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The Constructive Receipt of Dividends by Stockholders of a Closely Held Corporation

Part II*

By William Charles Brafford**

Section 162(a)(1) of the 1954 Code states that "there shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business including—(a) a reasonable allowance for salaries or other compensation for personal services actually rendered. . . ." This section is the same as Section 23(a) of the 1939 Code and was not changed. Whether the payment to officers is in the form of a fixed salary, bonus, stock purchase option or other forms of fringe benefits intended as additional compensation, it is necessary that all such payments or benefits when considered together pass the Code test of "reasonableness".¹ Under the Code, the Commissioner has authority to determine whether a particular salary deduction is reasonable, and in keeping with the general rule that a taxpayer must sustain the burden of proof as to deductions, the corporation must prove that the compensation was reasonable under all the circumstances.² This requirement of reasonableness is a constant source of controversy. It is primarily directed against officer-stockholders of close corporations to prevent a corporate deduc-

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¹ Mosher, Tax Problems of Compensating the Corporate Executive, 8 J. Taxation 37 (1958).

² Shield Co., 2 T.C. 463 (1943).
tion for payments which should be treated as distributions of earnings by the corporation to the stockholders. The usual ground for disallowance or reduction of the compensation is that the amount paid is unreasonable, although the Commissioner may also contend that part of the compensation is in effect payment of a constructive dividend. The regulations issued under section 162(a)(1) state:\(^3\)

An ostensible salary paid by a corporation may be a distribution of a dividend on stock. This is likely to occur in the case of a corporation having few shareholders, practically all of whom draw salaries. If in such case the salaries are in excess of those ordinarily paid for similar services, and the excessive payments correspond or bear a close relationship to the stockholdings of the officers or employees, it would seem likely that the salaries are not paid wholly for services rendered, but that the excessive payments are a distribution of earnings upon the stock.

The above regulation thus puts stockholders of close corporations on notice. An analysis of the cases indicates that the regulations reflect the conclusions of the courts. The decisions lay down no hard and fast rules, but merely state certain factors which will be used in determining the question of reasonableness. One or more of these factors may be present in any given case. Likewise, the weight which the courts attach to these factors vary from case to case. To attempt any determination of the relative weight or the controlling effect which any one factor will play in a particular case would, therefore, be futile. Only those factors which the courts have mentioned in the determination of reasonableness are set forth.

1. **Bona fide employment relationship.** The first question in determining whether amounts paid are deductible from corporate income as ordinary and necessary business expenses is whether there is an actual bona fide employment relationship between the recipient and the corporation. This question exists quite apart from the requirement of reasonableness inasmuch as the Code specifically requires that the compensation must be for services actually rendered. Thus, it is not enough that a person be carried on the payrolls of the corporation; he must "actually"

\(^3\) Proposed U.S. Treas. Reg., sec. 1.162-7(b) (1) (1956).
render some services. In *Outlet Clothing Co.*,\(^4\) the corporation made payments of $500 to each of the wives of the stockholder-officers, who were also directors of the corporation. When the corporation sought to deduct these amounts, the payments were denied in full on the basis that the evidence did not show that these directors participated in director's meetings or has rendered any type of services to the corporation. Not only will a deduction be denied altogether where no services have been rendered, but where the employee only renders part-time services, deduction will be allowed only for compensation which reflects the amount of time spent in the employment relationship.\(^5\) In general, it may be stated that after the normal employment relationship is terminated, any additional compensation paid is not deductible. In *Fifteenth and Chestnut Realty Co.*,\(^6\) such a termination occurred by the death of the employee-stockholder. Here, the two sole stockholders of the corporation agreed that each should receive a salary of $22,500 for 80 years and if either of them should die, this sum was to be paid to his estate for the same period. After the death of one of the stockholders the corporation continued to make payments to his estate and sought to deduct this amount from the corporate income as compensation for personal services. The deduction was denied on the ground that the deceased stockholder and former officer could perform no services. No argument seems to have been made in this case that the sums were a type of delayed compensation.

A significant exception to the general rule is made, however, where the payments are to the family or dependents of a deceased employee. It has long been recognized in the regulations and in the cases that payments may be made to the deceased employee's estate for a "reasonable" period following his death.\(^7\) Aside from this exception, however, the cases leave no doubt that a bona fide employment relationship must exist, that services must actually be rendered by the employee, and that the compensa-

\(^5\) In *Wilshire-LaCinega Gardends Co. v. Commissioner*, 148 F. Supp. 938 (D.C. Cal., 1950), the Commissioner's reduction from $9,000 to $2,000 of director's salaries was upheld where they only gave a small amount of time to the corporation.
\(^6\) 29 B.T.A. 1080 (1934).
\(^7\) U.S. Treas. Reg. 118, sec. 39.23(a)-9 (-956); Mclaughlin Cormley King Co., 11 T.C. 569 (1948).
tion must accurately reflect the amount of time spent in the employment relationship.

2. **Role in building up the business.** Since the question of reasonableness is a factual determination in each case, it is quite natural for the courts to determine whether it is reasonable for this particular corporation to pay the sum in question to the particular officer-stockholder. There seems to be a decided trend to look more favorably upon compensation payments made to officers who have been largely responsible for the growth and development of the business. In *Hachman's Department Store v. Earle,* the corporation was engaged in the retail merchandising business. For the years 1943 and 1944 it paid four principal officers (President, Vice President, Treasurer and Secretary) salaries aggregating $95,000 and $96,000 respectively. The Commissioner disallowed as a deduction approximately $24,000 of the 1943 compensation and the same amount of the 1944 compensation on the ground that these sums represented unreasonable compensation. Each of the officers had been in the employment of the company for many years. The District Court found for the taxpayer corporation stressing the fact that:

- The plaintiffs business has been developed largely as a result of—the personality, energy and business acumen of [the] . . . President, and other officers, from a smart and obscure beginning to one of the outstanding stores in the state of Virginia.

Although other factors were present in this case, such as additional duties performed by the officers, the court's language leaves no doubt that the part which the officers played in developing the business is a highly significant factor. This was effectively brought out by the Tax Court in *Hymen Friednash.*

In this case the manager of the taxpayer's bar and restaurant was paid a fixed salary of $6,195 in 1944. Under his contract of employment, he was also entitled to receive 50% of the net profits of the business. During 1944 net profits totaled $75,345.84, the managers portion being $37,678.62, for a total compensation of $43,867.62. The Commissioner determined that $24,000 repre-

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9 Id. at 1141.
sented reasonable compensation to the manager and disallowed the excess. The Tax Court overruled the Commissioner and allowed a deduction for the full amount. The court stressed the fact that the manager played a significant role in developing the business in that he "was an experienced bartender" and was "in charge of the business from the beginning and was solely responsible for the results of the operation". Many other cases have stressed this factor in allowing as reasonable what might otherwise be considered unreasonable compensation.\(^{11}\) It is significant in the *Friednash* case that the compensation allowed the manager amounted to over half of the profits of the corporation, a factor which is ordinarily detrimental to a full deduction.

