a distribution out of earnings and profits. Loosely speaking, earnings and profits measures the productivity of the capital contributed to the corporation. If the contributed capital has produced no gains in any year, any distribution to the shareholder will not be a dividend. When contributed capital is returned to the shareholders, the treatment accorded the shareholder is specified in Int. Rev. Code of 1954, § 301(c). See note 5 supra.
31. Commissioner v. Young Corp., 103 F.2d 137 (3d Cir. 1939) (gain resulting from a tax free exchange enters into earnings and profits) was abandoned by Int. Rev. Code of 1939, ch. 1, § 115(1), as amended, 54 Stat. 1004 (1940) [codified without substantial change in Int. Rev. Code of 1954, § 312(f)(1)] which required that earnings and profits not be augmented until the gain was recognized.
32. Jacoby, supra note 18, at 652.
33. See Henry C. Beck Co., 52 T.C. 1, aff'd per curiam, 433 F.2d 309 (5th Cir. 1970) which involved gain on intercompany transactions not recognized under 1955 rules for consolidated returns. The court held that the gain increased earnings and profits and stated:

[Earnings and profits] are not synonymous with taxable income. . . . Frequently, items of unallowable losses will decrease earnings and profits, or items nontaxable income will increase earnings and profits. . . . Many items are includable in earnings and profits which are not taxable income. . . . It is clear, therefore, that "earnings and profits" is much broader than "taxable income."

52 T.C. at 6. See B. Bittker & J. Eustice ¶ 7.03.
34. See Commissioner v. Gross, 236 F.2d 612 (2d Cir. 1956).
To compute earnings and profits, taxable income is adjusted for those transactions which were not included in computing taxable income and also for transactions which, while included in computing taxable income, had no effect upon the corporate assets.

Transactions of the first category, those not taken into taxable income, may increase or decrease earnings and profits. Earnings and profits are increased by items such as municipal bond interest and life insurance proceeds which increased the assets of the corporation, but which were not included as receipts in the computation of taxable income. Conversely, items such as excess charitable deductions and lobbying expenses are subtracted from earnings and profits. These items, while not reflected in taxable income, were actually paid and served to reduce the corporate assets.

In the second category, transactions which are taken into taxable income but which do not reduce earnings and profits, are items such as net operating loss carry forwards and dividend received exclusions. These items, while providing an income tax deduction, do not reduce the corporate assets in the year of deduction and are therefore added back to taxable income in computing earnings and profits. A transaction very similar in character because it does not represent an actual reduction of corporate assets is the stock dividend. A stock dividend is a paper transfer from retained earnings to the capital account which does not reduce either taxable income or earnings and profits, but does

36. *Id.* at 7-14.
37. *See* Cummings v. Commissioner, 73 F.2d 477 (1st Cir. 1934). The current Code exemption for life insurance proceeds is specified in INT. REV. CODE of 1954, § 101(a).
40. B. Bittker & J. Eustice ¶ 7.03, at 7-18.
41. *Id.* at 7-17. Net operating losses may be carried forward under INT. REV. CODE of 1954, § 121. Such losses do reduce earnings and profits in the year incurred.
42. Dividends received from another corporation are received in full and the 85% dividends received deduction under INT. REV. CODE of 1954, § 243 for taxable income is artificial. *See* Rudick, "Dividends" and "Earnings or Profits" Under the Income Tax Law: Corporate Non-Liquidating Distributions, 89 U. PA. L. REV. 865, 885-86 (1941).
43. Commissioner v. Fender Sales, Inc., 338 F.2d 924, 927 (9th Cir. 1964).
44. *See* Eisner v. Macomber, 252 U.S. 189 (1920) (paper transfer). Although a stock dividend reduces the retained earnings account of a corporation the dividend itself is paid in additional shares of stock rather than out of the realized earnings of the corporation. For this reason, non-reduction of earnings and profits is the theoretically proper treatment, Walker v. Hopkins, 12 F.2d 262 (5th Cir.), cert. denied, 271 U.S. 687 (1926). The current Code provides for a reduction of earnings and profits by the amount of a taxable
reduce the corporation's retained earnings account on its financial statements.\textsuperscript{45} From this discussion it can be seen that earnings and profits necessarily does not follow taxable income\textsuperscript{46} or the accounting concept of retained earnings.

