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REDUCTION OF EARNINGS AND PROFITS TO REFLECT THE BARGAIN SPREAD ACCOMPANYING RESTRICTED STOCK OPTIONS

Financial accounting procedures direct that a corporation reduce its earnings and profits to compensate for the difference between the amount paid by an employee for the corporation's stock purchased pursuant to a stock option plan and the market price of that stock existing at the time that the terms of the option are fixed for a particular employee.¹ This reduction is required to avoid the overstatement of corporate income that would result if no attempt was made on the corporate balance sheet to reflect the cost of compensation paid for services received.² Despite the desirability of concurrent accounting for both tax and balance sheet purposes,³ the Tax Court and two federal courts of appeals⁴ have held that other methods should be used in the corporation's tax accounting for the bargain spread inherent in the restricted stock options authorized by section 424 of the Internal Revenue Code of 1954.⁵ It is the contention of this Comment that the generally accepted accounting procedure (GAAP) reflects financial reality better than does the alternative utilized by the Tax Court and avoids the unwarranted shareholder tax benefits portended by the accounting method of the ap-

1. See AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS (AICPA), OPINIONS OF THE ACCOUNTING PRINCIPLES BOARD No. 25, ACCOUNTING FOR STOCK ISSUED TO EMPLOYEES (1972); AICPA, ACCOUNTING RESEARCH BULLETIN No. 43, ch. 13B (1953).

2. AICPA, ACCOUNTING RESEARCH BULLETIN No. 43, ch. 13B (1953).

3. Commentators have recognized both the general desirability and the occasional impossibility of achieving uniformity between tax and financial accounting. See, e.g., Carley, *Important Areas in Which Book Accounting Differs from Tax Accounting; Tax and Nontax Results; Requirements of Federal and State Regulatory Agencies*, N.Y.U. 26TH INST. ON FED. TAX. 541 (1968); Cohen, *Accounting for Taxes, Finance and Regulatory Purposes—Are Variances Necessary?*, 44 TAXES 780 (1966); Address by then Assistant Secretary of the Treasury Stanley S. Surrey, 25 J. TAX. 325 (1966).

Section 446(a) of the Internal Revenue Code of 1954 directs that taxable income be computed in the same manner that the taxpayer regularly keeps his books. The statutory and judicially created exceptions to this general rule are numerous, however. See generally *American Automobile Ass'n v. United States*, 367 U.S. 688 (1961); *Hagen Advertising Displays, Inc. v. Commissioner*, 407 F.2d 1105 (6th Cir. 1969); *Artnell Co. v. Commissioner*, 400 F.2d 981 (7th Cir. 1968).

4. See *Divine v. Commissioner*, 500 F.2d 1041 (2d Cir. 1974), *rev'g* 59 T.C. 152 (1972); *Luckman v. Commissioner*, 418 F.2d 381 (7th Cir. 1969), *rev'g* 50 T.C. 619 (1968); Note, *Employee Stock Options: The Effect Upon A Corporation's Earnings and Profits*, 33 MD. L. REV. 190 (1972); 39 U. CIN. L. REV. 384 (1970).

5. See note 8 *infra*.

pellate courts. Despite the progressive retirement⁶ of restricted stock option plans by Congress, a determination of the appropriate earnings and profit treatment of the bargain spread is necessary for the plans still in existence and, to an extent, for the qualified stock option and employee stock purchase plans now favored.⁷

Prior to January 1, 1964, the Internal Revenue Code empowered corporations to grant selected employees restricted stock options with which to purchase shares of the corporation's stock at a bargain price as low as 85 percent of fair market value on the date the options were granted.⁸ An employee electing to pursue the benefits of such a plan would exercise his option by purchasing stock at the agreed price generally within the succeeding 10 years,⁹ presumably at a time when the market value of the stock had risen above the level existing on the date of grant. Although the option spread at exercise, the market value of the stock at date of exercise less the agreed purchase price, constitutes economic gain to the exercising employee, the Code postpones taxation of any portion of this spread to the employee until his realization of income upon his ultimate disposition of the stock.¹⁰ The Code does not set forth expressly,

6. See note 8 *infra*.

7. See INT. REV. CODE OF 1954, §§ 421-23.

8. INT. REV. CODE OF 1954, § 424(b) provides:

For purposes of this part, the term "restricted stock option" means an option granted after February 26, 1945, and before January 1, 1964 . . . to an individual, for any reason connected with his employment by a corporation, if granted by the employer corporation or its parent or subsidiary corporation, to purchase stock of any of such corporations, but only if—

(1) at the time such option is granted—

(A) the option price is at least 85 percent of the fair market value at such time of the stock subject to the option, or

(B) in the case of a variable price option, the option price (computed as if the option had been exercised when granted) is at least 85 percent of the fair market value of the stock at the time such option is granted

. . . .

Restricted stock options still may be granted to employees provided that the options are granted pursuant to a plan or contract adopted prior to January 1, 1964, and the plan operates as a section 423 employee stock purchase plan. See *id.* §§ 424(b), (c)(3).

9. *Id.* § 424(b)(4).

10. INT. REV. CODE OF 1954, § 421(a) provides:

If a share of stock is transferred to an individual in a transfer in respect of which the requirements of section 422(a) [qualified stock options], 423(a) [employee stock purchase plans], or 424(a) [restricted stock options] are met—

(1) except as provided in section 422(c)(1), no income shall result at the time of the transfer of such share to the individual upon his exercise of the option

however, all of the consequences of the grant or the exercise of the option for the corporation; section 421(a)(2) forbids the offering corporation from deducting the option spread from gross taxable income as a business expense,¹¹ but nowhere does the Code specify whether the corporation may reduce its earnings and profits by an equivalent amount.¹²

The earnings and profits treatment of any particular transaction is crucial for determining whether a subsequent distribution by the corporation to its shareholders is to be deemed a dividend taxable to the shareholder as ordinary income, a capital gain receiving special tax treatment, or a nontaxable return of capital.¹³ For a corporate distribution to be deemed a dividend, it must by definition be paid out of the corporation's earnings and profits.¹⁴ Therefore, if earnings and profits may be reduced by the bargain spread inherent in a stock option, it is possible for earnings and profits to be so diminished that a distribution of corporate assets occurring in the

with respect to such share;

(2) no deduction under section 162 (relating to trade or business expenses) shall be allowable at any time to the employer corporation, a parent or subsidiary corporation of such corporation, or a corporation issuing or assuming a stock option in a transaction to which section 425(a) [corporate reorganizations] applies, with respect to the share so transferred; and

(3) no amount other than the price paid under the option shall be considered as received by any of such corporations for the share so transferred.

The purchase of stock by an employee possessing a restricted stock option is treated as a capital purchase transaction. The employee receives no income at the time of acquiring the stock in the amount of the "bargain spread." Upon disposition of the stock he is, however, taxed on any increase in value above his purchase price at capital gains rates. H.R. REP. NO. 749, 88th Cong., 2d Sess. 4 (1964), in 1 U.S. CODE CONG. & AD. NEWS 1371-72 (1964).