3. *Increase in duties.* Where there is a substantial increase in compensation over prior years, this increase is immediately suspect and will be disallowed unless justification can be shown by the taxpayer. Where the taxpayer fails to show that the officers performed more or different services than they did in prior years, a deduction of the increased amount will invariably be denied by the courts.\(^{12}\) Of course notice will be taken of general economic conditions as justification for increases based on inflationary price of goods and services. In general, increases may be justified by a showing that additional supervisory duties were undertaken,\(^ {13}\) that the officer was required to work additional and longer hours due to some abnormal condition,\(^ {14}\) that additional responsibilities were undertaken by the officer in connection with expansion of the corporation;\(^ {15}\) or even that the officer was responsible for obtaining machinery which the corporation might not otherwise have been able to secure.\(^ {16}\) However, the increased salary must correspond with the increased duties, and where the salary is doubled over previous years with only a slight increase in duties, the increased portion will be allowed only in part.\(^ {17}\)


\(^{13}\) John A. Dunn Co., 2 B.T.A. 955 (1927).


\(^{16}\) Ticket Office Equipment Co. v. Commissioner, 213 F.2d 318 (2d Cir. 1954).

4. *Qualification of the officers.* The fact that the officer is a person who possesses unusual ability over and above that of a normal corporate officer is an important factor in determining whether his salary is reasonable. In *Schoefer Klaussman Co.*,\(^{18}\) the Tax Court approved a very substantial salary amounting to approximately 50 percent of net profits to the President of a coffee importer corporation observing that "he was considered one of the countries foremost coffee experts and was favorably known in foreign trade circles in several Central and South American countries as well as in Europe". Likewise, in *Bergen Pabvis Corporation*,\(^{19}\) the court upheld payment to three corporate officers of $26,512.15 which left net profits after salaries of only $6,967.95. In this case the court stressed the fact that the officers not only had wide knowledge of textiles, the business in which the corporation was engaged, but also were considered *experts* in this field.

Technical skill and particularly inventive ability is also of considerable importance in determining reasonableness. In *Boabar Co.*,\(^{20}\) the fact that the officer in question had invented, designed and perfected practically all of the machines used by the corporation was the substantially controlling factor in the court’s determination that the salary paid to him was reasonable. Managerial ability has also played a part in determining the qualifications of an officer. Where it is possessed to a high degree, this fact will bear heavily in the taxpayer’s favor.\(^{21}\) That qualifications of the officers are very important in the determination of reasonableness is demonstrated by the fact that it is reversible error for the Tax Court to refuse to admit opinion evidence of persons who are familiar with the abilities of such officers.\(^{22}\)

5. *Evidence of comparable salaries.* Perhaps the most important factor in determining the reasonableness of compensation is evidence of salaries paid to officers in similar businesses. Where the compensation compares favorably with similar competing businesses in the same area, it will ordinarily be held

\(^{19}\) P-H 1948 T.C. Mem. Dec. sec. 48048.
\(^{20}\) 7 T.C. 89 (1946).
\(^{22}\) Builder’s Steel Co. v. Commissioner, 179 F.2d 877 (8th Cir. 1950).
reasonable. However, it is not clear in a case where the Commissioner fails to impeach or contradict such testimony whether the courts must give this testimony conclusive weight. The courts of appeal for the fifth\textsuperscript{24} and sixth\textsuperscript{25} circuits hold that conclusive weight must be given, while the courts of appeal for the seventh\textsuperscript{26} and eighth\textsuperscript{27} circuits hold that the Tax Court is not obligated to accept such testimony even though there is no contradictory testimony on this point. In 

\textit{Loesch and Green Construction Co. v. Commissioner},\textsuperscript{28} officers of a competing company testified that the salaries paid by the taxpayer corporation to its officers were reasonable and in line with those paid by similar companies. The Commissioner did not introduce any contrary evidence. The Tax Court, nevertheless, found for the Commissioner. The court of appeals for the sixth circuit reversed, stating in effect that the Tax Court should have accepted this testimony. The court stated:\textsuperscript{29}

Their testimony was unimpeached and should have been accepted by the Tax Court in a matter in which it had no knowledge or experience upon which it could exercise independent judgment; and such evidence cannot be arbitrarily disregarded.

In \textit{R. H. Oswald Co. v. Commissioner},\textsuperscript{30} decided by the seventh circuit, the taxpayer argued that the court should accept the opinion of his expert witness to the effect that the salaries were reasonable. The court stated:\textsuperscript{31}

[W]e know of no reason why the opinion of an expert such as offered in the instant case may not in the discretion of the trier of the facts be rejected, even though there is no other evidence on the subject.

In reaching its determination, the court will not only look to the salaries paid by competing and similar businesses, but may

\textsuperscript{23} George Bernard's Inc., 8 B.T.A. 716 (1927).
\textsuperscript{24} Burford-Toothaker Tractor Co. v. Commissioner, 192 F.2d 633 (5th Cir. 1951).
\textsuperscript{25} Loesch and Green Const. Co. v. Commissioner, 211 F.2d 210 (6th Cir. 1954).
\textsuperscript{26} R. H. Oswald Co., Inc. v. Commissioner, 185 F.2d 6 (7th Cir. 1950).
\textsuperscript{27} Builder's Steel Co. v. Commissioner, 197 F.2d 263 (8th Cir. 1952).
\textsuperscript{28} Supra note 25.
\textsuperscript{29} Id. at 212.
\textsuperscript{30} Supra note 26.
\textsuperscript{31} Id. at 9.
go further and compare the volume of business done. In *Pfeiffer Brewing Co.*, the court upheld salaries to officers which were the highest in the industry where the corporation also had much of the business and the highest percentage of net profits. However, this comparison to sales and net profits of similar businesses can have its adverse consequences. In *Builders Steel Co. v. Commissioner*, the court compared the salaries with those paid by six competing companies. The salaries were disallowed in part largely on the fact that the evidence showed that all but one of these companies had greater sales than taxpayer.

Another approach which the court will take is to look at the overall salary policy of the corporation to determine whether the compensation paid is reasonable. If it is out of line with that paid to other officers, it may be reduced. In *Mills Supplies Corporation*, the Commissioner's reduction was upheld where the salary of the president and principal stockholder exceeded the total compensation paid to five other key employees. It was not shown that his abilities justified the disproportionate salary.

