Tax Models for Nonrecourse Employee Liability

CALVIN H. JOHNSON

Reprinted from
TAX LAW REVIEW
Vol. 32, No. 3, Spring, 1977

Tax Models for Nonrecourse Employee Liability

CALVIN H. JOHNSON *

Introduction

Section 83 of the Code, added by the Tax Reform Act of 1969,[1] purports to settle the rules for taxing "property transferred in connection with the performance of services."[2] One of the problems addressed by the proposed regulations under section 83 is that of an employee's[3] acquisition of property from his employer[4] using nonrecourse liability.[5] An employee may derive substantial benefits from these acquisitions. This article will examine the problems which arise in determining the amount taxable as compensation to the employees as well as the time at which such benefits should be taxed. The proposed regulations treated these acquisitions as if they were options. They might also be treated as if they were arm's length transactions or as if they were an interest or forgiveness of indebtedness benefit. Finally, the employee's liability might be ignored or treated as property worth less than the face value of the liability. The alternative models for taxing these benefits will be explored.

Description of the Transaction

An acquisition of property using nonrecourse liability can look very much like any transaction in which the employer lends the employee money to purchase property from the employer. Nonrecourse liability

---

* CALVIN H. JOHNSON (B.A., Columbia, 1966; J.D., Stanford, 1971) is an assistant professor of law at Rutgers Law School in Newark, New Jersey. He was formerly a tax attorney with the Office of Tax Legislative Counsel in the Department of the Treasury. The views expressed, however, are entirely his own.

[1] Pub. L. No. 91–172, § 321(a), 83 Stat. 588 (1969).

[2] From the heading of section 83. *But see* I.R.C. § 7806(b).

[3] Section 83 uses the terms "person who performs services" and transfer to a "person other than the person for whom such services are performed" to cover transfers to an employee or independent contractor or their beneficiaries. This article will use the term "employee" without meaning to exclude transfers to independent contractors or beneficiaries.

[4] Section 83 uses the term "person for whom services were performed," but this article will use the term "employer" without meaning to exclude anyone who hires an independent contractor.

[5] Prop. Reg. § 1.83–1(a), 36 Fed. Reg. 10788 (June 3, 1971).

installments, where the employee's equity is large, are like the price of an option exercisable at far below market. Although the employee who has paid most installments can acquire the property for the unpaid installment, he need not do so; he has the option. A bargain on an option may be so substantial that it is extremely unlikely that a market decline will destroy the bargain and the option is sure to be exercised. Unless the bargain element of an unexercised, but certain to be exercised, option were to generate capital gains for the option holder, arguably, no capital gains should be granted for gain attributable to unpaid installments of nonrecourse liability. Although, in general, amounts borrowed are treated as equivalent to amounts supplied by the taxpayer out of his own pocket, where the borrowed liability so resembles an option price, arguably, no "advance credit" for the liability is warranted.[38] The argument is supported somewhat by the Tax Reform Act of 1976 which limits deductions of losses generated by movie, farming, equipment leasing and oil and gas shelters to "amounts considered at risk," and excludes from the definition of "amounts considered at risk" any nonrecourse liability only secured by the fair market value of the property in the

---

with pledged shares. In other words, an option protects the employee because the option price cannot be collected out of the employees' other shares, whereas the nonrecourse liability does not provide the employee any protection because the full nonrecourse liability can be collected out of the pledged shares (although not beyond). Of course, the employee with 50 pledged shares in the example could achieve the same result as the employee with the option if 20 shares were freed from the employer's lien. The employee would then have property worth $1,200 free and clear. It does not make sense, however, to determine whether a taxable transfer has taken place on the basis of whether the employee has pledged transferred shares; certainly a taxpayer does not cease to be the owner of property simply because he uses it to secure a loan. If the employee's tax should properly not depend upon whether stock is pledged, then the distinction between the employee with an option and the employee with pledged shares similarly should not be used to distinguish between transfers and nontransfers.

Needless to say, however, the option approach is far more likely to attain acceptance when the employee's equity is small, at least if protection against loss is the overriding characteristic. Thus, in Moore v. Comm'r, 124 F.2d 991, 992 (7th Cir. 1941), the government argued that the vendor was taxable on dividends on the sold stock because the purported purchaser of the stock had a mere option. The court responded, "the payments are too large to leave any option to [taxpayer]." *See also* Comm'r v. Baertschi, 412 F.2d 494 (6th Cir. 1969) (for purposes of section 1034(c)(5) time limits for replacement of a personal residence, sale and not option took place where payment was 29 percent of purchase price); Comm'r v. Stuart, 300 F.2d 872 (3d Cir. 1962) (in determining when the year of sale was for section 453(b) installment reporting, no sale took place where the down payment was only 10 percent of the purchase price).

[38] By contrast, comparing the nonrecourse acquisition to personal liability might lead one to conclude that the employee is at least as likely to pay the nonrecourse as the personal liability so that he has at least as much capital at risk as does the employee with personal liability.

something to tax early, it seems misplaced. This criticism is strengthened by the fact that early taxation does not seem to be a doctrinal barrier to also taxing the compensation later,[53] as long as proper basis adjustments are made to prevent double taxation. For instance, an employee may be taxed several times on his interest in a nonqualified trust—first when the employer makes a nonforfeitable contribution to the trust and/or when a forfeitable interest changes to a nonforfeitable one and again when the contribution or interest is distributed to him.[54] In computing the tax on the distribution, however, proper regard must be given to the taxpayer's basis in the property generated by the earlier inclusion. As to nonrecourse liability, it seems reasonable—if the proposed regulations are reasonable—to tax the initial bargain, if any, at the time of the purchase, and also, to tax appreciation attributable to unpaid installments on nonrecourse liability as ordinary income when the installments are paid. The proposed regulations already treat every acquisition with nonrecourse liability payable in installments as, in part, an option yet to be taxed and, in part, as a bargain purchase which has already been taxed. The initial bargain would be treated as just another segment,

---

feiture lapse. I.R.C. § 83(b)(1). Section 1.83–3(a) of the proposed regulations continues the view by delaying tax not only for nonrecourse liability, but also for transfers recharacterized as transfers of "mere security interests in property for payment of deferred compensation." Criticism of delaying tax for nonrecourse liability would seem to apply as well to the security interest analysis, at least where the interest has enough value to be taxed when the employee gets it.

[52] Under sections 1.421–6(c) and (d) of the regulations, an employee is taxed on an option when it is granted to him only if the option has a "readily ascertainable value." If the option is not actively traded on an established market, demonstrating readily ascertainable value can be quite difficult. *See* Reg. §§ 1.421–6(c)(2), (3); Ns. 29 and 30 *supra,* and the accompanying text. *See also* 1 SURREY, WARREN, MCDANIEL & AULT, FEDERAL INCOME TAXATION 1089 (1972) (regulations forestall taxpayer's advantage in paying tax initially in order to have subsequent appreciation be taxed as capital gains). By contrast, in prescribing when a sale may be treated as an open transaction, section 1.453–6(a)(2) of the regulations provides that the value of the property is too unascertainable to be taxed "only in rare and extraordinary cases." *Accord,* Reg. § 1.1001–1(a). Forcing immediate valuation to close sales, while preventing valuation of options appears blatently inconsistent except that in both cases (assuming that most sales would yield capital gains) the regulations appear to be trying to minimize the taxpayer's capital gains from the transaction and to maximize the ordinary income. Under the analysis presented in the text, forcing delay in the taxation of options often would be of considerable benefit to the employees.

[53] A second chance to tax compensatory values given to an employee seems to have been anticipated by the Supreme Court in Commissioner v. Smith, 324 U.S. 177, 181–82 (1945): "Hence the compensation for respondent's services, which the parties contemplated, plainly was not confined to the mere delivery to respondent of an option of no present value, but included the compensation obtainable by the exercise for that purpose."

[54] I.R.C. § 402(b); Prop. Reg. §§ 1.402(b)–1(a) (taxation of contributions), 1(b) (taxation at vesting), 1(c) (taxation of distributions).

continued payment and suffered foreclosure when the stock was worth $50, then he would have a $10 capital loss which is equal to his paid installments—and to the difference between his basis of $100 and the remaining nonrecourse liability. The loss would be recognized upon foreclosure.

Revenue Ruling 76–111 indicates that the entire amount of the unpaid indebtedness—not just the indebtedness up to the value of the property—would there be treated as arising out of a sale or exchange of the property. Thus, for capital assets, the unpaid indebtedness would increase capital gains or reduce capital loss.[82] However, the ruling deals with a sale and return of property between parties dealing at arm's length. By contrast, where an employer forgives an amount which is more than the value of the property, the excess of indebtedness over the value of the property should be considered to be ordinary income compensation rather than proceeds from the sale of property. If the foreclosure is a purchase of the property by the employer and the employer has paid a premium for the property, then, just as a bargain sale to an employee is compensation to the extent of the bargain,[83] so the premium repurchase from an employee should be considered compensation to the extent of the premium.[84] A similar analysis is that the nonrecourse

---

decline in the value of stock owned by the taxpayer when the decline is due to a fluctuation in the market price of the stock or due to a similar cause," and losses on stock on foreclosure seem to be within its proscription. In any event, realization of the nonrecourse liability on foreclosures of all kinds is on solid ground and finding such realization without making the loss, if any, to be within a sale or exchange would be strained.

[82] Notwithstanding Revenue Ruling 76–111, it is arguable that there is realization with respect to a sale or exchange of the property only to the extent of the fair market value of the property. *See* Reg. § 1.1017–1(b)(5); Harry Bialock, 35 T.C. 649, 660 (1961); Estate of W.R. Whitthorne, 44 B.T.A. 1234 (1941), *aff'd per curiam,* 148 F.2d 825 (9th Cir. 1945). The remainder of the forgiven indebtedness would be explained as a cancellation of indebtedness, since it could not be explained as in return for the value of the property. Sometimes bifurcation of the forgiveness into an amount realized segment and a cancellation of indebtedness segment would help and sometimes it would hurt the taxpayer. Cancellation of indebtedness is ordinary income, whereas the amount realized might generate capital gains, but cancellation of indebtedness would be excluded from income if the taxpayer is insolvent, while capital gains would not be excluded. *See, e.g.,* Reg. § 1.61–12(b). The issue would seem to be moot if the taxpayer elects under sections 108 and 1017 to exclude the cancellation but reduce basis and possibly as well, without election, if the cancellation represents a mere adjustment in the purchase price. *See* Comm'r v. Sherman, 135 F.2d 68 (6th Cir. 1943); Helvering v. A.L. Killian Co., 128 F.2d 433 (8th Cir. 1942); Hirsch v. Comm'r, 115 F.2d 656 (7th Cir. 1940); *but see* Fifth Avenue-Fourteenth Street Corp. v. Comm'r, 147 F.2d 453 (2d Cir. 1944); Edward W. Edwards, 19 T.C. 275 (1952).

[83] Comm'r v. LoBue, 351 U.S. 243 (1956); Comm'r v. Smith, 324 U.S. 177 (1945).

[84] *See, e.g.,* William C. Atwater & Co., 10 T.C. 218, 247 (1948).

Tender and Kind

In making the employee's liability nonrecourse, the employer has limited the liability to the value of the property transferred and, usually with full premeditation, caused a quantum jump in the risks that the full purchase price will not be paid. Another possible solution to the taxation of nonrecourse liability is to deny that the employee's nonrecourse liability for the purchase price should be treated as the equivalent of legal tender. As noted, it is difficult to tax the benefit of nonrecourse liability to the employee at the time of the purchase, over the course of payment of the liability or when the risks become actual losses. If the nonrecourse liability is not considered legal tender, then the employee would be taxed on the value of the property when it is transferred to him, reduced, to some extent, for the consideration paid by the employee in the form of the nonrecourse liability.

That reduction might be the fair market value of the nonrecourse liability. Where a note is received as payment for services rendered, we do, after all, require the note to be valued—considered property in kind and not tender—in determining the taxable income of the employee or shareholder.[86] Arguably, "the amount (if any) paid" for the property under section 83(a)(2) should also be the market value rather than the face amount of the employee's note.[87] Nonrecourse obligations which are like undiscounted commercial indebtedness would be usable to the extent of their full face amount in reduction of the compensation because they are worth their full face amount. Nonrecourse obligations which are given little credence in any market evaluation would be given little value as an offset to the taxable compensation. Actual payment of the liability promised would be the time for settlement; any amount which was not recognized at the purchase would be recognized at the time of payment. If there is only one installment,

[86] Reg. § 1.61–2(d)(4), T.D. 6274, 1957–2 C.B. 960, amended by T.D. 6696, 1963–2 C.B. 23 (notes received in payment for services are income in the amount of their fair market value at time of transfer); *accord,* Nichols v. Comm'r, 44 F.2d 157 (3d Cir. 1930); Brinkerhoff-Paris Trust and Savings Co., 14 B.T.A. 801 (1928). *Cf.* Rose Ann Coates Trust, 55 T.C. 501 (1970), *aff'd,* 480 F.2d 468 (9th Cir.), *cert. denied,* 414 U.S. 1045 (1973) (shareholder has dividend measured by fair market value of distributed notes). Note also that under section 301(b)(1)(A) a dividend is measured by the fair market value of a distributed note, even though under section 312(a)(2) earnings and profits are reduced by the face amount of notes of the distributing corporation.

