Wolters Kluwer

The M&A Tax Report

MARCH 2017 VOLUME 25, NUMBER 8

The Monthly Review of Taxes, Trends & Techniques

Buyer Diligence & Code Sec. 83: All that Glitters…

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In the world of M&A, due diligence is usually treated as a necessary evil. Target companies may represent and warrant that everything is shipshape, if not better. But prudent buyers still want to avoid nasty surprises. Trust but verify, as a politician might say.

So, a potential buyer will instruct its legal team to spend many tedious (but surely billable) hours combing through the target's contracts and minute books. If there are any red flags or smoking guns, due diligence is supposed to find them.

Occasionally, however, the diligence team will exceed expectations. Somebody will spot a giant and unexpected nugget glittering in the recesses of the data room. Of course, all that glitters is not gold. The buyer may have to spend years in court to discover whether its efforts have paid off in bullion or in pyrite.

For a memorable example, let's look at the Fourth Circuit's recent decision in *QinetiQ U.S. Holdings, Inc.* [No. 15-2192 (4th Cir. Jan. 6, 2017), *aff'g* 110 TCM 17, Dec. 60,340(M), TC Memo. 2015-123]. There, the buyer's diligence appeared to have uncovered a Code Sec. 83 problem the size of a Volkswagen. That was bad news for the target's founders, who were sitting on what looked like a huge pile of *unvested* shares.

But the founders' apparent Code Sec. 83 disaster opened the door for the target—soon to be the buyer's wholly owned subsidiary—to claim a $118 million compensation deduction. That is an impressive write-off by anybody's reckoning. The fact that it represented more than *95 percent* of the target's $123 million purchase price makes it even more remarkable.

The IRS certainly took notice. It challenged the deduction and prevailed in the Tax Court. [*See* Robert W. Wood, *Tax Court Holds Stock Not Subject to Substantial Risk of Forfeiture*, THE M&A TAX REPORT (Aug. 2015).] The Fourth Circuit has now affirmed, applying the "clearly erroneous" standard used to review factual determinations. But the Fourth Circuit's opinion glosses over a significant *legal* issue concerning the enforcement of forfeiture conditions.

ALSO IN THIS ISSUE

This question deserves to be put on the table for readers to consider *de novo*. *QinetiQ* (pronounced "kinetic"—sometimes corporate branding can go too far) is also worth examining for some rather unorthodox arguments advanced by the IRS and the taxpayer. Several of these gems even found their way into the courts' opinions.

Ironically, one of the government's winning arguments could provide aid and comfort to shareholders who have forgotten a cardinal rule: they need to make elections under Code Sec. 83(b).

Transfers in Connection with Services

When stock or other property is transferred in connection with the performance of services, Code Sec. 83(a) generally requires the service provider (who we will assume is the recipient of the property) to take a tax hit. He must report *compensation* income equal to the fair market value of the property, reduced by the amount, if any, he had to pay for it.

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THE M&A TAX REPORT (ISSN 1085-3693) is published monthly by Wolters Kluwer, 2700 Lake Cook Road, Riverwoods, Illinois 60015. Subscription inquiries should be directed to 2700 Lake Cook Road, Riverwoods, IL 60015.
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If a cash-strapped corporation pays a consultant's bill with stock worth $5,000, the consultant must report $5,000 in compensation. Under Code Sec. 83(h), the corporation can deduct $5,000 as a business expense. But stock usually operates as more than a substitute for cash. Shares issued to an officer or employee are often intended to secure the recipient's *future* services.

This is done by making the recipient's right to keep the stock conditional on his continued employment. If the risk of forfeiting the shares to the employer is "substantial," Code Sec. 83(a) excuses the recipient from reporting their value in the year of receipt. For tax purposes, the recipient and the issuer are treated as if the transfer didn't happen.

If and when the shares vest, however, the recipient and the issuer are treated as if the stock had been transferred at that time. Vesting occurs as soon as (1) the recipient holds the shares free of any substantial risk of forfeiture; or (2) the recipient has the right to transfer the shares to a third party free of such a risk.

The amount taxable under Code Sec. 83(a) is based on the fair market value of the shares at the time of vesting. Code Sec. 83(b), on the other hand, gives the recipient the option to report the transfer in the year of receipt, based on the *current* value of the shares. To do so, he must make an "83(b) election" within 30 days of the transfer.