6. Relation of compensation to net profits. Reduction of a salary deduction is usually upheld where the circumstances show that the effect of the salary is to absorb the corporate profits rather than to compensate for services rendered. What is sought to be prevented is a distribution of all corporate profits in the form of salary. Thus, in the *Outlet Clothing Company* case, the Tax Court upheld the Commissioner's reduction of salaries of two corporate officers from $33,200 to $21,000 where there was only a small amount of corporate profits left after payment of the salaries. To the same effect see *Crescent Bed Company*, where a reduction from $50,000 to $25,000 was sustained where it appeared that after payment of these salaries practically no net income was left. It is not clear where the line will be drawn. In *International Building Co.*, the salaries were held excessive largely because they absorbed all corporate profits in excess of 6% of invested capital. However, in *Law and Credit Company*,

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33 Supra note 22.
36 21 B.T.A. 617 (1930).
37 5 B.T.A. 51 (1926).
the Tax Court allowed higher salaries to corporate officers, observing that net income after salaries for the tax years in question was 7.97%, 8.59% and 10.31%, which was a “fair return” on the investment. A factor which might have influenced the court in this case, however, was the exceptional ability of the officers.

Many of the cases involving this question arise where a fixed salary is paid plus a percentage of profits and where the compensation is based solely on a percentage of profits. In these cases, a distribution of dividends is more nearly approached. In this regard, the regulations state:38

While any form of contingent compensation invites scrutiny as a possible distribution of earnings of the enterprise, it does not follow that payments on a contingent basis are to be treated fundamentally on any basis different from that applying to compensation at a flat rate. Generally speaking, if contingent compensation is paid pursuant to a free bargain between the employer and the individual made before the services are rendered, not influenced by any consideration on the part of the employer other than that of securing on fair and advantageous terms the services of the individual, it should be allowed as a deduction even though in the actual working out of the contract it may prove to be greater than the amount which will ordinarily be paid.

Even here, however, the compensation must meet the same test of reasonableness as salary paid on a fixed basis. If the agreement is reasonable when made, the fact that subsequent events may greatly increase this percentage is not necessarily detrimental to the taxpayer’s case.39 This is particularly true where the agreement is of long standing.40 The difficulty here is that the agreement must be of an arm’s-length character. Stockholders of a close corporation cannot always establish this.

7. Compensation in relation to stockholders. Payment of compensation in proportion to stockholdings of the officers invites a scrutiny as to whether the payment constitutes in part a distribution of profits in the guise of compensation. An attack

38 Proposed U.S. Treas. Reg. sec. 1.162-7(b) (2) (1956).
40 Draper and Co., 5 T.C. 822 (1945).
by the Commissioner may be made directly or it may be made indirectly by alleging that the salary paid is unreasonable and pointing out its proportional relationship to stock as a factor in the determination. Even where the latter factor is present, salaries paid will still be deductible if not excessive. It does, however, put the taxpayer in an unfavorable light in proving reasonableness. Undoubtedly where such a relationship exists, the Commissioner and the courts will require stronger evidence of reasonableness. This is particularly true where additional amounts of compensation are paid over and above fixed salaries. Thus, where bonuses and salary increases are made in proportion to stockholdings, the additional sums appear to be a distribution of dividends rather than salary payments and the courts very often declare these additional sums to be excessive compensation. In Sarfert Hosiery Mills, three corporate officers received bonuses of $3,000, $2,000 and $1,000 respectively in addition to their regular salaries. These sums were held to be excessive compensation by the court which made the following observation:

\[\text{[T]he bonus payments are in very close proportion to the dividend rights of the three officers involved herein, those rights being in the ratio of sixty, forty and twenty, while the bonuses are in the ratio of $3,000, $2,000 and $1,000. We do not consider this relationship of great weight in itself, but we do consider it of sufficient importance to be worthy of consideration.}\]

As pointed out by the court, payments corresponding to stockholdings are not conclusive evidence that they in part represent a distribution of earnings; but it is significant that the courts lay much stress on this factor, in support of a decision adverse to the taxpayer. It would be an exceptional case where salaries in proportion to stockholdings would be held deductible in full.

As stated previously, no fixed rules exist in this area. The

42 Supra note 12.
43 Id. at 1040.
44 K and H Realty Corp., P-H 1956 T.C. Mem. Dec. sec. 56107, was a case where this factor was overcome. The court allowed the deduction in full where it was shown that the officers performed equal services and that no salaries had been paid to them for 7 out of the 13 years of the corporations existence.
decisions vary with the particular circumstances. While it is readily apparent that in cases of this nature fixed mechanical rules cannot be stated which would be applicable to all situations, some policy determinations could be made to help the situation. It has been suggested by one author that the history of this section "furnishes no basis whatever for the assumption of the treasury of a visitatorial power over salary payments actually made". This would appear to be an overstatement as well as an undesirable policy conclusion. All would agree that corporate profits should not be withdrawn under the guise of salary. Failure to review such payments would disrupt the whole system of taxing corporations and render it meaningless, especially in the case of small close corporations. Whether the power of the Commissioner should be as broad as it is at present is another question. The consequences can be rather severe in cases where the corporation gets overly ambitious in the payment of salaries. At the outset the taxpayer has two strikes against him. Not only is the determination of the Commissioner presumptively correct, but the courts of appeals have made it clear that the Tax Court will not be reversed unless its decision is "so clearly out of line with the evidence as to be arbitrary and unfair." In discussing who should make the determination of whether an expense is ordinary and necessary under this section, the Supreme Court in *Heininger v. Commissioner* also stated:

> Whether an expenditure is directly related to a business and whether it is ordinary and necessary are doubtless pure questions of fact in most instances. Except where a question of law is unmistakably involved a decision of the Board of Tax Appeals on these issues, having taken into account the presumption supporting the Commissioner's rulings should not be reversed by the federal appellate courts. Careful adherence to this principal will result in a more orderly and uniform system of tax deductions in a field beset by innumerable complexities.

