CSU
College of Law Library

Cleveland State Law Review

Volume 11
Issue 3 *Symposium on Brain Injuries*

Article

1962

Stock Options for Directors in Small Corporations

Robert H. Moore Jr.

Follow this and additional works at: https://engagedscholarship.csuohio.edu/clevstlrev

Part of the Business Organizations Law Commons, and the Taxation-Federal Commons
How does access to this work benefit you? Let us know!

Recommended Citation

Robert H. Moore Jr., Stock Options for Directors in Small Corporations, 11 Clev.-Marshall L. Rev. 396 (1962)

This Article is brought to you for free and open access by the Journals at EngagedScholarship@CSU. It has been accepted for inclusion in Cleveland State Law Review by an authorized editor of EngagedScholarship@CSU. For more information, please contact library.es@csuohio.edu.

Stock Options for Directors in Small Corporations

*Robert H. Moore, Jr.**

THE WALL STREET JOURNAL on April 3, 1962 reported Treasury Secretary Douglas Dillon as condemning the existing tax treatment of stock options but asking Congress to wait until next year to make changes in the present law. Secretary Dillon said that any changes should be considered as part of the Kennedy Administration's general tax revision bill expected to be sent to Congress late this year.[1]

The treatment stock options have received since the enactment of Section 421 of the 1954 Code has come under much criticism.[2] Section 421 of the Code[3] authorizes the so-called "restricted" stock options, and it is these options to which Secretary Dillon undoubtedly was referring. It is not the purpose of this paper, however, to enter the controversy about restricted stock options but to consider the so-called "non-restricted" and to suggest revisions in the law that appear merited with respect to them. But first, it would be well to distinguish generally between these two types of options.

---

* B.A., Washington & Lee Univ., with Cert. in Commerce; M.B.A., Harvard Business School; Secretary, Assistant Treasurer, Director, Otis & Co., Cleveland, Ohio; Director also: Jewell Ridge Coal Corp., Jewell Ridge Coal Sales Co., Pocahontas Mining Co.; a Senior at Cleveland-Marshall Law School.

[1] Wall Street Journal, April 3, 1962, p. 2, col. 4 (midwest ed.).

[2] Griswold, Are Stock Options Getting Out of Hand?, 38 Harv. Bus. Rev. 49 (1960); The Mysterious Stock Option, 2 Tax Revision Compendium 1327 (1959);

Griswold & Seligman, Should Small Companies Be Enabled to Adopt Stock-Option Compensation Plans, 12 J. Taxation 20 (1960);

Mann, Are Stock Option Plans Ethical?, 93 J. Accountancy 324 (1952);

Wallace, Should We Continue to Encourage the Use of Restricted Stock Options?, 39 Taxes 785 (1961);

Ware, Stock Purchase Options; Their Morality and Practical Applications, 41 Barrons 5 (1961) (Discussion: J. A. Livingston 41:6 (1961)) See also Ware, 194 Comm. & Fin. Chr. 491 (1961);

Case Against Executive Stock-Option Plans, 41 Managem't Rev. 320 (1952);

Stock Option Hassle, 89 Chem. W. 106 (1961);

The Stock Option Scandal, Industrial Union Department AFL-CIO, Washington, D. C. (1959).

[3] Int. Rev. Code of 1954, Sec. 421.

Published by EngagedScholarship@CSU, 1962

Restricted Stock Options

Section 421(d)(1) of the Code[4] defines a restricted stock option as: "... an option granted after February 26, 1945, to an *individual, for any reason connected with his employment* by a corporation, if granted by the employer corporation or its parent or subsidiary corporation, to purchase stock of any of such corporation ..." under certain conditions. If these conditions are strictly complied with: "... no income shall result [to the optionee] at the time of the transfer of such [optioned] share to the individual [i.e., optionee] upon his exercise of the option with respect to such share. ..."[5]

The conditions permitting such favorable tax treatment are that option price of the shares must not be less than 95% (or in some cases 85%) of the fair market value of the shares to which they relate on the day of the grant and the employee-optionee must not dispose of the shares transferred to him as a result of the exercise of his option for 2 years from the date of the grant or within 6 months of the transfer of the shares to him. Whatever amount he receives, then, upon the disposition of the shares, less what he paid for them when he exercised his option, will be taxed to him at capital gains rates.[6]

For the purpose of our discussion, the important part of this Section 421 is the specific provision that limits those who qualify for this special tax treatment to: "... an individual for any reason connected with his employment by a corporation ..."[7] Non-employees are expressly excluded.

