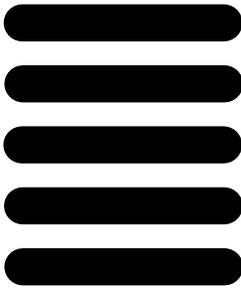




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Code Sec. 83(b) Elections: The Good, the Bad and the Ugly

By Robert W. Wood • Wood & Porter • San Francisco

M&A TAX REPORT readers are no doubt used to thinking that Code Sec. 83(b) elections are generally good. That makes sense. Code Sec. 83 provides the rules under which workers (whether employees or independent contractors) are taxed on property transferred in connection with the performance of services. Code Sec. 83 is therefore one of the key provisions governing stock options, restricted stock and various other property transfers in a work setting.

Perhaps the hallmark of Code Sec. 83 is that one should not be taxed on something until restrictions on the item lapse. Thus, if an executive receives a stock bonus subject to a number of conditions that will lapse in three years, Code Sec. 83 generally provides that the stock will not be treated as transferred for income tax purposes until those restrictions lapse three years from now.

To be sure, Code Sec. 83 is more complicated than this, and there are exceptions, notably for “non-lapse restrictions,” meaning that the restrictions will *never* lapse. However, in common parlance, many nontax people know that Code Sec. 83 governs the income tax treatment of property (including stock) transferred in connection with the performance of services. They also know that Code Sec. 83(b) allows them to make an election for *current* taxation, notwithstanding the imposition of restrictions.

Why Elect?

In the above example, therefore, the executive receiving the stock bonus subject to the three-year vesting condition could elect current taxation of the stock bonus, even though the restrictions remain in place for another three years. Why would someone do this? The Code Sec. 83(b) election is desirable where the worker thinks he or she will ultimately satisfy the conditions (in this example, the three-year vesting), and where the worker thinks the tax play is better electing to recognize the

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income now. That may sound counterintuitive, since far and away the major tax planning goal we all have is to push our tax obligations off into the future wherever possible.

The Code Sec. 83(b) election, however, accomplishes two goals. Since property transferred in connection with the performance of services is ordinary income, and for employees would be wages subject to employment taxes to boot, it might on first blush seem unreasonable to make a Code Sec. 83(b) election. Yet, there are often two distinct advantages of doing so.

First, by making the election, you in effect cap the ordinary income (and wage) portion of the gain you expect to realize. If you feel you are going to meet the vesting criteria that would result in your being taxed later, and that the value of the property you are receiving will go up, electing earlier taxation *via* a Code Sec. 83(b) election will result in the later

appreciation being taxed as a capital gain. You pay ordinary income (and potentially wage) taxes now, in order to get that flexibility and rate advantage later.

Second, you also alter timing. If you do not make a Code Sec. 83(b) election and instead simply allow Code Sec. 83 to tax you when the restrictions lapse (after three years in the above example), you will be taxed (as ordinary income and wages as applicable) when the restrictions lapse. In contrast, if you elect under Code Sec. 83(b) to be taxed now, there will be no tax event when the restrictions lapse. The only remaining tax event will be when you ultimately sell the property.

If you meet the three-year vesting hurdle, hold onto your shares, and sell them in year six, what is the tax result? If you have filed a Code Sec. 83(b) election:

- you are taxed on the value of the shares in year one when you received them (notwithstanding the restrictions);
- you have no tax event in year three when the restrictions lapse; and
- you have capital gain in year six when you sell the shares.

The Bad and the Ugly

All this seems straightforward, but what can go awry? For one thing, the Code Sec. 83(b) election may mean that you pay some tax that you would not normally pay. Suppose that even though you *expect* to meet the three-year threshold, and therefore make a Code Sec. 83(b) election to be taxed on the grant of the shares in year one, you unexpectedly leave the company or are fired in year two. What result?

If you make the election but end up not meeting the three-year vesting requirement so forfeit the property, you get no deduction for the forfeiture. [Code Sec. 83(b)(1).] If that seems harsh, the IRS answer seems to be that it's too bad—you shouldn't have elected to include the income in the first place. There may be some consolation in the fact that you do get a deduction for out-of-pocket losses you incur by reason of the forfeiture. Thus, you get a deduction if the amount paid for the property is not fully restored on the forfeiture.

