The Art and Science of Elective Compensation

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M&A TAX REPORT readers are probably used to thinking about Internal Revenue Code Section ("Code Sec.") 83(b) elections. We think of them as astute, as important plays on timing and the increasingly important distinction between ordinary income and capital gain. They are all these things and more, even if at times we wish we could undo one.

We know that Code Sec. 83 provides rules under which employees—and even independent contractors—are taxed on property transferred in connection with their performance of services. Code Sec. 83 is therefore one of the key provisions governing stock options, restricted stock and various other property transfers. The hallmark of Code Sec. 83 is that we should not be taxed until restrictions lapse.

For example, if an executive receives a stock bonus subject to conditions that will lapse in three years, Code Sec. 83 generally provides that the value of the stock is not income until the lapse occurs. Of course, this rule would make no sense if the restrictions are permanent. Thus, the wait-and-see approach does not apply to "nonlapse restrictions" that will *never* lapse.

Options

Most of us may think of Code Sec. 83 as classically applying to restricted property such as a stock bonus. Yet we also know it can apply to stock options. With nonqualified stock options, the first question to ask is whether the option has a readily ascertainable fair market value at the time it is granted.

Nonstatutory stock options must meet four conditions to have a readily ascertainable fair market value:

- The option is transferable by the holder.
- The option is exercisable immediately in full by the holder.
- Neither the option nor the underlying property is subject to any restrictions that have a significant effect on the value of the option.
- The fair market value of the option is readily ascertainable.

Assuming that the four conditions are met, the fair market value minus any amount paid for the option will be taxed in the taxable year of the grant. Of course, it is treated as compensation (ordinary income). There is no tax consequence upon the *exercise* of the option. Upon sale of the stock, you should realize capital gain.

In the real world, of course, in the vast majority of employment situations the options do not have a readily ascertainable fair market value. In fact, the last condition alone virtually precludes it. It would require one to know about the future value of the underlying stock.

Therefore, virtually no options have a readily ascertainable fair market value when they are granted. If, as will almost always be the case, the options do not have a readily ascertainable fair market value on grant, there is no taxable event when the option is granted. If the underlying property is not restricted upon exercise, the difference between the fair market value at date of exercise and date of the grant is compensation.

Thus, the appreciation in the value of the property underlying the option between the date of grant and the date of exercise is compensation. Upon the later sale of the stock, one's basis in the stock will equal the sum of the exercise price plus the amount included in ordinary income upon exercise.

If the underlying property is restricted upon exercise, one can postpone the taxable event until the restrictions lapse. By making a Code Sec. 83(b) election within 30 days after the transfer of the property, one can limit the amount of ordinary income from the transaction to any difference on the date the property is transferred between the fair market value and the amount paid for the property. Any appreciation in the property after the date of transfer is converted into capital gain.

Tax Me, Please!

Code Sec. 83(b) allows recipients of restricted property to elect *current* taxation, notwithstanding the presence of restrictions. Why would someone do this? The Code Sec. 83(b) election is desirable where the worker thinks he will ultimately satisfy the conditions and where the worker also thinks the tax play is better to elect to recognize the income now.

That sounds counterintuitive. A major goal of tax planning is to push our tax obligations off into the *future* wherever possible. Of course, a small tax today may be more palatable than a large tax tomorrow. The Code Sec. 83(b) election affects two goals: One based on size and one based on timing.

Property transferred in connection with the performance of services is ordinary income. For employees it is also treated as wages subject to employment taxes. Yet, the election caps the ordinary income (and wage) portion of the gain. If you feel you are going to meet the vesting criteria that would result in your being taxed later, and if the value of the property you are receiving will go up, electing earlier taxation will result in the later appreciation being taxed as a capital gain.

You pay ordinary income (and potentially wage) taxes now to get that flexibility and rate advantage later. The election also alters timing. If you do not make a Code Sec. 83(b) election and allow Code Sec. 83 to tax you when the restrictions lapse you will be taxed (as ordinary income and wages as applicable) at that future date. If you make the election, there will be no tax event when the restrictions lapse. The only remaining tax event will be when you ultimately sell the property.

The election means the following:

- You are taxed on the value of the restricted shares when you received them.
- You have no tax event when the restrictions lapse.
- You have capital gain when you later sell the shares.

Of course, the Code Sec. 83(b) election means a current income inclusion. Moreover, the restrictions may lead to a forfeiture. A taxpayer who makes the election but ends up not meeting the vesting requirement may forfeit the property. Such an unfortunate taxypayer can claim no deduction for the forfeiture. [Code Sec. 83(b)(1).] You can, however, claim a deduction for out-of-pocket losses incurred because of the forfeiture.