As far as the corporation is concerned, where there is a payment of excessive amounts, the deduction is limited to the pro-

46 Long Island Drug Co. v. Commissioner, 111 F.2d 593,595 (2d Cir. 1940).
47 320 U.S. 467 (1943).
48 Id. at 475.
portion of the payment which constitutes reasonable compensation.\textsuperscript{49} However, not only will the corporation lose its business deduction, but the payments made to stockholders may be treated as constructive dividends.\textsuperscript{50} If a direct attack has been made by the Commissioner by alleging that the purported compensation was not actually salary but a disguised dividend distribution, it would seem to follow that the recipient will be taxed accordingly. However, where the attack has been made indirectly by alleging that the salary was unreasonable, whether the disallowed excess will be compensation in his hands or a dividend is not clear. There is some indication in the regulations that the taxability of this excess will depend on the circumstances of each case. They state:\textsuperscript{51}

The income tax liability of the recipient in respect of an amount ostensibly paid to him as compensation, but not allowed to be deducted as such by the payor, will depend on the circumstances of each case. Thus, in the case of excessive payments by corporations, if such payments correspond or bear a close relationship to stock holdings, and are found to be a distribution of earnings or profits, the excessive payment will be treated as a dividend... In the absence of evidence to justify other treatment, excessive payments for salaries or other compensation for personal services will be included in the gross income of the recipient.

The regulations seem to make it clear that the Commissioner will treat excessive compensation received by stockholders as dividends if such payments bear a close relationship to stockholdings. Thus, since they are dividends and not compensation in his hands, they will not be taxable to him as ordinary income unless the payment was out of earnings and profits. If there are no earnings and profits to cover these proportional payments, it would necessarily follow that the excessive amounts received would constitute a return of capital.

There is very little authority on how a sole stockholder who received excessive compensation would be taxed. It is to be

\textsuperscript{49} Outlet Clothing Co., supra note 4.
noted, however, that the regulations do not expressly apply unless there are earnings and profits available to render the dividend taxable. Thus, he should be able to prove that the excessive payments are dividends, not compensation and thus non-taxable if there are insufficient earnings and profits to support a 'dividend'. What complicates these matters is that the three year statute of limitations has ordinarily run by the time that the deduction is disallowed to the corporation and held a taxable dividend in the hands of the stockholders. He may find that what has been reported by him as income is really a return of capital because the corporation had insufficient earnings and profits to support a taxable dividend. May he now secure an adjustment? It would appear that he cannot file a claim for refund as the prior tax years are closed by the statute of limitations.

In addition to the fact that the stockholder may find himself taxable on a distribution which was in reality a return of capital, he may find himself in hot water on another score. Where the corporation is insolvent or is rendered insolvent by the payment of an excessive salary, it may be unable to pay the tax deficiency arising from the disallowance. In this case the Commissioner will likely assert transferee liability against the stockholder to the extent of the excessive portion of the salary. Thus, in *Healy v. Commissioner*, the officers received salaries from a closely held corporation in which they were both officers and stockholders. Each was on a cash basis and each reported the salary in the year received. The salaries were subsequently held excessive and deficiencies in income tax were determined against the corporation. The Commissioner also determined that the officers were liable as transferees under Section 811 of the 1939 Code (now section 6501) for the corporation's deficiency. After payment of the liability the officers sought to exclude

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52 In Smith v. Manning, 189 F.2d 845 (3rd Cir. 1951), compensation paid to two daughters of the controlling stockholder was held excessive. The excessive amounts were held to be compensation to the daughters, the court pointing to the fact that the amounts paid by the employer were paid and received as compensation for services. Accord, Poorman v. Commissioner, 131 F.2d 946 (9th Cir. 1942). In these cases, however, the employees were not stockholders and the amounts were held compensation in the face of their contention that the excess represented a gift from the corporation. It is obvious that the court could not hold that they had received dividends.

53 345 U.S. 278 (1952).
from taxable income in the year of receipt such part of the excessive salary as was paid out by the application of the transferee liability, contending that an adjustment should be made in the year of the original receipt of the salary. The court held that under the "claim of right doctrine" the officers realized income in the year of receipt to the full amount and the tax could not be recomputed. The court stated:  

A rule which required that the adjustment be made in the earlier year of receipt instead of the later year of payment would generally be unfavorable to the taxpayer, for the statute of limitations would frequently bar any adjustment of the tax liability for the earlier year.

In the ordinary case, the court's reasoning is proper and would thus appear to provide an advantage for the taxpayer, since he would be entitled to a loss deduction in the year of repayment of the amount that was earlier included in his income. However, as discussed previously, where the corporation had insufficient earnings to support a taxable dividend in the first instance, not being able to recompute his taxes for the prior year leaves the stockholder holding the "bag" which has been considerably lightened by taxes. In addition, a loss deduction in the later year may not materially lessen his taxable income. If he had no taxable income, a loss deduction would be valueless to him. In this situation, however, Section 1341 of the Code may provide some relief if certain conditions are met.

II

RENTS AND ROYALTIES PAID TO STOCKHOLDERS

Rents and royalties are useful devices for siphoning off earnings and profits of a closely held corporation. Corporations which occupy property, title to which is held by shareholders, may pay out a portion of the corporate earnings in the form of rent and royalties and deduct these payments as business expenses. Sec-

54 Id. at 284.
55 If the repaid amount exceeds $3,000, sec. 1341 permits the taxpayer to reduce his tax for the year of repayment by the amount of tax for the previous year which was attributable to the inclusion of this amount. However, if a smaller tax liability results from simply deducting the repaid amount in the year of repayment, the taxpayer must take this deduction. In either event, however, the adjustment is made for the year of repayment. The return for the prior year in which the item was received is not reopened.
tion 162(a)(3) of the 1954 Code allows as a business expense deduction “rentals and other payments required to be made as a condition to the continued use or possession, for the purpose of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity.” This section does not expressly require that rental or royalty payments must be reasonable. However, it has been held that allowable rental payments must meet the test of reasonableness.

Rentals and royalty payments are seldom questioned except where the transaction is between related parties. Because of the close relationship of the landlord-shareholder and tenant-corporation, payments of rents and royalties to a stockholder are usually scrutinized by the Commissioner to determine whether the amounts are reasonable or whether the corporation is paying for property which it does not actually use. Where it is determined that the rental is excessive, the corporation is limited to a deduction in an amount which is considered reasonable for the use of the property.

Originally the traditional test as to whether a given rental or royalty was deductible was whether it was “reasonable” in the light of similar leases in the general areas. However, in Stanley Imerman, the Tax Court seemed to have abandoned this test. In this case a partnership was using property owned by the mother of the partners under a lease which provided for a fixed rental plus a percentage of the gross sales. The original lease was executed in 1938 when sales were low; but the war had increased sales to the point that the rent totaled $33,206.75 in 1941. The Commissioner disallowed $21,206.75 of this amount as a rental deduction on the grounds that only $12,000 constituted a “reasonable” rent. The Tax Court held that the Code does not limit the deduction for rental payments to a reasonable sum and that the only requirement is that the payments actually constitute rent rather than dividends or gifts. The court stated:

56 Greenspon v. Commissioner, 156 F.2d 917 (5th Cir. 1946); Lincoln Electric Co. v. Commissioner, 176 F.2d 815 (6th Cir. 1949), held that reasonableness is inherent in the phrase “ordinary and necessary expenses.”


