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CHAPTER 8

Stock Compensation Under Section 83: A Reassessment

by

CALVIN H. JOHNSON*

Synopsis

* Associate Professor of Law, Rutgers Law School, Newark; J.D., Stanford Lav School, 1971.

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Compensation in the form of employer stock has become considerably less attractive for tax planning than it once was, mostly because plans that produce employee capital gain but forego the corporate deduction are decreasingly attractive. The enactment of Section 83 of the Code,[1] and the recent promulgation of the final Regulations under Section 83[2] reduced some benefits previously available, although both show signs of the constant tug of war between revenue protection and tax reduction. Many issues of interpretation remain unresolved. Given past optimism about the advantages of nonqualified stock compensation, however, it is time for a more pessimistic reassessment of its role and time to discuss its traps and limitations.

¶ 800 ROLE OF STOCK COMPENSATION

¶ 800.1 Planning in aggregate

Planning for compensation should consider the tax impact of the transaction on both the employer and employee. It is shortsighted planning for the executive to negotiate for the best tax treatment for himself if that route increases the total tax the employer and employee pay in combination. The combined tax is important even when an executive and employer are adverse as to the amount of compensation. The lower the combined tax cost on the transaction as a whole, the more money they have to divide.

¶ 800.2 Better aggregate alternatives to stock

Stock compensation is not the only way to compensate, and when the employer and employee are viewed together, it is

[1] Tax Reform Act of 1969, Pub. L. No. 91–172, § 321(a), 82 Stat. 588.

[2] T.D. 7554, 43 Fed. Reg. 31913 (1978).

not the best tax alternative. First place on the tax scale is held by fringe benefits and second place is held by qualified plans.

A. Fringe benefits

For tax purposes, fringe benefits that are exempt from employee tax are the best compensation. Stock cannot match the advantage of a deduction by an accrual employer as soon as it incurs the liability combined with an exemption for the employee. The overall impact of taxes on fringe benefits is to increase the resources available to the parties. For a corporate employer in a 46 percent bracket, the pretax cost of compensation is reduced by 46 percent.

The major planning danger in exempt fringe benefits is that they will be overused. Most shifts in the form of compensation from cash to in-kind fringe benefits involve a loss in utility to the employee. Cash allows the employee to choose what he wants or needs with flexibility. The advantage in exempt benefits is that the employee avoids the tax he would have to pay if he received cash, but there is danger that the shift away from cash will create greater loss in utility than is saved in taxes. The loss in utility cannot be gauged nor controlled with any precision.

Moreover, there is danger in expanding benefits beyond those that are clearly exempt. Since the employee avoids tax on fringe benefits, it is rational to plan benefits in which the employee gets less from the benefit than it costs the employer. If the benefit turns out to be taxable, however, then the employee has suffered the diminution in utility in shifting from cash and must pay his tax as well. While familiar or statutorily authorized benefits do not seem to present that possibility, unfamiliar benefits might be includable.[3] Moreover, if the benefit is includable, but not included by the employee there is danger that the employer will lose its deduction. Section 1.83–6(a) of the Regulations provides that the

[3] See, generally, Mann, "Black, White and Gray Fringe Benefits—Is Employer Withholding The Key to Rational Taxation?" 1979 *S. Cal. Tax Inst.* 421.

employer can get a deduction for compensation only if the employee has actually included the compensation in income or the employer has withheld from the compensation.

Even so, fringe benefits will probably remain a large part of the executive's compensation package for the future. Fringe benefits may be undertaxed, but the debate on fringe benefits seems largely confined to debates on tax doctrine, and tax doctrine has the difficult if not impossible job of distinguishing such working conditions as factory ceilings or air conditioning, which will never be considered compensation, from economic transfers like lunches and entertainment, which would be subject to an economically sound tax.[4] If anything, Congress has expanded statutory fringe benefits in recent years.[5]

B. Qualified plans

Second place for tax advantageous compensation is occupied by qualified compensatory plans. Stock compensation cannot match the tax advantages of the employer's deduction for a contribution to the plan when made or accrued, the tax deferral for the employee until he actually withdraws the contributions, and earnings on them, and the other incidental advantages.[6] Qualified plans, however, are limited in amount. The nondiscriminatory requirements mean that qualified plans cannot be focused entirely on more highly paid employees.

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[4] Compare Hickman, "Outlook for Fringe Benefits," 1977 *S. Cal. Tax. Inst.* 459 and Dept. of Treas., Discussion Draft of Proposed Regulations on Fringe Benefits, I.R. 1935 (Sept. 2, 1975), with Tax Treatment of Employee Fringe Benefits, Hearings Before a Task Force of the Ways and Means Comm., 95th Cong., 2d Sess., 9, 50 (1978) (Statements of Jerome Kurtz and Donald Alexander); Nolan, "Taxation of Fringe Benefits," 30 Nat. Tax. J. 359 (1977); Note, "Federal Income Taxation of Employee Fringe Benefits," 89 Harv. L. Rev. 1141 (1976).

[5] Revenue Act of 1978, Pub. L. No. 95–600, § 134, § 164, 92 Stat. 2783, 2811, enacting I.R.C. § 125 (cafeteria plans) and I.R.C. § 127 (educational assistance programs); Tax Reform Act of 1976, Pub. L. No. 94–455, § 2134, 90 Stat. 1926, enacting I.R.C. § 120 (legal services plans).

[6] I.R.C. § 2039(c) (estate tax exclusion), § 2517 (gift tax exclusion), § 402(e) (10 year averaging for lump-sum distributions), § 402(a)(5) (roll-over into individual retirement account).

¶ 800.3 Preliminary comparison of stock compensation to cash plans

Fringe benefits and qualified plans have such favorable tax consequences that stock compensation should not be substituted for them, but they are commonly used at or near their limits. The role of stock compensation, accordingly, depends upon its comparison to cash or to plans in which the ultimate payment is in cash.

Stock and cash compensation have much in common. A cash basis employee pays tax at personal service income rates when compensation is transferred or received. The employer gets a deduction when compensation is paid or accrued, whether payment is in stock or cash. Both stock and cash can be used for tax deferred as well as current compensation.

A. Stock as incentive compensation

Stock of the employer corporation is quite poor incentive compensation, although its use is sometimes justified on the ground it will provide an incentive. The argument is that the employee who becomes or will become a shareholder of the employer will work harder when his ultimate benefit is tied to the future prices of his employer's stock. A major difficulty with the argument is the independence of stock prices from the performance of any single employee. Earnings may go up despite a dismal performance by the employee, or go down though his performance was magnificent. Even if the employee affects earnings, the price for corporate stock is affected by many factors, other than earnings, well beyond his control. Moreover, stock compensation is less flexible than bonuses or promotions given after the fact. The incentive from stock compensation depends on gains in stock prices after the employee is promised or transferred the stock and so future gains on stock are released to the employee before he performs.

Any advantages that stock might have can be matched by cash plans. Deferred compensation can be measured by future stock prices if that were helpful. The independence of stock price changes from earnings can be cured by measuring compensation by corporate profits. Incentive compensation can be contingent on the performance of a division or subdivision or some other measures more closely tied to individual performance. If, then, stock compensation has an advantage over cash, it has to be because of something other than its incentive characteristics.

B. Cash flow of the employer

Stock compensation, unlike cash, does not come from current cash flow. A corporation with current cash flow problems would find that compensating its employees in part with its own stock would improve its current cash flow. Stock has a cost even to the issuing corporation. At minimum it could be sold to outsiders. But using stock as compensation is easier than selling stock for cash.

Stock compensation also increases current cash flow because of the employer deduction. Cash compensation, like stock compensation, is deductible, but cash by presumption comes from previously taxed sources and the deduction then does nothing but return the tax which the source of the compensation bore. The corporate employer's issuance of its own stock, by contrast, gives the employer a source for compensation which is already tax free; the deduction for stock then does more than just offset the prior tax. For a 46 percent bracket corporate employer, every dollar of deductible stock compensation will give an extra 46 cents in cash flow in the year the stock is deductible.

From a longer perspective, however, stock compensation is usually as expensive as cash. Stock requires that the corporation ultimately make cash distributions as dividends or in redemption or liquidation. The stock has value only because of the expectation of that cash. The cash distributions with respect to stock is cash devoted to the employee because of his services and it could have been structured as deductible compensation. As distributions on stock, however, the distributions are not deductible. The deduction for stock took its place. Thus if the source of stock compensation is pretax, still the ultimate cash payments are posttax.

The deduction for stock compensation comes earlier than the deduction would be allowed if instead the corporation had structured the cash distributions as the compensation, but the deductions are of roughly equal value. The price of stock sold on a public market may diverge from the discounted present value of future cash distribution on it, but not stably or predictably in either direction. Assuming the stock's value does equal the discounted present value of the future cash and that the employer's tax rate is constant, the value of the early deduction is nothing but the discounted present value of the deductions that the employee could have obtained if the cash distributions were restructured as compensation. An employee might perceive the value of stock he receives to be higher than it proves to be, but commonly the employee, with less control and information than the employer, values the shares when transferred at below what the employer would value them and below what the shares prove to be worth.

Stock compensation is, moreover, more expensive to the employer than marketable debt. An employer can get both its own stock and its own debt without paying tax. Debt is cheaper to the employer for the same value given to the employee because none of the cash distributions on the stock can be deducted, but interest on the debt can be. Debt is incidentally more advantageous than stock on the employee level because it can be retired in fragments without the employee's worrying about dividend redemptions[7] in which he is not allowed to use his basis from prior taxation of his compensation against the cash the corporation pays to retire the instrument. Debt, even marketable debt, has limited potential for giving employees capital gain, but, as explained next, capital gain for employees ordinarily is not an advantage.

¶ 801 EMPLOYEE CAPITAL GAIN

¶ 801.1 Planning in aggregate

In general, deferred compensation is more advantageous from a purely tax perspective than plans constructed to give

[7] I.R.C. § 302(d).

employees capital gain. Capital gain and deferred compensation are both aimed at the employee who does not need more current liquidity. Deferred compensation has the considerable advantage in that it can be deducted by the employer. The employer can deduct the employee's compensation from appreciated stock upon the future lapse of a forfeiture restriction,[8] or the employee's deferred compensation measured by appreciation of stock, but appreciation which is capital gain to the employee is not deductible compensation. The employee tax rates on capital gain are as much as 30 percent below the rates on personal service income eligible for the 50 percent maximum rate.[9] But for the 46 percent bracket corporation, the loss of the 46 percent deduction hurts more than the lower capital gain rate helps. The corporate deduction is an asset in compensation which should not be abandoned when the benefit sought is less valuable. Capital gain plans often adopted make money for the Government.

For example, assume a 70 percent bracket employee receives employer stock in 1980 for which he pays full value, which appreciates by $10,000 by 1985 when the employee wants his gains in cash. The employee will have $10,000 capital gain in 1985. The employee's capital gain tax is 28 percent, computed by deducting 60 percent of the employee's gain[10] and then imposing tax at the assumed 70 percent rate on the remaining 40 percent of the capital gain that is included. The employee's after-tax benefit is $7,200.

If, by contrast, the employer defers compensation until 1985, the employer, here assumed to be in the 46 percent corporate bracket, could deduct 46 percent of what it pays the employee in 1985. The compensation could be deferred, for instance, either by making the stock subject to a substantial risk of forfeiture in the employee's hands or just by deferring

[8] I.R.C. § 83(h).

[9] A 50 percent bracket employee includes 40 percent of capital gain in ordinary income under Section 1202 of the Code and so has a net 20 percent tax on capital gain. Section 1348 of the Code contains the 50 percent ceiling on personal service income.

[10] I.R.C. § 1202.

transfer or constructive receipt of the stock until 1985. Given the availability of the deduction, the employer could pay the employee 185 percent of the appreciation on the stock at the same posttax cost to it. For instance, if deferred compensation were measured by the appreciation of the stock between 1980 and 1985, the employer could afford to give the employee the $10,000 amount of the appreciation and another $8,519 in cash or stock above that. The deduction of 46 percent of $18,519 would bring the employer's cost back down to $10,000. The employee would, however, receive $18,519 not $10,000 before tax. With the 50 percent maximum rate on personal service income of Section 1348 of the Code, the highest bracket employee would have $9,260 post tax.

The combined tax costs on the transaction were $2,800 in the capital gain alternative. The combined tax costs went down to $740 when the planning switched from capital gain to deferred compensation. The employee's after-tax benefit went up from $7,200 to $9,260 by switching and the raise came solely out of the reduction in combined tax costs.

The difference between deferred compensation and capital gain is the tax treatment of the appreciation. If the employee is not expected to pay any purchase price, the differences in treatment of appreciation would not stand alone. The capital gain plan would give the employee taxable income and the employer a deduction for the unappreciated stock in 1980, while deferred compensation would defer both income and deduction to 1985. Still, the deduction for the appreciation would give the advantage to the deferred compensation alternative.

Appreciation on stock after the employee becomes its owner is sometimes not thought of as a cost to the employer, so that capital gain is often considered a cost-free form of compensation while deferred compensation costs the employer something. In the example, however, the employee's benefit from both the deferred compensation and the capital gain was dependent on subsequent appreciation of the employer's stock. Making employee benefits contingent in future appreciation is, accordingly, no general advantage for capital gain taxation. If, on hindsight, it can be seen that appreciation would have reduced combined costs if made deductible when the employee wanted the cash, then it follows before the appreciation is known that a deductible form makes more sense. Deductible compensation, of course, need not be contingent on appreciation, but if it is, then it is comparable enough to capital gain to demonstrate that it is more advantageous than capital gain.

There are, however, several qualifications to the general advantageousness of the deferred compensation alternative. The financial accounting charge to earnings can be far lower for capital gain than for forms that give the employer a deduction. For accounting purposes there is no charge to earnings for appreciation on stock after the measurement date for compensation.[11] There was no charge for the employee's $10,000 capital gain in the example because the measurement date was 1980 when the employee received and paid for the stock. The measurement date, however, is the time when the number of shares the employee receives is known and the purchase price, if any, is set.[12] If the deferred compensation plan increases the number of shares the employee is to receive by to reflect the corporate deduction, the measurement date will be deferred and the charge to earnings will be computated from the stock as appreciated. If, in the example, the $18,519 deferred compensation is paid by increasing the shares under the plan, then there is a charge of $18,519 in 1985, reduced by the tax benefit to $10,000.[13] A $10,000 charge instead of no charge may mean that the employee of a publicly held company will find that the employer, instead of increasing compensation to reflect the deduction, will reduce the benefit to below $10,000 because the deferred compensa-

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[11] Accounting Principles Board, Opinion No. 25, "Accounting for Stock Issued to Employees" ¶ 10 (1972).

[12] *Id.* at ¶ 10b.

[13] *Id.* at ¶ 17 provides that the value of the deduction ($8,519 in the illustration in text) reduces the income tax expense in the period the charge to compensation ($18,519) is taken. (If the $18,519 had not been a charge to earnings, the $8,519 tax benefit would be a direct addition to capital under A.P.B. Opinion No. 25 ¶ 17.)

tion required the charge to earnings. If the employer will not consider subsequent appreciation on its stock to be a cost, except where the appreciation is given as deferred compensation, then the employee can expect no raise in switching to deferred compensation.

Still, the employee can participate in the employer's deduction without such a drastic effect on the charge to earnings. The $10,000 charge, just cited, arose in primary part because the measurement date for the employee's compensation was changed from 1980 to 1985. If the employee's total shares (and his purchase price, if any) is set in 1980, then the appreciation will not become a charge to earnings merely because the employee participates in the benefit of the employer's deduction. For instance, if the employee's $8,519 pretax raise in the example were paid in cash or a supplemental agreement and the amount of shares under the basic grant were set in 1980, then only the added compensation and not the basic $10,000 appreciation would create a charge.

The employee need not get the benefit of the entire corporate deduction to be better off after-tax. Moreover, even if the employer does nothing but keep the employee's after-tax benefit of $7,200 constant, the employee's cost will go down from a nondeductible $10,000 in appreciation to a deductible $14,400 which costs it $7,776 after a 46 percent deduction. When the combined tax costs on the transaction go down, the employee's after-tax benefit goes up, or the employer's after-tax cost goes down, or both.

Even from a purely tax perspective, employee capital gain plans do sometimes make sense, looking to combined tax costs, but only in limited situations. Under Section 1014 of the Code, property held by the employee until death bears not a 28 percent tax, but rather no tax. Capital gain thus makes sense as a death benefit to employees in a tax bracket over 46 percent, even if it means loss of a 46 percent corporate deduction. Of course, such death benefits compare unfavorably with the $5,000 employee death benefits allowed by Section 101 (b) of the Code, where the corporate deduction is added to the employee exclusion, and with group life insurance allowed by Section 79 of the Code, where an exclusion from the employee's taxable estate is usually also available.[14] In any event, limiting stock compensation to its postdeath advantages would reduce its current use.