[87] "[A] promise is not payment unless it would naturally be so regarded in the common speech of men, . . . the extent of payment, whether partial or complete, must be subject to a kindred test." Realty Associates Securities Corp. v. O'Connor, 295 U.S. 295, 300 (1935) (Cardozo, J.) (holding that bankruptcy referee's fees are measured by value of promises creditors received and not by the face amount of the promises).

then the difference between the face amount and the value of the note (the discount) would be deducted by the employee at payment of the installment. If there are multiple installments, then, on the one hand, some proportion of the discount might be made deductible at the time of each installment or, on the other hand, the payments, after payments actually made exceed the original value of the note, might be deductible in full. Either proportionate deduction or deduction of the final payments would probably require the setting up of an account, parallel to a basis account but for the deduction side, to keep track of the offset or deductions already allowed because of the value of the note and of prior payments.

It might also be appropriate to go another step and deny that the nonrecourse liability has any recognizable value when incurred. Requiring valuation of nonrecourse liability might be next to impossible, *e.g.*, requiring the pretense of asking a nonexistent market to appraise risks that none of the parties involved can appraise. If the value of the property transferred to the employee is known, but the value of the obligation given in return is speculative, then it would be possible to tax the full value of the property at the time of the purchase, but recognize the liability only when it is paid, just as for income purposes promises an employee receives which have no ascertainable value are ignored.[88] A provision for ignoring nonrecourse liability of unknown value could also be useful within a system that expects most nonrecourse liability to be valued to encourage taxpayers to demonstrate sound valuation rather than face the detriment of having no value for the liability. In any event, section 83(a)(2) requires that compensation be reduced by the "amount (if any) paid" for the property, and a conclusion that a promise to pay in the future is not such an amount paid is literally quite defensible.

The reasoning is apparent. The note may never be paid, and if it is not paid, "the taxpayer has parted with nothing more than his promise to pay." [89]

---

[88] Estate of Joseph Nitto, 13 T.C. 858, 863 (1949) (no dividend until distributed note paid in cash); R.V. Board, 18 B.T.A. 650, 654 (1930) (note given as salary had no fair market value).

[89] Don E. Williams Co. v. Comm'r, 97 S. Ct. 850, 856 (1977) (note given to qualified trust is not deductible "payment" under section 404(a)), *quoting* Hart v. Comm'r, 84 F.2d 848, 852 (1st Cir. 1932). *See also* Schlemmer v. United States, 94 F.2d 77 (2d Cir. 1938) (Hand, J.) (note was mere evidence of promise to pay compensation and not payment); *accord*, Jay A. Williams, 28 T.C. 1000, 1002 (1957); Robert J. Dial, 24 T.C. 117, 123 (1955); *cf.* Fehrs Finance Co., 58 T.C. 174, 191–92 (1972), *aff'd*, 487 F.2d 184 (8th Cir. 1973) (note given as dividend was mere evidence of promise to pay and not payment); Allan S. Vinnell, 52 T.C. 934, 945 (1969).

If the liability were ignored, nonrecourse liability would be treated as employer imposed lapse restrictions are treated. Under section 83, if property transferred in connection with the performance of services is subject to a forfeiture restriction (*e.g.*, a requirement that the employee return the property if he commits a crime[90] or if Niagara Falls falls), which qualifies neither as a substantial risk of forfeiture[91] nor as a nonlapse restriction,[92] then the restriction is ignored and the property is

---

[90] Section 1.83-3(c) of the proposed regulations provides "[A] requirement that the property be returned to the employer if the employee commits a crime will not be considered to result in a substantial risk of forfeiture." Section 1.83-5(a) of the proposed regulations defines nonlapse restriction, *but see* N. 92 *infra.*

[91] If property is subject to a substantial risk of forfeiture and the risk is binding on a subsequent transferee of the property, the employee is not taxed on the property, except by his own election, until the restriction terminates. Section 1.83-3(c)(1) of the proposed regulations defines a substantial risk of forfeiture exclusively as a condition that the employee perform substantial services or refrain from performing services after transfer of the property. It is arguable in opposition to the proposal that any statistically meaningful risk of forfeiture was intended to qualify as a "substantial risk of forfeiture." On the other hand, it is indeed arguable that the drafters of section 83 intended to require taxation of all property at transfer unless the property could in some sense be said to have been earned by the employee after transfer of the property. The Senate Committee on Finance report indicates that there will be substantial risks of forfeiture other than those conditioned on the future performance of services, but does not otherwise indicate the required nature of the other conditions. S. REP. No. 91-552, 91st Cong., 1st Sess. 121 (1969). If the other conditions must be of the same kind as future services, then qualifying substantial risks of forfeiture would probably be limited to earnouts and noncompetition clauses. All this leaves very little respect for forfeitures which would have deferred taxation under prior law, but which neither require a future earnout nor are statistically significant.

[92] A restriction which by its terms will never lapse (a nonlapse restriction) is under section 83(a) considered in determining the value of the property, but any other restriction (lapse restriction) is ignored and the employee is taxed on the property as if the lapse restriction were not there. The statute's ignoring of a lapse restriction was upheld against constitutional challenge in Miriam Sakol, 67 T.C. No. 81 (1977). Section 1.83-5 of the proposed regulations defines a nonlapse restriction exclusively as a limitation which prevents the transfer of property except by sale at a price determined under a formula; nonlapse restrictions must also be enforceable against a subsequent purchaser. The proposal seems far too limited—it merely lists one nonlapse restriction noted by section 83(d)—but it is not clear what a lapse or nonlapse restriction is. Section 83 itself seems irritatingly drafted as grand general rules drawn from small specific cases with no conception of any case except that listed. The draftsmen seem to have assumed that they solved problems of valuing stock which was subject to restrictions which under prior law would have prevented the stock from being taxed at transfer (*see e.g.*, Harold H. Kuchman, 18 T.C. 154 (1953)) by mandating that lapse restrictions be ignored. However, the specific language is ill fitting; not all restrictions or contingencies which do not lapse are easy to value (or are worth arguing over); not all temporary restrictions are shams or trivial or imposed to confuse valuation or difficult to value. Lapse restrictions seem clearly to include temporary restrictions, such as "employee may not sell for five years," "employee may not sell until retirement," or "employee may not sell stock during the registration period." In-

Tax Profs Urged SEC to Take Tough Stance on Auditor Independence

The following letters were sent by two groups of tax law professors to the Securities and Exchange Commission Secretary Jonathan G. Katz on January 10, 2003, and January 15, 2003, respectively.

Dear Mr. Katz:

We, the undersigned professors of law, support the SEC's proposals under Sarbanes-Oxley Act 201 that would prohibit an auditor from undertaking various tax services for an audited firm that undercut the auditor's independence.

- We agree with the SEC's conclusions that tax services are not per se prohibited by the Act, but that there is also no categorical exemption for tax services. Thus, activities that come within the scope of the prohibitions listed by Rule 10A(g) do not cease to be prohibited merely because they are also tax related.
- We think that the SEC proposals correctly identify sound principles inherent in the Sarbanes-Oxley Act that prohibit an auditor from (1) auditing its own work, (2) undertaking management functions for the audited firm, (3) acting as an advocate for the firm, or (4) promoting the firm's stock price or financial interests. Those principles should guide the auditors themselves, the Public Company Accounting Oversight Board, and the audit committees of the audited firms as to what types of activities may not be undertaken by the auditor, even as to tax services.
- We also support bright-line rules prohibiting certain tax-related services that are especially likely to undercut auditor independence.

Background

The Sarbanes-Oxley Act of 2002 manifests congressional shock that the auditing CPAs were not being loyal to outside investors who rely on financial reports. The Enron accountants, for example, taught Enron (for a good fee) how to maneuver through the minefields laid down by FASB standards on "unrelated" partnerships, so that the Enron financial statements arguably complied with technical requirements while simultaneously providing utterly useless or misleading "information" to investors. Since the auditing accountants participated in setting up the partnerships, there is not even a great deal of confidence that there was technical compliance. The accountants, we found out, were trying to be both Consiglieri and cops with respect to the same Don.

Auditors are a linchpin of our market system. The financial reports that auditors certify are critical to our economy because they so profoundly influence the flow of precious capital. When financial statements mislead investors, capital goes to less meritorious activities (for instance, to Global Crossing or Enron) or is utterly wasted. Cheating financial statements, certified by auditors, make it difficult for legitimate, successful enterprises to raise capital by selling stock. When diversified investors do not have reliable information about the firm, they must underbid for stock of the firm to take account of risks that the stock is a "lemon," worth less than the available information suggests. When foreign or diversified investors cannot count on accurate financial reports about stocks, they flee the market. In every part of the globe, if diversified investors do not have legal protection and accurate information, the market for stock is anemic. Firms must then raise their capital from bank financing; and when banks lend, they want to control corporate decisions. Cheating financial reports may provide a short-term advantage to the company that cheats, but the cheating hurts the common good of all companies in the economy by raising the cost of equity capital or making it entirely unavailable.

The lesson from the market is that an auditor firm must be zealously loyal in protecting the interests of investors. The auditor must ultimately place investor protection above accommodating management goals. The interest of an auditor that thinks of itself as a friend of management in provision of non-audit services inherently conflicts with the auditor's responsibility to maintain the necessary skepticism and zeal to audit the company properly on behalf of investors. The audit firm must be loyal to the efficient market. An auditor owes no duty to the audited firm, except insofar as enhancing the reliability of all financial reports makes equity capital cheaper for all.

Cheating financial reports ultimately steal from individual investors who rely in good faith on a stock at all, but rather a grant of the stock to the employee when the dividends on the stock equaled the purchase price.[25] As would be expected from an intent test, however, the cases are inconsistent as to economically identical transactions. Thus, courts have also held that where payment is to be made from future dividends, the possibility that the employee might not pay for the stock was a mere condition subsequent and did not delay the purchase nor the measurement of compensation.[26] In any event, intent of the parties is hardly a bedrock rationale. It probably requires that the employer and the employee be consistent as to what was intended, but, if the documentation and the undocumented understandings are that the purchase is to be the taxable compensatory event to the employee, under the case law that intent would probably govern. If intent is the governing principle, it would seem that the proposed regulations ought to have allowed the employee to make an election under section 83(b) and ought to have let the employer have his deduction, if any, at the time of the purchase. Of course, if there are additional policy reasons for delaying the taxable event, then an intent test, in this age of tax planning, allows the parties to avoid whatever the policy is that mandates delay.

A possible policy issue is simply that of choosing the most administratively convenient date during the course of the entire transaction on which to measure the compensation which the employee receives. If the value of the compensation in nonrecourse acquisitions cannot be

---

[25] Indianapolis Glove Co. v. United States, 96 F.2d 816 (7th Cir. 1938); Hudson Motor Car Co. v. United States, 3 F. Supp. 834 (Ct. Cl. 1933); Alger-Sullivan Lumber Co. v. Comm'r, 57 F.2d 3 (5th Cir. 1932). *Cf.* National Clothing Co., 23 T.C. 944 (1955) (price paid for repurchase of stock from employee was compensation). *Accord,* Marts, Inc., 19 T.C.M. 669 (1960). *Also cf.,* Reg. § 1.421–7(f) (a qualified option is not exercised by a promise to pay the option price unless the optionee is subject to personal liability on such promise).

[26] Commercial Investment Trust Corp., 28 B.T.A. 143 (1933), *aff'd per curiam,* 74 F.2d 1015 (2d Cir. 1935). *Cf.* General Outdoor Advertising Co. v. Helvering, 89 F.2d 882 (2d Cir. 1937) (employer's cost of stock deductible when he purchased stock for the benefit of employees as it was unlikely that employees would fail to pay their portion).

To add to the inconsistency, a line of cases stands for the proposition that where dividends or earnings must be applied to the purchase price, what is given as compensation is the interim dividends or earnings and not the bargain on the stock at all. Omaha Nat'l Bank v. Comm'r, 75 F.2d 434 (8th Cir. 1935); W.T. Grant Co., 58 T.C. 290 (1972) *rev'd on other grounds,* 483 F.2d 1115 (2d Cir. 1973), *cert. denied,* 416 U.S. 937 (1974); U.S. Steel Corp., 2 T.C. 430 (1943); Electric Storage Battery Co., 39 B.T.A. 121 (1939); Gordon M. Evans, 38 B.T.A. 1406 (1938). Of course, insofar as these latter cases rest on the premise that a bargain to employees in what is otherwise a bona fide sale is not compensation, so that the dividends or earnings applied toward the stock must be compensation in substitution, they stand reversed by Commissioner v. LoBue, 351 U.S. 243 (1956), and by section 83 itself.

measured when the purchase occurs, it might be possible to ascertain the ultimate compensation conferred by the transaction when the troublesome feature of nonrecourse liability is discharged. Under the open transaction doctrine, the courts have easily and often held that compensatory benefits—the value of which is unascertainable when the rights arise—are taxable as ordinary income at their value when that value becomes clear.[27] It is doubtful, however, that administrative convenience should be called upon to justify a system which, at least for installment transactions, multiplies the number of times the taxpayer and the Commissioner must fight over the value of property. Furthermore, in the case of installment nonrecourse acquisitions, delaying the measurement date does not seem, even theoretically, to clarify the value of the compensation, ultimate or otherwise. Once some installments have been paid, some of the employee's ultimate benefit from the transaction should be attributed to a capital investment which the employee has made in the property and not to compensation. Even if the value of the transaction to the employee becomes more clear, the investment of capital seems to compete with compensation as an explanation for the benefit.