59 7 T.C. 1030 (1946).

60 Id. at 1037.
Here the . . . [Commissioner] has merely determined that $12,000 constituted 'a reasonable rental on the building' . . . He has made no determination that the amount disallowed was in fact or in character something other than rent. . . . We find nothing which might form a basis for claiming that the renewal of the lease . . ., was not an arm's length transaction or that the payments were of any other nature or character than rents.

Subsequent decisions of the Tax Court have paid lip service to this decision. In Manos Amusements, Inc., rental payments made to the wife of the controlling stockholder of the lessee corporation were disallowed in part on the ground that the lease was less than an arm's-length transaction. The court, citing the Imerman decision, stated:

[W]here rent is paid or incurred as the result of an arm's length transaction and there is no evidence that any part of the payments were in fact gifts or distributions of dividends, . . . [this section] does not limit the deduction for rental to a reasonable amount.

Similarly, in Abe Wender, the court considered the controlling issue to be the arm's-length nature of the transaction and not the reasonableness of the rentals. Here the taxpayer operated a liquor store on premises owned by his mother. The premises were leased at a rental of 5 percent of the gross sales with a minimum guarantee of $200 per month. The rental amounted to $17,000 in 1949. Prior to this lease, the property had been rented for only $125 a month. The Commissioner disallowed payments in excess of $3,600 a year. The court upheld the Commissioner stating that the taxpayer failed to prove that the payments made by him under the lease in excess of $3,600 per year were required to be made as a condition to the continued use of the premises. In other words, the court concluded that the arrangements must have been something less than an arm's-length transaction.

After there has been a determination that the transaction was not at arm's-length, the question necessarily arises as to

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62 Id. at 654.
what is a reasonable allowance under the circumstances. There is an additional question as to the tax status of the disallowed rental in the hands of the shareholder. If the disallowed portion is treated as a rental payment in the hands of the lessor-shareholder, it will be taxed in full to him as ordinary income. At least one case has held that the excessive portion constituted rental income. However, it is generally stated that such excess constitutes a distribution of a dividend to the stockholder. If the excess rental is treated as a distribution of property to the stockholder, and if the corporation does not have sufficient earnings and profits to cover a dividend, the excess amount received by the stockholder would properly constitute a return of capital and not a receipt of rent. However, no cases have been found where the stockholder has had occasion to argue that the excessive rentals were non-taxable to him because the corporation had insufficient earnings and profits to make a taxable distribution.

The approach of the Imerman case appears to be more equitable for a more basic reason. Where there are several stockholders in a corporation and one of them rents property to the corporation in an arm's-length bargained transaction at a rental in excess of normal and usual rental, it seems inequitable that the other stockholders and the corporation should be penalized by denial of a deduction because they have made a bad bargain. It is not clear as to how far the Imerman decision will be extended. If the Tax Court adheres to the philosophy of that case, the deduction in the foregoing illustration would be allowed and would be sustained upon review by the court of appeals. The attitude of the court of appeals in these matters was well stated in Limericks v. Commissioner, as follows:

The substance of the transaction is for the Tax Court to determine upon the appraisal of all the facts, and its decision must be sustained if there is a rational basis for its conclusion.

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64 Greenspun, 7 T.C.M. 509 (1948).
65 Peterson and Pegau Baking Co., 2 B.T.A. 637 (1925); Chicago Shipping and Storage Co., 15 B.T.A. 431 (1929); Tressler v. Commissioner, 206 F.2d 538 (4th Cir. 1953); Roy Champayne, 26 T.C. 634 (1956).
66 165 F.2d 483 (5th Cir. 1948).
67 Id. at 484.
Where there is a sale of property by the corporation to its stockholders followed by a lease-back, a rental deduction will be allowed provided there has been an arm's-length transaction. It is likely, however, that the Commissioner will question the arrangement and attempt to disallow the whole amount of the rents and royalties and treat them as constructive dividends to the stockholders. In many cases the sale and transfer will be disregarded on the ground that the transaction was a sham and a tax avoidance arrangement.

The first of these arrangements involving a sale and lease-back was a transfer on trust. Although corporate leases were not involved the basic principle is the same. In A. A. Skemp, the taxpayer created a trust for his wife and children and transferred to this trust a building that he used in his business. On the same day, the trustee leased the building to the taxpayer at a rental of $500 a month for two years. A deduction of the rental was denied by the Tax Court on the ground that the taxpayer had reserved a leasehold from the transfer and had simply promised to make a monthly gift of $500 to the trust for a period of two years. On appeal, the seventh circuit court of appeals reversed, holding that the transaction gave rise to a real obligation to pay rent and that it would not be presumed that the trustee would breach his fiduciary duty. The attitude of the Tax Court as to this type of arrangement was again expressed in Helen C. Brown. Here partners acquired coal lands and transferred these properties to trustees for the benefit of minor children and then arranged a lease-back of these properties to the partnership in consideration of the payment of rents and royalties. The trust was valid and irrevocable. The Tax Court disallowed a deduction of these payments. The court of appeals reversed on the basis that the Skemp case was controlling. In spite of the fact that the Commissioner has entered his nonacquiescence in the Skemp and Brown cases, the Tax Court now considers them controlling. In John

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69 8 T.C. 415 (1947), rev'd, 168 F.2d 598 (7th Cir. 1948).
70 12 T.C. 1095 (1949).
71 180 F.2d 926 (3d Cir. 1950).
72 Rev. Rul. 54-9, 1954-1 Cum Bull. 20, holds that rental payments when made to a trust to which the settlor has transferred property do not constitute deductible expenses but should be treated as gifts on the theory that such a transaction is in substance a diversion of income within the family group.
T. Potter, the taxpayer created a trust for the benefit of his wife and children and transferred to this trust a patent. In consideration for the use of the patent in his business, he made royalty payments to the trust. Deduction of these amounts was upheld by the Tax Court.