Employee capital gain also makes sense if the corporate employer's rate is low enough, even if capital gain is taxed and not forgiven by death, because the employer deduction is not worth enough to preserve. If one assumes that the employer does not vary the employee's benefit by the absence or availability of the deduction, the cases when the combined tax costs go up for capital gain plans are those in which the benefit, that is, the spread between employee capital gain and employee personal service income, is less than the detriment in loss of the employer deduction. The maximum spread between capital gain and compensation eligible for the maximum tax on personal service income, is 30 percent and the employer deduction is worth as much or more than the benefit unless the employer has under $50,000 taxable income a year.

A more natural assumption, however, is that the corporation rationally changes the gain (or compensation) available to the employee to take account of the loss of the deduction (or increases ordinary compensation to reflect its presence). If so, computing the relative advantage of capital gain and compensation requires one to take account of the fact that the employee's pretax benefit subject to capital gain tax will be less by an amount equal to the employer's deduction (or that there will be both increased employee income and increased deduction on an amount increased to reflect the availability of the corporate deduction) and that requires algebra. The following table computes the employer rate, for employees in various brackets, at which capital gain reduces combined tax because the employer deduction is not worth enough to preserve.[15]

[14] See, Terry & Kinyon, "Tax Planning for the Prospective Retiree," 1979 *S. Cal. Tax Inst.* 457, 475.

[15] The algebraic formula from which the table is derived is $T = \frac{t-c}{1-c}$, where "t" represents the employee's tax rate on personal service income and is assumed to be at a

EMPLOYER RATES AT WHICH CAPITAL GAIN SAVES COMBINED TAXES

(1) For employee in ordinary bracket (I.R.C. § 1) of	(2) Employer rate at which capital gain is algebraically advantageous	(3) Employer taxable income (I.R.C. § 11)
70%	under 31%	under $75,000
50%	under 38%	under $75,000
40%	under 29%	under $50,000
30%	under 20.5%	under $50,000
28%	under 19%	under $25,000
26%	under 17.5%	under $25,000
under 26%	under 17%	0 or under

As the table indicates, capital gain plans are not advantageous for the employer in the 46 percent bracket, but there are situations in which the employer's deduction is an asset of such little relative value that the benefits of capital gain on the employee level are worth more. Still, the chart must be used with care. The appropriate rate to look to is the marginal corporate rate and many corporations pay marginal rates of 46 percent even while the effective rate is considerably below 46 percent. Moreover, the appropriate period to look at is not the corporate rate in the year compensation is negotiated, but rather the rate in the years of "payout." That is, the years the employee would normally sell his stock for capital gain and the years that the employer could have obtained a deduction under a plan meant to match the employee's economic gain from a sale of his stock, but in the form of

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maximum 50 percent because of Section 1348 of the Code, "c" represents the employee's capital gain rate, and "T" represents the employer's tax-rate from which the deduction is taken.

The formula, $T = \frac{t-c}{1-c}$ is algebraicly equivalent to $x(1-t) = x(1-c)(1-T)$, where "x" (which is factored out in the final formula) is the amount of ordinary compensation the employer is willing to give. The left side of the equation is the employee's post-tax benefit from ordinary compensation and the right side his post-tax benefit from capital gain, where capital gain available to him was reduced by the absence of the corporate deduction. The formula can be derived from other ways of looking at the comparison as long as corporate behavior is sensitive to the deduction.

employee personal service income. Thus, corporations which are only temporarily in lower than 46 percent rates may find that capital gain plans prove to be disadvantageous if the corporate rate returns to a norm of 46 percent when the employee liquidates his benefit.[16]

There is a strong inverse relationship between the advantage of capital gain and its availability, at least where capital gain depends upon use of the employer's own stock. Corporations which are losing money and corporations which are "zeroing out," that is, distributing all their business receipts as deductible compensation, interests or rents, get no value from the corporate deduction, but they also cannot expect their stock to be appreciating because they are not retaining any earnings. Corporations which steadily receive taxable income of less than $75,000 a year would find capital gains plans advantageous, at least for some of their employees, and may have some appreciation on their own stock. But still appreciation arises most commonly for those corporations which will receive more than $100,000 taxable income a year when the employee wants to liquidate his benefits. Capital gain plans generally make money for the Government once corporate income exceeds $100,000.

A final and probably the most important qualification is that employee capital gain is advantageous if the deferred compensation would be unreasonable. The employer's deduction and the eligibility for the maximum tax is limited to reasonable compensation for services rendered. Even if the question of reasonability is addressed from the facts known when compensation is negotiated, large amounts paid as deferred compensation would raise reasonability as an issue. Large capital gains realized in the same circumstances would not

[16] Perfect planning would also take account of changes in tax rates before payout, but even if one could predict the general direction of the applicable marginal tax rates, it seems impossible to predict how the rates on capital gain, corporate income and personal service income will change in relation to each other. The Revenue Act of 1978, for instance, while decreasing the capital gains rate and value of the maximum corporate deduction, also made capital gain plans algebraicly disadvantageous for most high bracket employees because the 50 percent maximum on compensation became available to them for the first time.

flag the reasonability issue nor be included in considering reasonability even if the gains were made available because of services rendered. Perhaps the best way to look at stock compensation, accordingly, is that capital gain plans should not be substituted for plans that give the employer a deduction that would reduce combined tax costs, but that once the deduction for compensation is used at or near its limits, then employee capital gain becomes advantageous planning.

¶ 801.2 Planning on the employee level

In those cases in which the corporate deduction is of sufficiently low value and in those cases in which the employer will not consider the deduction to be an asset, tax planning will be focused on the effects of the plan on the employee's own tax. Even looking to the employee alone, however, there are some strict limitations on when capital gain planning makes sense.

A. General intent of Section 83

Section 83 of the Code was enacted to limit employee capital gain to those cases where the gain is attributable to the employee's prior investment in or prior tax on the value of property. Under prior law, transferring property to the employee subject to restrictions which substantially affected value meant that the employee was not taxed on the property until the restrictions lapsed. However, the employee's taxable compensation on release from the restrictions was subject to a ceiling equal to the value of the property at the earlier point when it was given to the employee subject to restrictions.[17] Thus, appreciation on the property which occurred before the restrictions lapsed, but after transfer, was capital gain to the employee when he ultimately sold the property. Section 83 repealed the ceiling on compensation so that appreciation on the property after the transfer, but before the employee is taxed on it, is compensation to the employee when the restriction lapses.[18] As a core concept, Section 83 denies capital gain

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[17] Reg. § 1.421–6(d)(2)(1961), which was a mere renumbering of Reg. § 1421–6(c)(2)(1959).

[18] I.R.C. § 83(a).

for appreciation occurring before the employee has paid tax on the property on which the appreciation arose.

Employee capital gain is often lost under Section 83 and the Regulations thereunder even where employee capital gain does not reduce the combined tax costs on the transaction. Section 83 was enacted from the perspective that equity among employees demanded that compensation be taxed as ordinary income, even when that equity reduces government revenue. During the gestation period of Section 83, commentators had explained that the old restricted stock plans were not generally advantageous, considering combined tax, and did not lose Government revenue.[19] The most influential commentary during that period, however, had assumed the employer was a tax-exempt entity and then attacked the logic and inequity of giving the employee capital gain from the restricted stock plans.[20] Section 83 went forward, looking to the employee alone. The Committee Reports on Section 83 said that, because of the increased employer deduction for compensation, there would be no revenue gain,[21] but that ordinary income still was the proper result since plans available to lower paid employees had an ordinary income payout.[22] Advisers to employees, accordingly, should not count on saving employee capital gain merely because their client's loss of capital gain would also reduce Government revenue.

B. Comparison with deferred compensation in theory

Section 83 did not by any means prevent an employee from getting capital gains from property received from his employer. If the employee receives property and pays tax on its val-

[19] Schapiro, "Restricted Property Received as Compensation for Services," 22 Tax Law. 529, 535–536 (1969); Carpenter, "High Cost of Restricted Stock Incentives," 46 Harv. Bus. Rev. 139 Nov.-Dec. 1968); Kidder, "Restricted Stock Arrangements—An Economic Consideration, " 46 Taxes 680 (1968).

[20] Blum, "Restricted Stock Arrangements Reconsidered," 46 Taxes 598 (1968).

[21] H. Rep. No. 91–413 (part 1), 91st Cong., 1st Sess., 89 (1969); S. Rep. No. 91–552, 91st Cong., 1st Sess., 124 (1969).

[22] H. Rep. No. 91–413 (part 1), N. 21 *supra* at 86–87; S. Rep. No. 91–552, N. 21 *supra* at 120–121.

ue, subsequent appreciation due to market forces is capital gain. Appreciation that occurs before the employee is taxed on the property's value, however, is not eligible for capital gain. Given that premise, one difficulty with planning capital gain is that a transfer of property that will give capital gain from future appreciation is in theory less advantageous to the employee than deferred compensation.

In theory, the value of property is the discounted present value of the future cash receipts that it gives. Both sales proceeds and interim income are taken into account in valuation. the employee's tax rate is assumed to be constant and if one discounts future tax at the same discount rate at which the property was valued, it follows that the present value of tax on future cash is equivalent to a tax applied to the current value. In turn, accepting immediate taxation of the value of the property has the same effective cost as if the employee had accepted a tax on the future proceeds that gave the property its value. In that sense, the employee who sells property he has paid tax on has already paid tax on the sales proceeds when he first received the property. The capital gain tax that is paid on the sale is over and above the equivalent to an ordinary tax on sale. If under a deferred compensation plan, the payout was deferred until the employee was ready to take cash, then the employee would pay ordinary tax on his benefit, but the added capital gain tax would have been avoided. If the employee's tax rate is not constant but declines, immediate tax is even worse than a future ordinary tax because deferred compensation both avoids the extra capital gain tax and takes advantage of the decline.

Accepting the foregoing, it follows that the capital gain strategy can be advantageous to the employee only if the full proceeds of the property are not reflected in valuing the property for tax purposes when the property was transferred and taxed to the employee. The essence of the capital gain strategy thus is to find property which will be valued for tax purposes at below its theoretical value or to find ways to give the employee gains that are not taken into account in valuing the property when the employee received it. Valuation is not precise art and future cash proceeds cannot be predicted with enough certainty to affect value as valuation theory says they should. Sound investment strategy, like sound tax strategy, looks for investments that are undervalued. If stock is purchased with employee debt, capital gain is advantageous whenever the after-tax gain exceeds the after-tax interest cost the employee is charged. Still, in theory, capital gains are not advantageous unless taxable value departs significantly from theoretical value and in practice that means that capital gains strategies are worthwhile only if the taxable value on transfer to the employee can be surpressed or if the gain on sale can be elevated.

Even for stock that appreciates far more than expected, the capital gain strategy will be disadvantageous if the tax accepted to get it reduces the amount that can be invested in the property. For instance, assume that stock worth $1000 is transferred to two executives and that both executives will pay their tax by selling part of their property. Both executives are in 50 percent brackets throughout. Both want cash in two years, and both executives have a valid substantial risk of forfeiture with respect to their stock in that they must work for the two years to retain it. Executive *A* wants capital gain in two years and, accordingly, as allowed by Section 83(b) of the Code, elects to be taxed on the $1000 stock notwithstanding the restriction. Executive *B* wants deferred compensation and accordingly makes no election. Under Section 83(a), the taxation of his stock is deferred until the forfeiture restriction lapses in two years.

Executive *A* who opted for capital gain is worse off after tax, even if the appreciation is extraordinary and not considered a possibility in valuation of his stock when received. For example, assuming that there is an extraordinary appreciation from $1,000 to $5,000 in the two years, Executive *B*, who deferred taxation, will have $5,000 before tax and $2,500 after a 50 percent personal service tax on his stock. Under this assumption he will sell half of his stock to pay the tax, but there would be no gain on an immediate sale. He will have a $2,500 basis in stock he retains and the basis will allow him to sell the stock without further tax.

Under the assumption that taxes reduce investment, Executive *A*, who wanted capital gain, sold stock when received to pay his $500 tax obligation when he made the Section 83(b) election and he was left with only $500 worth of the stock. The appreciation of the stock at the same rate gave him only $2,500 before tax. He has only a $500 basis in that stock, however, and $2,000 of gain, taxable as capital gain when the stock is ever, sold. Any capital gain tax at all on this $2000 will reduce Executive *A*'s after-tax benefits to less than the $2,500 which Executive *B* obtained. Thus, even if appreciation is not taken into account in valuation, the conclusion is still the same if early taxation reduces the amount invested: the capital gain tax is an added tax which could have been avoided just by deferring the taxable event. Tax on the employee will not always reduce investable amounts, but still, theory gives the practical perception that advantageous employee capital gain is hard planning.

¶ 801.3 Effect of the final Regulations

The final Regulations under Section 83 are aggressive in taking away employee capital gain advantages arising from undervaluation of the property when it is taxable. The theories and remedies adopted differ considerably, but the underlying target is the same.

A. Stock options

Planning for employee capital gain has sometimes sought to use stock options issued with an option price equal to or greater than the market value of the underlying stock at the time the option is granted. Such options have no accounting cost to the employer under Opinion No. 25 of the Accounting Principles Board and yet in an appreciating market, they can give the employee a large ultimate value. If the taxable value of the option when granted could be limited to the accounting cost or something near it, then the employee can get into a capital gain position with a small enough tax for it to be an acceptable toll charge.

Section 83 of the Code and the Regulations thereunder, however, make it difficult to get into a capital gain position upon grant of the option. Section 83(e)(3) excludes the grant of an option "without a readily ascertainable value" from the section. The exclusion tracks the language of the pre-Section 83 Regulations on stock options,[23] and was intended to ratify those rules, notwithstanding the changes Section 83 made to the same Regulations. Those rules now appear without significant modification as Section 1.83–7 of the Regulations. Options without readily ascertainable value are not taxed when the option is granted and the determination of the employee's compensation is left open until the option is exercised. Upon exercise, the taxable compensation is the bargain the employee receives by purchasing stock at less than its then fair market value.[24]

The Treasury in the prior and continuing Regulations on stock options was unwilling to value the compensation in an option by the accountant's measure. A stock option issued at an option price equal to or greater than current value may have no charge to earnings, but it usually has considerable actual value. The option gives the holder the opportunity to get the value of any future appreciation on the property, but the holder need not finance the purchase price of the underlying stock nor divert the price from other investments until the option is exercised. An option protects the employee from risk of loss of his purchase price since if the property declines in value the purchase price will not be paid. In theory, if volatile stock could be known to double or become valueless within a short period of time, the value of a short term option on the stock with an option price just equal to the current purchase price would be half the value of the underlying stock.[25] If a share of stock is worth $1 solely because there is a

[23] Reg. § 1421–6(d)(1961).

[24] Reg. § 1.83–7(a) (assuming the stock is not itself subject to a substantial risk of forfeiture).

[25] Disregarding the time value of money because of the short time and income from the stock for the same reason, stock which has a 50 percent chance of doubling in value and 50 percent chance of becoming worthless is worth its current price because of the 50 percent chance of doubling. An option for the stock with an option price

one-in-a-million chance of the share becoming worth $1 million, then the share and an option to buy it for its current price have a value that differs only by a millionth of a dollar. Long-term options are more valuable than short-term options because volatility of stock increases as the period under consideration increases and because the financing costs become a more important consideration. But determination of value is complicated, even when the underlying stock value is known, because future volatility is never known. An option does not give the holder dividends before exercise and the holder saves fewer financing costs in acquiring an option instead of the stock as the cost of the option itself approaches the cost of the underlying stock.

The problem with options from an administrative perspective is not so much their high value as their unknown value. In a variation of the open transaction doctrine, the stock option Regulations solve the valuation problems for stock options by waiting until the bargain the option gives is known on exercise. The intent is to forestall employee capital gain arising from undervaluation of options. The Regulations provide that options must have a "readily" ascertainable value for the employee's compensation to be closed on grant.[26] To get into a capital gain position upon grant of an unmarketable option, the employee must show that the option is transferable and exercisable immediately in full when granted, that neither the option nor the underlying property is subject to restrictions affecting value and that the value of the "option privilege" can be measured with reasonable accuracy.[27]

The "option privilege" is defined as the opportunity to benefit from any appreciation during the option period without investment of capital and without risk of losing it.[28] In determining whether the option privilege is measurable, the Regu-

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equal to the current value of the stock has 50 percent chance of giving a bargain equal to the current price (and a 50 percent chance of being worthless), so it is worth one-half the current price.

[26] Reg. § 1.83–7(a).

[27] Reg. § 1.83–7(b)(2).

[28] Reg. § 1.83–7(b)(3).

lations direct inquiry into the length of the option period, the ascertainability of the value of the underlying property, and the probability of changes in ascertainability.[29] That list of factors seems more intended to cast suspicion on the possibility of measuring the option privilege than to give any help in measurement. Additions to the Regulations proposed in 1977, moreover, would have created a presumption, on top of the general presumption in favor of the Commissioner, that options have no ascertainable value unless the employee and employer both agree that the option has an agreed-upon value and explain the method by which that value was reached.[30] Failure to promulgate the proposed 1977 amendments when the rest of the Section 83 Regulations were issued probably means that they will never be issued in the form proposed. Still, the barriers against getting into a capital gain position on the grant of an unmarketable option remain formidable. It is difficult to see how any unmarketable option would have a "readily" ascertainable value even if some value could be approximated by appraisal.

