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Using the Section 83(b) Election For Market Value Transfers

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According to the author, the *Alves* case illustrates the importance of considering the appropriateness of a Section 83(b) election in the year in which property is received, even if by purchase, in connection with the performance of services.



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Compensating executives, other employees and independent contractors with restricted stock or other property under the rules of Section 83 is commonplace, and the situation is one in which many tax advisors are well versed. It is important to remember, however, that Section 83 and its stringent rules are applied not only in the context of elaborate plans involving a number of participants, but also to ad hoc arrangements with particular employees or independent contractors. Moreover, recent authority makes clear that Section 83 applies to transfers even for fair market value. The potentially onerous results that this rule can have are easily avoided, and a provision of the Tax Reform Act of 1984 gives some taxpayers additional time to correct this potentially widespread problem under Section 83.

Essentials of Section 83

Section 83 provides that if an employee or any other person receives restricted stock or other property in connection with the performance of services, the excess in value of the property received over the amount paid for the property by the employee or other person is taxed to the recipient in the first taxable year in which his interest in the property either is freely transferable or is not subject to a substantial risk of forfeiture. Thus, the employee

is taxed only when his interest in the property becomes substantially vested—either when he can transfer the property or when it is no longer subject to a substantial risk of forfeiture. A “substantial risk of forfeiture” will be deemed to exist if there are conditions relating to the future performance of substantial services that restrict the employee’s right to full enjoyment of the property. The substantial services which must be performed need not even be substantial services of the particular employee receiving the restricted property, so theoretically the full enjoyment of the property could be conditioned upon another’s services.

Regulations describe what types of restrictions do and do not prevent the full enjoyment of the property for this purpose, “lapse” restrictions (those which will lapse or disappear after the expiration of a period of time or the occurrence of an event) generally preventing such full enjoyment and “nonlapse” restrictions (those which are of indeterminate duration) not preventing such full enjoyment.¹ Some restrictions which are merely imposed by law, for example, restrictions imposed by Section 16(b) of the Securities Exchange Act of 1934, are still considered to subject property to a substantial risk of forfeiture.

The employer may take no deduction for the stock or other property transferred to the employee until the time that the employee includes it in income, generally the time at which the property is freely transferable or is not subject to a substantial risk of forfeiture. Moreover, the employer’s deduction for a transfer of property is, with minor exceptions, completely forfeited unless the employer withholds tax on the compensation as required by the withholding provisions of the Code. An amendment to the regulations proposed in November 1983 provides an exception to this withholding rule in cases where the employer is unable to withhold but includes the compensation on a Form W-2 or information return filed with the Internal Revenue Service.²

The most notable provision of Section 83 for purposes of this discussion is Section 83(b), providing that one may elect to be taxable on the difference between the price paid for the stock or property and its market value in the year of its receipt, even though it is not then freely transferable or is subject to a substantial risk of forfeiture. Once the election has been filed, future increases in the value of the stock or property will be treated as capital gains rather than ordinary income.

An election under Section 83(b) (irrevocable except with IRS consent) is a simple document, filed with the appropriate Service Center within 30 days after the property transfer, essentially including: the name, address and identification number of the taxpayer; a description of the property; the date on which the property was transferred and the taxable year; the nature of the restrictions; the fair market value at transfer; any amount paid; and a statement that a copy of the election has been furnished to the employer. A copy of the election is also filed with the recipient’s return for the year in which the property was transferred.³

Unintended Results Under Section 83

Section 83 not infrequently produces unintended results. There may be a property transfer which the taxpayer assumed was not covered by Section 83,⁴ restrictions on transferability which the taxpayer was sure made the property not currently taxable,⁵ or conditions on the property which the taxpayer was sure were not connected with the performance of substantial services.⁶

The circumstance which is perhaps most disturbing in the Section 83 area, however, is that in which an employee or consultant to whom an employer seeks to give added incentives is subjected to substantial ordinary income tax on a gain he was confident would be taxed at capital gain rates. The recent case of *Alves v. Commissioner*,⁷ in which the Ninth Circuit applied Section 83 to a market value transfer, illustrates this point.

Gross Income and Fair Market Value Transfers

Lawrence J. Alves joined General Digital Corporation as vice president for finance and ad-

¹ See Reg. § 1.83-3(h) and (i).