The best rationale for the proposed regulations appears to be that they attempt to apportion the employee's ultimate benefit from the property between capital gains and compensation by denying that the employee's gain from a transaction with his employer is capital gains, unless it is attributable to capital the employee has put at risk. If the gain is not attributable to capital at risk, then it is attributed to compensation. Under the 1961 version of section 1.421–6 of the regulations, which is the predecessor of section 83, any appreciation in the value of the optioned property between the grant of the option and its exercise, was taxable as ordinary income to the employee on exercise of the option, unless the fair market value of the "option privilege" was readily ascertainable when the option was granted.[28] The option privilege was defined as "the opportunity to benefit . . . from any appreciation . . . in the value of the property subject to the option *without risking any capital.*"[29] Thus, under the predecessor regulations, if the

[27] Vestal v. United States, 498 F.2d 487 (8th Cir. 1974); Pounds v. United States, 372 F.2d 342, 345 (5th Cir. 1967); Ford S. Worthy, Jr., 62 T.C. 303, 312 (1974); Prop. Reg. § 1.421–6(d)(2), 33 Fed. Reg. 15870 (Oct. 26, 1968). *See also* Burnet v. Logan, 283 U.S. 404 (1931).

[28] Reg. §§ 1.421–6(c), (d) (1961). Prior to amendment in 1961, the regulations provided for taxation of an option only upon its exercise. Reg. § 1.421–6(c) (1959).

[29] Reg. § 1.421–6(c)(3)(ii) (1961) (emphasis added). The 1961 regulations also provided that the option privilege has sufficiently ascertainable value for the option to be taxed when granted if the option was actively traded on an estab-

Service could not tax the benefit by valuing it when the option was granted, then taxing, as ordinary income, the appreciation on the property was the way to reach it. The proposed regulations under section 83 ignore the possibility of valuing the benefit at the purchase, so that taxing the appreciation as ordinary income is the sole remedy for reaching the compensation when the employee has no capital at risk.[30]

The remedy, at least, is arguably appropriate since the employee has no capital tied up in the property. Insofar as the reduced tax on capital gains functions to encourage capital accumulation[31] or capital mobility,[32] it need not function here. No capital is invested which need be made mobile; no capital is accumulated here on which accumulation need be encouraged.[33]

The employee who is denied capital gains is not maltreated. He has the opportunity to use the cash or personal credit resources he would have invested in the property to make other investments. These other investments should generate capital gains. If the property the employee received from the employer in the nonrecourse acquisition were also to

---

lished market. Reg. § 1.421–6(c)(2) (1961). An established market assuages doubts about abusive undervaluations of the option privilege. It is convenient. It provides a wide collection of foresights as to what avoiding risks and commitment of capital will be worth. By presumption if not by definition, then, an established market should provide a fair measure of compensation the employee has received.

[30] The conference committee on the 1976 Tax Reform Act suggested that the Service for the future make every reasonable effort to value an option when granted if the employee elects such treatment, even if the option privilege has no readily ascertainable value. H.R. Rep. No. 94–1515, 94th Cong., 2d Sess. 438–39 (1976). The election would undermine the legitimacy of delaying taxation as a remedy for reaching compensation in absence of capital at risk since any employee could avoid delay as a matter of right. There is considerable doubt, however, as to whether the Service should or will adopt the election.

For accounting purposes, the employer's charge against earnings is only the bargain, if any, when the option is granted, provided the option price and number of shares are fixed at grant. Accounting Principles Board, Opinion No. 25, *Accounting for Stock Issued to Employees* ¶ 10 (1972).

[31] *See, e.g.*, Blum, *A Handy Summary of the Capital Gains Arguments*, 35 Taxes 247, ¶ 23 (1957); *General Tax Reform, Panel Discussion Before the House Committee on Ways and Means*, 93d Cong., 1st Sess. 274, 276 (Feb. 6, 1973) (written statement of Wallich).

[32] *See, e.g.*, Blum, *A Handy Summary of the Capital Gains Argument*, 35 Taxes 247, ¶ 21 (1957); *General Tax Reform, Panel Discussion Before the House Committee on Ways and Means*, 93d Cong., 1st Sess. 263, 276 (Feb. 6, 1976) (statement of Brazer); *Federal Tax Policy for Economic Growth and Stability, Subcommittee on Tax Policy, Joint Committee on Economic Report*, 84th Cong., 1st Sess. 307 (Dec. 12, 1955) (statement of Brown).

[33] Courts have also held that unless the employee has established a basis in the property he receives from his employer, his gain is ordinary gain. *See* Vestal v. United States, 498 F.2d 487, 494 (8th Cir. 1974); Artis C. Bryan, 16 T.C. 972, 980 (1951); Ruth B. Rains, 38 B.T.A. 1189 (1938). Nonrecourse liability, however, is usually included in basis.

generate capital gains, the employee would have the benefit of two capital gain investments while committing cash or personal credit to only one. By contrast, an employee who must use cash or personal credit to purchase the property from his employer has but one capital gain investment opportunity.

Having no capital at risk also means that the employee will not lose his capital if the property goes down in value. It is this protection against loss which seems to underlie the finding by some courts that what was intended in a nonrecourse acquisition of stock was a transfer of the stock only when payment on the nonrecourse liability was completed.[34] A similar argument, adopted by various courts, is that if the employee does not bear the risks and burdens of ownership of the property, then he should not be considered the owner of the property; absent ownership, the appreciation of the property should not generate capital gains for him.[35] Finally, symmetry arguably requires that if there is no

---

[34] Hudson Motor Car Co. v. United States, 3 F. Supp. 834 (Ct. Cl. 1933) (at the time the stock was issued, "there was everything to gain and nothing to lose"); National Clothing Co., 23 T.C. 944 (1955) ("The employees could not lose in these transactions.").

[35] Indianapolis Glove Co. v. United States, 96 F.2d 816 (7th Cir. 1938) (at issuance of stock to employees with payment to be made solely out of dividends, the employees received nothing except the right to become participants in an arrangement by which they might benefit in the future); Moore v. McGrawl, 63 F.2d 593 (5th Cir. 1933) (employer owns stock "sold" to employees for nonrecourse liability in determining employer's eligibility to file consolidated returns); *cf.* Robert P. Grey, 33 T.C.M. 3 (1974) (denying an employee a loss when stock was given up).

The argument that without risk of loss the employee is missing one of the fundamental characteristics of ownership and is thus not the owner of the property seems to underlie another of the special definitions of "transfer" in section 1.83–3(a) of the proposed regulations. These regulations provide that no transfer of property occurs upon a person's acquisition of an interest in property for the sole purpose of securing the payment of deferred compensation and the examples make the question of whether an employee has a mere security interest or a real transfer of ownership in the property depend on whether an employee loss is possible under the employee's total transaction with the employer. For instance, in cases in which the employee must resell stock given him for the increase in book value, if any, or the sum of declared dividends, if any, while the stock was in the employee's hands, the proposed regulations conclude that the employee's interest is more in the nature of a security interest for the payment of deferred compensation. Prop. Reg. § 1.83–3(a)(2) Exs. 1, 3. *See* National Clothing Co., 23 T.C. 944 (1955); Marts, Inc., 19 T.C.M. 669 (1960) By contrast, where the employee must resell the property for three-fourths of book value and thus could lose if the book value of the stock goes down, the employee is held to have an ownership interest. Prop. Reg. § 1.83–3(a)(2) Ex. 4. *See* Schapiro, *Proposed Regulations Under Code Section 83,* 25 TAX LAWYER 281, 286–88 (1972).

Of course, protection against loss does not necessarily go to the heart of ownership. If, for instance, the employer, in a completely separate instrument and separate transaction, gave the employee a guarantee that the employee would never lose a cent by buying the employer's stock (perhaps on the open market), possibility of loss from market fluctuations, then there ought not to be favorable taxation of gain from market fluctuations.[36]

The defense of the proposition that the employee has an option and not capital at risk changes somewhat where the employee has substantial equity in the property. Since an employee will complete a nonrecourse acquisition even if the property declines in value, provided his loss from the decline would be less than the loss in forfeiting his equity, where there is employee equity, it is not possible to say that the employee is protected from loss of all unpaid installments. In fact, with sufficient employee equity, any reasonably foreseeable market decline might be borne in full by the employee.[37] Arguably, however, the last unpaid

---

the instrument should not prevent the employee from being considered the owner of the stock to get his capital gains. He has clearly invested capital in the property. The separate instrument would then be seen as a separate means of compensation having nothing to do with ownership. Further, even where the protection against loss arises out of a nonrecourse feature integral to the stock acquisition, where the employee has other indicia of ownership, such as the nonforfeitable right to appreciation and dividends from the stock, voting rights and state law shareholder remedies, the protection against loss does not convincingly negate employee ownership of the stock for much of any purpose.

[36] Favorable rates for capital gains are occasionally stated to be required by necessary limitations on the deductibility of capital losses. *General Tax Reform, Panel Discussion Before the House Committee on Ways and Means,* 93d Cong., 1st Sess. 251, 252 (Feb. 6, 1973); Blum, *A Handy Summary of the Capital Gains Arguments,* 35 TAXES 247, ¶ 17 (1957). Where limitations are inapplicable because no loss is possible, favorable taxation of the gains might not be justified. Realistically, however, the symmetry argument is not especially strong. Symmetry implies that if market losses are ordinary, then market gains should be ordinary, and if market losses are capital, then market gains should be capital. Even if the syllogisms were valid (and there are numerous exceptions to them—notably, the taxation of section 1231 property), where there is no loss possible under the transaction, neither premise of capital nor ordinary loss arises and the syllogisms imply nothing as to how gain should be treated.

[37] It has been argued that the proposed regulations' treatment of nonrecourse liability as if it were an option is invalid once installments have been paid:

> Dealing first with economics, it is clear that the owner of 50 shares of stock [worth $100 per share or $5,000 in sum] subject to indebtedness of $3,000 ("pledged shares") is in quite a different position from the owner of 20 shares free and clear who in addition has an independent option to purchase another 30 shares. If the 50 shares of pledged stock decline in value to $60 a share, the owner of the pledged shares has no equity whatsoever since the value of the collateral ($3,000) is no greater than the amount of the debt. On the other hand, the owner of the 20 shares outright still has value of $1,200 (20 shares at $60 per share) and an option to acquire 30 more shares. Schapiro, *Proposed Regulations Under Code Section 83,* 25 TAX LAWYER 281, 284 (1972).

The employee with the option in the above example must have had an option for $100 per share for both employees to have started with the same equity. If the employee had (quite irrationally) exercised that $100 option when the market price was $60 per share, the employee would have lost $40 per share, or a total of $1,200, and would have been in the same net position ($0) as the employee activity.[39] In any event, under the proposed regulations, the employee will have capital gains to the extent the appreciation is attributable to paid installments.

Harmful Side Effects of the Option Cure

Beyond the question of whether the proposed regulations are doctrinally correct, there are serious practical problems with the effects of the proposal.

Revenue

Increasing the amount of gain which is taxed as compensation rather than capital gains might, contrary to first impressions, reduce rather than increase government revenue. Under section 83(h), any amount included in the income of the employee is matched by an equal deduction given to the employer, provided the overall compensation is reasonable and is business related.[40] An employee's capital gains, by contrast, would not entitle the employer to a compensation deduction. With the decreasing spread between capital gain rates and ordinary income rates created by the Tax Reform Acts of 1969 and 1976, the value of the difference between ordinary income and capital gains is only very rarely worth more than the value of the employer's compensation deduction. Thus, the government, in successfully characterizing the appreciation on the property between the purchase and payment of the nonrecourse liability as ordinary income rather than capital gains, will usually find that the compensation deduction it has thereby given the employer more than offsets the revenue gain on the employee side. For instance, for a high income taxpayer without other capital gain or tax

[39] Tax Reform Act of 1976, Pub. L. No. 94–455, § 204, 90 Stat. 1531 (1976) (enacting section 465 of the Code). *See* I.R.C. § 465(b)(2). Note by contrast that if property of equal value which is not used in the activity is pledged as security, the amount considered to be at risk is increased by the fair market value of the collateral. I.R.C. § 465(b)(2)(B). From a purely technical point of view it would seem that equal collateral means equal risk, whether or not the property is used in the activity (or to complete the analogy, is the property sold to the employee). Allowing the value of property in the activity, however, as an increase in amounts considered at risk would seem to destroy the purpose of the change. Here, as there, absence of risk seems not to be the sole target; leverage of a certain vulnerable sort is aimed at as well.

[40] Section 1.83–6(a) of the proposed regulations provides that the employer's deduction is allowed only to the extent that such amount meets the requirements of section 162 or 212 and sections 1.162–7 and 1.212–1(d) of the regulations require that compensation paid be reasonable in amount and business or profit related to be deductible.

preferences, capital gains would be taxed at 35 percent,[41] while the same amount treated as compensation would be taxed at 50 percent.[42] For the same taxpayer with high capital gain or other tax preferences, capital gains could be taxed at as high as 49 percent,[43] while compensation would be taxed at 70 percent.[44] The 15 to 21 percent greater tax which the government could collect from a high income taxpayer by recharacterizing capital gains as ordinary income compensation would be small revenue if the employer is a corporation with a typical tax rate of 48 percent. By treating a dollar of appreciation as ordinary income rather than capital gains, the government could lose 27 to 33 cents for every dollar of appreciation the employee receives, because the employer gains 48 cents from the deduction. If the employee is in lower, rather than the highest tax brackets, ordinary income treatment could cost the government even more.[45]

---

[41] The 35 percent tax rate on capital gains is computed as the sum of the following rates: (1) 25 percent under the section 1201(b) alternative tax; (2) zero minimum tax because of the $10,000 and half-of-tax exclusions under sections 56(a) and (c); (3) 10 percent derived from one half of capital gains being used to offset section 1348 personal service income, under section 1348(b)(2) and section 57(a)(9)(A), and thus pushing that personal service income out from under the protection of the 50 percent maximum tax and into a 70 percent bracket.

