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# THE ALCHEMY OF INCENTIVE STOCK OPTIONS—TURNING EMPLOYEE INCOME INTO GOLD

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The proper federal income tax treatment of employee stock options has been a source of controversy and confusion in the law for over fifty years.<sup>1</sup> Three issues—when employees must recognize income from option transactions, the amount they must include in income, and the character of the amount—elude satisfactory solutions.

Congress, in labors resembling those of Sisyphus, has pushed forward several alternative approaches. Before 1950, Congress did not provide special treatment for employee stock options in the Internal Revenue Code. Such options were treated in the same manner as other employee bargain purchases.<sup>2</sup> From 1950 until 1976, Congress provided

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<sup>1</sup> Absent specific statutory provisions to the contrary, the Treasury Department since 1923 has treated the spread in an employee bargain purchase from the employer as compensation. See, e.g., T.D. 3435, 2-1 C.B. 50, 50 (1923) ("Where property is sold by . . . an employer to an employee, for an amount substantially less than its fair market value, such . . . employee shall include in gross income the difference between the amount paid for the property and the amount of its fair market value."); Rubinfeld & Blessing, *Taking Stock: Executive Stock Options After the Economic Recovery Tax Act of 1981*, 36 TAX LAW. 347, 354 nn.55, 56 and accompanying text (1983) (discussing 1945 and 1946 amendments to 1923 position). Before 1956, some courts held that gross income did not include the difference in value at the time of purchase if a bargain purchase of employer stock was "proprietary" rather than "compensatory." See *Geeseman v. Commissioner*, 38 B.T.A. 258, 264-65 (1938), *acq.*, 1939-1 C.B. 13; [NONSTATUTORY STOCK OPTIONS] TAX MGMT. (BNA) 87-3d, at A-4 n.42 (Jan. 15, 1979). Moreover, commentators supported this view. See Alexander, *Employee Stock Options and the 1950 Revenue Act*, 6 TAX L. REV. 165, 202-03 (1951); Sax, *Stock Options*, 23 TAXES 505, 510 (1945); Note, *Taxing Employees on Stock "Purchases"*, 41 COLUM. L. REV. 239 (1941); Note, *The Valuation of Option Stock Subject to Repurchase Options and Restraints on Sale: A New Tax Bonanza in Executive Compensation*, 62 YALE L.J. 832, 838 (1953) [hereinafter cited as Note, *Valuation of Option Stock*]. The Supreme Court finally resolved the issue in favor of the Treasury Department's treatment. *Commissioner v. LoBue*, 351 U.S. 243, 249 (1956). The tax treatment of compensatory bargain sales, however, continues to be troublesome. See *Gresham v. Commissioner*, 79 T.C. 322, 335 (1982) (Simpson, J., dissenting). See generally Burke, *How should an economic interest acquired for services be treated after Rev. Rul. 83-46?*, 58 J. TAX'N 352 (1983) (discussing ruling that applied I.R.C. § 83 to acquisition of royalty interest in oil and gas properties).

<sup>2</sup> See *Commissioner v. LoBue*, 351 U.S. 243, 248-49 (1956); Alexander, *supra* note 1, at 167-73.

special tax benefits for particular types of employee stock options.<sup>3</sup> In 1976, Congress reinstated the earlier approach and once again treated these options in the same manner as other employee bargain purchases.<sup>4</sup> This approach lasted until 1981 when Congress reversed course once again. The Economic Recovery Tax Act of 1981<sup>5</sup> provides special tax treatment for certain employee options with the introduction of "incentive stock options" (ISOs) into the Internal Revenue Code.<sup>6</sup>

This article will analyze and evaluate the benefits Congress sought to gain by reinstating tax favored employee stock options.<sup>7</sup> The article will show that these benefits may be achieved without treating employee options differently for tax purposes than other employee bargain purchases.

## I

### INTRODUCTION: THE CLEAN-SLATE APPROACH

#### A. A Model Employee Stock Option

Absent statutory requirements, the terms and conditions of an employee option to purchase stock from his employer are limited only by the creativity of the parties.<sup>8</sup> The Treasury Regulations define an option broadly to include "the right or privilege of an individual to purchase stock from a corporation by virtue of an offer of the corporation continuing for a stated period of time, whether or not irrevocable, to sell such stock at a price determined under [regulations], such individ-

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<sup>3</sup> For a historical summary of the various tax-favored benefits afforded employee stock options by Congress, see 2 B. BITTKER, *FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS* ¶ 60.5.1, 60.5.4 (1981), ¶ 60.5.6 (Supp. No. 2 1983); Bennett, *Incentive Stock Options: Their Place in History, in Policy and in Compensation Packages*, 40 *INST. ON FED TAX'N* § 9.02 (ERISA Supp. 1982); Jassy, *Incentive Stock Options: The Reincarnation of Statutory Stock Options Under the Economic Recovery Tax Act of 1981*, 37 *TAX L. REV.* 357, 359-63 (1982); Rubinfeld & Blessing, *supra* note 1, at 347-54.

<sup>4</sup> Tax Reform Act of 1976, Pub. L. No. 94-455, § 603, 90 Stat. 1520, 1574 (codified at I.R.C. § 422(b), (c)(7) (1976)). See S. REP. NO. 938, 94th Cong., 2d Sess. 161 (1976), *reprinted in* 1976-3 C.B. 49, 199. The 1976 congressional action did not repeal "employee stock purchase plans" under I.R.C. § 423. These plans, however, require participation by substantially all employees and are therefore significantly different from other tax-favored options. See 2 B. BITTKER, *supra* note 3, at ¶ 60.6.

<sup>5</sup> Pub. L. No. 97-34, 95 Stat. 172 (ERTA).

<sup>6</sup> I.R.C. § 422A (Supp. V 1981).

<sup>7</sup> This article addresses only employee options to purchase employer stock; it does not address the problems of bargain purchases by nonemployees. For a discussion of bargain purchases by nonemployees, see Note, *Avoidance of Tax Through Purchase*, 50 *HARV. L. REV.* 500, 504-11 (1937). For a discussion of bargain sales to charities see 2 B. BITTKER, *supra* note 3, at ¶ 35.2.4.

<sup>8</sup> See, e.g., Task Force on APB Opinion 25, Accounting Standards Division, American Inst. of Certified Pub. Accountants, *Accounting for Employee Capital Accumulation Plans* ¶¶ 196-210 (Issues Paper, Nov. 4, 1982) (describing variety of option and option-like programs) [hereinafter cited as *APB Task Force*].

ual being under no obligation to purchase."<sup>9</sup> ISOs, by contrast, must meet extensive statutory requirements to qualify for preferred tax treatment.<sup>10</sup>

A model employee stock option<sup>11</sup> that includes features typical both to options without specific statutory rules ("nonstatutory options") and to ISOs will help in analyzing and understanding the issues that this article addresses. Assume an employer grants an employee a nontransferable option to purchase a specified number of shares of the employer's stock.<sup>12</sup> Assume, further, that the option is open for a period of years after the date it is granted (the "date of grant"). Under the employer-employee agreement, the option privilege terminates if the employee ceases employment. The option price, the amount the employee must pay for the stock, is equal to the value of the stock on the date of grant. To exercise the option, the employee tenders<sup>13</sup> the option price to the employer.

Most employee stock option arrangements share these basic characteristics. Some arrangements, however, impose restrictions on the employee's ability to transfer the stock received.<sup>14</sup> These restrictions range

<sup>9</sup> Treas. Reg. § 1.421-7(a)(1) (1966). The regulations also provide, for example, that "if the amount paid for the transfer of property is an indebtedness secured by the transferred property, on which there is no personal liability to pay all or a substantial part of such indebtedness, such transaction may be in substance the same as the grant of an option." Treas. Reg. § 1.83-3(a)(2) (1978).

<sup>10</sup> I.R.C. § 422A(a), (b) (Supp. V 1981); see *infra* note 69.

<sup>11</sup> The model is taken in part from testimony of Daniel I. Halperin, Treasury Department Deputy Assistant Secretary (Tax Legislation), at 1980 hearings to consider, *inter alia*, reinstatement of tax-favored options. See *Miscellaneous Tax Bills VI: Hearings on S. 753, S. 1384, S. 1826, S. 1854, S. 1867, S. 2179, S. 2239, S. 2367, S. 2396, S. 2415 and H.R. 5973 Before the Subcomm. on Taxation and Debt Management Generally of the Senate Comm. on Finance, 96th Cong., 2d Sess. 95* (1980) [hereinafter cited as *1980 Senate Hearings*].

<sup>12</sup> The purposes raised to support employee stock options are inapplicable to employee purchases of property other than employer stock. See *infra* text accompanying notes 78-130; Blum, *Restricted Stock Arrangements Reconsidered*, 46 TAXES 598, 599-601 (1968). This article, therefore, addresses only issues raised by employee options to purchase employer stock.

<sup>13</sup> Transfer of a nonrecourse note does not constitute exercise. See Treas. Reg. § 1.83-3(a)(2) (1978). The originally enacted ISO provisions permitted the employee to pay all or part of the option price with stock of the employer corporation. I.R.C. § 422A(c)(5)(A) (Supp. V 1981). Recent legislation to make technical corrections to ERTA and other tax bills limits this "pyramiding" to employer stock held by the employee which has met the applicable ISO post-exercise holding period requirement. I.R.C. § 425(c)(3) (West Supp. 1983) (added to Code by Pub. L. No. 97-448, § 102(j)(6)(A), 96 Stat. 2365, 2737 (1983), effective for transfers after March 15, 1982). For a discussion of the pyramiding issue and the related issue of the basis of stock acquired through pyramiding, see Bennett, *supra* note 3, § 9.05[6], at 9-33; Jassy, *supra* note 3, at 375-83; Rubinfeld & Blessing, *supra* note 1, at 405-12; Letter from J. Edward Shillingburg and Brian T. Foley to Internal Revenue Service Commissioner Roscoe L. Egger, Jr. (Mar. 19, 1982) (discussing Rev. Rul. 80-244, 1980-2 C.B. 234, and issue of pyramiding) summarized in *Applicability of Rev. Rul. 80-244 After Recent Service Announcement Questioned*, 15 TAX NOTES 293 (1982).

<sup>14</sup> See, e.g., *APB Task Force, supra* note 8, at ¶¶ 196-210; Note, *Tax Effects of Absence of Market Value on Employee Bargain Purchases—The Marshall Plan*, 21 U. CHI. L. REV. 464, 467 (1954); Note, *Valuation of Option Stock, supra* note 1, at 832.

from statutorily imposed adverse tax consequences on early disposition of the shares<sup>15</sup> to forfeiture of the gain realized at exercise if the employee terminates employment within a stated period after exercise.<sup>16</sup>

To illustrate this model, assume an employer grants an employee a nontransferable option to purchase employer stock for \$10 per share, the fair market value of the stock on the date of grant. If the stock value increases to \$30 per share during the period the option is exercisable, then, under the model, the employee receives \$30 of stock (valued without restrictions) for each \$10 the employee tenders to the employer. When post-exercise restrictions apply, however, and limit transferability of the stock, the stock may be worth less than \$30 per share while the restrictions are in force and when they lapse.

### B. A Clean-Slate Approach

Commentators have observed that the general income tax principles<sup>17</sup> applied to employee bargain purchases, including stock options,<sup>18</sup> are as "self-evident as any ideas in the law of taxation."<sup>19</sup> If the proper income tax treatment of employee stock options is fashioned on a clean slate of tax policy,<sup>20</sup> however, applying these self-evident principles to

<sup>15</sup> See I.R.C. §§ 422A(a)(1), 421(b) (1976 & Supp. V 1981).

<sup>16</sup> See, e.g., Treas. Reg. § 1.83-3(c)(1), (2), (4), 1.83-7(a) (1978).

<sup>17</sup> These principles are presented and critiqued *infra* at text accompanying notes 78-130.

<sup>18</sup> See *infra* notes 67-77 and accompanying text.

<sup>19</sup> 2 B. BITTKER, *supra* note 3, ¶ 60.4.1, at 60-19.

<sup>20</sup> Three tax-policy assumptions underlie this article. First, the federal revenue collection system should be based on a comprehensive definition of personal income. The classic definition, commonly referred to as the Haig-Simons definition, is that income is "the algebraic sum of (1) the market value of rights exercised in consumption and (2) the change in value of the store of property rights between the beginning and the end of the period in question." Halperin, *Business Deduction for Personal Living Expenses: A Uniform Approach to an Unsolved Problem*, 122 U. PA. L. REV. 859, 876 (1974) (quoting H. SIMONS, *PERSONAL INCOME TAXATION* 50 (1938)). This definition is too broad, however, for general adoption in a voluntary system; the measurement problems of including psychic or imputed income in the base, for example, are apparently insurmountable. See, e.g., *id.* at 880-85; Andrews, *Personal Deduction in an Ideal Income Tax*, 86 HARV. L. REV. 308, 320-25 (1972); Bittker, *A "Comprehensive Tax Base" as a Goal of Income Tax Reform*, 80 HARV. L. REV. 925, 931-34 (1967). Therefore, exceptions to a broad-based income tax are necessary.