In defining earnings and profits the courts have focused on the corporation's potential for distributing realized gains\textsuperscript{47} to its shareholders.\textsuperscript{48} The realization requirement causes the earnings and profits effect of a transaction on the corporation to be different from the income tax effect of that transaction upon the shareholder. Illustratively, if the corporation pays a dividend in property so that it does not recognize any gain or loss on the distribution\textsuperscript{48.1} and the property so distributed has a basis below its fair market value, the corporation would reduce earnings and profits by the basis and the shareholder would take into income the fair market value of the property.\textsuperscript{49} This is proper because the basis represents the realized cost to the corporation. To subtract the fair market value would be to subtract gain that had never been included in earnings and profits and consequently to understate the account.

\footnotesize{stock dividend \textsuperscript{[INT. REV. CODE OF 1954, § 312(d)]} but this reduction follows from equitable rather than theoretical considerations. See note 68 infra and accompanying text.}

\textsuperscript{45}. P. Grady, Accounting Research Study No. 7, Inventory of Generally Accepted Accounting Principles for Business Enterprises 206-07 (1965).

\textsuperscript{46}. See notes 13, 15 supra.

\textsuperscript{47}. See note 32 supra and accompanying text. This is best illustrated by the treatment accorded a distribution by the corporation to the shareholder of appreciated property. By reason of \textsuperscript{INT. REV. CODE OF 1954, § 311(a)(2)} the transaction is not deemed to be a sale by the corporation and no gain or loss is recognized. Therefore, \textsuperscript{INT. REV. CODE OF 1954, § 312(a)(3)} reduces the corporation's earnings and profits by the adjusted basis of the asset. If earnings and profits were reduced by the market value there would be a subtraction of gain that had never been included in earnings and profits. Such a treatment would understate those earnings and profits available for distribution to the shareholders. Harold S. Divine, 59 T.C. No. 15 (1972) (Raum, J. concurring). See B. Britke & J. Eustice \textsuperscript{¶} 7.03 at 7-13: "[I]t is quite clear that appreciation or depreciation in value that has not been 'realized' in the income tax sense does not affect earnings and profits."

Although current earnings and profits theory requires realization and recognition, the validity of this requirement has been seriously questioned. See Jacoby, supra note 28. Other commentators have thought that the whole concept of earnings and profits should be abandoned. Andrews, "Out of its Earnings and Profits": Some Reflections on the Taxation of Dividends, 69 Harv. L. Rev. 1403 (1956).

It is not within the intended scope of this note to analyze the requirement of realization in earnings and profits theory or to deal with the abolition of the concept entirely. Accordingly, this note sets forth an analysis of the effect of stock options upon earnings and profits within the context of current judicial resolutions that realization is required before earnings and profits can be affected.

\textsuperscript{48}. Henry C. Beck Co., 52 T.C. 1, 6 aff'd per curiam, 433 F.2d 309 (5th Cir. 1970).

\textsuperscript{48.1}. \textsuperscript{INT. REV. CODE OF 1954, § 311}.

\textsuperscript{49}. Timberlake v. Commissioner, 132 F.2d 259 (4th Cir. 1942); Treas. Reg. § 1.312-1(c) (ex. 1) (1956).
As with most rules of law, the realization requirement can claim several exceptions to its general operation. In some transactions the realization requirement is temporarily ignored and the earnings and profits treatment of an item will closely track that item’s income tax treatment. For administrative convenience, this course is followed in those transactions where there is an ultimate tax effect that will correctly state earnings and profits in accord with the realization requirement at some future date. Because mechanical rules generally create this ultimate accord, this exception will be termed the mechanical exception.

_Bangor & Aroostook Railroad Co._ nicely illustrates the mechanical exception. In that case the taxpayer corporation received income from the discharge of indebtedness and elected to exempt the gain from that year’s income. Mechanically, that election required the corporation to reduce the basis of its assets. Reducing the basis of the corporation’s assets had two effects. It reduced subsequent depreciation charges and, upon disposition, would also serve to increase the gain taken into taxable income, or decrease the loss, if the assets were not fully depreciated at the time of disposition. The court held that earnings and profits would follow the tax treatment and be augmented in the latter years by the effect of the reduced basis. This result seems proper because otherwise the earnings and profits account would be increased twice by the same gain—first, at the time of the discharge of indebtedness and second, by the effect of the reduced basis.

