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Do Friendly Founders *Really* Hold Restricted Shares Subject to a Substantial Risk of Forfeiture?

By Donald P. Board • Wood LLP

This year, U.S. tax professionals mark the 50th anniversary of the Tax Reform Act of 1969 [P.L. 91-172]. Although the celebration has so far been muted, there is no denying the historic significance of the 1969 Act. Its most notable feature, at least in retrospect, was the adoption of the predecessor to today's Alternative Minimum Tax, a levy whose fiscal consequences expanded beyond all expectations.

Transactional tax professionals grumble about the AMT, but the minimum tax is usually a matter of personal concern. When they're at the office, they're more likely to engage with another legacy of the 1969 Act, *viz.*, Code Sec. 83. As anyone who advises founders and new enterprises will testify, this comparatively non-technical provision can generate some surprisingly nuanced tax issues.

Five decades on, the courts and the IRS are still grappling with the basic concepts underlying Code Sec. 83. In this article, we will look at two recent cases that reached opposite conclusions on an elementary question: Do closely allied founders *really* hold restricted shares subject to a "substantial risk of forfeiture"?

Code Sec. 83 Framework

When a corporation transfers stock in connection with the provision of services, Code Sec. 83(a) requires the service provider (who we will assume is also the recipient of the shares) to take a tax hit. The stock recipient must report ordinary income equal to the fair market value of the shares, reduced by the amount, if any, the recipient paid for them. Even if the share transfer occurs long after the services were provided, this income is taxable as compensation.

An early-stage company trying to conserve cash might pay an employee's bonus by issuing shares instead of cutting a check. If the fair market value of the bonus shares is $15,000, the employee will have $15,000 in compensation subject to withholding. Under Code Sec. 83(h), the company will be able to deduct $15,000 as a business expense.

However, start-ups use stock as much more than a surrogate for cash. Almost invariably, shares are issued with strings attached. The goal is not simply to meet payroll, but to ensure that the company will have the benefit of 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 possibility of forfeiting "unvested" shares is substantial, Code Sec. 83(a) excuses the recipient from reporting their value as income in the year of receipt. For tax purposes, the issuance of the restricted shares is ignored.

When the shares vest, however, the recipient and the corporation are treated as if the stock were issued at that time. Vesting occurs as soon as the recipient: (1) holds the shares free of a substantial risk of forfeiture; or (2) has the power to transfer the shares to a third party free of any such risk. Notably, the amount taxable under Code Sec. 83(a) is keyed to the fair market value of the shares *at the time of vesting*, not issuance.

In private companies, shares frequently vest before they become transferable. This can trigger a large tax liability at a time when the recipient cannot sell or pledge shares to fund the applicable withholding. The new "deferral election" under Code Sec. 83(i) can mitigate analogous liquidity problems involving compensatory options or restricted stock units, but it does not apply to restricted shares. [*See generally* Donald P. Board, *New Code Sec. 83(i): Buy Now! Pay Later!*, The M&A Tax Report 1 (Jan. 2019).]

Under Code Sec. 83(b), on the other hand, a service provider may elect to report his receipt of restricted stock in the year of issuance. The tax is calculated using the current fair market value of the shares, determined without regard to the depressing effect of any "lapse" restrictions. [Reg. §1.83-1(a)(i).] In a start-up situation, the value of shares when issued will typically be only a small fraction of their value when they vest—assuming, of course, that the company is a success.

To opt into current taxation, the service provider must file an 83(b) election within 30 days of receiving the unvested shares. If the election is made, the stock recipient and the corporation are treated as if the restricted shares had been fully vested when issued. The actual vesting of the shares on some future date becomes a non-event for tax purposes.

A second advantage of an 83(b) election is that it starts the stock recipient's holding period. Companies almost always declare all shares vested when they are about to enjoy a liquidity event, which lets more employees get a piece of the pie. But it generally comes too late for the recently vested to report their big payday as long-term capital gain.

QinetiQ U.S. Holdings

Despite the advantages of an 83(b) election, sometimes it just doesn't get done. That can be a very expensive gap in the paperwork, especially when the holders of the restricted stock are the *founders* of a company that hits it big. This is strikingly illustrated by *QinetiQ U.S. Holdings, Inc.* [CA-4, 2017-1 USTC ¶50,119,

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In 2002, Thomas Hume and Julian Chin each paid $450 for 4,500 shares of their newly organized corporation, Dominion Technology Resources, Inc. (Dominion). Mr. Hume was issued 50.25 percent of the voting shares, with Mr. Chin receiving the remaining 49.75 percent. Dominion had a single director, Mr. Hume, who was also the CEO. Mr. Chin served as chief operating officer and executive vice president.