Second, in fashioning exceptions to the broad-based income tax approach, similarly situated taxpayers should be treated similarly; a principle of "horizontal equity." See, e.g., W. KLEIN, *POLICY ANALYSIS OF THE FEDERAL INCOME TAX* 7-8 (1976); Klein, *Income Taxation and Commuting Expenses: Tax Policy and the Need for Nonsimplistic Analysis of "Simple Problems,"* 54 CORNELL L. REV. 871, 883-94 (1969). Thus, for example, employees receiving compensation from an employer for their services should be treated the same whether the compensation is paid in cash or in kind.

Third, exceptions to the broad-based income approach that are justified by appeal to nontax policies, such as the need to create incentives for certain behavior, should be carefully examined as to both the effectiveness of the tax system as a means of delivering the purported incentive and the effects of the incentive device on the structure of the system. See, e.g., Surrey, *Tax Incentives as a Device for Implementing Government Policy: A Comparison with Direct Government Expenditures*, 83 HARV. L. REV. 705 (1970); see also Musgrave, *In Defense of an Income*

the issues of timing, value, and character of employee option transactions presents substantial problems.

The clean-slate approach affords three alternative times at which to recognize income from employee option transactions: (1) the date of grant, (2) the date of exercise, and (3) if restrictions on transferability apply, the date on which the restrictions lapse. The issues of valuation and characterization arise at each time.

### 1. *Date of Grant*

If a stock option granted to an employee as compensation has terms similar to those of an option traded on an established options exchange (a "tradable option"), then the value of the property received is easily ascertained.<sup>21</sup> If the tradable option is transferable and is not subject to other substantial restrictions, then the employee's compensation at the date of grant equals the value of the tradable option less any amount paid for it.<sup>22</sup> After including the value of the tradable option in income, the employee should be entitled to treat the option as any other capital asset;<sup>23</sup> this result is functionally equivalent to receiving cash compensation and then purchasing the option. When the employee later exercises the option, it should be treated in the same manner as the exercise of an option by a nonemployee.

The terms of employee stock options, however, usually differ materially from the terms of tradable options; these differences affect the option's value to the employee at the date of grant and undermine the usefulness of this time for determining the employee's compensation. The differences arise in three areas. First, an employee stock option generally is not transferable.<sup>24</sup> Second, the underlying employer stock often

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*Concept*, 81 HARV. L. REV. 44, 52-53 (1967) (equity is not only criterion for tax policy); Pechman, *Comprehensive Income Taxation: A Comment*, 81 HARV. L. REV. 63, 66 (1967) (conditions for departure from comprehensive income tax base); Sneed, *The Criteria of Federal Income Tax Policy*, 17 STAN. L. REV. 567 (relationship of differing goals and purposes of federal income tax).

Finally, a "clean slate" assumes away the complex and sometimes contradictory history of employee stock options, *see, e.g., supra* note 3, and allows the analysis to focus initially on basic tax principles.

<sup>21</sup> *See, e.g.,* Commissioner v. LoBue, 351 U.S. 243, 249 (1956) ("It is of course possible for the recipient of a stock option to realize an immediate taxable gain. . . . The option might have a readily ascertainable market value" at the date of grant); McNamara v. Commissioner, 210 F.2d 505 (7th Cir. 1954) (option, which was fully assignable and immediately exercisable (in part), valued at date of grant).

<sup>22</sup> *See, e.g.,* Treas. Reg. § 1.83-1(a)(1), 1.83-7(a) (1978).

<sup>23</sup> I.R.C. § 1234(a)(1) (1976) provides that the Commissioner will consider gain or loss from the sale or exchange of an option as gain or loss from the sale or exchange of the property to which the option relates. Employer stock generally will be a capital asset in the hands of the employee. *See id.* § 1221 (1976 & Supp. V 1981) (definition of capital asset).

<sup>24</sup> *See, e.g.,* M. CHIRELSTEIN, FEDERAL INCOME TAXATION 316 (3d ed. 1982); Nasuti, *New twists for nonstatutory stock options: how they work; how they're viewed by IRS*, 53 J. TAX'N 142, 142 (1980); APB Task Force, *supra* note 8, at ¶ 142.

is not traded publicly, making valuation difficult.<sup>25</sup> Third, the period of exercise for an employee option is usually much longer than for a tradable option.<sup>26</sup> Because the value of an option includes the right to benefit from future increases in the value of the underlying stock without risking capital,<sup>27</sup> the duration of an employee option must result in substantial uncertainty as to its value.

Although the value of a typical employee stock option may be difficult to establish at the date of grant, a value could be assigned to the option privilege at that time.<sup>28</sup> In appropriate cases, however, substantial reasons exist for leaving a transaction "open" rather than immediately valuing an option.<sup>29</sup> One reason to resist valuing an option at the date of grant is the potential for "spurious" capital gains" generated by tax-motivated restrictions on the option.<sup>30</sup> A second reason is that the nature of the option may suggest that it is intended to confer a compensatory economic benefit on the employee at the date of exercise rather than at the date of grant.

## 2. Date of Exercise

Where the right to exercise an employee stock option is contingent upon the recipient remaining an employee, for example, the value of the employer's stock received when the option is exercised, rather than the speculative value of the option at the date of grant, more accurately reflects the compensatory nature of the transaction. The Supreme Court recognized this position in *Commissioner v. LoBue*,<sup>31</sup> where an employee received and later exercised nontransferable stock options. The

<sup>25</sup> See generally S. PRATT, VALUING A BUSINESS: THE ANALYSIS AND APPRAISAL OF CLOSELY-HELD COMPANIES 28-38 (1981) (summary of valuation process); A. DEWING, THE FINANCIAL POLICY OF CORPORATIONS 275-307, 369-91 (5th ed. 1953).

<sup>26</sup> An ISO, for example, may provide for a 10-year exercise period. See I.R.C. § 422A(b)(3) (Supp. V 1981). Tradable options, in contrast, usually have a much shorter duration. See, e.g., 2 B. BITTKER, *supra* note 3, ¶ 60.5.2, at 60-40.

<sup>27</sup> See Treas. Reg. § 1.83-7(b)(3) (1978). The option privilege has a value even when the option price is the same as the value of the stock at any time before exercise. See *id.*; APB Task Force, *supra* note 8, at ¶ 237.

<sup>28</sup> See, e.g., APB Task Force, *supra* note 8, at ¶ 147-61.

<sup>29</sup> See, e.g., *Burnet v. Logan*, 283 U.S. 404, 412-13 (1931); 2 B. BITTKER, *supra* note 3, at ¶ 43.2; Spiegel, *Development and Current Status of Nonstatutory Stock Options*, 19 MAJOR TAX PLAN. 217, 224 (1967) (emphasis in original):

[W]hether property shall be valued so that a transaction may be "closed" and income computed at that time, or whether the transaction shall be left "open" and the income computed at a later time, may depend on what the transaction is and what policy reasons exist for choosing one alternative as against another. . . . If [this policy-oriented] approach is used in the employee stock-option situation, it is apparent that the receipt of a stock option by an employee is not an occasion which *demands* that the option be valued. In fact, there may be strong practical and policy reasons why an immediate but approximate valuation is not desirable.

<sup>30</sup> Blum, *supra* note 12, at 602-03.

<sup>31</sup> 351 U.S. 243 (1956).

Court held the spread between the option price paid and the fair market value of the stock received at the date of exercise was a "substantial economic and financial benefit from [the] employer prompted by the employer's desire to get better work from" the employee.<sup>32</sup> Although the Code does not require recognition of income when a buyer pays a bargain price for property in an arm's length transaction, an option transaction in the employer-employee relationship is "unlike a mere purchase."<sup>33</sup> The bargain-purchase stock option arrangement reflects an employer's transfer of valuable property to employees "in recognition of their services."<sup>34</sup> When an employer ties availability of the option to the employee's continued employment, the event giving rise to compensation is exercise of the option.<sup>35</sup> It is therefore reasonable to include the spread in income at the date of exercise, at least where no post-exercise restrictions apply to the stock received.

### 3. *Restrictions After Exercise*

If restrictions on transferability apply to the stock when the employee exercises an option, then the spread between the option price and the fair market value of the stock without restrictions may reflect some compensatory benefit. It may not reflect accurately, however, the ultimate benefit the employee receives.<sup>36</sup> In the model stock option described above,<sup>37</sup> for example, the fair market value of the stock received was \$30 per share. If the terms of the option require the employee to resell these shares to the employer at the option price if his employment terminates during a specified period, the value of the compensatory ben-

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<sup>32</sup> *Id.* at 247.

<sup>33</sup> *Id.* at 248.

<sup>34</sup> *Id.*

<sup>35</sup> The employee, however, does receive property with some value at the date of grant, even if its value is not readily ascertainable. *See id.* at 250-51 (Harlan, J., dissenting); *APB Task Force*, *supra* note 8, at ¶ 224. The approach in the text does not provide for recognition of this value if the employee fails to exercise the option. *See* 2 B. BITTKER, *supra* note 3, ¶ 60.5.1, at 60-36. This seems proper for two reasons. First, the result is consistent with the argument that the employee does not have an investment for tax purposes until he exercises the option. *See infra* text accompanying notes 86-88. Second, nonrecognition of the value of the option privilege during the required employment holding period is consistent with the general principles of constructive receipt as set forth in I.R.C. § 451(a). *See* Treas. Reg. § 1.451-2(a) (1964); Rev. Rul. 80-300, 1980-2 C.B. 165, 166 (an employee with "stock appreciation rights" in the employer's stock "is not in constructive receipt of income by virtue of the appreciation of the employer's stock"). To hold otherwise would require, for example, an individual who sees but does not pick up a \$10 bill in the street to nonetheless report the \$10 as income.

<sup>36</sup> The employee nonetheless receives a substantial benefit from deferral of recognition, particularly when the restrictions are without substance. The issues in this situation, therefore, are (1) whether the risk that the value of employer stock will drop below the value of the stock (without restrictions) at the date of exercise is sufficient to justify deferral of recognition, and (2) whether the change in value before and after the restrictions lapse should receive capital gain treatment.

<sup>37</sup> *See supra* text accompanying notes 11-16.

efit received at exercise probably is less than the spread because a buyer would not pay the unrestricted market value for such stock,<sup>38</sup> and the stock may be worth less than \$30 per share at the end of the specified holding period.

Three clean-slate methods exist to determine the timing, amount, and character of the income recognized in an option transaction when post-exercise restrictions apply.

a. *Ignoring the Restrictions.* One way to deal with post-exercise restrictions on transferability is to ignore them. Under this approach, compensation equal to the spread (without regard to any restrictions) is recognized when the employee exercises the option. The employee's basis in the stock then equals its fair market value and no further income tax consequences arise until the stock is sold or otherwise disposed of.<sup>39</sup> Because the employee voluntarily entered into the option transactions,<sup>40</sup> presumably with the intent to participate in an incentive-compensation arrangement, this approach treats the transaction as essentially compensatory and closed at exercise. It recognizes that the employee now holds the stock and is entitled to receive dividends, vote the shares, and act as any other shareholder. The employee thus is treated the same as any investor who risks capital in the employer's stock.

Ignoring post-exercise restrictions may be appropriate when such restrictions are the same as restrictions on outside investors and do not reflect the employer-employee relationship. Thus, restrictions should be ignored in three situations: when the restrictions generally apply to employer stock,<sup>41</sup> when they do not reflect the compensatory nature of the employer-employee relationship,<sup>42</sup> and when they are established purely

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<sup>38</sup> See, e.g., Rev. Rul. 59-60, 1959-1 C.B. 237 (market value is price at which property would change hands between willing buyer and willing seller when former is not under any compulsion to buy and latter is not under any compulsion to sell, both parties having reasonable knowledge of relevant facts); Rev. Rul. 68-609, 1968-2 C.B. 327, 328 (Rev. Rul. 59-60 applies to income tax valuation matters); Note, *Valuation of Option Stock*, *supra* note 1, at 833 (courts have adopted various methods, depending on nature of restriction, of valuing restricted stock for tax purposes); *APB Task Force*, *supra* note 8, at ¶ 281.

<sup>39</sup> See, e.g., T.D. 3435, 2-1 C.B. 50 (1923) (when employee acquires property in bargain purchase from employer, then "[i]n computing the gain or loss from the subsequent sale of such property its cost shall be deemed to be its fair market value at the date of acquisition"); see also Treas. Reg. §§ 1.83-4(b) (1978), 1.1012-1(a) (1980).

<sup>40</sup> Although an employer may award an option without the employee's consent, exercise of the option requires affirmative action by the employee. Cf. *Commissioner v. LoBue*, 351 U.S. 243, 244 (1956) (LoBue and "other employees were notified that they had been tentatively chosen to be recipients of nontransferable stock options contingent upon their continued employment").