Non-Restricted Stock Options

Non-restricted stock options are governed by Section 1.421-6 of the Income Tax Regulations of the 1954 Code.[8] This class of options is described by this section as "Options to which section 421 does not apply."[9] Specifically, Section 1.421-6(a)(1) provides:

---

[4] *Id.* par. (d), subpar. (1). See 2 Oleck, Modern Corporation Law, Sec. 1019 (1959).

[5] *Id.* par. (a), subpar. (1).

[6] *Id.* Sec. 421.

[7] *Id.* par. (d), subpar. (1).

[8] Treas. Reg., Sec. 1.421-6.

[9] *Id.*

> If an employer or other person grants to an employee *or other person* for any reason connected with the employment of such employee an option to purchase stock of the employer or other property, and if section 421 is not applicable, then this section shall apply. [Emphasis supplied.] [10]

The tax treatment applied by this section depends upon whether the option has a readily ascertainable fair market value at the time of grant. If it does, compensation results to the optionee-employee (to be taxed at ordinary income rates) at the time of grant in an amount equal to the excess of the fair market value over what was paid for the option.[11] If it does not, the optionee-employee realizes compensation (to be taxed at ordinary income rates) at the time an unconditional right to receive the stock subject to the option is acquired (if at that time the stock is not subject to a restriction which significantly affects its value), and the amount of such compensation is the difference between the amount payable for the stock and the fair market value of the stock at the time an unconditional right to receive it is acquired (or the restrictions lapse). [12] A significant difference between this type of option and the restricted type is that the corporation granting the option can take a deduction from its taxes in the same amount and at the same time that the optionee realizes compensation from the exercise of his option.[13]

After this section was enacted, the Treasury was asked whether the section covered options granted to non-employees ("or other person"). It answered that it did not, but that the question was under study.[14] At the present time, only employees of corporations qualify for either restricted or non-restricted stock options.

---

[10] *Id.* par. (a).

[11] *Id.* par. (c), subpar. (1).

[12] *Id.* par. (d), subpar. (1).

[13] *Id.* par. (f).

[14] I. R. S. Withdraws Proposals on Stock Options for Other Than Employees, 14 J. Taxation 159 (1961). See also I. R. S. Technical Information Release No. 293 of 1/20/61.

By T. D. 6481, Sec. 1.421-6 (b) (2) was amended in 1960 to add the words "employment" and "employer" in the definition of "employee." The effect of this amendment is to remove any doubt that may have heretofore existed as to whether non-employees could be considered as included with employees as qualifying for the tax treatment provided by this section.

Non-Statutory Stock Options

Options for those other than employees are governed by Section 1.61-2 of the Income Tax Regulations of the 1954 Code.[15] Under the provisions of this section, non-employee optionees are taxed at ordinary income rates on the difference between the option price and the fair market value of the shares to which the option relates on the date of the grant. When the stock is sold, after exercise of the option, the amount received from the sale, less the difference given above, is taxed to the optionee at ordinary income rates.[16]

Therefore, under the present status of the law on stock options, directors of corporations, unless they are also employees thereof, are not eligible to receive the favorable tax treatment of restricted or non-restricted stock options. It is important, in the consideration that is being given to the revision of these sections, that corporate directors be included among those who qualify for this special treatment.

Value of Stock Options for Small Companies

Dean Erwin N. Griswold of the Harvard Law School, when he appeared in 1959 before the House Ways & Means Committee when it was conducting hearings on tax reform, testified as follows:

> It is in small and closely held companies that the stock option device may have its clearest justification. It is in such companies, perhaps, in need of better management, that an outsider can be brought in and given the real incentive through a stock option of sharing in the investment of the company. It is in such companies, too, that the effects of an individual can have some impact on the value of the stock.[17]

In a recent article in *Taxes,* Mr. Emmett Wallace of James O. Rice Associates, Inc. of New York City considered the question, "Should we continue to encourage the use of restricted stock options?" One of his conclusions is particularly pertinent to this discussion. He said:

> Stock options do have one value for smaller companies which is generally not sought by the larger firms: they provide a mechanism for conserving cash through the offer of con-

[15] Treas. Reg. Sec. 1.61-2.