Example. Suppose you paid \$100 for the property, filed a Code Sec. 83(b) election and reported \$1,000 of income. You then



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forfeit the property receiving no cash back. Here, you get to deduct \$100, but only as a capital loss. [Reg §1.83-2(a); *see also* LTR 8025127 (Mar. 28, 1980).] If on forfeiture you got back the \$100 you paid, you receive no tax deduction.

“No Income” Elections

In deciding whether to make a Code Sec. 83(b) election, it is worth noting the “no income” election. Not too many years ago, more than a few recipients of options and restricted stock did not make elections if they paid what they thought was the fair market value of the stock. That would seem to make sense, for if you pay fair market value, how could it be a compensatory payment?

Yet, suppose you are offered stock in your employer that you would not otherwise have been offered but for your employment (or consulting work)? Also suppose that you pay for the stock what is meant to be fair market value, say a dollar a share. Let’s assume this is a private company. Your position might be that you bought the shares for fair market value, and that Code Sec. 83 is not implicated at all.

Watch out! The IRS view will be that your shares were transferred in connection with the performance of services, even if you paid fair market value for the shares. The point will be obvious if the shares are subject to restrictions, such as resale restrictions (which will typically occur in a private company context). If you make a Code Sec. 83(b) election, you probably would state that you have paid fair market value for the shares, and that therefore you are electing to include that value (\$0) in income.

Reporting Zero

Does such a zero-income Code Sec. 83(b) election work? Yes, it does. In fact, an ugly situation arises if you could make such an election and don’t. Consider the case of *L.J. Alves*, CA-9, 84-2 USTC ¶9546, 734 F2d 478 (1984).

There, the Tax Court and Ninth Circuit Court of Appeals recognized that Alves paid what was indisputably fair market value for the shares. Therefore, it might seem logical that he could simply report the sale many years later as a capital gain. Nevertheless, the Tax Court and Ninth Circuit both held that Alves was stuck with ordinary income. Why? The IRS and

the courts viewed the shares as transferred in connection with the performance of services.

Thus, even though there was no “bargain element,” Alves would not have been offered the shares were it not for his position with the company. The fact that Alves failed to make a Code Sec. 83(b) election meant that his shares were still ordinary income property when he sold them all those years later. Ouch!

Code Sec. 83 itself, and particularly the Code Sec. 83(b) election, contain nuances, not the least of which is that one is required to do some amount of crystal ball gazing.

AMT Problems Too

I was reminded of all of this by the recent Ninth Circuit case of *A.J. Kadillak*, 127 TC 184, Dec. 56,670 (2006), *aff’d*, CA-9, 2008-2 USTC ¶50,462. This case involved incentive stock options. As M&A TAX REPORT readers know, when you receive an ISO, you don’t have income.

Likewise, when you exercise an ISO, you still don’t have income (at least for regular tax purposes). You do have income for AMT purposes. The benefit of an ISO is that, since you don’t have regular income tax on exercise, you would pay capital gain tax much later, only when you dispose of the shares. The real rub for ISOs is therefore the AMT.

Many a taxpayer has been hoodwinked by this problem. The problem grew exponentially larger during the dot.com era, when many ISOs were exercised and shares were increasing enormously in value, only to plunge thereafter. More than a few taxpayers still have large tax liabilities extant based solely on AMT liability, where the shares became worthless in subsequent years.

How does this relate to Code Sec. 83? Under Code Sec. 83, if stock is substantially vested on exercise, the amount of the bargain element of the option is generally included in

alternative minimum taxable income for the year in which the exercise occurs. Of course, as we've just seen, Code Sec. 83(b) allows an election to recognize the income early, that is, in the year the substantially nonvested stock is received, notwithstanding the existence of forfeiture restrictions.

In *Kadillak*, the Tax Court held that a Code Sec. 83(b) election for nonvested stock acquired pursuant to the exercise of ISOs was valid. Moreover, the Tax Court held that the taxpayer recognized alternative minimum taxable income to the extent the fair market value of the underlying shares on the date the taxpayer exercised the ISOs exceeded the option price. But, I'm getting ahead of our story.