Section 312(m) of the Internal Revenue Code illustrates the application of the mechanical exception to unrealized losses. Under that section an asset must be depreciated on the straight line method and the depreciation deduction reduces earnings and profits. Illustratively, if an asset has a cost of $100 and a useful life of ten years, this section requires a reduction of earnings and profits by $10 each year. Thus, if after five years the asset is sold for $50 the reduction of earnings and profits by $50 will then be

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50. 16 T.C. 578, aff’d, 193 F.2d 827 (1st Cir. 1951), cert. denied, 343 U.S. 934 (1952).
52. Of course, if the corporation elected to take the gain from the discharge of indebtedness into income, earnings and profits would be augmented at that time. Int. Rev. Code of 1954, §§ 108, 1017.
54. For purposes of this example, the use of salvage value has been omitted. Salvage value is explained in Int. Rev. Code of 1954, § 167(f) and its application to Int. Rev. Code of 1954, § 312(m) is discussed in Jacoby, _supra_ note 18, at 680-81.
realized and no further reduction is made. This tax effect demonstrates that the depreciation charge, although unrealized, is brought into accord with the realization requirement when the asset is disposed of. This treatment of unrealized losses represents the converse of Bangor & Aroostook, yet like Bangor & Aroostook insures that the earnings and profits account will not be twice affected by the same item of gain or loss.

For policy reasons, another exception to the realization requirement has recently developed for expenditures that have been disallowed as a deduction in computing taxable income. Although this policy exception is of unsettled status, it is important because its application contravenes the separate entity theory of earnings and profits.54

In Davis v. United States55 the defendant was criminally prosecuted for tax evasion, being charged with unreported taxable income as a result of diverting checks payable to the corporation to his own use. He defended on the theory that for the government to prevail, the monies he diverted must have been income. The defendant argued that as a shareholder of the corporation the money he received was a dividend rather than income. Thus, he concluded, the government must prove the existence of earnings and profits. The court rejected this argument and would not reduce earnings and profits although it was not clear if they considered the sums diverted by the defendant to be dividends.

Although Davis makes for unclear reading, the general proposition advanced by the case is that in criminal prosecutions the corporation and the shareholders will be treated as a single entity.56 Originally the court that decided Davis held that the single entity rationale would be limited to criminal prosecutions,57 but in a subsequent decision,58 the same court indicated that the Davis rationale was applicable in civil litigation. If applied in civil litigation the Davis theory would be combined with the code sections which provide that no deduction shall be allowed for illegal bribes of government employees,59 fines and penalties paid to any government,60 and treble damage penalties for violations of the anti-trust laws.61

54.1. See note 27 supra and accompanying text.
55. 226 F.2d 331 (6th Cir. 1955).
56. Id. at 335.
57. Drybrough v. Commissioner, 238 F.2d 735 (6th Cir. 1956).
59. INT. REV. CODE OF 1954, § 162(c).
60. Id. § 162(f).
61. Id. § 162(g).
Juxtaposed, the codified disallowed business deductions and the single entity theory of *Davis* provide the basis for a court to pierce the separate entity theory and impute the behavior of the corporation to its shareholders. Although *Davis* and its progeny all involved closely-held corporations, the thrust of the juxtaposition does not require that the application of the single entity theory be so limited. If the behavior of a corporation is imputed to its shareholders so that there is no reduction of earnings and profits, a distribution to them might be taxed as dividend income when in fact it was a return of capital. Aside from reliance on the merger concept of *Davis* in the event of wrongdoing, such a result could be justified under the theory that a reduction in earnings and profits would be a benefit to the shareholders. For anyone to benefit from the expenditure would be violative of the social policy against that type of expenditure; therefore, the expenditure should not reduce earnings and profits.

Another type of policy exception can be found in the earnings and profits treatment of taxable stock dividends. Following the decision in *Eisner v. Macomber*, which held that stock dividends did not result in income that could be constitutionally taxed, courts held that earnings and profits were not reduced by a stock dividend on the theory that the transaction involved a paper transfer which did not reduce the corporate assets available for distribution. With the erosion of the *Macomber* constitutional doctrine, stock dividends became taxable even though no corporate assets were paid out. The Code provides that if any shareholder had an election to take property (including cash) rather than stock the stock dividend will be taxable. The recipient will take into income the fair market value of the stock distributed and that amount will reduce the corporation's earnings and profits.

Indefensible in theory—as no amount is actually taken out of the corporate assets—the earnings and profits treatment of taxable stock dividends must be supported by a policy consideration if it is to be supported at all. One policy to support the

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64. See B. Britker & J. Eustice § 7.60, at 7-61.
treatment of taxable stock dividends springs from equitable considerations. Because the recipient has paid a tax on the receipt of a piece of paper, the stock dividend, which represents amounts still within the corporate assets, earnings and profits must be reduced to avoid taxing the same recipient a second time upon the earnings when they are actually distributed. 68

This equitable argument, however, rests upon a tenuous proposition. In a public issue corporation shares are rapidly traded and, thus, the recipient at the time of the stock dividend may not be the one who receives the actual proceeds from the asset distribution. 69

Another argument, similar to that made in Luckman, can be made to support the earnings and profits treatment of taxable stock dividends when the choice of cash or stock makes the distribution taxable. This argument asserts that in net effect the vehicle of income is the same. 70 If the recipient of the stock desired, he could have received cash and used it to purchase shares of the corporation. Therefore, this argument concludes, since a cash payment would reduce earnings and profits, so also should a stock dividend when the cash or stock choice is offered.

