

Calendar No. 1208

85TH CONGRESS }
2d Session }

SENATE }

REPORT
No. 1183

CERTAIN RESTRICTED STOCK OPTIONS

JANUARY 23, 1958.—Ordered to be printed

Mr. BYRD, from the Committee on Finance, submitted the following

R E P O R T

[To accompany H. R. 9035]

The Committee on Finance, to whom was referred the bill (H. R. 9035) to amend the Internal Revenue Code of 1954 with respect to the basis of stock acquired by the exercise of restricted stock options after the death of the employee, having considered the same, report favorably thereon without amendment and recommend that the bill do pass.

I. GENERAL STATEMENT

This bill amends the restricted stock option provision of present law. In general, it provides substantially the same treatment where one of these options is held by an employee at the time of his death and is exercised by his estate as is presently available where the option is exercised prior to the employee's death. The bill provides that, where an option is held by an employee at the time of his death, it receives a new basis for purposes of determining gain or loss with respect to the income tax. This new basis reflects the spread between the option price and the value of the stock at the date of death (or optional valuation date). Any amount presently taxable as ordinary income at the time of the sale of the stock by the estate or heir, however, still is to be taxable as such under the bill, and, as under present law, a deduction is to be allowed at the time of the reporting of this income for any estate tax paid with respect to the decedent which is attributable to this income. The principal change made by the bill is that any appreciation in value of the stock in which the option is granted, between the time of the granting of the option and the death of the employee (or optional valuation date), no longer is to result in a taxable gain at the time of the sale of the stock by the estate or heir. The changes made by this bill are effective with respect to employees dying after December 31, 1956, in the case of taxable years ending after that date.

II. REASONS FOR THE BILL

Present law in general terms provides that, where an option granted an employee to buy stock qualifies as a "restricted stock option," tax on any gain to the employee is postponed until the time he sells the stock. If the option price was 95 percent or more of the price of the stock at the time of the granting of the option, any gain realized at the time of the sale of the stock is a capital gain. Where the option price is from 85 to 95 percent of the value of the stock at the date of the grant, any gain, to the extent the option price is less than the price of the stock at the date of the grant, is taxed as ordinary income and any additional gain is treated as capital gain. As in the former case, however, this gain generally is not taxed until the time of the sale of the stock; this is true of both the amount taxed as ordinary income and any amount taxed as capital gain.

Where one of these restricted stock options is exercised by an employee before his death, but the stock is not sold prior to his death, current law provides that any ordinary income element involved in the option (that is, in the case of an 85- to 95-percent option) is to be taxed to the employee in his last income-tax return. Thus, if an option is granted to buy at \$85 stock selling at \$100, the option is exercised, and then the employee dies, \$15 of ordinary income is included in the last income-tax return of the employee. In such a case, however, and also in the case of options where there is no ordinary income element, the stock held at date of death is included in the estate of the employee for purposes of the Federal estate tax and receives a new basis for purposes of realizing gain or loss on subsequent sale in the case of the income tax. This estate-tax treatment and new basis at death is the same as is generally accorded property held at the time of an individual's death. As a result of this treatment, where an option is exercised prior to an employee's death and there is appreciation in value of the stock prior to the employee's death, this amount is not taxed when the stock ultimately is sold. Thus, in the above example, if the price of the stock had risen to \$120 at the time of the employee's death, it would be valued for purposes of the employee's estate at this price, or \$35 above the money outlay for the stock, although \$15 of this would have been taxed as ordinary income in the employee's last return.¹

A quite different treatment applies under present law, however, where the option is exercised by the estate or an heir after the employee's death. In such a case, although under present law the option is included in the employee's estate for estate-tax purposes, no new basis is available for the option at date of death. Instead, at the time of the disposition the basis for any stock which has been so acquired is the amount which was paid for the stock under the terms of the option (plus any amount taxed as ordinary income upon disposition). Any excess over this amount at the time of the sale of the stock is taxed as a capital gain. If the option was one providing a price between 85 and 95 percent of the price of the stock at the date of grant, and, therefore, giving rise to gain taxable as ordinary income, a deduction is allowed against such income for any estate tax which is payable with respect to this amount taxed as ordinary income.

¹ In this and subsequent examples, it is assumed that the estate-tax valuation and the basis of the option are equal to the spread between the option price and the value of the stock at date of death.

However, no new basis is provided as the result of the employee's death for any rise in the value of the option prior to that time which is attributable to appreciation in the value of the stock in the period between the granting of the option and the death of the employee. (Nor is any deduction for estate tax available with respect to any tax eventually paid with respect to this appreciation.) This discrimination against these options exercised after an employee's death can be seen by examining the tax treatment which would be accorded in the example presented above had the option been exercised by the estate immediately after, rather than before, the employee's death. In this case, as in the prior one, \$15 would be reported as ordinary income. A deduction would be allowed for the estate tax attributable to it in lieu of excluding from the estate-tax base the income tax paid on this income. However, with respect to the appreciation in the value of the stock from \$100 to \$120, no increase in basis would be allowed, even though this value is reflected in the value of the option for estate-tax purposes.

