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Restricted Stock Comes of Age

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Reports suggest that corporate America's love affair with stock options has passed. THE WALL STREET JOURNAL even asked if it was the *Last Gasp for Stock Options?* [Aug. 27, 2013, at B4.] Sure, some companies still award options, either nonqualified options, ISOs or both. Yet they do not do so with the broad brush of the past. In large part, options have been replaced by restricted stock.

Curiously, the basics of restricted stock haven't changed much over the years. With a few quirks, the area is governed by fundamental tax concepts, including constructive receipt, fair market value and the risk of forfeiture. The tax rules are described in Internal Revenue Code Section ("Code Sec.") 83.

Restricted stock might be purchased or bonused but is subject to Code Sec. 83. The hallmark of Code Sec. 83 is that one should not be taxed on something until restrictions on the item lapse.

Value and Vesting

The classic fact pattern involves an employee who receives a stock bonus subject to a number of conditions that will lapse in a stated number of years. Code Sec. 83 generally provides that the stock will not be treated as transferred for income tax purposes until those restrictions lapse upon the expiration of the term of years. There are exceptions to this general rule, notably for "nonlapse restrictions."

A nonlapse restriction means that the restrictions will *never* lapse. In such a case, it would be unreasonable to delay taxes on the transfer forever. This is straightforward, but the rules can be surprisingly confusing, in part because they are often paired with the rules governing stock options.

If a worker receives stock or other property subject to restrictions and those restrictions will lapse with time, the IRS waits to see what happens before taxing it.

Example. As a carrot to stay with the company, Sam's employer agrees that if he remains with the company for 36 months, he will be awarded $50,000 worth of stock. Sam does not have to pay anything for the stock. He'll simply receive it as a bonus. Sam has no tax consequence until he receives the stock. In effect, the IRS waits 36 months to see what will happen. When Sam receives the stock, he will have income (measured by the value of the stock at that time), which will be treated as wages.

Restrictions that will never lapse are "nonlapse" restrictions. Taking a wait-and-see approach won't work with nonlapse restrictions, so the IRS values the property taking those restrictions into account.

Example. Betty's employer promises her stock if she remains with the company for 18 months. When she receives the stock it will be subject to permanent restrictions under a company buy/sell agreement to resell the shares for $20 per share if Betty ever leaves the company's employ. The IRS will wait and see (no tax) for the first 18 months. At that point, Betty will be taxed on any value she receives in excess of the price she pays. Here, Betty is not separately paying anything for the shares, and there is a $20 resale price. That means she will probably be treated as receiving $20 of compensation.

In most cases, the employer is allowed a business expense deduction under Code Sec. 162 for the compensation paid once the restriction lapses. The amount of this deduction includes the appreciated value of the company's stock while the restriction on the property was in place. Still, the employer's deduction and the employee's income are very much connected.

Value and Risk

Code Sec. 83 provides that the fair market value of employer-provided stock is includable in income during the first tax year in which rights in the stock were transferable or not subject to a substantial risk of forfeiture. The FMV of the stock is determined without regard to any restriction other than one that by its terms will never lapse, *i.e.*, a permanent limitation on transferability.

Code Sec. 83 sets out the circumstances in which stock will be considered subject to a substantial risk of forfeiture. Some restrictions are "lapse restrictions," and others are "nonlapse restrictions." Only the former are relevant in assessing whether the employee should be currently taxed on the items. Nonlapse restrictions (which, by their terms, will never lapse) are not considered.

Whether a risk of forfeiture is considered substantial (preventing current tax) depends on the facts. A substantial risk of forfeiture exists where the rights and the property transferred are conditioned, directly or indirectly, upon the future performance of substantial services by any person, or upon the occurrence of a condition relating to the purpose of the transfer, and where the possibility of forfeiture is substantial if such a condition is not satisfied. [*See* Reg. §1.83-3(c)(1).]

Many conditions deal with what happens on termination of employment. A requirement that an employee return stock in the event he is discharged for committing a crime or for cause is not a substantial risk of forfeiture. However, a requirement that the employee return the shares if he leaves for any reason (resignation or discharge without cause) is typically considered substantial.