The compensatory aspects of a stock option are closed when the option is granted if the option is "actively traded on an established market."[31] More and more corporations will find that options for their stock are actively traded as the established markets for options expand. Use of such options, however, is not good tax planning: the options are short term for a price in excess of current value and have a high taxable value when given to the employee. One analysis reports that for a sample where the stock was selling fairly close to the option price, the options themselves were sold for between 40 and 60 percent of the value of the underlying stock.[32] A meaningful taxable value for options takes away any advantage in subsequent capital gain.[33] Marketable options, moreover, often ex-

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[29] Reg. § 1.83–7(b)(3)(i), (ii), (iii).

[30] Prop. Reg. § 1.83–6(e), (f), 7(c), 42 Fed. Reg. 47222 (Sept. 20, 1977).

[31] Reg. § 1.83–7(b)(1).

[32] Graham, Dodd & Cottle, *Security Analysis: Principles and Techniques* 659 (1962) (1961 sample).

[33] See § 801.2[B] *supra*.

pire before exercise becomes profitable and, in that case, the employee has paid an ordinary income tax that he just as well could have avoided.

The Service has requested comments on how unmarketable options should be valued.[34] That request may be the prelude to an amendment to the Regulations to allow freer closing of the compensatory aspects of options at grant. However, given that use of marketable options is bad tax planning, planners should not be optimistic about being able to establish an acceptably low value for unmarketable options. Unless the Service promulgates rules that are so conservative that unmarketable options may be considerably undervalued, relying on early valuation and taxation of the options will entail too high an entry fee for capital gain.

B. Lapse restrictions

Section 83 prevents the capital gain arising from undervaluation of stock options by keeping the transaction open, but Section 83 has another attack on employee capital gain derived from undervaluation of property, which is to ignore the source of the undervaluation. The restricted property rules of prior law, while allowing the employee to get capital gain from appreciation prior to his taxation, were sometimes also perceived as an attack on employee capital gain in another respect. They prevented the employee from getting capital gain attributable to discounts arising from an employer-imposed restriction which had "a significant effect on value" because the old Regulations measured the employee's compensation only when the restriction lapsed.[35] Section 83 instead ignores any discounts attributable to certain employer imposed restrictions, called "lapse restrictions," so that the employee has compensation measured by the full value of the stock without discount. In Section 83, Congress made a separate judgment that the old restrictions were not a sufficient reason to defer employee taxation, as the open transaction

[34] Study Project Relating to the Treatment of Nonqualified Stock Options; Invitation for Public Comments, 44 Fed. Reg. 20538 (1979).

[35] J. Sneed, *The Configurations of Gross Income* 55, n. 47 (1967).

doctrine requires. It could have used a recapture-like remedy of finding some ordinary income on sale of property to reach the compensation arising from employer-imposed discounts, but that remedy would have required the difficult job of measuring what discount was attributable to restrictions at the time of transfer. Ignoring the discount from "lapse restrictions" avoids the administrative difficulties of determining what the restrictions were really worth.

Section 1.83–3(i) of the Regulations defines a lapse restriction as any restriction other than a nonlapse restriction. Section 1.83–3(h) of the Regulations in turn defines nonlapse restrictions very narrowly to include only requirements that the employee sell, or offer to sell, his property at a price determined under a formula. A nonlapse restriction must also be permanent and binding against a transferee of the employee. Under Section 83(d)(1) of the Code such formula agreements set the taxable value of the employee's property, unless the Commissioner can prove otherwise, so that reading the definitions one would conclude that a restriction either sets the taxable value or is ignored, and that discounts from employer-imposed restrictions would never be computed. Section 1.83–5(a) of the Regulations, however, provides that in certain circumstances the formula price will not set value, but will be a substantial factor in determining value.[36] That statement is difficult to reconcile with the all-or-nothing system set out in the definitions of Sections 1.83–3(h) and (i) of the Regulations, and its scope is not clear, but it seems to mean that some discounts attributable to employer-imposed restrictions will still be computed. Moreover, because of the broad regulatory definition of lapse restrictions, one would expect some tension in determining whether the employees' rights arise under a "restriction," in which case any discount from the restriction would be ignored, or are inherent in the property the employee has received, in which case the value of the rights must be calculated, even if that is difficult. One does not have any confidence that Section 83 has really solved

[36] See, also, S. Rep. No. 91–552, 91st Cong., 1st Sess. 121 (1969) to the effect that resale agreements are merely to be "taken into account."

all its valuation problems nor that the intended scope of "lapse restriction" was thought out, but some restrictions are to be ignored. If the employee can sell his stock on the market after some period of time, then the current market price of the stock will determine its taxable value. Moreover, it appears that restrictions which lapse upon the occurrence of some contingency are lapse restrictions, even if the contingency may or may not ever occur. Risks of forfeiture are lapse restrictions[37] because they lapse if the forfeiture event does not occur and if the risk does not qualify as a substantial risk of forfeiture, it will neither delay tax nor reduce taxable value.

Ignoring the discount from lapse restrictions will mean that the employee will sometimes be taxed on a value in excess of the value of the stock, as restricted, to the employee.[38] Still, ignoring as many discounts as possible seems necessary to make taxation of compensation simple enough to be administrable. A national tax like the income tax cannot depart from quoted market prices for comparable property, when available, and still do a reasonable job of computing compensation evenly. Every property undoubtedly has intrinsic or subjective value to the employee which is different from the value the market sets for the property. No one would buy property if he did not get at least enough of a premium from it over its market price to justify the transaction costs of purchase. Premium values are ignored in practice, however, even when they are plausible. By symmetry, private discounts of a like kind would be ignored as well. An efficient public market requires that property be fungible with other property and restrictions which destroy fungibility—perhaps called fungicides—can effectively take property off that market. Still, the market price of comparable property should govern. Without any market guides, guesses about the value of property, especially guesses reported on tax returns, are more

[37] Reg. § 1.83–3(a)(7), Ex. 1.

[38] See, Theodore M. Horwith, 71 T.C. 932 (1979) (undisclosed corporate fraud did not reduce taxable value of stock subject to S.E.C. prohibitions on insider short-term sales below quoted market price of the stock).

likely to depart from subjective or intrinsic value by more than the quoted market price.

For temporary restrictions, ignoring the restriction might be argued as proper because the long-term, post-lapse value of the property subject to the restrictions is equal to the long-term value of identical but unrestricted property. That rationale seems less powerful than the sheer administrability rationale. Lapse restrictions which are forfeitures, but not substantial risks of forfeiture, may mean that the employee never has access to the public market for stock, but the employer is taxed as if he had. Restrictions on sale are lapse restrictions, unless they are formula resale agreements, and restrictions on sale can be permanent—a kind of fee tail to the employee and his heirs—without generating a discount. Moreover, for many properties the entire or predominant value of the stock is short-term. Since in the long term we will all be dead, the long-term equivalence of the employee's stock to comparable but traded stock may not mean very much even when long-term equivalence is true.

Use of quoted market prices for property subject to employer-imposed restrictions is justified or at least mitigated by the bargaining situation out of which the employee's rights arose. Employer and employees bargain over the form of compensation, subject to the constraints of habit and precedent. If the taxable value of property is very much higher than the subjective value of the property to the employee, then the parties have a private remedy in switching to a form or kind of property which is worth its value to the employee. If the employer and employee bargain to pay compensation in the form of a ton of goldfish, there is something fair in taxing the employee on the quoted market price for a ton of goldfish even when the employee later argues he does not like them. The discounts from quoted market price sometimes given by courts in gift or other nonbargained situations[39] seem inappropriate to situations in which bargaining is possible.

[39] See, Reginald Turner, T.C. Memo. 1954–38 (price trip was discounted by one-third of retail value); G. Cooper, *A Voluntary Tax: New Perspectives on Sophisticated*

Although many of the restrictions under pre-1969 law were applied for tax purposes, lapse restrictions that are ignored under Section 83 are not limited to restrictions imposed with tax avoidance scienter. Since valuation at a discount would in fact reduce employee tax or allow an employee opportunities for capital gain not arising from market appreciation. Proof of knowledge of the tax reduction is not a necessary element of finding a lapse restriction.

C. Penny stock plans

One technique to give capital gain to employees under prior law was to give the employee stock of the corporate employer immediately before it was registered and offered to the public with a view that the stock—sometimes called penny stock—had a low value because it was subject to investment letter restrictions before registration, whereas it would have a high value once there was a public market. The employee's stock could be piggybacked with registration of the offering so that his sale occurred on the public market. If the value of the unregistered stock was low enough, then tax paid by the employee on transfer was not a significant enough consideration to destroy the advantage of the plan.[40]

Section 1.83–3(h) of the Regulations limits the benefits available from penny stocks by defining "limitations imposed by registration requirements of state of federal security laws" as lapse restrictions. Since lapse restrictions are ignored, the employee is taxed on the public, not the private market value of his shares. The old investment letter restrictions, designed to qualify the employer's transfer to the employee for the "private placement" exclusive from the registration requirements of the Securities Act of 1933,[41] have been replaced by Rule 144 since Section 83 was enacted, but Rule 144, like the old

Estate Tax Avoidance 44–55, 84–89 (1979), published in earlier form, 77 Colum. L. Rev. 161 (1977) (discussing discounts on value under the estate tax).

40 See, e.g., Morris M. Messing, 48 T.C. 502 (1967) in which gift stock was valued at $13 per share though it had a $37 value four months later at the time of public offering.

41 Securities Act of 1933 § 4(2), 15 U.S.C.A. § 77d(2)(1971).

investment letters, is not usually a permanent barrier to public sale.[42]

On this issue the final Regulations are consistent with the accounting treatment. Accounting Principles Board Opinion No. 25, in what is called a "practical solution," requires that the charge to earnings from stock compensation be computed by reference to the quoted market price of the stock, even if the shares are subject to Rule 144 or to Rule 16(b) insider sale restrictions.[43] Practicality is undoubtedly the major rationale for tax treatment as well,[44] but there are other explanations. The gain the employee gets in going from a private to a public market for stock, for instance, does not arise from single market price fluctuations on the employee's investment, but rather is gain much like the ordinary profits a retailer or subdivider makes in carrying property from one market to another.[45]

D. Formula resale agreements

The hardest issue in the Section 83 Regulations is the treatment of agreements which require the employee to resell stock to the employee upon some inevitable event at a price determined under a formula. The desired results can be outlined simply, but the law after the promulgation of the Regulations is more difficult to describe. The Regulations attack employee capital gain in the plans, but there is no single the-

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[42] 17 C.F.R. § 230.144 (1979). Briefly, if information is publicly available about the corporation, Rule 144 allows a holder of unregistered stock to "dribble it" out, after holding the stock for two years. "Dribble out" sales cannot, during a three-month period, exceed the greater of (1) 1 percent of stock outstanding, or (2) the average weekly trading volume. "Dribble out" restrictions end for nonaffiliates of the issuing company by the end of four years, if information about the issuer is publically available, but continue for affiliates, at least as long as they remain affiliated.

[43] Accounting Principles Board, Opinion No. 25 ¶ 10a (1972).

[44] See Thomas R. Pledger, 71 T.C. 618, 629 (1979) (35 percent discount from restrictions on sale of unregistered stock ignored), holding that while some fairness might result, Congress could rationally disregard securities restrictions because of the ease of taxation.

[45] Section 1221(1), of the Code denying capital gain for property held "primarily for sale to customers in the ordinary course of the trade or business."

ory or even coordinated attack. Instead there is a rather impressive array of possible characterizations and rules of law of uncertain scope, any one of which could mean planning disaster.

The success of formula resale plans in giving the employee capital gain depends upon several critical assumptions about tax treatment. First, the employee must be taxed when the stock is transferred to him at a value for the stock which does not reflect the full present value of the proceeds the employee will receive on resale of the stock. Section 83(d)(1) of the Code provides that when stock is subject to a permanent restriction which allows the employee to sell the stock only at a price determined under a formula, the formula price at the time the employee receives the stock is presumed to be the fair market value for tax purposes. If the formula is at a low enough value when the employee receives a transfer of stock, and if the presumption holds, then the tax on transfer will not destroy the advantage of subsequent capital gain. Secondly, to give the employee gain on resale, the formula price has to go up by the time of resale. If the resale agreement is enforced and the stock, in fact, is redeemed by the employer, the employee's gain must be capital gain for the plan to be successful. An alternate strategy, however, like that for penny stock plans, is to sell not to the employer but on a public market for the stock, usually at a price in excess of what the formula would bring. Under that alternative, the resale agreement must be cancelled without tax to the employee. Section 83(d)(2) of the Code provides that the cancellation of a formula resale agreement is presumed to give the employee taxable compensation, but it also allows the taxpayer to establish that the cancellation was not compensatory, and if so established, the employee will get access to the public market without tax. There are problems achieving the necessary tax treatment at each of the three points, that is, value at transfer, capital gain at redemption, and cancellation without tax.

1. Valuation at transfer

There is no advantage to the employee in structuring plans in which the employee is to get capital gain if the taxable value of the stock is too high when it is transferred to the employee. Use of a formula resale agreement is thought to help suppress the value, relying on the following language in Section 83(d)(1):

> VALUATION—In the case of property subject to a restriction which by its terms will never lapse, and which allows the [employee] to sell such property only at a price determined under a formula, the price so determined shall be deemed to be the fair market value of the property, unless established to the contrary by the Secretary. . .

There will be a great deal of pressure in determining whether restrictions fall within this language since discounts arising from restrictions which presumptively set value under Section 83(d)(1) may be able to give the employee capital gain; discounts from other employer-related restrictions are ignored. It seems difficult, however, to understand what a restriction which presumptively sets value is supposed to be. Arguably, the key statutory requirement is that resale to the employer is inevitable; no one seems to have any content in mind in the term "formula." If the employee receives property with a restriction which disappears, then the restriction has no effect on his ultimate value, even if the restriction disappears in a noncompensatory context, and Section 83 seems intent on ignoring any discount from those restrictions which will ultimately disappear. Section 1.83–3(h) of the Regulations requires that the restriction be permanent and enforceable against any subsequent transferee of the employee. Apparently, the difference between a restriction which presumptively sets value and a restriction which requires forfeiture from true value is that the former is inevitable while the forfeiture may or may not arise. Forfeitures might defer tax, if they qualify as substantial risks of forfeiture, but they are ignored if they are not substantial risks and they never give any opportunity for capital gain.

Inevitability seems to be the best hope for understanding Section 83(d), but it does not work completely. Requirements that the employee offer to sell the employer stock is considered a value affecting restriction as long as the offer must be made before a sale to someone else.[46] There seems to be little implication of inevitability of resale in the concept of offer. The Regulations also, however, require that the repurchase requirement be binding against a purchaser or donee of the employee,[47] and it is the rare "first offer" agreement which meets that requirement, if it is possible at all.

How far a formula repurchase agreement can suppress the taxable value at transfer remains an open question. Formula repurchase agreements do not necessarily define the value of the employee's rights for taxation; they remain an employer-imposed restriction and not a definition of the accession to wealth the employee has received upon receipt of the stock. Under Section 83(d)(1), the Commissioner may establish a true value for stock, other than the formula price, although the burden is on the Commissioner. If one treats the value setting effect as solely a matter of evidence, then the Commissioner will always rebut the low value formula when the alternative evidence of value is good, i.e., when comparable stock is traded on a public market or when there are recent arm's length sales of the stock. Nothing in the Regulations, for instance, allows publicly sold stock to be used in a formula resale agreement plan. On the other hand, the Commissioner will be unable to rebut the formula when the alternative evidence of value is relatively poor. It would, for instance, be difficult for the Commissioner to show some alternative value under discounted cash flow analysis, because the cash flows from the stock are unpredictable and because it cannot be known how long the employee will remain a shareholder. Formulas, if setting value without limitation, have considerable capacity for manipulation, but where there is no good alternative evidence of value, then the accession to wealth which the employee has can just as well be measured by the formula as any other equally arbitrary measure.

The right given to the Commissioner to rebut the formula

46 Reg. § 1.83-3(h)(i).
47 Reg. § 1.83-3(h)(ii).

price can be read not only as a question about the alternative measures of value, but also as a question about the quality of the formula itself. Section 1.83–5(a) of the Regulations provides that a formula based on book value, a reasonable multiple of earnings or a reasonable combination thereof will ordinarily be regarded as determinative of fair value. Example (2) of Section 1.83–5(c) favorably cites an example of a multiple of earnings per share formula "which is a reasonable approximation of value at the time of transfer." The term "reasonable," if it is the test of the value setting effect of a formula, bears a lot of weight. If reasonable formulas allow sufficient suppression, then capital gain planning will be viable; if they do not, then capital gain planning cannot be profitable, even on the employee level. Still it would seem that formulas should try to mimic market values, as if there were a market available, if the presumption is to be maintained.