[16] *Id.* par. (d), subpar. (2).

[17] Griswold & Seligman, *op. cit. supra,* note 2.

> tingent compensation. Not only can stock options replace salary payments, but there is cash inflow at the time options are exercised. Small growing firms with limited working capital may find stock options the only device available for offering attractive compensation to their top executives.[18]

The comments of Dean Griswold and Mr. Wallace were directed at the use of restricted stock options to compensate executives, who, of course, would be employees of their corporations. It is suggested in this paper that the provisions relating to non-restricted stock options be broadened to permit directors to qualify. Non-restricted as opposed to restricted has been selected because it is thought that there is more economic justification to the operation of this type, which, unlike the restricted, taxes property at capital gains rates only when it has been placed at risk.[19]

Function of Directors

In an analysis of the answers received from the polling of a large number of company directors on questions to do with the subject: "How to utilize management's most neglected tool, the board of directors," the author sums up the findings as: ". . . [T]he board of directors is the best mechanism for bringing the lessons of past experience to bear on the problems of the future." [20] In answer to the question asked of these directors: "How do you contribute to the growth and profit of the company?," the writer says:

> The experience of the respondents leads them to the conclusion that breadth of experience is the chief factor in the make up of a good board. The problems dealt with are almost necessarily "frontier" types of issues for which no precise precedent exists. In addition to being novel, the problems dealt with by the boards are large scale, basically important, and enormously complex. Legal, financial, technical, and organizational factors must be identified, weighed, and properly evaluated. The pooled judgment of men with wide variety in their backgrounds is required if such problems are to be solved . . . It is apparent that small companies have the same problems as large. To solve them re-

---

[18] Wallace, *op. cit. supra,* note 2.

[19] *Supra,* note 8 at par. (c) (3) (ii).

[20] Masterson, How to Utilize Management's Most Neglected Tool, the Board of Directors. 30 Am. Bus. 23 (1960).

quires harmonious and effective pooling of judgment of experienced men.[21]

But the question is, how can small companies attract such men as directors? "The principal disadvantage of relying on outside directors is in the difficulty of obtaining capable people who are willing to spend the amount of time which would be required to familiarize themselves in a responsible way with the company's activities." [22] . . . "One might observe that the typical outside board member receives compensation for this duty far less than the value of his time and knowledge." [23]

Inducing Directors to Serve

In a discussion of the book, *The Director Looks At His Job* by C. C. Brown, Dean of the Graduate School of Business Administration of Columbia University, and E. E. Smith of McKinsey and Company of New York,[24] *Business Week* magazine gave the authors' findings on the problem of finding capable directors and inducing them to serve:

> As one incentive, compensation of directors has been rising. Even part-time outside directors now receive anywhere from $3,500 to $15,000 a year, and one director reports he has been offered substantially more as an incentive to serve. But for men of the caliber companies want, taxes generally wipe out this sweetening.[25]

In an article "Company Presidents Size Up the Boards," *Dun's Review & Modern Industry* reported the typical comment of one of the presidents surveyed: "It takes considerable persuasion to induce a busy man to join your board . . . The responsibilities are fairly heavy, and the incentives are rather intangible." [26]

Business Week, in its discussion of Dean Brown and Mr. Smith's book, says that the conclusions of the authors on the

---

[21] *Id.*

[22] Brown & Smith, The Director Looks at His Job, as quoted in 13 Mgt. Methods 27 (1958).

[23] Kennedy, Jr., & West, Jr., The Board of Directors; Its Composition and Significance, 24 Advanced Mgt. 8 (1959).

[24] Brown & Smith, The Director Looks at His Job, Columbia University Press, N. Y. (1957).

[25] The Directors Peer Into the Mirror, Business Week, p. 57 (Dec. 21, 1957).