11. INT. REV. CODE OF 1954, § 421(a)(2).

12. There is no comprehensive statutory definition of the term "earnings and profits," nor any comprehensive statement of the effect of transactions upon earnings and profits. B. BITTKER & J. EUSTICE, *FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS* ¶ 7.03, at 7-9 (3d ed. 1971). Although Congress has prescribed the effect certain transactions will have on corporate earnings and profits, the determination of the effect of most transactions has been left to judicial or administrative determination. *Id.* at 7-10. The earnings and profits of a corporation for a year are determined by making adjustments to its taxable income; income which may not be taxed by the federal government under the Constitution will be included in earnings and profits. For example, depletion expenses, while they may be deducted in computing taxable income, may not reduce earnings and profits. Treas. Reg. § 1.312-6(c) (1973). Basically, whether a transaction affects earnings and profits involves a question of how the transaction should affect the distribution made by the corporation to a shareholder after the transaction has occurred. *See generally* B. BITTKER & J. EUSTICE, *supra*, ¶ 7.03, at 7-12.

13. INT. REV. CODE OF 1954, § 301(c)(3)(B).

14. *Id.* § 316(a).

same taxable period as the deduction will avoid dividend treatment to the extent that it exceeds the remaining accumulated and current earnings and profits.¹⁵ Because the employee presumably would exercise his option at a time when the market value of the stock has risen above the level existing when he received the option, the GAAP method of reducing earnings and profits by the option spread at the time shares are committed to the option normally should produce less of a reduction, thus less chance of avoiding dividend treatment, than would the alternative of reducing earnings and profits by the amount of the option spread at exercise. If neither the option spread at commitment nor at exercise is determined to be deductible, then the possibility of avoiding dividend treatment for concurrent distributions is decreased further.

JUDICIAL METHODS

Federal courts of appeals now have twice disagreed with the Tax Court regarding the reduction of earnings and profits during the year stock is sold to employees pursuant to a restricted option plan. The Courts of Appeals for the Seventh and Second Circuits in *Luckman v. Commissioner*¹⁶ and *Divine v. Commissioner*,¹⁷ respectively, have sanctioned reduction by the amount of the spread at exercise, in each instance overturning a Tax Court decision that would have denied any reduction. No one of the four decisions, however, analyzed the GAAP alternative of reducing earnings and profits by the amount of the spread existing when the corporation committed shares to the option.

Divine and Luckman, in their capacity as shareholders of the Rapid American Corporation (Rapid), received a total of \$76,391.19 in cash distributions from the company in respect of their stock during 1961 and 1962.¹⁸ Pursuant to a restricted stock option plan

15. Under existing tax accounting treatment of "dividends" and "earnings and profits," taxable dividend distributions must first be made out of current earnings and profits before any return of capital can be made. If the aggregate value of the dividend distributions exceeds the earnings and profits for the current year, the additional distributions must be made out of accumulated earnings and profits. If there are insufficient current and accumulated earnings and profits to cover the total value of the distributions, only then can they be treated as nontaxable returns of capital. See Rudick, "Dividends" and "Earnings or Profits" Under the Income Tax Law: Corporate Non-Liquidation Distributions, 89 U. Pa. L. Rev. 865, 869-72 (1941).

16. 418 F.2d 381 (7th Cir. 1969), *rev'g* 50 T.C. 619 (1968).

17. 500 F.2d 1041 (2d Cir. 1974), *rev'g* 59 T.C. 152 (1972).

18. 59 T.C. at 154; 50 T.C. at 621.

offered officers and key employees during those years,¹⁹ shares of Rapid with a fair market value of \$5,671,120 were purchased by option holders for \$2,044,748.²⁰ Although prevented from taking any deduction from taxable income by section 421 of the Code,²¹ Rapid did reduce its financial balance sheet earnings and profits by the \$3,626,372 option spread at exercise.²² Since this reduction eliminated Rapid's current and accumulated earnings and profits, it informed its shareholders that the cash distributions made in 1961 and 1962 represented nontaxable returns of capital rather than dividends taxed at ordinary income rates.²³ The Internal Revenue Service (IRS) asserted instead that the distributions to Divine and Luckman were not returns of capital but taxable gross income embraced within the meaning of section 61 of the Code because Rapid's earnings and profits reduction was invalid. Failing to obtain redeterminations of their purported tax liability upon separate petitions to the Tax Court, Luckman and Divine nonetheless succeeded in persuading appellate courts that the distributions were not taxable.²⁴

In both its *Luckman* and *Divine* decisions, the Tax Court adopted the position that the options granted did not constitute compensation and thus did not warrant a reduction in earnings and profits as an expense of producing earnings. Searching for congressional guidance in legislative history, the Tax Court found certain excerpts from the Senate Report to be persuasive evidence that restricted stock option plans were to be used as "incentive devices by corporations who wish to attract new management, to convert their officers into 'partners' by giving them a stake in the business . . . or to give

19. 50 T.C. at 622.

20. 59 T.C. at 155.

21. See note 10 *supra*.

22. 59 T.C. at 155.

23. 59 T.C. at 153; 50 T.C. at 621.

24. Divine contended less successfully that the decision by the Court of Appeals for the Seventh Circuit in *Luckman v. Commissioner*, 418 F.2d 381 (1969), collaterally estopped the Commissioner of Internal Revenue from relitigating the issue of whether Rapid's earnings and profits should have been reduced by the option spread at exercise. 500 F.2d at 1045. The Court of Appeals for the Second Circuit held that the service was not bound by the determination made in *Luckman* since Divine was not a party to that action. The court in *Divine* upheld the traditional requirement of "mutuality" that a person not a party to an action cannot apply collateral estoppel against a party unless the one invoking the doctrine is himself bound by the former judgment. *Id.* The court of appeals stated that if the Commissioner were bound by a determination made in one court of appeals, the chances of having tax questions resolved would be hindered, since the Supreme Court rarely grants certiorari for such cases unless there is a conflict between the circuits. *Id.* at 1049.

employees generally a more direct interest in the success of the corporation Since the options which qualify for special treatment are regarded as incentive devices rather than compensation, no deduction is allowed the corporation."²⁵

When Congress initially considered restricted stock options,²⁶ the income tax regulations discouraged employee stock purchase benefits by treating all option spreads as ordinary taxable income realized on the date of exercise.²⁷ The statutory stock option device was a congressional response to relieve the recognized hardship faced by

25. The historical development of restricted stock options as traced by the Tax Court, Harold S. Divine, 59 T.C. 152 (1972), indicated that statutory stock option plans were to be treated differently from other kinds of stock options. Citing S. REP. NO. 2375, 81st Cong., 2d Sess. 59 (1950), the Tax Court supplied emphasis to the wording which supported its thesis: "[S]ince the options which qualify for special treatment are regarded as incentive devices rather than compensation, no deduction is allowed" 59 T.C. at 166. The Tax Court presupposed that "the treatment prescribed by Congress for statutory stock options follows closely the treatment which had been prescribed by those pre-1950 cases which had found stock options to be simply capital purchase transactions." *Id.* See *id.* at 164, citing *Rosshelm v. Commissioner*, 92 F.2d 247 (3d Cir. 1937); *Merhengood Corp. v. Helvering*, 89 F.2d 972 (D.C. Cir. 1937); *Bothwell v. Commissioner*, 77 F.2d 35 (10th Cir. 1935); *Gardner-Denver Co. v. Commissioner*, 75 F.2d 38 (7th Cir. 1935); *Omaha Nat'l Bank v. Commissioner*, 75 F.2d 434 (8th Cir. 1935); *Herbert H. Springford*, 41 B.T.A. 1001 (1940); *Charles E. Adams*, 39 B.T.A. 387 (1939); *Gordon M. Evans*, 38 B.T.A. 1406 (1938); *Delbert B. Geeseman*, 38 B.T.A. 258 (1938).