It is this failure to provide a new basis at date of the employee's death which is discriminatory in present law in the case of the option not exercised at the date of death. This bill is designed to remove this inequity by providing a new basis for a restricted stock option at the date of the employee's death. This also requires certain other modifications in the restricted stock option provisions which are explained below.

III. EXPLANATION OF BILL

The first section of the bill adds a new subparagraph providing certain basis rules to section 421 (d) (6) of the code, relating to restricted stock options exercised by an estate or heir of a deceased employee. Section 2 repeals subsection (d) of section 1014 of the code, which provides that restricted stock options are not to receive a new basis at the date of an employee's death. And section 3 provides an effective date for the bill.

Subsection (d) of section 1014 of the Internal Revenue Code provides that section 1014 is not to apply in the case of restricted stock options. The repeal of this subsection, which is provided by section 2 of this bill, therefore, means that section 1014 is to be applicable in the case of these restricted stock options. Thus, as is provided by subsection (a) of section 1014, a restricted stock option acquired from a decedent employee, which is exercised, is to have a new basis equal to its value at the date of death of the employee, or, if an election is made under section 2032, its value at its applicable valuation date.

The new subparagraph (C), added to section 421 (d) (6) of the code by the first section of this bill, provides certain basis rules which are to be applicable in the case of stock acquired by the estate or heir with one of these restricted stock options which has received a new basis at the date of the employee's death.

Clause (i) of the new subparagraph (C) indicates that, as a general rule, any share of stock acquired as the result of the exercise of one of these restricted stock options is to include its allocable portion of the basis of the option, as well as the money or other payment for the stock. However, an exception is provided to this general rule. The basis otherwise provided is to be reduced by any excess of the amount which would have been taxable at the time of the employee's

death (had the option been exercised before that time) over the amount actually taxed as ordinary income. This adjustment is necessary to make sure that the overall effect on income is the same whether the option is exercised before or after the employee's death. This exception can, of course, only affect an option granted at 85 to 95 percent of the then existing stock price, since only such options result in the taxing of a portion of the gain at ordinary income rates.

The exception provided in clause (i) can be illustrated as follows: Assume an option is granted to buy at \$85 stock then having a market price of \$100, and that the price of this stock advances to \$120 at the time of the employee's death (or optional valuation date), but declines to \$90 at the time the estate sells the stock acquired with the option. The estate-tax valuation in this case will reflect the spread between the \$85 option price and \$120, the price of the stock at the time of death (or optional valuation date), and will be \$35. The basis for the option will be this same \$35. Thus, when the estate or heir exercises the option to acquire the stock, the basis of the stock becomes \$120, the \$85 of money paid plus the \$35 basis for the option. When the stock is sold for \$90, \$5 becomes taxable as ordinary income, since this is stock subject to the ordinary income-tax treatment provided by section 421 (b) and since the stock is sold for more than the option price. If there were no adjustment provided by clause (i) of the new subparagraph (C), there would also be a capital loss of \$30, the difference between the \$120 basis and the \$90 for which the stock was sold. The adjustment required by clause (i), however, reduces the basis of the share of stock at the time of its disposition by \$10, thereby reducing the capital loss to \$20. The \$10 by which the basis is reduced in this case represents the difference between what was taxed as ordinary income—namely, \$5—and the \$15 which would have been so treated had the option been exercised before death. Thus, there is the same overall effect on income whether the option is exercised before or after the employee's death; in both of the cases presented here the overall effect is a negative effect of \$15. Where the option was exercised after death, there was ordinary income of \$5 and a capital loss of \$20; where it was exercised before death, the ordinary income would be \$15 but the capital loss also would be larger—namely, \$30. The difference in proportions treated as ordinary income or capital loss in these two cases is a necessary result of not determining the amount of ordinary income until the stock is sold where the option is exercised after the employee's death.

Clause (ii) of the new subparagraph (C) is necessary to prevent a double allowance of basis with respect to the same amount. The last sentence of section 421 (b) provides that, in the case of the disposition of a share of stock where the option price is between 85 and 95 percent of the value of the stock, the basis of a share of stock is to be increased by the amount taxed as ordinary income with respect to it. However, with the repeal of subsection (d) of section 1014, that section also may provide a step-up in basis at death with respect to this same amount. This can be illustrated by an option to buy stock at \$85 which, at that time, and subsequently, is worth \$100. In this case the basis of the option would become \$15 at the time of the employee's death, which subsequently would be transferred as basis for the stock along with the \$85 of cash paid for the stock. However, when the stock was sold for \$100, \$15 would be taxed as ordinary income, and

the last sentence of section 421 (b) (without taking into account the new 421 (d) (6) (C) (ii)) would also provide an additional \$15 of basis. This would result in a basis of \$115 for the stock and would provide a capital loss of \$15 where, in reality, no loss occurred.