[26] Company Presidents Size Up the Board, 72 Dun's Review & Modern Industry 40 (1958).

payment of directors was that they should be compensated as executives should: in relation to qualifications and performance.[27] This is hardly the answer for the small company, however. The problems the small company board must deal with are often as complex and time consuming as those faced by boards of larger corporations, and there is not the prestige appeal of serving on the boards of many small companies that there is in serving on those of the larger corporations. Furthermore, the small companies, in the many instances, simply cannot afford the cash drain caused by directors' fees of sufficient size to attract the caliber of men needed. Even if the small company were to offer a top-flight executive a handsome retainer for service on its board, because of the executive's high income tax bracket, such fee would not be as much of an inducement to him as a similar fee from a larger company where he might be associated on the board with the "captains of industry." If it is admitted that smaller companies have as pressing a need for strong and capable direction from their boards as do the larger companies, a solution should be sought to the problem of how to attract qualified men to the small company boards by permitting these men also to receive favorable tax treatment on options granted to them in the stock of the corporations on whose boards they sit. Indeed, it may be the only way such men can be so attracted.

Directors Fixing Own Compensation

There are, in general corporation law, some basic considerations with respect to the granting of stock options to directors as compensation that must be examined.[28] On the right of directors to recover for their services to the corporation, *Ohio Jurisprudence* has this to say:

> It is the general rule that directors are presumed to serve without compensation. [Citation omitted.] . . . Of course, the directors are entitled to compensation where there is an understanding to that effect or an express provision for

---

[27] *Supra,* note 25.

[28] See Ohio Rev. Code, Secs. 1701.15, .16, .17, .19, and .60. Compare Model Bus. Corp. Act Ann., Sec. 18A (1960); N. C. Gen. Stat., Sec. 55-45 (1960); Purdon Pa. Stat. Ann. tit. 15, Sec. 2852-612 (1958).

See 12 O. Jur. 2d 507, 508, 515, 521; 13 Am. Jur. 975, Sec. 1027 and p. 981, Sec. 1036; 5 Fletcher Cyc. Corp. (Perm. ed.) Secs. 958, 1110, 2125, 2137, 2140, 2142, and 2143 (1952).

See, 2 Oleck, Modern Corporation Law, Secs. 1019, 1020 (1959).

Published by EngagedScholarship@CSU, 1962

compensation in the articles or the regulations. [Citation omitted.] [29]

In 1955, the Ohio Legislature enacted 1701.60 R. C. to get around the troublesome problem of directors fixing their own salaries. This section provides that directors, unless otherwise prohibited by the articles or regulations of the corporation, have the authority to fix their own compensation. On this point *Ohio Jurisprudence* says:

> Since the revision of the General Corporation Law, it is expressly provided that unless otherwise provided in the corporate articles or regulations, the directors, by the affirmative vote of a majority of those in office, and irrespective of any personal interest of any of them, shall have authority to establish reasonable compensation . . . for services to the corporation by directors and officers . . . Despite this statutory provision, it still remains the rule that the compensation allowed must be reasonable.[30]

Specifically, with respect to directors issuing shares to themselves, *Ohio Jurisprudence* says:

> The principle that equity will not interfere with the management and control of the corporation's business as long as the directors act within the scope of their authority and are not guilty of violating their fiduciary obligations [citation omitted] is applicable to a purchase by a director of authorized but unissued shares and to treasury shares. Accordingly, where all of the original issue of shares has not been sold by the corporation, a director, with the consent of the remaining directors, may purchase the unsold shares when the transaction is free from fraud, beneficial to the corporation, and will promote its objects [citations omitted] . . . However, where it is apparent that the transaction is neither bona fide nor beneficial to the corporation, the sale of authorized but unissued shares to a director will be set aside. [Citation omitted.] [31]

Consideration in the Issuance of Shares to a Director

The primary question, then, in considering the matter of the issuance of shares to a director, is what would constitute a "bona fide" transaction that would be "beneficial to the corporation."

---

[29] 12 O. Jur. 2d 639, Sec. 515. And see Oleck, *op. cit. supra*, note 28.

[30] *Id.* Sec. 521, p. 644.

[31] 12 O. Jur. 2d 630, Sec. 507.