The distinction drawn by the Tax Court concerned the purpose of the option plan. In the pre-1950 cases, if the courts determined that the stock option was compensatory in nature, the employee would be required to pay tax on the spread and the corporation would be allowed a deduction in the amount of the value of the spread for purposes of computing taxable income; if the option was designed to induce the employee to purchase stock to increase the corporation's capitalization, taxation would be postponed until time of disposition by the employee. See, e.g., *Commissioner v. Smith*, 324 U.S. 177 (1945) (where option had no value when granted, increment in value at subsequent time of exercise taxable as income to employee; Court acknowledged possibility that the option value at grant could be treated as compensation under different circumstances); *Commissioner v. Stone's Estate*, 210 F.2d 33 (3d Cir. 1954); *Bothwell v. Commissioner*, 77 F.2d 35 (10th Cir. 1935); *Delbert B. Geeseman*, 38 B.T.A. 258 (1938).

26. The restricted stock option plan was first codified in section 130A of the Internal Revenue Code of 1939. Int. Rev. Code of 1939, ch. 994, § 218(a), 64 Stat. 942 (1950). This section was later included as section 421 of the Internal Revenue Code of 1954. Int. Rev. Code of 1954, ch. 736, § 421, 68A Stat. 142. The *Luckman* and *Divine* cases concerned this statute. In 1964, Congress revised the treatment of statutory stock options and imposed new limits upon section 421 in the process of recodifying it as section 424. Revenue Act of 1964, Pub. L. No. 88-272, § 221(a), 78 Stat. 19. See note 8 *supra*.

The qualified stock option plan, found in section 422 of the Internal Revenue Code of 1954, largely replaced the restricted stock option plan. Section 422(c)(1) requires that the option price equal the fair market value of the stock on the date of grant in order for the employee to avoid immediate taxation at date of exercise. INT. REV. CODE OF 1954, § 422(c)(1).

27. I.T. 3795, 1946-1 CUM. BULL. 15; T.D. 5507, 1946-1 CUM. BULL. 18.

employees whereby they frequently would have to liquidate some of their newly acquired shares to raise sufficient cash to finance payment of the tax.²⁸ With the enactment of the restricted stock option provisions, Congress removed these unfavorable tax consequences by treating all spreads as incentives and postponing taxation until time of disposition of the stock.²⁹ The Tax Court was convinced that no reduction could be allowed against concurrent earnings and profits because a corporate income tax deduction for the option spread at exercise expressly was proscribed and the income tax treatment of an item generally should determine its earnings and profits treatment.³⁰

28. The Senate Report stated:

The rule applied under existing regulations is that an employee exercising an option to purchase stock receives taxable income at the time the option is exercised to the extent of the difference between the market value of the stock at the time of exercise and the option . . . price Since the employee does not realize cash income at the time the option is exercised, the imposition of a tax at that time often works a real hardship. An immediate sale of a portion of the stock acquired under the option may be necessary in order to finance the payment of the tax. This . . . reduces the effectiveness of the option as an incentive device.

S. REP. NO. 2375, 81st Cong., 2d Sess. (1950), in 2 U.S. CODE CONG. & AD. NEWS 3115 (1950).

29. "[N]o tax will be imposed at the time of exercise of a 'restricted stock option' or at the time the option is granted and the gain realized by the sale of the stock acquired through exercise of the option will be taxed as long-term capital gain." *Id.*

30. See 59 T.C. at 162; 50 T.C. at 624.

The Tax Court also relied upon construction of the Code to support its result. Luckman contended that the purpose of section 421(a)(3), Int. Rev. Code of 1954, ch. 736, § 421(a)(3), 68A Stat. 142 ("no amount other than the price paid under the option shall be considered as received by any such corporation for the share so transferred") was merely to limit the taxable gain that a corporation received when it issued treasury stock pursuant to a restricted stock option. 50 T.C. at 625. The Tax Court stated that it refused to relegate the status of section 421(a)(3) to a "useless appendage" because section 1032 already provided that "no gain or loss shall be recognized to a corporation on the receipt of money or other property in exchange for stock (including treasury stock) of such corporation." *Id.* at 626. The Tax Court reasoned that Congress must have included section 421(a)(3) to proscribe any reduction in earnings and profits, since if no amount was considered received, no amount could be considered as an item of expense which reduces earnings and profits. 50 T.C. at 628.

The Court of Appeals for the Seventh Circuit, however, held that section 421(a)(3) was intended to limit taxable gain received by the corporation when it granted restricted stock options in the form of stock of a parent or subsidiary corporation rather than the stock of the employer corporation. The court of appeals thus found in section 421(a)(3) a congressional intent different from that in section 1032, so as not to render the former section a "useless appendage." 418 F.2d at 385-86.

The Court of Appeals for the Second Circuit adhered to the position taken by the court of appeals in *Luckman*. Section 421(a)(3) was not a "useless appendage" because section 1032 did not prevent recognition of gain on the sale of stock by an "affiliated" corporation. 500

The Court of Appeals for the Seventh Circuit, however, correctly identified the failure of the Tax Court to recognize financial reality: the emphasis upon the option as incentive to the employee in the legislative history³¹ is not dispositive in view of the Supreme Court's holding in *Commissioner v. LoBue*³² that the bargain spread is compensatory even when designed as an incentive to spur the employee on to greater efforts for the corporation by giving him an ownership interest.³³ Even though *LoBue* concerned a nonstatutory stock option,³⁴ the tax inducements provided by Congress to facilitate participation in option plans by employees should not work a change in the fundamental nature of the option itself from the standpoint of the corporation. As compensation, the courts of appeals reasoned,³⁵ the expense to the corporation entailed in the bargain

F.2d at 1053-54. Not finding any express proscription of an earnings and profits reduction, the court of appeals held that if Congress desired to prohibit a reduction, it would have done so explicitly. *Id.* at 1056.

31. Both appellate courts noted deficiencies in the legislative history, particularly that the Senate Report was in many places inconsistent with the plain language of the Code and thus could not be trusted. For example, both courts noted that the Senate Report incorrectly stated that employees could exercise a restricted stock option only if they remained in the employ of the company after acquiring the option. See 500 F.2d at 1056; 418 F.2d at 386-87.

32. 351 U.S. 243 (1956).

33. The Court stated: "LoBue received a very substantial economic and financial benefit from his employer prompted by the employer's desire to get better work from him. This is 'compensation for personal service' . . ." *Id.* at 247.