Free Elections

At one time, recipients of options and restricted stock tended not to make Code Sec. 83(b) elections if they paid fair market value (FMV) for what they received. If one pays fair market value, how could it be a compensatory payment? Yet if the stock is transferred in connection with the performance of services, Code Sec. 83 applies even if you pay FMV.

In *L.J. Alves*, CA-9, 84-2 USTC ¶9546, 734 F2d 478 (1984), the court held that an executive who paid FMV for shares in a family company had ordinary income rather than long-term capital gain on shares. Even though he paid FMV for the stock, the fact that he failed to make a Code Sec. 83(b) election meant the shares were never purged of their ordinary income taint. Thus, the painful lesson of the *Alves* case is that you would still want to make a Code Sec. 83(b) election, even though it would state that you paid fair market value for the shares. You would elect to include that value ($0) in income.

Conversely, in another Ninth Circuit case, *A.J. Kadillak*, 127 TC 184, Dec. 56,670 (2006), *aff'd*, CA-9, 2008-2 USTC ¶50,462, the court held that a Code Sec. 83(b) election for nonvested stock acquired pursuant to the exercise of ISOs was valid. The taxpayer who had thus triggered a terrible AMT liability tried to undo or invalidate the election, but to no avail. "Be careful what you wish for or what you elect," the case seems to say. If you fail to elect, you may be sorry. Alternatively, if you elect but that turns out badly, you can't undo it.

New Age

As these cases demonstrate, some amount of Code Sec. 83 planning inevitably involves a crystal ball. Yet in some cases—such as the zero income election, it is hard to think of any reason you would *not* want to make it. But if anything, these issues are tougher today.

In part, this is due to new regulatory and administrative developments that are roiling this seemingly most staid and stable of topics. The IRS has issued Proposed Regulations, 77 FR 31783 (May 30, 2012) clarifying when a risk of forfeiture is "substantial." Although the proposed changes are not cataclysmic, it is clear that the IRS is tightening its fist around this venerable Code section. That could make it harder to handicap.

Less substantively but more practically, the IRS has also put some thought into exactly what a Code Sec. 83(b) election should include. In Rev. Proc. 2012-29 (IRB 2012-28, 49), the IRS gives guidance on acceptable formats for making the Code Sec. 83(b) election.

What Risks Are Substantial?

One of the two key concepts in Code Sec. 83 is the substantial risk of forfeiture. If your right to property is subject to a substantial risk of forfeiture, it is not yet yours so it is not yet taxed.

Thus, in the case of nonqualified options, a worker is typically granted the option to purchase the stock of his employer at a future date provided that he fulfills certain obligations. If he fails to fulfill them (often a longevity requirement such as working for the company for three years), he loses any right to acquire the stock.

Obviously, a requirement that one work for three years to purchase company stock is a substantial risk of forfeiture. After three years he can act on the provision, pay for the stock and incur tax. Thus, what constitutes a substantial risk of forfeiture is of key importance. Plainly the IRS would prefer to collect taxes sooner rather than later.

The Proposed Regulations reflect a new stinginess about what is substantial and even what is a forfeiture. The Proposed Regulations alter the definition of substantial risk of forfeiture in several respects. The Proposed Regulations clarify that a substantial risk of forfeiture exists *only* where rights in property are conditioned upon the future performance of substantial service or upon the occurrence of a condition related to the purpose of the transfer.

Double Trouble

What's so different? The current regulations do not say that these are the "only" ways to qualify. The Proposed Regulations clarify that *only* one of these two conditions can constitute a substantial risk of forfeiture:

- A condition based on future performance of services, such as one to ensure continued performance and loyalty
- A condition related to the purpose of the transfer (*e.g.* the transferee invented a new device, performed some essential task, or brought some needed expertise to the organization)

Consider a restricted stock award granted to an employee subject to vesting conditions. The award vests only if the employer's gross revenues do not fall below 90 percent of current levels over the next three years. This gross revenue restriction is surely a "condition related to the purpose of the transfer."

After all, this kind of restriction should presumably incentivize the employee to prevent the company's gross revenue from falling below the key revenue figure. Nevertheless, the Proposed Regulations state that this kind of provision would *not* be a substantial risk of forfeiture if the facts and circumstances indicated that the employer is a long-standing seller and there is no expectation that demand for its products would fall.

This is perhaps the best illustration of how the new rules will work in tandem. A restriction on paper may look quite substantial indeed. Yet in real life and with on-the-ground probability, the restriction may be quite *insubstantial*.

Practice and Procedure

Writing a tax opinion based on such musings may not be easy. That means giving client advice almost certainly will not be. Perhaps saying something is likely or arguable or might happen won't be too hard, but that may not be too comforting and may not conform to Circular 230 opinion standards. Besides, as cases like *Alves* make clear, the stakes can be quite large.