To prevent this double basis, clause (ii) of the new subparagraph (C) provides that the last sentence of subsection (b) is to apply only to the extent the amount taxable as ordinary income exceeds the basis for the option attributable to the share. Thus, in the above example, the last sentence of subsection (b) will have no effect since the amount taxed as ordinary income (\$15) does not exceed the basis for the option (also \$15). If, however, the value of the stock at the date of death had been \$95 and then subsequently gone back to \$100, the basis for the option would be only \$10 while the amount taxed as ordinary income would be \$15. In this case, section 1014 would give the option, and, subsequently, the stock, a \$10 basis, and the last sentence of section 421 (b), as limited by clause (ii) of the new subparagraph (C), would add another \$5 to the basis. This \$15 of basis plus the \$85 of basis for the money paid for the stock provides a total basis of \$100, which is equal to the selling price for the stock.

Section 2 of the bill, which repeals subsection (d) of section 1014, has been explained above.

Section 3 of the bill provides that the amendments made by this bill are to apply to taxable years beginning after December 31, 1953, but only with respect to employees dying after that date. The amendments made by the bill are associated with the date of the death of the employee since they are concerned primarily with a new basis for an option upon the employee's death.

It is expected that this bill will result in a negligible revenue loss.

CHANGES IN EXISTING LAW

In compliance with subsection (4) of rule XXIX of the Standing Rules of the Senate, changes in existing law made by the bill, as reported, are shown as follows (existing law proposed to be omitted is enclosed in black brackets, new matter is printed in *italic*, existing law in which no change is proposed is shown in roman):

INTERNAL REVENUE CODE OF 1954

SEC. 421 EMPLOYEE STOCK OPTIONS.

(a) TREATMENT OF RESTRICTED STOCK OPTIONS.—* * *

(d) DEFINITIONS.—For purposes of this section—

(1) * * *

(c) EXERCISE BY ESTATE.—

(A) IN GENERAL.—If a restricted stock option is exercised subsequent to the death of the employee by the estate of the decedent, or by a person who acquired the right to exercise such option by bequest or inheritance or by reason of the death of the decedent, the provisions of this section shall apply to the same extent as if the option had been exercised by the decedent, except that—

(i) the holding period and employment requirements of subsection (a) shall not apply, and

(ii) any transfer by the estate of stock acquired shall be considered a disposition of such stock for purposes of subsection (b).

(B) DEDUCTION FOR ESTATE TAX.—If an amount is required to be included under subsection (b) in gross income of the estate of the deceased employee or of a person described in subparagraph (A), there shall be allowed to the estate or such person a deduction with respect to the estate tax attributable to the inclusion in the taxable estate of the deceased employee of the net value for estate tax purposes of the restricted stock option. For this purpose, the deduction shall be determined under section 691 (c) as if the option acquired from the deceased employee were an item of gross income in respect of the decedent under section 691 and as if the amount includible in gross income under subsection (b) of this section were an amount included in gross income under section 691 in respect of such item of gross income.

(C) BASIS OF SHARES ACQUIRED.—*In the case of a share of stock acquired by the exercise of an option to which subparagraph (A) applies—*

(i) the basis of such share shall include so much of the basis of the option as is attributable to such share; except that the basis of such share shall be reduced by the excess (if any) of the amount, which would have been includible in gross income under subsection (b) if the employee had exercised the option and held such share at the time of his death, over the amount which is includible in gross income under subsection (b); and

(ii) the last sentence of subsection (b) shall apply only to the extent that the amount includible in gross income under such subsection exceeds so much of the basis of the option as is attributable to such share.

* * * * *

SEC. 1014. BASIS OF PROPERTY ACQUIRED FROM A DECEDENT.

(a) IN GENERAL.—Except as otherwise provided in this section, the basis of property in the hands of a person acquiring the property from a decedent or to whom the property passed from a decedent shall, if not sold, exchanged, or otherwise disposed of before the decedent's death by such person, be the fair market value of the property at the date of the decedent's death, or, in the case of an election under either section 2032 or section 811 (j) of the Internal Revenue Code of 1939 where the decedent died after October 21, 1942, its value at the applicable valuation date prescribed by those sections.

* * * * *

[(d) EMPLOYEE STOCK OPTIONS.—This section shall not apply to restricted stock options described in section 421 which the employee has not exercised at death.]