Restricted Stock SNAFUs

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

Employee stock plans are hardly new. Moreover, 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 concepts of constructive receipt, risk of forfeiture and the like.

Code Sec. 83 provides that the fair market value of employer-provided stock is includable in income in 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 which 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 accessing 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).]

Examples

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.

Covenants not to compete are common. A noncompete agreement may (but ordinarily will not) be considered as a substantial risk of forfeiture. Factors considered in accessing 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.

83(b) Election

One common area of opportunity as well as confusion is the 83(b) election. Despite the rule that stock is not taxable to the employee until it is no longer subject to a substantial risk of

forfeiture, Code Sec. 83(b) allows an election to include the stock in current income. The election must be filed within 30 days of the transfer, and a copy must be attached to the employee's tax return.

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. In contrast, if no Code Sec. 83(b) election had been filed, the employee has ordinary income on the value of the property when the restrictions lapse (not necessarily when the property is disposed of). The election therefore affects both an important timing difference and a tax rate differential.

This election makes sense where there seems no compensatory element to the stock transfer, and lack of a compensatory element might cause one to believe that Code Sec. 83 should not apply at all. Yet actually, the zero-value 83(b) election is common, appropriate in any arguably compensatory setting where what purports to be market value is paid for the stock. [*See* Wood, *Code Sec. 83(b) Elections: The Good, the Bad and the Ugly*, M&A TAX REP., Oct. 2008, at 1.]

Table 1 illustrates the radical shift an 83(b) election affects.

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. For example, 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. He was also subject to Aurora's Insider Trading Policy, requiring 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.

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 non-event)
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)

Often, the 83(b) election seems to be ignored, and that can lead to a painful surprise. [*See L.J. Alves*, 79 TC 864, Dec. 39,501 (1982), *aff'd*, CA-9, 84-2 USTC ¶9546, 734 F2d 478 (1984).] Sometimes, it isn't a lack of planning or foresight that seems to trip up taxpayers, but bad luck. Recently the Second Circuit Court of Appeals considered an unlucky executive with restricted shares who tried every argument to avoid an unfortunate result.

When Value and Luck Fail

In *O. Gudmundsson*, DC-NY, 2009-2 USTC ¶50,722, 665 FSupp2d 227 (2009), Olafur

Second Circuit

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, but Gudmundsson was none of those.

The court also rejected Gudmundsson's claim that the restrictions imposed by securities laws were nonlapse restrictions. The court ultimately found that the stock was transferrable for purposes of Code Sec. 83. The transfer restrictions didn't prohibit transfers; 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.

No Easy Fix

It is worth asking what Gudmundsson could have done to avoid this mess. Unfortunately, there's no easy answer. 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. 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.

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