

Comment

Tax Planning With Restricted Stock

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I. INTRODUCTION

A series of well-formulated guidelines exist for employers who wish to benefit their employees through the use of qualified stock option plans. The advantages of these plans include a deferral of taxation until the ultimate sale of the stock and capital gains treatment.¹ Rather than re-examine the foregoing, this Comment will analyze Internal Revenue Code section 83² and will consider stock options or other stock purchase plans established to provide benefits free of the constraints of qualified plans. These plans, for example, may arise when an employer transfers restricted stock to an employee without cost or at a discounted price. Under section 83, this form of transfer will result in unrealized gain to the extent of the difference, if any, between the fair market value and the purchase price of the stock. The gain will be realized either upon an immediate election or any ultimate transfer or

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¹INT. REV. CODE of 1954, § 422; Treas. Reg. §§ 1.422-1, 1.422-2. Employee interest in qualified plans could be adversely affected by recent disenchantment with the stock market. For example, on September 30, 1974, the Dow Jones Industrial Average had fallen to 577.60, only 5.8 times the per share earnings of the thirty companies represented. These figures were down from 838.05 and 9.4 times earnings for the same date twelve months earlier. Wall Street Journal, Dec. 9, 1974, at 25, col. 5.

²It is true that this legislation, passed in 1969, is not limited in its application merely to stock or to an employer-employee relationship, so that the present inquiry must necessarily be viewed as a selective one. For example, the section purports to deal with any circumstance in which "in connection with the performance of services property is transferred to any person other than the person for whom such services are performed . . ." INT. REV. CODE of 1954, § 83(a). A company issuing new shares of its own stock might need to avoid a bargain sale at less than par or perhaps the issuance of stock for future services. N. LATTIN, *THE LAW OF CORPORATIONS* 467-83 (2d ed. 1971). If so, the use of no par shares, treasury shares, or even shares in another company are alternatives.

forfeiture of the stock. Under this section, therefore, it still is possible to defer a taxable event beyond the granting or exercising of a stock option, although the resultant gain will emerge as ordinary income. It is also true that present tax planning under section 83 is hampered somewhat by a shortage of administrative and judicial guides,³ and those few that exist tend to emit more heat than light. Nevertheless, despite some of the uncertainty associated with its use, restricted stock under section 83 has a viable role to play in an option agreement. It is advisable for the tax planner, therefore, to remain or become aware of its characteristics. The purpose of this Comment is to assist the tax planner in this effort.

II. SCOPE OF THE PROBLEM

Section 83 creates a deferral procedure by which stock, which is nontransferable and is subject to a substantial risk of forfeiture, may escape taxation until one or the other of these limitations ceases to exist.⁴ It also deprives the taxpayer of a prior advantage of reporting as income the *lesser* of the difference between the cost of the stock transferred and either the fair market value of the stock at its acquisition or the fair market value at the lapse of a restriction affecting the stock's value.⁵ At first it may appear that the new section has no relevance to stock options because it is expressly inapplicable to transfers of options without a readily ascertainable fair market value.⁶ Similarly, it is

³At this writing, proposed regulations have existed for some time so that the reader should be alert to any changes in them that might be forthcoming.

⁴INT. REV. CODE of 1954, § 83(a). This stock might be obtained through the exercise of an option. Although both limitations must exist, the section provides that if a substantial risk is present, the stock will be considered as nontransferable. *Id.* § 83(c). To make certain the agreement is carried out, however, the planner may wish to mark the stock certificates with notice of the restrictions or perhaps to place the certificates in escrow. For an extended treatment of section 83, including the pre-section 83 rules, see Hindin, *Internal Revenue Code Section 83 Restricted Stock Plans*, 59 CORNELL L. REV. 298 (1974). See also Note, *Stock Options and the Tax Reform Act of 1969: The Question of Continued Utility*, 26 VAND. L. REV. 1261, 1282 (1973); Comment, *Property Transferred in Connection with Performance of Services under Section 83—Effectuation of Tax Reform Act Purposes*, 17 WAYNE L. REV. 1267 (1971).