This argument may be criticized on the ground that it equates two forms of payment based upon their economic effect on the shareholder. It does not address itself to the issue of why the earnings and profits effect of a taxable stock dividend should differ from a nontaxable stock dividend and therefore cannot support a discriminatory earnings and profits approach. Consequently, the distinction between taxable and nontaxable stock dividends for earnings and profits purposes seems most aptly classified as an anomaly in earnings and profits theory unless one accepts the equitable justification.

The discussion thus far has attempted to point out the incomplete analysis inherent in the Divine court’s resolution of necessarily similar treatment of an item for the corporation’s income tax and earnings and profits computations. Rather than be blindly guided by income tax treatment, the line of analysis must look to the real effect of the transaction on the corporate assets.

68. This policy argument is made in Jacoby, supra note 18, at 667.
The Nature of Stock Options

An examination of the stock option begins with the recognition that stock options present considerations for income tax treatment to the employee that do not resolve the problems presented for earnings and profits purposes. For income tax analysis, the central problem is the character of a stock option composed of compensation and capital contribution elements. Prior to two clarifying decisions, one by the Congress and the other by the Supreme Court, courts struggled to classify the option as either totally compensatory or totally a contribution to capital.

Delbert B. Geeseman, a 1938 Board of Tax Appeals decision, began the quandary for the courts by holding that a stock option was a capital transaction. Subsequent decisions distinguished Geeseman, and, later, were themselves distinguished. Important factors in the decisions included the characterization of the option by the approving board resolution and the existence of an option spread at grant. Generally, if a resolution existed proclaiming the option compensatory or if there were an option spread at grant, the court would classify the entire transaction as compensatory. Alternatively, the absence of either the resolution or the spread could lead a court to classify the transac-

74. 38 B.T.A. 258 (1938).
75. The cases between Geeseman and LoBue which held stock options to be compensatory were as follows: Albert Russel Erskine, 26 B.T.A. 147 (1932); Connolly’s Estate v. Commissioner, 135 F.2d 64 (6th Cir. 1943); Commissioner v. Smith, 324 U.S. 177 (1945); Van Dusen v. Commissioner, 166 F.2d 647 (9th Cir. 1948); McNamara v. Commissioner, 210 F.2d 505 (7th Cir. 1954).
76. E.g., McNamara v. Commissioner, 210 F.2d 505 (7th Cir. 1954).
77. E.g., Commissioner v. Smith, 324 U.S. 177 (1945).
78. Commissioner v. Smith, 324 U.S. 177 (1945) (option spread at grant); McNamara v. Commissioner, 210 F.2d 505 (7th Cir. 1954) (board resolution); Connolly’s Estate v. Commissioner, 135 F.2d 64 (6th Cir. 1933) (board resolution).
ERRATA

In Note, Employee Stock options: The Effect Upon a Corporation's Earnings and Profits, 33 Md. L. Rev. 190 (1973), the second paragraph of footnote 85 should be the first paragraph of footnote 86. Thereafter, add one number to each succeeding footnote through the present footnote 98. Thereafter, all footnotes correspond to the text except that footnote 108.1 should be deleted.
tion as a capital contribution. Unfortunately for the taxpayer, the decisions finding the transaction compensatory preponderated, and culminated in *Commissioner v. Smith* which clearly implied that all stock options were compensatory.

Essentially in response to the *Smith* decision, Congress made a policy decision that employees should receive preferred tax treatment for some stock option plans, and, in 1950 enacted the bill that eventually was codified as section 130A of the Internal Revenue Code of 1939. This section, which essentially codified the *Geeseman* decisional line, introduced the restricted stock option. Those stock options which met the section 130A requirements were to be treated as capital transactions. An employee receiving such an option would not be taxed until he disposed of the stock, and, thus would be treated as if he had purchased and sold the shares in the open market. The employer participating in the restricted stock option transaction would not be allowed a deduction at any point in time. This section 130A resolution of the income tax effect of a statutory stock option was carried forward under the current Code.