34. Without the special tax treatment accorded statutory stock options, see INT. REV. CODE OF 1954, §§ 421-25, nonstatutory stock options or ordinary bargain purchases are a form of compensation for services rendered taxable to the employee as ordinary income. See *Commissioner v. LoBue*, 351 U.S. 243, 247-48 (1956); *Commissioner v. Smith*, 324 U.S. 177, 180-82 (1945). See note 27 *supra* & accompanying text.

The existence of the *LoBue* precedent had not gone unnoticed by the Tax Court. In its *Luckman* opinion, the court summarily distinguished *LoBue* with the assertion that the Congress had provided that restricted stock options were not compensation, but incentives. 50 T.C. at 628. This attempt to distinguish *LoBue*, however, overlooks the fact that the Supreme Court had characterized the stock options in *LoBue* as incentive devices also, yet found them to constitute compensation for the employee. 351 U.S. at 247. In *Divine*, the Tax Court returned to its attempt to distinguish *LoBue* with even less success, dismissing the precedent as inapplicable because it did not address statutory stock options or corporate earnings and profits. This time around, the court did not bother to advance any reason for attaching significance to the fact that *LoBue* concerned a nonstatutory option. See 59 T.C. at 170. Furthermore, although the Tax Court was correct in stating that reduction of earnings and profits was not a litigated issue in *LoBue*, the Supreme Court began its analysis of the case with the assertion that the exercise of LoBue's option had reduced the worth of the corporate employer to its stockholders. 351 U.S. at 245.

35. The appellate court in *Divine* stated: "Compensation paid to and received by the employees of a business are, of course, business 'expenses of producing gross receipts' and

spread is a cost incurred in the production of gross receipts and therefore properly deductible from earnings and profits.³⁶

A potential problem for the contention that Congress did not intend to alter the fundamental nature of the stock option in authorizing the restricted stock option is the fact that it specifically disallowed any business expense deduction under section 162 of the Code for the corporation in connection with the granting of the option.³⁷ Unlike the postponement of taxation for the employee, this provision cannot be explained as a device to facilitate use of the plans; indeed the disallowance of a business expense deduction might remove one inducement for corporations to offer restricted stock options. The Court of Appeals for the Second Circuit in *Divine* categorized the disallowance of deduction as a quid pro quo exacted by Congress to compensate for the temporary loss of revenue caused by deferred taxation of the employee's gain.³⁸ Because of the likelihood of different tax rates being applied to the corporation and its employees and because the employees ultimately were to be taxed on the basis of the speculative capital gain accruing to them upon disposition of the stock purchased,³⁹ however, refusing deduction to the corporation would provide only a very approximate quid pro quo for the deferred taxation of employees.

A more likely explanation for the refusal of deduction is suggested by the congressional awareness of the potential for abuse inherent in the stock option, in that such an option holds the possibility of being used to compensate officers in such a manner as to convert

therefore reduce earnings and profits." 500 F.2d at 1051. See also *Luckman v. Commissioner*, 418 F.2d 381, 384 (1969).

36. Two Revenue Rulings provided the Court of Appeals for the Second Circuit with further support for its conclusion that earnings and profits should be reduced. 500 F.2d at 1052. The Internal Revenue Service (IRS) had declared that all awards of bonus stock to employees constitute business expenses which reduced earnings and profits by the fair market value of the transferred stock, regardless of whether the value exceeded the corporation's cost basis. Rev. Rul. 69-75, 1969-1 CUM. BULL. 52; Rev. Rul. 62-217, 1962-2 CUM. BULL. 59. The court asserted that the only difference between bonus stock and a stock option is that in the latter case the employee pays something for the stock whereas in the former case he pays nothing. 500 F.2d at 1052. Adopting the language and the rationale of *Commissioner v. LoBue*, 351 U.S. 243, 245 (1956), the court in *Divine* stated: "[I]t remains that in both instances, 'at the end of these transactions, [the corporate] employer [is] worth . . . less to its stockholders.'" 500 F.2d at 1052.

37. See INT. REV. CODE OF 1954, § 421(a)(2).

38. 500 F.2d at 1053.

39. See note 10 *supra*.

ordinary corporate income into capital gains.⁴⁰ By making the immediate tax consequences of the stock option more expensive for the corporation than would be the direct payment of cash to an employee,⁴¹ Congress may well have intended to ensure that a corporation would be induced to use the device only for its incentive value rather than as an inexpensive method for distributing corporate income.⁴² Disparate treatment of an expense item, refusing a deduction from taxable income while permitting a reduction of earnings and profits for the item, is not uncommon where tax accounting furthers a different purpose from that of financial accounting;⁴³ the need to reduce tax avoidance would justify providing a method of tax accounting that does not accord with the financial reality of the compensation expense.⁴⁴

Just as the Tax Court's rationale for refusing any reduction in earnings and profits is marred by the failure to recognize any actual cost to the corporation resulting from the bargain spread, however, the alternative method of tax accounting utilized by the appellate courts pays insufficient attention to the possibility of unwarranted

40. The Senate Report indicates that Congress wanted to eliminate some of the abuses of stock options:

The status of a "restricted stock option" will be denied if the recipient of the option owns directly or indirectly more than 10 percent of the combined voting power of all classes of stock of the employer corporation or of the parent corporation at the time the option is granted. This rule is intended to prevent the use of stock options by employers who seek merely to convert the earnings of a corporation from ordinary income into a capital gain.

S. REP. NO. 2375, 81st Cong., 2d Sess. (1950), in 2 U.S. CODE CONG. & AD. NEWS 3115 (1950).

41. A direct cash payment as compensation of course would be deductible from the corporation's taxable income as a business expense. INT. REV. CODE OF 1954, § 162.

42. The Senate Report noted: "Since the options which qualify for special treatment are regarded as incentive devices rather than compensation, no deduction is allowed the corporation . . . with respect to a transfer of stock pursuant to a restricted stock option." S. REP. NO. 2375, 81st Cong., 2d Sess. (1950), in 2 U.S. CODE CONG. & AD. NEWS 3115 (1950).

43. For example, no deduction is allowed for extraordinary expenses or for taxes paid to the federal government, but a reduction of earnings and profits is permitted. R.M. Weyerhaeuser, 33 B.T.A. 594, 597 (1935). See B. BITTKER & J. EUSTICE, *supra* note 12, at ¶ 7.03, 7-13.

44. Both appellate courts advanced a financial-reality argument to support their holdings that the bargain-spread expense should reduce earnings and profits, arguing that a similar financial benefit extended in the form of cash, which could be used to purchase corporate stock, unquestionably would justify reduction of earnings and profits. 500 F.2d at 1056-57; 418 F.2d at 384. As one student commentator noted, however: "This argument is subject to the . . . criticism that it ignores the form of the transaction; there would be no statutory stock option if this form of payment were used." Note, *Employee Stock Options: The Effect Upon A Corporation's Earnings and Profits*, 33 MD. L. REV. 190, 208 (1973).

tax benefits created by the failure to identify precisely what cost is incurred by the corporation. Rapid's employees who exercised restricted options received the substantial value of the spread as compensation without being required to pay any tax thereon until disposition of the stock. In addition, all shareholders subsequently received tax-free distributions in the form of returns of capital once the earnings and profits account was depleted.⁴⁵ Nothing in the legislative history preceding the creation of restricted stock options⁴⁶ indicates that Congress intended to provide this "bonanza"⁴⁷ of benefits to employees and shareholders.