⁵Treas. Reg. § 1.421-6(d)(2); Kopple, *Restricted Stock: What's Left After the Tax Reform Act of 1969?*, 48 TAXES 558, 559 (1970). In general, the section is effective for property transfers, in connection with performance of services, made after June 30, 1969, except for transitional situations not relevant to this Comment. INT. REV. CODE of 1954, § 83(i).

⁶INT. REV. CODE of 1954, § 83(e)(3). It also is specifically inapplicable to qualified stock options and to certain transfers involving trusts and annuities. *Id.* § 83(e)(1), (2).

specifically inapplicable to a transfer of property pursuant to exercise of an option with a readily ascertainable fair market value.⁷ These last two exclusions, together with the failure further to exclude, suggest that the section *is* applicable to the transfer of property pursuant to the *exercise* of an option without a readily ascertainable fair market value. Thus, the effect of section 83 is important to one who wishes to construct a nonstatutory option plan.⁸

A troublesome problem one first must confront is making certain the property is actually "transferred" so that the transaction falls within the ambit of section 83. For example, if the stock is purchased and the price is paid in whole or in part with a nonrecourse obligation which does not result in personal liability, the transaction will fail, wholly or partly, to come within the scope of the rules until payment is made.⁹ Thus, the draftsman perhaps will wish to rely upon a debt instrument evidencing personal liability on the part of the acquirer if full cash payment is not to be made. This raises the question of whether a "purchase" must exist for section 83 to apply or whether bonus stock is outside the scope of the new law. Proposed regulations offer three confusing examples, two of which seem to involve the lack of a purchase and result in no transfer,¹⁰ and one of which involves a purchase and results in a transfer.¹¹ Of course, in the two examples which appear to involve bonus stock,¹² the trans-

⁷*Id.* § 83(e) (4).

⁸Apparently, the taxable event will occur at transfer of the property even though the option acquires a readily ascertainable fair market value between its grant and its exercise. Proposed Treas. Reg. § 1.83-7(a) (2), 36 Fed. Reg. 10793 (1971).

⁹Proposed Treas. Reg. §§ 1.83-3(a) (1), (2) example (2), 36 Fed. Reg. 10790 (1971). Schapiro, *Proposed Treasury Regulations under Code Section 83*, 25 THE TAX LAWYER 281, 283 (1971).

¹⁰Proposed Treas. Reg. § 1.83-3(a) (2) examples (1) & (3), 36 Fed. Reg. 10790 (1971). The first example seems to illustrate bonus stock to be repurchased at the excess, if any, of book value upon termination of employment over book value at the time of purported transfer. The third example seems to illustrate bonus stock to be repurchased for declared and unpaid dividends since the time of purported transfer. Neither appears to be subject to a restriction that carries a specific time limitation other than the undetermined term of employment. Further, both are utilized as examples of situations in which no transfer has occurred.

¹¹Proposed Treas. Reg. § 1.83-3(a) (2) example (4), 36 Fed. Reg. 10790 (1971). In this example a sale at one-half of book value to be repurchased at three-fourths of book value at an undetermined time of termination of employment was said to be a transfer within the meaning of section 83 because a shareholder acquired a valuable right that could increase or decrease during the employment.

¹²Proposed Treas. Reg. § 1.83-3(a) (2) examples (1) & (3), 36 Fed. Reg. 10790 (1971).

actions seem to have failed as "transfers" primarily because the stockholders were protected from any downside risk of loss.¹³ The stock transferred without a purchase is shown in at least one other example, however, to be potentially within the scope of section 83.¹⁴ Because of this ambiguity, it may be unnecessarily conservative to avoid fully the use of bonus stock. On the other hand, requiring a minimal payment may set a planner's mind at ease as well as raise capital for the company. At the very least, an attempt should be made to assure that the holder of the stock has a chance of loss as well as an opportunity for gain. Requiring a payment is a certain way to assure that the stockholder bears the risk of a potential loss. Avoidance of the fact situations described in the regulatory examples, both of which are badly in need of clarifying revision, is also an obvious precaution.