The current qualified stock option, which replaced the re-

79. Rossheim v. Commissioner, 92 F.2d 247 (3d Cir. 1937) (option price substantially equal to market price at time of grant); Gardner-Denver Co. v. Commissioner, 75 F.2d 38 (7th Cir.), cert. denied, 295 U.S. 763 (1935) (option price equal to market price at time of grant).
80. 324 U.S. 177 (1945).
85. Int. Rev. Code of 1954, § 422(b) sets out the qualified stock option which, in 1964, replaced the restricted stock option. Under the qualified stock option, the option plan must meet certain requirements, among which are the following: the option is granted according to a plan which includes the aggregate number of shares which may be issued under the option; the shareholders of the corporation approve the plan; the option is not exercisable after the expiration of five years from the date of grant; and, generally, the option price at the date of grant is not less than the fair market value of the stock. For the exception to this last requirement, see note 87 infra.
86. The restricted stock option [Int. Rev. Code of 1939, ch. 1, § 130A, 64 Stat. 942 (1950)] was carried forward without substantial change in Int. Rev. Code of 1954, § 424 but is only applicable to options granted prior to January 1, 1964. For the taxable years under discussion in *Divine*, and *Luckman* the restricted stock option provisions were codified in Int. Rev. Code of 1954, § 424. Differing from the qualified stock option, the restricted stock option did not have to be granted at a price equal to then market value of the shares of the corporation. Moreover, the recipient of a restricted stock option could own 10% of the combined voting power of all the corporation's classes of stock and the option could be exercised up to ten years following the grant. Int. Rev. Code of 1954,
stricted stock option in 1964, differs from the restricted stock option in one important respect. The restricted stock option permitted the option price to be below the market price of the stock at the time the option was granted.\textsuperscript{86} The qualified stock option generally requires that the option price be equal to the market value of the stock at the date of grant.\textsuperscript{87} Although the taxpayers in Divine and Luckman had been recipients of restricted stock options, the analysis of the earnings and profits question in these cases is equally applicable to current qualified stock options. For this reason, unless the context otherwise requires, option plans

\textsuperscript{86} INT. REV. CODE OF 1954, § 422(b)(4). An exception to this requirement is provided in § 422(c). Under this exception, if the corporation made a good-faith attempt to set the option price at the market price which failed, the option remains qualified. In the year of the option's exercise, however, the employee will take into gross income an amount equal to the lesser of:

(A) 150 percent of the difference between the option price and the fair market value of the share at the time the option was granted, or

(B) the difference between the option price and the fair market value of the share at the time of such exercise.

INT. REV. CODE OF 1954, § 422(c). The taxpayer's basis will be increased by the amount includible under this exception in his gross income. INT. REV. CODE OF 1954, §§ 422(c)(A)-(B).

\textsuperscript{87} The INT. REV. CODE OF 1954 does not specify the tax treatment accorded the recipient of a non-statutory stock option. A non-statutory stock option is defined as one which fails to meet the statutory requirements of a statutory stock option plan, Treas. Reg. § 1.421-6 (1956).

The tax treatment accorded the recipient of the non-statutory stock option depends upon when the fair market value of the option is ascertainable. If the option has a readily ascertainable fair market value, it is taxed when granted and the employee receives ordinary compensation income at that time. The existence of an option spread at the date of grant does not demonstrate the existence of a readily ascertainable fair market value. Commissioner v. Smith, 324 U.S. 177 (1945). Treas. Reg. § 1.421-6(a)(3) (1961) requires that the option be actively traded or freely transferable in order to have an ascertainable fair market value.

Ordinarily, if the option lacks a readily ascertainable fair market value, Treas. Reg. § 1.421-6(d)(1) (1961) holds that the spread between the option price and the market value of the stock at the exercise of the option is compensation income to the employee in the year of the option's exercise.

The final possibility for income tax treatment of the recipient of a non-statutory stock option is obtained by juxtaposing INT. REV. CODE OF 1954, § 83 and Treas. Reg. § 1.421-6(d)(1) (1961). If the option lacks a readily ascertainable fair market value and the stock that would be purchased by the exercise of the option is not freely transferrable or would be held under a substantial risk of forfeiture, then the employee has a choice. He may choose to include upon exercise of the option the excess of the fair market value over the option price as ordinary income in the year of exercise. Alternatively, he may choose to include in income the excess of the fair market value of the stock over the option price in the year when either the forfeiture provision or the restriction on transferability lapses, whichever occurs first.
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will be designated as statutory (qualifying under the 1939 or 1954 Code) or nonstatutory.\(^8\)

The stock options which failed to meet the statutory requirements for a restricted stock option were governed by the case law prior to 1950. Under that case law, the compensatory stock option created an employer deduction equal to the amount of compensation the employee took into income in the year of compensation. For compensatory stock options, the major issue was when the compensation was received. Some courts held that the compensation occurred on the date the option was granted.\(^8\) Other courts held that the date the option was exercised was the date at which compensation occurred.\(^9\) Because the employee receiving compensation would be treated as a purchaser on the open market after he had taken the compensation into income, it was to the employee's tax advantage to have the compensation occur at the date of grant. This treatment would be favorable because, assuming the stock to be a capital asset to the employee, the appreciation in value between the grant and exercise date would be capital gain rather than ordinary compensation.