Insofar as the effect on the shareholders of the corporation, the Court of Appeals for the Second Circuit in *Divine* attempted to defend the tax bonanza as necessary to encourage corporations to provide stock option plans for their employees; if no reduction of earnings and profits is allowed, the court asserted, the use of statutory stock options might be unattractive because of inequities that could be imposed on pre-option shareholders.⁴⁸ Although shareholders sometimes have the opportunity to vote on the granting of a statutory stock option plan,⁴⁹ they frequently are unaware of the possibility that a plan may cost the corporation more than a direct cash bonus given to employees since a cash bonus would be deductible from the corporation's income.⁵⁰ When an employee exercises an

45. See note 15 *supra* & accompanying text.

46. See note 25 *supra* & accompanying text.

47. 500 F.2d at 1059 (dissenting opinion).

48. 500 F.2d at 1056.

49. INT. REV. CODE OF 1954, § 422(b)(1) provides: "[T]he [qualified stock] option is granted pursuant to a plan which includes the aggregate number of shares which may be issued under options, and the employees (or class of employees) eligible to receive options, and which is approved by the stockholders of the granting corporation within 12 months before or after the date such plan is adopted." Code section 423(b)(2) places an identical shareholder approval requirement on employee stock purchase plans.

Shareholder approval was not required for restricted stock options, although most corporations did ask for shareholder ratification. Griswold, *The Mysterious Stock Option*, 51 Ky. L.J. 246, 258 (1962). Former section 421(d)(5), repealed by Revenue Act of 1964, Pub. L. No. 88-272, § 221(a), 78 Stat. 63, provided: "If the grant of an option is subject to approval by stockholders, the date of grant of the option shall be determined as if the option had not been subject to such approval."

50. One authority has contended that pre-option shareholders generally labor under the misapprehension that statutory stock option plans do not cost them anything. See Griswold, *supra* note 49, at 257-59. Since no cash distributions are made out of operating accounts, there exists an outward appearance that corporate capital is increasing by the amount of the option price paid by the employee into the corporate treasury and that the employee is being compensated at no cost to the corporation. In reality, the cost of the option spread is borne

option to purchase at a price below market value, the equity of all current shareholders in the corporation is diluted. In one sense the cost of the spread offered is borne not by the corporation, but by the individual shareholders. To disallow any deduction from earnings and profits would aggravate the inequities suffered by pre-option stockholders because of the greater possibility that all cash distributions made by the corporation would be treated as dividends as opposed to returns of capital for personal income tax purposes.⁵¹ Should pre-option shareholders become cognizant of the actual cost of the plan to the corporation and its effect on individual share holdings, the possibility exists that shareholders would not approve the grant of statutory stock option plans at all,⁵² thus frustrating the congressional intent to promote utilization of the device.

This bonanza, however, is an unjustified exception to the general tax policy that taxpaying entities should be taxed on benefits received, regardless of form, at the time of receipt.⁵³ By the exercise of their options, employees become stockholders and thus, would receive a multiple benefit in the deferred taxation of their receipt of the bargain-price stock and in the possibility of avoiding dividend treatment of corporate distributions if the appellate court method of tax accounting is followed. As noted by the Tax Court, such a compounding of tax benefits normally is not allowed without express congressional authorization.⁵⁴ Not only did Congress not specifically provide for such multiple tax benefits for restricted tax options, its modifications of the tax laws seemed aimed more at facilitating employee participation rather than at contriving additional tax benefits to induce corporations to offer the plans. Had Congress been concerned specifically with enticing shareholders into causing management to offer restricted stock options to employees, the more certain inducement would have been to allow a deduction against the corporation's taxable income for the bargain spread inherent in the option. Instead of providing such a tax incen-

by individual shareholders, who each incur a small part of the expense through a reduction in their ownership percentage. A direct cash bonus payment to an employee may cost the shareholders and corporation far less than the grant of a section 421 option. *Id.* See also 39 U. Cn. L. Rev. 384, 388 (1970).

51. See *Luckman v. Commissioner*, 418 F.2d 381, 387 (1969) (Congress said not to have intended to impose the cost of the option spread on pre-option shareholders).

52. 500 F.2d at 1054.

53. Griswold, *supra* note 49, at 248.

54. 59 T.C. at 168-69, *citing* *White v. United States*, 305 U.S. 281 (1938); *New Colonial Ice Co. v. Helvering*, 292 U.S. 435 (1934).

tive to the corporation and its shareholders, however, Congress merely deferred taxation of the employee to avoid forcing him to sell a portion of the stock immediately upon exercise of the option in order to raise sufficient cash to pay the tax.⁵⁵

Rather than furthering legislative intent, the reduction of earnings and profits by the amount of the bargain spread at exercise as advocated by the appellate courts frustrates one clearly expressed goal of Congress. Restricted stock option plans are defined to include only those options granted to individuals holding no more than 10 percent of the voting power of all classes of the corporation's stock at the time the option was granted.⁵⁶ The legislative history is very clear in indicating that the reason for the limitation was to reduce the likelihood of the plans being used to convert corporate profits taxable as ordinary income into capital gains taxable at reduced rates.⁵⁷ Under the accounting method utilized by the appellate courts in *Divine* and *Luckman*, it would be quite possible in a rising market for a controlling group of shareholders in a closely held corporation to exercise selectively options granted to themselves as employees in such a manner as to reduce earnings and profits in an amount sufficient to minimize the likelihood that any concurrent corporate distributions would be taxed as dividends.⁵⁸ Because the exercise of the options would not reduce the cash flow of the corporation, the possibility of a corporate distribution would not be diminished; instead of being a dividend taxable as ordinary income to the shareholders, however, the distribution would be a tax-free return of capital. By allowing reduction of earnings and profits in the amount of the option spread at exercise, the appellate courts thus would encourage tax avoidance that Congress specifically intended to reduce.⁵⁹

55. See note 28 *supra*.

56. See INT. REV. CODE OF 1954, § 424(b)(3).

57. See note 40 *supra*.

58. See notes 14-15 *supra* & accompanying text.

59. Congress reaffirmed its desire to avoid undue tax avoidance by the enactment of Code provisions pertaining to qualified stock options. INT. REV. CODE OF 1954, § 421-22. The House Report accompanying the Revenue Act of 1964, Pub. L. No. 88-272, 78 Stat. 19, states: "For an individual to receive full qualified stock option treatment, he must not sell . . . his stock within 3 years of the date of exercise of the stock option. . . . This provision is designed to give assurance that the key executive involved actually maintains a 'stake in the business' and is not merely selling the stock shortly after he receives it, thus . . . converting ordinary compensation into capital gain." H.R. REP. NO. 749, 88th Cong., 2d Sess. (1963), in 1 U.S. CODE CONG. & AD. NEWS 1375 (1964).