In spite of these trust cases, where the form of the transaction has seemed to be of controlling significance, several corporate cases seem to point in the other direction, perhaps in a much too restrictive degree. In the year following the Skemp case, the Tax Court decided Ingle Coal Corporation. In that case the corporation held a coal mining lease for a period of 20 years under which it was required to pay a royalty of five cents a ton. The corporation was dissolved and the assets including the lease were distributed to the stockholders. Simultaneously the stockholders created a new corporation and transferred this lease to it in consideration for its stock and the assumption of the debts of the old corporation and an additional royalty of five cents a ton on the lease. The stock of the new corporation was issued to the stockholders in the same proportion in which they held stock in the old corporation. The Tax Court held that this was an "integrated transaction" and that no consideration had passed to the taxpayer corporation to support the royalty and that the purported royalty was therefore a distribution of corporate profits and was not deductible from corporate income. On appeal the circuit court affirmed. Similarly, in R. E. L. Finley, two controlling stockholders of a corporation engaged in general construction work transferred their stock in the corporation to their wives. The wives then dissolved the corporation and transferred the assets to themselves. They then formed a partnership to engage in the rental of construction equipment and the taxpayers formed a partnership to engage in general construction work. The latter used the equipment owned by their wives at will without any formal lease arrangement. Rental deduction was denied to the taxpayers for the use of this equipment, the court pointing out among other things the unrestricted

73 27 T.C. 200 (1956).
74 10 T.C. 1199 (1948).
75 174 F.2d 569 (7th Cir. 1949).
76 27 T.C. 413 (1956).
control the taxpayers had over their wives' property. A rental deduction was also denied in *Riverpoint Lace Works*, where two sole stockholders and their wives organized a new corporation and transferred to it for a small consideration the property upon which the taxpayer corporation was doing business. The court, while recognizing the possibility of a valid arrangement, stated:

The transaction between the petitioner and J and G (new corporation) requires careful scrutiny because they were family corporations which could use legal formalities to give a false appearance where substance would be lacking. . . . This arrangement was a sham concocted by the two brothers and their wives on poor advice, for non-business purposes. . . .

The thing that appeared to be detrimental to the taxpayer in this case was the fact that the property sold to the new corporation was worth far more than the selling price. Also, the annual rental was more than 68 percent of the sales price and of the small amount of rent paid under the lease, most of it was borrowed back from the corporation.

Notwithstanding the statement of the court in the *Riverpoint* case that a sale and lease-back arrangement would be recognized where there was a good business purpose, the case of *Armston v. Commissioner*, leaves doubt. Here the corporation purchased expensive heavy equipment to carry on its construction business. It was decided that it was not good business policy for the corporation to have substantially all of its capital and surplus tied up in heavy fixed equipment when funds were needed for the payment of current debts. The equipment was sold to one of the two sole stockholders but with the understanding that the company would lease it back at an agreed rental. The money was borrowed by the stockholder-purchaser from a bank for this purpose. The Tax Court refused to allow any deduction for the rentals on the ground that the sale and lease-back arrangement was without "substance" and that the alleged rentals were actually distributions of corporate profits. The court of appeals

78 Id. at 487.
79 188 F.2d 531 (5th Cir. 1951).
affirmed, laying much stress on the fact that the equipment transferred would not have been sold on the open market with competitive bids and stated:  

[S]ince the company required the use of the equipment for its construction work, no sale of the equipment would have been permitted to an outsider, or anyone who might have dealt at arm's length with the company in the transaction.

If the statement of the court is taken literally, it would appear that all of these sale and lease-back arrangements will fail to secure court sanction. In no case would the corporation sell to outsiders who might charge excessive rentals. According to the court, apparently no others may deal with the corporation in an arm's-length transaction.

If the corporation has a good business purpose for the sale, and all the formalities of a valid sale are adhered to, and the selling price and the rentals are fair and are in line with the amounts that would have been secured in an arm's-length sale or lease to the general public, the courts should recognize the arrangement. Under the present status of the decisions, however, a sale and lease-back between a stockholder and his closely held corporation has little chance of recognition.

III  
Distributions of Property and Bargain Sales and Purchases

When a corporation makes an ordinary distribution in cash to its stockholders, the only question is whether such distribution is from the corporation's "earnings and profits." However, it often happens that a distribution will be made in property in kind. Under the 1939 Code the tax consequences of distributions in kind was uncertain. However, it is now apparently settled under the 1954 Code that the amount of any such distribution to the individual stockholders is the fair market value of the property received. In Commissioner v. Hirshon Trust, decided under the 1939 Code provisions, it was held that a distribution

80 Id. at 533.
83 213 F.2d 523 (2d Cir. 1954).
by a corporation of appreciated property was taxable in full to the stockholders notwithstanding the fact that the corporation did not have earnings and profits equal to the fair market value of the property. The court held that since the earnings and profits exceeded the book value or cost of the property to the corporation, the fair market value of the property distributed was taxable as dividend income. The regulations, however, have modified the Hirshon decision, and provide in effect that such a distribution of appreciated property by a corporation is a dividend only to the extent of the earnings and profits of the corporation at the date of the distribution. The excess of the fair market value of the property distributed in kind over the earnings and profits will be treated as a return of capital and applied in reduction of the basis of the stock.

It often happens that instead of distributing the property in kind, a corporation will sell property to its stockholders for less than fair market value. A transaction of this kind may also result in a "constructive dividend" to the purchasing stockholder or stockholders. The regulations provide:

If property is transferred to a shareholder which is not a corporation for an amount less than its fair market value in a sale or exchange, such shareholder shall be treated as having received a distribution to which section 301 applies. In such case, the amount of the distribution shall be the difference between the amount paid for the property and its fair market value. (Emphasis added).

Thus, under the regulations, any such excess would be a "constructive dividend" in the hands of the stockholders and would be taxed as ordinary income provided there are sufficient earnings and profits to cover the distribution.

The validity of the regulations quoted above was first presented in the case of Frank E. Taplin. In that case a majority stockholder of a corporation purchased from the corporation shares of stock having a fair market value of $162,000 for a consideration of $37,860. The Commissioner assessed a deficiency

84 Proposed U.S. Treas. Reg. see. 1.316(a)(2) and (3) (1955).
86 Supra note 81.
87 12 B.T.A. 1264 (1928).
based upon the difference between the fair market value and the price paid as a dividend received by the shareholder. He relied upon the applicable regulations which provided:88

Where property is sold by a corporation to a shareholder . . . , for an amount substantially less than its fair market value each shareholder . . . shall include in gross income the difference between the amount paid for the property and the amount of its fair market value. (Emphasis added).