Thus, in 1950 two pressing issues were unresolved: first, were some non-statutory stock options still treatable as a capital investment; and second, if all non-statutory stock options were compensatory to the employee, when did the compensation occur.\(^9\)

*Commissioner v. LoBue*,\(^9\) a 1956 Supreme Court decision, generally resolved these two pressing issues. *LoBue* involved a stock option transaction, completed prior to the enactment of section 130A, that gave the employee the privilege of purchasing a stated number of shares of the employer corporation at a set price over a three year period. Although it was not explicit in the majority opinion,\(^9\) the *LoBue* Court implied that the stock option price was below the fair market value of the stock at the date of the grant. The Court held the option compensatory and stated that "[w]hen assets are transferred by an employer to an employee to secure better services they are plainly compensation."\(^9\)

88. E.g., McNamara v. Commissioner, 210 F.2d 505 (7th Cir. 1954).
89. E.g., Van Dusen v. Commissioner, 166 F.2d 647 (9th Cir. 1948).
90. For the various possible dates at which the compensation may be measured see notes 88 *supra* and 96 *infra*.
92. 351 U.S. at 250 (Harlan, J., dissenting).
93. 351 U.S. at 247.
94. That merely an income tax question was resolved by Int. Rev. Code of 1939, ch.
Secondly, and equally adverse to the employee, the Court held that the amount of compensation received was to be measured on the date of the option's exercise.

The stock option plan in *LoBue* was not statutory and would not have met the section 130A requirements had section 130A been available when the parties entered into the stock option transaction. However, the Court addressed itself to section 130A and its effect upon the nature of a stock option. The Court viewed section 130A as a policy resolution and therefore did not view this section's treatment of the employee as an investor determinative in deciding that the basic purpose of any stock option, statutory or non-statutory, was to compensate, irrespective of how the employee was taxed on the benefit received.

**Earnings and Profits and Stock Options**

The major *LoBue* implication, that the clothing of an employee stock option in statutory dress failed to conceal the compensatory nature of all stock option plans, was crucial to the *Luckman* court. The *Luckman* court analyzed the nature of stock options and found the *LoBue* implication controlling. Because stock options are compensatory and because compensation expenses reduce earnings and profits, the *Luckman* court reasoned, the compensation element of a statutory stock option reduces earnings and profits. Also, in light of *LoBue*, the *Luckman* court measured the compensation on the date of the option's exercise and reduced earnings and profits by the option spread at exercise.

The court's characterization of the stock option as compensation expense demonstrated a willingness to examine the nature of the transaction rather than to rely on a mechanical formula as

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1, § 130A, 64 Stat. 942 (1950) is undoubtedly correct. In *Luckman*, the Seventh Circuit agreed with the Tax Court and held:

*Int. Rev. Code of 1954, § 421* was intended to lay down rules relating to the specific income tax treatment of applicable transactions. As the Tax Court concluded, [section 421] . . . “refer[s] only to the tax treatment of the options for income tax computation purposes.”

*Luckman v. Commissioner*, 418 F.2d 381, 386 (7th Cir. 1969).

95. There may be at least six dates at which to measure the loss to the corporation: (a) date of the adoption of the option plan; (b) the date on which the option is granted; (c) the date on which the optionee has performed any conditions precedent to the exercise of the option; (d) the date on which the optionee may first exercise the option; (e) the date of exercise; and (f) the date on which the optionee disposes of the stock acquired. P. GRADY, ACCOUNTING RESEARCH STUDY NO. 7, INVENTORY OF GENERALLY ACCEPTED ACCOUNTING PRINCIPLES FOR BUSINESS ENTERPRISES 217 (1965). For purposes of this note only the date upon which the option is granted or the date upon which the option is exercised will be considered.
was done in *Divine*. Unfortunately, once attuned to the nature of the transaction the court was unable to examine the mode of payment in light of its effect on the corporation.