THE FINANCIAL METHOD

Because of the deficiencies of the earnings and profits treatments of restricted stock options by the Tax Courts and the two appellate courts in *Luckman* and *Divine*, the financial accounting method merits closer attention. Without referencing specifically the financial accounting procedure, the Tax Court observed in *Divine* that if a reduction were to be allowed, it should be measured by the option spread existing at grant rather than at exercise;⁶⁰ this time would accord with the Accounting Principles Board (APB) recommendation concerning options for which the price and number of shares offered is settled at time of grant.⁶¹ Otherwise, nowhere in the four reports of the *Luckman-Divine* litigation is there any indication that the taxpayers, the Government, or the appellate courts considered the methods adopted by the accounting profession. This oversight is unfortunate because the GAAP alternative could avoid the shortcomings of the Tax Court and appellate court holdings by recognizing that the option spread at exercise reflects factors other than the corporation's compensation of the employee.

Relevant considerations for determining the effect of the bargain spread upon the corporation are illustrated in the reasons given by the Board for accepting or rejecting certain dates as the appropriate benchmark for measuring the option expense.⁶² The date on which

60. 59 T.C. at 165.

61. AICPA, OPINIONS OF THE ACCOUNTING PRINCIPLES BOARD No. 25, ACCOUNTING FOR STOCK ISSUED TO EMPLOYEES ¶ 10 (1972) [hereinafter cited as APB No. 25].

Although procedures suggested by *Opinions* of the Accounting Principles Board may not be followed by all members of the profession in all financial statements, departures from the *Opinions* are to be disclosed in notes to such statements; accountants departing from the suggested procedures assume the burden of justifying the departure. *Id.* at 481.

62. *See id.*; AICPA, ACCOUNTING RESEARCH BULLETIN No. 43, ch. 13B (1953) [hereinafter cited as ARB No. 43, ch. 13B]. The accounting principles developed in ARB No. 43, ch. 13B were reaffirmed in 1972 by the Accounting Principles Board except that "quoted market price" was substituted for "fair value" as the standard for pricing stock and alternative measurement dates were adopted to reflect the development of compensation plans utilizing variable numbers of shares of stock or variable option or purchase prices. APB No. 25, *supra* note 61, ¶ 4.

In one category of options, financial accounting procedures offer superficial support to the Tax Court decisions in *Luckman* and *Divine*. APB No. 25 recognizes that some plans are not compensatory in nature; the Board has concluded that a noncompensatory plan has at least four essential characteristics:

(a) substantially all full-time employees meeting limited employment qualifications may participate (employees owning a specified percent of the outstanding stock and executives may be excluded), (b) stock is offered to eligible employees equally or based on a uniform percentage of salary or wages (the plan may limit

the corporation first decides to offer an option plan was rejected as irrelevant because no cost accrued to the corporation merely by the fact of the decision to offer the plan.⁶³ At the other end of the time spectrum, the date the employee disposes of stock purchased pursuant to an option plan, was found irrelevant because the timing of that event concerned only the employee's investment judgment as a shareholder without any relationship to whatever services the employee may have performed for the corporation.⁶⁴ The *Luckman-Divine* appellate court alternative, measurement on the date that the employee exercises the option, was rejected for reasons similar to those for not using the disposition date: the time the employee exercises his option is an investment judgment having "no discernible relation to [the optionholder's] status as an employee"⁶⁵

Two other possible dates for measurement, the date that the employee first may exercise the option and the date by which time the employee satisfies all prerequisites for exercise of the option, were determined to be substantially similar in effect upon the option's expense to the corporation.⁶⁶ Although these two dates were plausible alternatives as times for the measurement of cost, the Board rejected them in favor of the date the option was granted because the spread existing at grant would better reflect the cost that the corporation intended to bear in making the option available to the employee,⁶⁷ provided that the number of shares to be offered and the price of offering were specified at the time of grant.⁶⁸ Implicit in the rationale for using the date of grant as a benchmark is the seemingly

the number of shares of stock that an employee may purchase through the plan), (c) the time permitted for exercise of an option or purchase right is limited to a reasonable period, and (d) the discount from the market price of the stock is no greater than would be reasonable in an offer of stock to stockholders or others.

Id. ¶ 7. Although employee stock purchase plans authorized by section 423 of the Internal Revenue Code are categorized expressly by the Board as noncompensatory, *id.*, it does not follow that the Tax Court was correct in labeling the restricted stock options in *Divine* and *Luckman* as being something other than compensation. Only restricted options issued under Code section 424(c)(3)(B) must be available to all employees on a nondiscriminatory basis as required by the Board's first essential characteristic for noncompensatory plans.

63. ARB No. 43, ch. 13B, *supra* note 62, ¶ 7.

64. *Id.*

65. *Id.* ¶ 8.

66. *Id.* ¶ 9.

67. *Id.* ¶ 10. See also Jacoby, *Earnings and Profits: A Not So Theoretical Concept—Some Winds of Change*, N.Y.U. 29TH INST. ON FED. TAX. 649, 662-67 (1971) (advocating reduction of earnings and profits by option spread at grant).

68. See APB No. 25, *supra* note 61, ¶ 10.

reasonable assumption that the corporation would not in effect give the employee a "blank check" by which he would be compensated at a cost uncontrolled by the corporation. Of the possible dates for which a compensation cost could be computed, only the date of grant is in the exclusive control of the corporation; it is thus the cost which could be computed on that date which the corporation intended to bear as an expense of compensating the employee.⁶⁹

When the number of shares of stock to be offered pursuant to the plan or the option price is not determined at the date the option is granted,⁷⁰ however, no compensation expense can be computed on that date. Accordingly, because of the growing complexity of stock option plans,⁷¹ the APB has provided an alternative to the date of grant as a measurement date, substituting instead the date when the number and price of the shares first becomes known.⁷² The two dates, of course, will be the same in a straightforward plan that does not vary the price or quantity of shares offered at the date the option is granted.⁷³

The rationale the accounting profession used for accepting or rejecting the various times for measuring the corporation's compensation expense recognizes a distinction that the Tax Court and the appellate courts in the *Luckman-Divine* litigation overlooked, namely, the fact that the stock option affects the corporation and the employee differently. This distinction is crucial to determining the nature of the corporation's compensation expense. While accepting that there was an expense to the corporation entailed in an option plan, the appellate court in *Divine* did not pause to consider carefully the nature of that expense, merely identifying it as the opportunity cost of selling stock to the employee at a reduced cost instead of selling it on the open market at full value.⁷⁴ It offered no explanation for measuring that cost at the time the employee exercised the option, but it apparently chose that date because it is then that the employee receives a direct economic benefit from having received the option.⁷⁵

69. See ARB No. 43, ch. 13B, *supra* note 62, ¶ 10.

70. See INT. REV. CODE OF 1954, § 424(c)(2) (variable price restricted stock option).

71. APB No. 25, *supra* note 61, ¶ 2.

72. *Id.* ¶ 10.