<sup>41</sup> If, for example, the restriction is included in either the corporate charter or bylaws and permanently limits transferability to preserve the employer's status as a closely-held corporation, then the value of the stock at the time of exercise should equal the fixed or determinable resale price under the resale restrictions. See, e.g., Treas. Reg. § 1.83-5(a) (1978).

<sup>42</sup> Federal securities law restrictions, for example, are not related to the compensation

for tax avoidance purposes.<sup>43</sup>

b. *Recognizing Gain When the Restrictions Lapse.* Where the post-exercise restrictions are intended as an integral part of the compensation package and are designed to reflect the employer-employee relationship, however, they should not be ignored.<sup>44</sup> Restrictions on transferability, for example, may be designed to encourage continued employment by penalizing an employee who terminates employment during the required holding period.<sup>45</sup> In the case of such employment-related restrictions, the appropriate point at which to recognize gain is when the restrictions lapse because only after lapse is the stock comparable to the employee's other unrestricted capital investment.

If deferring recognition of gain until the restrictions lapse is correct, however, then characterization of the gain when the restrictions lapse should be reconsidered. Although the entire spread between the option price and the fair market value of the stock when the restrictions lapse may be treated as a compensatory transfer to the employee,<sup>46</sup> the issue of characterization is complicated because the status of the employee's investment has changed. During the period before the employee exercises his option, the employee has no capital at risk;<sup>47</sup> if the value of the employer's stock were to fall below the option price, the employee would suffer no loss of invested capital. After exercising the option, however, the employee has invested in a capital asset and risks losing part, or all, of the option-price investment under some post-exercise restrictions.<sup>48</sup>

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received by the employee. *See, e.g.*, *Pledger v. Commissioner*, 641 F.2d 287 (5th Cir. 1981) (1933 Securities Act "investment letter" reduces value of stock at exercise but is ignored for purposes of I.R.C. § 83(a) (1976)), *cert. denied*, 454 U.S. 964 (1981). *But see* *Gresham v. Commissioner*, 79 T.C. 322 (1982) (1933 Securities Act "investment letter" restrictions have an effect on value which should be recognized for minimum-tax purposes); *Rubinfeld & Blessing*, *supra* note 1, at 401-05.

<sup>43</sup> *See, e.g.*, S. REP. NO. 552, 91st Cong., 1st Sess. 121 (1969), *reprinted in* 1969-3 C.B. 423, 501; *Blum*, *supra* note 12, at 602.

<sup>44</sup> When the option privilege is dependent on continued employment, arguably the option agreement may be considered "in the nature of an offer, to be made irrevocable by the performance of services," in which case "no income is received until the offer has been accepted." Note, *supra* note 7, at 503. It may be difficult, however, to distinguish between restrictions that are an integral part of the employer-employee relationship and those that are spurious. *See* *Blum*, *supra* note 12, at 602.

<sup>45</sup> *See, e.g.*, Treas. Reg. § 1.83-3(c)(4), Ex. 1 (1978) (employee must resell stock to employer at option price if he leaves employment within two years).

<sup>46</sup> *See, e.g.*, *Blum*, *supra* note 12, at 603.

<sup>47</sup> *See, e.g.*, *Griswold, Are Stock Options Getting Out of Hand?*, 38 HARV. BUS. REV. Nov.-Dec. 1960, at 49, 50-51.

<sup>48</sup> The effect of the ISO post-exercise holding period, I.R.C. § 422A(a)(1) (Supp. V 1981), for example, is loss of preferential tax treatment if the stock is sold during the restriction period; the employee's investment is not protected. If, however, the employer guarantees repurchase of the stock at the option price during the post-exercise period without regard to the stock's unrestricted value, *see, e.g.*, Treas. Reg. § 1.83-3(c)(4), Ex. 1 (1978), then the conclusion that the employee has "invested in a capital asset" may be too generous. Moreover, a

The employee thus has a mixed economic gain when the restrictions lapse: part of the gain is attributable to the employee's investment in the stock when he exercised the option and part is attributable to compensation for services. It seems appropriate to bifurcate the gain for income tax purposes as well: the compensatory element should be recognized when the restrictions lapse, but the investment gain need not be recognized until disposition.<sup>49</sup>

c. *Allocating Gain When the Restrictions Lapse.* One way to allocate gain when post-exercise restrictions lapse is to compare the unrestricted value at exercise with the value when the restrictions lapse and to treat that portion of the final value attributable to the spread<sup>50</sup> at exercise as compensation. In the model employee option described above,<sup>51</sup> for example, because the option price of the stock was \$10 per share and the unrestricted fair market value was \$30 per share at exercise, the spread was \$20, or two-thirds of the unrestricted value of the stock. If this stock were subject to employment related restrictions on transferability, then under the clean-slate approach the employee would not recognize any income at the time of exercise. When the restrictions lapsed, however, the employee would include in income two-thirds of the value of the stock. The employee would attribute the remainder of the gain (i.e., the remaining value less the option price) to unrealized capital appreciation and would not include it in income at that time. To illustrate, if the stock received on exercise had increased in value to \$75 per share when the restrictions lapsed, then the employee would treat \$50 (two-thirds of the value when the restrictions lapsed) as compensation income and \$15 as unrecognized capital appreciation.<sup>52</sup> If the stock declined in un-

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leading commentator has questioned whether an increase in the stock's value to the level of the value of unrestricted stock should receive capital gain treatment because the "increment is not due to a rise in the price of unrestricted . . . shares, but rather to the passage of time during which the restrictions on . . . [the] shares gradually expired. Thus the increase is comparable to that displayed over time by a bond purchased with interest coupons detached." Blum, *supra* note 12, at 601. On the other hand, even in those cases in which the employee protects himself during the post-exercise restriction period against the loss of the option price paid for the stock, the Internal Revenue Service apparently has treated the stock as a capital asset held by the employee. Cf. Rev. Rul. 59-242, 1959-2 C.B. 125 (purchase of option (a "put") to sell stock acquired on exercise of restricted stock option does not constitute disposition of stock).

<sup>49</sup> Cf. Blum, *supra* note 12, at 603 (direct purchase of "restricted stock," not by exercise of option, where restrictions apply to all shares acquired, is similar to part-purchase, part-restricted stock bonus; capital gain, therefore, should be allocated to purchased shares when restrictions lapse).

<sup>50</sup> Sprcad is the difference between the option price and the value at exercise. See *supra* text accompanying note 32.

<sup>51</sup> See *supra* text accompanying notes 11-16.

<sup>52</sup> The employee's basis in the now unrestricted stock would be the option price plus the amount included in income as compensation; see *supra* note 39.

restricted value between exercise and lapse of the restrictions, the same ratio would apply to the lower value.

#### 4. *Employer Deductions*

Another issue related to the tax consequences of stock options to employees is whether employers should be allowed a deduction in connection with employee stock option transactions and, if so, when.<sup>53</sup> Under the clean-slate approach, the employer's deduction should be matched with the employee's recognition of compensation income. This simple matching approach, although inappropriate for financial accounting purposes,<sup>54</sup> satisfies the basic tax policy objective of clearly reflecting income.<sup>55</sup> Therefore, when the employee recognizes compensation income, the employer should receive an equivalent deduction.

## II

### THE CURRENT LAW OF EMPLOYEE STOCK OPTIONS

#### A. Nonstatutory Options

The current law of nonstatutory stock options generally reaches the same results as the clean-slate approach. Both provide that if an option has a readily ascertainable fair market value<sup>56</sup> on the date of grant, the employee recognizes income to the extent that the fair market value of the option exceeds the amount, if any, paid for the option.<sup>57</sup> If the option does not have a readily ascertainable fair market value on the date of grant, the current law of nonstatutory options, like the clean-slate approach, provides that the employee recognizes compensation in an amount equal to the spread at exercise if there are no post-exercise restrictions.<sup>58</sup>

If post-exercise restrictions apply to the stock received, some differences arise in characterizing the gain realized. Where the stock received on exercise is subject to general restrictions, such as a right of first refusal

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<sup>53</sup> The Code limits the amount of the employer's deduction to the amount representing "reasonable" compensation. *See* I.R.C. §§ 162(a)(2), 404(a)(5), (a)(6) (1976); *cf.* *Harolds Club v. Commissioner*, 340 F.2d 861 (9th Cir. 1965) (disallowing as unreasonable, corporate deduction for contingent compensation based on net profits). *See generally* 2 B. BITTKER, *supra* note 3, at ¶ 22.2; Ford & Page, *Reasonable Compensation: Continuous Controversy*, 5 J. CORP. TAX'N 307 (1979) (although prevailing compensation rates are critical factor in assessing reasonableness of salary, substantial consideration is given to numerous other factors).

<sup>54</sup> *See APB Task Force, supra* note 8, at ¶¶ 16-19.

<sup>55</sup> *See, e.g.*, I.R.C. §§ 446, 482 (1976); 4 B. BITTKER, *supra* note 3, at ¶ 105.1.6.

<sup>56</sup> The readily ascertainable fair market value standard was established in *Commissioner v. LoBue*, 351 U.S. 243, 248-49 (1956), but has its roots in the early nonrecognition provisions dealing with property-for-property exchanges. *See* 2 B. BITTKER, *supra* note 3, ¶ 60.5.1, at 60-36 n.6.

<sup>57</sup> I.R.C. § 83(a), (e)(3) (1976); Treas. Reg. § 1.83-7(a) (1978).

<sup>58</sup> Treas. Reg. § 1.83-7(a) (1978).

in the employer at a formula price, both approaches treat the spread at exercise as compensation.<sup>59</sup> Of course, the value of the stock for this purpose should reflect the restrictions.<sup>60</sup> On the other hand, if post-exercise restrictions limit transferability and may result in a "forfeiture"<sup>61</sup> of the spread, then both approaches defer recognition until the restrictions lapse.<sup>62</sup> Under the nonstatutory option rules, the employee recognizes the entire spread as income,<sup>63</sup> but under the clean-slate approach, income is recognized on a pro-rata basis.<sup>64</sup> The difference in the amount and character of income recognized could reflect a determination under current law that because, in most cases, the post-exercise restrictions protect the employee's investment from loss, the employee is not risking capital and does not deserve capital investment treatment for the option price.<sup>65</sup>

Finally, both the clean-slate and the current nonstatutory option rules provide that the employer is entitled to a deduction at the time the employee recognizes compensation.<sup>66</sup>

## B. Incentive Stock Options

The incentive stock option (ISO) provisions differ from the current law of nonstatutory options and the clean-slate approach in both timing and character of gain recognized. An employee stock option that satisfies the ISO requirements in Internal Revenue Code section 422A has the same terms and conditions as the model employee stock option provisions,<sup>67</sup> including a post-exercise holding period requirement.<sup>68</sup> The ISO also must satisfy many specific requirements, however, and it creates significantly different tax consequences for both the employer and the employee.<sup>69</sup> If the ISO requirements are satisfied, the employee does

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<sup>59</sup> I.R.C. § 83(d)(1) (1976); Treas. Reg. § 1.83-4(h) (1978).

<sup>60</sup> Treas. Reg. § 1.83-5(a) (1978). *But see* Treanor, *Is the Eighth Circuit's St. Louis Bank case the death knell for restrictive stock agreements?*, 57 J. TAX'N 200 (1982) (discussing opinion rejecting restrictive buy-sell agreement for estate-tax purposes).

<sup>61</sup> Treas. Reg. § 1.83-3(c)(1) (1978).

<sup>62</sup> I.R.C. § 83(a)(1) (1976).

<sup>63</sup> Treas. Reg. § 1.83-7(a) (1978).

<sup>64</sup> *See supra* notes 50-52 and accompanying text.

<sup>65</sup> The nonstatutory option rules examine the "extent to which the transferee [the employee] does not incur the risk of a beneficial owner that the value of the property at the time of transfer [i.e., exercise of the option] will decline substantially" in determining whether there is a risk of loss. Treas. Reg. § 1.83-3(a)(6) (1978).

<sup>66</sup> I.R.C. § 83(h) (1976).

<sup>67</sup> *See infra* note 69 and accompanying text.

<sup>68</sup> I.R.C. § 422A(a)(1) (Supp. V 1981).

<sup>69</sup> For a detailed discussion of the new requirements, see Bennet, *supra* note 3, ¶ 9.05, at 9-16 to 9-36; Jassy, *supra* note 3, at 363-93; Rubensfeld & Blessing, *supra* note 1, at 361-64. *See also* 2 B. BITTKER, *supra* note 3, at ¶ 60.5.6 (Supp. No. 2 1983); Colvin, *Qualified "incentive stock options" under the new law: Requirements and advantages*, 55 J. TAX'N 202 (1981); Sollee, *Planning for the new incentive stock options in light of the Temporary Regs.*, 56 J. TAX'N 194 (1982).

not recognize income on the date of grant,<sup>70</sup> on the date of exercise,<sup>71</sup> or on the date the post-exercise restrictions lapse.<sup>72</sup>

Because the ISO price must equal the fair market value of the employer's stock on the date of grant<sup>73</sup> and because the ISO does not have a readily ascertainable fair market value on the date of grant,<sup>74</sup> section 422A treats qualifying options in the same manner as the clean-slate approach at the date of grant. Section 422A also reaches the same result as the clean-slate approach at the time of exercise because the ISO post-exercise holding period requirement<sup>75</sup> does not protect the employee against risk of loss. When the one-year ISO holding period is satisfied, however, ISO treatment differs substantially from the clean-slate approach for both the employee and the employer. Upon timely disposition of the stock, the employee treats the entire gain realized as a long-term capital gain.<sup>76</sup> Moreover, the employer is not entitled to a deduction for the spread at any time.<sup>77</sup> These differences effectively transform compensation into capital gains, and the deferral of recognition further reduces the tax burden. The remainder of this article will examine the purposes ISOs are said to achieve and consider the objections to the current nonstatutory option rules.