The Regulations threaten to increase the taxable amount on transfer when the value claimed does not account for high payments to be made under the repurchase agreement.

Section 1.83–5(a) of the Regulations provides:

> [I]n certain circumstances the formula price value will not be considered to be the fair value of [the] property . . . even though the formula price restriction is a substantial factor in determining value. For example, where the formula price is the current book value of the stock, the book value of the stock at some time in the future may be a more accurate measure of the value of the stock for purposes of determining the fair market value of the stock at the time the stock becomes substantially vested.

Example (4) of Section 1.83–5(c) illustrates the rule by a plan in which the recipient of compensation, an independent contractor who is to build an office building, is given stock of the corporation for which the building is to be completed. The stock has no book value when the contractor receives it, but the contractor is required to sell the stock to the corporation at the book value of the stock once the contractor completes the building. The example concludes:

In determining the fair market value of the stock [at transfer], the expected book value of the stock after construction of the office building will be given great weight. The likelihood of completion of construction would be a factor in determining the expected book value after completion of construction.

The example seems to be identifying the building contractor as a scoundrel by the reasonable view that he did not report the value of the stock when he received it at a value which reflected the cash that the builder would ultimately receive from the stock. The stock is his compensation. The provision, however, seems too timid and the remedy too unwieldy to be administered with any effectiveness. The Regulations do not appear to rely on hindsight and, at the time of transfer, the future repurchase price is speculative. Uncertainty will undoubtedly work to the employee's advantage both because the courts are likely to settle on a conservative prediction when the range of possibilities is wide and because a high discount rate is necessary to reflect doubts about predictions. If so, advantageous capital gain will remain possible. Still, the courts cannot be expected to ignore hindsight entirely when it is necessary to identify a scoundrel,[48] so that there may be occasional cases in which the Example (4) remedy is applied. One could argue that when the remedy is applied is too lenient to a scoundrel because it allows the difference between value at transfer and the resale price to be taxed as capital gain, whereas the builder's earnings between transfer and repurchase were more appropriately ordinary income.

2. Capital gain on redemption

The repurchase of the stock by the employer under an inevitable resale agreement will not necessarily give the employer capital gain. At the outset, purchases by the employer of its own stock are redemptions under Section 317 of the

[48] Diamond v. Comm'r, 492 F.2d 286 (7th Cir. 1974) (Court found service partner's receipt of partnership income interest was taxable compensation, undoubtedly because partner sold interest for purported capital gain).

Code and redemptions must pass the rules of Section 302(b) of the Code to qualify for capital gain. More importantly, Treasury Regulation § 1.83–3(a)(3)–(6) has a series of rules which prevent an employee from getting into a capital gain position with respect to stock subject to an inevitable repurchase agreement because the stock it is said not to have been transferred when the employee received it. Such agreements might be called "prevent–transfer" restrictions.

Section 1.83–3(a)(7) Example (3) of the Regulations provides as follows:

> On January 3, 1971, *X* corporation purports to transfer to *E*, an employee, 100 shares of stock in *X* corporation. The *X* stock is subject to the sole restriction that *E* must sell such stock to *X* on termination of employment for any reason for the excess (if any) of the book value on January 3, 1971. The stock is not transferable . . . Under these facts and circumstances, there is no transfer of the *X* stock within the meaning of Section 83.

Because the employee received no "transfer" of the stock in 1971, the sales proceeds he receives on sale will be compensation to him in full. Since the formula, equal to subsequent increases in book value of the stock, gave the employee no vested interest in the stock when the employee received it, the conclusion that his ultimate sales proceeds were compensation seems sound. Without an investment in the stock, the employee's gain could not have been said to be due to market appreciation of his capital. The sole explanation of the sale proceeds were that they were compensation. The example has considerable case law support.[49]

The example is, however, identical in principal with Example (4) of Section 1.83–5(c) of the Regulations, discussed earlier, in that in both the resale agreement gave the employee no vested interest when the stock was physically transferred to

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[49] See, e.g., Vestal v. United States, 498 F.2d 487 (8th Cir. 1974); Ford S. Worthy, 62 T.C. 303, 311 (1974); Estate of Aylesworth, 24 T.C. 134, 144 (1955); National Clothing Co. of Rochester, 23 T.C. 944 (1955); Artis C. Bryan, 16 T..C. 972, 981 (1951); Marts, Inc., T.C. Memo. 1960–127.

the employee and in both the agreement would give the employee gain. The remedies applied in the two examples are inconsistent, however, and there is no attempt in the Regulations to delineate the borders between them. In Example (4), the builder was taxed by increasing the amount of tax he must pay on transfer. In Example (3) of Section 1.83–3(a)(7), no attempt was made to find a true value of the stock when received. Instead of creating an investment in the stock for the employee which is sufficient to make subsequent gain capital, Example (3) just waits until resale and characterizes the full redemption price as compensation."

One possible interpretation is that the Commissioner has an election to apply either remedy depending on how he audits and which he feels will reach the compensation more fairly, but it is more likely that the coordination between the two examples was just never thought out. Looking at the two remedies afresh, it seems that denying the employee subsequent capital gain will be the much more common remedy. That seems far more administrable than trying to predict the resale value and discounting it back at some unknown discount rate. The judicial decisions support the denial of capital gain alternative.

Employee capital gain abuses are not limited to cases where the employee has minimal or no investment in the stock and the Regulations do not limit the denial of capital gain to no investment situations. In Example (4) of Section 1.83–3(a)(7), the employer paid $3000 when the stock was transferred and resale agreement was for the greater of (1) the dividends declared on the stock between the time the employee received the stock and the time he resold it and, (2) the $3000 employee's purchase price. The Regulation's conclusion is the same as in Example (3) and the employee has compensation and not capital gain if the resale agreement gives him gain.

The Regulations do not state what happens when an employee has a taxable interest under an agreement which is said to prevent transfer. If, for instance, the agreement in Example (4), that the employee must resell the stock for the greater of $3,000 or subsequent dividends, had been used, but the employee had paid no purchase price for the stock, then the employee would be entitled to at least $3,000 from the stock, for which he had not paid, as soon as he received the stock. It seems that the proper resolution of the issue is that the employee should have $3,000 compensation in the year he receives the stock and that any gain on redemption should still be compensation.

The taxation of $3,000 when the employee receives the stock seems clear enough. The employee has a vested and funded interest of $3,000 as compensation when he receives the stock. The employee's interest in the stock secured his deferred compensation. Property is defined under the Regulations to include a beneficial interest in assets set aside from the claims of the employer's creditors, so it seems that taxation of mere security interests is intended. Section 83 gives no basis for deferring tax on such interests unless they are subject to a substantial risk of forfeiture. But for immediate taxation of the $3,000, the employee could defer tax on vested beneficial interests and avoid all the rules defining a substantial risk of forfeiture. But for that result the employee could avoid taxation of contributions to a nonqualified employee trust[50] because the employee could transfer his contribution directly to the employee, under circumstances in which the Regulations would hold that the repurchase agreement prevents transfer, and defer taxation of the contribution.

Taxation of the vested interest, however, does not seem to be sufficient for the employee to get into a capital gain position with respect to the property. First, the employee's investment which arises from purchase price seems to have at least equal dignity with an employee investment which arises from a taxed interest. If the repurchase agreement is one like subsequent dividends or subsequent increase in book value, the Regulations seem intended to prevent capital gain, even though the employee has an investment. The gain in Exam-

[50] Reg. § 1.402(b)–1(a). See also cases cited note 70 *infra*.

ples (3) and (4) looks more like the payout of some funded compensation arrangement than like market appreciation on the stock the employee owns. The surrender price has nothing to do with capital appreciation. Congress, in enacting Section 83, intended to equate the taxation of stock compensation with the taxation of nonqualified employee trusts[51] and an employee has compensation on the payout from such a trust,[52] notwithstanding that he also had compensation when he acquired a vested interest in the trust.[53] An employee who has a mere security rather than ownership interest in stock he has in hand does not get capital gain when he surrenders that security interest to the employer for cash.

While it may not be particularly disturbing to have agreements with a resale equal to interim dividends treated as giving ordinary gain on redemption, it is not clear when the employee has a mere security interest in stock he has in hand and when he will be deemed to have received an ownership interest on which he can get capital gain. The results in Examples (3) and (4) are based on the most unsatisfactory language of Section 1.83–3(a)(5) of the Regulations, which provides that if stock is subject to an inevitable resale agreement:

> [a]n indication that no transfer has occurred is the extent to which the consideration to be paid the transferee upon surrendering the property does not approach the fair market value of the property at the time of surrender.

The language is gibberish. A small point is that the phrase "the extent to" is meaningless unless it is redundant with "approach" or "indication" or both. Secondly, the word "transferee" refers to the employee who transfers the stock at surrender rather than to the employer, who receives the stock on surrender. Thirdly, the concern is not that the employee will receive too little on surrender, but that he will be taxed on too

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[51] S. Rep. No. 9–552, 91st Cong., 1st Sess., 120 (1969).

[52] Reg. § 1.402(b)–1(c).

[53] Reg. § 1.402(b)–1(a) and (b).

little at the time of transfer to the employee if the surrender price sets the value of the stock too low or else the concern is that the employee will receive too much on surrender above the fair market value of the stock. Finally, there is no case that properly fits within the language, not even the Regulation's examples. If the repurchase price sets the value of the stock, there is no logical possibility that the value can diverge from the repurchase price; if the repurchase price does not set value, because the presumption of Section 83(d)(1) of the Code is rebutted, because the resale agreement is a lapse restriction or because the transfer value is increased to reflect future sale proceeds, then application of those remedies would seem to preempt the application of the prevent transfer remedy the language is explaining. Planning in the face of such inexplicable language is disconcerting.

Still one comes away from Section 1.83–3 (a)(5) of the Regulations with the impression that formula resale agreements are not an open game in which the employee can automatically be given capital gain just by providing gain under the agreement. It seems that repurchase agreements must give a value on transfer "approaching" the price an outsider would pay for the stock when the employee receives the stock and must give a value no greater than what the outsider would pay for the stock when the stock is repurchased. Unless the face of the agreement demonstrates an attempt to mimic outsider values, the employee will probably be deemed to have a deferred compensation contract and the stock he has in hand will be just a security for the agreement. Agreements rigged to give the employee gain unrelated to normal appreciation on the employee's investment are deferred compensation arrangements.

Part of the reason for conservative advice in this area is the ineffectiveness of the business purpose doctrine to save employee capital gain. Any reasons which the employee has for setting up the formula are compatible with the theory that he has a deferred compensation plan with business contingencies. Even with a business purpose to give the employee gain, the gain is compensation unless the gain is like appreciation on the employee's investment.

If one can assume that the gain sufficiently mimics market appreciation, then the rule in Example (5) of Section 1.83–3(a)(7) of the Regulations that the employee can have no capital gain if he is protected from loss seems harsh. In Example (5), the agreement provided that, upon leaving employment, the employee must sell his stock for the greater of (1) the fair market value of the stock at the time of surrender, or (2) the fair market value of the stock when the employee received it. The employee was held not to be entitled to capital gain on repurchase because he did not incur "the risk of a beneficial owner that the property would decline substantially."[54]

An employer's agreement to protect his employee from loss gives the employee who sells at a gain no tangible benefit, because the employee has no loss to be protected from. The denial of capital gain treatment, accordingly, cannot be said to match any benefit the employee has received. No-Loss guarantees can be separate instruments which provide a compensatory benefit unrelated to the employee's ownership of stock. It thus seems that a protection against loss is not incompatible with treating the employee as owning the stock. He has ownership and an added benefit. The Regulations, however, do seem to require that a formula repurchase agreement that is valid for tax purposes must mimic the market not only in giving gain, but also in generating risk of substantial loss.

Speculating a bit beyond the Regulations, it seems that abuses of employee capital gain are not limited to those apparent on the face of the agreement at the time of transfer. Often it will be possible to determine whether the employee's payment is like the payout of a deferred compensation arrangement or like gain from investment only by viewing the full circumstances surrounding the payment after the fact. If the law were omniscient, then it might separate every employee redemption into two elements. One element would be normal return on investment and the other element would be explained by the compensatory relationship out of which it

[54] Reg. § 1.83–3(a)(7) Ex. (5) based on Reg. § 1.83–3(a)(6).

arose. The law rarely attempts to allocate a single gain between capital and ordinary elements and consistently the employee on redemption would probably be considered to receive either entirely ordinary gain or entirely capital gain, even when the origins of the gain are mixed. A substantial compensatory element to the repurchase, however, might be sufficient to make the gain ordinary, just as substantial development or retailing activity is enough to classify real estate as "primarily held for sale to customers in the ordinary course of a trade or business,"[55] even when some of the seller's gain arises from market appreciation. In any event, asking the question whether an employee originally had a transfer of stock which is redeemed by the employer seems to be a poor way to identify whether the employee's gain is properly attributable to investment or to compensation. Redemptions in which the employee receives a price which does not resemble normal appreciation on the employee's investment, as all the facts are known upon redemption, are probably taxable as compensation. Given the variety and complexity of agreements which might be considered setting the resale price and the variety of contingencies under which they occur, the question of whether the repurchase was compensatory seems answerable only after the redemption occurs. It, accordingly, seems insufficient for the employee to establish that stock was transferred to him. The employee should also be prepared to establish that the repurchase separately had no substantial compensatory intent.

3. No tax on cancellation

Employee gain can come from sale to outsiders as well as sale to the employer, but if stock is subject to an inevitable repurchase agreement which determined value under the Section 83(d)(1) presumption, the agreement must be cancelled for the employee to get access to the public market. Section 83(d)(2) provides that a cancellation of a restriction within Section 83(d)(1) is presumptively compensation to the employee, although not all cancellations are compensatory.

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[55] I.R.C. § 1221(1).

The taxation of the employee on cancellation will not necessarily take away the full advantage of capital gain from formula resale agreements, even if the cancellation is compensatory. The amount of tax on cancellation is the difference between the value of the stock after cancellation over the value of the stock set by the formula before the cancellation. "Appreciation" of the stock under the formula prior to cancellation is not taxed at cancellation. Presumably, however, the Service will have the right to prove that "appreciation" caused by the formula was excessive.

Section 83(d)(2) allows the employee to avoid any tax on cancellation if he can establish that the employer will not take a deduction and that the cancellation was noncompensatory. The Regulations require that the employee file a statement that the employer will not take a deduction when he claims that the cancellation is noncompensatory,[56] so that noncompensatory cancellations will be a flagged issue, but the employee can in fact sometimes ride through to a public market for stock on the argued noncompensatory motives in the cancellation. Section 1.83–5(b)(1) of the Regulations, for instance, provides that the cancellation of a "buy-sell" restriction in connection with a public offering of the stock will ordinarily be considered a noncompensatory cancellation, at least if the original intent of the restriction was to limit the ownership of the corporation before the public offering. Accordingly, the old penny stock plans may have continued life if prepared with a value suppression formula resale agreement. The employee would be taxed at a low value determined by a formula but receive his gain from a public market.

As a practical matter, however, the possibility of a noncompensatory cancellation of a formula agreement should be viewed as an opportunity that arises on fortuitous occasions and not a benefit that can be safely planned. One of the best ways to prove compensatory intent is to show that cancellation was anticipated when the employee received the stock. Whether or not the disappearance of the restriction was in

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[56] Reg. § 1.83–5(b)(2) (relying on I.R.C. § 83(d)(2)(B).

compensatory circumstances, the employee received his property stock as compensation and Congress seems to have intended in enacting Section 83 that capital gain would not be available from temporary employer-imposed restrictions.

The "prevent-transfer" characterizations of Treasury Regulation § 1.83–3(a)(3)–(6), which prevent the employee from receiving capital gain upon redemption of stock subject to an inevitable repurchase agreement will also prevent the employee from getting a cancellation of the restriction without tax. If, for instance, the employee was obligated to resell the stock for its future dividends or future increase in book value, the employee had no transfer of the stock when he received it under Examples (3) and (4) of Treasury Regulations § 1.83–3(a)(7). If the employee was protected against loss, Example (5) of Treasury Regulation § 1.83–3(a)(7) holds he had no transfer. When the agreement is cancelled, therefore, the employee is considered to receive transfer of the stock for the first time. Under Section 83(a), the standard to determine whether a transfer is compensation is whether it was "in connection with the performance of services." It is difficult to think of a case within the scope of this paper in which the cancellation of restrictions described by Treasury Regulation § 1.83–3(a)(3)–(6) would not be a transfer in connection with the performance of services. The Section 83(d)(2) test of whether cancellation is compensatory is also in theory intended to reach the compensation that the employee receives, but the noncompensatory cancellation test seems somewhat easier to meet.

A final trap, discussed more fully in ¶ 803.4[E] *infra*, is that there is difficulty in distinguishing a partial risk of forfeiture from a repurchase agreement providing for a price below the true value of the stock, but lapses of forfeiture restrictions give the employee compensation, whether the lapse is itself compensatory or noncompensatory.