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Covenants not to compete are common. A noncompete agreement may (but ordinarily will not) be considered a substantial risk of forfeiture. Factors considered in assessing a covenant not to compete include the employee's age, the availability of alternative employment, the likelihood the employee might obtain other employment, the degree of the employee's skill, *etc.* The employer's historical practice in enforcing covenants can also be relevant.

Electing Income

Many business 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. But details matter.

An employee receiving a stock bonus subject to a three-year vesting condition could elect current taxation of the stock bonus, even though the restrictions remain in place for another three years. Why? 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 he or she is better off locking in capital gain treatment for the future.

Electing to pay now sounds counterintuitive. A nearly universal rule of tax planning is to push our tax obligations off into the future wherever possible. We do not want to accelerate income or paying taxes. We want to accelerate deductions and *defer* income.

The Code Sec. 83(b) election, however, accomplishes two goals. Property transferred in connection with the performance of services is ordinary income. For employees, that property would also be wages subject to employment taxes. Thus, 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. By making the election, one can 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 likely 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. Moreover, you can even alter the *timing* of future gain recognition. If you do not make a Code Sec. 83(b) election, you would simply allow Code Sec. 83 to tax you when the restrictions lapse. You will be taxed (as ordinary income and wages, as applicable) when the restrictions lapse.

The hallmark of Code Sec. 83 is that one should not be taxed on something until restrictions on the item 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. Suppose that you meet the three-year restrictions hurdle and hold onto your shares. Assume that you wait another three years 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). Then, you have no tax event in year three when the restrictions lapse. Finally, you have capital gain in year six when you sell the shares.

Missed Expectations

All this seems straightforward, but the facts may play out differently than you expect. Indeed, the Code Sec. 83(b) election may mean that you pay some tax that you would never pay. Suppose that you *expect* to meet the restrictions threshold, and want to lock up capital gain rates for the future. Therefore, you make a Code Sec. 83(b) election to be taxed on the grant of the shares in year one.

Unfortunately, you unexpectedly leave the company or are fired in year two. If you make the election but end up not meeting the three-year vesting requirement, you forfeit the property. Moreover, you get no tax deduction for the forfeiture. [Code Sec. 83(b)(1).] That seems harsh, and does mean that Code Sec. 83(b) elections are not risk-free, except perhaps when they involve zero income (a topic addressed below).

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 you paid for the property is not fully restored on the forfeiture.

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

Elections *Without* Income

In deciding whether to make a Code Sec. 83(b) election, it is important to note the "no income" election. This too may seem counterintuitive. Some recipients of options and restricted stock may fail to make elections if they are paying what they consider to be the fair market value of the stock.

Indeed, this seems definitional. If you pay fair market value, how could it be a compensatory payment? By definition, a payment at full fair market value might logically mean that there is no discount that could be linked to services. This has long been one of the alluring traps set by Code Sec. 83.

Suppose you are offered stock in your employer that you would not otherwise have been offered but for your employment (or consulting work, for it is worth noting throughout that nonemployees too can receive restricted stock). Also suppose that you pay for the stock what is meant to be fair market value, say a dollar a share. Let's assume you work for a privately held company.

You might well assume that you bought the shares for fair market value, so Code Sec. 83 is not implicated. However, the IRS view is that your shares were *still* 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 should indicate that you have paid fair market value for the shares. Therefore, you are electing to include the compensatory amount ($0) in your income. Clearly, such a zero-income Code Sec. 83(b) election is appropriate. In fact, an ugly situation arises if you *could* make such an election and fail to make it.

Consider the now-famous case of *L.J. Alves*, CA-9, 84-2 USTC ¶9546, 734 F2d 478 (1984). 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.

The IRS and the courts viewed the shares Alves received as transferred in connection with the performance of services. Even though there was no "bargain element," Alves was offered the stock because of his employment. He 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 many years later. This remains a danger today,

Table 1. Transfer of Property Subject to Substantial Restrictions

	Without Code Sec. 83(b) Election	**With Code Sec. 83(b) Election**
Taxable on initial transfer?	No	Yes (as ordinary income)
Taxable when restrictions lapse?	Yes (as ordinary income)	No (the lapsing of restrictions becomes a nonevent)
Taxable on sale or disposition of property?	Yes (only on appreciation between time restrictions lapse and time of disposition, as a capital gain)	Yes (only on appreciation between initial transfer and time of disposition, as a capital gain)

and is one reason to stress the timing and mechanics of Code Sec. 83(b) elections.