When exercised, all stock options create the appearance of a loss to the corporation which may be measured at any one of several points. 96 One measuring point for this loss, applicable to both non-statutory and restricted stock options granted at a price below market value, is the date of grant. If the employee were to exercise the option immediately, the corporation would receive less capital than it would have received had it sold the shares on the open market. By suffering a purchase at the option price, the corporation has suffered an apparent loss measurable by the difference between the market value on the date of grant and the option price (the option spread at grant). An alternate measuring point for the loss, applicable to all stock options, is the date of the option’s exercise. By suffering a purchase at the option price, the corporation has suffered an apparent loss measurable by the difference between the market value on the date of exercise and the option price (the option spread at exercise). Regardless of the measuring point selected, the loss to the corporation is not realizable in the sense that it is a cash payment, 97 but is rather an opportunity cost. The corporation has lost the opportunity to sell the stock at a higher price. With a rising market, the opportunity cost will be greatest for any stock option at the exercise date, 98 so, quite naturally, the taxpayers in *Divine* and *Luckman* contended that the exercise date was the appropriate measuring point for the corporation’s loss on the stock options.

The *Luckman* court erred when it focused on the amount of income to the employee rather than the income tax basis of the assets to the corporation. When the court reduced earnings and profits by the amount of the income to the employee it was in-

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96. See Gardner-Denver Co. v. Commissioner, 75 F.2d 38 (7th Cir.), cert. denied, 295 U.S. 763 (1935) where the taxpayer corporation had granted an option whose price at grant equalled the stock's market value. The taxpayer claimed the option spread at exercise as a compensation deduction and lost, the court stating:

> [W]hen a specified price was paid, a subsequent increment in the value of the stock cannot be regarded as . . . compensation. . . . And in no event would such a subsequent advance in value represent loss or outlay or expense to the corporation

75 F.2d at 40.

97. This is true because the option will be exercised only in a rising market. Dean Griswold has criticized the income tax treatment of a qualified stock option as a capital contribution because the employee has risked no capital. Griswold, *The Mysterious Stock Option*, 51 KY. L. REV. 246 (1962).

cluding in the reduction the amount of unrealized loss on the sale of stock. Such an inclusion violates the realization requirement because earnings and profits are being reduced while the corporate assets remain unchanged. This principle is demonstrated when the corporation distributes appreciated property to a shareholder. The corporation reduces earnings and profits by the adjusted basis of the property to the corporation and not by the amount of income to the shareholder. In its own unissued stock, however, a corporation lacks a basis. The corporation has not expended any sum to acquire its own unissued stock and upon issuing it has not realized or recognized any loss. In fact, even if the corporation distributed treasury stock in which it had a basis there would be no reduction of earnings and profits because a capital stock transaction never results in a gain or loss, but rather is an adjustment of the capital account.

As an alternative to the compensation argument, the Luckman court maintained that in net effect the granting of a stock option was the same as paying the employee in cash and allowing him to purchase the stock. Because a cash payment would reduce earnings and profits a stock option with the same net effect should reduce earnings and profits.

This argument is subject to the initial criticism that it ignores the form of the transaction; there would be no statutory stock option if this form of payment were used. Also, taking this net effect argument at face value, it assumes that a corporation would commit itself to pay a cash sum dependent upon external market factors that may bear little relation to the value of the corporation. More fundamentally, the net effect argument ignores the realization requirement of earnings and profits. With a cash payment, an actual expense is subtracted from realized gains. With a stock option, the appreciated value of the stock has

100. Jacoby, supra note 18, at 668.
101. See note 47 supra and accompanying text for a discussion of the realization requirement.
102. INT. REV. CODE OF 1954, § 1032.
103. This type of compensation, a cash payment, could not qualify as a stock option under INT. REV. CODE OF 1954, § 422(b). The court drew this analogy from dictum in Hudson Motor Car Co. v. United States, 3 F. Supp. 834 (Ct. Cl. 1933) which involved a delivery of treasury stock to an employee with the intention to compensate him. Against the contention of the Commissioner, the Court of Claims held that the taxpayer corporation was allowed a compensation deduction. Assuming that the Hudson analogy was once valid, the validity it possessed ceased with the enactment of a statutory stock option.
104. This criticism was leveled in Jacoby, supra note 18 at 664.
not been realized by the corporation as a loss.\textsuperscript{105} Under the realization requirement of earnings and profits, an unrealized loss does not reduce earnings and profits.