¶ 802 WITHHOLDING

Section 1.83–6(a)(2) of the Regulations provides that the employer will be entitled to a deduction for compensation only if the employer withholds for employee income tax from the compensation in accordance with Section 3402 of the Code. Stock compensation is subject to withholding when taxable to the employee under Section 83(a).

¶ 802.1 Origin of the withholding rule

The requirement that the employer withhold employee tax to get its deduction is based on Section 83(h) of the Code, which provides that the employer's deduction for compensation is equal to the amount of compensation the employee has included in his taxable income. Section 83(h) has an anti-"whipsaw" principle built into it. The statutory language is "included" in employee's income and not merely "includable" so that the employer's deduction is contingent on the employee's inclusion. A taxpayer ordinarily computes its taxes from its own books and information, but anti-whipsaw remedies seem justified to protect the revenue. "Whipsaw" situations, that is, situations in which each party to a transaction claims a theory, time, or value for the compensatory transfer advantageous to itself without regard to the fact the other party is taking an advantageously inconsistent view are incompatible with the common sense view that the transaction has but a single nature.

Section 83(h) reinforces an anti-whipsaw principle, but it did not itself create any administrative mechanism to enforce it. Section 83(h), for instance, creates no employer right nor obligation to inspect employee's return before claiming a deduction. Pro-taxpayer whipsaw arises more from deficiencies in the enforcement or administration of tax law than from any pro-whipsaw principle. Consistency as a principle is not new to Section 83(h). However, administrative enforcement of the principle seems within the scope of Regulations. Section 1.83–6(a)(2) of the Regulations, requiring the employer to withhold from compensation to get a deduction for compensation, is one of the administrative remedies against whipsaw.

The Proposed Regulations under Section 83 had allowed the employer deduction only when the employee actually included compensation in income.[57] The rule, while literally within Section 83(h), meant the employer was responsible for the employee duty of inclusion and could be charged with a detriment from employee fraud. Section 1.83–6(a)(2) of the Regulations liberalized the Proposed Regulations, although it did not abandon the anti-whipsaw principle entirely. The employer may deduct compensation the employee fails to include, as long as the employer has done everything within its duty to ensure the employee includes. Section 1.83–6(a)(2) denies the employer deduction for compensation if the employer has not fulfilled its own obligation to withhold on the compensation.

Section 1.83–6(a)(2) creates no substantive withholding obligation. The substantive obligation is created only by Section 3402 of the Code. Thus, Section 83(h) allows deduction of payments to independent contractors, with respect to which the payor of compensation has no withholding obligation. Moreover, an employer corporation, pursuant to Section 1.83–6(d) of the Regulations, may deduct compensation paid to its employees by the corporation's shareholders and where the corporation is not the transferor, it is not the party charged with the withholding obligation.[58] If the employer has no Section 3402 duties, then the deduction is allowed without withholding. Social Security (F.I.C.A.)[59] and federal unemployment (F.U.T.A.)[60] taxes are not imposed by Section 3402 and are not carried into Section 1.83–6(a)(2).

If the employer does not withhold, but the employee nonetheless includes his compensation in income, the statute authorizes the deduction. Section 3402(d) provides that with-

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57 Prop. Reg. § 1.83–6(a), 36 Fed. Reg. 10793 (1971). The proposal would have allowed the deduction for statutorily exempt employee death benefits.

58 I.R.C. § 3401(d)(1); Letter Ruling 7939011, June 13, 1979, (C.C.H.) Letter Ruling Reports.

59 I.R.C. § 3102.

60 I.R.C. § 3301.

holding tax cannot be collected from the employer, although he should have withheld, if the employee thereafter pays the tax. The burden, however, is apparently on the employer to show inclusion.[61] Proof of actual inclusion should, accordingly, give the employer its deduction, whether because it has no further withholding obligation or because that is what Section 83(h) allows. Proof that the employee included the compensation, however, will often be hard to establish in practice. The employer must track down the employee, possibly long after the fact, and get him to reveal information he has no duty to reveal. Many employees rely on the information provided by the employer in the W-2 Form so that the employer cannot be sure of inclusion even if all information were available. It is unsettled whether the employer deduction will be allowed when the employee pays tax only because of an audit. On the one hand, Section 3402(b) of the Code prohibits "collection" of withholding from the employer if the employee pays the tax even after audit, but the Section 83(h) term is "included," in the past tense, and it is possible the Regulations mean to prevent whipsaw in unaudited cases by denying the employer deduction when the employee includes only after audit. Certainly the safest planning course for the employer is to withhold consistently with any claim for a deduction for stock compensation.

Withholding on stock compensation can be done by withholding the stock itself, although withholding in stock may require something to be done about fractional shares. However, the withholding tax must be paid over in cash and not in stock. Hence, the employer may find that it has a cash obligation with respect to stock compensation when it expected only a stock cost. Often that cash obligation can be funded out of the tax savings the employer deduction gives from the corporation's periodic payments of tax. But the withholding will sometimes be an unexpected cost, especially as noted next, when the employer has a withholding obligation in a period in which there is no transfer to the employee in stock or otherwise.

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[61] Staff of Jt. Comm. on Tax., Issues in the Classification of Individuals as Employees or Independent Contractors 7 (Comm. Print 1979).

¶ 802.2 Withholding without physical transfer

In Revenue Ruling 79–305[62] the Service ruled that the employer has a withholding obligation when a substantial risk of forfeiture lapses and the employee becomes taxable under Section 83(a) of the Code. There is no physical transfer of stock from which to withhold when the restriction lapses, but still the deduction requires withholding. The rule of Revenue Ruling 79–305 will undoubtedly be extended to the employer's deduction when an employee makes a Section 83(b) election or has a compensatory cancellation of a formula resale agreement, again even though there is no transfer in the period the deduction is taken.

For stock compensation, the employer's withholding requirement can usually be met by withholding at the 20 percent rate for supplemental payments.[63] Twenty percent is not too onerous a requirement, especially with respect to the employees who will bear a 50 percent tax rate on their final return. Still, withholding can be an embarrassment if the employer is not prepared for it. At minimum, employees will be upset if cash needed to pay over withholding on stock is taken out of regular take-home pay or expected benefits, without clear prior notice. It is not in any event clear how the employer has any legal right to withhold from unrelated benefits. Finally, the employer may have no separate cash payments for the period large enough to bear the 20 percent withholding obligation. The best planning is for the employer to prepare for withholding by contract to authorize withholding from unrelated payments and by requiring the employee to return cash if necessary to satisfy the employer's withholding obligation at whatever future withholding rate applies.

A final possibility, if all else fails, is for the employer to increase the employee's compensation by enough to pay the withholding. Withholding is computed on gross compensation, not take-home pay, so that paying the 20 percent with-

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[62] 1979–2 C.B. 350.

[63] Reg. § 31.3402(g)–1(a)(2)(ii) (1966).

holding requirement from new compensation means that the 20 percent withholding rate on supplemental compensation becomes 25 percent of the value of the stock compensation. Paying another 25 percent on behalf of the employee will upset the bargaining where the employer was not willing to pay the extra amount when the compensation was negotiated, but if the employer has not prepared for withholding, the extra compensation can be rational. The 25 percent compensation is deductible so its after-tax cost for a 46 percent bracket employer is only 13 1/2 percent of the stock compensation. If the employer neither withholds nor shows inclusion, it would lose the employer deduction worth 46 percent of the stock compensation.

¶ 803 DEFERRED COMPENSATION

¶ 803.1 Planning strategies

Nonqualified deferred compensation can have some disadvantages as well as advantages over current compensation. Deferred compensation, if successful, defers the employee's tax, but Section 405(a)(5) of the Code or Section 83(h) of the Code, if applicable, will also defer the employer's tax savings. Employees are often in 50 percent brackets and where so, the benefit derived from deferring the employee's tax is worth the cost of deferring a 46 percent benefit from the corporate deduction. In the highest brackets, the spread between employer and employee rate may be only 4 percent and where lower bracket employees are involved, the deferral of the deduction is a greater cost than the deferral of the income is worth. In practice, however, the deferral of the employer cost of compensation more than makes up for the deferral of the employer's tax savings, so that the employer will usually be willing to defer the cost if the employee wants it.

Deferred compensation is advantageous tax planning not only when the employee's tax rate is higher than the employer's, but also because it can take advantage of changes in rates between the time deferred compensation is planned and the time it is paid. Retirement income of the employee is often lower, and when so, the drop in employee tax is a benefit without symmetrical cost to the employer. Highly paid employees, however, may find that their retirement income is taxed at no lower than the 50 percent rate available for current compensation. Deferred compensation is also advantageous when the corporate rate for deductions is higher in the year of payout than the year of negotiations. Thus, many starting-up corporations or corporations temporarily in a tax loss position may find that deferring the compensation not only defers the cost of compensation, but also increases the ultimate tax savings. Even from an aggregate view of tax costs, accordingly, deferred compensation can make a great deal of sense.

¶ 803.2 General effect of Section 83

Under Section 83 of the Code, meaningless restrictions on stock the employee has in hand were not intended to be a basis for deferral. Prior law had allowed the taxation of stock subject to a restriction "which has a significant affect on value" to be deferred until the restriction lapsed.[64] Section 83 ignores most such restrictions and requires the employee to include the stock in income immediately even though it is restricted. Deferral is permitted under Section 83 only in cases in which the restriction is meaningful, that is, where there is a "substantial risk of forfeiture" on the stock. Limiting deferral was an important motive for the enactment of Section 83. The two core concepts in Section 83 are to limit employee capital gain[65] and to limit employee deferral of income. Moreover, the 50 percent limitation on earned income, as enacted by Congress at the same time as Section 83, left deferred compensation to be taxed at a maximum rate of 70 percent.[66] Both provisions seem part of an attack on deferral. On some issues the final Regulations promulgated under Section 83 continue the harsh attitude toward deferred compensation. The legislative climate in which Section 83 was enacted might more-

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64 Reg. § 1.421–6(d)(2)(i)(1961).

65 See § 801.2[A] *supra*.

66 Pub. L. No. 91–172, § 804, 83 Stat. 685 (1969) (amended 1976).

over encourage hostile interpretations by the courts. However, on some issues, the Regulations seem hospitable toward deferred compensation.

The Revenue Act of 1978 prohibited changes, after February 1, 1978, in the Treasury's position on deferred compensation plans,[67] but the Section 83 Regulations are unaffected. The final Section 83 Regulations were promulgated after February 1, 1978, but were final when Congress considered the freeze.[68] Section 132(b)(2)(D) of the Act exempts that portion of any plan involving property within the jurisdiction of Section 83 from the freeze.

¶ 803.3 Funding

Section 83(a) of the Code provides that the employee is taxed on unrestricted stock when it is transferred to the employee and Section 1.83–3(a)(1) of the Regulations defines the time of transfer as when the employee "acquires a beneficial ownership interest in such property." Under the "beneficial interest"[69] test, an employee is taxed when his deferred compensation is funded. Section 83 was enacted to equate the taxation of stock compensation with that of nonqualified employee trusts and "beneficial interest" was originally a trust term. An employee can be said under Section 83 to be taxed on funding of his deferred compensation because that is like the contribution to an employee trust. The result is no change since under prior law an employee was said to have an "economic benefit" when his promise for deferred compensation was funded.[70] "Economic benefit," however, is a term applica-

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[67] Pub. L. No. 95–600, § 132, 92 Stat. 2782.

[68] T.D. 7554 was issued on July 24, 1978 and Pub. L. No. 95–600 was enacted on November 6, 1978.

[69] The word "ownership" in the full term "beneficial ownership interest" is intended to distinguish stock subject to certain restrictions described in Section 1.83–3(a)(3)–(6) of the Regulations, which prevents the employee from getting into a capital gain position with respect to the stock because the employee has a "security" rather than "ownership" interest in it. See § 801.3[D][2] *supra*.

[70] Candido Jacuzzi, 61 T.C. 262 (1973); E. T. Sproull, 16 T.C. 244 (1951) aff'd *per curiam* 194 F.2d 541 (6th Cir. 1952); Rev. Rul. 60–31, 1960–1 C.B. 174 (Ex. 4).

ble to a very wide range of employee benefits while "beneficial interest" seems to focus more on the funding question.

The Regulations do not delineate the scope of funding in full, but Section 1.83–3(e) defines the term "property," within the jurisdiction of Section 83, to include:

> a beneficial interest in assets (including money) which are transferred or set aside from the claims of creditors of the employer, for example, in a trust or escrow account.

There have been no further interpretations of the phrase and it is conceivable that "beneficial interest" could come to have a different meaning from "economic benefit." "Beneficial interest" often has a state trust law meaning. Without a regulatory definition of funding, however, it seems unlikely the Regulations intended to change prior law. Such arrangements as employer-controlled investments used for the employer's benefit to allow it to a pay off liability for future compensation seem still not to constitute funding.[71]

The beneficial interest test can also be expected to clarify, if there was ever confusion, that the employee can be taxed on stock that he has not physically or constructively received. Section 1.451–2(a) of the Regulations provides that a cash basis employee has not constructively received stock if the employee's "control of its receipt is subject to substantial limitations." Section 83 ignores limitations on control which do not reach the dignity of a substantial risk of forfeiture; control of assets in an employee trust is usually exercisable only by the trustees and not by the employee beneficiaries. This, however, is again no change of substance. Under prior law, an employee had an economic benefit from funded compensation, notwithstanding that he had no constructive receipt of the funding property.[72] Employee control or designation of assets, however, could be important enough to mean that the em-

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[71] Rev. Rul. 72–25, 1972–1 C.B. 127 (annuity contract); Rev. Rul. 68–99, 1968–1 C.B. 193 (insurance contract).

[72] See *supra*, note 70.

ployee is taxed on property, whether the test is atriculated as "economic benefit" or "beneficial ownership interest."[73]

¶ 803.4 Substantial risk of forfeiture plans

An employee is not taxed on stock transferred to him if the stock is both subject to a substantial risk of forfeiture and is nontransferable. The employee's interest in the stock is said by the Regulations to be "substantially nonvested."[74] Stock is nontransferable, even though it can be legally sold or assigned for value, as long as the transferee is subject to the employee's risk of forfeiture.[75] Nontransferability thus is best seen as a reinforcement of the substantial risk requirement. If the employee can get the full cash value of his stock by pledge or sale because the provider of the cash need not worry about the risks, then the employee can fairly be taxed immediately on the stock's value and await the occurrence of the risk for tax recognition of its existence. In any event, nontransferability will be assumed herein when it is stated that stock is subject to a substantial risk of forfeiture.

Under Section 83(a) stock which is subject to a substantial forfeiture (hereinafter "SRF") is taxed when the risk lapses. On lapse, the value of the stock at that time is personal service income to the employee. The employee's right to ownership on which he is taxed is sometimes called "full enjoyment" by the statute,[76] and "substantially vested" by the Regulations,[77] but the result is the same.

Stock subject to a SRF is thought of as the paradigm of deferred compensation allowed by Section 83, but SRF plans are

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[73] Helvering v. Clifford, 309 U.S. 331, 335 (1940) (control makes grantor the owner of trust assets); Higgins v. Smith, 308 U.S. 473, 478 (1940) (command marks real owner of the property); Rev. Rul. 77–85, 1977–1 C.B. 12 (variable annuities with investment control by annuitant), questioned, Investment Annuities Inc. v. Blumenthal, 437 F. Supp. 1095 (D.D.C. 1977) rev'd on other grounds____F.2d____, 44 A.F.T.R.2d 79–5746 (D.C.Cir. 1979).

[74] Reg. § 1.83–3(b).

[75] Reg. § 1.83–3(d). See also, S. Rep. No. 91–552, 91st Cong., 1st Sess., 122 (1969).

[76] I.R.C. § 83(c)(1).

[77] Reg. § 1.83–3(b).

in many respects considerably less advantageous than other forms of deferred compensation. First, the creation of a SRF is probably considerably more difficult in some cases than many planners anticipate. For instance, stock held by controlling shareholders of the employer is never subject to an SRF. Second, if a SRF is used, the employer's deduction cannot be earlier than the time the employee includes the compensation in income. Without a SRF, the employer can sometimes obtain a deduction before, possibly long before, the time he must pay compensatory benefits. Third, many of the SRF plans were adopted to ensure that the employee's receipt of deferred compensation still qualified for the 50 percent maximum tax on earnings, but with the extension of the ceiling rate to deferred compensation plans in 1976, the SRF is no longer necessary. Finally, the employer is considered to be the owner of stock transferred to employee subject to a SRF and that can complicate life for many issues throughout the Code.