The two founders entered into a Shareholders Agreement on equal terms. Neither founder was permitted to transfer shares without the other's consent, which is typical in a closely held corporation. Rather less conventionally, the agreement subjected both founders' shares to a *20-year* vesting schedule, with shares vesting at a rate of five percent per year of continued employment.

If a founder voluntarily left Dominion, the Shareholders Agreement let the company repurchase his vested shares at a reasonable formula price. Unvested shares, on the other hand, would be forfeited. The founders' ownership of their shares was conditioned on their provision of substantial future services, so they would have been well advised to make timely elections under Code Sec. 83(b).

Messrs. Hume and Chin omitted the 83(b) elections, but they still managed to do all right with Dominion. Just six years later (2008), they sold their shares to QinetiQ U.S. Holdings, Inc. (QinetiQ) for $118 million. Their $900 investment had grown at a rate of more than 600 percent *per year*.

The founders' shares vested shortly before the sale, so they were required to report the fair market value of their shares ($118 million) as *compensation* on their 2008 individual returns. At the time, the top ordinary and capital gains rates differed by almost 25 percentage points. So, the founders' failure to elect under Code Sec. 83(b) arguably cost them $29 million in federal tax.

Challenging the Deduction

The deferred vesting of the founders' shares was a boon to Dominion, which was able to claim a $118-million compensation deduction in 2008. One suspects, in fact, that a significant portion of the $118 million price of the shares was actually paid for the $41-million tax benefit that the deduction was expected to confer on QinetiQ's new subsidiary. Messrs. Hume and Chin would still have been better off if they had filed 83(b) elections, but getting, say, a $20-million bump to the purchase price of their shares would have provided some consolation.

The IRS threw a wrench into the works when it challenged Dominion's $118-million deduction. According to the IRS, the founders had never *really* held their shares subject to a substantial risk of forfeiture. The shares were vested when issued back in 2002, so there was no deemed transfer to generate a massive compensation deduction in 2008.

Under Reg. §1.83-3(c)(1), 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." To decide whether a forfeiture condition is unlikely to be enforced against an employee who owns a "significant" amount of the company's stock, Reg. §1.83-3(c)(3) requires us to consider several common-sense factors:

- The employee's relationship to other stockholders and the extent of 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;
- The person or persons who must approve the employee's discharge; 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. This makes sense, but it was irrelevant to Dominion. The newly organized company had no history of anything when it issued the shares to the founders.

Position and Relationships

The other factors focus on the employee's position in the company and his relationship to influential others who could affect enforcement of the forfeiture condition. This raised an obvious question about Mr. Hume, who not only served as Dominion's CEO and sole director, but also owned an outright majority of the company's voting stock. Seeing the writing on the wall, QinetiQ conceded in the midst of the proceeding before the Tax Court that Mr. Hume's risk of forfeiture had not been substantial.

That wiped out half of Dominion's $118-million deduction, but it did not resolve the status of the other founder's shares. Mr. Chin's stake in the company was certainly significant. As a *legal* matter, however, neither his stock ownership nor his position as chief operating officer gave him any right to block or even delay enforcement of the forfeiture condition if he left the company.

Looking beyond legal rights, the regulations also require us to consider the service provider's relationships to the company's directors, its officers, and any stockholders who might be able to exercise control. The Tax Court reported its findings:

> Hume and Chin had a very close work relationship. They were [Dominion'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 [Dominion] 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. [*QinetiQ*, *supra*, TC Memo. 2015-123 at 11.]

The Tax Court concluded that Mr. Chin's shares were not issued subject to a substantial risk of forfeiture. The Fourth Circuit affirmed, stating that the Tax Court's findings were not clearly erroneous. Mr. Chin's shares had actually vested in 2002, so Dominion could not claim a $59-million compensation deduction in 2008.

Erroneous? Clearly.

The Tax Court and the Fourth Circuit went badly off track here. 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 indicate that the forfeiture condition is unlikely to be enforced. The Tax Court's evaluation of Mr. Chin's relationship with Mr. Hume focused almost entirely on developments in the years *after* the transfer, which were irrelevant.

Moreover, the Tax Court and the Fourth Circuit were focusing on the *wrong question*. The Tax Court found that Mr. Chin had played a "vital role" at Dominion, both as chief operating officer and as a major shareholder. As a consequence, there was no real risk that Mr. Hume would have *terminated* Mr. Chin's employment.