III. SEMANTIC ISSUES

Although the term "substantial" appears in several places in the Code, section 83(c)(1) perhaps best illustrates the multiple meanings of the term. In what could be either a definition or an illustration of a substantial risk of forfeiture, Congress provided in section 83(c)(1) that such a risk will exist if rights to the property's full enjoyment depend upon an individual's performance of "substantial services." Taken literally, the substantiality of the services yet to be performed would be the sole test of the substantiality of the risk.¹⁵ If this were so, presumably the only factual issue to be resolved would touch upon items such as the difficulty of the services, the length of time over which they are to be performed,¹⁶ and the length of an employee's expected working career after the lapse of the restriction.¹⁷

¹³In the first example, the shares may have increased in book value, but the stockholder stood to lose nothing. In the third example, the stockholder might have received dividends if they were declared but again stood to lose nothing if none were declared. Schapiro, *supra* note 9, at 287.

¹⁴Proposed Treas. Reg. § 1.83-3(c)(2) example (2), 36 Fed. Reg. 10791 (1971) (shares transferred in connection with services and released from a forfeiture restriction in installments over a ten-year period). One author, however, has commented that the effect of regulations illustrating transfers "may" be to deny section 83 treatment to bonus stock. Kopple, *Proposed Regs on Section 83: An Analysis of the Remaining Planning Possibilities*, 35 J. TAXATION 130, 132 (1971).

¹⁵Proposed Treas. Reg. § 1.83-3(c)(1), 36 Fed. Reg. 10790-91 (1971), uses the substantial services language of the section though it also contains other examples, yet to be mentioned, that suggest "service" is not the only relevant yardstick. Apparently the history of the legislation also suggests that there may be risks other than those related only to service. Schapiro, *supra* note 9, at 290 n.7.

¹⁶Proposed Treas. Reg. § 1.83-3(c)(1), 36 Fed. Reg. 10790-91 (1971), notes that "regularity" and "time spent" are probative of substantiality. Fur-

It is arguable that section 83(c) (1) means only what it expressly states. If a substantial risk may exist without the need for substantial services, however, then a much clearer description of substantial risk is needed. For example, the proposed regulations¹⁶ add to section 83 and indicate that forfeitures, either because of the commission of a crime or upon the breach of an enforceable covenant not to compete, would not be substantial risks. The latter case is qualified by taking into consideration such matters as the covenantor's age, the availability of other job opportunities, and the *likelihood* of obtaining other employment and is illustrated by an employee who buys stock on the termination of his employment and who has a good chance of obtaining a competing position and thereby forfeiting the shares. In this situation, his stock *would* be deemed to include a substantial risk under the proposed regulations.¹⁷ Although the forfeiture is not conditioned upon the performance of substantial future services, these additions seem to indicate that it still is possible for stock to contain a substantial risk of forfeiture. Pinning the forfeiture upon commission of a crime or upon the breach of a covenant not to compete, however, is normally not the advisable method. In this regulatory emphasis upon the likelihood that an employee can succeed in his efforts to compete, and in the exclusion of the crime-forfeiture as a substantial risk, the Internal Revenue Service has clearly shifted from "substantial services" with its connotation of "how much" toward "substantial risk" with its connotation of "probability." In other words, a substantial risk exists if substantial services, however measured, must be performed. In the

ther clarification, however, would help. For example, would seasonal work, part-time work, or full-time work also be relevant? At least a restriction extending over ten years seems to be long enough to qualify as substantial services. Proposed Treas. Reg. § 1.83-3(c) (2) example (1), 36 Fed. Reg. 10791 (1971).

¹⁷This is similar to the old collapsible corporation dispute whether one should consider the income realized or *not yet* realized of primary importance in deciding if a "substantial part" of income has been earned within the meaning of INT. REV. CODE of 1954, § 341. *Compare* Commissioner v. Kelley, 293 F.2d 904 (5th Cir. 1961), *with* Abbott v. Commissioner, 258 F.2d 537 (3d Cir. 1958). Though an argument based upon this premise may be intriguing, section 341 criteria could be distinguishable since that section speaks of "substantial part" of a whole while section 83 speaks of "substantial services." If services to be performed after the lapse are relevant, an employee's advanced age could penalize him. Nevertheless, employee age has been made relevant in the proposed regulation's criteria to determine whether or not a covenant not to compete is a substantial risk. Proposed Treas. Reg. § 1.83-3(c) (1), 36 Fed. Reg. 10791 (1971).

