

Restricted Stock and Corporate Transactions: What, Me Worry?

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M&A TAX REPORT readers are familiar with Internal Revenue Code Section (“Code Sec.”) 83 governing transfers made in connection with the performance of services. The most common property transferred under Code Sec. 83 is stock.

The timing and amount of income recognition on receipt of restricted property depend on whether an 83(b) election is made. In the absence of an 83(b) election, the recipient is not deemed to be the owner of the property for federal income tax purposes until the restrictions lapse.

This is so despite the fact that, in many cases, restricted stock will have equal voting power and equal dividend rights to unrestricted stock. The vaunted 83(b) election, of course, has the effect of accelerating the income, treating the recipient as the owner of the property upon the transfer. Where the recipient makes an 83(b) election, notwithstanding the restrictions, the exchange is taxed on the date the property is transferred, rather than on the day the restrictions lapse.

One effect of the election is on the recipient’s basis. His basis will then equal the fair market value of the property on the date of transfer. Significantly, the recipient will then take a holding period commencing on the date of the transfer.

The decision whether to make an 83(b) election involves some degree of crystal ball-gazing. In some ways, the recipient takes risks in make an 83(b) election. If the stock appreciates, the election will defer income recognition on the appreciation until the stock is eventually sold. Plus, the election has the effect of changing the character of the income recognition from ordinary to capital. That makes the 83(b) election well worth considering. Yet, there is often fear that electing current taxation will be a mistake.

Nevertheless, if you transfer stock subject to restrictions to an employee and fail to mention the availability of an 83(b) election, you will likely have an unhappy camper. If you’re a lawyer or accountant giving advice in such a situation, it can be malpractice to fail to discuss the availability of an 83(b) election.

Corporate Transactions

In the context of corporate transactions, Code Sec. 83 can be considerably more puzzling. Consider the continuity of proprietary interest concept. That fundamental doctrine requires target shareholders to receive significant qualifying consideration in the acquiring corporation in a reorganization.

Yet, is restricted stock (when it is not the subject of an 83(b) election) counted? The IRS has indicated some ambivalence about restricted stock in determining continuity of proprietary interest. [See T.D. 9225, 2005-2 CB 716.]

Recent Authority

Rev. Rul. 2007-49, IRB 2007-31, 237, considers three circumstances under Code Sec. 83. Each situation deals with the interaction between Code Sec. 83 and other transactional rules. In the first situation, a private equity group makes an investment in a target, with the proviso that management shareholders agree to the imposition of restrictions on their shares, such that the shares become substantially nonvested. The ruling says that subjecting unrestricted stock to later restrictions does not amount to a “transfer” of property. Code Sec. 83 applies to *transfers* of property, so it does not apply to this imposition of restrictions.

In the second situation in Rev. Rul. 2007-49, a private equity group (or other buyer) acquires a target in a fully taxable purchase. In exchange for fully vested shares (having a basis of \$10), a target executive receives restricted shares worth \$100. Other nonemployee shareholders in the deal receive fully vested shares. The restrictions on the executive’s shares call for repurchase by the company if the executive’s employment is terminated for any reason within three years. The formula buyback price is the lesser of \$100 or the fair market value of the stock on the date of the buyback.

We’re told that the executive completes his three-year term, and the restrictions lapse when the shares are worth \$200. Two years after vesting, he leaves the company, selling

his shares for \$400. How does Code Sec. 83 apply to this set of facts?

There's no question that these shares were issued in connection with the performance of services. Even though the executive received the same consideration as nonemployee shareholders. Consequently, each shareholder who makes this swap—including the executive who receives the restricted shares—has a capital gain on the exchange of \$90.

When the restrictions lapse, the executive has compensation income under Code Sec. 83 equal to the difference between the value of the shares on vesting (\$200) and the value of the target shares he relinquished in return for the restricted shares (\$100). That means he recognizes compensation income of \$100 when the restrictions lapse. Two years later when he sells the shares, the executive has a capital gain equal to the difference between the sale price (\$400) and his basis in the shares (\$200).

Code Sec. 83(b) Election Downsides?

What if the executive in this example had made an 83(b) election? Plainly, this would have turned out much better. The value of the restricted stock (\$100) was equal to the amount paid for it. This is an example of the zero-income 83(b) election, which is nearly always a good idea. The zero-income 83(b) election was made famous by the infamous case of *L.J. Alves, CA-9, 84-2 USTC ¶9546, 734 F2d 478 (1984)*.

By filing an 83(b) election, the executive would have recognized *no* income at vesting. That means he would have a capital gain of \$300 when he disposed of the shares.

What if the stock had depreciated in value rather than gone up? If the executive had made an 83(b) election, it would not have hurt him here.

Third Situation

The third situation considered in Rev. Rul. 2007-49 concerns the same facts, but with a tax-free rather than taxable transaction. Assume that the transaction was a merger or other tax-free transaction, and that the executive received his restricted shares worth \$100 and made a Code Sec. 83(b) election. What result?

The ruling says that this transfer, too, was made in connection with the performance of services, so Code Sec. 83 applies. However,

here, there is no gain on the exchange (\$100 given, \$100 received). If he makes an 83(b) election, that also does not result in gain recognition. The fair market value of the restricted shares on the date of transfer (\$100) equals the amount paid (the shares given up were also worth \$100).

On the ultimate sale of the shares, the executive receives capital gain treatment on the entire amount. Notably, though, his basis in the stock is not stepped up to the fair market value owing to the Code Sec. 83(b) election. Instead, it remains at \$10, the historical basis in the shares that originally went into the reorganization.

Conclusion

In some respects, Rev. Rul. 2007-49 is unexceptional. It should not be a surprise that putting restrictions on already fully vested shares does not trigger Code Sec. 83. It should also not be a surprise that an exchange of unrestricted shares for restricted shares can trigger Code Sec. 83, and this is true whether the transaction is a taxable one or qualifies as a tax-free reorganization. While not a surprise, this is worth underscoring.

Beyond this, the ruling makes crystal clear (if it wasn't already) that making an 83(b) election is usually the right thing to do in such a case. If it is a tax-free transaction, the transferring shareholder will have a carryover basis in the newly received restricted stock. That means the shareholder's basis in the shares will not be stepped up to fair market value. Still, the 83(b) election in the tax-free transaction makes sense. Likewise, in a taxable transaction, the 83(b) election also yields a better result.

Does restricted stock count as stock for purposes of determining whether the tax-free reorganization clears continuity of interest and other requirements? Presumably yes, though Rev. Rul. 2007-49 does not address this. Certainly there's a better case for counting restricted stock for all purposes if the stock has been the subject of an 83(b) election. [See LTR 9712029 (Dec. 23, 1996).] That may be one of the best messages of Rev. Rul. 2007-49, that 83(b) elections not only (usually) benefit the recipient worker, but in tax-free deals, can potentially benefit all participants too.