In a start-up context, 83(b) elections are *de rigueur*. It's not hard to see why. If the stock recipient makes the election, he is taxed on the current value of the shares. But that is usually not too painful because start-up stock valuations are typically quite low.

Making an 83(b) election brings two major benefits if the start-up hits it big. First, the recipient does not have to pay tax on the value of the shares when they actually vest. By reporting $2,000 of compensation now, he can avoid reporting $2 million five years from now.

Second, the election starts the recipient's capital-gains holding period, effective on the day of the transfer. If he is around for the fabled "liquidity event," the recipient will likely be able to report all of the shares' post-transfer appreciation as long-term capital gain.

From the issuer's perspective, the economics are flipped. Under Code Sec. 81(h), the corporation's deduction corresponds in amount and timing to the recipient's inclusion. If the recipient makes an 83(b) election and reports just $2,000 of income, the corporation will deduct $2,000. But if the recipient skips the election and the stock is worth $2 million on vesting, the corporation will enjoy a $2 million deduction.

Founding Forfeitures

In 2002, Thomas Hume organized Dominion Technology Resources, Inc. (DTRI) to provide technology services to the government. DTRI elected to be taxed as an S corporation.

Hume brought in Julian Chin as a co-founder. On December 12, 2002, DTRI accepted (1) Hume's subscription for 4,500 shares of Class A voting common stock; and (2) Chin's subscription for 4,455 shares of Class A and 45 shares of Class B nonvoting common stock.

Hume and Chin each paid DTRI $450, the par value of their shares. The founders got their stock certificates on December 18. The same day, Hume and Chin entered a Shareholders Agreement with DTRI. Under the agreement, neither founder could transfer his shares (Founders' Shares) without the consent of the corporation and the other founder.

This kind of restriction is standard in closely held corporations. Of course, it does not raise any issue under Code Sec. 83. But the Shareholders Agreement went further. After reciting that the parties wished to limit stock ownership to *employees*, the agreement subjected the Founders' Shares to a *20-year* vesting schedule—five percent for each year of employment.

Hume became CEO and president. Chin was appointed chief operating officer and executive vice president. If a founder voluntarily left DTRI, the Shareholders Agreement gave the company the right to purchase his vested shares at a reasonable formula price. Any unvested shares, however, would be forfeited.

If a founder quit to compete with DTRI, he would still forfeit his unvested shares. But now the price paid for his vested shares would be subject to a cap that would give the founder credit for, at most, five years of service.

The QinetiQ Acquisition

Over the next few years, the start-up flourished mightily. Early in 2008, QinetiQ U.S. Holdings, Inc. (QinetiQ), a large defense and aerospace contractor, offered to purchase DTRI. On August 4, 2008, the founders agreed to QinetiQ's acquisition of all the company's stock for $123 million.

Of this amount, $118 million would be paid for the Founders' Shares. That was *131,000 times* what Hume and Chin had paid for them in 2002. The transaction closed on October 17, 2008.

Just before the papers were signed, Hume, Chin and DTRI waived the restrictions in the Shareholders Agreement. On paper, at least, the Founders' Shares finally vested.

The $118 Million Deduction

Meanwhile, QinetiQ had become aware of the employment-related forfeiture conditions in the Shareholders Agreement. Even more importantly, its diligence had revealed that the founders had *not* made 83(b) elections covering their shares. The tax implications were breathtaking.

If the Founders' Shares vested just before the closing, Hume and Chin would have to report their $118 million payday as *compensation* under Code Sec. 83(a). That is exactly what they did when they filed their tax returns for 2008. DTRI, on the other hand, claimed a $118 million deduction pursuant to Code Secs. 83(h) and 162(a).

Unfortunately for the founders, they had converted DTRI into a *C corporation* at the beginning of 2007. That meant that the company's 2008 deduction could not flow through to Hume and Chin, who held more than 95 percent of the company's stock. Instead, the deduction remained an asset of DTRI, which became a subsidiary of QinetiQ.

The IRS had no problem taxing Hume and Chin at ordinary rates, but it challenged DTRI's $118 million deduction. Focusing on the requirements of Code Sec. 83(a), the IRS contended (1) that DTRI had not transferred the Founders' Shares in connection with the performance of services; and (2) that the shares had not been subject to a substantial risk of forfeiture in any event.

"In Connection With"

One of the IRS's central arguments rested on the absence of documentation stating that the Founders' Shares had been issued "in consideration of" services. The IRS argued that the "true consideration" for the stock was the founders' payment of $900. The transaction was simply an investment—it was *not* connected with services.