[42] I.R.C. § 1348(a).

[43] A tax rate on capital gains of 48.6 percent is computed as the sum of the following rates: (1) 35 percent under section 1201(c), assuming that capital gains exceed $50,000 for the year; (2) 10 percent from the offset to maximum tax amounts described in N.41 *supra;* (3) ~~3.6~~ 4 percent from the 15 percent minimum tax—sections 56(a) and (c) impose the tax on tax preferences less one half of the regular taxes paid, where tax preferences exceed $10,000. Tax preferences include one half of capital gains. Since regular taxes paid are 45 percent (rates (1) and (2)), the minimum tax is 0.15(½) (100%–45%) ≈ or ~~3.6~~ 4.1 percent of the capital gains.

[44] This assumes that under section 1348(b)(2)(B), tax preferences make the maximum tax unavailable.

[45] The employer's deduction will not always make treating the appreciation as ordinary income a revenue loser. First, the employer may be tax-exempt or already have excess net operating losses or compensation may already be excessive so that any revenue gained from the employee will be the net revenue gain. Second, even if the deduction gives the employer 48 cents for every dollar deducted, in some cases the difference between ordinary income rates and the present value of capital gain rates can be greater than 48 percent. The example in text assumes that capital gains and ordinary income arise at the same time. In fact, the employee would pay ordinary income tax under the proposed regulations when he paid an installment on the nonrecourse liability while he would pay capital gain tax, if the payment of an installment were not an event on which compensation was realized, only when he sells the stock or other property he is purchasing. The employee may not need or anticipate early sale of the property he is purchasing. Thus, the present value of the ultimate capital gain tax may be far less than 35 or 49 percent. Under section 1014, in force when section 83 was enacted and the proposed regulations were promulgated, capital appreciation

The argument that ordinary income treatment is a revenue loser, however, possibly proves too much. It means first that none of the benefit of nonrecourse liability should be treated as compensation in any way. In extremes, it would mean that all corporate employees should be able to report all their compensation as capital gains so that their corporate employer would be denied a deduction.

Section 83, however, had a different goal than revenue raising. At the heart of the section is the change in the amount taxable as ordinary income when restrictions on the transferred property lapse. Under prior law, the unappreciated value of the property at the time of its earlier transfer acted as a cap on the compensation element. Under section 83, the value of the property at the later time when the restrictions lapse is used to measure the taxable compensation. The fact that taxation of restricted stock plans under prior law helped Treasury revenue, while generous to employees was well publicized in the period of section 83's gestation.[46] Section 83, however, went forward on the analysis that the old restricted stock plans were too generous to employees by comparison with other forms of compensation.[47] Thus, the House Committee on Ways and Means and the Senate Committee

---

was forgiven on death so that the effective rate on capital gains could have been zero. If the rate on capital gains is zero, then treating the appreciation as ordinary income is a revenue gainer for any employee with a tax rate higher than his employer's. The Tax Reform Act of 1976, for the future, will require heirs to pay capital gain tax on the appreciation of the stock over the employee's cost (Pub. L. No. 94–455, § 2005, 90 Stat. 1872 (1976), enacting section 1023 of the Code) so that capital gain rates for the future will not be zero. However, even when carryover basis is fully effective, deferral of tax can be of tremendous value. Using a conservative 6 percent discount rate, the present value cost of the capital gain tax can be cut in half if the employee holds stock for 12 years after paying the installments even if his nominal capital gain rate remains the same. Of course, the employee could also be in a lower tax bracket by the time he sells the property. If, as of the time installments are paid, the present value of the tax on ultimate capital gains drops below a 20 percent rate, the taxing of appreciation at ordinary income rates when installments are paid could mean a revenue gain from employees who must pay 70 percent on immediate personal service income, even if that means that the employer will get an immediate 48 percent deduction. The holding period needed to make the difference between capital gains and immediate ordinary income so large, however, is quite long, so that even for the highest bracket employees, a revenue loss because of the increased ordinary income would be the overwhelmingly common case. This is especially true since taxpayers are likely to avoid nonrecourse liability where the proposed regulations would increase government revenue but use nonrecourse liability where the proposed regulations would decrease government revenue.

[46] Carpenter, *High Cost of Restricted Stock Incentives,* 46 HARV. BUS. REV. 139 (1968); Kidder, *Restricted Stock Arrangements—An Economic Consideration,* 46 TAXES 680 (1968); Schapiro, *Restricted Property Received as Compensation for Services,* 22 TAX LAWYER 529, 535–36 (1969).

[47] H.R. REP. No. 413 (Part 1), 91st Cong., 1st Sess. 86–87 (1969); S. REP. No. 552, 91st Cong., 1st Sess. 120–21 (1969).

on Finance both stated, in reporting section 83, that "[t]he revenue impact of this provision is believed to be negligible in terms of any pickup in revenues from existing law. This is because restricted stock plans, for the most part, have the effect of transferring tax liability from the employees to the company."[48] Section 83 seems to mandate that the equity of including compensatory benefits in full in the income of employees outweighs the possible revenue losses of the provision. The revenue consequences are then arguably a problem that should be ignored.[49]

Inequity of Delaying Tax

A second criticism is that the proposed regulations unwisely defer taxation. As noted, the proposed regulations appear to require that any bargain at the time of the purchase be ignored until installments are paid on the nonrecourse liability.[50] Absent the option analysis of nonrecourse liability, the bargain would be taxed at the time of the purchase under the statutory language of section 83(a). Delaying the taxable event in order to capture more of the appreciation attributable to the bargain segment of the property as ordinary income may, in fact, put

---

[48] H.R. REP. No. 413 (Part 1), N. 47 *supra*, at 89; S. REP. No. 552, N. 47 *supra*, at 124.

[49] Arguably, section 83(h) is the source of the erroneous revenue loss in allowing the employer a deduction measured by the compensation the employee includes in income. A deduction requires, it seems, not only that the employee have taxable income but also that the employer have some diminution in his ability to pay tax. For instance, when a shareholder transfers some of a corporate employer's own stock to an incoming employee (perhaps to insure that the employee's best efforts for the corporation will increase the shareholder's remaining stock), the arrangement is plausibly a mere change in the ownership of the corporate employer rather than a diminution in the economic condition of the employer; section 83(h), however, gives the employer a deduction equal to the employee's income. *See* Prop. Reg. § 1.83–6(d); S. REP. No. 91–552, 91st Cong., 1st Sess. 123–24 (1969). The idea that a deduction requires loss is supported by cases such as Gardner Denver Co. v. Commissioner, 75 F.2d 38, 40 (7th Cir. 1935), which denied the employer a deduction for the following reason: "[An] increment in the value of the stock [subsequent to an agreement between employer and employees for conveyance of stock for a certain price] cannot be regarded as contemplated or actual additional compensation to the employees. *And in no event would such subsequent advance in value represent loss or outlay or expense to the corporation itself.*" (Emphasis added.)

On the other hand, it has long been established that the fair market value of stock and not the basis of stock measures a taxpayer's deductible expense paid with stock. *See, e.g.*, International Freighting Corp. v. Comm'r, 135 F.2d 310 (2d Cir. 1943). Arguably, section 83(h) provides only that such fair market value is to be measured when the deduction is allowed and thus is merely the employer's side of the proposition that the time for measurement of the compensation is the time when it is taken into account for tax purposes.

[50] *See* N. 24 *supra*.

the employee who pays a bargain price with nonrecourse liability in a better position than that of his colleague who pays the same bargain price with cash or personal liability. An employee who avoids tax on property received keeps the tax he would have paid, and his investment return on that amount usually makes up for his having to pay ordinary income (and not capital gains) at some later date.

For instance, assume that property worth $101 is transferred to two executives in 50 percent brackets and that both executives will pay their tax by selling part of the property. Both executives are to pay $1 for the property. The first executive pays his $1 with nonrecourse liability, thus, under the regulations, he avoids current taxation on the bargain element. The second executive pays his $1 with personal indebtedness and thus has immediate taxation on his $100 bargain. Now, the first executive must report subsequent appreciation as ordinary income when he pays his $1, while the second can get long-term capital gains, but the first executive should be in a better position. Assuming, for instance, that there is appreciation of 30 percent, on payment of the liability, the first executive would pay tax of $15 on the $30 appreciation and $50 tax on the $100 original bargain element and would be left with $65 worth of property after tax. The second executive, having only $50 worth of property left after paying a $50 tax on the original purchase would receive a return before tax of $15 (30 percent of $50) leaving him with a total of $65 worth of property before tax on the $15 of appreciation. Since the effective rate of taxation on capital gains is greater than zero, the second executive—who absorbed the tax earlier to get capital gains later—is left with property or cash worth less than $65 and is therefore worse off than the first executive (who avoided early tax). In sum, the return to the first executive generated by the tax deferral more than makes up for the difference between ordinary and capital gain rates. The situation could be reversed. The first executive, for instance, might go from a low to a higher bracket tax year. Nonetheless, the possible advantages of nonrecourse liability might start compensation schemes whereby a trivial nonrecourse payment is required for property that but for tax, would have been given to the employee without cost. While trivial payments can be ignored as shams, nonrecourse liability one notch above trivial or one notch above a sham, however defined, cannot.

Preventing premature taxation of compensation is a common theme in section 83 [51] and the predecessor regulations,[52] but where there is

[51] The view that taxpayers are evading tax by paying tax too early is reflected within section 83 itself in that a rather healthy penalty—denial of a deduction for the employee's losses upon forfeiture of the property—is required if a section 83(b) election is made to pay tax on transfer of property before risks of for-

taxable at the time of the purchase. After taxation, the segment of the property attributable to the initial bargain would be considered transferred and would generate capital gains, just as do segments which are considered transferred because of an installment payment.

Another problem with delaying the taxable event relates to the deductibility of dividends. If the rationale for delaying taxation and denying capital gains is that the employee is not deemed the owner of the property,[55] then he might well not be treated as the owner for other purposes. If the property is stock, then dividends on the stock might, by reason of this rationale, be considered not true dividends but additional compensation.[56] If so, the dividends would be deductible by the corporation "to

[55] *See* N. 35 *supra* and the accompanying text.

[56] In "phantom stock" plans, where compensation is measured by the dividends declared on the employer's stock but the employee is never made a real or prospective shareholder, it seems clear that amounts measured by dividends remain deductible compensation. On the other hand, when dividends are received by the employee as a shareholder, the dividends are not deductible by the employer, even if the shareholder rights arise from employment. William C. Atwater & Co., 10 T.C. 218, 246 (1948); A. Levy & J. Zentner Co., 31 B.T.A. 386, 390 (1934); S.C. Toof & Co., 21 B.T.A. 916, 940 (1930); Hamilton Manufacturing Co., 3 B.T.A. 1045, 1049 (1926). Beyond that, the exact line between deductible compensation and nondeductible dividends remains neither clear nor consistent. An early test is that dividends are deductible compensation if so intended by the parties, even if the employee has become a shareholder for another purpose. Indianapolis Glove Co. v. United States, 96 F.2d 816 (7th Cir. 1938) (stock had been issued); Alger-Sullivan Lumber Co. v. Comm'r, 57 F.2d 3 (5th Cir. 1932) (employee had voting rights); A.M. Karagheusian, 2 T.C.M. 1142 (1942). Since compensation treatment is no detriment to either party and dividend treatment is no benefit, however, a considerable skepticism arises as to expressed intent, even in negotiated documents. As stated in Frank Lyon Co. v. United States, 536 F.2d 746, 751 (8th Cir. 1976), *cert. granted,* 97 S. Ct. 1097 (1977), "subjective intent is of importance only to the extent it affects the actual allocation of interests, not in spite of that allocation." Some sense can be made of the cases by noting that in many of the cases allowing deduction of dividends on issued (or unissued) stock, the dividends had to be applied to the purchase of the stock and the stock was to be purchased solely out of such applied dividends. Omaha Nat'l Bank v. Comm'r, 75 F.2d 434 (8th Cir. 1935); W.T. Grant Co., 58 T.C. 290 (1972) *rev'd on other grounds,* 483 F.2d 1115 (2d Cir. 1973) *cert. denied,* 416 U.S. 937 (1974); U.S. Steel Corp., 2 T.C. 430 (1943); Electric Storage Battery Co., 39 B.T.A. 121 (1939). Further, the courts in the above cases seem to be laboring under the misapprehension that compensation cannot arise in an employee's true "purchase" of the stock. However, as stated in Bastedo, *Taxing Employees on Stock Purchases,* 41 COLUM. L. REV. 239, 243 (1941): "to state that for his services the employee received credits . . . automatically applied against the purchase price of stock is merely an ingenious way of saying that he received stock for those services." Certainly where the dividends must be applied to the purchase of the stock, it seems inappropriate to consider both the dividends and the full stock value as compensation so that the courts noted above were apparently giving deduction of dividends in a search for a substitute for allowing deduction of the stock value. *Cf.* Hudson Motor Car Co. v. United States, 3 F. Supp. 834, 846 (Ct. Cl. 1933) (accumulation of dividends was means of determining when addi-

the extent that" installments remain outstanding, apparently even if the property is the employer corporation's own stock. In fact, it seems that the dividends should not become deductible merely because of the manner in which the employee pays for the property. but if the proposed regulations were intended to, or have the effect of, permitting a corporation miraculously to deduct its own dividends, then, in that respect, they seem to have gratuitously given away revenue without improving horizontal or vertical equity.