Code Sec. 83(b) Election Mechanics

A Code Sec. 83(b) election must be filed within 30 days of the transfer. A copy must be attached to the employee's tax return for the year of the transfer.

The election causes any difference between the value at the time of receipt and the ultimate sales price when the employee disposes of the stock to be capital gain. The election therefore affects both an important timing difference and a tax rate differential.

Table 1 illustrates the radical shift a Code Sec. 83(b) election affects.

Comparing Options

In evaluating restricted stock, it is useful to consider and compare the two varieties of stock options: incentive stock options (ISOs) and nonqualified stock options (NSOs). ISOs are taxed more favorably. There is generally no tax at the time ISOs are granted and no "regular" tax at the time ISOs are exercised. We'll come back to the "regular" versus not-so-regular tax shortly.

When you exercise an ISO, you acquire the shares. Thereafter, when you sell your shares, you pay tax, hopefully as a long-term capital gain. However, you need to know a special rule about selling shares you acquired *via* exercising an ISO.

The usual capital gain holding period is one year. Nevertheless, to get capital gain treatment for shares acquired *via* ISOs, you must hold the shares for more than a year. Moreover, you must sell the shares at least two years after your ISOs were granted. This latter two-year rule catches many people by surprise.

Although you pay no regular tax when an ISO is exercised, the AMT can take its own tax bite when you exercise ISOs.

> **Example.** Alice receives ISOs to buy 100 shares at the current market price of $10 per share. Two years later, when shares are worth $20, Alice exercises, paying $10. The $10 spread is subject to AMT. How much AMT Alice pays will depend on her other income and deductions, but it could be a flat 28-percent AMT rate on the $10 (28% × $10 = $2.80).

Note that one does not generate cash when exercising ISOs. That means if the exercise triggers an AMT tax, you will have to use other funds to pay the AMT.

NSOs: The Other Option

NSOs are far more prevalent than ISOs. They are not taxed as favorably as ISOs, but there is no AMT trap. Moreover, NSOs offer some planning possibilities that ISOs do not.

With NSOs, there is no tax at the time the option is granted. When you exercise the option, however, you have ordinary income (and, if you are an employee, employment taxes). An ISO, in contrast, produces no regular tax, but does trigger the AMT. With an NSO, the *exercise* triggers income. When you exercise the NSO, you are taxed on the difference between what you pay and the value of the stock you buy.

> **Example.** John receives an option to buy stock at $5 per share when the stock is trading at $5. Two years later, John exercises when the stock is trading at $10 per share. John pays $5 when John exercises, but the value at that time is $10, so he has $5 of compensation income. Then, if John holds the stock for more than a year and sells it, any sales price above $10 (John's new basis) should be long-term capital gain.

Exercising options takes money and generates tax. Many people exercise NSOs to buy shares but then sell the shares the same day. Some plans permit a cashless exercise, cutting down on the seemingly meaningless round trip flow of funds.

However, there is no *requirement* that you exercise and immediately sell the acquired shares. You might exercise and hold the shares. Moreover, you only must hold the stock for more than a year to get long-term capital gain treatment.

Restricted Stock and Options

The restricted property rules and the rules governing stock options often work in tandem. Sometimes one must deal with both sets of rules, and that creates confusion. For example, you may be awarded stock options (either ISOs or NSOs) that are restricted and that do not vest until a stated term elapses. The IRS generally waits to impose tax in such a case.

If you must wait two years to see if your options vest, there should be no tax until that vesting date. Then, the stock option rules take over. When the options vest, you would pay tax under either the ISO or NSO rules. It is even possible to make Code Sec. 83(b) elections for compensatory stock options. The idea of any Code Sec. 83(b) election is to trigger a tax event on the election, and to start the clock running on future appreciation which should be taxed as a capital gain.

AMT Issues

One reason to prefer restricted stock is AMT. 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 boom, when many ISOs were exercised and shares were increasing enormously in value, only to plunge thereafter. More than a few taxpayers had large AMT liabilities, where the shares became worthless or dropped precipitously in value.