The objection to a reduction of earnings and profits by the option spread at exercise of a statutory stock option lies not only in the absence of a realized loss, but in the harm such a reduction would do to the separate entity theory. Under the separate entity theory, if the shareholders of the corporation experience a loss the corporation does not adjust its earnings and profits account to reflect that loss. In the stock option transaction, the shareholders of the corporation have suffered a dilution of their aggregate equity in the corporation\textsuperscript{106} by the bargain purchase of the stock by the employee.

If the employee exercises his option at a price that is less than the book value of the shares he has become entitled to share in the corporate assets without paying full value for the share he receives. Consequently, his purchase results in the dilution of the equity of the other shareholders. Of course, if the employee purchases at a price which exceeds the book value there is no dilution effect and the other shareholders are not injured. If there should be a dilution effect the shareholders of the corporation and not the corporation have compensated the employee.\textsuperscript{107} Under the separate entity theory of earnings and profits, their loss should not be imputed to the corporation. Therefore, earnings and profits should not be reduced by a statutory stock option transaction.

This theoretical conclusion, rejecting the reduction of earnings and profits in a statutory stock option transaction, should be reached with respect to the non-statutory stock option. In both situations, the assets representing the realized gains upon the corporation's capital have not been reduced.

Although neither of the Luckman court's two theories support the reduction of earnings and profits, a reduction of earnings and profits might be supported on one of the exceptions to the realization theory not advanced by the court. Realization, of


\textsuperscript{106} See Griswold, \textit{The Mysterious Stock Option}, 51 Ky. L. Rev. 246 (1961). Perhaps this recognition of where the loss occurs underlies the requirement in \textit{Internal Revenue Code of 1954}, § 422(b) that the shareholders approve the option plan. Accounting practice also requires financial statement disclosure of possible future dilution from the exercise of unexercised but outstanding stock option. AICPA, APB \textit{Opinion No. 15} ¶ 38-42 (1969).

course, need not be present when there is a policy that would be advanced by the reduction of earnings and profits. The line of analysis that dealt with policy reasons for not reducing earnings and profits for certain anti-social types of expenditures would not mandate such a result for stock options. However, by analogy to Code sections which reduce earnings and profits by the amount of a taxable stock dividend, a policy argument might be made to reduce the earnings and profits of a corporation engaging in a stock option transaction. The policy argument would be that in a taxable stock dividend transaction the shareholder who elects to receive shares in lieu of cash has increased his interest in the corporation if other shareholders have elected to receive cash. Since the Code reduces earnings and profits in that circumstance, earnings and profits should also be reduced when an employee increases his interest in the corporation by reason of exercising a stock option. This analogy, however, remains unpersuasive for statutory stock options for two reasons. First, the recipient of the option is not taxed at the date of grant or at the date of exercise. Therefore, the equitable argument of double taxation that provides some support for the earnings and profits treatment of taxable stock dividends provides little or no support for similar treatment for statutory stock options. Even if this objection were assumed away, however, another objection to the analogy rests on the purpose of section 312(d). This section appears concerned with distributions to a shareholder in his capacity as a shareholder. With the statutory stock option, the distribution is made to an employee in his capacity as an employee. Thus, the thrust of section 312(d) would be directed to a new area if an analogy from it to the statutory stock option transaction were drawn.

As applied to the recipient of a non-statutory stock option, the analogy from section 312(d) is somewhat more persuasive.
Both the recipient of the non-statutory stock options and the stock dividend may increase their interest in the corporation. Once they do they have received value in the same way and are not being taxed on an illusory increase.

However, for both statutory and non-statutory stock options, the analogy is no stronger than the theoretical foundation for reducing earnings and profits for a taxable stock dividend. As was previously discussed, theoretical support for the earnings and profits treatment of a taxable stock dividend is all but nonexistent. Being such an aberration the theory should not be extended to an area for which it was not intended.

CONCLUSION

Although neither the statutory nor the non-statutory stock option involve the distribution of corporate assets, both courts that have examined the stock option have concluded that at some point in time a reduction of earnings and profits should occur. Although the Divine and Luckman courts differed on the time when a reduction was proper, the courts were not divided on what they considered the theory of earnings and profits. However, instead of theory, it was the mode of analyzing the stock option that divided the courts. Divine failed to provide a satisfying analysis by resting on the untenable proposition that the earnings and profits treatment of a stock option follows its income tax treatment. Luckman went so far as to examine the nature of the stock option transaction, but fell into a mechanical mode of analysis once it classified the payment as compensation. What neither court attempted was a delineation of earnings and profits theory and an application thereof to the stock option. If this were attempted, the theoretical result appears to be no reduction of earnings and profits by reason of either the statutory or non-statutory stock option at any time.