The single most important element of such a transaction is the sufficiency of consideration to the corporation.[32]

> . . . [T]he directors of a corporation cannot bestow such benefits [i.e stock options] on executives or employees without the corporation receiving some benefit or consideration in return. In general, directors and majority stockholders cannot make gifts of corporate assets for other than charitable purposes.[33]

The courts generally will not question the size of the option granted by the board to an employee so long as it is not unreasonable, holding that in the absence of fraud or some other vitiating circumstance, the judgment of the directors thereon is conclusive.[34]

> A number of states have enacted statutes making the directors' judgment "as to consideration and the sufficiency thereof" in connection with a stock option plan, conclusive in the absence of fraud.[35]
>
> Where there is stockholders ratification [of the option plan], however, the burden of proof is shifted to the objector [citations omitted]. In such a case the objecting shareholder

[32] "At the time of granting the option, there must be conditions in the option plan, or in the circumstances, which reasonably assure the corporation that it will receive the benefit for which bargained. Later resolutions or employment contracts cannot remedy the lack of consideration in the option grants." Frankel v. Donovan (Del. Ch. 1956), 120 A. 2d 311.

See also Kerbs v. Calif. East. Airways (Del. Ch. 1951), 83 A. 2d 473, rev'd (Del. 1952), 90 A. 2d 652, enforced (Del. 1952), 91 A. 2d 62; Gottlieb v. Heyden Chemical Corp. (Del. Ch. 1951), 83 A. 2d 595, rev'd (Del 1952), 90 A. 2d 660, reargued in part (Del. 1952), 91 A. 2d 57, enforced (Del. 1952), 92 A. 2d 594; Dow v. River Farm Co., 243 P. 2d 95 (1952); Elster v. Amer. Airlines, Inc., 106 A. 2d 202 (Del. Ch. 1954), 128 A. 2d 801 (Del. Ch. 1957), 148 A. 2d 343 (Del. Ch. 1959); Moore v. Keystone Macaroni Mfg. Co., 87 A. 2d 295 (Sup. Ct. Pa. 1952).

See also 42 Marq. L. Rev. 422 (1959); 55 Mich. L. Rev. 135 (1956); 39 Va. L. Rev. 335 (1953), particularly note 62 at p. 348 on "legal consideration."

[33] Kuelthan, Consideration in Corporate Stock Option Plans, 42 Marq. L. Rev. 442 (1959), citing Rogers v. Hill, 289 U. S. 582, 53 S. Ct. 731 (1933); 6A Fletcher Cyc. Corp., Sec. 2939 (1950). See also, 2 Oleck, Modern Corporation Law, Sec. 1020 (1959) as to other incentive plans.

[34] Beard v. Elster, 160 A. 2d 731 (Del. 1960); Otis & Co. v. Penn. R. R., 61 F. Supp. 905 (E. D. Pa. 1945).

See also 49 Calif. L. Rev. 373 (1961) and 12 Vand. L. Rev. 280 (1958): "A minority shareholder does not have grounds for complaint if the directors have inaugurated a program which they in their business judgment reasonably believe will benefit the corporation. If the stock option plan is so unwise or improvident as to constitute waste or a gift of the corporate assets, then the individual directors should be held liable for their negligence or fraud."

[35] DeCapriles, Corporate Practice—a Symposium, 13 Vand. L. Rev. (1) 9 (1959), citing N. Y. Stock Corp. Law, Sec. 69 and Del. Code Ann. tit. 8, Sec. 157 (1953); see also Ohio Rev. Code, Secs. 1701.16 and .19.

> must convince the court that no person of ordinarily sound business judgment would be expected to entertain the view that the consideration furnished by the individual directors is a fair exchange for the options conferred. [citations omitted.] [36]

There are, then, two primary elements that must be in the stock option plan, to avoid stockholder challenge, the reasonable assurance the corporation will receive the benefits it bargained for, and shareholder ratification.