¹⁶Proposed Treas. Reg. § 1.83-3(c), 36 Fed. Reg. 10791 (1971).

¹⁹*Id.* § 1.83-3(c) (2) example (4).

alternative, a substantial risk exists if there is a "probability," however measured, that a forfeiture will result.²⁰

Of course, the exact dimensions of a "substantial risk" might be clarified by legislative enactment, judicial opinion, or administrative regulation. In the interim, however, a conservative tax planner seeking a section 83 deferral of tax may wish to consider using, whenever possible, only those provisions that attempt to establish a substantial service requirement.

"Forfeiture" is another term in need of further clarification. The word suggests a loss, but the amount of sacrifice needed to constitute a forfeiture and transform shares into restricted stock is conjectural. In an example in the currently proposed regulations, a taxpayer is assumed to purchase stock at \$10 and to sell back at \$10 if he quits within ten years.²¹ This illustration in the regulations seems to indicate that a refund of the amount paid at the original exercise of an option would not prevent the return of the property from constituting a forfeiture. Thus, it appears to be unnecessary that a taxpayer lose money on the transaction but rather that he merely forego his right to "full enjoyment of the stock."²² If a stockholder sacrifices his interest in the shares, therefore, presumably it would be satisfactory for his employer to refund even a lesser sum, such as \$8, \$6, or even nothing, provided that the amount is equal to the original cost or less. The regulatory examples, however, continue to emphasize that a corporate purchase of bonus stock at its attained fair market value would *not* constitute a forfeiture.²³ Notably, this example is distinguishable since it involves stock for which the taxpayer paid

²⁰It has been implied that the crime exclusion exists because an employer normally would not hire someone if there is a probability he will commit an offense. This suggests it is the perceived likelihood that is important, since it is common knowledge that most employees do not turn out to be criminals. Zimet, *Property Transferred in Connection With the Performance of Services*, S. CAL. 1971 TAX INST. 149, 160. The probability in the covenant not to compete rationale seems to be a perceived one as well. At the time of the contract or transfer of the property, questions of an employee's age and his likelihood of successfully breaching are relevant. If this analysis is correct, it would seem that a later and actual commission of a crime or successful breach of a covenant would not be relevant as to the question of whether or not a substantial risk of forfeiture existed at time of contract. Thus, an actual forfeiture would not prove that a substantial risk of it existed.

²¹Proposed Treas. Reg. § 1.83(c)(2) example (1), 36 Fed. Reg. 10791 (1971).

²²INT. REV. CODE of 1954, § 83(c)(1). The forfeiture showing a refund of dollar for dollar can involve an economic loss, such as a sacrifice of dividend income or capital appreciation, if applicable, or of the right to future participation in any perquisites associated with stock ownership.

²³Proposed Treas. Reg. § 1.83-3(c)(2) example 3, 36 Fed. Reg. 10791 (1971).

nothing rather than optioned stock for which the taxpayer received a refund of cost. Presumably, a payment of fair market value would make the taxpayer whole in terms of the economic sacrifice brought about by his surrender of the shares. Although he still would be deprived of the full enjoyment of the property, the payment of its full value allegedly would ease the discomfort and prevent the transaction from constituting a forfeiture. Thus, payments from the employer would seem to have more relevance when they exceed rather than fall at or below employee cost. The regulations, however, continue to confuse this matter by stating that a risk of forfeiture generally will not exist if an employer is required to pay full or "substantially" full value on return of the property.²⁴ It would seem likely, therefore, that a payment of more than original cost would not necessarily impair the effectiveness of a forfeiture provision so long as the payment is less than the substantial full value. One can only guess, however, where the cross-over payment point lies between original cost and later fair market value. Pending clarification, if a deferral is sought, the prudent draftsman may wish to limit payments to a refund of cost or less. Surely it would be unwise for him to establish repayment at fair value.