73. *Id.*

74. 500 F.2d at 1057.

75. See *id.* See also *Commissioner v. LoBue*, 351 U.S. 244, 248 (1956) (holding that the employee taxpayer realized income at the time he exercised his stock option rather than at

Despite the economic importance to the employee of the time of exercise, the corporation incurs its cost at an earlier point. When the corporation commits itself to the terms of an option for a certain employee, it must set aside a certain quantity of stock to be sold to the employee in accordance with the option. Having thus lost control over that stock at the time of commitment, the corporation concurrently forgoes the alternative of selling it on the open market.⁷⁶ It is the difference between the option price and the market value of the stock existing at the commitment date that is the opportunity cost the corporation incurs to provide the option to the employee, and it is that cost which should reduce earnings and profits as a compensation expense.

Also implicit in the reasoning of the APB is the recognition that the economic benefits of a stock option for an employee flow from two sources, the compensation intended by the corporation and the speculative gain the employee receives as a result of his investment judgment.⁷⁷ Although the bargain spread existing at the time the employer grants a certain option to an employee reflects the employer's judgment as to the economic benefit it wishes to confer as compensation,⁷⁸ the benefit the employee eventually receives upon exercise of the option and ultimate disposition of the stock is a gamble dependent upon market factors and the employee's skills as an investor.⁷⁹ One premise of the stock option device is that the granting of an ownership interest in the corporation may spur the employee on to greater efforts for the corporation;⁸⁰ the efforts of one employee, nevertheless, may be only one very small factor affecting the market value of the corporation's stock.⁸¹ While recognizing the economic reality of the compensation expense inherent in an option

the time he received it). The employee, of course, would be taxed for gain accruing at the time he exercised a restricted stock option were it not for the fact that Code section 421(a)(1) results in deferral of the tax. See notes 27, 34 *supra*.

76. See ARB No. 43, ch. 13B, *supra* note 62, ¶ 11. Although the accounting profession originally tied the opportunity cost to the date of grant, *id.*, the commitment date for variable plans would seem to entail similar economic consequences for the corporation's alternatives for selling its stock on the open market. See APB No. 25, *supra* note 61, ¶ 10 (noting that the commitment date is the first time that the corporation knows the number of shares an employee is entitled to receive).

77. See ARB No. 43, ch. 13B, *supra* note 62, ¶ 8.

78. *Id.* ¶ 10.

79. "As an incentive device, stock options have a very large element of lottery in them." Griswold, *supra* note 49, at 255.

80. See *Divine v. Commissioner*, 500 F.2d 1041, 1057 (2d Cir. 1974).

81. Griswold, *supra* note 49, at 221.

plan for the corporation,⁸² the *Luckman-Divine* appellate courts failed to perceive the concomitant reality that the option spread at exercise correlates only weakly with the employee efforts that the corporation intends to compensate by use of an option plan.

Neither case law nor tax policies preclude following the financial accounting method of reducing earnings and profits by the bargain spread existing at a time earlier than the date of exercise. In *Commissioner v. Smith*,⁸³ the Supreme Court stated: "It of course does not follow that in other circumstances . . . the option itself, rather than the proceeds of its exercise, could not be found to be the only intended compensation."⁸⁴ The Court of Appeals for the Sixth Circuit in *McNamara v. Commissioner*⁸⁵ found an occasion when the grant of an option, rather than its exercise, constituted compensation to an employee when such was the intent of the parties.⁸⁶ This emphasis upon intent in *McNamara* comports with the emphasis upon intent inherent in the financial accounting method for treating the option spread: since the corporation normally would not intend to write the employee a "blank check" by compensating him in an amount over which it had no control, the compensation intended is the spread existing when the corporation still has control over the option, normally the time of grant.⁸⁷ Furthermore, *Commissioner v. LoBue*,⁸⁸ the case upon which the *Luckman-Divine* appellate courts relied,⁸⁹ does not compel reducing earnings and profits by the spread at exercise, since that Supreme Court case concerned the tax treatment of the employee exercising an option, not the treatment of the corporation granting it.⁹⁰ Moreover, four Justices would have reached a different result in *LoBue*: two, because the issue of the time at which *LoBue*'s tax should be measured was not properly before the Court;⁹¹ two others, because they would select the time

82. 418 F.2d at 384; 500 F.2d at 1052.

83. 324 U.S. 177 (1945).

84. *Id.* at 181 (dictum).

85. 210 F.2d 505 (6th Cir. 1954).

86. *Id.* at 508.

87. See note 69 *supra* & accompanying text.

88. 351 U.S. 243 (1956).

89. 500 F.2d at 1051-52; 418 F.2d at 384.

90. See 351 U.S. at 248-49.

91. *Id.* at 250 (Frankfurter & Clark, JJ.). The issue had not been raised before the Tax Court or the appellate court, and the Justices saw "no reason for departing from the general rule whereby [the Supreme] Court abstains from passing on such an issue in a tax case when raised here for the first time." *Id.*

at which the employer's commitment to the option for a certain employee became definite as the date to measure the employee's compensation.⁹²

With one modification, the financial accounting method of treating stock option expense also would conform to the requirements of tax policy. Financial accounting procedures would require the corporation to accrue the compensation expense of the option in each period during which the employee performs the services that are compensated by the option.⁹³ Such a procedure might conflict with the tax policy that requires expenses to be certain before a deduction is permitted,⁹⁴ since it is possible that the option granted might never be exercised.⁹⁵ Accounting procedures call for subsequent adjustments to be made to compensation expense in the event that options are not exercised,⁹⁶ but this procedure would appear undesirable for tax purposes.⁹⁷ Delaying the reduction in earnings and profits until the period in which an option is exercised would minimize the need for readjustment of prior tax years and comply with

92. *Id.* at 250 (Harlan & Burton, JJ.). Justice Harlan stated: "It was at [the time the right to the option vested] that the corporation conferred a benefit upon [the employee]. At the exercise of the option, the corporation 'gave' the [employee] nothing; it simply satisfied a previously-created legal obligation. That transaction, by which the [employee] merely converted his asset from an option into stock, should be of no consequence for tax purposes." *Id.* at 250-51.

93. See APB No. 25, *supra* note 61, ¶ 13.

94. Before a deduction can be taken by a corporation for an "ordinary and necessary" business expense, the expense must have been realized. INT. REV. CODE OF 1954, § 162(a). For example, no deduction is permitted for unrealized depreciation expenses. B. BITTKER & J. EUSTICE, *supra* note 12, ¶ 7.03, at 7-13. One requirement of the realization concept for tax purposes is that the expense be ascertainable. See *American Automobile Ass'n v. United States*, 367 U.S. 688 (1961). The expense of some stock options has been recognized as giving rise to an "actual" business expense to a corporation. P. GRADY, ACCOUNTING RESEARCH STUDY NO. 7, INVENTORY OF GENERALLY ACCEPTED ACCOUNTING PRINCIPLES FOR BUSINESS ENTERPRISES 215 (1965).