Yet another respect in which the proposed regulations take a toll relates to the meaning of a substantial risk of forfeiture based on the intended *purpose* of the transfer. The Proposed Regulations delete certain text in the current regulations to clarify that *both* the likelihood that the forfeiture event will occur *and* the likelihood that the forfeiture will be enforced must be considered.

The Proposed Regulations also provide that a substantial risk of forfeiture is generally not present by reason of transfer restrictions on securities. This includes transfer restrictions that could, if violated, result in the forfeiture or return of some or all of the property or other damages, fees or penalties. The Proposed Regulations include several new examples to show that restrictions imposed by lock-up agreements and restrictions relating to insider trading under Rule 10b-5 of the Securities Exchange Act (*www.proskauer.com/publications/client-alert/irs-issuesproposed-regulations-underinternal-revenue-code-Code Sec.-83-regarding-substantial-risk-of-forfeiture-analysis/ - _ftn3*) do not establish a substantial risk of forfeiture.

It bears noting that this is consistent with Rev. Rul. 2005-48 (2005-2 CB 259). That ruling states that various transfer restrictions, including those imposed by lock-up agreements or relating to insider trading under Rule 10b-5 of the Securities Exchange Act of 1934, do not create a substantial risk of forfeiture. On the other hand, there is at least a bolstering of the notion already present in Code Sec. 83(c)(3). Thus, a substantial risk of forfeiture would exist during the time that the sale or other transfer of property could subject the seller to a suit under Code Sec. 16(b) of the Securities and Exchange Act of 1934.

Prospective Impact and Reliance

How much this winnowed-down view of Code Sec. 83 will impact practice remains to be seen. The Proposed Regulations are set to apply commencing on January 1, 2013, although it is certainly possible that comments from practitioners could lead to changes. Barring changes, though, taxpayers will face these rules for transfers of property after January 1, 2013. Moreover, one may rely upon them electively for property transferred after May 30, 2012.

How will employers and employees react to these new rules? Both, but especially employers, will have to determine how likely it is that a forfeiture condition will occur. Is this solely a one-time event, or does it require constant retesting? To what extent can the IRS be expected, particularly with the enviable wisdom of hindsight, to second guess what the company has done?

Surely there will be some of this. That could well cause at least some employers to be fairly rigid in treating amounts that previously would have been considered subject to a substantial risk of forfeiture to no longer be thus. Yet one old staple, a forfeiture condition tied to a covenant not to compete, has survived. The Proposed Regulations do not say this is no longer substantial.

Instead, for such a risk to be sufficient to hold the event of taxation in abeyance, one must presumably use the new two-tiered test. That is, there must be a substantial likelihood that the noncompetition covenant will be breached. Plus, there must be a substantial likelihood that the forfeiture condition would be enforced. One can imagine some possible manipulation of these rules.

It's the Form, Stupid

In some respect, of course, a Code Sec. 83(b) election can be seen as a bet. If the value of the stock decreases between the date of exercise or purchase and the date on which the interest vests, the worker may end up paying additional ordinary income. Furthermore, what if the worker makes the election but fails to remain through the vesting period and ends up forfeiting the stock?

There is little consolation in such an event. The errant worker will only be allowed a capital loss deduction for the difference between the amount paid for the forfeited stock and the amount realized upon its forfeiture.

Given the importance of Code Sec. 83(b) elections, it is surprising that the IRS has never produced a form to allow taxpayers to make the election. Reg. §83-2(b) through (e) provide guidance on the timing, manner and contents of such an election. Still, filling in a form is often more comforting then producing data on a sheet of plain paper. Besides, the IRS is hardly shy about producing a plethora of forms fit for most any purpose.

Whatever one's predilections, Rev. Proc. 2012-29 provides a format that can (but is not required to) be used. These requirements include the all-important 30-day filing period and the necessary information about the taxpayer making the election and the property subject to the election. If nothing else, it serves as a useful checklist.

The last thing you want if you have made an election is to be questioned about it later, particularly with the threat that your election may not have been effective. That makes Rev. Proc. 2012-29 important. Even better than its election tabula rasa, Rev. Proc. 2012-29 provides six helpful examples of Code Sec. 83 fact patterns and their potential tax treatment.

Conclusion

Code Sec. 83 is not exactly a vibrant Code section. That is good for those of us who are old enough to find it tough learning new rules. It is, however, one of those terribly important Code sections that comes up across a wide array of situations and practice areas. It even seems a likely area for there to be misunderstandings and even (one must admit) potential malpractice claims. With the IRS's latest tinkering, that will only grow more likely.