A. Meaning of substantial risk of forfeiture

Section 1.83–3(c) of the Regulations, defining substantial risk of forfeiture, starts with the wisdom that the question of whether property is subject to a SRF or not depends on all the facts and circumstances. The Regulations proceed to some specific illustrations of restrictions which do or do not create a SRF, but the theory tying the illustrations together is not always apparent. They are schizophrenic in countering harsh rules with liberal rules without consistent pattern. Ambiguity runs throughout both the statute and the Regulations as to what the test of a SRF is supposed to focus on. On the one hand, it can be argued that a restriction qualifies as a SRF because the employee is not entitled to the stock until further services are rendered during the time between transfer and lapse (the earn-out theory). On this theory, the focus would be on the "substantiality" of the services yet to be rendered. The right to the stock must still be earned. On the other hand, a "substantial risk of forfeiture" seems to imply a statistical risk that a substantial number of employees do in fact lose their property (the statistical risk theory). Under this theory the "substantiality" of the risk is important. A final theory adopted in the final Regulations for the first time is that a SRF is any forfeiture that can be expected to be enforced where the contingency for forfeiture has a "purpose related to the transfer." This test is probably more liberal than either the earn-out or statistical risk theories, but its meaning is vague. In any event, the alternative theories have not been supplanted in full. All this suggests, much to the detriment of careful planning, that many issues will be settled only by future administrative process or litigation.

In plain English, a "substantial risk" implies that the employee could show from a valid statistical sample, if one were available, that a substantial number of employees in situations like that of the taxpayer employee in fact forfeit their stock once all facts are known. The qualification as a SRF must be judged before the facts are known and valid samples are never in fact available, but still "risk" has its only objective meaning because of results.

Looking at Section 83 from this view means that Section 83 was intended to end the deferral from meaningless restrictions like ones which had a "significant effect on value" under prior law, but that a substantial risk is not meaningless restriction. Under the claim of right doctrine, an employee's receipt of property is taxed even though the employee might, and in fact does, return the property.[78] Under the statistical risk theory, Section 83 is creating an exception to the claim of right doctrine for SRF stock only because the risks of return are significantly higher when there is a SRF than is usual for property held under claim of right. Hence, under Section 83, remote risks or risks not rising to the dignity of "substantiality" are ignored when the property is transferred. In those cases, recognition of the risk awaits its occurrence, if it happens.

The Regulations do not consistently adopt the statistical risk theory, but they deny a SRF exists where there is a possibility of nonenforcement of a forfeiture and on this they seem

[78] Healy v. Comm'r, 345 U.S. 278 (1953); United States v. Lewis, 340 U.S. 590 (1951).

to rely on the theory. Section 1.83–3(c)(3) of the Regulations has an example in which a 4 percent shareholder of a publicly held corporation holds stock under a restriction which fails to qualify as a SRF because the shareholder controls the corporation *de facto*, though not by law. One could argue that if the controlling shareholder ever leaves office, his successors would be very likely to enforce a forfeiture if the contingency had occurred, but still the controlling shareholder does not seem to have any greater risk of forfeiture than the taxpayers who pay tax on property held under a claim of right,[79] so that the tax recognition of the forfeiture can await actual forfeiture. The example established a *per se* rule that controlling shareholders, for instance, the founder of a closely held corporation, cannot qualify for a SRF.

The Regulations reach beyond cases of clear control to other cases in which the possibility of enforcement is not substantial, but how far they reach is not clear. On the one hand, if the employee can demonstrate that someone else, with allies and family members, controls the corporation, then the employee is not a controlling employee for whom a restriction never rises to a SRF.[80] On the other hand, control can be established by informal as well as formal relationships.[81] The Regulations direct attention to the employee's relationship to other shareholders, to officers or directors, and to those persons with authority to determine employment termination matters such as whether to enforce a forfeiture.[82] In directing focus on such matters, the Regulations imply that absolute control is not required, but some sort of influence which makes risks not very meaningful is enough. Given that, no high officer nor friendly shareholder in closely held corporations can count on holding stock with a qualifying SRF.

The Regulations, on the other hand, appear to be quite

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[79] See, e.g., United States v. Lewis, 340 U.S. 590 (1951); Vincent Oswald, 49 T.C. 645 (1968), both of which involved employees who did in fact forfeit.

[80] Reg. § 1.83–3(c)(3).

[81] *Id.*

[82] *Id.*

helpful in negating focus on how likely it is that the forfeiture event itself will occur. The questioning of "risk" is limited to questions of the likelihood of enforcement once the contingency occurs. Section 1.83–3(c)(1) of the Regulations states that a contingency "related to the purpose of the transfer" can be a SRF, as long as enforcement is a substantial possibility once the contingency occurs.[83] Thus, a forfeiture contingent on the failure of the corporation's earnings to increase is said to be a SRF, without inquiry as to whether the failure is likely or remote.[84] Arguably, if one could dream up a purpose related to the transfer, forfeiture upon such a remote contingency as, "if Niagara falls," would be a substantial risk. Quite contradictorily, however, the final Regulations carry over an example from the Proposed Regulations that forfeiture contingent on the employee's commission of a crime is not a SRF and that example seems explainable only because the risk of employee crime is not high and because the Regulations mean to deny tax deferral when the risk is low.[85] The plain English meaning of the statutory term "substantial risk" implies that a SRF involves real, not meaningless, risks so that highly unlikely contingencies are probably not sufficient, not withstanding the language the Regulations use.

On the other hand, "risk" is not necessarily the determinative factor. Under Section 83(c)(1), a forfeiture which occurs if the employee fails to perform substantial future services is a SRF, and presumably the statistical risks in such a contingency can be high, low or nonexistent. Restrictions which allow the employee permanent enjoyment only if he performs services after transfer are often called "earn-outs," and there are several indications that the term "earn-out" describes what the draftsmen of Section 83 were thinking about more accurately than does the term, "substantial risk." Under this view, Section 83 ended the easy deferral available under prior law with restrictions which had "a significant effect on val-

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[83] Reg. § 1.83–3(c)(1).

[84] Reg. § 1.83–3(c)(2).

[85] *Id.* See Edward L. Burnetta, 68 T.C. 387, 404–405 (1977) (holding that forfeiture upon theft of embezzlement is not substantial risk because too remote).

ue," but allows deferral where the employee has not yet earned the stock but will earn it only after he receives it and before the time the restriction lapses.

The earn-out theory explains, or at least is compatible with, several rules. Before 1976, Section 1348, as enacted simultaneously with Section 83, provided that deferred compensation did not qualify for the maximum tax.[86] Under Section 1348(b)(1) of the Code, however, compensation subject to an SRF could be paid many years after the plan was negotiated, as long as the payment was within the year after the SRF lapsed. The result can be explained on the theory that the property subject to the SRF was considered earned only between the time the rights arose and the SRF lapsed. The Tax Reform Act of 1976 extended the maximum tax to deferred compensation[87] so that the time compensation is earned no longer matters for Section 1348, but the original form of Section 1348 seems to reinforce the earn-out theory.

Section 83 itself has traces of the earn-out theory. Under Section 83(b), the employee may elect to be taxed on stock subject to a SRF when it is transferred. If the election is exercised, however, no deduction for loss is allowed if the risk of forfeiture materializes,[88] even if the loss arises out of an employment status and an employment related contingency. The penalty seems comprehensible, if at all, only under the earn-out theory. Under this theory, a SRF indicates that the stock is earned only by future services. The Section 83(b) election was thus considered an anticipation of income and a manipulation that had to be limited by a penalty.[89]

Finally, the earn-out theory explains why there can be no

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[86] Pub. L. No. 91–172 § 804, 83 Stat. 685 (1969) enacting I.R.C. § 1348(b)(1) (amended 1976).

[87] Pub. L. No. 94–455 § 302, 90 Stat. 1554 (1976).

[88] I.R.C. § 83(b)(1) (post–(B)).

[89] Section 1.83–2(a) of the Regulations allows a capital loss for any amount the employee pays for the stock so that if for some reason Section 83(b) election is planned, the employee might want to purchase the stock, perhaps out of separate compensation, to avoid the penalty of no loss at all.

noncompensatory cancellation of a SRF. Under Section 83(a), the employee is taxed on the disappearance of a SRF whether or not its disappearance is compensatory. If the SRF indicates that the employee is earning-out the stock, then the fact that the employee gets to keep the stock means that the stock is compensation to the employee, even if the occasion for substantial vesting is identified by noncompensatory motives.

Applying the earn-out theory to the Regulations seems to suggest how the regulatory tests of what services are sufficiently "substantial" might be interpreted where the forfeiture hinges on substantial services. Section 1.83–3(c)(2) of the Regulations provides that a requirement that the employee return stock if he accepts a job with a competing firm ordinarily does not result in a SRF and proceeds to list facts usually considered in the value or importance of a noncompetition agreement. The earn-out theory arguably indicates how the factors the Regulation lists will affect outcomes. If the stock subject to the restriction is significantly more valuable than the noncompetition agreement, that seems to indicate that the employee is not earning out the stock but in fact already has a "subsantially vested" interest in it and will be taxed when the restricted stock is received.

Section 1.83–3(c)(2) of the Regulations also provides that a forfeiture contingent on post-retirement consulting services will not be a SRF unless the consulting services are in fact expected to be performed.[90] As written, the example seems to have more to do with risk in the restrictions than substantiality of the services, but still, under the earn-out theory, services of only one day a quarter would not seem satisfactory, even if they will be performed. The earn-out theory would imply again that substantiality of the services is tested by relation to the value of the property. Where the stock is significantly more valuable than the value of the consulting services, then the consulting services are probably not substantial because the employee is not in fact earning-out his stock.

[90] See also, Gale R. Richardson, 64 T.C. 621, 630 (1975) (taxpayer had already earned property, since substantial future services not expected to be performed).

One might have argued, absent the Regulations, that the earn-out idea would at least give employees a safe haven within which one need not inquire about risks. However, the *per se* rule that an employee who controls the employer corporation cannot have a SRF seems to cut across the earn-out theory. One could have argued that a controlling shareholder of the employer was entitled to tax deferral on his compensatory stock because he was earning it between transfer and lapse. For such employees, however, earn-out alone is not sufficient for deferral under the final Regulations. For them, there must also be a risk of forfeiture which the Regulations deny they can have.

In contrast for other employees, the final Regulations allow restrictions to qualify as a SRF, even though they seem to involve neither earn-outs nor substantial risks. Section 1.83–3(c)(1) of the Regulations provides that a restriction qualifies as a SRF, once enforcement can be assumed, if either performance of substantial services is required or "if the contingency is related to the purpose of the transfer." The "purpose of the transfer" test is an alternative way to meet eligibility for a SRF and is not a cumulative requirement.

The scope of the "purpose of the transfer" rule is unclear, but it seems to be quite liberal and if so, it will probably become the primary form of a SRF. Undoubtedly, the contingency will have to relate to a legitimate business purpose, but whether the purpose must be entirely, almost entirely, primarily, substantially, or only somewhat for nontax reasons, remains unclear. One is tempted to say that such requirements as "the employee must return any compensation found on tax audit to be unreasonable" are SRF's, which defer tax, except that the tax motives in such an agreement are high. Whatever the level of business purpose required, the rule seems quite generous since Section 83 intended to ignore many lapse restrictions with only a business purpose, and a risk of forfeiture is still a lapse restriction.[91] One is tempted to say that noncompetitive agreements or consulting services

[91] Reg. § 1.83–3(a)(7), Ex. 1.

which are not substantial can still provide a contingency related to the purpose of the transfer, except that the Regulations undoubtedly did not intend to override rules specified in detail with the more general purpose of the transfer test. Finally, as noted, the purpose of the transfer rule on its face could be said to override any inquiry about the likelihood of the contingency and yet the statute did not seem intended to allow deferral for remote risks. The scope of the "purpose of the transfer" rule will probably be the subject for a fair amount of future litigation.

B. Floats

When stock is subject to a SRF, the employer's deduction cannot occur before the employee includes compensation in income. Section 83(h), moreover, allows the employer a deduction only upon the termination of the taxable year in which the employee includes the stock as compensation. For fiscal year employers, Section 83(h) can mean that no deduction is allowed even though the employee's taxable event has occurred and the employee has suffered withholding before the employer's year closes. For instance, if a SRF lapses in January 1980, a July to June fiscal year employer does not have a deduction until the fiscal year ending June 30, 1981 because the calendar year employee has the termination of his year of inclusion on December 31, 1980. If the employee's year of inclusion and the employer's year end simultaneously, however, the deduction is allowed under Section 83(h), so that calendar year employers will get a deduction in the same year the employee includes. Section 83(h) is stricter than Section 404(a)(5) of the Code, which also requires a kind of matching for deferred payment compensation plans. Section 404(a)(5) allows the employer deduction when the employee's taxable event occurs, even if the employee's year has not closed.

Even if Section 83(h) applies, it is still theoretically possible for the employer to save taxes before the employee pays taxes, at least to the extent the employee's full tax obligation is not covered by withholding or estimated taxes. The deduction upon termination of the employee's year can reduce the corporation's estimated tax payments made before April 15, when a calendar year employee pays his final tax. It should be common under Section 83(h), however, for employees to pay tax before fiscal year employers save tax.

Without a SRF, by contrast, the employer's deduction can anticipate the employee's inclusion possibly by many years. Notwithstanding the statutory language of Section 83(h), Section 1.83–6(a)(3) of the Regulations exempts stock or other property compensation from Section 83(h) matching as long as there is and will be no SRF on the property. If that exemption means that the accrual employer can use normal accrual principles to determine the timing of its deduction, it leads to a quite generous rule. With meritorious dissent outside the area of compensation,[92] it appears that accruals can occur many years before the employer is required to pay the employee for the amount accrued.[93] If so, then without the SRF, the employer might be able to get a long-term "float" between the time it accrues the compensatory expense and the time it must actually pay the expense. If the float is long enough, the employer can pay for its employment expenses by investing its earlier tax savings.

For floats to be available for compensatory benefits, however, the benefit must also avoid Section 404(a)(5). Section 404(a)(5), which is not pre-empted even within the jurisdiction of Section 83,[94] requires matching of the deduction to the employee's inclusion (although not to the termination of his year), even for the accrual employer.

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[92] Mooney Aircraft, Inc. v. United States, 420 F.2d 400 (5th Cir. 1969) (payment long after accrual meant that accrual *per se* did not clearly reflect income). The Commissioner's power to disregard accruals that do not clearly reflect income has been recently strengthened by Thor Power Tool Co. v. Comm'r, 439 U.S. 522 (1979).

[93] Timken Co. v. United States; 42 A.F.T.R.2d 78–5740 (Ct. Cl. 1978) (time of payment does not matter); Washington Post Co. v. United States, 405 F.2d 1279 (Ct. Cl. 1969) (accrual as earned, but payment only after retirement); Cyclops Co. v. United States, 408 F. Supp. 1287, 1299 (D. Pa. 1976) (7 years float was reasonable); Oxford Institute, 33 B.T.A. 1136 (1936) (10 year float). Section 404(a)(5) of the Code for various reasons applied to none of the above cases, although they were all compensatory benefits. See also Note, "Deductibility of Deferred Compensation Plans Under the 'All Events' Test," 30 Tax Law. 780 (1977).

[94] Rev. Rul. 75–448, 1975–2 C.B. 55.

Some floats are possible notwithstanding Section 404(a)(5). Section 1.404(b)–1 of the Regulations contains the following language:

> [Section 404(a)(5)] is not intended to cover the case where an employer on the accrual basis defers payment of compensation after the year of accrual, as . . . where the liability accrues in the earlier year but the amount payable cannot be exactly determined until the later year.

Clearly short-term floats are allowed by this language.[95] If the payment is made to the employee within a "short time" after the year earned, then the plan is considered direct rather than deferred compensation.[96] If the intent of the language is to throw back the timing of the deduction to the general law of accrual, long-term floats are available for stock compensation under this language.[97] The Committee Reports to the Revenue Act of 1978 said that unless payment was within a "reasonable time," matching would apply,[98] but even "'reasonable" has been interpreted to permit seven-year floats.[99] One technique, which the Service has so far unsuccessfully opposed,[100] is to create a fixed and ascertainable accrual to a group or plan, but pay the benefits to any individual, only at some long-deferred time.[101] The long-term floats, however, were given outside of the language of the Section

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[95] Kershaw Mfg. Co. v. Comm'r, 313 F.2d 942 (5th Cir. 1963) ("several months"), Willoughby Camera Stores v. Comm'r, 125 F.2d 607, 609 (2d Cir. 1942) (pre-Section 404 year) (court anticipates payment within a year); Avco Mfg. Co., 25 T.C. 975, 1001 (1956) vacated on other issues 57–2 U.S.T.C. ¶ 10,021 (2d Cir. 1957) (payment year following accrual).

[96] Rev. Rul. 57–88, 1957–1 C.B. 88.

[97] See N. 93 *supra*.

[98] H. Rep. No. 95–1445, 95th Cong., 2d Sess., 62 (1978); S. Rep. No. 95–1263, 95th Cong., 2d Sess., 74 (1978).

[99] Cyclops Co. v. United States, 408 F. Supp. 1287, 1299 (D. Pa. 1976).