² Proposed Reg. § 1.83-6(a)(2).

³ Reg. § 1.83-2(b) through (e).

⁴ Nonqualified stock options, for example, are covered. See, e.g., *Prentice I. Robinson*, CCH Dec. 41,055, 82 TC—, No. 32 (1984); Reg. § 1.83-7. Moreover, even if a shareholder of a corporation makes a transfer rather than the corporation itself, for example, Section 83 may apply. See Rev. Rul. 80-196, 1980-2 CB 32; Reg. § 1.83-6.

⁵ For a recent unsuccessful argument based on assorted restrictions, see *Prentice I. Robinson*, note 4, supra, and CCH Dec. 41,056, 82 TC—, No. 33 (1984).

⁶ See *Gale R. Richardson*, CCH Dec. 33,344, 64 TC 621 (1975).

⁷ 84-2 USTC ¶ 9546, —F. 2d—(CA-9). The Tax Court opinion is reported at CCH Dec. 39,501, 79 TC 864 (1982).

ministration, acquiring as part of an employment and stock purchase agreement the right to purchase 40,000 shares of common stock at 10¢ per share, the stock's market value at that time. Apparently the stock purchase was both to raise capital and to provide Alves with an interest in the company. Two-thirds of the stock was subject to resale restrictions for either four or five years: if Alves left the company prior to the expiration of either period, the company could repurchase the stock at the 10¢ price. Alves did not file a Section 83(b) election for the year of the purchase, and, when the sale restrictions lapsed, he did not report the difference between the fair market value of the stock at that time and the 10¢ purchase price as income. Not surprisingly, the Commissioner disagreed.

The Court of Appeals in *Alves* repeated the proposition that Section 83 requires the taxpayer either to elect to include the excess of the fair market value over the purchase price in the year the stock was transferred or to be taxed on the full amount of appreciation when the risk of forfeiture is removed. Applying this rule in the absence of an election at the time the stock was purchased had to result in ordinary income tax on the difference between the purchase price and the market value at the date of the lapse of the restriction. Alves, however, argued that since he had paid fair market value at the time of the purchase, it could not be said that the shares were issued "in connection with the performance of services." Indeed, the company had issued the shares at least in part in order to raise capital.

The Tax Court (in a court-reviewed decision to which five judges dissented) had concluded that Alves obtained the stock in connection with the performance of services as the company's vice president, and the Court of Appeals could not conclude that this finding was clearly erroneous. The most the court could say was that while the payment of full fair market value was one indication that stock was not transferred in connection with the performance of services, the record showed that until this transfer the company had sold stock only to officers, directors and employees (and an underwriter). Alves had purchased the stock when he signed his employment agreement, and the restrictions were linked explicitly to his tenure with the company. In addition, nothing in the record suggested that Alves could have purchased the stock had he not agreed to join the company.

Even if it could be said that Alves purchased the stock in connection with his employment, he

argued that Section 83(a) should not apply to purchases for full fair market value as a matter of law. "In connection with" had to mean that an employee was receiving compensation for performing services; in the unusual situation where an employee pays the same same amount for restricted and unrestricted stock, the restriction has no effect on value. Hence, contended Alves, there could be no element of compensation.⁸

Despite the persuasiveness of Alves's argument, the court found no mention of the word "compensation" in the statute, nor any requirement that property subject to Section 83 have a fair market value in excess of the amount paid at the time of the transfer. Indeed, as the court noted, such language would have been easy for Congress to use. Instead, Congress drafted Section 83(a) to apply to *all* restricted property rather than simply to stock, to property transferred to *any* person rather than merely to employees, and to property transferred "in connection with" the performance of services rather than simply as compensation for employment. All of the factors in the legislative history and the case law pointed to an extremely broad reading of Section 83, one which the court felt compelled to apply to Alves's facts.

