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By PwC Deutschland | 28 September 2011

No income from stock option exercise if disposal of shares legally impossible

The Supreme Tax Court has held that the issue of shares at a reduced price is not a taxable benefit if the acquirer is legally unable to dispose of them.

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An employee of a GmbH exercised his rights under a stock option plan to acquire shares in the US parent company. The shares were quoted on the New York stock exchange, although the shares in question were "restricted" under SEC rules to the extent that they could not be sold or pledged during the first year following the acquisition and could only be disposed of during the second year if the issuing company published the fact. The tax office, however, felt these restrictions on disposal to be irrelevant; the employee had acquired the other rights of ownership (dividend and voting) and had thus received taxable income in the amount of the difference between the payment made and the market price of the shares when issued.

The Supreme Tax Court has now followed previous cases in holding that the income from the exercise of a stock option is generally earned on receipt of the shares. Legal restrictions on disposal do not detract from this if their breach would merely expose the seller to a penalty. However, they are relevant where they prevent the disposal altogether. For example, if a disposal is conditional on the approval of the company, it may not be legally possible without that approval. This is a matter of fact, to be adduced from the law and regulations to which the issuing company is subject. If the shares are not disposable in this sense, the full rights of ownership have not been acquired through the option exercise and the option discount has not yet been earned as income. The court then went on to elaborate that if the disposal were dependent upon the company’s approval, the acquisition could be seen as complete if the approval had already been given. If, however, the approval had not yet been given, the acquisition should be seen as being in suspense; if it had already been refused, the acquisition was not, itself, a valid transfer of full ownership rights and thus not a valid flow of taxable income.

Supreme Tax Court judgment VI R 37/09 of June 30, 2011 published on September 21, 2011.

Keywords

disposal, exercise, stock options