[100] Rev. Rul. 76–345, 1975–2 C.B. 134; Rev. Rul. 54–608, 1954–2 C.B. 8, effective date for grandfathered plans deferred by Rev. Rul. 57–325, 1957–2 C.B. 302 and finally supplanted by Pub. L. No. 93–625, § 4, 88 Stat. 2109, (1975), enacting I.R.C. § 463 (vacation plans).

[101] See, e.g., Crucible Inc. v. United States, 591 F.2d 643 (Ct. Cl. 1979); Washington Post Co. v. United States, 405 F.2d 1279 (Ct. Cl. 1969).

1.404(b)–1 of the Regulations, not construing it, so that it is doubtful that the language of the Regulations should be stretched so far. Still, even one-year floats reduce the ultimate cost of compensation by more than a *de minimis* amount by giving anticipatory tax savings.

Before the Revenue Act of 1978, it was also possible to avoid Section 404(a)(5) matching for compensatory benefits, other than stock compensation, because they are not sufficiently like pensions or other deferred compensation plans. Section 1.404 (a)–1(a)(2) provided that matching does not apply to a plan solely for:

> a dismissal wage or unemployment benefit plan, or a sickness, accident, hospitalization, medical expense, recreation, welfare or similar benefit plan, or a combination thereof.

Plans for death benefits,[102] pay for voluntary severance[103] and plans for children's education[104] were held to be outside of this exemption and subject to matching. Although not covered by this language, plans for extended vacations were nonetheless held to avoid matching.[105]

The Revenue Act of 1978 changed the rules for avoiding matching because of the type of plan, but it is not clear by how much. The current Regulations are based on the language of Section 404(b) that matching covers.

> a method of employer contributions or compensation [that] has the effect of a stock bonus, pension, profit-sharing, or annuity plan, or similar plan deferring the receipt of compensation.

The Revenue Act of 1978 amended the quoted language to re-

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[102] Consumers Power Co. v. United States, 427 F.2d 78 (6th Cir. 1970) *cert. den.* 400 U.S. 925 (1970); Reg. § 1.404(a)–12(b)(2).

[103] New York Seven-Up Bottling Co., 50 T.C. 391 (1968); New York Post Corp., 40 T.C. 882 (1963).

[104] Rev. Rul. 75–448, 1975–2 C.B. 55.

[105] Latrobe Steel Co., 62 T.C. 456 (1974). See also I.R.C. § 463. But see, Crucible, Inc. v. United States, 591 F.2d 643 (Ct. Cl. 1979) (whether spillover of unemployment benefits into vacation and savings plan presents triable issue).

place the word "similar" plan with the word "other" plan,[106] apparently with the intent to force greater matching for employee benefits. The Joint Committee Explanation of the Act said that floats were still to be permitted for welfare plans, such as for medical reimbursement, because they "do not have a substantial economic consequences of . . . providing [deferred compensation]."[107] The language seems like a bit of after-the-fact legislative history,[108] but it may mean that the Regulations will not require matching to payment for entirely tax-exempt employee benefits, while taxable or partially taxable benefits like dismissal wages and unemployment pay become subject to matching. The 1978 Act also forces matching for compensation plans for independent contractors,[109] which were before 1978 allowed long-term floats,[110] and that provision may have very substantial impact on the tax shelter industry.

In any event, whatever the full possibilities of floats allowed outside of Section 83(h), it is clear that with stock subject to a SRF, none of the advantages are possible.

C. Eligibility for the maximum rate on personal service income

Many of the deferred compensation plans structured before 1976 had a SRF attached to them solely to enable the employee to get the benefit of the 50 percent maximum rate available for compensation. Before 1976, deferred compensation did not qualify for the 50 percent maximum rate,[111] but a SRF was considered nontax proof that the compensation was

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106 Pub. L. No. 95–600, § 133(b), 92 Stat. 2783.

107 Jt. Comm. on Taxation, Gen. Expl. of the Revenue Act of 1978, 78 (Comm. Print 1979). See also Section 1.83–6(a)(3) of the Regulations exempting welfare plans as defined in Section 1.162–10(a) from matching.

108 Compare H. Rep. No. 95–1445, 95th Cong., 2d Sess., 61–62 (1978) and S. Rep. No. 95–1263, 95th Cong., 2d Sess., 73–74 with Jt. Comm. on Taxation, N. 107 *supra*.

109 Pub. L. No. 95–600, § 133(a), 62 Stat. 2783, enacting I.R.C. § 404(d).

110 Washington Post Co. v. United States, 405 F.2d 1279 (Ct. Cl. 1969).

111 I.R.C. § 1348(b)(1) Pub. L. No. 91–172, § 804, 83 Stat. 685 (1969) (amended 1976).

being earned between the time the employee's rights arose and the time the SRF lapsed. If the employee's taxable receipt was within the year after the lapse of a SRF, the 50 percent rate applied.[112]

The Tax Reform Act of 1976 relabelled the compensation eligible for the 50 percent maximum as "personal service income," where it had previously been called "earned income" and, substantively, extended the benefit of the ceiling rate to compensation no matter how long deferred.[113] Accordingly, a SRF no longer serves any purpose in planning for the maximum tax.

SRF restrictions put on under prior law cannot now, however, be cancelled without the employee being taxed on any property he has a beneficial interest in, no matter what noncompensatory motives might attach to the cancellation. Announcement that the SRF will not be enforced will probably amount to a cancellation.

D. Employer ownership of SRF property

Section 1.83–1(a)(1) provides that the transferor — usually the employer — and not the employee is regarded for tax purposes as the owner of property held by the employee subject to a SRF, even if the employee is the state law owner. The principle has wide consequences. The rule, under Section 83(a), that the employee is not entitled to capital gain from appreciation on property prior to his including the property in income is one manifestation of the principle. Another is that, under Section 83(f), the employee's holding period starts only upon lapse of the SRF. Under the final Regulations, the principle also prevents employers from paying personal employees like gardeners and valets with pre-tax "assigned" income and prevents the employee from having the use of SRF property tax-free. The principle also allows the employer to take a deduction for dividends on stock held by employees subject to a SRF. Finally, the principle that the employer owns SRF

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[112] *Ibid.*

[113] Pub. L. No. 94–455, § 302, 90 Stat. 1554 (1976).

stock can be expected to affect any issue on which stock ownership is important.

1. Employer assignment of income

If the employer were not considered owner of stock subject to a SRF, then a employer could, despite Section 262 of the Code, achieve a tax result equivalent to the allowance of a deduction for personal and living expenses. He would transfer income-producing property subject to a SRF to his personal employees, such as housekeepers or valets. The employees would not pay tax on receipt of property subject to a SRF, and if the restriction were severe enough, they need never be given the property permanently nor be taxed on its value. The employee would pay ordinary income tax on the income distributed on the property. The employer, however, would not pay any tax on the income from the property and thus would have succeeded in compensating the employees out of pretax money. The effect would be the same as allowing a deduction to the employer for such compensation, although in form the employer would have diverted income before receiving it rather than receiving amounts which are thereafter deducted. By making the employer the owner of a SRF property for tax purposes, Section 1.83–1(a)(1) of the Regulations takes away this advantage. Though received by the employee, the income on the property is considered income on property owned by the employer. The employer pays tax on this income and Section 262 forbids a deduction for amounts received by the employee. The employee continues to pay tax on his receipt of the income, though as personal service income.

The principle that income on SRF property is attributed to the employer also operates where direct compensation would be capitalized and it makes clear that income on SRF property is included in considering whether compensation is reasonable.

2. Employee use of property

While Section 83 is normally thought of as governing stock compensation, it applies as well to property like cars or houses where compensation in kind is derived from use of the property. If the employee were considered to be the taxable owner of such property which is subject to a SRF, use of the property would be imputed income not subject to tax. For instance, the employee could be given a car subject to the restriction that he must forfeit it to his employer if he does not work for the next 15 years. The value of the car would eventually be taxed to the employee if he did not forfeit it, but only at a depreciated value which would not tax the employee's prior use. Similar and perhaps more spectacular results could be achieved with houses, although with houses it might be wiser to plan forfeiture at the end of employment instead of a taxable lapse of forfeiture. In any event the restrictions of Section 119 of the Code on nontaxability of lodging expenses could easily be avoided.

The concept that the employer is the owner of property subject to a SRF takes away the benefit of tax-free use of property since the employee is considered using the employer's, not his own property. The use is personal service income eligible for the 50 percent ceiling of Section 1348 of the Code. Similarly, interest on municipal bonds held subject to a SRF is compensation, not exempt Section 103 income.

Usually the employee is taxed on the fair rental value when he uses employer property.[114] Establishment of that value is sometimes difficult, however, and so the employer's cost is sometimes used as fair substitute.[115] Employees seem unlikely to accept that measure, however, because with accelerated depreciation and useful lives less than actual physical life, the employer's costs will often exceed the fair rental value of the property—at least in its early years.

Presumably the employer's deduction is just that of any other owner. Arguably this conclusion is at odds with Section

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[114] See Staff of Jt. Comm. on Int. Rev. Tax., Examination of President Nixon's Tax Returns for 1969 Through 1972, S. Rep. No. 93–768, 93d Cong., 2d Sess., 158–162 (1974).

[115] *Id.* at 162; Leonard J. Ruck, Inc., T.C. Memo 1969–16 (compensation measured as allowable costs and depreciation).

83(h) which generally grants the employer a deduction equal to the amount included in the employee's income. If Section 83(h), however, literally led to a double deduction from employee use, that is, a deduction for both depreciation and the fair rental value of the employee's use, it would be absurd. The sole question seems to be under what interpretation any argued double deduction for the employer would be denied. Use of property is not itself a transfer of property within Section 83(a) so that the employee appears to be taxable on use by reason of the normal rules of Section 61 of the Code, which are outside Section 83. Section 83(h) matches only employee income arising from Section 83 itself.[116]

3. Deductible Dividends

The principle that stock subject to a SRF is owned by the employer works to the benefit of transactions in that dividends on SRF stock become added compensation. Dividends in fact received by the employee on SRF property he owns under state law are reattributed to the employer. For the employer's own stock, the dividends are like dividends on Treasury stock and there is no tax from the attribution. For dividends on affiliated or portfolio stock, the employer gets a 100 percent or 85 percent dividend deduction respectively under Section 243 for the dividends attributed to it. The employer then gets a deduction, subject to the reasonable compensation and capitalization limits, for the employee's receipt of the dividends as if it had received the dividends and paid them over as compensation.[117] The employer is not the transferor of dividends on stock (other than his own stock) so that it probably has no withholding obligation and gets its deduc-

[116] An alternative argument is that since Section 1.83–6(b) of the Regulations requires the employer to recognize gain when he takes a deduction with appreciated property, the gain appropriate to employee use would wipe any double Section 83(h) deduction. Use of property is not the occasion for separate allowability of basis and use of property is not a sale or exchange. Hort v. Comm'r, 313 U.S. 28 (1941). The argument is especially apt since the function of the gain of Section 1.83–6(b) is to balance the employer's books for amounts which have never been included in income.

[117] Reg. § 1.83–1(f), Ex. 1. The preamble to T.D. 7554, promulgating Section 1.83–1 *et seq.*, highlighted this result and disowned the cases contrary to it. 43 Fed. Reg. 31912 (1978).

tion without withholding.[118] Withholding, however, would be required, on dividends on the employer's own stock.[119] The employee benefits from the maximum tax on compensation, if his compensation including the dividends is reasonable, even though the dividends would have been 70 percent ordinary income had the employee been considered the owner of the stock.

The effect of deductible dividends is generally no different than the effect would be if the employer had never transferred the stock. Cash compensation is deductible, even if measured by dividends the corporation makes on some amount of stock. Section 243 allows a 100 percent or 85 percent deduction with respect to dividends received from another corporation, even if the cash from the dividends is used to pay deductible expenses. If the stock is held by the employee because of his services, then in substance the dividends are devoted to the employee because of his services and there is no advantage, as long as the employer has not previously deducted the stock's value.[120] Dividends are subject to the reasonable compensation limits so that SRF stock is no extraordinary technique for expanding the compensation deduction. There are times when state law would restrict or prohibit the employer from owning the stock whereas it allows stock to be held by the employee subject to a SRF, but since every corporation can pay compensation, that seems to be at best a minor convenience.

The deduction for dividends, however, is probably an advantage when the employee pays the full price for stock subject to a SRF when the stock is transferred to him. The dividends the corporation pays in that case are less plausibly added compensation than they are investment returns to the employee. Section 83 does not allow the employee to become

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118 See note 58 *supra* and accompanying text.

119 Reg. § 1.83–6(a)(2).

120 Allowing the employer to deduct both the value of the stock and its subsequent dividends would be a double deduction, since the subsequent dividends are reflected in the value of the stock.

the owner of SRF stock, even if he has paid for it, when it is transferred. Under Section 83(a) the appreciation on stock after transfer is compensation to the employee when the SRF lapses, even where one might argue that the employee's right to the appreciation is attributable to his investment of a purchase price at transfer. Accordingly, there may be some advantage in putting a SRF on stock that the employer intends to sell to the employee for full price, in order to justify a deduction for subsequent dividends and make the dividends personal service income to the employee. Employees who have paid a full purchase price for stock are not likely to tolerate any real possibility of having it forfeited, but perhaps an eligible SRF can be created with a risk which is tolerable to the employee.

4. Other concerns

The ownership of SRF property is described by the Section 83 Regulations, but the consequences can reverberate throughout the Code. One would be hard pressed to draw a distinction in principle between stock ownership solely for the internal purposes of Section 83 and ownership for all tax purposes. Even on the points mentioned, while holding period and capital gain are explicit in Section 83, the other results seem to have more to do with Section 262 or 243 of the Code or use of property than with the operative provisions of Section 83. Certainly it is poor planning to rely on an inconsistent position on who owns SRF property for issues outside of Section 83.

There are many points at which ownership of stock is important.[121] To list a few: Section 1239 of the Code requires ordinary gain on sale to related parties; Section 302(b) of the Code defines what redemptions qualify for capital gain; Section 368 of the Code defines control for reorganizations; Section 1504 of the Code defines "affiliated groups" and Section 1563 of the Code defines "controlled groups" and all the Sec-

[121] For a list which is slightly different from the one presented herein, see Bernstein, "Final Sec. 83 Regs: Dividends on Restricted Stock as Compensation," 10 Tax Adviser 132 (1979).

tions depend upon ownership of stock. Because of Section 83 the employer owns SRF stock held by the employee even though the stock could not be attributed to the employer under the constructive ownership rules applicable on any issue. Often such ownership will work to the advantage of the employer or of the employee, but sometimes it will be an unpleasant surprise.

Income on SRF property assigned to the employer because of his ownership can upset the employer corporation that must receive or avoid some percentage of some kind of income. For instance, a Subchapter S corporation or real estate investment trust can be expected to become ineligible for their status if dividends on SRF stock held by their employees makes the difference. Corporations could also become personal holding companies solely because of such dividends. On the employee's side the characterization of the dividends as compensation may symmetrically avoid personal holding company status for a corporate provider of services or make it eligible for Subchapter S status. Finally, the source of income rules for nonresident aliens and the rules for taxation of U.S. citizens residing overseas will often depend upon whether the income is investment or compensation income and dividends on SRF stock transferred in connection with the performance of services are themselves compensation.

On some issues there might well prove to be an inconsistent resolution of ownership at least in practice. For instance, stock held by the employee is not available to the employer and is not likely to alert an auditing agent that the employer has excess liquid assets beyond the reasonable needs of the business for the purposes of the accumulated earning penalty tax.

None of these problems were caused by Section 83. Ownership of stock is an important question throughout the Code for reasons having nothing to do with compensation and for most if not all of these questions, state law ownership is not dispositive. Still, use of SRF plans can complicate planning, at least for the planner who normally looks only to stock held by the employer to determine what stock the employer owns.

E. Reducing forfeiture consequences

If the employee and the contingency can qualify for a SRF, then the forfeiture which justifies the deferral of tax need not involve loss of all of the employee's stock. A forfeiture can be a partial forfeiture without losing tax deferral of that part of the stock that is forfeitable. Under Example (1) of Section 1.83–3(c)(4) of the Regulations, an employee is not taxed on amounts he will forfeit if the SRF contingency arises, even if the forfeitable amount is an insubstantial part of the stock he has received. Example (1) involves a repayment of the amount that the employee originally paid for the stock, but in Example (4) of Section 1.83–3(c)(4), the employee has no purchase price and in the example the employee is again not taxable on the forfeitable portion of the stock. For this purpose, the Regulations "fragment" a block of stock held by the employee and treat some of it as vested and some of it as substantially nonvested.

It seems clear that Example (1) and Example (4) can be combined under the fragmentary view of partial forfeitures and protect the employee against loss of his vested interest without interfering with his tax deferral for his unvested interest. If, for instance, the employee is granted stock worth $2,000 without a purchase price under a restriction that he will forfeit the stock for the greater of 50 percent of its value or $1000, the employee will have income on transfer of $1000, but no more. If he pays $1000 for the stock he will have no income on transfer.