Meanwhile, many questions remain to vex the tax planner. For example, suppose that a stockholder paid \$10 per share for stock with a fair market value of \$15 and only a refund of cost was required. What would be the Service's position if the fair market value later fell to \$8 at which time the taxpayer breached and redelivered the stock and collected a refund of his \$10 cost, \$2 in excess of the prevailing fair market value? Would the receipt of more than the fair market value somehow emasculate the risk of forfeiture provision and throw the tax back into the year of original acquisition? Of course, the matter would be moot if the Service were to confine itself to a prospective view of these agreements, as the parties must do. Moreover, one way to circumvent the problem would be to require a return of the shares

²⁴Proposed Treas. Reg. § 1.83-3(c)(1), 36 Fed. Reg. 10790-91 (1971). The question remains whether there is a risk of forfeiture or not upon bonus stock if the employer is required to pay *anything* back. The regulations refer to fair value repayments, but if the taxpayer has paid nothing for the shares, any payment he receives would be a gain. The same question exists for stock acquired through an option if the taxpayer is to receive back a peppercorn over cost. Though the answers apparently are not certain, it would seem that the proposed regulations are aimed principally at the receipt of substantially full value for the stock that is given up, so that receipt of some amount over cost or something more than zero for bonus stock would not necessarily destroy the effectiveness of the forfeiture provision. Administrative clarification of the point, however, is very much needed. See Kopple, *supra* note 14, at 132.

and to provide for no refund at all, although this might be unacceptable to the person acquiring the restricted stock.

IV. ELECTING AN EARLIER TAX

Section 83 appears to provide a choice to the initial recipient of restricted stock. He may defer taxation to a time when either the substantial risk of forfeiture or the nontransferability feature disappears, and then report as ordinary income the excess of the attained fair market value over the cost.²⁵ Alternatively, he may elect to include the excess in his gross income for the year during which he acquired the stock.²⁶ In the latter case, the stockholder will report the excess as gross income in the taxable year of the election, and the transferor corporation can deduct the excess amount during the taxable year in which or with which the stockholder's year ends.²⁷

The elective provision provides the stockholder with some obvious flexibility in reporting his taxable income as well as control over his corporation's entitlement to a section 162 deduction. This is especially true in a continuing plan that permits stock acquisitions over a period of years. Not only does a stockholder control the year of the deduction, but he may also be able to report income in one tax year and delay the corporate deduction until the next tax year. For example, assume that a shareholder is on a calendar year and his corporation is on a fiscal year ending October 31. If a calendar year shareholder elected to report income realized from a stock transfer during 1974, his tax payment would be due by April 15, 1975.²⁸ However, the corporation's fiscal year coinciding with the close of the individual shareholder's calendar year would end October 31, 1975, and the section 162 deduction would be deferred until the next filing date, January 15, 1976.²⁹

At first it may appear senseless for a taxpayer to forego the deferral feature of section 83 and accelerate the payment of a tax on ordinary income. The earlier disbursement of cash for payment of the tax and the loss of the ability to earn interest on the amount disbursed raise questions about the wisdom of such an election. An explanation lies, however, in a taxpayer's expectation regarding the likelihood of the future capital appreciation of

²⁵INT. REV. CODE of 1954, § 83(a).

²⁶*Id.* § 83(b); Proposed Treas. Reg. § 1.83-2, 36 Fed. Reg. 10789-90 (1971).

²⁷INT. REV. CODE of 1954, § 83(h).

²⁸*Id.* § 6072(a).

²⁹*Id.* § 6072(b). The importance of all this may be minimal to the company, but if it should demand current deductions, perhaps the firm should avoid use of the deferral technique. Could the firm and the stockholder effectively agree that the latter would waive his right to elect under the statute?

his stock. If he were to forego the election, the entire excess of the later fair market value over the original cost of the stock would be taxed as ordinary income at the time the restrictions lapse. If an election were made, however, the amount of ordinary income would be measured by the excess of the fair market value over the original cost at the time of the election, and a new basis, consisting of cost increased by the amount taxed, would generally be used to measure the gain on a subsequent sale. This gain could then be treated as a capital gain rather than ordinary income.³⁰ Thus, the taxpayer must weigh the expected costs of each alternative.