### III

#### ANALYSIS OF THE ISO PROVISIONS

##### A. Purposes Served by ISOs

The legislative history of the ISO provisions states that ISOs were intended to

provide an important incentive device for corporations to attract new

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<sup>70</sup> STAFF OF THE JOINT COMM. ON TAXATION, 97TH CONG., 1ST SESS., GENERAL EXPLANATION OF THE ECONOMIC RECOVERY TAX ACT OF 1981, at 157, 159 (Comm. Print 1981) [hereinafter cited as 1981 GENERAL EXPLANATION].

<sup>71</sup> I.R.C. § 421(a)(1) (1976). After 1982 the ISO spread at exercise is an item of tax preference and may give rise to liability for the alternative minimum tax. *Id.* §§ 55(a), 57(a)(10), amended by Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248, § 201(a), 201(b)(1)(C), 96 Stat. 324, 411-17; see H.R. REP. NO. 760, 97th Cong., 2d Sess. 409, 475 (1982) (joint explanatory statement of Committee of Conference on TEFRA); Rubinfeld & Blessing, *supra* note 1, at 352-54, 365-66.

<sup>72</sup> See Rubinfeld & Blessing, *supra* note 1, at 365-66; cf. 1981 GENERAL EXPLANATION, *supra* note 70, at 159.

<sup>73</sup> I.R.C. § 422A(b)(4) (Supp. V 1981).

<sup>74</sup> See, e.g., *id.* § 422A(b)(3) (10-year exercise period), (b)(5) (restriction on transferability).

<sup>75</sup> *Id.* § 422A(a)(1) (to receive special tax treatment, employee must not dispose of stock within two years after option is granted and must hold stock itself for at least one year).

<sup>76</sup> *Id.* If the employee dies before disposing of the stock, all appreciation occurring before death will not be subject to income tax. *Id.* § 1014(a). If the option is exercised after the death of the employee, the special provisions applied to exercise by the employee also will apply. *Id.* § 421(c)(1) (West Supp. 1983).

<sup>77</sup> *Id.* § 421(a)(2) (1976).

management and retain the service of executives who might otherwise leave, by providing an opportunity to acquire an interest in the business. Encouraging the management of business to have a proprietary interest in its successful operation will provide an important incentive to expand and improve the profit position of the companies involved.<sup>78</sup>

Congress intended ISOs to provide an incentive device superior to non-statutory stock options. By giving employees an opportunity to acquire appreciated employer stock without tax consequences, Congress apparently sought to achieve three specific goals. First, Congress sought to provide a means to improve employee performance. Second, it attempted to create employee involvement and interest in the corporation equivalent to that of a stockholder or, if not equivalent to a stockholder's involvement, to at least encourage employees to become stockholders. Third, Congress wanted to encourage employees to remain with their employer. It is not clear, however, that the ISO provisions achieve these goals. Moreover, even if some objectives are achieved, the ISO provisions are not necessary to accomplish them.

### 1. *Improving Employee Performance*

Giving an employee a tax-favored opportunity to participate in possible appreciation of the employer's stock theoretically serves to improve the employee's performance. In practice, however, any causal relationship between improved employee performance and an increase in the fair market value of the employer's stock is questionable.<sup>79</sup> When it recommended repeal of tax-favored options in 1976, the Senate Finance Committee concluded that "it seems doubtful whether a [tax-favored] stock option gives key employees more incentive than does any other form of compensation, especially since *the value of compensation in the form of a [tax-favored] option is subject to the uncertainties of the stock market.*"<sup>80</sup> Although Congress expected ISOs to give the employee an incentive to "expand and improve the profit position"<sup>81</sup> of the employer, it is not clear that fluctuation in the stock market value of employer stock accurately reflects the employee's actions. If improved employee performance is the goal, it may be more effective to base the employee's reward on measurable performance, such as the profitability or productivity of the areas under the employee's control, rather than on fluctuations in

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<sup>78</sup> S. REP. NO. 144, 97th Cong., 1st Sess. 98-99 (1981).

<sup>79</sup> See Rubinfeld & Blessing, *supra* note 1, at 418; *APB Task Force*, *supra* note 8, at ¶ 25.

<sup>80</sup> S. REP. NO. 938, 94th Cong., 2d Sess. 161 (1976) (emphasis added). See Hoover, *Can Capitalism Win the Intellectuals?*, 37 HARV. BUS. REV., Sept.-Oct. 1959, at 47, 54 ("When [stock-option] value depends largely on the demand for the products of the industry and the level of the stock market at the time the options are bestowed—as compared with the level when they are exercised—it is difficult to present these stock options as simple incentives.")

<sup>81</sup> S. REP. NO. 144, *supra* note 78, at 99.

the market value of the employer's stock.<sup>82</sup>

A further questionable aspect of the new ISO provisions in this context is that although ISOs were designed to reward employees' future performance, the favorable tax treatment afforded ISOs is not limited to options granted after Congress enacted the law. The Act provides, instead, that those options granted after 1975, which conform (or are made to conform) to the ISO requirements, are treated as ISOs when exercised after 1980.<sup>83</sup> The scope of the provision, therefore, is broader than necessary to achieve Congress's goal of improving employee performance.<sup>84</sup>

## 2. *Enhancing Employee Involvement*

Enhancing employee involvement in the employer's business by providing employees with a proprietary interest is often advanced as a primary objective of employee stock options.<sup>85</sup> An employee holding an ISO is not, however, a shareholder. Moreover, the employee has no out-of-pocket capital investment in the option. Although the absence of invested capital distinguishes an employee with an option from a shareholder, such an employee arguably shares a community of interest with the investor in the market performance of the employer's stock, and to this extent the option may generate involvement in the employer's profitability.<sup>86</sup> If community of interest were sufficient to determine income

<sup>82</sup> Cf. Gough, *Recession in Executive Pay Hikes*, 70 NATION'S BUS., Dec. 1982, at 69 (executive compensation plans including SARs or performance units "are designed to keep managers interested and motivated and to provide rewards based on attainment of goals that management can affect more directly than it can affect stock price increases").

<sup>83</sup> Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, § 251(c)(1)(B), 95 Stat. 172, 259; see H.R. REP. NO. 215, 97th Cong., 1st Sess. 195, 231-36 (1981) (joint explanatory statement of Committee on Conference on ERTA). This retroactive benefit is limited to stock having a value at grant of \$50,000 in each year, with a \$200,000 aggregate limit on value at grant for all pre-1981 years. Pub. L. No. 97-34, § 251(c)(1)(B), 95 Stat. at 259.

<sup>84</sup> See 127 CONG. REC. 58,730 (daily ed. July 29, 1981) (statement of Sen. Dole) ("I am troubled by the retroactive feature of this bill's stock option provision. It seems to me that it is simply impossible to provide an effective incentive stock option benefit for options that have already been received.")

<sup>85</sup> See, e.g., S. REP. NO. 938, *supra* note 80, at 161 ("The principle reason for the present [1976] tax treatment of qualified stock options is said to be that such treatment allows corporate employers to provide 'incentives' to key employees by enabling those employees to obtain an equity interest in the corporation."); S. REP. NO. 144, *supra* note 78, at 98; 1980 Senate Hearings, *supra* note 11, at 119 (statement of Dr. Edwin V.W. Zschau, on behalf of American Electronics Association):

I want to point out a more subtle, attitudinal effect that granting stock options can have on a company's work force[;] . . . [the] dramatic difference between how people act when they are employees versus how they act when they are also owners [sic]. It is the extra effort people expend to achieve goals and get the job done when they have a stake in the company.

<sup>86</sup> See, e.g., Jensen & Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 323 (1976). See generally Beard v. Elster, 160 A.2d 731, 737 (Del. 1960) (employee stock option plan valid where corporation and shareholders benefit in aggregate from grant of options); Phillips, *Managerial Misuse of Property: The Synthesiz-*

tax consequences, however, the current income tax base would include psychic benefits from employment or leisure because the increase in wealth associated with psychic benefits<sup>87</sup> is at least as great as the psychological involvement arguably generated by ISOs. Of course, the tax base does not extend so far, and for income tax purposes, an employee with an option is in a substantially different position than a shareholder whose invested capital is at risk.<sup>88</sup> The anticipated psychological identification of the employee option holder with shareholders should not be enough to justify special tax treatment.

Moreover, prior tax law provides at least three ways to give employees a real proprietary interest in the employer's business without requiring Congress to provide for tax-favored stock options. First, an employer could make a direct grant of the employer stock.<sup>89</sup> Second, the employer could adopt a qualified stock bonus plan.<sup>90</sup> Third, the employer could establish a combination of deferred compensation arrangements.<sup>91</sup>

a. *Direct Grant of Stock.* The simplest way to give employees a proprietary interest in the employer's business is to make a direct grant of employer stock. An employee who receives stock as compensation would be a shareholder and, as such, does not need any additional incentive to become involved in the company's affairs.<sup>92</sup> Special tax rules

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*ing Thread in Corporate Doctrine*, 32 RUTGERS L. REV. 184, 195-202 (1979) (corporate doctrine that limits executive compensation focuses primarily on whether those who control corporate assets use them unfairly).

<sup>87</sup> For discussion of psychic income and the difficulties of including it in the income tax base, see Andrews, *supra* note 20, at 321-22; Campisano, *Ordinary Observing and Utilitarian Policymaking in the Internal Revenue Code*, 55 S. CAL. L. REV. 785, 794-97 (1982); Halperin, *supra* note 20, at 880-85.

<sup>88</sup> Even though the employee has no out-of-pocket investment in the option before exercise, he may have an economic interest in the option to the extent his employer reduces his direct compensation to reflect the ISO privilege. See, e.g., *1980 Senate Hearings*, *supra* note 11, at 110, 111 (statement of Thomas J. Perkins, Executive Vice President, National Venture Capital Association) ("It used to be [before the 1976 repeal of tax-favored options] that we could hire an individual for perhaps 80 percent of what he was making in a large company . . ."). In this case, the employee has invested, in a nontax sense, the opportunity to earn additional compensation from some other source; the employee's interest in the ISO is equal to the foregone compensation. This economic salary-reduction investment, however, does not distinguish the employee from a sole proprietor who, for example, builds widgets from raw materials and recognizes ordinary income on their sale, even though the proceeds include the value of wages foregone in operating as a sole proprietor. Unless the employee includes the value of the option in income at the date of grant, the investment of foregone wages, unlike a direct investment of capital, should be insufficient to justify special capital asset status for the ISO. See, e.g., *Commissioner v. LoBue*, 351 U.S. 243, 247-48 (1956); Blum, *supra* note 12, at 598-601; see also *Treas. Reg. § 1.1221-1(d)* (1974) (note received for services constitutes ordinary income).

<sup>89</sup> See *infra* text accompanying notes 92-96.

<sup>90</sup> See *infra* text accompanying notes 97-117.

<sup>91</sup> See *infra* text accompanying notes 118-28.

<sup>92</sup> If the employer, however, guarantees repurchase of the stock for its fair market value

designed to motivate the employee as shareholder would be unnecessary.<sup>93</sup>

This approach suffers, however, in comparison with ISOs because of its tax impact on the employee. An employee who receives stock directly as compensation has taxable income equal to the value of the stock when received.<sup>94</sup> The employee must pay the income tax attributable to the direct grant with other funds. Even if the employee's other income subjects the direct grant of stock to the maximum marginal federal income tax rate, fifty percent,<sup>95</sup> he receives the stock at a substantial bargain. This out-of-pocket tax "cost" is apparently too great to allow the direct-grant approach to serve as an attractive alternative to ISOs. Proponents of ISOs seem to be arguing that it is not enough to provide employees with a bargain-purchase proprietary interest. For the proprietary interest to be an effective incentive, it appears the employee must acquire shares of the employer's stock without current tax consequences.<sup>96</sup>

b. *Qualified Plan.* Certainly the most effective way to give employees a direct, proprietary interest in the employer's business without current employee tax consequences is by adopting a qualified stock bonus plan.<sup>97</sup> If the extensive requirements for qualified-plan treatment are satisfied,<sup>98</sup> employer contributions of its stock, or cash to be used to

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in the event that the employee terminates his employment or dies within a specified period, the employee would not have any risk of loss, *see* Treas. Reg. § 1.83-3(a)(6), (c)(1) (1978), and should not be treated as a shareholder for tax purposes.