Even if this happy assessment was accurate in 2002, it was still beside the point. Under the Shareholders Agreement, Mr. Chin would forfeit his shares only if he *voluntarily* left the company. So, even if Mr. Chin was 100-percent protected from *termination*, this tells us nothing about what Mr. Hume would have done about Mr. Chin's shares if he had left the firm of his own free will.

The adoption of the Shareholders Agreement reflected the founders' recognition that today's good intentions do not guarantee a harmonious future. Even if the relationship has been nothing but high fives over the years, the voluntary departure of a founder who plays a "vital role" can lead to hard feelings. After all, the whole point of the 20-year vesting schedule was to *prevent* one founder from taking off and leaving the other founder in the lurch.

We should also note that the abandoned founder would have had a huge economic incentive to enforce the forfeiture provision. Suppose, for example, that Mr. Chin had decided to quit after five years. His Dominion shares would have been only 25 percent vested.

Forfeiture of Mr. Chin's shares would have increased Mr. Hume's stock ownership by 60 percent at no cost to the company or Mr. Hume. This would have tempted Mr. Hume to enforce the forfeiture condition even if Mr. Chin's departure had been likely to *benefit* the company. Accordingly, the risk of forfeiture would have been "substantial" for most of the 20-year vesting period.

L.E. Austin

Now consider a second pair of founders, Larry Austin and Arthur Kechijian, who made a fortune in the distressed-debt-loan-portfolio business. The presence of "distressed debt" in a tax case usually signals that the reader is in for a wild ride. *L.E. Austin* [TC Memo. 2017-69], which featured an egregious employee stock ownership plan (ESOP) tax shelter, is no exception.

ESOPs and S Corporations

In 1998, tax-exempt ESOPs became eligible to hold shares of S corporations. [*See* Code Sec. 1361(c)(6).] There is nothing to stop an ESOP from holding *all* of an S corporation's stock, so it is possible for *100 percent* of an S corporation's earnings to escape current tax. However, putting all of an S corporation's stock into an ESOP means that ownership must be shared with employees, so this strategy is unlikely to appeal to the company's existing owners.

But Messrs. Austin and Kechijian's tax advisors were willing to think outside the box. What was needed was a way to get the *tax system* to treat the ESOP as if it owned 100 percent of the S corporation's stock, even though the ESOP actually held only, say, *five* percent. That sounds outlandish, but there was a formal solution lying readily at hand in Code Sec. 83.

Making Founders' Shares Disappear

The founders ran their existing distressed-debt business through a group of C corporations and limited liability companies. It was simple enough, however, for them to contribute their various ownership interests to a newly organized S corporation (New SCo) in a Code Sec. 351 transaction. The founders also arranged for the ESOP to acquire five percent of New SCo's stock, which left each of them holding a 47.5-percent block.

Then they squirted on the secret sauce. As part of the formation of New SCo, each founder entered into a restricted stock agreement (RSA) and an employment agreement with the new company. The RSA established a five-year "earn-out" period during which a founder who voluntarily terminated his employment would forfeit 50 percent of the value of his shares.

New SCo and the founders took the position that the RSA subjected the founders' new shares to a substantial risk of forfeiture, so they were "substantially nonvested" within the meaning of Reg. §1.83-3(b). Under Reg. §1.1361-1(b)(3), substantially nonvested shares are treated as *not outstanding* for purposes of Subchapter S. If the founders' shares were not outstanding, their *pro rata* share of New SCo's taxable income was *zero*.

With the founders' shares consigned to limbo, the ESOP became the sole shareholder for federal tax purposes. Hence, despite holding only a five-percent interest under state law, the ESOP was allocated *100 percent* of New SCo's taxable income pursuant to Code Sec. 1366. The ESOP was a tax-exempt trust protected from the UBIT rules [*see* Code Sec. 512(e)(3)], so it did not object to this outsized allocation.

If New SCo had declared any state-law dividends, the 95 percent paid to the founders would have been taxed to them as compensation. [*See* Reg. §1.1361-1(a)(1).] Not surprisingly, the corporation chose to retain the millions of dollars of untaxed profits it was earning. The artful use of restricted stock had converted New SCo into a gigantic 401(k) account, in which each founder had a 47.5-percent share.

Time to Pay the Piper? Nah.

Messrs. Austin and Kechijian were approaching retirement age, so their "earn out" plan required only five years of continued employment. Their stock vested on January 1, 2004, which would ordinarily have required them to report the fair market value of their shares on that date ($45.8 million each) as compensation pursuant to Code Sec. 83(a). Now it was time for the tax advisors to think *really* outside the box.

On March 30, 2004, each of the distressed-debt moguls entered into a "surrender agreement" and a "subscription agreement" with New SCo. Pursuant to these agreements, each founder: (1) surrendered all of the shares that had vested on January 1, 2004; and (2) purchased the same number of "new" shares for a $41.5-million promissory note.