Methodology for measuring the costs and making the decision whether to elect presumably should be based upon conventional financial criteria that discount future cash outflows to their present values for purposes of present comparative analysis. In this manner the smaller of the two present values can be selected. For example, suppose that a taxpayer exercises an option to buy restricted stock which has a fair market value of \$10 per share for the bargain price of \$8 per share. Assume that his marginal tax rate is 40%, that the substantial risk of forfeiture will lapse in ten years, that he plans to sell the stock after the lapse, and that he expects the value of the stock to rise to \$12 by that time. Under these assumptions, the taxpayer could elect to pay a current tax per share in the amount of \$.80³¹ and then pay a capital gains tax in the tenth year in the amount of \$.40.³² Alternatively, the taxpayer could wait ten years until the restriction lapsed and

³⁰Proposed Treas. Reg. § 1.83-2(a), 36 Fed. Reg. 10789 (1971). The section purports to disallow the elector any deduction for loss should the stock later be forfeited. INT. REV. CODE of 1954, § 83(b). The proposed regulations, however, seem to stretch this point to allow a deduction equal to the amount paid for the stock over the amount realized. Proposed Treas. Reg. § 1.83-2(a), 36 Fed. Reg. 10789 (1971). For example, suppose a taxpayer buys restricted stock at \$10 while its fair market value is \$15, and he elects to pay a current tax. His new basis is \$15 and, if fair market value remains at that level until such time as a complete forfeiture later occurs, section 83 seems to say no deduction would be allowed for the \$15 loss of value or the \$10 loss of original cost. The proposed regulations, however, seem to imply that there would be a deductible capital loss in the amount of \$10. Proposed Treas. Reg. § 1.83-2(a) (1) & (2), 36 Fed. Reg. 10790 (1971). This apparently has been criticized for its failure to allow the full \$15 economic loss. Schapiro, *supra* note 9, at 295. It is arguable that a literal reading of the statute suggests no deduction of any kind so that the drafters of the proposed regulations may already have gone farther than might be expected.

³¹\$10 minus \$8 (which equals \$2 of ordinary income) times 40% equals \$.80.

³²The expected fair market value of \$12 minus \$10 (which equals \$2 of long-term capital gain, only half of which is taxable at ordinary income rates) times 50% equals \$1 times 40% equals \$.40.

pay an ordinary income tax of \$1.60.³³ Thus, the total tax outlay with an election is \$1.20, including an \$.80 tax on ordinary income and a \$.40 tax on capital gains. By comparison, the total tax outlay without the election is \$1.60³⁴ of ordinary income tax.

Although it might appear that making the election is the less expensive choice, failure to consider the present value of the tax outlay in the tenth year distorts the entire decision process. The election's requirement that \$.80 be paid immediately deprives a taxpayer of the use of that amount for the entire ten years and results in an additional cost to him. Similarly, deferring a tax to the tenth year permits the taxpayer to employ the funds profitably elsewhere and reduces his effective tax cost. The usual manner for placing cash outflows into comparable time periods is to discount future payments and to provide a resultant present value. In other words, the future tax payments would be stated in their current equivalents: amounts that, if invested by the taxpayer at whatever rate he could expect to earn, would accumulate to the sums needed to pay the alternative taxes at the end of ten years.³⁵

Thus, assume that a stockholder could earn 6% after taxes if his excess funds were invested. A present value table represents the present worth of \$1 to be paid ten years in the future as \$.558.³⁶ Stated another way, if \$.558 were invested at a 6% after tax compound interest rate, it would accumulate to a sum of \$1 over ten years. After ascertaining the ten year equivalent of \$1, one needs only to multiply this equivalent by the actual amounts that are expected to be disbursed in ten years.

In the no-election alternative, ordinary income tax of \$1.60 payable in ten years has a present equivalent value of \$.8928.³⁷ In the election alternative, the capital gains tax of \$.40 payable in ten years has a present equivalent value of \$.2232.³⁸ Of course, the present value of \$.80 in income tax payable now under the election is \$.80. Thus, stated in equivalent dollars, the election will have a total effective tax cost of \$1.0232, including an \$.80 tax on present ordinary income and a \$.2232 tax on future capital gains. In contrast, the no-election alternative will have a tax cost of \$.8928 of future ordinary income tax. It would be less expensive,

³³\$12 minus \$8 (which equals \$4) times 40% equals \$1.60.

³⁴For simplicity, the example ignores expenses from the exercise of the election, stock sales, and other sources.

³⁵The entire discounting process is illustrated in Banks, *A Selective Inquiry into Judicial Stock Valuation*, 6 IND. L. REV. 19, 38 (1972).