M&A Tax Report readers may smile at this one. Did the IRS think it could flip decades of tax law on its head? One would have expected the Tax Court to make short work of the IRS's seemingly outlandish argument. After all, it has been established since *L.J. Alves* [79 TC 864, Dec. 39,501 (1982), *aff'd*, CA-9, 84-2 USTC ¶9546, 734 F2d 478 (1984)] that a transfer does not have to be compensatory to be considered "in connection with" the performance of services.

Of course, the IRS was right that the sale of stock to an employee at fair market value is not a transfer "in consideration of" services. But if the purpose of the sale is to bind the employee to the corporation, that is enough to satisfy the "in connection with" requirement.

Binding the Employee: 20-Year Vesting

Under the Shareholders Agreement, the Founders' Shares vested ratably over 20 years. During this period, Hume and Chin risked forfeiture of their unvested shares if they quit their jobs. If they had quit and competed, that would have cost them even more.

It seems undeniable that at least part of the function of the shares was (1) to secure the founders' future services for the company; and (2) to prevent the founders from providing services to a competitor. Yet, the Tax Court found that QinetiQ (as successor to DTRI) had failed to sustain its burden of proof on whether the shares were issued "in connection with" the performance of services. The court got detoured into reviewing other documentation for evidence that supposedly raised doubts about what DTRI had *really* intended when it issued the Founders' Shares.

The company had issued restricted stock to several nonfounder employees. The Tax Court observed that these other employees' forfeiture conditions had been set forth in their *employment* agreements. What's more, the agreements had clearly stated that the shares were being issued "in consideration of" their employment.

However, nothing in Code Sec. 83(a) prevents an employment-related forfeiture condition from appearing outside an employment agreement. And, as previously noted, there is no requirement that property be transferred "in consideration of" services. For the Tax Court to contend that this raised a *real question* about whether the Founders' Shares had been issued in connection with the performance of services is quite a stretch.

If the Tax Court entertained any scintilla of doubt, it should have been extinguished by the express terms of the Shareholders Agreement. If a founder quit within 20 years, he forfeited his unvested shares. That's pretty cut and dried.

Entrepreneurial Investment?

The IRS also argued that Hume and Chin had each paid his $450 as an "entrepreneurial investment" in DTRI stock. This was supposedly unrelated to their employment. As evidence, the government pointed to the fact that they had stated in their subscription agreements that they were purchasing the shares "for investment and not for the purpose of distribution or resale."

The Tax Court also took notice of the founders' statements. But those statements only prove that DTRI was selling shares in a *private offering*. To establish its exemption under the Securities Act, DTRI needed the purchasers to represent that they would not distribute or resell their shares. Treating this as evidence that the shares were not purchased in connection with the performance of services is far-fetched, to say the least.

An Unfortunate Sequence of Events

The IRS offered a more plausible argument based on the sequence of events involving the issuance of the Founders' Shares. Hume and Chin paid their $900 on December 9, 2002. On December 12, Hume signed a director's consent accepting the subscriptions and authorizing the issuance of the shares.

On December 18, DTRI delivered stock certificates and the parties executed the Shareholders Agreement. Hume and Chin also signed individual employment agreements with DTRI. This all sounds pretty normal.

But there is a timing issue. The stock certificates were executed and delivered on December 18. However, as a corporate law matter, Hume and Chin became the beneficial owners of the shares on December 12, when their subscriptions were accepted and DTRI was authorized to issue their paid-up shares.

Under Reg. §1.83-3(a)(1), property is transferred to a person when he acquires "a beneficial ownership interest." Hence, for tax purposes, the shares were transferred to Hume and Chin *before* they entered into the Shareholders Agreement. For six blissful days, the founders owned their shares *not* subject to a risk of forfeiture.

The shares were vested when received on December 12. They became unvested only when Hume and Chin signed the Shareholders Agreement on December 18. Code Sec. 83(a) says that income must be recognized in the "first taxable year" in which the transferred property is not held subject a substantial risk of forfeiture.

Going by the book, that would have been 2002. The Tax Court alluded to the timing issue but did not address it. That is not too surprising. When they can avoid it, courts prefer not to decide cases based on whether start-up documents were signed in precisely the right order.