95. ARB No. 43, ch. 13B, *supra* note 62, ¶ 10, states: "In most of the cases under discussion . . . the only important contingency involved is the continuance of the grantee in the employment of the corporation, a matter very largely within the control of the grantee and usually the main objective of the grantor." There is the further contingency that the market price of the corporation's stock might fall such that exercise of the option would be economically disadvantageous to the employee. Perhaps less likely, given the extended time period during which the option may be exercised, see INT. REV. CODE OF 1954, § 424(b)(4), but still possible, is the contingency that the employee simply might not have sufficient resources to purchase stock even at a bargain price. None of these contingencies would affect the cost to the corporation of each share sold pursuant to an option plan, however; they would only affect the total number of shares sold.

96. APB No. 25, *supra* note 61, ¶ 15.

97. See note 94 *supra*.

the tax principle that expenses be certain before they are afforded recognition.⁹⁸

Compliance with the financial accounting method for treatment of option spreads as compensation expense for the purposes of earnings and profits also accords with the specific legislative intent of the restricted stock option scheme. Because the principal change in tax treatment worked by enactment of the statutory plan, deferred taxation of the employee's gain,⁹⁹ is not affected by allowing a reduction in corporate earnings and profits, the employee's ability to participate in the plan is not diminished. Inasmuch as the option spread at grant is limited statutorily to 15 percent of the stock's value,¹⁰⁰ the threat of selective reduction of earnings and profits in order to achieve tax-free distributions of capital posed by the *Luckman-Divine* appellate court method is negligible,¹⁰¹ thus protecting the congressional goal of assuring that restricted option plans not be used to convert ordinary corporate income into income taxable at reduced rates.¹⁰²

Furthermore, use of the financial accounting method would give effect to the emphasis Congress placed upon the restricted stock option as an incentive device as opposed to compensation.¹⁰³ Although the holding in *Commissioner v. LoBue*¹⁰⁴ requires that the expense of an incentive device be treated as a compensation expense,¹⁰⁵ proper attention to the financial accounting method indicates that the option spread at exercise is not the cost of the device to the corporation. Reduction of earnings and profits by the spread

98. Delaying recognition of the compensation expense until the time the option is exercised also preserves some symmetry in the tax treatment of stock options. Were it not for the deferred taxation of the employee provided by Code section 421(a)(1), his taxable event would be the exercise of his option. *Commissioner v. LoBue*, 351 U.S. 243 (1956). Reducing earnings and profits at that same time thus preserves temporal symmetry, at least from a theoretical standpoint. The fact that the amount of the earnings and profits reduction by the corporation is less than the total economic benefit the employee receives does not violate the principle of symmetry since the amount of the reduction does include the full amount of the economic benefit conferred by the corporation upon the employee; whatever additional economic benefit that accrues to the employee is the result of the exercise of his investment judgment, not compensation related to the services he performs for the corporation. See notes 64-65 *supra* & accompanying text.

99. See note 28 *supra* & accompanying text.

100. INT. REV. CODE OF 1954, § 424(b)(1).

101. See notes 45-47 *supra* & accompanying text.

102. See notes 56-59 *supra* & accompanying text.

103. See *Harold S. Divine*, 59 T.C. 152, 165-66 (1972).

104. 351 U.S. 243, 247 (1956).

105. See notes 32-33 *supra* & accompanying text.

at exercise would be precluded, not because it is an incentive payment, but because it is not an expense borne by the corporation. The option spread at exercise benefits the employee economically, allowing him to share in the good fortune of the corporation; it is not an economically significant event for the corporation, however, since the corporation effectively lost control of the affected shares of stock at the time it committed them to the option agreement with the particular employee.¹⁰⁶ Thus the spread at exercise gives the employee an incentive without itself being a compensation expense for the corporation. Accounting thusly for the stock option comports with the congressional language to the effect that the exercise of the option should not generate a business deduction for the corporation, while it recognizes the economic opportunity cost of the option to the corporation by permitting reduction of earnings and profits in the amount of the spread existing at the time the corporation commits stock to an option rather than selling it on the open market.

CONCLUSION

Reference to financial accounting procedures resolves the difficulties surrounding the earnings and profits treatment of statutory restricted stock options. By reducing earnings and profits by an amount equal to the option spread existing on the date the corporation commits shares to an employee's option, normally the date the option is granted, the financial accounting method recognizes the economic opportunity cost that the Tax Court in the *Luckman-Divine* litigation ignored while avoiding the tax bonanza created by the appellate courts in that same litigation. The superiority of the financial accounting methods stems from its recognition of the different economic effects of the restricted stock option upon the corporation and the employee and from its more precise identification of the particular opportunity cost incurred by the corporation in offering such plans.

Because of the progressive extinction of restricted option plans worked by the Revenue Act of 1964,¹⁰⁷ the precise problem raised in the *Luckman-Divine* litigation will pass away within a few years as the remaining outstanding options are exercised.¹⁰⁸ Similar prob-

106. See note 69 *supra* & accompanying text.

107. Pub. L. No. 88-272, 78 Stat. 19.

108. See Baker, *Employee Stock Options Under the Revenue Act of 1964*, 20 TAX L. REV. 77, 83 (1964). See also note 8 *supra*.

lems are raised, however, by the congressional substitutes, the qualified stock option plan¹⁰⁹ and the employee purchase plan,¹¹⁰ in that Congress once again did not specify the earnings and profits treatment to be afforded the plans. Treatment of employee stock purchase plans poses the lesser problem since the financial accounting treatment is in accord with the rather specific legislative history indicating that the plans are intended primarily as a means of raising capital;¹¹¹ thus no reduction in earnings and profits for compensation is appropriate.

Qualified stock options raise the same potential for abuse that exists with restricted stock options, but the alterations Congress provided for the qualified option plans tend to support applying the financial accounting methods in the same manner as has been advocated for the restricted option plans. Congress specified that any option spread existing at the time a qualified stock option is granted would be taxed as compensation to the employee.¹¹² As compensation to the employee, this spread at grant should reduce corporate earnings and profits in the same manner as financial accounting methods would demand for restricted stock options. Application of financial accounting methods to qualified stock options would prevent the threat of tax manipulation raised by the inappropriate attention paid to the option spread at exercise for restricted stock options by the *Luckman-Divine* appellate courts.

109. INT. REV. CODE OF 1954, §§ 421-22.

110. *Id.* §§ 421, 423.

111. Compare APB No. 23, *supra* note 61, ¶ 7, with H.R. REP. No. 749, 88th Cong., 2d Sess. (1963). The essential purpose of employee stock purchase plans is to raise capital for the corporation:

Some companies have made stock options available to all, or practically all, of their employees. Taking advantage of the fact that the option may be granted at 85 percent of the market price they make discount sales of the stock to their employees generally. These are known as employee stock purchase plans. Where stock options are used in this manner, they are designed primarily as a means of raising capital; and, in such cases, the discounts from market price made available to the employees usually correspond approximately with the costs the company would otherwise incur in floating a new stock issue.

H.R. REP. No. 749, 88th Cong., 2d Sess. (1963), in 1 U.S. CODE CONG. & AD. NEWS 1372-73 (1964).

112. INT. REV. CODE OF 1954, § 422(c)(1).