

## Repurchase Nuances and Code Sec. 83

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

On its face, Internal Revenue Code Section (“Code Sec.”) 83 is pretty simple. If an employee (or independent contractor) receives restricted stock or property in connection with the performance of services, one looks to the nature of the restrictions. If the restrictions are “lapse” restrictions (ones that will eventually lapse), there generally is no tax event until those restrictions to lapse. Of course, at that time (when they lapse), there is a tax.

In contrast, if the restrictions are “nonlapse” restrictions (ones that will *never* lapse), you generally must value the restricted item then, imposing the tax on the initial transfer. The rules can become somewhat complicated in the case of options, but in general, Code Sec. 83 contains relatively few surprises. There are factual issues and valuation concerns, of course, but Code Sec. 83 on its face is not all that complex.

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#### Election Day

Then there is the 83(b) election. This too is straightforward, though it is rather constantly fouled up in practice. Notwithstanding the general rule that one does not have a tax event on a transfer of restricted property (that is subject to restrictions that will lapse) in connection with the performance of services, one can *elect* to include the income currently.

To do so, one must file an 83(b) election within 30 days of the initial transfer. Presto, change-o, one reports the ordinary income on the transfer. Thereafter, though, future appreciation on the shares (or other property) should be taxed as a capital gain (hopefully long term).

Many of the issues surrounding Code Sec. 83 and its operation involve nitty-gritty facts. A good example is the IRS’s ruling in LTR200934020

(Apr. 20, 2009). The company in question had one class of common stock outstanding owned by employees. The employees had paid full-book value for the shares. The shares were not subject to a substantial risk of forfeiture or vesting schedule.

However, the shares could not be transferred, sold or exchanged except to the company when they terminate employment. In fact, if an employee terminates employment, the company must repurchase the shares at a purchase price equal to the then-book value. The price is paid out in installments over a number of years following the employment termination.

There were other restrictions, including a nonsolicitation provision. A former employee who violates this nonsolicitation prohibition would forfeit remaining installments, reverting back to a rebate of the original purchase price. The idea, thus, is to deprive such a soliciting employee of the appreciation.

#### Big Change?

In connection with an IPO, the company wants to recapitalize, and among other things, to have these common shareholders exchange their shares for new shares of a different class. Significantly, however, the new shares will not be subject to the same repurchase requirements as the existing shares.

Therefore, the ruling considers whether the cancellation of the repurchase requirement on the existing shares is or is not a compensatory cancellation of a nonlapse restriction. Making the company and employee-shareholders happy, the IRS ruled that such a cancellation is not compensatory and does not result in the recognition of income by the employees under Code Sec. 83.

Whether there has been a noncompensatory cancellation of a nonlapse restriction, of course, depends on all of the facts and circumstances. In general, if an employee must perform additional services or his compensation is adjusted to reflect the cancellation, a compensatory purpose for the cancellation may be considered to exist. [See Reg. §1.83-5(b)(1).]