ROBERTS & HOLLAND LLP

December 21, 2017

Stock Option Exercise Leading to Capital Loss: *Hann v. United States*

By: *David E. Kahen*

Though (as of this writing) the United States appears to be on the verge of substantial changes to its income tax, certain basic rules that have been reflected in the Internal Revenue Code for many years appear likely to survive. One of those rules is that a loss from the sale or exchange of a capital asset cannot be used to offset ordinary income, apart from a *de minimis* amount of not more than $3,000 for individuals (IRC § 1211(b)). Further, the circumstance that income and loss attributable to the acquisition and disposition of a capital asset (such as stock) arise out of what may appear to be, from a business person's perspective, a single overall transaction, does not necessarily prevent a taxpayer from being in the unfortunate situation of recognizing (i) ordinary income and (ii) a capital loss that cannot be offset against such income.

A common example of such a mismatch of character of income and loss involves the exercise of compensatory stock options and immediate sale of the stock so acquired. The potential for both ordinary income and capital loss in such situations is illustrated by the recent Court of Federal Claims decision in *Hann v United States* (133 Fed. Cl. 559 (2017)), discussed below.

David E. Kahen *is a partner in the law firm of Roberts & Holland LLP.*

Facts in *Hann*

Gregory Alan Hann (Hann or the plaintiff) was Executive Vice President and Chief Financial Officer of Wesco Aircraft (Wesco). In 2009, Hann received, in connection with his employment, options to purchase common stock of Wesco, which was a privately held corporation at that time.

A prospectus for an initial public offering (IPO) was filed with the Securities and Exchange Commission in July of 2011 (the year at issue) providing for the sale of stock by the two primary stockholders of Wesco. The company advised its employees that they could exercise their stock options (to the extent then exercisable) and sell the stock so purchased in the IPO. However, each employee who participated in the IPO in this manner would have to pay or bear an underwriter's discount or commission.

At the time of the IPO, Hann's options related to 356,558 shares and his exercise price was $6.293333 per share. The public offering price was $15 per share.

Hann was not required to exercise his options and sell stock in the IPO. He could refrain from exercising his options at that time, or could exercise but not sell the stock so acquired. Under a lock-up agreement, however, Hann was precluded from selling shares of stock of Wesco during a lock-up period of 180 days after the IPO, other than through the IPO.

Hann decided to exercise some of his options and to sell the shares so purchased in the IPO. Under a so-called "cashless exercise" procedure, Hann signed various documents that authorized exercise of his options, the immediate sale of stock so purchased to the lead underwriters, and the withholding from the sale proceeds of the exercise price.

The opinion states that Hann sold the stock so acquired to the underwriters for $14.1375 per share, equal to the public offering price minus the underwriter's commission of $0.8625 per share. (It is not entirely clear whether the underwriters purchased his shares as principal, or acted as agent in facilitating the sale of his shares in the IPO.) The gross proceeds from the sale of the 89,139 shares Hann purchased under the options was $1,337,085, and he received and retained that amount minus the sum of the associated option exercise price ($560,981) and underwriter's commission ($76,882).

Wesco issued to Hann a Form W-2 for 2011 that reported ordinary income from the IPO of $776,104, being the excess of the fair market value of the shares he acquired pursuant to exercise of the options based on the public offering price (89,139 * $15 = $1,337,085) over the option exercise price (see IRC § 83(a)), and his 2011 tax return was timely filed reflecting that amount as ordinary income.

Upon the exercise of a compensatory stock option, the basis of the person exercising the option in the stock so acquired is, generally, the sum of the exercise price paid for the stock and the amount included in gross income by reason of exercise (Reg. § 1.61-2(d)(2)(i)). Accordingly, the basis for the stock purchased by Hann was the sum of the option exercise price of $560,981 and the $776,103 included in income, or $1,337,085. The stock was sold by Hann for an amount realized of $14.1375 per share, or $1,260,203. Consistent with these calculations, Hann's 2011 tax return also reported a short-term capital loss of $76,882.

Hann filed an amended tax return on April 19, 2012, that treated the underwriters' commission as a reduction of gross income from the exercise of the option, and sought a tax refund on that basis. The IRS denied the claim for refund and Hann timely filed suit in the Court of Federal Claims. Cross-motions for summary judgment were made by the parties.

Analysis

Hann (appearing pro se) made four arguments. The first was that the transaction was a single step: the disposition of stock options and the receipt of cash. The court disagreed, noting that, in order to participate in the IPO, Hann was required to submit an exercise notice in order to acquire the shares to be sold in the IPO. He therefore must be viewed as having exercised options to purchase stock and then as having sold the stock. The fact that he had to acquire legal ownership of the shares in order to sell the shares meant that the option exercise and stock sale must be given effect as a two-step transaction notwithstanding the short duration of his stock ownership.

Hann also argued that the underwriters' commission was a cost of exercising the options and therefore should be subtracted in determining the income from the option exercise. The court disagreed, noting that Hann could have exercised options and retained the stock, in which case the underwriters' commission would not have been incurred by him.

The plaintiff further argued that the underwriters' commission was an ordinary and necessary business expense incurred in connection with his trade or business as an executive of Wesco, and therefore deductible under IRC section 162(a). The court agreed that Hann could be in a trade or business by reason of his employment, but concluded that the sale of stock was not part of that business and was separate from his status as an employee. Since there was also no evidence that Hann was in the business of selling securities, the underwriters' commission was not deductible under section 162 and was properly treated as a cost reducing his amount realized from the sale of stock (see Reg. § 1.263(a)-1(e)(1)), which in turn resulted in a capital loss.

The court also dismissed the substance over form argument made by Hann to the effect that, because the commission was incurred in a transaction undertaken to generate ordinary income (from the exercise of options), the commission should be viewed as incurred in connection with the option exercise and the form of the transactions disregarded. The court appeared to conclude that the form of the transactions was consistent with the substance, noting that Hann chose both to exercise his options and to participate in the IPO, and that it was therefore appropriate to treat the commission as an expense incurred to sell his stock.

Observations

The court's analysis and conclusions are straightforward and unsurprising. As indicated above, a capital loss often arises where there is an immediate sale of stock acquired pursuant to the exercise of a compensatory option, by reason of a change in value, transaction costs, or other circumstances. Perhaps unusual in this case were (i) the magnitude of the loss, attributable to the transaction cost being an underwriters' commission rather than a (typically much smaller) broker's commission, and (ii) the taxpayer's decision to contest the tax result of a capital loss that could not be offset against ordinary income.

In some contexts (though not necessarily in the IPO transaction relating to this case), there may be some flexibility as to whether compensatory options held by employees and other service providers will be exercised as part of the overall transaction (with the purchased shares being sold) or surrendered for cash, or as to whether options are exercised at the time of the larger transaction or significantly earlier (and at a time when the value of the underlying stock may be lower). Such alternatives, where available, may produce a better result in minimizing the potential for a capital loss.

Reprinted with permission from the December 21, 2017 edition of the *New York Law Journal* © 2017 ALM Media Properties, LLC. All rights reserved. Further duplication without permission is prohibited. ALMReprints.com 877-257-3382 – reprints@alm.com.