Some form of fragmentation of the employee stock held subject to a partial forfeiture requirement seems necessary to account for partial forfeitures equitably from both the taxpayer and the Treasury perspective. But for the rule, employees would be taxed on small bargains, even though they would forfeit the full bargain, where the bargain was too small to be substantial in relationship to the underlying stock. Since the employee in fact has a SRF for everything he would be taxed on, however, it would be odd to consider him vested enough to be taxed on the bargain. On the other side, the fragmentation rule requires the employee to pay tax on amounts he will in fact not forfeit. Arguably, if the forfeiture is itself a substantial part of the underlying block of stock, then the forfeiture is substantial. However, such a rule would allow plans in which the employer funds the employee with considerable more stock than he expects the employee to keep in order to defer taxation of the vested portions. Under the fragmentation rule, vested portions are taxed without need to determine at what level the amount that would be forfeited is "substantial."

Partial forfeitures can be quite complicated, especially when the forfeiture is determined by a percentage of the value of stock on forfeitures. While such partial forfeitures are fragmented for some purposes, they are sometimes treated as unitary restrictions. Example (4) of Section 1.83–3(c)(4) of the Regulations treats a percentage forfeiture as fragmenting the stock, as if the stock were separate pieces of property,[122] at least to determine the amount taxable when the percentage of forfeiture changes. In Example (4), when the forfeiture amount changes, under the agreement between the parties, to increase the amount the employee will receive on forfeiture by 10 percent of the stock, then the employee is taxed on 10 percent of the value of the stock at the time of change. The fragmentation concept, at least as Example (4) uses it, can result in the employee's being taxed on vested amounts over the years which exceed the amount he will get on forfeiture.[123] For constantly appreciating stock, the fragmentation rule Example (4) uses also means the employee is considered vested on less than what he would receive on forfeiture.

On the other hand, Example (4) sometimes treats the partial foreclosure as a unitary restriction. Thus when the employee has loss on forfeiture, the loss is ordinary in full as if the entire stock were substantially nonvested.[124] The allow-

[122] Compare Example (4) with Example (3) of Reg. § 1.83–3(c)(4).

[123] By 1976 the employee in Example (2) of Section 1.83–3(c)(4) of the Regulations has paid tax on a total of $90, although the 50 percent, of the value of stock to which he is entitled, gives him only $50.

[124] See Reg. § 1.83–1(b)(2).

ance of ordinary losses for market fluctuations of vested portions of stock seems anomalous because outside Section 83, losses on employee-owned stock because of market fluctuations would be treated as capital losses.[125]

Percentage forfeitures can also give the employee gain on forfeiture. Example (4) seems to anticipate that the employee does not have taxable income as his vested amount increases with the value of the stock, as long as the percentage of forfeiture does not change. If the stock appreciates, accordingly, the employee will have gain on forfeiture because the redemption price will exceed the employee's basis. Example (4) of Section 1.83–3(c)(4) of the Regulations is not explicit, but it probably means to apply a unitary concept to that gain and make it all ordinary income, just as losses are entirely ordinary. If so, the rule seems best seen as ordinary taxation of gain that has vested previously rather than as arguably capital gain on previously vested fragments.

It seems probable that the restriction will be viewed as unitary when a risk of partial forfeiture lapses in full, but the evidence of the Regulation's intent is contradictory. If the lapse is viewed as unitary, the employee will be taxed on the full value of the stock (with reduction only by his tax or purchase price basis). Section 83(a) anticipates that the employee will be taxed on the full fair market value of the stock (similarly reduced by purchase price or prior tax) when a full SRF lapses, even when some of the employee's gain could be argued as attributable to the employee's purchase price and it seems anomalous to change that result merely because the purchase price is made nonforfeitable under a partial lapse restriction. Since all gain or loss is ordinary when the employee redeems the stock on forfeiture, then it seems wrong to allow the employee to get capital gain from public sale after lapse of the same restriction, assuming no further appreciation. Example (4), on the other hand, seems to say, at least by extrapolation, that the employee is taxed only on the percentage of the value of the stock which changes from nonvested to

[125] Reg. § 1.165–4(a)(1960).

vested, even if it is the final lapse.[126] In any event, the rule will give ordinary gain, but never any loss on lapse, even when the lapse of the restriction is considered noncompensatory.

SRF's also mean that the employer and not the employee is the owner of the property subject to the SRF and the Regulations do not explain whether unitary or fragmenting view of partial forfeitures will be used to determine the deductibility of dividends or the taxation of use of property. Providing that the employer is owner in full of property subject to partial forfeiture would extend deductible dividends where they would be unwarranted and inequitably tax the employee on the use of property that he has partially paid for, but it would be simple. Allocating dividends as partially deductible and partially not or use of property as partially tax-free and partially not would seem a more equitable rule, but considering how far stock ownership questions range,[127] allocating ownership might produce complications for the planner.

There was a great deal of tension in distinguishing a restriction which is a formula resale requirement within the meaning of Section 1.83–3(h) and 1.83–5 from a restriction which is a risk of partial forfeiture within the meaning of Example (4) of Section 1.83–3(c)(4). Redemption under a formula resale provision will give capital gain in full; redemption under a partial forfeiture restriction will apparently give ordinary gain in full. A noncompensatory lapse of formula resale agreement is not a taxable event, a noncompensatory lapse or cancellation of a partial forfeiture gives ordinary income. A compensatory lapse of a formula resale agreement generates tax only on the difference between the value of the property before cancellation and its value after cancellation. The lapse of a partial forfeiture restriction probably generates tax on the entire value of the property, reduced only by the employee's prior basis. Formula resale agreements are supposed to be inevitable, while forfeitures are merely substantial possi-

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126 See also Reg. § 1.402(b)1(b)(7) Ex.

127 See § 803.4[0] *supra*.

bilities, but both restrictions draw their dramatically different tax results from the expectation that the stock might be returned to the employer. If return to the employer is not anticipated, then neither restriction has any effect on valuation or timing. A forfeiture restriction which might not be enforced is ignored, because it is a lapse restriction and not a substantial risk. A formula that will be cancelled is similarly a lapse restriction which will be ignored.

¶ 804 SHAREHOLDER PAYMENTS

¶ 804.1 The contribution construction

Following the Senate Committee Reports on Section 83,[128] the final Regulations adopted a construction designed to give the corporate employer a deduction even when the cost of compensating the employees was borne by shareholders of the corporation:

> If a shareholder of a corporation transfers property to an employee of such corporation . . . in consideration of services performed for the corporation, the transaction shall be considered to be a contribution of such property to the capital of such corporation by the shareholder, and immediately thereafter a transfer of such property by the corporation to the employee. . .[129]

The construction arose out of two rulings issued by the Service during the gestation period of Section 83,[130] dealing with shareholders who had transferred stock to their corporation for transfer to its employees. The logic of the transaction was apparently to preserve a deduction for compensation. Shareholders costs of compensating corporate employees are not deductible,[131] but the transaction, if successful, meant at least that the corporation would get the deduction.

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128 S. Rep. No. 91–552, 91st Cong., 1st Sess., 123–124 (1969).

129 Reg. § 1.83–6(d)(1).

130 Rev. Rul. 69–368, 1969–2 C.B. 27; Rev. Rul. 69–369, 1969–2 C.B. 27.

131 See, e.g. Deputy v. Dupont, 308 U.S. 488 (1940).

The Service, in reaction, issued two rulings. One allowed the corporate deduction where the plan to use the stock as compensation arose from the corporation's sole discretion.[132] The other, however, denied the corporate deduction where the plan to compensate was formulated by the shareholder, saying that the transaction would be treated as if "the majority shareholder had transferred the stock directly to the employees of the corporation."[133] The reaction of the draftsmen of Section 83 was that it was impossible to police a distinction between earmarked and unearmarked transfers and unwise to try since the economic situation of all the parties was the same before and after the transaction no matter who decided to compensate employees.

The construction gives the corporation a deduction for costs it has not itself borne, but the courts had previously been willing to give a taxpayer a deduction for costs borne by another party where it was possible to hypothecate an exempt transfer to the taxpayer as a intermediate step.[134] The Committee Reports and, in turn, the Regulations, hypothecate a contribution to the corporate employer even when the transfer is directly to the employee, so that the shareholder need not undertake the otherwise meaningless step of a physical contribution.

Saying that the shareholder has made a contribution to capital means that the shareholder's cost is a capital expenditure, under Section 1.263–2(f) of the Regulations, which increases his basis in retained shares. That result seems appropriate to the shareholder since he is seeking deferred, not current income from his stock investment when he makes the contribution and since his return will be usually capital gain.[135] Since a contribution to capital is normally not a tax

[132] Rev. Rul. 69–368, 1969–2 C.B. 27.

[133] Rev. Rul. 69–369, 1969–2 C.B. 27.

[134] Patrick v. United States, 186 F. Supp. 48, 52 (D.S.C. 1960) *aff'd on another issue*, 288 F.2d 292 (4th Cir. 1961) *rev'd on another issue*, 372 U.S. 53 (1962) (loan to taxpayer); Pierce Oil Co. v. United States, 77 F. Supp. 273 (D. Va. 1947) rev'd on another issue, 169 F.2d 542 (4th Cir. 1948) (contribution to capital of taxpayer); Royal Oak Apartments, Inc., 43 T.C. 243 (1964) (satisfaction of debt to taxpayer).

[135] See, e.g., Edith Scouville, 18 B.T.A. 261, 264(1929)(pro rata contribution) See, e.g., Charles Lesley Ames, 14 B.T.A. 1067 (1929) *aff'd* 49 F.2d 853 (8th Cir. 1931).

recognition event,[136] the shareholder's addition to his basis for retained shares will equal his basis in the contributed property.

On the corporate level, the construction of an intermediate contribution to capital means that the corporation will get a deduction for the fair market value of the transferred property, subject to the capitalization and reasonable compensation limitations. Section 1.83–6(d) of the Regulations, by reference to § 1.83–6(b), requires that the corporation recognizes gain, except where the property is its own stock,[137] where the fair market value of the property, as claimed for the compensation deduction, exceeds the corporation's basis in the property.[138] Under Section 362 of the Code, the corporation takes the shareholder's basis as its own. The gain balances the books for costs that have never been included in income but are allowed as a deduction. Similarly, for transferred loss property, the corporation will take a deduction for the fair market value of the property and the balance of the basis will be a loss. The corporation's gain or loss is computed when its deduction is taken and for SRF property the deduction arises later than transfer. Accordingly, the corporation can have gain or loss, even when the shareholder had a basis in the property equal to its value when transferred.

The Regulations give the corporate deduction and employee basis adjustment without need for the shareholder to make an actual contribution to the capital of the corporate employ-

[136] Section 1.83–6(d)(1) of the Regulations does not necessarily overrule J.K. Downer, 48 T.C. 86 (1967), holding that a shareholder who makes an in-kind nonpro rata transfer to pay corporate employees recognizes gain or loss (if any) for the transferred property. The shareholders' resulting basis, equal to value of the property when transferred, would, however, be capitalized under Section 1.263(a)–2(f) and the corporation would have a fair market value basis for the property, under Section 362, in computing its basis for the gain or loss where required by Section 1.83–6(b).

[137] I.R.C. § 1032.

[138] See, Tasty Baking Co. v. United States, 393 F.2d 992 (Ct. Cl. 1968); Riley v. Comm'r, 328 F.2d 428 (5th Cir. 1964) (*per curiam*); United States v. General Shoe Corp., 282 F.2d 9 (6th Cir. 1960); International Freighting Corp. v. Comm'r, 135 F.2d 310 (2d Cir. 1943); F. C. McDougal, 62 T.C. 720 (1974); Rev. Rul. 73–345, 1973–2 C.B. 11; Rev. Rul. 69–181, 1969–1 C.B. 196.

er, but a physical transfer is nonetheless advisable for the shareholder to avoid being considered the continued owner of the stock in some circumstances. Section 1.83–1(a)(1) of the Regulations provides that the transferor of property is considered to be the owner of property subject to a SRF, notwithstanding that the employee actually holds the property. For stock, that rule means that the transferor will be taxed on the dividends on the stock. The shareholder as transferor would be taxed on dividends on stock he has transferred and would be entitled to only a basis adjustment in his retained shares to reflect the fact that the employee is the actual recipient of the dividends. It seems advisable for the shareholder to transfer stock subject to a SRF in the employee's hands to the corporation, so that the corporation and not the shareholder will be considered the "transferor" who is the owner of the stock before the SRF lapses. The same transaction seems advisable if the stock will be subject to "prevent-transfer" restriction, within Section 1.83–3(a)(3), (6), in the employee's hands.

¶ 804.2 Individual shareholder sales to employees

The construction of shareholder transfers as going through the corporation was adopted primarily to give the corporation a deduction, but it may be a disadvantageous construction in aggregate when the shareholder makes compensatory sales to corporate employees of stock of the corporate employer. In those cases in which the corporation can be expected to get a deduction from sold property, the construction, at least as applied by the final Regulations, requires that the shareholder be treated as receiving the sales proceeds not from the employee but rather from the corporation. When the property transferred is stock of the corporate employer, as is common, that will mean that the sale is a redemption under the Section 317 definition. Depending on application of the Section 302(b) tests for redemption, the sale of stock to employees can be a dividend to the selling shareholder.[139] If so, an individual shareholder cannot use his basis in the sold stock against the sale proceeds and the sale proceeds become ordinary income in full.

[139] Reg. § 1.83–6(d)(1).

The Regulations limit the contribution and redemption construction to cases in which the employer will or can be expected to get a deduction. The redemption to the employee arises if the employee has a taxable amount when the stock is transferred or if the property is subject to a substantial risk of forfeiture.[140] If, however, there is neither bargain on the stock when sold nor "substantial risks of forfeiture," within the term-of-art meaning of Section 83(d)(1) of the Code, then the sale is treated as a noncompensatory sale to the employees without hypothetication of a redemption purchase by the corporation. However, the construction can prove to be quite an unpleasant trap for shareholders who, without considering the consequences, give the employee an undeniable bargain, and possibly even for the shareholder who simply miscalculates value.

During the consideration of the Regulations, a further construction was considered in which the employee sales were to be fragmented into two parts. The shareholder would have been considered to have contributed one fragment, equal to the bargain he has given to the employee, to the corporation. He would have been considered to have sold the other fragment, equal to the sales proceeds, to the employee in an arm's length sale that was not a redemption. The further construction is not reflected in the final Regulations. The preamble to the publication of the Regulations said that some suggested changes to the proposal would have "made the regulations unreasonably long and complex."[141] That language certainly describes any construction fragmenting stock into two parts, possibly with different tax owners.[142] The contribution construction in its simplest form is complicated enough. That history implies, however, that it is in fact a viable planning tool for the shareholder to separate his sold stock into two blocks, one to be sold to the employee for full fair market value and the other to be contributed to the corporation.

Shareholders now facing the problems of Section 302 re-

[140] *Ibid.*

[141] Preamble, T.D. 7554, 43 Fed. Reg. 31912.

[142] See, e.g., § 803.4[E], discussion of partial forfeiture restrictions.

demptions because of past sales, who cannot rely on the safe haven rules of Section 302(b)(2) and 302(b)(3) of the Code, may find that they have a good litigation stance under Section 302(b)(1), that is, that the redemption is "not essentially equivalent to a dividend." When one steps back from the construction the Committee Reports mandated, one can see that the sale is not essentially equivalent to a dividend because no funds have in fact come out of the corporate solution. Moreover even within the construction, no outstanding shares have been cancelled. The reason that most redemptions which fail the safe havens of Section 302(b)(2) or (3) are properly treated as dividends is that the purchase and cancellation of the shares by the corporations reduces the outstanding shares of the corporation and the shareholder's remaining stock recaptures substantially all the fractional interest in the corporation that the shareholder had before giving up his certificates. Thus, those redemptions involve mere differences in the number of shares outstanding without the shareholder substantially changing his fractional interest in the corporation. When, however, the shares are not cancelled but go directly to a third party, there is no recapture by the retained shares, and it is appropriate to allow the transferor to use basis and give him capital gain, even where the shareholder disposes of too little of his total holdings to qualify for the safe havens.[143] Of course if the shareholder has a victorious litigation position under Section 302(b)(1) whenever the shares go to a third party, then the Regulations should be amended to reflect that by deleting the requirement that such sales be tested under Section 302.

[143] George M. Wright, 18 B.T.A. 471 (1929) *rev'd on other grounds* 47 F.2d 87(1) (7th Cir. 1931) and Helene Baldwin Burdick, 20 B.T.A. 742 (1930) *aff'd* 59 F.2d 395 (3d Cir. 1932) distinguished Edith Scoville, 18 B.T.A. 261, 264 (1929) on the ground that in *Scoville* there was a mere change in form because stock was surrendered pro-rata, but in *Wright* and *Burdick* the stock, while surrendered pro rata, went immediately to a third party, so there was a real disposition of the stock. The issue was not the treatment of a redemption, but the test used is so close to that for redemptions that the holdings would seem applicable.