Administrative Burden

The foremost criticism of the proposed regulations is that they intolerably complicate the administration of the tax system. The extra administrative burden, if nothing else, should be enough to kill or at

---

tional compensation would be paid; dividends not deductible); George W. Mason, 41 B.T.A. 1287 (1940) (fair market value of stock and not the earnings committed to the purchase of the stock was the compensation); Commercial Investment Trust Corp., 28 B.T.A. 143 (1933) (to allow deduction of fair market value of stock and of dividends used to purchase would be a double deduction).

The Tax Court seems now to have settled on a test that dividends on a corporate employer's stock are deductible by the employer if the employee is not yet owner of the stock under state law. W.T. Grant Co., 58 T.C. 290 (1972) *rev'd on other grounds,* 483 F.2d 1115 (2d Cir. 1973), *cert. denied,* 416 U.S. 937 (1974); U.S. Steel Corp., 2 T.C. 430 (1943). In view of the more fundamental proposition that state law characterizations of ownership are not determinative for federal tax purposes (Heiner v. Mellon, 304 U.S. 271, 279 (1938); Burnet v. Harmel, 287 U.S. 103, 110 (1932)), however, it seems reasonable, at a minimum, that dividends received by an employee on stock of which he is the beneficial owner—under a federal standard—are true dividends and are not deductible. *See* Gardner-Denver Co. v. Comm'r, 75 F.2d 38, 40 (7th Cir. 1935), *cert. denied,* 295 U.S. 763 (1935) (employee's receipt of dividends indicated that employee was shareholder from moment of binding sales contract; dividends not deductible); Harold F. Jones, 6 T.C. 412, 430 (1946) (dividends on stock held for employee in trust were true dividends); W.M. Ritter Lumber Co., 30 B.T.A. 231, 275 (1934) (dividends on stock subject to binding sale agreement not deductible); Commercial Investment Trust Co., 28 B.T.A. 143, 151 (1933), *aff'd per curiam,* 74 F.2d 1015 (2d Cir. 1935) (dividends on allotted shares not deductible). As a matter of determining the beneficial ownership of the stock, it seems reasonable that if the employee has a nonforfeitable right to the income from the stock, he is the owner of the stock in determining whether dividends are deductible even if the stock itself is subject to a substantial risk of forfeiture. *See, e.g.,* Higgins v. Smith, 308 U.S. 473, 478 (1940) ("It is the command of income and its benefit which marks the real owner of property."). The employee might be only a temporary shareholder, but then again, given most risks of forfeiture in practice, he is probably also the permanent owner. Probably "transfer" of stock, however the final regulations define the term, will ultimately be considered to shift the beneficial ownership of stock and mark the termination of deductibility of the dividends on stock given by the employer; having "transfer" for purposes of ending such deductibility differ from "transfer" for other purposes—such as the section 83(b) election—probably is possible, but it would certainly add to the complexity of the regulations.

least to require modification of the proposal. If each installment is a taxable event, then to compute his tax, the employee must ascertain the fair market value of the property at the time of every payment on a nonrecourse note. That burden may be relatively small if installments are relatively rare, but computations could be required every month or so for the full period that installments remain outstanding. If the property is regularly traded on an established market, computation of its value could be relatively easy. Absent frequent market quotations, however, the difficulty and inaccuracy of the numerous appraisals of fair value would be required, and, given the difficulty and questionable accuracy of these appraisals, it is submitted that they are not worth whatever equity the proposed regulations would accomplish.[57]

One modification to reduce the administrative burden would be to limit the number of transfers. For instance, it is possible to provide that a transfer occurs only when all installments have been paid. Under prior law the regulations provided that an option was not exercised by payment of the purchase price with nonrecourse liability.[58] The difficulty with such a position is that the employee has capital at risk—almost to the full extent of the property—by the time he makes the final payment. If it is to his benefit to get into a capital position (rather than to delay tax), he should be entitled to capital gains from most of the property's appreciation. In any event, to bring the employee who has paid all but a small amount of the purchase price more into line with those employees who pay cash for their property, an earlier transfer seems justified. One possibility is that the property could be considered transferred when the employee's equity is so large that the losses against which the employee is protected are remote and speculative. How remote and speculative the losses are would depend on (1) how volatile the property transferred is and (2) how long the protection lasts, so that a judgment that the losses are remote and speculative might have to be made individually for every case. Better yet, some reasonably arbitrary overall standard might be provided to cut down on the burden and uncertainty of determining the transfer point. For instance, since property rarely declines to less than a third of its value, the regulations could provide that property is transferred when the employee's equity is two-thirds of the property's current value. Such a standard does not

[57] A taxable transfer has other consequences beyond determining when to tax the property. It starts the holding period and if the property is sold before the statutory holding period would be satisfied, if measured from the last payments, some allocation would have to be made between long-term and short-term gains. Further, if the employer's ownership of the property ends in segments for all purposes, some allocation must be made to determine the employer's depreciation deductions.

[58] Reg. § 1.421-7(f).

accomplish very much, however, if it still requires interim appraisals to test when the one transfer occurs, but a half dozen other rules are possible, *e.g.*, "Transfer occurs when the initial bargain, together with employee payments, exceed two thirds of the initial value"; or "Transfer occurs when the employee pays two thirds of the original price." Such a later transfer date would still deny capital gains to the appreciation attributable to a great deal of employee investment.

An earlier date for the transfer would give the employee more capital gains, but as the transfer date is pushed earlier in time and to purchases with less employee equity, the losses from which the employee is protected become less and less remote, and the employee capital investment becomes less. In the extreme, the transfer date might be pushed back to the purchase if there is some small employee equity, with the result that the significant value of not having capital at risk, which the nonrecourse liability provides, would not be reached as compensation in any way.

Some compromise between the policy of reaching absence of capital at risk and the policy of allowing the employee credit for his investment could be reached,[59] but any compromise has to slight one policy or the other, and maybe both. Any compromise in the transfer point would miss the peculiar accommodation between the policies which the proposed regulations effect by giving the employee capital gains for his paid installments but not for the unpaid installments.

In any event, given the modifications in the proposed regulations which are necessitated by a modicum of practicality and the extent of these changes, it seems that completely different approaches to the taxation of employee nonrecourse liability should be examined.

---

[59] Schapiro, *Proposed Regulations Under Code Section 83,* 25 TAX LAWYER 281, 285 (1972), recommends:

> Administrative convenience could suggest that the regulations establish a percentage down payment which "ordinarily and in absence of other facts and circumstances" will measure the dividing line between option and ownership. The writer's experience suggests that such a figure could reasonably be set between 20 percent and 30 percent of purchase price. It could be argued that a shoestring purchase of five percent down with a 95 percent nonrecourse obligation, for example, could become converted to a full transfer of property merely be reason of a market value appreciation of the pledged property which by itself would provide the employee with a meaningful equity in the property. It is suggested, however, that the proposed regulations adopt a view disregarding market value appreciation or depreciation after the purchase or purported purchase.

This approach makes sense, but the 30 percent down payment would be inadequate, for instance, for volatile stock for a payment period of five or even ten years, if the goal is to make the losses protected against remote and speculative. It is not clear, however, how he reached the 20 and 30 percentage figures or what he was attempting to measure.

The Interest Approach

If a nonrecourse acquisition is not to be treated as an option, a possible alternative is to tax the absence of capital at risk as if it were the employer's undertaking an interest like benefit for the employee. Arguably, the only compensation in nonrecourse employee acquisitions is the employer's forebearance from demanding immediate payment of the purchase price for the property given to the employee. The classic definition of interest is that it is a charge for "the use or forebearance of money."[60] Interest is like rent for use of money and, as employees are commonly taxed on the fair rental value of such things as yachts and summer homes provided by their employer,[61] so one would expect that the employer's forebearance from demanding the purchase price could be taxed as interest compensation and as taxable income. If the loan is for the full value of volatile stock, the risks that the employer has assumed are substantial enough to drive the appropriate interest rate quite high. Even if the loan is not interest free, it might call for such a low rate of interest that compensation income is generated.

An employee's benefit from an interest-free loan, however, has been held to be excludable from taxable income. The rationale is that if the employee had paid the appropriate interest, he would have had a deduction under section 163, without regard to whether the interest were a business or income producing expense.[62] If the employer had paid a third party for interest on the employee's loan, the employee would have both income and an offsetting deduction.[63] Arguably, in providing an

---

[60] Deputy v. DuPont, 308 U.S. 488, 498 (1940); Fall River Electric Light Co., 23 B.T.A. 168 (1931); Reg. § 1.856–2(c)(2)(ii).

[61] United Aniline Co. v. Comm'r, 316 F.2d 701 (1st Cir. 1963) (personal use of corporate yacht was dividend); *accord,* Challenge Manufacturing Co., 37 T.C. 650 (1962); Percy M. Chandler, 41 B.T.A. 165, 178 (1940), *aff'd* 119 F.2d 623 (3d Cir. 1941) (personal use of lodge was compensation); Robert R. Walker, Inc., 24 T.C.M. 140 (1965) (personal use of lake house was dividend). *See* STAFF OF THE JOINT COMMITTEE ON INTERNAL REVENUE TAXATION, EXAMINATION OF PRESIDENT NIXON'S RETURNS FOR 1969 THROUGH 1972, S. REP. NO. 768, 93d Cong., 2d Sess. 157–68 (1974).

[62] J. Simpson Dean, 35 T.C. 1083, 1089–90 (1961).

[63] Glenn C. Oury, 34 T.C.M. 1568 (1975). In other contexts, payments by another on behalf of the taxpayer can justify a deduction by the taxpayer at least where it is possible to recharacterize the transaction as if it were, first, a transfer of some sort to the taxpayer and then a payment by him. Patrick v. United States, 186 F. Supp. 48 (D.S.C. 1960), *aff'd without discussion of this point,* 288 F.2d 292 (4th Cir. 1961), *rev'd without discussion of this point,* 372 U.S. 53 (1962) (payment was considered loan to taxpayer); *accord,* Pierce Oil Corp. v. United States, 77 F. Supp. 273 (D. Va. 1947), *rev'd on another issue,* 169 F.2d 542 (4th Cir. 1948), *cert. denied,* 335 U.S. 908 (1948); Royal Oak Apartments, Inc., 43 T.C. 243 (1964) (payment was considered as in satisfaction of debt to taxpayer). *See also* section 83(h) as explained by S. REP. No. 552, N. 47

interest-free loan, the employer is just paying himself the interest, and, the employee should still be allowed the offsetting deduction. Another way to state the argument is that the law excludes the economic benefit of forebearance without interest from gross income in order to equate the employee who is charged no interest with an employee who is charged deductible interest, but given additional compensation to make up for it.[64] By contrast, rent on a yacht or summer home would not be deductible if actually paid by the employee, and there should be no offset to additional compensation.

The exclusion from the employee's income of the benefit from an interest-free or interest-poor loan rests on the premise that the interest, if paid, would have been deductible. That premise would obviously fail in the relatively rare case in which the properties the employer is selling are tax-exempt bonds. The deduction for imputed interest would be disallowed by section 265(2), leaving the employee with nothing to offset and exempt his compensation. Further, assuming abandonment of the approach of the proposed regulations in denying capital gains on the acquired property, the property should be considered investment property. If the employee spends more than $10,000 a year on interest to acquire or carry other investments, then section 163(d), as amended by the 1976 Reform Act,[65] could disallow deduction of up to half of the imputed interest payment and make the benefit of interest-free and interest-poor loans a taxable compensatory benefit. For most cases, however, section 483, in finding an original issue discount for unstated interest, would provide the sole relevant exception to the exclusion for interest-free loans. Section 483 is also important even where section 265(2) or section 163(d) applies. While the latter sections might deny an offsetting deduction for interest where section 483 would find that there was some unstated interest, section 483 seems preemptively to determine the appropriate interest rate in an acquisition of property and thus to determine the maximum interest compensation.

Under section 483, if an employee purchase—for more than $3,000 and with installments of the purchase price deferred for more than six months—does not require the employee to pay at least 6 percent simple interest[66] then a part of each payment of what is ostensibly an install-

---

supra, at 123–24 (under section 83 payment of compensation by shareholders is considered contribution to capital of corporate taxpayer).

[64] SNEED, THE CONFIGURATIONS OF GROSS INCOME 84–88 (1967). *See also* Duhl & Fine, *New Case Allowing Interest Deduction Calls for Reappraisal of No-Interest Loans,* 44 J. TAXATION 34 (1976); O'Hare, *The Taxation of Interest-Free Loans,* 27 VAND. L. REV. 1085, 1094–96 (1974).

[65] Pub. L. No. 94–455, § 205(c), 90 Stat. 1535 (1976) (amending I.R.C. § 163(d)).