<sup>93</sup> "Cash bonuses and stock bonuses are incentive devices, but they are not exempt (from ordinary income taxes). In fact, capitalist theorists have often preached that all compensation for services is merely an incentive desire [sic: device]. Why this particular stock option device [I.R.C. § 424 (1976 & Supp. V 1981)] should be preferred is not clear." 96 CONG. REC. 13,687 (1950) (statement of Sen. Humphrey) *quoted in* Wallace, *Should We Continue to Encourage the Use of Restricted Stock Options?*, 39 TAXES 785, 787 (1961).

<sup>94</sup> I.R.C. § 83(a) (1976).

<sup>95</sup> *Id.* § 1.

<sup>96</sup> *Cf.* 1980 Senate Hearings, *supra* note 11, at 114 (statement of Rep. Bill Frenzel) ("Reinstating the use of some form of incentive stock option would broaden the base of employee ownership . . . by giving employees who could not otherwise afford to risk their scarce funds in an emerging enterprise an opportunity to share in the success of the company as owners."); *id.* at 119 (statement of Dr. Edwin V.W. Zschau on behalf of American Electronics Association):

Normally, few employees would have the capital needed to become significant owners in the companies that employ them, but restricted stock options can give them the opportunity for the benefits of ownership without their having to make the up-front cash outlay. Instead of cash, they invest their time, careers, and talents.

<sup>97</sup> The term "qualified stock bonus plan" refers to an employee benefit plan described in Treas. Reg. § 1.401-1(b)(1)(iii) (1960). Many of the same benefits, however, are conferred on employees under infrequently used employee stock purchase plans described in I.R.C. § 423 (1976 & Supp. V 1981). *See* 2 B. BITTKER, *supra* note 3, at ¶ 60.6.

<sup>98</sup> *See* I.R.C. § 401(a) (1976, Supp. V 1981 & West Supp. 1983) (general qualification requirements); *id.* § 410 (minimum participation standards); *id.* § 411 (minimum vesting

purchase its stock,<sup>99</sup> are currently deductible by the employer<sup>100</sup> but are not included in income by the employee until actually distributed from the plan,<sup>101</sup> usually when the employee terminates employment.<sup>102</sup> This deferral of income recognition gives an employee the equivalent of a tax exempt return on what would have been the employee's after-tax compensation if the stock had been distributed directly to the employee.<sup>103</sup>

The tax on qualified-plan distributions differs from ISO treatment but is comparable in overall effect. Under the qualified-plan rules, when the stock is distributed, the employee includes in income only the trust's cost or other basis in the shares<sup>104</sup>—usually an amount equal to the deductions taken by the employer for contributions under the plan.<sup>105</sup> The Code treats any appreciation over this amount as “net unrealized appreciation,” which is not recognized until the employee disposes of the stock.<sup>106</sup> The ISO rules, in contrast, provide that the option holder treats all appreciation over the option price as a capital gain when the stock is eventually disposed of,<sup>107</sup> but the alternative mini-

standards); *id.* § 415 (limitation on benefits and contributions); *id.* § 416 (West Supp. 1983) (“top-heavy” plan rules); *see also* 2 B. BITTKER, *supra* note 3, ¶ 61.1-.7; Halperin, *Retirement Security and Tax Equity: An Evaluation of ERISA*, 17 B.C. INDUS. & COM. L. REV. 739, 742-64 (1976).

<sup>99</sup> A qualified stock bonus plan is not required to invest in the employer's stock. Such plans generally must distribute employer stock when a participant is entitled to a distribution, *see* Miller, P.C. v. Commissioner, 76 T.C. 433 (1981), although a 1980 amendment allows qualified stock bonus plans to distribute cash in certain cases, I.R.C. § 401(a)(23) (Supp. V 1981).

<sup>100</sup> I.R.C. § 404(a)(3), (a)(6), (a)(7) (1976).

<sup>101</sup> *Id.* § 402(a) (Supp. V 1981).

<sup>102</sup> *Cf.* 2 B. BITTKER, *supra* note 3, at ¶ 61.4.

<sup>103</sup> If, for example, an employee directly receives 10 shares of employer stock with a value of \$50, the employee may sell five shares to pay the tax (\$25 at the maximum marginal rate) assessed on this receipt and will have stock worth \$25 left after tax. If the employer's stock pays a 10% dividend, in one year the employee will have a return of \$2.50 on the stock. This return, however, will be taxed (ignoring the dividend exclusion provisions of I.R.C. § 116 (1976 & Supp. V 1981)) leaving the employee with a \$1.25 return after tax. If, on the other hand, the original 10 shares of stock are contributed to a qualified plan, held for one year and then distributed to the employee, the value of the distribution will be \$55 (stock originally worth \$50 plus dividends at 10% on all shares). After paying tax at the maximum marginal rate, the employee will have \$27.50, the same as if the dividends on the direct grant of stock were tax exempt. *See* Sunley, *Employee Benefits and Transfer Payments*, in COMPREHENSIVE INCOME TAXATION 75, 77 (J. Pechman ed. 1977).

<sup>104</sup> This rule applies if the distribution qualifies as a “lump sum distribution” as defined in I.R.C. § 402(e)(4)(A) (1976 & Supp. V 1981). Generally, a “lump sum distribution” is a distribution of the employee's entire account balance “on account” of the employee's death or separation from service. Treas. Reg. § 1.402(a)-1(a)(1)(ii), -1(a)(6)(i) (1963). If the distribution is not a “lump sum distribution,” the employee includes in income the fair market value of the stock received less the “net unrealized appreciation in [employer stock] attributable to” employee contributions, I.R.C. § 402(a)(1) (Supp. V 1981); *see* Treas. Reg. § 1.402(a)-1(a)(1)(i)-(iii), (b)(1)(i) (1963).

<sup>105</sup> *Cf.* Treas. Reg. § 1.402(a)-1(b)(2)(ii) (1960).

<sup>106</sup> *See* I.R.C. § 402(e)(4)(J) (Supp. V 1981); Treas. Reg. § 1.402(a)-1(b)(1) (1960).

<sup>107</sup> 1981 GENERAL EXPLANATION, *supra* note 70, at 159.

num tax may apply when the ISO is exercised, even though the ISO post-exercise holding period restrictions limit favorable tax treatment for one year after exercise.<sup>108</sup>

The wide variety of provisions that an employer may include in a qualified stock bonus plan<sup>109</sup> and the availability of a "cash or deferred" election under which employees may elect to have current compensation contributed to the plan on a salary-reduction basis without current income tax,<sup>110</sup> give the employer great flexibility in designing a qualified plan. This flexibility in turn provides the employer with a range of methods to achieve specific incentive-compensation goals.

The utility of using a qualified plan is reduced, however, by two important differences between qualified plans and ISOs. First, qualified plans must provide benefits to a broad range of employees; participation by the rank and file must be more than nominal.<sup>111</sup> An ISO, on the other hand, may be limited to "key" employees,<sup>112</sup> designated by name or by "class."<sup>113</sup> Second, the total value of the stock allocated to an employee's account in a qualified stock bonus plan for a plan year may not exceed \$30,000 per year after 1982.<sup>114</sup> ISOs, in contrast, permit employers to grant an employee options that total \$100,000<sup>115</sup> per year with the figure even higher if carryovers exist from prior years.<sup>116</sup>

<sup>108</sup> See *supra* note 75.

<sup>109</sup> The choices include use of Employee Stock Ownership Plans (ESOPs) and Tax Credit Employee Stock Ownership Plans (commonly referred to as TRASOPs), as well as special provisions in the garden-variety qualified stock bonus plan. See I.R.C. §§ 409A, 4975(e)(7) (1976 & Supp. V 1981); S. REP. NO. 498, 96th Cong., 1st Sess. 19 (1979) (ESOP and TRASOP name changes); 2 B. BITTKER, *supra* note 3, at ¶ 61.1.1-.1.2; Horowitz & Curtis, *Tax credit employee stock ownership plans: Determining where rules of prior laws apply*, 59 J. TAX'N 30 (1983).

<sup>110</sup> I.R.C. §§ 401(k), 402(a)(8) (Supp. V 1981); 46 Fed. Reg. 55,546 (1981) (proposed Treas. Reg. § 1.401(k)-1); see also 46 Fed. Reg. 55,544, 55,545 (preamble); 2 B. BITTKER, *supra* note 3, at ¶ 61.2.10 (cash or deferred plans); Hirsh, *Qualified cash or deferred arrangements offer unusual tax benefits and flexibility*, 56 J. TAX'N 142 (1982).

<sup>111</sup> See I.R.C. § 410(b)(1) (1976) (generally requiring participation either by specified percentage of employees who have satisfied minimum age and service conditions for eligibility or by persons in "a classification set up by the employer and found by the Secretary [of the Treasury] not to be discriminatory;" referred to as "fair cross section test"); see, e.g., Rev. Rul. 83-58, 1983-14 I.R.B. 14 (application of fair cross section test); Forsyth Emergency Services, P.A. v. Commissioner, 68 T.C. 881, 890 (1977) (court invalidated petitioner's plan because it did not operate "for a 'fair cross section' of all employees" and could not be cured retroactively by making contributions for excluded employees).

<sup>112</sup> See, 1981 GENERAL EXPLANATION, *supra* note 70.

<sup>113</sup> I.R.C. § 422A(b)(1) (Supp. V 1981).

<sup>114</sup> I.R.C. § 415(c)(1)(A) (1976), amended by Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248, § 235(a)(2), 96 Stat. 324, 505; see H.R. REP. NO. 760, 97th Cong., 2d Sess. 195, 617-18 (1982) (joint explanatory statement of Committee of Conference on TEFRA outlining proposed amendment to limit allocations).

<sup>115</sup> I.R.C. § 422A(b)(8) (Supp. V 1981).

<sup>116</sup> *Id.* § 422A(c)(4) provides that if options worth less than \$100,000 are granted in a year, one half of the unused option amount may be carried over to the subsequent three years. Options granted in any year exhaust the \$100,000 current-year limitation first, *id.*

The congressional decision to provide for ISOs and thus favor executive compensation over broad-based qualified plans is questionable as a matter of tax policy.<sup>117</sup> The decision, however, does make ISOs a superior method for providing tax-favored benefits to selected key employees by giving them an opportunity to participate in potentially large capital gains while avoiding compensation income. Even if narrowly targeted compensation schemes are the goal, however, it remains to be seen if ISOs are necessary to achieve it.

c. *Combination of Deferred Compensation Arrangements.* An employer also may provide incentive compensation based on market performance of employer stock by combining a nonstatutory option with the employer's unfunded promise to pay the employee an amount equal to the spread between the option price and the fair market value of the stock when the employee exercises the option. The employer may structure the promise to pay cash equal to the spread at exercise in any way that satisfies the general rules for nonqualified, unfunded, deferred compensation arrangements.<sup>118</sup> The employer's promise to pay cash equal to the spread at exercise is referred to as a "stock appreciation right" (SAR).<sup>119</sup>

Applying this combination to the model employee option described earlier,<sup>120</sup> an employer would grant the employee an option to purchase the stock at \$10 per share (its fair market value at the date of grant) and promise to pay the employee an amount equal to the spread at exercise. If the stock is worth \$30 per share when the option is exercised, the

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§ 422A(b)(8), and then deplete the carryover from the earliest year. See H.R. REP. NO. 215, 97th Cong., 1st Sess. 235 (1981).

<sup>117</sup> See *Employee Contributions to IRA's and Other Pension Plans: Hearing Before the Subcomm. on Private Pension Plans and Employee Fringe Benefits of the Comm. on Finance, 96th Cong., 1st Sess. 112, 122-24 (1979)* (statement of Daniel I. Halperin, U.S. Treasury Deputy Assistant Secretary (Tax Legislation)) (tax incentives for retirement savings depart from goals of progressive income tax system; tax-qualified retirement plans can be justified only because they advance nontax social policy goals such as assuring retirement income for employees at all wage levels); Griswold, *The Mysterious Stock Option*, 51 KY. L.J. 246, 259 (1962-63) (if establishing large fortunes through stock option plan tax benefits is "sharply discriminatory, it raises questions as to why some segments of the population should have tax-free income while others pay high rates of tax on much smaller incomes").

<sup>118</sup> See STAFF OF JOINT COMMITTEE ON TAXATION, 96TH CONG., 1ST SESS., GENERAL EXPLANATION OF THE REVENUE ACT OF 1978, at 75-76 (Comm. Print 1979) (time to include compensation deferred under deferred compensation plan "is to be determined in accordance with the principles set forth in rulings, regulations and judicial decisions" in effect on February 1, 1978); 2 B. BITTKER, *supra* note 3, ¶ 60.2.1-2.3.

