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Tax Court Holds Stock Not Subject to Substantial Risk of Forfeiture

By Robert W. Wood • Wood LLP

When stock or other property is transferred to a worker in connection with the performance of services, there is a tax hit. The rules apply to employees and independent contractors. The worker has income on the excess of the fair market value of the property over the amount, if any, he or she pays for the property.

Of course, there may be a delay in the taxable event because of restrictions. And in some cases, despite the restrictions, the worker receiving the stock or other property makes an election to pay tax currently. But eventually, the worker has income.

The corollary is that the company should have a corresponding deduction. Usually, most of the disputes with the IRS are over the income question. When and how much is the worker taxed? How can the worker minimize it, pay tax later, or pay only (or largely) a capital gain tax?

Occasionally, the corporate side of the equation can be controversial too. In *QinetiQ U.S. Holdings, Inc.* [110 TCM 17, Dec. 60,340(M), TC Memo. 2015-123], the Tax Court considered a corporation that had issued 49.75 percent of its stock to an employee shortly after the formation of the corporation. The question in the case was the applicability of Code Sec. 83.

There was some clever post-acquisition planning by a buyer too. Employees think of the income side of Code Sec. 83—and when something is taxed. Companies, on the other hand, tend to see the deduction question. A successor corporation—QinetiQ—claimed a compensation deduction for the stock issued to the employee.

The Tax Court agreed with the IRS that no deduction was available. The reason? There was no substantial risk of forfeiture at the time the stock was issued.

The hallmark of Code Sec. 83 is that one should not be taxed on something until restrictions on the item lapse. The classic fact pattern involves an employee who receives a stock bonus subject to a number of conditions that will lapse in a stated number of years.

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Deduction Too

Code Sec. 83 generally provides that the stock will not be treated as transferred for income tax purposes until those restrictions lapse upon the expiration of the term of years. Restrictions that will never lapse are are "nonlapse restrictions". Taking a wait-and-see approach will not work with nonlapse restrictions, so the IRS values the property taking those restrictions into account.

In most cases, the employer is allowed a business expense deduction under Code Sec. 162 for the compensation paid once the restrictions lapse. The amount of this deduction includes the appreciated value of the company's stock while the restriction on the property was in place. Still, the employer's deduction and the employee's income are very much connected.

And whenever there is an income inclusion, there should be a deduction to balance the equation.

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Just the Facts

Mr. Hume formed TGH, an S corporation that provided government contracting services. He approached Mr. Chin about joining the business. They formed DTRI, another S corporation, to perform the same contracting services.

On December 9, 2002, Hume received Class A voting stock for $450 and became DTRI's president. On that day, Chin received Class A stock for $445 and Class B nonvoting stock for $5 (collectively, the Chin stock) and became the vice president. A few days later, the corporation executed a document authorizing the stock issuances and authorizing it to enter into a shareholder agreement and an employment agreement with Hume and Chin.

Hume and Chin entered into shareholder agreements. The agreements provided that they could transfer the Class A and Class B shares of stock either as gifts or for value with prior notice and consent of DTRI and the other shareholders. If a shareholder's employment was terminated by the corporation with or without cause within 20 years of receiving the stock, he had to offer the stock back to the corporation at a price lower than its market value. The price increased annually up through the 20th year.

Other Employee Issuances

Between 2002 and 2004, DTRI entered into restrictive stock agreements with employees other than Hume and Chin and granted shares of restricted Class B stock. They called for five-year vesting. DTRI had a right to repurchase at a specified price. Notably, the "shareholder" would have no rights as a shareholder prior to vesting.

Between 2002 and 2008, DTRI, Chin and Hume made representations that Chin was a shareholder of DTRI. Chin showed his share of DTRI income on his personal tax return. But until 2008, DTRI took no deduction with respect to the Chin stock and Chin reported no income with respect to the stock.

In 2008, QinetiQ purchased all the stock of DTRI. All of the previous shareholders received cash for their DTRI stock. At that point, QinetiQ considered the Chin stock no longer subject to a substantial risk of forfeiture, so it deducted the 2008 value of the stock as a compensation expense.

Code Sec. 83 Redux

The Tax Court ruled that QinetiQ failed to prove that the Chin stock was issued in connection with the performance of services. Moreover, the court found that the company failed to establish that the stock was subject to a substantial risk of forfeiture until it was purchased by QinetiQ.

The following factors are relevant in evaluating whether stock is issued in connection with the performance of services:

1. Whether the property right is granted at the time the employee or independent contractor signs his employment contract;
2. Whether the property restrictions are linked explicitly to the employee's or independent contractor's tenure with the employing company;
3. Whether the consideration furnished by the employee or independent contractor in exchange for the transferred property is services; and
4. The employer's intent in transferring the property.

The Tax Court noted that the Chin stock was transferred near the time when DTRI entered into the shareholder agreement and Chin's employment agreement. The stock certificates, shareholder agreement and employment agreements were all dated in December 2002.

But was the Chin stock restricted and conditioned on Chin's continued employment with DTRI? The Tax Court noted that it was not clear whether the third and fourth factors were present.

Stock for Services

The company argued that Chin's services were the consideration for the Chin stock. The $450 that Chin deposited into the bank account was arguably nominal, merely being the par value of the shares. However, the Tax Court was not convinced that the $450 deposit was not an entrepreneurial investment. Maybe it was the true value of the shares at that time!

Of course, QinetiQ had no ownership interest in DTRI until 2008. QinetiQ was not a party to the shareholder agreements or to the employment agreements. QinetiQ was not involved in any of the discussions between DTRI, Hume and Chin in 2002. So how could QinetiQ speak to the question of DTRI's intent?

There were some damning facts too. From 2002 through 2008, DTRI, Hume and Chin made representations that Chin had outright unrestricted ownership of the Chin stock. DTRI distributed income to Chin as if he was the owner of the Chin stock as fully vested and outstanding stock. Chin voted and signed corporate documents as an outstanding owner of Class A stock in DTRI from 2002 through 2008.

The situation with other employees was also telling. For all other cases in which DTRI transferred stock to employees in connection with the performance of services, the relevant documents *explicitly* tied the stock grants to the performance of services. Chin's did not.

In sum, the court concluded that QinetiQ failed to prove that the Chin stock was transferred in connection with the performance of services.

No Substantial Risk of Forfeiture

QinetiQ argued that the shareholder agreement contained provisions that could not be waived unilaterally by Chin. They also required Chin to sell his stock back to DTRI at a price below fair market value if he terminated employment within 20 years of execution of the shareholder agreement. Finally, the agreement precluded Chin from transferring or selling his stock without first offering it to DTRI.

QinetiQ also argued that Chin was subordinate to Hume because Hume owned 50.25 percent of the voting shares and served as DTRI's president, CEO and sole director. But the IRS and Tax Court agreed that it was unlikely Hume would have taken any actions to terminate Chin's employment.

Besides, there was no enforcement history by DTRI of restrictions in connection with Class A common voting stock. The Tax Court ruled that the taxpayer failed to show that the Chin stock was subject to a substantial risk of forfeiture. Chin and Hume worked closely. Moreover, everyone treated the Chin stock as if it gave Chin full ownership rights and control from initial issuance.

In contrast, the Class B common nonvoting stock was issued subject to restricted stock grants. Those grants were entirely different. Despite its clever arguments, there was simply no deduction for QinetiQ.