How does this relate to Code Sec. 83? Under Code Sec. 83, if stock is substantially vested on exercise, 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.

Code Sec. 83(b) Elections and AMT?

In *A.J. Kadillak*, 127 TC 184, Dec. 56,670 (2006), *aff'd*, CA-9, 2008-2 USTC ¶50,462, 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 exceeded the option price on the date the taxpayer exercised the ISOs. But, I'm getting ahead of our story.

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 Code Sec. 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.

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 argued that 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.

Irrevocable Elections

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.

Restrictions and Luck

Sometimes, it isn't a lack of planning or foresight that seems to trip up taxpayers, but bad luck. The Second Circuit Court of Appeals considered an unlucky executive in *O. Gudmundsson*, DC-NY, 2009-2 USTC ¶50,722, 665 FSupp2d 227 (2009). Olafur Gudmundsson was an officer of Aurora Foods and participated in its employee incentive compensation plan.

When Aurora went public in 1999, he received the right to 73,105 shares of Aurora stock on July 1, 1999. His Form W-2 showed nearly $1.3 million in compensation (73,105 shares × $17.685, the average per-share price July 1, 1999). Gudmundsson held his stock subject to a number of restrictions. He could not sell his stock on a public exchange for a year after the distribution, though he could transfer it to a limited group of recipients.

In deciding whether to make a Code Sec. 83(b) election, it is important to note the "no income" election.

Gudmundsson was also subject to Aurora's Insider Trading Policy. It required compliance with waiting periods and consent procedures. Violation of these restrictions could have serious consequences, including termination of his employment.

In late November of 1999, Aurora announced disappointing earnings and its stock price fell 26 percent within a few days. In February of 2000, Aurora announced an investigation into its accounting practices, prompting the resignations of several members of management. Within a few days, the stock fell roughly 50 percent.

In April 2000, Aurora announced that it was significantly reducing its previously reported earnings. In January of 2001, indictments against former Aurora officers were announced and they plead guilty to securities fraud. In early 2003, Gudmundsson filed an amended 1999 tax return, asserting that the Aurora stock should have been valued at $7.5625 per share as of December 31, 1999, not the $17.685 per share he originally reported.

When the IRS denied the refund, he filed suit. The district court gave summary judgment to the government, ruling that the stock was not subject to a substantial risk of forfeiture.

Insubstantial Risk

The Second Circuit rejected the argument that Gudmundsson's risk of losing his job was a substantial risk of forfeiture. The court also rejected Gudmundsson's claim that his exposure to a potential suit under Section 10(b) of the Securities Exchange Act of 1934 evidenced a substantial risk of forfeiture. Code Sec. 83(c)(3) excludes civil suits other than those brought under Section 16(b) of the '34 Act. Section 16(b) applies to officers, directors and 10-percent shareholders.

The court rejected Gudmundsson's claim that the restrictions imposed by securities laws were nonlapse restrictions. The court found that the stock was transferrable for purposes of Code Sec. 83. The transfer restrictions did not prohibit transfers. In fact, they merely limited the pool of potential transferees, and that was only for a time.

Even if the restrictions rendered the stock extremely difficult to sell, that impacted its marketability but not its transferability. Turning to the stock's value, the Second Circuit agreed with the district court. The stock was properly valued based on the average per-share price of unrestricted stock on the New York Stock Exchange.

Monday Morning Quarterback

It is worth asking what Gudmundsson could have done to avoid this mess. Precipitous drops in value are a risk of any investment, and that certainly goes for compensatory stock. In the wake of the dot-com bubble, ISO problems were rampant, since ISOs trigger an AMT preference.

Indeed, many who were quite wealthy on paper ended up with only a large AMT bill to show for it. That led to Congress eventually enacting remedial legislation as part of the Emergency Economic Stabilization Act of 2008. Even that was no panacea. To an even greater extent, for restricted stock, there's no easy fix.

Conclusion

Restricted stock does not avoid all of the accounting and tax problems of options. But the rules are generally predictable and time-worn. Planning, however, is still important, as is having a bit of luck.

Article Submission Policy

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