> Generally the consideration for option rights is based on future services, and the most common benefits to the company found to be sufficient are employment contract rights, and the assumption or continuation of corporate duties by the benefited employees. [citations omitted.] The Delaware courts have taken the strict view of requiring that there be conditions in the plant, or in the circumstances, which reasonably assure that the corporation will receive the benefits for which it bargained, i.e., that the consideration is not illusory. The courts hold that the time for ascertaining whether the option plans are supported by sufficient consideration is not when the options are exercised but when they are granted. [Citations omitted.] Therefore, in order for the consideration to be sufficient the Delaware decisions require (a) a benefit to the corporation, (b) bargained and exchanged for the option, (c) with reasonable assurance in the option plan, or in the circumstances, that the corporation will receive the benefit for which it bargained. These requirements can easily be met, and future representative suits avoided, by tying stock options to employment contracts for a specific period. Greater insurance that the corporation will receive the benefit for which it bargains is obtained when the options are exercisable only after a specified period of employment [citation omitted], preferably in installments, with the consideration to the corporation in each installment reasonably commensurate with the benefits granted. [Citations omitted.] [37]

---

[36] Gottlieb v. Heyden Chemical Corp., 91 A. 2d 57, 58 (Del. Ch. Sup. Ct. 1952).

[37] Day, The Nature of Consideration Required For a Valid Employee Stock Option Plan, 55 Mich. L. Rev. 135 (1956).

See also: Kuelthan, *op. cit. supra,* note 33: "Sufficient consideration to validate a plan may be the retention of key personnel, the acquisition of a new employee, or the signing of a favorable employment contract, provided there is a reasonable relationship between the value of the services to be rendered by the employee and the value of the option." Citing Wyles v. Campbell, 77 F. Supp. 343; McQuillan v. National Cash Register Co., 27 F. Supp. 693; Sandler v. Schenley Industries, Inc., 79 A. 2d 606; Holthusen v. Budd Mfg. Co., 53 F. Supp. 488; Clamitz v. Thatcher Mfg. Co., 158 F. 2d 687.

(Continued on next page)

This quotation relates to the adequacy of consideration with respect to stock options granted to employees. Can a corporation assure itself that it can meet these standards of adequacy in devising a plan for directors? What would be required would be a plan which provided that, in return for the option granted, the director would perform his services for a period of time before the option could initially be exercised, and that it then could be exercised in installments as the services were performed. It would be well to have prior stockholder approval of the plan before putting it into effect.[38]

Corporation Contracting with Director for His Services

Directors of corporations are, of course, elected by the shareholders, usually annually for a term of one year, but in some instances for a longer term, such as three years.[39] The board of directors of a corporation could not, therefore, as an inducement to get someone on to the board, promise that the person would be re-elected a director each year for the option period; the most the board could do would be to require that the person sought promise to serve as a director if re-elected over this period, and that if he faithfully performed his duties as director, his name would be submitted to the shareholders each year as one of management's nominees. His option rights would be conditioned on the performance of his duty as director and his continued re-election as same during the option period. The plan would be

---

(Continued from preceding page)

Perlin, Jr., Stock Option Incentive Employment Contracts For Corporation Executives, 47 Mich. L. Rev. 1179, 1181 (1949): "Although an employment contract is not specifically enforceable, the law is clear that it may constitute valid consideration for a promise to issue stock of the employer corporation." Citing Am. Dist. Co. v. Hayes Wheel Co. (D. C. Mich. 1918), 250 F. 109 at p. 115, rev. on other grounds (C. C. A. 6th, 1918), 257 F. 881, cert. den., 250 U. S. 672, 40 S. Ct. 13 (1919).

Gruber v. C&O Railway Co., 158 F. Supp. 593 (N. D. Ohio 1958). Held: An executive stock option plan is supported by sufficient consideration and does not constitute a waste or gift of corporate assets where the rights granted a participant are conditioned upon further rendition of his services.

Kerbs v. Calif. East. Airways, 90 A. 2d 652 (Del. 1952): "There was some element, either in the plan itself or in the surrounding circumstances, reasonably calculated to keep the optionee in the corporation's employ. We do not think it is indispensable to bind the optionee by an employment contract but there must be some circumstances which may reasonably be regarded as sufficient to insure that the corporation will receive that which it desires to obtain by granting the options."

[38] See *supra* notes 34 and 36.

[39] 12 O. Jur. 2d 487, Sec. 388.

drawn so that he could exercise his option, after a suitable waiting period, over the period of time he had served on the board. The only difference between an arrangement such as this and those involving employment contracts is that in this the shareholders each year would be able to ratify the arrangement. If they felt that they were not receiving equivalent value, they could terminate the arrangement by not re-electing the director and letting him take whatever stock in the company he had acquired up to that point through the exercise of his options.