<sup>119</sup> See Rev. Rul. 80-300, 1980-2 C.B. 165 (cash payment includible in gross income in year employee exercises SAR). The term is used here to refer to cash compensation awards paid concurrently with the exercise of a nonstatutory option. SAR is sometimes used in other contexts to refer only to alternatives to nonstatutory option benefits. See Rev. Rul. 82-121, 1982-1 C.B. 79 (exercise of SAR cancels option and exercise of option cancels SAR); *APB Task Force, supra* note 8, at ¶¶ 2, 200.

<sup>120</sup> See *supra* text accompanying notes 11-16.

employer pays the employee \$20 in cash, the difference between the option price (\$10) and the market value of the stock (\$30). Under current law applied to nonstatutory options, the employee receives \$40 of compensation income, \$20 from the exercise of the option, and \$20 from the SAR payment.<sup>121</sup> Assuming that this additional compensation is subject to the maximum marginal federal rate of individual income tax, 50%,<sup>122</sup> the total employee tax payable in the year of exercise is \$20 per share. Because the \$20 in cash received under the SAR exactly covers the employee's federal income tax liability, the employee is in the same economic position as an employee who exercises an ISO. The employee, in both cases, incurs a net after-tax cost of \$10 a share for employer stock worth \$30 a share.

The tax position of the employee with the combination of a nonstatutory option and an SAR is more favorable than the tax position of an employee with an ISO; the cost to the employer, however, is greater. The employee's tax position is better because his basis in the stock received under the nonstatutory option is equal to its fair market value at the date of exercise (\$30 in the model);<sup>123</sup> the basis of stock acquired under a tax-favored option would be the option price (\$10 in the model).<sup>124</sup> The employer's cost generally is greater under the combination approach than with an ISO because the employer's maximum marginal tax rate (46%)<sup>125</sup> is lower than the employee's assumed rate.<sup>126</sup>

The employee also may have more flexibility in the timing of the disposition of the stock under the combination approach, depending on the terms of the nonstatutory option.<sup>127</sup> An employee who exercises an ISO, on the other hand, must wait at least one year after exercise to dispose of the stock in order to take full advantage of the ISO tax

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<sup>121</sup> I.R.C. §§ 61, 83(a) (1976).

<sup>122</sup> *Id.* § 1 (Supp. V 1981).

<sup>123</sup> *See* T.D. 3435, 2-1 C.B. 50 (1923); [NONSTATUTORY STOCK OPTIONS], *supra* note 1, at A-15 (basis of stock is equal to option price plus amount taxable to employee as compensation income).

<sup>124</sup> *See* [NONSTATUTORY STOCK OPTIONS], *supra* note 1, at A-15.

<sup>125</sup> I.R.C. § 11 (Supp. V 1981).

<sup>126</sup> *See 1980 Senate Hearings, supra* note 11, at 95 (statement of Daniel I. Halperin, Treasury Deputy Assistant Secretary (Tax Legislation)) (where employer's marginal tax rate is 46% and employee's marginal tax rate is 50%, "cost" to employer of combination approach is 8% of spread at exercise). If both marginal rates are 50%, however, there is no "cost" to the combination approach. Nasuti, *supra* note 24, at 142 (citing letter from Treasury Secretary G. William Miller to Steven J. Ross, Chairman of the Board, Warner Communications, March 6, 1980).

<sup>127</sup> The employer, of course, may impose substantial post-exercise restrictions on transferability in the case of a nonstatutory option. *See, e.g., Note, Valuation of Option Stock, supra* note 1, at 843 n.57 ("Short-term restrictions do help a corporation retain an employee's services for a specific period of time [and] long-term restrictions provide the employer with an effective weapon for inducing the employee to remain with the company until he reaches retirement age.").

benefits.<sup>128</sup>

The greater flexibility of nonstatutory options may make them more attractive than an ISO to employees, at least where the nonstatutory option is combined with an SAR. This difference, however, may also explain, in part, why employers apparently prefer ISOs.

### 3. *Employee Attachment to the Employer*

The legislative history of the ISO provisions shows that Congress intended, in part, to provide a "device for corporations to attract new management and retain the services of executives who might otherwise leave . . . ." <sup>129</sup> This implies that once the employer attracts a key employee or convinces him to stay, the employer's objective is to obtain the maximum benefit from the employee for as long as possible. Two ISO requirements demonstrate the goal of extending the duration of the employer-employee relationship, or of at least encouraging extension of the relationship. First, section 422A(a)(2) requires that the individual exercising an option must be an employee of the granting employer (or a related company) "at all times during the period beginning on the date of the granting of the option and ending on the day 3 months before the date of such exercise . . . ." Second, section 422A(a)(1) denies favorable tax treatment on the disposition of stock acquired under an ISO if the employee disposes of the stock within two years of the date of grant or within one year of the date of exercise.

These two requirements reflect Congress's attempt to help employers retain employees by tying favorable tax treatment of ISOs to service with the employer for a substantial period. Nonetheless, because employers who adopt nonstatutory options have the flexibility to design any post-exercise restrictions necessary to retain key employees, the apparent advantage of ISOs in this area is illusory.<sup>130</sup>

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<sup>128</sup> Failure to hold the ISO stock at least one year after exercise, or two years from the date of grant, is a disqualifying disposition. I.R.C. §§ 421(b), 422A(a) (Supp. V 1981). The tax consequences to the employee and the employer if there is a disqualifying disposition are the same as those in the case of a nonstatutory option. *Id.* § 421(b).

<sup>129</sup> S. REP. NO. 144, 97th Cong., 1st Sess. 98 (1981).

<sup>130</sup> Perhaps the employer is concerned with this difference between ISOs and nonstatutory options because of the way it focuses responsibility for the restrictions; if a nonstatutory option is used, the employer must acknowledge responsibility for any post-exercise restrictions, while "the Congress" may be said to be responsible for the ISO holding period requirement. A similar problem appears to have arisen in ERTA's amendment of I.R.C. § 402(a)(1) (Supp. V 1981) to remove the spectre of constructive receipt from tax-qualified plans. Pub. L. No. 97-34, § 314(c), 95 Stat. 172, 286 (1982). Before the amendment, employers could argue that restrictions on withdrawal by employees from a plan were necessary to prevent constructive receipt of the amounts that could be withdrawn, but this reason is no longer available. See Lewis & Kushner, *Repeal of Constructive Receipt Rules of Section 402(a)*, in ECONOMIC RECOVERY TAX ACT OF 1981: DETAILED ANALYSIS, TAX MGMT. (BNA) 900A, A-219 (1981).

## B. Perceptions of Unfairness in the Nonstatutory Rules

The goal of an employee stock option to generate employee involvement and interest in the employer's business suggests that the current law of nonstatutory options, which requires recognition of compensation when the option is exercised unless a substantial risk of forfeiture is present, accurately reflects the relationship between employer and employee. To the extent an option's purpose is to encourage the employee to remain with the employer, the spread at exercise reflects employee compensation for the period the employee held the option.

The legislative history of ISOs, in contrast, focuses on the goals of attracting new employees and retaining those employees who would otherwise leave,<sup>131</sup> events that emphasize the importance of options on the date of grant. Focusing on the date of grant, rather than on the holding period and employee status requirements, which support recognition at a later date, reflects a basic resistance by businesses<sup>132</sup> and courts<sup>133</sup> to the idea that the spread at exercise constitutes compensation.

An early Tax Court opinion, *Lehman v. Commissioner*,<sup>134</sup> exemplifies this resistance. In *Lehman*, the taxpayer was a partner in a firm that received options to buy stock in two companies in return for services rendered. The partnership exercised the options and bought the stock subject to restrictions on their transferability.<sup>135</sup> Shortly after the restrictions lapsed, the partnership sold the shares and treated the excess of the amount realized over the option price as a long-term capital gain. The taxpayer reported his distributive share of the gain in the same manner. Although agreeing that the options did not constitute compensation at the time of grant because they had no ascertainable fair market value due to the restrictions on transferability,<sup>136</sup> the government argued that the taxpayer should treat his distributive share of the gain

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<sup>131</sup> S. REP. NO. 144, 97th Cong., 1st Sess. 99 (1981).

<sup>132</sup> See, e.g., 1980 Senate Hearings, *supra* note 11, at 120 (statement of Dr. Edwin V.W. Zschau, on behalf of American Electronics Association) ("[T]axation at ordinary income rates [is] inconsistent with what other owners would pay on their capital appreciation [and] . . . the employee must pay the tax before he actually realizes the gain.") (Dr. Zschau, perhaps inadvertently, took a different position earlier in his testimony: "The employees who are granted the options ultimately receive compensation in the form of increased stock value . . ."). *Id.* at 119).

<sup>133</sup> See, e.g., *Geeseman v. Commissioner*, 38 B.T.A. 258 (1938), *acq.*, 1939-1 C.B. 13; Sax, *supra* note 1, at 510 (citing Tax Court's suggestion that the exercise of an option is not compensation if purpose of option was "to increase the employee's interest and proprietary attitude toward the employer corporation").

<sup>134</sup> 17 T.C. 652 (1951), *acq. and nonacq.*, 1962-2 C.B. 7; see also [NONSTATUTORY STOCK OPTIONS], *supra* note 1, at A-2, -3 (discussion of history of nonacquiescence in *Lehman*).

<sup>135</sup> See Note, *Valuation of Option Stock*, *supra* note 1, at 837 (describing restrictions Tax Court opinion did not address).

<sup>136</sup> Cf. *supra* text accompanying notes 21-30.

recognized at exercise as compensation.<sup>137</sup> In holding for the taxpayer, the Tax Court stated:

Termination of the restrictions was not a taxable event such as the receipt of compensation for services or the disposition of property. Values fluctuate from time to time and the value on a later date might be out of all proportion to the compensation involved in the original acquisition of the shares.<sup>138</sup>

The Tax Court has since expressly overruled *Lehman*.<sup>139</sup> Its result—no compensation at any time—is arguably wrong.<sup>140</sup> *Lehman's* facts also are distinguishable from the *employee* stock option case because in *Lehman* the services were performed by the date of grant—neither the firm nor the taxpayer performed any services after grant in *Lehman*. Nonetheless, the perceived lack of a connection between the value of services performed at the time the option is granted and the value of the stock when employees exercise the option generates many of the tax problems concerning employee stock options. These problems are reflected in two general arguments.

First, the employee option has been characterized as an investment by employees of “their time, careers and talents” so that compensation treatment is inappropriate.<sup>141</sup> This human-capital approach, however, generally has been rejected in the treatment of employee compensation in other contexts. Lawyers, for example, do not receive a human-capital basis in their educational costs when they calculate income from their services as lawyers after graduation from law school.<sup>142</sup> The human-capital approach does not justify special treatment for compensation paid in employer stock, particularly after comparing ISOs with a direct grant of stock.<sup>143</sup>

A second argument suggests that the nonstatutory-option approach is unfair because it taxes employees on “paper profits.”<sup>144</sup> If “paper

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<sup>137</sup> *Lehman*, 17 T.C. at 653-54. In a later case the government lost on its argument that compensation should be recognized at the grant of the option. *Kuchman v. Commissioner*, 18 T.C. 154, 163 (1952). For a discussion of *Kuchman* see Blum, *supra* note 12, at 604.

<sup>138</sup> *Lehman*, 17 T.C. at 654.

<sup>139</sup> *Lighthill v. Commissioner*, 66 T.C. 940, 946-49 (1976). For a discussion of *Lighthill*, see Crumbley & Grossman, *Nonqualified Stock Option Treatment*, 55 TAXES 195 (1977).

<sup>140</sup> See, e.g., M. CHIRELSTEIN, *supra* note 24, at 319 (nonstatutory option rules “seem rather harsh, [but] the alternative—complete escape from ordinary income—seems even less acceptable in the circumstances”).

<sup>141</sup> 1980 Senate Hearings, *supra* note 11, at 119 (statement of Dr. Edwin V.W. Zschau on behalf of American Electronics Association).

<sup>142</sup> See Goode, *The Economic Definition of Income*, in COMPREHENSIVE INCOME TAXATION 1, 12-13 (J. Pechman ed. 1977) (comparison of athlete with race horse); Halperin, *supra* note 20, at 899-905 (discussing nondeductibility of educational expenses that qualify taxpayer for new trade or business).

<sup>143</sup> See *supra* text accompanying notes 92-96.

<sup>144</sup> 1980 Senate Hearings, *supra* note 11, at 112 (statement of Thomas J. Perkins, National

profits" referred to unrealized appreciation in the property,<sup>145</sup> this argument would have some merit.<sup>146</sup> The "profits" referred to here, however, are not the same as unrealized appreciation; the "profits" on employee bargain purchases are accurately characterized as compensation—the spread at exercise reflects an employer's transfer of property to employees "in recognition of their services."<sup>147</sup> The tax treatment of nonstatutory options thus is consistent with the tax treatment of all bargain purchases by employees from employers.