A few months later (June 22), New SCo redeemed the ESOP's five-percent stake for $10.4 million. As soon as the ESOP was out of the way, New SCo's declared a $35-million "special dividend." This gave each of the founders $17.5 million in cash.

Tax Positions

The founders reported no passthrough income from New SCo during the period 1998–2003—after all, they had been holding unvested shares. However, they each reported about

$4.5 million in share-related compensation during 2004. This was the difference between what they had paid for their "new" New SCo shares on March 30 ($41.5 million) and the fair market value of those shares on that date ($46 million).

Neither founder reported any income from the $35-million special dividend. Each of them treated the distribution as simply reducing his new $41.5-million cost basis in his shares. Remarkably, neither founder reported any income from the *vesting* of his shares on January 1, 2004.

The IRS raised numerous objections. First, it denied that the RSA had really imposed a substantial risk of forfeiture, so the founders should have reported 95 percent of the income that had been allocated to the ESOP during 1998–2003. Second, the founders' simultaneous surrender and repurchase of their New SCo shares lacked economic substance, so the founders did not acquire a cost basis that could absorb the special dividend. Alternatively, the IRS argued that the founders' "surrender" of their shares in March 2004 could not eliminate the compensation they had earned when their shares vested on January 1.

Substantial Risk Revisited

As in *QinetiQ*, the IRS contended that the RSAs had not *really* imposed a substantial risk of forfeiture. After all, the founders owned 95 percent of New SCo's voting stock. The ESOP would have had to consent to any waiver of the forfeiture condition, but its board of trustees consisted of the two founders and an employee of New SCo.

Reg. §1.83-3(c)(3) requires us to consider, among other things, an employee's relationship to the directors and officers of the corporation and to influential stockholders. Given the founders' stock ownership and their day-to-day control of New SCo, one suspects that they could have persuaded the ESOP to join them in waiving the forfeiture provisions. The founders would have continued to dominate the ESOP even after they resigned (on the advice of counsel) as trustees, since they were replaced by employees of the corporation.

The Tax Court, however, was not prepared to give up on the ESOP. The trustees had credibly testified that they understood their fiduciary obligations, suggesting that they were not going to rubber stamp the founders' decisions. Indeed, the trustees had taken several actions (*e.g.*, engaging outside counsel) indicating that they took their obligations seriously.

The Tax Court also commented on the ESOP's substantial economic incentive to enforce the forfeiture provisions. The court noted that plan participants were entitled to vote *confidentially* to instruct the trustees how to vote on any proposed waiver of the forfeiture provisions. The Tax Court concluded that plan participants would have been "uninhibited in voting their economic interest," so the ESOP was not the founders' stooge.

The Tax Court recognized—contrary to its decision in *QinetiQ*—that the cordiality of the founders' *actual* relationship should carry little weight for purposes of Reg. §1.83-3(c)(3). The inquiry must focus on a counterfactual: What would have happened if one of the founders had unilaterally decided to leave the company?

The Tax Court emphasized that the two founders' skill sets were quite distinct. They understood that the success of their business would depend on their *both* continuing their employment. This is why they had entered into their five-year RSAs in the first place.

The Tax Court saw nothing in the founders' relationship (*e.g.*, family ties) to indicate that they would have waived a breach of their agreement that could have put the company in jeopardy. The fact that the founders had been getting along well in the *absence* of a breach proved nothing. (The Tax Court might have added that the positive tenor of the founders' *continuing* relationship was, in principle, irrelevant, because Reg. §1.83-3(c)(1) assesses the prospects for enforcement at the time of transfer.)

There are, of course, situations in which a founder's departure will pose no threat to the value of the company. But, even in such cases, the remaining founder may be tempted to enforce a forfeiture condition in order to increase his ownership of the company. When large blocks of stock are in play, it seems rash to conclude that a forfeiture provision between unrelated shareholders is "unlikely" to be enforced.

Termination "For Cause"?

The IRS also argued that the risk of forfeiture was insubstantial under Reg. §1.83-3(c)(2). The regulation states that a requirement that an employee return property to the employer if the employee is "discharged for cause or for committing a crime" should *not* be considered to result in a substantial risk of forfeiture. Unfortunately, "discharged for cause" is not defined.

The IRS tried to make a case based on the phrasing of the RSAs. The agreements did not state, in so many words, that a founder would forfeit shares if he voluntarily terminated his employment prior to January 1, 2004. Instead, the RSAs and employment agreements were drafted so that a forfeiture was triggered only if the founder was "discharged for cause."