The Board of Tax Appeals sustained the Commissioner's determination, holding that the transaction was not a bona fide sale since the parties were not dealing at arm's-length. On appeal, the court of appeals reversed,89 holding that the regulation was without force to impose tax liability on a stockholder of a corporation who merely purchased property from it for an amount substantially less than its fair market value. The court stated that controlling statutes were not broad enough to support the regulation in question. The same result was reached in the subsequent case of Commissioner v. Van Vorst.90 In that case a taxpayer, who owned almost all of the outstanding shares, purchased real estate from the corporation for $54,559.60 which was the cost at which the corporation had purchased the property and carried it on its books. The fair market value at the time of the purchase was $154,559.60. The Commissioner assessed a deficiency relying on the same regulation which the sixth circuit had disapproved in the Taplin case. The court held that the regulation did not control and that the mere interest of the stockholder in the corporation does not convert a bargain purchase into a realization of taxable income. The Commissioner contended that the gross inadequacy of the consideration and the relationship between the parties made what was called a sale in reality a distribution of assets. The court conceded that such a case might arise but stated that this case did not fit that pattern. In spite of this early rebuff, the Commissioner continued to rely on the regulations and his persistence finally bore fruit in Timberlake v. Commissioner.91 There the corporation bought stock in

88 Id. at 1271.
89 41 F.2d 454 (6th Cir. 1930).
90 59 F.2d 677 (9th Cir. 1932).
91 132 F.2d 259 (4th Cir. 1942).
another corporation and subsequently sold this stock to a stockholder for a price substantially less than its fair market value. At the time of the sale the corporation had a large surplus from which dividends could have been declared. The Commissioner again applied his regulations, and this time with success. The court held that the excess of fair market value over the purchase price was taxable income to the stockholder and stated:92

We accept the regulation . . . as a correct interpretation of the statutes since its long continuance and application to frequent reenactments justifies the inference that it has received Congressional approval.

The court further held that the case was controlled by Palmer v. Commissioner,93 where the Supreme Court had stated that a bargain sale may be as effective as a formal declaration of a dividend to stockholders, if in its purpose of effect, it actually brings about a distribution of corporate earnings. The court then held that the Taplin and Van Vorst cases would not be followed and stated:94

It is of no importance that the transfer assumed the form of a sale and that there was no express declaration of a dividend. The substance of the transaction determines its character for purposes of taxation.

Thus, it seems to be settled that the regulation is here to stay. It has been approved and applied in several subsequent cases, where the stockholder has bought property from the corporation at a bargain price.95 It is to be noted that the former requirement that the consideration be "substantially less" than the fair market value of the property has been eliminated from the present regulation. Thus any difference may be subject to taxation. So long as there are corporate earnings sufficient to cover the difference between the fair market value and purchasing price, the stockholder will almost assuredly be held to have realized a constructive dividend. In Stanley Waldheim,96 it was held that the stock-

92 Id. at 261.
93 302 U.S. 63 (1937). This case was decided by the Supreme Court subsequent to the Taplin and Van Vorst decisions.
94 Supra note 91 at 261.
95 Elizabeth Strake Trust, 1 T.C. 1131 (1943); Stanley Waldheim, 25 T.C. 839 (1956), aff'd., 244 F.2d 1 (7th Cir. 1957).
96 Supra note 95.
holder was taxable on the difference between the fair market value and the purchase price even though the corporation had a deficit. The court held that all that was required is that there be earnings and profits in the year of sale sufficient to cover the difference.

Ordinarily, a payment to a stockholder as the purchase price for property is not a corporate distribution. However, by application of the bargain sale principles, it should follow that if a stockholder sells property to his corporation at an inflated price, the excess of the purchase price over fair market value may be taxed as a constructive dividend to him. Even though the authority in this area is limited, the indications are that this will be the result. Such a contention was made by the Commissioner in George Staub.97 There the taxpayers, who were partners, transferred partnership assets to a corporation which they owned for the sum of $90,610.85. The tangible assets consisted of machinery which had a market value of only $29,331.50. The resulting gain of $61,278.85 was reported as a long term capital gain. The Commissioner assessed a deficiency on the theory that this sum was a dividend distribution by the corporation which at the time had considerable earnings and profits. The court held that since there was a transfer of a going business, the good will of such a business justified the full price and refused to sustain the Commissioner. In Jacob M. Kaplan,98 the taxpayer who was the sole owner of all the stock of a corporation sold to the corporation 172 shares of stock which had cost him $1,229,890 in cancellation of his indebtedness to the corporation. It was held by the court that the excess of the purchase price over the fair market value was a dividend to the stockholder. It would appear, therefore, that since all sales to a close corporation will be carefully scrutinized by the Commissioner, care must be exercised to insure that the purchase price approximates the fair market value at the time of sale to avoid receipt of an uninvited dividend.

A corporation may grant to its stockholders an “option” to purchase corporate property at less than its fair market value. These options are usually for the purchase of corporate stock or stock in another corporation. It is apparently settled that tax-

97 20 T.C. 834 (1953).
98 21 T.C. 134 (1953).
able stock rights give rise to income only when exercised or sold.  

The Commissioner following the decision in *Palmer v. Commissioner*, has ruled:

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[T]his office is of opinion that stock right issued . . . are taxable as dividends to the stockholders only when exercised by them. Prior to that time, there has been no distribution by the corporation and the statutory definition of a dividend has not been met.
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The question whether a taxable dividend results from the granting and exercise of an option has arisen in several cases. One of the first cases was *Palmer v. Commissioner*. In that case the corporation which held stock purchase rights in another corporation granted an option to its stockholders to purchase this stock. When granted the market value was equal to the option price. However, when the taxpayer exercised his rights, the market value was far in excess of the option price. The Commissioner ruled that the rights to subscribe were dividends, and assessed a deficiency against petitioner based on their market value on the dates when the taxpayer was first entitled to exercise them. The Tax Court found that there was no intention to distribute corporate earnings and that the transaction was a bona fide sale. The court of appeals reversed. On appeal, the Supreme Court agreed with the Tax Court, holding that it was necessary to show that the transaction was in purpose or effect used as an implement for the distribution of corporate earnings. The court further held that the mere issue of rights to subscribe and their receipt is not a dividend stating:

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Even though the rights have a market or exchange value, they are not dividends in the statutory sense. . . . They are at most options or continuing offers, potential sources of income to the stockholder through sale or the exercise of the rights.
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99 Section 805 (a) of the 1954 Code excludes from gross income distributions from a corporation in its own stock of rights to acquire such stock. It is only when a distribution is (1) made in discharge of preference dividends, or (2) is at the election of any of the shareholders payable in its stock or property (money), that it becomes a taxable distribution.

100 Supra note 93.


102 Supra note 93.

103 Id. at 70.
The controlling factor in the court's determination was that at the time the options were granted the sales price represented their market value. The court held that the transaction was not converted into a dividend by the fact that at a later date when the stock was delivered market value had increased. The court stated:\textsuperscript{104}

Its character is not altered by the fluctuations of a speculative market, after the corporate action which defines the character of the transaction has been taken.