As to the necessity of the Section 83(b) election, which in this instance would plainly have resulted in all of the increased value of the stock being taxed to Alves as a capital gain,⁹ Alves argued for a reading of Section 83(b) that would exclude a fair market value purchase from its operation. In effect, if no Section 83(b) election could be made, Section 83(a) could, by definition, not apply. The court correctly noted, however, that "nothing in Section 83(b) precludes a taxpayer who has paid full fair market value for restricted stock from making an 83(b) election."¹⁰ The regulations clearly support this view.¹¹

Alves's last-ditch effort to avoid the tax liability was the argument that if he could have avoided all of the additional tax merely by filing

⁸ Of course, it is at least arguable that stock subject to restrictions and stock not subject to restrictions cannot be viewed as having the same fair market value. Even if the "market value" of the stock is established only by reference to the stock's book value, in a very real sense stock subject to a resale restriction is worth less than stock in the same company which is unrestricted as to sale.

⁹ Moreover, had the Section 83(b) election been made, not only would Alves have had a capital gain on the entire amount of the difference between the 10¢ purchase price and the increased value of the stock, he would not have had *any* income until he disposed of it.

¹⁰ *Alves*, 84-2 USTC at 84,574.

¹¹ Reg. § 1.83-2(a).

a simple Section 83(b) election, this was a "trap for the unwary." After all, any well-informed taxpayer would have made the Section 83(b) election. The court, however, was unmoved.

Congressional Response to Alves

The recently enacted Tax Reform Act of 1984 contains a specific provision allowing additional time for Section 83(b) elections as to certain property transferred in connection with the performance of services after June 30, 1976, and on or before November 18, 1982. In order to qualify for the additional time to file a Section 83(b) election, the amount paid for the property transferred within this period must have been not less than its fair market value at the time of the transfer (determined without regard to restrictions other than nonlapse restrictions), and the election must be consented to by the person transferring the property. If these conditions are met, the election may be filed with the income tax return for the first taxable year ending after the date of enactment of the Act.¹² That this provision is intended to ameliorate (although not to reverse) the decision in *Alves* is clear from the Conference Report, which mentions the case and derives one of the provision's applicable dates (November 18, 1982) from the date of the Tax Court's decision.¹³

Conclusion

The *Alves* case, ostensibly correctly decided when measured only against the language of the statute and regulations, illustrates the importance of considering the appropriateness of a Section 83(b) election in the year in which property is received, even if by purchase, in connection with the performance of services. As was apparently the case in *Alves*, the election may most likely be neglected where the stock or property is not awarded under a formal plan, particularly where the parties may have assumed that a market value purchase obviated the election. Many restricted stock plans will explicitly provide for the election and even include a form for participants'

use, although appropriate elections may be neglected even if brought to the attention of participants.

The fact that an election is generally irrevocable dictates that it be well considered. A recent private letter ruling held that a misinformed taxpayer who filed a Section 83(b) election in reliance upon a company's attorney could not revoke it.¹⁴ If stock or other property as to which an election was previously made is forfeited, however, there is a deduction measured by the excess, if any, of the amount paid for the property (if any) over any amount realized upon the forfeiture.¹⁵

If there is a difference between the market value of the stock and the price paid for it, an election will obviously cause income to the taxpayer in the current year. Whether the election is wise in this circumstance will depend, among other things, upon the probability of an increase in the stock's value. As in *Alves*, however, the Section 83(b) election is particularly appropriate when the income which will be reported in the year of the transfer is zero.

As to participants who did not make an election with respect to property transferred at fair market value in connection with the performance of services between June 30, 1976 and November 18, 1982, and who obtain the transferor's consent, the new tax act provides an additional window for filing the election. While it seems artificial to award this benefit only to taxpayers who received property prior to November 18, 1982 (taxpayers may not have been duly warned of Section 83's broad reach the moment the Tax Court decided *Alves*), the provision provides some taxpayers with the opportunity to remove a potential specter from their tax planning. ●

¹² P. L. 98-369, the Tax Reform Act of 1984, § 556.

¹³ CCH STANDARD FEDERAL TAX REPORTS, No. 27, June 26, 1984 (Extra Edition), "Tax Reform Bill of 1984 (H. R. 4170)," 165, 281.

¹⁴ CCH IRS LETTER RULINGS REPORTS No. 375, May 9, 1984, Ltr. Rul. 8418037. See Reg. § 1.83-2(f).

¹⁵ Reg. § 1.83-2(a). See also Reg. § 1.83-1(e), providing for a deduction when no election has been filed and property was therefore includible when substantially vested, but nevertheless is later forfeited.