[66] Reg. § 1.483–1(d)(1)(ii)(B), T.D. 7394, 1976–1 C.B. 135. For sales before

ment of the purchase price instead will be recharacterized as interest. The distinctive contribution of section 483 here is not its creation of some interest, but rather its creation of interest discount.[67] The amounts characterized as interest are no longer part of the purchase price[68] so that a sale ostensibly for the full value of the property is instead a bargain sale. If, for instance, an employee promises to pay $100 in nonrecourse liability—or any liability—payable in ten installments over five years for stock worth $100 and there is no provision for interest, then under section 483 there would be $17 of total unstated interest in the sale,[69] computed using the current 7 percent interest rate compounded semi-annually,[70] and the employee would be considered to have paid only $83 for the property. Under section 83(a), the $17 difference between the value and the purchase price would be immediate income to the employee. An employee on the cash basis would be entitled to the deduction for the unstated interest—assuming it is not disallowed by sections 265(2) and 163(d)—only as he paid the installments. If the employee were in a 50 percent marginal tax bracket throughout, then section 483 would mean that $8.50 tax was collected in our $100 sale, but was returned over five years. Conveniently using a 7 percent (compounded semi-annually) discount rate, the deductions for interest would have a present value of $7 so that the net cost of the employee would be about $1.50. Considering that the 50 percent rate is the maximum rate for much earned income and that five years is quite a long time for an option to operate, a net tax effect of 1.5 percent of the sales price where no interest is charged is a very minimal tax.

Section 483 discount might in its humble way supersede the exclusion for interest-free loans in a number of acquisitions,[71] but it does not

---

July 24, 1975, or pursuant to commitments binding before that date, the test rate is 4 percent simple. Reg. § 1.483-1(d)(1)(ii)(A).

[67] In creating interest discount here, section 483 is arguably erroneous, since the question is not the character of amounts the employee actually pays. Discount is the amount by which the proceeds of a loan fall short of the amount the borrower promises to pay back at maturity. I.R.C. § 1232(b)(1). In the nonrecourse acquisition, the employee receives loan proceeds—the property purchased—worth at least the amount to be paid on maturity of the loan. Imputed interest should arguably then be considered a benefit on top of the principal repayment and not a discount. If section 483 imputed added interest payments by the employee only when they would be deductible, there would be no compensation.

[68] Reg. § 1.483-2(a)(1)(i).

[69] Computed as $100 total payments minus $83.17 present value of five year annuity. Reg. §§ 1.483-1(c), 1(g)(2) Table V, (g)(4), (g)(7), as amended by T.D. 7394, 1976-1 C.B. 135.

[70] Reg. § 1.483-1(c)(2)(ii), applicable to sales after July 24, 1975, except for sales pursuant to a commitment binding before such date.

[71] Section 483 applies only to payments in years after 1963 which are, in turn,

so function in at least one important case. If payments are indefinite as to time, liability or amount—in which case the employee's option like benefits might be especially great—it is impossible to compute discount at the time of the purchase, and section 483 waits until payments are actually made to compute the unstated interest.[72] If unstated interest reduces the purchase price only when unstated interest is deductible, then, in the case of the indefinite time, liability or amount, the compensation from the interest would apparently be offset and would be exempt from tax.

The difficulty with the preemptive application of section 483 and with the entire interest approach is that it misses the special benefits of nonrecourse liability to the employee, *i.e.*, the employer's absorption of at least some of the risks that the property will go down in value. Section 483 is intended to apply a fairly conservative interest rate and the rate seems far more appropriate to loans with personal liability than to loans in which the employer has intentionally increased the risks that his loan principle will not be returned. Interest is only that charge for the use of forebearance of money per se. The Service, for instance, has redundantly stated that charges with different names are interest if for the use or forebearance of money per se, but not if for specific services rendered by the lender in connection with the loan.[73] There is some small tolerance of charges which are "allocable to no specific charges"[74] and of charges designated by the parties as interest,[75] and no one has suggested that the cost of the lender's services in evaluating the loan or interest rate once the data is in must be carved out of the borrower's interest deduction. Similarly, there must be tolerance for lender's risks

after the years to which the Tax Court's 1961 *Dean* decision relates. *See* Reg. § 1.483–1(b)(6) Ex. 6 (to the effect that section 483 is applicable to employee loans in connection with sales).

[72] I.R.C. § 483(d); Reg. § 1.483–1(e)(1).

[73] Rev. Rul. 74–187, 1974–1 C.B. 48 (late payment fee); Rev. Rul. 69–290, 1969–1 C.B. 55 (premium charge); Rev. Rul. 69–189, 1969–1 C.B. 55 (maximum loan charge); Rev. Rul. 69–188, 1969–1 C.B. 54 (loan processing fee); Rev. Rul. 57–541, 1957–2 C.B. 319 (financing and application fee).

[74] Rev. Rul. 69–188, 1969–1 C.B. 54 (separate charges were made for title report, insurance, escrow fee and drawing of the deed).

[75] Rev. Rul. 69–189, 1969–1 C.B. 55 (taxpayer must substantiate the part of a "maximum loan charge" which is for use or forebearance of money but arm's length agreement between lender and borrower designating what portion is the true interest will ordinarily be accepted). In view of the fact that the lender will have to report the charge promptly as ordinary income whether it is designated interest or fees for his services, there is no apparent interest adverse to the parties, at arm's length, designating the entire charge as interest. It is difficult to see why such a designation should be so readily accepted, except that avoiding complexity over trivial matters requires some toleration of noninterest within the section 163 deduction.

—every addition to the lender's bad debt reserve cannot be considered noninterest to the payor. However, when the risks of nonpayment become too high or where they are intentionally created to benefit the borrower, it seems a misnomer to call the employee's benefit interest. The benefit in nonrecourse liability is not exactly like the temporary rental of money, but is also like a charge to account for the fact that the money might not have to be returned at the end of the term. The nonrecourse feature functions as a kind of investment insurance to prevent or reduce the employee's loss in case the property declines in value. Just as it would be inappropriate to allow an offsetting deduction under section 163 for the cost of such insurance,[76] so it seems that its equivalent in the form of a nonrecourse loan should not be exempt from tax. The benefit of protection against loss can easily overshadow the pure interest benefit to the employee. Six-month options on volatile stock with an option price equal to the present fair market value of the stock are, when available, worth more than 3.5 percent of the stock's value (*i.e.*, interest computed at 7 percent compounded semi-annually).

An interest analogy might still be useful in implying that the benefit of protection against loss ought to be taxed currently over the period that the loan is outstanding. Premiums on term insurance and interest are both periodic charges and, perhaps, the protection against loss in the nonrecourse feature should periodically be taxed. The recurrent difficulty, however, is that of valuing the benefit. It does not seem any easier to determine the periodic benefit of protection against loss than to determine its value when the purchase occurs. The interest analogy, accordingly, does not seem helpful.

The Foreclosure Approach

Rather than require periodic measurement of the protection against risks, perhaps it is possible to find the losses, if any, that the employee would have suffered with cash or personal liability, but did not suffer because of the nonrecourse feature, and use that to measure the compensation which the nonrecourse feature provides. If the property transferred declines in value, an employer would have to refund cash to an employee who purchased with cash just to put such an employee in the same economic position as the employee who purchased with nonre-

[76] Rev. Rul. 69–188, 1969–1 C.B. 54 (charges for creditor insurance not deductible). *Cf.* Merrill Stubbs, 24 T.C.M. 938 (1965), where the court held that a creditor's receipts for modifying the terms of his installment sale were not interest income to the creditor where, in addition to extending the time to pay the sales price, the creditor significantly increased his risk that the sale price would not be paid by subordinating the sales price to significant other debt.

course liability which he does not ultimately pay. If the refund of cash would be compensation in some amount,[77] so it seems should be the failure to pay the indebtedness.

Protection against actual loss, rather than protection against risk of losses, would provide the measurement of the compensation. An employee whose property increases in value would have no compensation, even though any employee would have at least a psychological benefit in knowing that his risks of losses were limited to his equity, if any, in the property. Using actual measurable losses, rather than immeasurable psychic benefits, seems to be a wise trade-off. However, the tax burden of the advantages of nonrecourse liability would fall on those whose investments turned sour, rather than upon those whose investments were successful.

For present convenience, the time for measuring the avoided losses is labeled "foreclosure" realizing that in strict usage, foreclosure is limited to description of a certain process with respect to mortgages on real property. In fact, the employer probably is likely to terminate the transaction simply by notifying an escrow agent that stock is to be returned, or the employee will voluntarily return the property in settlement of the debt or refuse to pay an overdue installment on property the employer retains. As noted, the employee would complete a transaction in which the property is worth more than the indebtedness he must pay to get it, so that foreclosure will occur only in cases in which the fair market value of the property has dropped below the employee's remaining indebtedness.

Although the Supreme Court has reserved decision on the issue,[78] the Service, in Revenue Ruling 76–111,[79] has ruled that the unpaid nonrecourse liability is realized upon a disposition of the securing property, even where the fair market value of the property is less than the unpaid liability at disposition.[80] Revenue Ruling 76–111 also indicates that the

---

[77] *Cf.* Harris W. Bradley, 39 T.C. 652 (1963) (reimbursement of employee's loss on sale of his residence was compensation).

[78] In Crane v. Comm'r, 331 U.S. 1, 14 n.37 (1947) (holding that nonrecourse liability is included in amount realized in a sale, where property sold is worth more than the liability), the Court said: "Obviously, if the value of the property is less than the amount of the mortgage, a mortgagor who is not personally liable cannot realize a benefit equal to the mortgage. Consequently a different problem might be encountered where a mortgagor abandoned the property or transferred it subject to the mortgage without receiving boot. That is not the case."

[79] 1976–1 C.B. 211. *See* Handler, *Tax Consequences of Mortgage Foreclosures and Transfers of Real Property to the Mortgagee,* 31 TAX L. REV. 193, 225–27, 234–45, 254 (1976).

[80] It can be argued in opposition to the ruling that there is no realization. Once the securing property declines in value below the point where it is profitable to pay off the debt, there is no economic incentive to pay the indebtedness; hence

disposition which extinguishes the borrower's obligation is a sale or exchange of the securing property.[81] Accordingly, if a taxpayer acquired stock for $100 in nonrecourse liability, paid $10 in installments, dis-

---

there is no continuing detriment to the borrower in the indebtedness nor benefit in its disappearance. *See* N. 78 *supra,* and Adams, *Exploring the Outer Boundaries of the* Crane *Doctrine: An Imaginary Supreme Court Opinion,* 21 TAX L. REV. 159, 169, 181 (1966) (raising some doubt that such realization would be constitutional). In some cases, whether the indebtedness is realized or not is moot, so long as its inclusion in basis for computing loss is treated consistently. Thus, a taxpayer would get a loss deduction for his paid installments in a stock sale, whether or not unpaid nonrecourse liability used to acquire the stock were included or excluded from basis *and* amount realized at foreclosure (*but see* N. 81 *infra,* for character of the loss). However, where the indebtedness was incurred in return for cash after the acquisition of the securing property or where depreciation has been taken, failure to require realization would allow the nonrecourse borrower to keep loan proceeds tax free or to keep the depreciation deduction for costs he did not incur. Realization is then required to offset the earlier error (which seemed reasonable at the time) of reducing tax by treating the nonrecourse liability as if it were legitimate, that is, as if it were going to be paid. Woodsam Associates Inc., 16 T.C. 649, 654 (1951), *aff'd,* 198 F.2d 357 (2d Cir. 1952) (taxpayer received and used the proceeds of the obligation for his own benefit); SNEED, THE CONFIGURATION OF GROSS INCOME 313 (1967); Del Cotto, *Basis and Amount Realized Under Crane: A Current View of Some Tax Effects,* 118 U. PA. L. REV. 69, 86 (1969). For constitutional purposes, it may be the income which was originally offset by the ultimately unpaid indebtedness which we are taxing at disposition. In the case of employee nonrecourse acquisitions, the nonrecourse liability has given a prior tax benefit in that if the liability were ignored the employee would have been taxed on the full value of the property transferred under section 83(a), so that realization on foreclosure is appropriate.

[81] *See also* Gavin S. Millar, 34 T.C.M. 554 (1975), *vacated and remanded,* 540 F.2d 184 (3d Cir. 1976), *on remand, reaffirming prior opinion,* 67 T.C. No. 49 (1977). If, contrary to Revenue Ruling 76–111, the nonrecourse liability is not an amount realized on foreclosure, then, under cases decided prior to *Crane,* the employee can obtain an ordinary deduction for the installments he has paid as a loss, by abandoning the property or transferring it in settlement of the nonrecourse indebtedness, because he has received nothing to make the disposition a "sale or exchange." Polin v. Comm'r, 114 F.2d 174 (3d Cir. 1940); Comm'r v. Hoffman, 117 F.2d 987 (2d Cir. 1941); William H. Jamison, 8 T.C. 173 (1943). The commentators are critical of allowing such an ordinary loss: Andelman, *Mortgage Foreclosure: Effects Upon Mortgagor, Mortgagees, Receiver in Possession; Deed in Lieu of Foreclosure,* 30 N.Y.U. TAX INST. 309, 311 (1972) (personal or nonrecourse liability should not mark distinction between capital and ordinary treatment); Handler, *Tax Consequences of Mortgage Foreclosures and Transfers of Real Property to the Mortgagee,* 31 TAX L. REV. 193, 234–45, 254 (1976) (supporting Revenue Ruling 76–111 and arguing that distinctions between personal and nonrecourse liability, foreclosure and voluntary transfers on this issue are artificial). *See generally* Surrey & Warren, *The Income Tax Project of the American Law Institute: Gross Income, Deductions, Accounting, Gains and Losses, and Cancellation of Indebtedness,* 66 HARV. L. REV. 761, 811 (1953) (arguing for elimination of sale or exchange requirement for capital treatment). A better view is represented by section 1.165–4(a) of the regulations, which denies a section 165(a) ordinary deduction to losses "solely on account of a

feature is like the granting of a compensatory "put" option to the employee under which the employee may return the stock to the employer in exchange for the unpaid liability. If the put option, like an unmarketable call option, cannot be valued when the employee is given the right, its value can be ascertained when the employee actually returns the stock in foreclosure as the excess of the liability over the property's value.[85] Thus, in our example, if an employee acquired stock with $100 in nonrecourse liability from his employer, paid installments of $10 and discontinued payment when the stock was worth $50, he would have received $40 compensation in the ability to walk away from the transaction—the difference between the $90 forgiven liability and the $50 value of the stock. Consistently, the $40 compensation no longer would be treated as an amount realized with respect to the property, so that the employee would have a $50 capital loss—the difference between his basis of $100 and that part of the avoided nonrecourse liability forgiven in exchange for property worth $50—rather than a $10 loss. The added capital loss, however, would only partially offset the ordinary income from the compensation.