The effect of the \textit{Palmer} case was that if the option price approximated market value at the time it was granted by the corporation, no dividend resulted even though market value was far in excess at the time the option was exercised. In \textit{Choate v. Commissioner},\textsuperscript{105} however, the court ignored value at the time of adoption of the plan. There the corporation issued to its common stockholders "rights" to purchase unissued preferred stock. The taxpayer received 10,000 such rights which had a fair market value of $4,375 at the time of receipt. He then gave his rights to several members of his family who exercised them. The Board of Tax Appeals had held that $4,375, the value of the rights at the time of receipt, was income to the taxpayer. He argued that he was subject to no tax. The court did not agree with either contention holding that it was bound by the \textit{Palmer} case. The court stated:\textsuperscript{106}

The court in the Palmer case makes basic the corporate intention to distribute corporate earnings. We take it that the essential factor is an 'objective', not a 'subjective', intention, i.e., that a substantial 'spread' would be regarded as showing that such an intention existed regardless of what the corporation officers said or did not say.

The court further stated that if the contract is for a sale at its fair market value so that no spread then exists:\textsuperscript{107}

\begin{itemize}
  \item There is no corporate intention to distribute profits, and therefore, no dividend. If, after such a sale, or after such a contract to sell, the market value of the property in-
\end{itemize}

\textsuperscript{104} Id. at 73.
\textsuperscript{105} 129 F.2d 684 (2d Cir. 1942).
\textsuperscript{106} Id. at 686.
\textsuperscript{107} Ibid.
creases, so that a 'spread' beneficial to the stockholders then accrues, that 'spread' is no more taxable than if the purchasers had not been stockholders, for an intention to distribute that 'spread' cannot be imputed to the company.

The court went on to state, however, that if at the time of the sale or at the time the contract was entered into there was a substantial spread favorable to the stockholders that:

[I]t will be considered that there was a corporation intention to distribute that spread, i.e. that a corporate distribution of earnings, and therefore a dividend was intended.

The court held that even if there is a substantial spread when the option is issued, the Palmer case required that any increase in spread between the date of issuance of the options and their exercise is not a dividend, and since there is no distribution until the option is exercised, the taxable dividend cannot exceed the spread which exists when that option is exercised. Thus, the effect of the Choate case was to hold that the exercise of the right produces income measured by the "spread" between the option price and market value, either at the time of issuance or at the time of exercise, whichever is less. Notwithstanding, the Choate case the Commissioner has ruled in effect that if the rights are exercised, the amount to be taken into income as a dividend is the excess of the fair market value of the new stock received over the subscription price. Since the ruling cites the Choate case it may be that the spread referred to means the spread existing at the time of the granting or at the time of exercise of the option.

However, it may well be that the complete spread will be taxable to the stockholder as a dividend. This appears to be the trend in employee stock option cases. In Commissioner v. Smith, the same principal was involved as in Palmer. There the corporation gave an employee, as compensation for his services, an option to purchase from the employer certain stock in another corporation at a price not less than the then value of the stock. However, in 1938, when the option was exercised, the

108 Id. at 687.
109 Supra note 101.
110 324 U.S. 177 (1945).
market value of the stock was greater than the option price. This excess amount was held by the Tax Court to be compensation in the year in which the stock was received. The Supreme Court upheld the Tax Court's finding that the option had no value when granted, but held that the employee realized taxable income in the year in which the stock was acquired, through exercise of the option, in the amount of the difference between the option price and the then market value of the stock. On rehearing, taxpayer contended that he was taxable in 1938 when he exercised the option and not when he received the stock in 1939. There was a substantial increase in value between these years. The Supreme Court again held that he was taxable when the stock was received, not when he made his election and paid the option price. The recent Supreme Court case of Commissioner v. LoBue, has also thrown new light on these stock option cases. Here the corporation granted the employee an option to purchase stock. The Court held that the gain should be measured by the difference between the option price and the market value of the stock at the time the option was exercised and not when the option was granted. The court viewed as unwarranted the distinctions made in earlier cases between "proprietary" and "compensatory" options, where it was held that if an option was "proprietary" in nature, any increment in value between the granting of the option and its exercise was not income. It is believed that the distinction made in the Palmer and Choate decisions as to whether the corporation intended to distribute profits to the stockholders is likewise doomed to have a short life and that any difference in the spread between the date when the option is granted and when it is exercised will be held to be a dividend to the stockholder on the basis of the rationale of the LoBue case.

If the stock rights are not exercised, but sold, the Commissioner has ruled as follows:

[U]pon a sale of the rights ordinary income is realized. 
... It is not believed that the amount of such income is measured by the value of the rights at the time of receipt

111 324 U.S. 695 (1945).
113 Supra note 101.
thereof. In the opinion of this office, the entire amount received upon the sale of the rights is taxable as ordinary income. (Emphasis added).

The ruling cited Gibson v. Commissioner.114 However, it does not appear that Gibson entirely supports the Commissioner. There the rights received by the taxpayer had a value of $12,255 on the date of receipt. She did not exercise the rights, but instead sold them for $13,728.04. The court upheld the Commissioner's determination that $12,255 was a dividend stating:115

Since the option gives a privilege of obtaining income to the extent of the spread between the market value of the stock at the time of issuance of the option and the option price for the stock, the proceeds of sale, at least to this extent, constitute income. (Emphasis added).

In this case the Commissioner raised no objection to treating the excess of $1,473 as a capital gain and the court did not consider this question. However, the court did indicate that the spread at the date of granting the option was income. The foregoing ruling does indicate that in any subsequent cases such excess will not be considered capital gains.116

114 133 F.2d 308 (2d Cir. 1943).
115 Id. at 309.
116 Some relief may be obtained under the provisions of sec. 421 of the 1954 Code. First enacted in 1950, this provision was provided for the purpose of allowing corporations to provide incentives to corporate officers by the sale of stock to them in the corporation. When an option qualifies as a “restricted stock option” under this section, no tax is imposed at the time the option is granted or exercised. Instead the tax is deferred until the stock is sold and at that time if certain conditions are met, any gain realized is a capital gain. The two most important conditions are that: (1) the option price must be at least 85% of the fair market value of the stock at the time the option is granted and (2) such individual must not own stock possessing more than 10 percent of the total combined voting power of all classes of stock of the employer corporation or of its parent or subsidiary. The latter requirement, however, would effectively foreclose its use by many closely held corporations.