### C. Objections to Nonstatutory Options

Unfairness, or the perception of unfairness, in taxing the spread between the value of stock on the date of grant and the value of the stock when the option is exercised provides ISO proponents with a reason to oppose the current law of nonstatutory options. When a nonstatutory option is combined with an SAR, however, the economic result to the employee at exercise is the same for the nonstatutory option as for the ISO.<sup>148</sup> Moreover, the tax consequences to the employee are more favorable.<sup>149</sup> If justifications for the special tax treatment accorded ISOs exist, they apparently lie not only in the need to provide employees with tax benefits, but in the perceived inadequacy of the normal employee bargain-purchase rules.

Opponents of nonstatutory options have articulated five areas of inadequacy in the nonstatutory-option rules to justify the special tax

Venture Capital Association); *id.* at 120 (statement of Dr. Edwin V.W. Zschau on behalf of American Electronics Association); *id.* at 152 (statement of Sen. Alan Cranston).

<sup>145</sup> *Cf. id.* at 114 (statement of Rep. Bill Frenzel) ("[T]axation at ordinary income rates [is] inconsistent with what other owners would pay on their capital appreciation."); *id.* at 120 (statement of Dr. Edwin V.W. Zschau on behalf of American Electronics Association) (repeating Frenzel).

<sup>146</sup> Most commentators recognize the theoretical validity of including unrealized appreciation in the tax base but conclude that the difficulty of administering such a rule prohibits its adoption. *See, e.g., Bittker, supra* note 20, at 967-70; Campisano, *supra* note 87, at 798.

<sup>147</sup> *Commissioner v. LoBue*, 351 U.S. 243, 248 (1956). Full acceptance of the "paper profit" argument would treat any form of noncash compensation as exempt from current inclusion in income. While there are precedents for excluding certain in-kind compensation from income where nontax social-policy goals are sought to be achieved through the tax system, *see, e.g., I.R.C. §§ 105, 106* (exclusion of employer-provided medical benefits), the fundamental "paper profits issue" is whether the amounts realized at exercise of an option are compensation. The treatment of the spread at exercise as other than compensation would have adverse effects on the tax system, particularly with respect to the goal of horizontal equity: employees who receive cash wages would be at a substantial disadvantage in comparison with ISO employees. *See generally* Griswold, *supra* note 47, at 49-50 (discussing possible discrimination in favor of relatively wealthy stockholders); *Treasury, Joint Tax Committee Discuss Taxation of Fringe Benefits*, 19 TAX NOTES 1191, 1191-93 (1983) (where value of fringe benefits is not included in income, employees with equal economic incomes are taxed unequally; this unequal treatment reduces public confidence in fairness of tax system).

<sup>148</sup> *See supra* text accompanying notes 118-23.

<sup>149</sup> *See supra* text accompanying notes 123-24.

treatment of ISOs.<sup>150</sup>

### 1. *Nontax Restrictions*

The current law of nonstatutory options ignores post-exercise restrictions that do not relate to the continuing employment relationship and recognizes gain at exercise.<sup>151</sup> For example, although section 16(b) of the Securities Exchange Act of 1934 prohibits officers, directors, and other insiders from retaining profits on the sale of employer stock within six months of acquisition,<sup>152</sup> the nonstatutory option approach ignores this rule,<sup>153</sup> and an employee who exercises a nonstatutory option must include in income the spread at exercise<sup>154</sup> without regard to potential section 16(b) liability.<sup>155</sup>

The effect of this profits "regurgitation" rule<sup>156</sup> was cited to Congress as an example of the harsh results generated by the nonstatutory-

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<sup>150</sup> These arguments apply whether nonstatutory options alone, or nonstatutory options combined with stock appreciation rights, are under consideration.

<sup>151</sup> I.R.C. § 83 (1976 & Supp. V 1981); Treas. Reg. § 1.83-1(a)(1), -3(c), (d), (h) (1978); *see supra* text accompanying notes 59-64.

<sup>152</sup> Securities Exchange Act of 1934, § 16(b), 15 U.S.C. § 78p(b) (1976). Section 16(b) provides that, with respect to any beneficial owner (defined in § 16(a)), director, or officer, "any profit realized by him from any purchase and sale, or any sale and purchase, of any equity security of [the corporation] . . . within any period of less than six months . . . shall inure to and be recoverable by the [corporation] . . . ."

<sup>153</sup> *See, e.g.,* Horwith v. Commissioner, 71 T.C. 932, 940 (1979) (neither prior fraud nor potential § 16(b) liability affected finding that New York Stock Exchange price on day of exercise established fair market value of stock acquired by exercise of nonstatutory option).

<sup>154</sup> This harsh result has been criticized, *see* Rubinfeld & Blessing, *supra* note 1, at 398-405, and the Tax Court has limited its scope by rejecting the *Horwith* analysis in a case not involving the calculation of compensation income under I.R.C. § 83 (1976 & Supp. V 1981), Gresham v. Commissioner, 79 T.C. 322 (1982) (effect of securities law restrictions on value of stock received at exercise of option taken into account for minimum tax purposes). *See infra* note 158.

<sup>155</sup> Because he includes in income the fair market value at exercise (less any cash paid) notwithstanding the obligation under § 16(b) to repay to the corporation any profit realized, the employee must pay tax on money he may not retain. Under these circumstances taxpayers often have tried to deduct the § 16(b) payment as an "ordinary and necessary" expense. Although the Tax Court has accepted this argument, the courts of appeal have not. *Brown v. Commissioner*, 529 F.2d 609, 613 (10th Cir. 1976); *Cummings v. Commissioner*, 506 F.2d 449, 450-51 (2d Cir. 1974), *cert. denied*, 421 U.S. 913 (1975); *Anderson v. Commissioner*, 480 F.2d 1304, 1307-08 (7th Cir. 1973); *Mitchell v. Commissioner*, 428 F.2d 259, 263-64 (6th Cir. 1970), *cert. denied*, 401 U.S. 909 (1971). *See generally* Husband & Powers, *Section 16(b) of the Securities Exchange Act of 1934 and Insider Trading Involving Issuer-Granted Employee Stock Options*, 57 DEN. L.J. 71 (1979) (federal court decisions have impermissibly departed from particular remedy Congress established in § 16(b)); Lokken, *Tax Significance of Payments in Satisfaction of Liabilities Arising Under Section 16(b) of the Securities Exchange Act of 1934*, 4 GA. L. REV. 298 (1970) (advocating addition of § 16(b) payments to basis of shares acquired). Note also that ISOs receive special treatment under SEC Rule 16b-3. 17 C.F.R. § 240.16b-3 (1982); *see* Husband & Powers, *supra*, at 79-82.

<sup>156</sup> "Section 16(b), Securities Exchange Act of 1934, does not restrict the transferability of shares of stock but rather provides for the regurgitation of profits from 'insider trading.'" Horwith v. Commissioner, 71 T.C. 932, 940 (1979).

option rules.<sup>157</sup> If the tax rules governing employee stock options must change in response to securities laws or other nontax rules, an obvious solution is to limit the tax rules to reflect the difficulty encountered with the other rules. Thus, in the case of insider trading limitations, the response should be to provide that the amount that the employee must include in income will be determined when the limitations on retaining insider profits lapse, rather than when the employee exercises the option.<sup>158</sup> Reinstating favored tax treatment for employee stock options, however, goes beyond the remedy necessary to compensate for any unduly harsh effects of section 16(b) or any other nontax post-exercise restriction.

## 2. *Complexity of SARs*

Critics view the combination of stock appreciation rights (SARs) and nonstatutory employee stock options in a deferred compensation arrangement as "very complex to explain to an employee"<sup>159</sup> and "Byzantine."<sup>160</sup> These characterizations are inaccurate; the critics themselves seem to have little difficulty in explaining such agreements in their attempts to deride them.<sup>161</sup> Moreover, these objections pale in comparison to the highly technical and detailed rules that govern the ISO tax benefit.<sup>162</sup> Because the combination of an SAR with a nonstatutory option is no more complicated than an ISO, complexity should not be an issue.

## 3. *Employer Deductions and Cash Flow*

Another argument that critics of the nonstatutory option advance is that current law grants the employer an income tax deduction equal to

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<sup>157</sup> See, e.g., *1980 Senate Hearings*, *supra* note 11, at 111 (statement of Thomas J. Perkins, Executive Vice President, National Venture Capital Association); *id.* at 120 (statement of Dr. Edwin V.W. Zschau on behalf of American Electronics Association).

<sup>158</sup> Congress recognized this narrowly focused approach at the time ISOs were added to the Code. Section 252 of the Economic Recovery Tax Act of 1981 amends the Code and treats § 16(b) of the Securities Exchange Act of 1934 as a restriction making the stock non-transferable and subject to a substantial risk of forfeiture so that the value of the stock to be included in the employee's income is not determined until the securities law rule has lapsed. Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, § 252, 95 Stat. 172, 260 (codified as amended in I.R.C. § 83(c)); see H.R. REP. NO. 215, 97th Cong., 1st Sess. 195, 285-86 (1981), *reprinted in* 1981 U.S. CODE CONG. & AD. NEWS 285, 374-75 (joint explanatory statement of Committee on Conference).

<sup>159</sup> *1980 Senate Hearings*, *supra* note 11, at 117 (statement of Dr. Edwin V.W. Zschau on behalf of American Electronics Association).

<sup>160</sup> *Id.* at 111 (statement of Thomas J. Perkins, National Venture Capital Association).

<sup>161</sup> See *id.* (statement of Dr. Edwin V.W. Zschau on behalf of American Electronics Association).

<sup>162</sup> See, e.g., Jassy, *supra* note 3, at 363-93; Rubinfeld & Blessing, *supra* note 1, at 359-65, 372-92.

the spread at exercise,<sup>163</sup> but the deduction does not benefit employees.<sup>164</sup> This argument assumes that the employer's tax savings from the noncash compensation deduction<sup>165</sup> will not be passed to employees, an assumption that contradicts the employer's avowed interest in providing employees with low-cost incentive compensation.<sup>166</sup> If the employer has taxable income, the spread under the nonstatutory option generates a deduction without out-of-pocket cost to the employer that has a value in terms of reduced employer tax liability. The employer, therefore, may pass along all or part of this tax savings in the form of additional cash compensation to the employee without increasing the employer's cost. Because the employer may deduct the additional cash compensation as well, the employer may increase the amount of cash paid to employees to reach a net, after-tax position of no out-of-pocket cost to the employer. The employee, however, may pay more tax under this approach than in the case of an ISO.<sup>167</sup>

Because nonstatutory options enable the employer to substantially reduce the employee's tax burden and satisfy the employer's objective of providing low tax "cost" incentive compensation to the employee, those who contend that the employer's deduction does not benefit the employee apparently base their argument on the assumption that the em-

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<sup>163</sup> I.R.C. § 83(h) (1976). The employer is not entitled to a deduction at any time under the ISO provisions. *Id.* at § 421(a)(2).

<sup>164</sup> *See, e.g., 1980 Senate Hearings, supra* note 11, at 120 (statement of Dr. Edwin V.W. Zschau on behalf of American Electronics Association).

<sup>165</sup> I.R.C. § 83(h); *see, e.g.,* Treas. Reg. § 1.162-9 (1960) (immaterial whether bonuses paid in cash or in kind); *1980 Senate Hearings, supra* note 11, at 95.

<sup>166</sup> *See supra* text accompanying notes 95-96.

<sup>167</sup> Where a nonstatutory option is combined with an SAR that provides cash equal to the entire spread at exercise, there is less positive after-tax cash flow to the employer than with an ISO. *See supra* note 126. Employer payments under the SAR may be modified, however, to increase the employer's cash position. In the model, *see supra* note 11 and accompanying text, an employee exercises a nonstatutory option at \$10 per share when the stock is worth \$30 per share. The employer is entitled to a deduction of \$20, I.R.C. § 83(h) (1976), and, assuming a 46% marginal corporate income tax rate, *id.* § 11 (Supp. V 1981), saves \$9.20 in taxes otherwise due. The employer does not incur any out-of-pocket cost when nonstatutory options alone are involved, and in the absence of an SAR, the employer has a positive cash flow in this case. The employer then may adopt an SAR providing additional cash compensation of less than the entire spread such that the employer's after-tax cost equals the total tax savings from the deductions for both cash and noncash compensation. The employer would still retain cash-flow parity with the tax-favored option case (i.e., where positive cash flow is equal to the option price). Under this alternative, the employer in the model could pay \$17 (\$3 less than the entire spread) to the employee under an SAR at exercise of the option. The employer would be entitled to receive a deduction of \$37 (\$20 for the nonstatutory option plus \$17 in cash) with a tax savings of \$17 (46% of \$37); thus, the tax savings equals the employer's cash outlay, and the employer retains the \$10 paid by the employee for the stock at exercise of the option. The employee, assuming a 50% marginal tax rate, *id.* § 1 would incur tax liability of \$1.50 more per share under this approach than under the ISO approach or under an SAR that gives cash equal to the full spread at exercise. This "cost" to the employee, however, is again attributable to the lower tax rate of the employer. *See supra* note 126.

ployee cannot or should not bargain for a share of these tax savings. Given the employer's expressed desire to use low-cost incentive compensation to attract and retain employees,<sup>168</sup> however, the need to bargain for a share of the employer's tax savings should not be considered a substantial burden.