The RSAs and employment agreements had defined "cause" to include not only the usual embezzlement and gross negligence, but also the employee's refusal, following 15 days' written notice, to continue working for the promised five-year term. The Tax Court did not offer any explanation of what it called "the peculiar drafting" of the agreements. One suspects, however, that the point was to ensure that the founders would not forfeit shares until they had received notice and an opportunity to repent of an impulsive or poorly advised decision to quit.

The IRS jumped on the contractual label. Under Reg. §1.83-3(c)(2), a risk of forfeiture triggered by an employee being "discharged for cause" is not substantial. The parties' own agreements had treated a voluntary departure as a "discharge for cause," hence the risk of enforcement must be treated as insubstantial.

The Tax Court had discussed this issue several years before, when it denied an IRS motion for summary judgment against the founders. [*See Austin*, 141 TC 551, Dec. 59,719 (2013).] Asserting that "for cause" in the regulation was ambiguous, the Tax Court examined the history of the regulation. The phrase was added to Reg. §1.83-3(c)(2) in 1978, but with no comment beyond the suggestion that the Department of the Treasury did not regard the addition as a significant change.

The Tax Court treated the lack of comment or explanation as evidence that "for cause" was not intended to alter the focus of the regulatory test. The original provision, adopted in 1971, had referred only to discharge "for committing a crime." Because such serious misconduct is unlikely to occur, the inclusion of a crime-triggered forfeiture provision should not prevent current taxation of a compensatory stock grant.

Voluntary termination of employment, on the other hand, is about as routine as it gets. If the addition of "for cause" in 1978 had been intended to cover such everyday cases, the Treasury would have said something. But the Treasury had remained silent, so the Tax Court sensibly inferred that terminations "for cause" were not meant to include voluntary departures, no matter what the parties called them.

Unringing the Vesting Bell

The Tax Court found that Messrs. Austin and Kechijian *had* held their shares subject to a substantial risk of forfeiture. Consequently, New SCo had correctly allocated 100 percent of its net income to the ESOP during the years 1998–2003. Score a big one for the founders.

Under the terms of the RSAs, however, the founders' shares had vested on January 1, 2004. The IRS argued that New SCo should have been treated as issuing the shares on that date. Under Code Sec. 83(a), each founder should have reported the fair market value of his shares ($45.8 million) on his 2004 individual return.

Messrs. Austin and Kechijian tried to defend their omission of this income by pointing to a subsequent event—their purported surrender and repurchase of their New SCo shares in March 30, 2004. The idea seems to have been that they could each avoid almost $45.8 million of taxable income by abandoning their shares and pretending that the vesting event had never happened.

There are situations in which that approach actually works. Under the annual accounting principle, the tax consequences of a transaction can sometimes be avoided if the parties rescind it in the *same year* it was entered into. [*See* Rev. Rul. 80-58, 1980-1 CB 181.] The founders presumably argued that their previously unvested shares had not been issued until 2004, so it was not too late to make it all go away.

However, the fact that the founders surrendered their shares on the same day that they purported to repurchase them would have been fatal. To be effective for tax purposes, a rescission must restore the *status quo ante*. That would have required the founders to terminate their ownership of New SCo, which they were obviously unwilling to do.

The Tax Court did not discuss the technicalities of rescission. Instead, it dismissed the simultaneous surrender and repurchase of the shares as a transaction "palpably lacking in economic substance." The shares had vested on January 1, 2004, and neither founder "could unring this bell by subsequent actions." [*Austin*, 141 TC 551, Dec. 59,719 (2013), at 39.]

Messrs. Austin and Kechijian were each required to report $45.8 million in compensation in 2004. The Tax Court also upheld IRS's assessment of the negligence and substantial understatement penalties under Code Sec. 6662(b). These two merchants of debt had *not* acted under an "honest misunderstanding of fact or law," so they could not avoid penalties under Code Sec. 6664(c).

Conclusion

Austin is currently on appeal to the Fourth Circuit. The Court of Appeals can do us all a favor by re-examining what makes a risk of forfeiture "substantial" for purposes of Code Sec. 83. The first point to clarify is that substantiality must be determined based on conditions at the *time of the initial transfer*, not the circumstances that obtain months or years later.

The second point is that the inquiry is *counterfactual*. The fact that two founders were on the best of terms when they imposed their forfeiture condition doesn't prove anything. What matters is the probability, judged *ex ante*, that the forfeiture condition *would* have been enforced if the founder in question had departed in defiance of the terms of the agreement. Since neither event will have happened, the court or jury will have to use its imagination.

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