Up to now, we have assumed that foreclosure is the time for measurement of the compensation, but there are problems with that concept. First, an actual foreclosure can arguably be too early an event to measure the employee's true benefit. Suppose, for instance, that the property collapses in value completely, but that an employee, with the foresight to recognize a dive when he sees it is able to force a foreclosure on the liability just when the property's value drops below the amount of the unpaid indebtedness. The employee's compensation—the excess of the unpaid indebtedness over the property's value—would be zero if

[85] Miller, *Capital Gains Taxation of the Fruits of Personal Efforts: Before and Under the 1954 Code*, 64 YALE L.J. 1, 52–54 (1954) (taxation of employee put option). At least two cases stand in opposition to this analysis in that they deny the employer a compensation deduction. In Western Maryland Dairy Corp., 32 B.T.A. 769 (1935), an employer reduced the liability his employees had undertaken in payment for stock to the depreciated fair market value of the stock. The court held that the employer's expense, though helpful and necessary, was not an ordinary expense. In Patent Buttons Co. v. Commissioner, 203 F.2d 479 (2d Cir. 1953), the court held that a repurchase put was not compensatory when the employee exercised it because the parties did not intend the employee's gain to be compensation. *Western Maryland* seems inconsistent, however, with the analysis that the "ordinary" requirement is principally to identify capital expenditures. Comm'r v. Tellier, 383 U.S. 687, 690 (1966). *Patent Buttons* seems inconsistent with the analysis in Duberstein v. Commissioner, 363 U.S. 278 (1960), that compensation is not limited to specifically bargained for amounts, and the analysis in Commissioner v. LoBue, 351 U.S. 243 (1956), that intent to compensate is not a distinction between taxable and excludable bargains when an employee exercises a call option.

the crossover point is also the point for measurement of the compensation. If the employee had paid significant installments, the prospect of a capital loss for the installments would reinforce the drive for an early foreclosure and for zero or negligible compensation.

On the other hand, if some employers are slow to foreclose (*e.g.*, if the due date for an installment or other default event is delayed or if some employees do not have the ability, foresight or tax incentive to force foreclosure until some time after the property declines below the crossover point), then there is some possibility that the value of the property at foreclosure will be sufficiently low to generate some taxable income. It seems unfair, however, to tax an employee depending upon the fortuity of the time when actual foreclosure occurs, when other faster or luckier employees are avoiding compensation altogether by having an earlier measurement. Apart from tax, the slower employee is not hurt by a delayed foreclosure. With nonrecourse liability, it does not matter to the employee how far below the indebtedness the property declines. The property could be worth nothing or just less than the indebtedness, since in either case the employee will have no equity and will have no liability for any deficiency. Even when the property collapses in value completely, there is no economic difference in the employee's position to tell us whether the employee should have had zero compensation or compensation equal to the full amount of the indebtedness from the transaction. In view of the economic equivalence between the two cases, relying on the actual value of the property at the time of foreclosure to apportion between compensation and a sale or exchange seems to be reliance on accident.

Given this economic equivalence, it is also plausible to say that the employee was saved from the worst loss, even when foreclosure occurred before the property hit its nadir, and should therefore be taxed on compensation measured from the minimum value of the property. Since no foreclosures ever occur after liability is paid, the minimum value of the property in the period over which the liability was to have been paid seems to be the appropriate mark from which to compute compensation, no matter when the foreclosure actually occurred. If so, then it would seem that generally the compensation would have to be taxable only at the end of the period in which the liability was to have been paid, so that the minimum value of the property could be established.

If the period for payment of the liability is open ended, then the worst loss approach would seem to require that the entire amount realized be apportioned to compensation and none to exchange for the property on the ground that at some time during an indefinite period the property might decline in value to nothing. Since the worst loss is known, the actual foreclosure rather than the end of the indefinite payment period, whenever that is, could be the time to include the taxable compensation.

A host of other problems ride with the worst loss approach. When the payment period is fixed, is the employee's capital loss similarly to be deferred until the end of the payment period? What is the effect of accelerated payment provisions? What is the employer's basis for the reacquired property before the employee has compensation? Will employees keep records of the value of property long after they have lost it? The problems are not insuperable, nor need they necessarily be solved with perfect symmetry, but they destroy much of the appeal of the foreclosure approach if the appeal rests on simplicity of measuring the loss.

Whether or not the employee receives compensation computed from the worst loss, the foreclosure approach requires an actual foreclosure. A second problem with the foreclosure concept is that there may not always be an identifiable foreclosure. Further, actual foreclosure can be delayed for too long to be an adequate time for collecting the tax. While a foreclosure will occur only when the property is worth less than the outstanding indebtedness, it need not then occur. From the fact that it is not rational for the employee to complete the acquisition, it does not follow that it is rational to abandon it. The employee is in a valuable position even if the property declines below the indebtedness because of the possibility that the property might recover in value or, perhaps, the possibility that he may retain some temporary rents or income from the property. Those possibilities, however remote, are worth something, so that the employee's position is never truly valueless. In some cases, the employee might be willing to pay some installments that have come due to stay in this position. But, more commonly, the employee will keep his property without foreclosure because he is not forced to his choice of continuing payments or abandoning the acquisition, either because payment dates were indefinite at the outset or because the employer enforces them with leniency. If the employee is not forced to his choice between abandonment or payment, then he can indefinitely remain with property worth less than the indebtedness, retaining the possibility that the property might some day become valuable, and yet avoiding any foreclosure that is the prerequisite for finding compensation. As the employee's position is rational throughout, it is awkward to impute a constructive abandonment or foreclosure. Obviously, there will be actual foreclosures on nonrecourse liability even between friends, but with such a wide possibility of indefinite avoidance of the taxable event under the foreclosure approach, other measures of the compensation in nonrecourse liability are more appealing.

taxed at its value, ignoring the restriction when the property is transferred. If the forfeiture in fact comes about, then the employee is allowed a loss at the time of forfeiture.[93] Similarly, property subject to nonrecourse liability would be taxed at its value ignoring the obligation to pay for it, but an ordinary deduction would be allowed when the obligation comes into effect through payment.[94]

The system anticipates a temporary payment of tax. If the employee paid the liability, and this payment constitutes a deduction from ordinary income in a year in which his tax bracket was the same as that of the year in which the property was taxed, then the employee would lose the tax on the property only for the period between receiving the property and paying the liability or, in other words, would permanently lose value equivalent to the interest on the tax for the period before the liability is paid. If tax and interest rates are constant, the lost interest on the tax equals the tax saved by an employee's deduction for interest and the added cost does no more than would making an interest cost nondeductible. Especially where the employer does not charge interest, that permanent cost seems appropriate to the benefit of avoiding early

---

vestment letter restrictions placed on stock for SEC purposes to guarantee the limited circulation of private placements were also to be ignored, but investment letter restrictions have been replaced since 1969 by the enactment of SEC rule 144. 17 C.F.R. 284 (1976). *See* Rice, *Restricted Stock as Executive Incentives: Interplay Between IRC Section 83 and SEC Rule 144,* 28 Bus. Lawyer 128 (1972). Rule 144 restrictions do not automatically lapse after the passage of time (*see* rule 144(e)) as did investment letter restrictions, although, arguably, the public and not the private market value of stock was intended to be required (*see, e.g.,* Accounting Principles Board, Opinion No. 25, *Accounting for Stock Issued to Employees* ¶ 10a (1972)) and the profit from carrying stock from private to public markets was intended to be taxed as ordinary rather than capital income. Restrictions such as "employee must forfeit stock if Niagara Falls falls," are probably ignorable as remote and speculative even if they are, in some sense, nonlapse restrictions.

[93] Section 1.83–1(a) of the proposed regulations provides that the forfeiture of property which is no longer subject to a substantial risk of forfeiture is a disposition of the property and that if the property is a capital asset in the employee's hands, the loss on forfeiture is capital. Arguably, a loss due to a forfeiture restriction present when the property was transferred should, under Arrowsmith v. Commissioner, 344 U.S. 6 (1952), be considered an offset to compensation and an ordinary deduction. *See, e.g.,* Vincent E. Oswald, 49 T.C. 645 (1968); Rev. Rul. 69–115, 69–1 C.B. 50 (return of excessive compensation pursuant to previously binding agreement was deduction). On the other hand, the loss is arguably in the nature of an investment and capital loss if triggered by an investment like condition. *See* Reg. § 1.165–4(a) (denying ordinary loss to stock loss caused by market decline); Betram H. Slator, 64 T.C. 571, 575 (1975) (loss on stock transferred back to employer was due to market decline).

[94] Payment under an obligation incurred when the property was transferred is in no sense a market loss, so that *Arrowsmith* and *Oswald* would make the payment deductible against ordinary income.

investment of capital. Where the employer charges a fair interest rate, the system adds to the employee's interest cost.

If the nonrecourse liability allowed the employee to avoid capital at risk, then taxing the full property by ignoring the liability would give the employee the equivalent of capital at risk in the property for the period before the liability is actually paid. Since the employee would have the equivalent of an investment in the property, appreciation on the property would appropriately be considered capital gains to him. If the obligation were never paid and the employee lost his property, he should be considered to have a loss equal to the amount previously taxed to him without diminution for the unpaid nonrecourse liability.[95]

Both the valuation and the ignoring of nonrecourse liability require that the state of the law allow nonrecourse liability to be treated as something other than payment in the amount of the full face value of the liability. A taxpayer is usually given credit for the full face value of his liability or his liability is ignored.[96] There is no concept of valuing

---

[95] The primary rationale for including unpaid nonrecourse liability in the amount realized if the property is worth less than the outstanding indebtedness is that the indebtedness has previously reduced the borrower's taxable income and when it turns out not to have been paid it is appropriate to require the indebtedness to be realized at least because of the previous taxable income which the debt sheltered. As the nonrecourse indebtedness will be of no tax benefit when incurred under the approach noted in the text, it is appropriate that it should have no tax detriment when the indebtedness disappears. Thus, the employee would have a loss if the employer foreclosed equal to the full amount he has previously included in income.

The loss should arguably be considered an ordinary loss on the ground that the full value of the property was included in income solely for administrative convenience and that it is necessary to "correct" the prior inclusion when it turns out that the employee had no ultimate gain. On the other hand, the loss is also due to an independent market decline after the employee has accepted the stock, so that the loss is quite plausibly an investment and a capital loss.

[96] While liability incurred in acquiring property is ordinarily included in the basis of the property, basis does not include contingent liabilities. Douglas J. Lemery, 52 T.C. 367, 378 (1969), *aff'd per curiam,* 451 F.2d 173 (9th Cir. 1971) (payments contingent on future business earnings); Albany Car Wheel Co., 40 T.C. 831 (1963), *aff'd per curiam,* 333 F.2d 653 (2d Cir. 1964) (contingent employee severance pay); Lloyd H. Redford, 28 T.C. 773 (1957) (payments contingent on future profits). If a contingent note is given to a third party for cash used to purchase property, however, the infirmities in the purchaser's note to the third party are not considered and basis includes the cash. James T. Benn, 22 T.C.M. 151 (1963), *aff'd per curiam,* 366 F.2d 778 (5th Cir. 1966), *cert. denied,* 389 U.S. 833 (1967); Edward W. Edwards, 19 T.C. 275 (1952). Similarly, a cash basis taxpayer gets no deduction for paying expenses with a note (Baltimore Dairy Lunch, Inc. v. United States, 231 F.2d 870 (8th Cir. 1956); Hart v. Comm'r, 54 F.2d 848 (1st Cir. 1932); Demor, Inc., 27 T.C.M. 279 (1968); James W. England, Jr., 34 T.C. 617 (1960); Stanley C. Warrick, 20 B.T.A. 220 (1930); John Hoskins, 7 B.T.A. 299 (1927)), but no one questions a deduction for expenses made using borrowed cash. For another area in which

the liability a taxpayer has incurred to acquire property, even if the acquisition price of the property might well have been less if cash rather than a risky liability were paid.[97] It is well settled that a liability is not excluded from basis merely because it is nonrecourse, at least if the value of the securing property is as great as or greater than the indebtedness.[98] Arguably, ignoring or valuing the liability to determine the section 83(a)(2) "amount (if any) paid" is compatible with including nonrecourse liability in basis on the most crucial point. Since the employee is taxed on the bargain, then, whether or not the nonrecourse liability is an amount paid, the employee's basis for depreciation purposes is the market value of the property and not just the employee's equity. Depreciation deductions computed from such a basis would meet the Supreme Court's criteria used in *Crane v. Commissioner,*[99] in holding that basis included nonrecourse liability. The depreciation deductions would "represent . . . the cost of the corresponding physical exhaustion"[100] in the depreciable property and would match with the periodic income from use of the property; the system would not have the problem of "repeatedly recomputing basis and annual allowances"[101] with each payment. Even if the depreciable basis were correct whether or not the "amount paid" includes nonrecourse liability, however, it still seems hard to distinguish the issue of including nonrecourse liability in basis from the issue of whether nonrecourse liability is an amount paid. As explained by one court, "The effect [of including nonrecourse liability in basis] is to give the taxpayer advance credit for the amount of the mortgage."[102] Giving advance credit for liabilities can be criticized, especially when considering the role of such advance credit in eroding the tax base and undermining progressive taxation through tax shel-

---

a taxpayer is given no credit for bona fide liability when incurred, see Velma W. Alderman, 55 T.C. 662 (1971) (notes given to new corporation do not reduce section 357(c) gain).