Suggested Changes in Non-Restricted Stock Option Provisions

On the thesis then that small companies need to be able to compete with the larger corporations in getting good men to serve on their boards and that the stock option device would appear to have a real justification and a valid function in performing this service, what changes can be suggested to permit their use therefor?

The first change to be suggested is specifically to permit non-restricted stock options to be granted to non-employees of corporations, that is, that Section 1.421-6 be broadened to include non-employee directors.

The second change has to do with the exercise of the option. The Treasury does not consider the option exercised until the optionee has an unconditional right to receive the shares thereunder.[40] This regulation apparently is not in accord with Mr. Justice Black's dictum in *Commissioner v. LoBue,* which held that the optionee exercised his options by the bona fide delivery to the corporation of his binding promissory note.[41] It is suggested that this regulation be changed to provide that so long as the optionee, who in the exercise of his option pays for the shares, either entirely or partially, by his note against which the shares so acquired are held as security, and thereby obligates himself under a bona fide debt, that he be considered as having exercised his option when he gives his note and so obligates himself.

The third change has to do with the timing of the collection of the tax. The spread between the value of the shares when the option is exercised (or when there is an unconditional right

---

[40] *Supra,* note 12.

[41] Comm. v. LoBue, 351 U. S. 243, 250 (1956), reversing and remanding 223 F. 2d 367 (3rd Cir. 1955), which had affirmed 22 T. C. 440 (1954).

to receive the shares) and the amount received from the sale or other disposition of the shares is taxed to the optionee at capital gains rates. Under suggestion Number 2 above, the period for computing the capital gains tax would commence to run upon the exercise of the option. It is suggested that the collection of the tax incurred, both as to ordinary income and capital gains, be deferred until the shares are sold, when cash would be available to pay the tax, or pass by gift or death.

This treatment would be liberal, but it has the effect of throwing the risk of the ownership of the shares on to the optionee, to be taxed according to the risk he has assumed and the value he could add to the shares he had optioned.

These suggestions may create a problem in valuation. The stock of many small companies, such as those we are talking about, is difficult to value. It might develop that it would be hard to assess the worth of the option at the time of grant so that the optionee could determine what his ordinary income tax liability was on such option when he exercised it. On this problem Robert J. McDonald of the law firm of Sullivan & Cromwell of New York has recently said in an article in the *Journal of Taxation*:

> The proper time to tax an item of property which is difficult or impossible to value at the time of receipt is no new problem. For example, upon the liquidation of a corporation an asset which is difficult to value is received, such as contracts for a specific period. Greater insurance that the cor-Susan J. Carter (170 F. 2d 911), for example, the court held that the computation of the value upon liquidation is merely postponed until it can be computed, and thereafter the amount received is treated conceptually as measuring the value received upon liquidation. . . . But the Service is not quite satisfied with that doctrine as to valuation of property upon liquidation. It now says in Rev. Rul. 58-402 that upon a liquidation, except in rare and unusual circumstances, the assets received in liquidation must be valued, as in the case of death, no matter how difficult it may be so to value them. The Service also says that options, including employee options, are to be valued at death.[42]

Since the optionee and the granting corporation are the ones who are to benefit from the grant of the option, it would seem just that the burden of proving the value of the option at time

[42] McDonald, I. R. S. Errs in Denying That Non-Restricted Options Can Be Compensation at Grant, 12 J. Taxation 331 (1960).

of grant be on them. Possibly the theory that should be used to accomplish this is the one suggested above, that the options in problem situations be valued at the time of grant as if at death, and such proof and procedure applied.

> What Congress had originally intended as a boon to the small, closely held corporation has become a very real problem to those self same corporations while creating a highly favorable situation for publicly held, nationally listed corporations whose stock can be easily valued.[43]

Possibly these suggestions will help in giving the small company the assistance, through favorable tax treatment of stock options to persons whom it wants to attract as directors, that it is said that Congress intended them to have.

---

[43] Schlesinger, Selected Problems in the Use of Restricted Stock Options, 36 Taxes 709 (1958).

https://engagedscholarship.csuohio.edu/clevstlrev/vol11/iss3/4