The Fourth Circuit did not address the timing issue, either. In fact, it side-stepped the whole question of whether the Founders' Shares had been issued "in connection with" the performance of services. It upheld the Tax Court based exclusively on the IRS's *second* argument—that the risk of forfeiture was not "substantial" enough to trigger Code Sec. 83(a).

"Substantial" Risk of Forfeiture

Code Sec. 83(a) permits deferral, and there is no question that employers could abuse it by transferring property to employees subject to *illusory* risks of forfeiture. However, Reg. §1.83-3(c)(1) responds by declaring that property is *not* transferred subject to a *substantial* risk of forfeiture "if at the time of transfer the facts and circumstances demonstrate that the forfeiture condition is unlikely to be enforced."

Likelihood of Enforcement

Reg. §1.83-3(c)(3) provides specific guidance in the case of an employee who holds "a significant amount" of the combined voting power or value of all classes of stock of the issuer. To assess whether a forfeiture condition is "unlikely" to be enforced, we must consider several common-sense factors, including:

- the employee's relationship to other stockholders and their control of the corporation,
- the employee's relationship to the directors and officers,
- the employee's position and the extent to which he is subordinate to other employees, and
- past actions of the employer in enforcing the forfeiture condition.

If a company has a long history of letting employees resign and keep their shares, the forfeiture condition is a dead letter and should be disregarded. Similarly, we should disregard a condition imposed on stock held by an employee who is the majority shareholder and CEO. That last one sounds a lot like Hume, who held 50.25 percent of DTRI's voting shares and served as president, CEO and sole director.

Apparently, QinetiQ reached the same conclusion. In the midst of the proceedings before the Tax Court, it conceded that Hume had *never* held his shares subject to a substantial risk of forfeiture. That took Hume's shares out of the case, along with a $59 million potential deduction.

Unlikely to Do What?

That still left Chin's shares. Since there was only a single director, Chin's ownership of 49.75 percent of the voting stock would never put him in control. Legally, Hume had always been in the driver's seat.

Under the Regulations, the Tax Court was supposed to evaluate Chin's relationship to Hume. The Tax Court reported its findings as follows:

> Hume and Chin had a very close work relationship. They were DTRI's initial investors, and together they built the company from its early stages of incorporation. Along with Hume, Chin voted on all company matters and helped determine the company's overall direction. Since Chin held such a vital role within DTRI as the executive vice president, COO, and a 49.75% shareholder in voting stock, it is unlikely that Hume would have taken any actions to terminate his employment.

That is all perfectly plausible. But the question under Reg. §1.83-3(c)(1) is *not* whether Hume would have taken action to terminate Chin's employment. It is whether

Hume would have enforced the forfeiture condition if Chin had *resigned*.

The answers can certainly diverge. An irreplaceable employee may be secure from termination. But suppose he resigns, leaving his employer in the lurch—he is irreplaceable, after all. Would it really be "unlikely" that the corporation would enforce a forfeiture condition against the departing employee?

The Tax Court also found it significant that DTRI had never imposed a forfeiture on a holder of Class A voting stock. That is far from compelling. Hume and Chin were the only Class A stockholders, so there had never been an event that would have triggered a forfeiture. The absence of a record of enforcement is not the same thing as a record of *non*-enforcement.

Substantial, When?

Reg. §1.83-3(c)(1) states that a risk of forfeiture is not substantial if, *at the time of the transfer,* the facts and circumstances demonstrate the forfeiture condition is unlikely to be enforced. But the Tax Court's evaluation of Chin's relationship with Hume focused almost entirely on developments in the years *after* the transfer. Neither the Tax Court nor the Fourth Circuit made any effort to justify their use of subsequent events to evaluate Chin's relationship with Hume on the transfer date.

In fact, the Fourth Circuit did not even acknowledge the problem. It simply agreed with the Tax Court that Chin's "strong relationship with Hume demonstrated that the stock was not transferred in 2002 subject to a 'substantial risk of forfeiture.'"

Now that we see the issue, we can ask whether Reg. §1.83-3(c)(1) is right to focus exclusively on the situation when the property is *transferred*.

As a theoretical matter, the limitation is hard to justify. If a condition imposing a substantial risk of forfeiture is *formally* terminated, the shares vest at that time. As a matter of principle, shouldn't we reach the same result if the condition is terminated *de facto*?

For example, suppose that an employee who was granted restricted stock in 2014 purchased another 50 percent and became CEO in 2016. Plainly, the risk of forfeiture ceased to be substantial. From a consistent policy perspective, the shares should be treated as vesting in 2016.