[97] The remedy for inflated indebtedness is to ignore the liability, not to discount it. Franklin v. Comm'r, 544 F.2d 1045 (9th Cir. 1976) (failure to demonstrate that nonrecourse liability exceeded a reasonable estimate of the fair market value of property means liability not included in basis); Leonard Marcus, 30 T.C.M. 299 (1971) (liability which exceeded the seller's initial request and had a term longer than the useful life of the property was excluded from basis); Rev. Rul. 69-77, 1969-1 C.B. 59 (liabilities designed to create or inflate depreciation deductions are excluded from basis).

[98] Comm'r v. Fortee Properties, 211 F.2d 915 (2d Cir.), *cert. denied,* 348 U.S. 826 (1954); Parker v. Delaney, 186 F.2d 455 (1st Cir. 1950), *cert. denied,* 341 U.S. 926 (1951); David F. Bolger, 59 T.C. 760 (1973); Manuel D. Mayerson, 47 T.C. 340 (1966). *See* Crane v. Comm'r, 331 U.S. 1, 9–11 (1947).

[99] 331 U.S. 1 (1947).

[100] *Id.* at 9.

[101] *Id.* at 10.

[102] Manuel D. Mayerson, 47 T.C. 340, 352 (1960).

ters.[103] If a taxpayer is entitled to an advance credit for the purpose of basis, however, it seems that he would normally be entitled to an advance credit for the purpose of "amount (if any) paid."

The inclusion of nonrecourse liability, however, is a rule for arm's length transactions and the rules for compensatory purchases differ. Thus, as noted, the purchaser in an arm's length bargain purchase is not taxed at the time of the acquisition, but the purchaser in a transaction connected with the performance of services realizes ordinary income as soon as nonforfeitable property is transferred to him.[104] The taxpayer who is taxable on the receipt of income would ordinarily value that property discounting its value by the presence of lapse restrictions placed on the property by the transferee; and employee has taxable income based upon the value of the property "(determined without regard to any restriction other than a restriction which by its terms will never lapse)."[105] Given these large differences between thc taxation of employment and arm's length purchases, if the property is sold in connection with the performance of services, then notwithstanding the normal rules for basis, "the amount (if any) paid for such property"[106] could be interpreted to include only actual payments on such liability and not nonrecourse liability.

There is, however, no denying that ignoring nonrecourse liability is at least somewhat penal. The system—like the nonrecourse liability—would be neither tender nor kind.[107] It is difficult to see what real gain the employee has had at the time of the purchase if he must eventually

---

[103] *See* Staff of the Joint Committee on Internal Revenue Taxation, Overview of Tax Shelters 3 (Comm. Print 1975). The dramatic erosive effect of tax shelters on taxable income of high income individuals is shown by Staff of the Joint Committee on Internal Revenue Taxation, Tax Shelter Investments: Analysis of 37 Individual Income Tax Returns, 24 Partnership and 3 Small Business Corporation Returns (Comm. Print 1975). Deductions for borrowed amounts magnify any anticipation of deductions which other provisions allow and generate the phenomenal mismatching of deductions and income which characterizes a tax shelter. Allowing deductions for borrowed amounts provides not merely an exclusion, but rather the more advantageous subtraction of amounts which have never been included in the tax base; allowing exclusion of the proceeds and a deduction for use of the proceeds allows a double deduction. At least before the proceeds must be repaid the taxpayer is better off by borrowing and using the borrowing for deductions than if he had never borrowed at all. Leveraging, however, works as well with personal liability as with nonrecourse liability and its importance is enough to significantly affect the national tax base.

[104] I.R.C. § 83(a). Comm'r v. LoBue, 351 U.S. 243, 248 (1956).

[105] I.R.C. § 83(a).

[106] I.R.C. § 83(a)(2).

[107] The pun, unfortunately, is intended, but is unavoidable since the alternative position is that "tender is the note."

pay the full value for the property, even if nonrecourse liability is in its pristine and most compensatory form, *i.e.*, if the liability need not be paid until the employee wants to sell the property. Even if the property is salable at will, the full lien still must be paid before or upon sale and an immediate sale of the property would leave the employee with no remaining value. Ownership means other rights beyond the right to sell property for value, but traditionally they are not separately taxed: Voting rights for stock are not usually taxed and appreciation beyond the lien price is not yet realized. Dividends or other income from the property certainly indicate true ownership of the property, but the income will be taxed on its own as it is received. The same question could be asked in the case of nonconsumable property which is subject to lapsing restrictions such as a prohibition against sale for five years. One might ask (1) what gain is there in owning stock that cannot be converted to cash or consumed until restrictions lapse, or (2) what immediate value does an employee receive from contributions to a nonqualified trust that he cannot reach, yet sections 83 and 402(b) require the employee to be taxed on the property when transferred to him or to a nonqualified trust at a value ignoring the fact that the employee can neither sell nor immediately use it. Restricted property subject to lapse restrictions or contributions to a nonqualified trust, however, seem to represent an increase in the store of the employee's property rights—a kind of savings—in a way that property which must be paid for does not. Of course, the tax on property sold for nonrecourse liability is intended to be temporary and, at least if the employee's deduction for payment of the liability saves the same amount of tax as was imposed at the time of the purchase, the penalty will be relatively small—often equivalent to denying a deduction for interest. It is, nonetheless, a penalty if interest is otherwise deductible.

Arguably, some penalty is justified. Cash compensation is superior to compensation in kind in that the employee has a chance to maximize his own choice of the uses to which the compensation is put. Shifting from cash compensation to compensation in kind usually means a loss in utility because of a reduction in employee choice, and it should be discouraged. Moreover, some penalty to "reduce the time and effort devoted to tax planning"[108] and to "forestall the development of new methods of tax avoidance"[109] would also be justified. If the choice is

---

[108] H.R. REP. No. 413 (Part I), 91st Cong., 1st Sess. 208 (1969).

[109] *Ibid.* These quotations were made in connection with the enactment of the maximum tax on earned income in section 1348. They appear in a passage which in fact talks about reducing tax to reduce tax avoidance, but section 1348 as enacted by the Tax Reform Act of 1969 had several antitax gimmick penalties. At first, earned income did not include any deferred compensation. *But see* Tax

between a penalty on financing with nonrecourse liability or an equal windfall in foregoing taxation of its special benefits, there is a great deal to be said for the penalty. On the other hand, nonrecourse liability does not seem so much an evil as it is just difficult to tax, so that the tax treatment should probably be as neutral as possible in intent, even if inaccuracies have to be tolerated to avoid insuperable administrative burdens.

Moreover, a penalty on the employee does not mean that there is any disincentive to undertaking the transaction as a whole. Section 83(h) provides that the employer is allowed a deduction equal to the amount included in the employee's income under section 83. If the employer's deductions must match the employee's income, the employer will get a windfall where the employee has a penalty. Section 83(h) does not require that the employer have borne an actual economic loss. For any corporation, getting deductions for the full value of its stock for which the employee has obligated himself to pay with nonrecourse liability would seem to be an advantageous transaction—if the nonrecourse liability were ignored, the immediate deduction would involve neither a charge to earnings nor a cash cost. Indeed, if the employee would have more ordinary income, the savings, even if temporary, from corporate tax, usually at the 48 percent corporate rate, would allow the corporation ample room to compensate an employee for the temporary income tax he must pay on the stock and to still come out ahead. Thus, from a model intended to discourage nonrecourse employee liability might come a proliferation of nonrecourse stock purchase plans, especially for employees in brackets lower than 48 percent, designed to take advantage of the model. Given the existence of section 83(h), the penalty provisions inherent in ignoring nonrecourse liability could not function to discourage employee acquisitions using nonrecourse liability.

Conclusion

After examining the alternative ways of taxing the compensatory benefits of nonrecourse liability, the proposed regulations, at least as modified to meet the major objections, do not seem too bad. Ignoring the benefits seems to give high income employees a windfall, which may

---

Reform Act of 1976, Pub. L. No. 94–455, § 302, 90 Stat. 1554 (1976) (amending section 1348(b)(1)(A) to include deferred compensation within personal service income eligible for the maximum tax). Under section 1348(b)(2)(B) the income eligible for the maximum tax is reduced by tax preferences. *See* Asimow, *Section 1348: The Death of Mickey Mouse?*, 58 CALIF. L. REV. 801 (1970); Watts, *The Maximum Tax on Earned Income: Section 1348*, 26 TAX L. REV. 1 (1970).

or may not be made up by reduced deductions on the employer's side and which, even if fully made up, seems objectionable within what tries to be a comprehensive and progressive tax system. Valuation of the benefits at the purchase or periodically over the course of payments on the liability, or valuation of the liability itself, seems, even if justifiable in theory, impossible in practice. Section 483 might, after a great deal of effort, produce a small interest discount for some cases, but misses the protection against loss altogether. Relying on foreclosure to account for the benefits is a rather unreliable way to reach the benefits and, if it is to tax employees equitably, the model would require some rather complicated restructuring of the time and measurement of tax. With section 83(h), ignoring the liability when the property is transferred seems too harsh a treatment of employees without giving anyone the advantage of making the problem go away.

Thus, given the alternatives, the final regulations could tax appreciation on the property sold to the employee as ordinary income if the appreciation is not attributed to employee capital at risk. As noted, the proposed regulations should probably be modified to reduce the number of transfers in order to reduce the number of times an appraisal of the property would have to be made. The writer's own feeling is that the initial bargain should be taxed at the purchase and that there should be another measurement of the bargain and a taxable event when, by administrative fiat or definition, the employee's equity is deemed large enough to make the protection against loss trivial. Of course, the various models are not necessarily incompatible: Foreclosure could be a taxable event as to transferred property and the limited coverage that model provides, even in its simplest version, could nonetheless be considered enough coverage of the benefit of protection against loss to push the time of transfer a little earlier or reduce slightly the amount of employee's equity needed to effect a transfer.

Any point adopted by the regulations as the point when property subject to a nonrecourse liability is transferred would, being an administrative fiat, be subject to attack. Some employees will want earlier taxation to get into a capital gain position. Other employees will want to delay tax longer or will want the bargain to be measured at its minimum. Employers will want a deduction early and will want compensation measured by the highest fair market value of the property, except when measuring compensation on foreclosure, when speaking for employees, and when financial conformity and nontax benefits outweigh tax benefits. A standard set by regulations should reduce whipsaw—each party reporting its tax claiming the position most beneficial to itself without regard to the other party's position. Given the peculiar advantages of nonrecourse liability, a regulatory standard delaying the final taxable event until there is substantial employee equity should bring the taxation of compensation in employee acquisitions using nonrecourse liability into a more equitable relationship with the taxation of acquisitions made with cash or personal liability.

Even this recommendation is made with reservations. It would not be unreasonable for the final section 83 regulations to delete any statement about nonrecourse liability. The doctrinal rationales for the option approach are open to very considerable attack. The recommendation is a not particularly elegant compromise between competing considerations. A minimum revision of the proposed regulations to make them acceptable as a full, prompt measure of the employee's compensation would be to tax any initial bargain at the time of transfer of the property; if it is impossible to tax as compensation both the initial bargain and the subsequent transfers due to payments of installments, the initial bargain should be the taxable event. Moreover, nonrecourse liability seems quite far removed from the core of a statute intended to deal with the problem of restricted stock and perhaps the distance of the nonrecourse liability problem from the core of section 83's concerns should mean that revenue considerations, which are to be ignored under section 83, must be considered with respect to nonrecourse liability. A rule that nonrecourse liability is per se an option until the employee's equity is sufficient will guarantee loss of revenue, because the employer's deduction usually means more than the difference between capital gains and ordinary income and because employers will use nonrecourse liability only when it is beneficial to do so. If the final regulations under section 83 are silent on the nonrecourse liability problem, the Service could still reach out to recharacterize nominal purchases as options in truly egregious cases where the position would mean a revenue gain. If in the future nonrecourse liability becomes a problem of some magnitude, then sections 83(h) and 83(a)(2) could be amended to permit the nonrecourse liability to be ignored until payment, so that without giving the employer a windfall, a penalty appropriate to the liability could be adopted. Such a solution would leave the problem to another day and to a statute other than that enacted in 1969 as section 83.