Two situations remain, however, in which one can argue that the nonstatutory option-SAR solution is inappropriate. First, when a company is "cash poor," the company's ability to reduce the employee's tax burden by passing on its tax savings in the form of additional cash is said to be limited.<sup>169</sup> If, however, the company has any income tax liability before taking a deduction for compensation and also has the cash available to satisfy this liability, then a noncash deduction for the spread at exercise generates tax savings, making cash available for distribution to the employee. Therefore, the "cash poor" company is irrelevant in all cases where the employer otherwise would have liability for taxes.

Second, when a company has no current tax liability against which to apply the deduction for the nonstatutory option,<sup>170</sup> the tax deduction for the spread at exercise does not generate any cash savings for the employer to pass on to the employee. The employee, under these circumstances, will prefer the ISO which has a lower tax "cost." This problem, however, is not limited to nonstatutory options; it exists for all ordinary and necessary business expenses, including compensation.

If this no-employer-tax-benefit argument were extended to its logical conclusion, one could argue that if a profitable employer has no current income tax liability, its employees should not include wages in income because a deduction for wages paid would not benefit the employer's profit position. This extreme argument illustrates the inappropriateness of using the employer's tax position to justify special treatment of employee compensation. In particular, to argue that the employer in a tax-loss position receives no benefit from the deduction for the nonstatutory option and, therefore, that the employee should not be taxed on the spread, ignores the issue of how the employee should be taxed on compensation. The no-employer-tax-benefit argument, on the

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<sup>168</sup> See *supra* text accompanying notes 78-79.

<sup>169</sup> See, e.g., 1980 Senate Hearings, *supra* note 11, at 113 (statement of Rep. Frenzel) (employers "need incentives which will not place too great of a strain on the company's limited cash resources"); *id.* at 119 (statement of Dr. Edwin V.W. Zschau on behalf of American Electronics Association).

<sup>170</sup> In a 1981 letter to David G. Glickman, U.S. Treasury Deputy Assistant Secretary (Tax Policy) Designate, Morton Collins of the National Venture Capital Association described this situation as a problem inherent in the nonstatutory option-SAR combination approach because the benefit of the combination "does not apply to companies that have yet to earn a profit on a current basis or [to] those that have substantial tax loss carryforwards or credits." *Problems Seen in the Use of Stock Options Combined with Stock Appreciation Rights*, 12 TAX NOTES 881 (1981) (summarizing Glickman letter) [hereinafter cited as Letter to David G. Glickman].

other hand, may represent an attempt to disguise the necessity of providing the employee with a proprietary interest at no tax cost for the incentive to be effective.<sup>171</sup> This result cannot be achieved with the non-statutory option absent an SAR, and the SAR is useful only when the employer has a tax liability affected by the deduction for the spread.

#### 4. *Revenue Losses from Nonstatutory Options*

Proponents of reinstating tax-favored employee stock options most frequently argue that ISOs in comparison to nonstatutory options increase federal revenues.<sup>172</sup> In 1981, Congress estimated that the new ISO provisions would increase aggregate federal-budget receipts by \$11 million in 1985 and \$21 million in 1986.<sup>173</sup> Congress estimated further that the new ISO rules would cause a revenue loss of less than \$5 million per year for 1981 through 1984.<sup>174</sup> These revenue estimates assume that the tax revenues resulting from requiring employers to forego a deduction for compensation (at the 46% marginal tax rate) will exceed the revenue loss resulting from the nonrecognition of ordinary income by employees who, under the ISO provisions, will pay capital gains tax at a 20% rate when they sell the stock.<sup>175</sup> If, however, the ISO is viewed as providing zero tax at the employee level in lieu of being recognized as compensation at exercise, which would be taxed at the 50% marginal rate for most executives, then the increase in revenues associated with adopting ISOs is questionable. This is reflected in the revenue estimates for repeal of "qualified" options in 1976.<sup>176</sup>

Even if the projected increase in federal revenues is correct, it fails to justify the special treatment afforded ISOs. Although increased revenues may be important for fiscal policy, small changes in revenue should not be an important criterion for federal tax policy, particularly when the result benefits an extremely narrow class of taxpayers. Disallowing the corporate deduction for compensation paid to employees earning high salaries, and allowing high paid employees of taxable employers to

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<sup>171</sup> See *supra* text accompanying note 96.

<sup>172</sup> See, e.g., *1980 Senate Hearings, supra* note 11, at 112 (statement of Thomas J. Perkins, Executive Vice President, National Venture Capital Association); *id.* at 114 (statement of Rep. Frenzel); *id.* at 116 (statement of Rep. McCloskey); *id.* at 120 (statement of Dr. Edwin V.W. Zschau on behalf of American Electronics Association); *id.* at 153 (statement of Sen. Cranston).

<sup>173</sup> H.R. REP. NO. 215, 97th Cong., 1st Sess. 195, 291 (1981), *reprinted in* 1981 U.S. CODE CONG. & AD. NEWS 285, 379.

<sup>174</sup> *Id.* at 292 n.4, *reprinted in* 1981 U.S. CODE CONG. & AD. NEWS at 380.

<sup>175</sup> See Letter to Herbert M. Dwight, American Electronics Association, from Peter J. Hart, Price Waterhouse & Co. (Oct. 26, 1979), *reprinted in 1980 Senate Hearings, supra* note 11, at 122-23.

<sup>176</sup> STAFF OF JOINT COMM. ON TAXATION, 94TH CONG., 2D SESS., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1976, at 151, 156 (Comm. Print 1976) (repeal of "qualified options" would increase budget receipts by \$7 million in 1977, \$20 million in 1978, and \$5 million in 1981).

receive compensation at capital gains rates, would increase revenues even more dramatically than choosing ISOs over nonstatutory options;<sup>177</sup> no one, however, would argue that such measures reflect sound tax policy.

##### 5. *Disclosure of SAR Effect to Shareholders*

Proponents of the favored options are concerned with the effect of SARs on disclosures to shareholders.<sup>178</sup> Under current financial accounting rules, the potential spread of an ISO or of a nonstatutory option (if granted at market value) is not reflected as a charge against a corporation's earnings or its earnings per share on either the date of grant or the date of exercise.<sup>179</sup> An employer's promise to pay deferred compensation, however, generally requires a charge against earnings at some point.<sup>180</sup> When the deferred compensation arrangement involves SARs, the annual increase in the value of those rights is charged currently against earnings.<sup>181</sup> Thus, an employer who would otherwise provide an employee with cash compensation on the date of exercise to reduce the employee's tax cost<sup>182</sup> might prefer an ISO because it allows the employer to compensate employees without direct disclosure of such compensation to shareholders or to potential investors who track earnings per share. ISO proponents have cited the different accounting treatment accorded ISO and deferred compensation arrangements as a reason to reinstate tax-favored options.<sup>183</sup>

<sup>177</sup> See 1980 Senate Hearings, *supra* note 11, at 93-94 (testimony of Daniel I. Halperin).

<sup>178</sup> See, e.g., 1980 Senate Hearings, *supra* note 11, at 113 (statement of Rep. Frenzel) ("The company also benefits by being able to provide its employees with a meaningful incentive without having . . . to recognize any expense on its profit-loss statement."); *id.* at 117 (statement of Dr. Edwin V.W. Zschau on behalf of American Electronics Association) ("[U]sing SARs forces companies to show unusually high costs at the time that their stock prices are rising. That is, as their stock prices rise, the amount of money paid out in the [SAR] rises, which reduces the profitability that is reported."); Letter to David G. Glickman, *supra* note 170.

<sup>179</sup> See Bachelder, *Tax and Accounting Aspects of Costs of Nonqualified Compensation Plans*, 30 INST. ON FED. TAX'N 443, 447-62 (1972); Chazen, *The Impact of Compensation on Earnings Per Share*, 24 MAJOR TAX PLAN. 575, 580-81 (1972); Rubinfeld & Blessing, *supra* note 1, at n.145.

<sup>180</sup> Bachelder, *supra* note 179, at 451-66; Chazen, *supra* note 179, at 575-78; *APB Task Force*, *supra* note 8, at ¶¶ 51-62.

<sup>181</sup> Chazen, *supra* note 179, at 578-84; Rubinfeld & Blessing, *supra* note 1, at n.145.

<sup>182</sup> See *supra* text accompanying notes 118-26.

<sup>183</sup> See *supra* note 178. The disclosure arguments of ISO proponents and their subsequent attacks on the Treasury's representations of the issue were inconsistent. After the 1980 Senate Hearings, *supra* note 11, where proponents of ISOs stated that the approach combining non-statutory options with SARs created disclosure problems, the Treasury again opposed proposals to reinstate tax-favored options, testifying that "some employers may favor the qualified [tax-favored] option if it permits them to pay compensation without clear disclosure to shareholders and without adding an expense item to the profit and loss statement. We question whether facilitating such reporting motivations can be good tax policy." *Foreign Convention Tax Rules and Minor Tax Bills: Hearing Before the Subcomm. on Select Revenue Measures of the House Comm. on Ways and Means*, 96th Cong., 2d Sess. 28, 46 (1980) (testimony of Daniel I. Halperin,

Concern about disclosure to shareholders, or the lack thereof, is unjustified for two reasons. First, although shareholders must approve the plan to grant ISOs, shareholders "rarely know much about the *exercise* of stock options, and, in particular, they are given little direct information as to the actual amount of benefit derived from such exercise, either for individual employees or in the aggregate."<sup>184</sup> Second, if the theory that a stock's value fully reflects *all* reasonably available information about the company is correct,<sup>185</sup> then the difference in financial reporting methods does not adversely affect the value of an employer's stock. Under this efficient-capital-market theory, the compensation effect of ISOs already is figured into the price, at least to the extent that securities law disclosure<sup>186</sup> makes it possible for market analysts to calculate the effect of options. Although proponents of tax-favored options apparently reject the efficient-capital-market theory, the theory supports the conclusion that not even unsophisticated investors without access to this information are misled by the different financial treatment accorded ISOs and nonstatutory options with SARs.

Because employers forego a tax deduction in adopting ISOs compared with nonstatutory options, and because the combination of a nonstatutory option with an SAR allows employees to achieve the same economic position as ISOs, the need for and desirability of ISOs is questionable. Moreover, if one rejects the efficient-capital-market theory, the potential for misleading unsophisticated shareholders suggests that the different accounting treatment of options and deferred compensation is wrong; ISOs, which are not included in a company's earnings statement, are far more likely to mislead investors than SARs. Thus, using this financial-reporting difference to justify reinstating tax-favored options is an egregious abuse of the tax system. The net effect of ISOs is to allow the employee to avoid recognition of compensation as ordinary income and the employer to avoid disclosing a compensation charge when reporting earnings.

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Treasury Department Deputy Assistant Secretary (Tax Legislation) [hereinafter cited as *1980 House Testimony*]. Mr. Halperin's point about the treatment of expense items on a company's profit and loss statement reiterated the position of ISO proponents at earlier hearings, *see supra* note 178. ISO proponent, T.Z. Chu, Chairman of the Board of the American Electronics Association wrote to U.S. Treasury Secretary G. William Miller, objecting to the disclosure argument in the *1980 House Testimony*. 11 TAX NOTES 740 (1980). Mr. Chu stated that the Treasury's testimony about disclosure was "preposterous." *Id.*

This exchange suggests that either Mr. Halperin's statement was wrong, or reliance by proponents of ISOs on the nondisclosure argument is untenable. Nonetheless, in its letter to Treasury Deputy Assistant Designate Glickman on March 31, 1981, Letter to David G. Glickman, *supra* note 170, the National Venture Capital Association again used the disclosure "problem" as an argument against the combination approach.

<sup>184</sup> Griswold, *supra* note 47, at 54 (emphasis added).

<sup>185</sup> *See, e.g.,* Fama, *Efficient Capital Markets: A Review of Theory and Empirical Work*, 25 J. FIN. 383, 413-16 (1970).

<sup>186</sup> *Id.*

## CONCLUSION

The bargain purchase of property from an employer fits the general concepts of compensatory transfers between employer and employee. Because the spread between option price and fair market value cannot be characterized as a gift, it must be characterized as compensation for services. Moreover, because employees do not incur any downside risk of loss prior to exercise—risk that an out-of-pocket investment will decline in value—employees do not have a proprietary interest until after exercise. On balance, therefore, examining the nature of employee stock options, a system that characterizes such options as compensation is preferable. An examination of employee stock options in the context of overall tax policy supports this conclusion.

ISOs are a means of avoiding accurate characterization of compensation, and further, they contradict the purposes and goals of the qualified-plan provisions. ISOs, like any device that allows current compensation to escape current taxation, have a built-in incentive for their use. Because the goals sought to be achieved by ISOs can be secured without special tax benefits, however, and because the costs to employers and employees of other forms of incentive compensation are roughly equivalent to those of ISOs, Congress erred in introducing ISOs into the Internal Revenue Code.