No Cadillac for Kadillak

Mr. Kadillak received ISOs from Ariba Technologies. The options were subject to a restriction on employment termination, under which Ariba could repurchase nonvested stock at the exercise price. On April 5, 2000, Kadillak exercised his ISOs. He received his vested stock; his nonvested stock was placed in escrow, transferred to him out of escrow *seriatim* as the shares vested monthly over the next four years. He could receive all regular cash dividends on the nonvested shares even though they were held in escrow. In May 2000, Kadillak timely filed a Code Sec. 83(b) election for the exercised ISOs.

About a year later, Kadillak's employment with Ariba was terminated, and Ariba repurchased the shares. Although in 2000 Kadillak had elected to realize AMT income of nearly \$680,000 on the shares, he wound up reselling the shares to Ariba, forfeiting them at his 2001 cost. He realized no regular capital gain or loss, but solely an AMT capital loss of the same \$680,000.

Kadillak filed his 2000 and 2001 federal income tax returns assuming that his 83(b) election was valid. Thus, he reported no regular taxable income for the shares in 2000, but an AMT capital gain in 2000 of \$3,263,000 on all of the shares (both vested and nonvested). He reported AMT of \$932,309, and a total tax liability of \$1,099,388. Interestingly, although he reported a total tax liability of over \$1 million, he paid only \$25,000 with his return, showing a whopping balance due of \$963,597.

Bad Luck

For 2001, Kadillak forfeited his nonvested shares. At tax return time, he reported no gain or loss on the forfeiture in 2001 (for either regular tax or AMT purposes). Although he realized an AMT capital loss on the forfeiture, he claimed no deduction because the loss was attributable in part to his Code Sec. 83(b) election. Kadillak reported zero tax liability for 2001, and despite his more than \$900,000 outstanding liability for 2000, he requested a refund of \$12,720 for 2001.

In 2002, Kadillak sold his remaining vested shares to a third party. For regular tax purposes, he had a \$60,000 capital gain. For AMT purposes, given the upward basis adjustment by the realized AMT income in 2000, he had an AMT capital loss of over \$2,500,000 on the sale.

Kadillak later amended his 2000 and 2001 returns, claiming he wasn't subject to AMT because the Code Sec. 83(b) election was invalid. He also claimed that his capital loss limitations did not apply for AMT purposes. He claimed he could use his 2002 capital loss to reduce his AMT income in 2000. Predictably, the IRS rejected these arguments, and Kadillak went to Tax Court.

Full Court Press

The Tax Court found Kadillak's Code Sec. 83(b) election to be valid and dismissed all of Kadillak's arguments. The court also rejected the notion that he could offset or carry back his alternative minimum tax net operating losses from 2002 to 2000. Kadillak also argued Code Sec. 1341 and the claim of right doctrine and, predictably, lost. (For recent claim of right discussions, see *Wood, More Claim of Right Authority*, M&A TAX REP., Aug. 2008, at 1; and *Wood, Cleaning up Environmental (and Other) Cleanup Expenses via Claim of Right?* M&A TAX REP., Feb. 2008, at 4.)

In the Ninth Circuit, Kadillak again argued that his Code Sec. 83(b) election was invalid. Kadillak had some interesting arguments, primarily revolving around the question of what constitutes a transfer of property. Essentially, he argued that his Code Sec. 83(b) election was invalid as to the unvested shares, because they had not been legally transferred to him.

Yet, beneficial ownership and the fateful Code Sec. 83(b) election were enough, as it turned out. Indeed, the Ninth Circuit held that the *very purpose* of a Code Sec. 83(b) election was to realize income on assets that otherwise would not be included in income under Code Sec. 83 due to a substantial risk of forfeiture.

Conclusion and ISOs

Code Sec. 83 basics are not difficult. That is true about Code Sec. 83(b) elections as well. Yet, Code Sec. 83 itself, and particularly the Code Sec. 83(b) election, contain nuances, not the least of which is that one is required to do some amount of crystal ball gazing. That is always tough.

Speaking of ISOs, IRS Commissioner Shulman recently wrote Congress that the IRS would not undertake collection enforcement actions on cases involving AMT liability resulting from the exercise of ISOs. The commitment was only to the end of the IRS's September 30 current fiscal year. Ostensibly, it's to give Congress time to enact legislation to fix the AMT. H.R. 3961, the AMT Credit Fairness and Relief Act of 2007, and its companion bill S. 2389, would accelerate AMT credit and make various other changes.

Code Sec. 83 elections can be good or bad. When you add AMT considerations into the mix, it can get ugly.