But what if the post-transfer development is simply a change in the shareholder's relationship with the majority shareholder and CEO? In principle, that should also trigger vesting.

Fine, but how would that work in practice? In *QinetiQ*, Chin's relationship with Hume and DTRI developed over a period of years as the company grew. When his risk of forfeiture ceased to be substantial, Chin should have paid tax on his Founders' Shares. But *in which year* did the tax become due?

If we are dealing with evolving human relationships, there will often be no clear answer. Hence, it may be impossible to implement the theoretically correct approach in a fair and practical way.

That would explain why Reg. §1.83-3(c)(1) tells us to evaluate the likelihood of enforcement just *once*, at the time of the transfer. So, theory aside, there is a strong argument that the Tax Court and the Fourth Circuit should have evaluated the probability of enforcement *ex ante*—*i.e.*, based on the facts and circumstances in December 2002.

When All You Have Is Lemons

Faced with the explicit language of the Shareholders Agreement, the IRS argued that the parties didn't really *mean* it. The IRS emphasized that DTRI, Hume and Chin had all treated the Founders' Shares as outstanding for *corporate* law purposes. Indeed, Chin had even voted his shares! Didn't that show that the parties really intended for Chin's stock to be *fully vested,* despite the 20-year vesting requirement?

This argument from state corporate law has little to recommend it, although both courts seemed open to it. The fact that shares are subject to a substantial risk of forfeiture does not prevent them from being outstanding for state-law purposes. The holder owns the shares and will generally enjoy full voting and dividend rights.

Thus, the nontax treatment of the Founders' Shares was irrelevant. Yet the IRS didn't stop with state corporate law. It hammered on the fact that DTRI, Hume and Chin had all treated the Founders' Shares as outstanding for *tax* purposes. The founders reported and paid tax on their full share of DTRI's income as an

S corporation. Didn't this contradict QinetiQ's claim that the Shareholders Agreement had imposed a substantial risk of forfeiture?

Perhaps. But two other explanations seem more plausible, especially in a start-up context. One is that the parties simply did not understand that Code Sec. 83 applies to founders as well as to rank-and-file employees.

As the arguments in *QinetiQ* demonstrate, not everyone has gotten the memo about *Alves*. The founders, who paid cash for their shares, may have *assumed* that their "investments" had little in common with stock grants to regular employees. If they didn't even know they had a problem under Code Sec. 83, the founders and DTRI would have treated the shares as outstanding for tax purposes.

Alternatively, the founders—or at least their advisors—may have understood the need to file 83(b) elections. But what if somebody dropped the ball and elections were never actually filed?

Believe it or not, it happens. Once share certificates are in hand, participants in a start-up may assume that the legal paperwork has been taken care of. If there's a problem with the 83(b) elections, they may never realize it. The founders may turn their full attention to building a successful business and never think of Code Sec. 83 again. And advisors have been known to get distracted and fail to follow up.

Any of these scenarios would explain why the parties treated the founders as the owners of their shares for tax purposes. There would be no reason to infer that DTRI was not committed to enforcing the terms of the Shareholders Agreement.

However, the IRS's argument carried the day. According to the Tax Court, the fact that DTRI treated Hume and Chin as owning the Founders' Shares for tax purposes "directly contradicted" QinetiQ's contention that the Shareholders Agreement imposed a substantial risk of forfeiture. The Fourth Circuit did not disavow this reasoning.

QinetiQ could come in handy to taxpayers who have unwittingly fumbled their 83(b) elections. If the corporation has been treating the taxpayer as the owner of the shares for tax purposes, the taxpayer can argue that the company must not have intended to enforce the forfeiture condition in the first place!

Concluding Observation

Because the founders' Code Sec. 83 problem surfaced before the deal was signed, it is likely that some of the $123 million purchase price was paid for the economic benefits expected to flow from a $118 million compensation deduction. Now that those benefits have evaporated, it would be interesting to know whether Hume and Chin are obligated to indemnify QinetiQ for a portion of the shortfall.

Even if they are, the IRS's successful challenge to DTRI's deduction is not all bad news. Now that the IRS has established that Hume and Chin held *vested* shares at the time of the sale, it must acknowledge that the $118 million they reported as compensation was actually long-term capital gain. So, the Treasury will be sending them a $22 million refund.