³⁶V. BRUDNEY & M. CHIRELSTEIN, *CORPORATE FINANCE—CASES AND MATERIALS* 35 (1972). Tables similar to those in the Brudney book are usually available at local banks.

³⁷.558 times \$1.60 equals \$.8928.

³⁸.558 times \$.40 equals \$.2232.

therefore, *not* to make the election. Significantly, this conclusion is precisely opposite from that suggested when not using a discounting process.

It is true that monetary differences may seem small³⁹ and that assumptions and estimates are difficult to formulate and may not hold true.⁴⁰ Nevertheless, an informed planner should attempt to quantify the elements of his decision in a similar fashion. Otherwise, the process of making a choice in a section 83 circumstance would disintegrate into nothing more than a random selection.⁴¹

V. PERPETUAL RESTRICTIONS

A common purpose for selling restricted stock under a non-statutory option is to give an employee an equity interest at a bargain price that will induce him to remain in the company's service. Of course, the firm frequently will wish to regain the shares if the employee should decide to terminate the employment relationship. Under the elusive section 83 rules, it has already been shown that stock must meet the technical requirements for a transfer to the recipient and must include a substantial risk of forfeiture. If the company carefully attempts to meet these requirements, but then seeks to impose an obligation upon the employee to resell the shares to the company upon termination of employment, questions arise as to when, if ever, the restriction will cease, and what, if any, will be the effect under section 83. For example, suppose the employee must forfeit his stock by selling it to the company if he leaves its employment within five years. This limitation would seemingly end at a stated time so that employment thereafter would result in ownership without restriction. If so, the taxable event would occur during the fifth

³⁹Altering the discount rate, however, can affect the result so that the decision is greatly dependent upon what alternatives the taxpayer has available for his money. With an expectation of very large capital appreciation in the stock, it is apparent that the decision-making process would favor the election.

⁴⁰A partial solution would be to assign probabilities to the estimates. V. BRUDNEY & M. CHIRELSTEIN, *supra* note 36, at 55.

⁴¹These decision-making criteria could be explored endlessly. For example, only the *difference* between the future tax under each alternative need be discounted. In the above example, at least \$.40 would be due in the tenth year under either alternative. Since this element is common to both choices, it loses its relevance in the decision process and could be subtracted from each alternative. Furthermore, suppose a taxpayer does *not* intend to sell upon lapse of the restriction but instead plans to hold the stock until his death. Under present law, an estate tax, measured upon the fair market value at death or six months thereafter would be due. INT. REV. CODE of 1954, §§ 2031, 2032. This would constitute an additional tax, but since it would be common to both alternatives it also could be dismissed as irrelevant to the

year.⁴² If, however, the employee can never become the owner of the stock or transfer it free of limitations, then, as to him, the forfeiture restriction would in effect be perpetual.

Section 83 clearly allows for the existence of a no-lapse feature by requiring its consideration in determining the fair market value of the stock to which it applies.⁴³ This suggests that attaching such a never-ending restriction would not cause the issuance of the stock to fail as a "transfer" under section 83. Furthermore, the definition of a no-lapse restriction has been narrowed to include the type of situation already suggested: a limitation on a second transfer of the stock which permits the transfer at a formula price and which continues to apply to a subsequent holder of the stock other than the original transferor.⁴⁴ Regulatory examples illustrate this situation with an obligatory resale to the issuing company at the attained book value⁴⁵ or at a multiple of earnings.⁴⁶

It is generally agreed that the presence of such a no-lapse provision will cause the transaction to be taxed at the time of the original transfer,⁴⁷ and, though the rationale for the timing of the tax is not abundantly clear, the examples so indicate. Since both the examples involve repurchases that could result in a substantial gain to a shareholder, the explanation may be that the stock lacks a substantial risk of forfeiture for that reason. In the alternative, the explanation may be that any no-lapse provision "standing by itself will not be considered to result in a substantial risk of forfeiture."⁴⁸ Under either approach, the difference be-

election decision. However, suppose the Treasury should succeed in imposition of a capital gains tax at death? Such an incremental tax should be integrated into the decision process because its effect would be different under each alternative. Of course, all this would raise the problem of determining the year in which the proposed tax on capital gains at death would occur. Since the decision must be made currently and since it would require an estimate of the year of death, perhaps a mortality table would be a useful tool in approaching one of the many problems inherent in the decision process.

⁴²Proposed Treas. Reg. § 1.83-3(c) (2) example (1), 36 Fed. Reg. 10791 (1971).

⁴³INT. REV. CODE of 1954, § 83(a) (1).

⁴⁴Proposed Treas. Reg. § 1.83-5(a), 36 Fed. Reg. 10792 (1971). This somewhat restrictive definition is in curious contrast to section 83 that speaks of "a restriction which will never lapse, and which allows the transferee to sell such property only at a price determined under a formula . . ." INT. REV. CODE of 1954, § 83(d) (1). The statutory term "and" arguably suggests that there might be other no-lapse restrictions that do not require a sale only at a formula price.

⁴⁵Proposed Treas. Reg. § 1.83-5(d) example (1), 36 Fed. Reg. 10792 (1971).

⁴⁶*Id.* § 1.83-5(d) example (2).

⁴⁷Schapiro, *supra* note 9, at 288.

⁴⁸Proposed Treas. Reg. § 1.83-3(c), 36 Fed. Reg. 10790-91 (1971). *See*

tween cost and fair market value⁴⁹ should be included in income in the "first taxable year in which . . . the property is . . . not subject to a substantial risk of forfeiture" ⁵⁰ Of course, this would be the year of the initial transfer of the shares. In any event, the no-lapse regulations could be improved by a clarifying revision on this point.

Despite the uncertainty surrounding a no-lapse provision, at least the drafter of a buy-sell agreement has some reasonable assurance that his formula price will serve as a proxy for fair market value.⁵¹ If a compulsory buy-sell agreement with a formula price is desired, however, the company drafting the contract apparently must make a choice between placing a time limit on its right to reacquire or placing the would-be stockholder in the position of paying an immediate tax on the amount of the bargain purchase.⁵²

VI. CONCLUSION

This brief sketch is but a selective inquiry into the use of restricted stock and seeks to illustrate some of the many perplexing problems that face a tax planner who would establish a new nonstatutory stock option or stock purchase plan. Much of the difficulty is caused by a sketchy section 83 and a set of confusing regulations that, at least at this writing, have yet to reach final form. If a revision of these regulations is imminent, some of the problems discussed herein could soon disappear. At most, such a

generally 2 J. MERTENS, THE LAW OF FEDERAL INCOME TAXATION § 11.11c (1974) (comments on legislative history of no-lapse provisions). Presumably, stock might be sold to an employee under a provision for forfeiture at a zero return of cost for ten years and a no-lapse repurchase at a formula price upon termination of employment thereafter. Arguably, the stock would not be subject to a no-lapse provision "standing alone," and the accompanying substantial risk of forfeiture provision would defer the tax for ten years.

⁴⁹Normally, the formula price will be accepted as a measure of fair market value. INT. REV. CODE of 1954, § 83(d)(1).

⁵⁰*Id.* § 83(a)(2).

⁵¹*Id.* § 83(d)(1). This avoids the tedious task of stock valuation if the shares have no established market. See *generally* Banks, *Present Value and the Close Corporation*, 49 TAXES 33 (1971). It also does away with an otherwise troublesome question of how much to reduce fair market value so that a no-lapse restriction is given effect.

⁵²One pair of authors has suggested that an option to repurchase may constitute a substantial risk of forfeiture while a mandatory repurchase will not. Sexton & Boyle, *How Proposed Section 83 Regs Create Traps in Restricted Stock and Stock Option Areas*, 39 J. TAXATION 184, 186 (1973). A repurchase at fair value is not considered a no-lapse provision. Proposed Treas. Reg. § 1.83-5(a), 36 Fed. Reg. 10792 (1971). Presumably, a taxable event would occur upon the initial transfer since the requirement of repurchase at fair value would negate the existence of a substantial risk of forfeiture.

change would merely transform this study from an inquiry into a prologue. Thus, even if changes occur or the proposed regulations become final, the prudent planner should nevertheless avoid innovative deviations from the examples contained in any Treasury guidelines until this relatively new area receives the benefit of judicial interpretation.