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INTERNAL REVENUE CODE SECTION 83 RESTRICTED STOCK PLANS*

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Section 83 of the Internal Revenue Code, enacted by the Tax Reform Act of 1969,[1] resulted in one of the most important reforms ever to be promulgated in the restricted stock plan area.[2] This Article will explore the problems that have and will be encountered in the application and interpretation of section 83, and the effect that this section will have upon the further use of the restricted stock plan as a form of deferred compensation.[3] Recommendations will also be advanced as to how section 83 can be interpreted or amended to provide more meaningful and effective treatment of the restricted stock plan.

I

Structure, Development, and Purpose of Restricted Stock Plans

A restricted stock plan is an arrangement whereby an employer transfers stock to one or more of its employees at no cost or at a bargain price. Prior to the enactment of section 83, stock under such an arrangement was transferred subject to certain restrictions which affected its value, such as the condition that the employee must resell the stock to the employer upon termination of employment within a specified period. Such conditions may be imposed either to preserve the limited numbers of stockholders in

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[1] INT. REV. CODE OF 1954, § 83 (added by Tax Reform Act of 1969, Pub. L. No. 91-172, § 321(a), 83 Stat. 487 (1969)).

[2] Section 83 is the first express Internal Revenue Code section specifically covering restricted stock plans. *Cf.* Treas. Reg. § 1.421-6 (1966); *id.* § 1.61-2 (1959).

[3] Deferred compensation arrangements, whether included in group plans or in individual employment or other agreements, principally involve an agreement by an employer to make payments to an employee at a future date for his services. The employee's tax objective in participating in such an arrangement is to insure that he will be taxed (generally, at ordinary income tax rates) only when payments are received under the plan or agreement. The underlying assumption is that the employee's effective tax rate at the time of payment will be lower than his current tax rate, and that he will be able to retain a larger portion of the total paid to him.

a close corporation or to provide an incentive to employees to remain with their employer. Under both prior and existing law, the stock plan may cover one or more employees, and the stock transferred may be stock in the employer corporation, stock of another corporation, or even shares of a mutual fund.[4]

The purpose of a restricted stock plan is to transfer stock to the employee in order to defer the payment of tax to a later date when the employee will be better able to pay the tax. The main objective is to treat the future appreciation of the stock, upon its realization as income, as a capital gain rather than as ordinary income. Such an objective is premised upon fundamental principles of tax law which dictate that no taxable income will result if property received does not exceed in value the consideration paid.[5] Therefore, if significant restrictions are placed on the employee's right to the transferred stock, the fair market value of the stock is depressed to the point that the value either is unascertainable, the predominant situation, or at least is not in excess of the consideration paid. In the past the Internal Revenue Service (IRS) has accepted this contention, with the result that under prior law, no income was realized in the year of transfer or purchase, and when the restrictions finally lapsed, any appreciation of the stock received capital gains treatment.[6]

The restricted stock plan also developed as an incentive to employees to remain in the service of their employers. It gives the employee a chance for significant capital gains and an equity position in the employer without any cash drain on the employer.[7] Furthermore, the restricted stock plan serves as an alternative to qualified stock plans.[8] In a quest for flexibility and, in particular, with the aim of transferring restricted stock to employees for amounts substantially less than the stock's fair market value, employers are often unable to meet the strict requirements of the qualified stock plan provisions of the Internal Revenue Code.[9]

[4] *See* H.R. REP. No. 413, 91st Cong., 1st Sess., pt. 1, at 86 (1969) [hereinafter cited as HOUSE REPORT]; Kopple, *Restricted Stock: What's Left After the Tax Reform Act of 1969?*, 48 TAXES 558 (1970).

[5] *See* INT. REV. CODE OF 1954, §§ 1001, 1011-12.

[6] Treas. Reg. § 1.421-6 (1966); *see* Cordes, *The Tax Reform Act of 1969: Its Effect on Corporations,* 19 U. KAN. L. REV. 71, 79-80 (1970).

[7] *See* Rice, *"Restricted Stock" as Executive Incentives: Interplay Between IRS Section 83 and SEC Rule 144,* 28 BUS. LAW. 127, 128 (1972).

[8] For the various requirements that must be complied with in order to qualify for treatment as a qualified stock plan, see INT. REV. CODE OF 1954, §§ 422-24.

[9] Qualified stock plans are plans whereby by complying with the various requirements of §§ 422-24 of the Internal Revenue Code, employees are allowed to realize capital gains

Thus, employers gravitated to the restricted stock plan because it is the only form of a nonqualified deferred compensation plan which takes advantage of capital gains treatment.[10]

II

Treatment of Restricted Stock Plans Prior to the Tax Reform Act of 1969

Prior to the Tax Reform Act of 1969, there existed no specific statutory provision for the treatment of restricted stock plans. Until sections 1.421-6(d)(2)[11] and 1.61-2(d)(5)[12] of the regulations were adopted in 1959, the Treasury tried to regulate restricted stock plans without the benefit of specific regulations. In *Robert Lehman*,[13] the Commissioner met with a disastrous setback at the hands of the Tax Court.[14] Lehman, the petitioner, was a partner in the firm of Lehman Brothers which had received stock options that it had exercised in February 1943. The parties agreed that the acquisition of the shares did not give rise to any income in 1943 because they had no ascertainable fair market value as a result of restrictions upon their sale.[15] The restrictions terminated on December 31, 1943. In February and March 1944, the firm sold the stock and reported the excess of the amount realized over cost as long-term capital gain. Lehman reported his share of the gain as a partner of the firm. The Commissioner's position was that the firm realized ordinary income at the time the restrictions lapsed to the extent that the fair market value of the shares at the time the restrictions lapsed exceeded their cost. The court held that the termination of

upon the exercise of a stock option and the later sale of the stock, gains that would be characterized as ordinary income under § 83. An example of such a requirement is § 423(b), under which no employee can be granted an option if such employee, immediately after the option is granted, owns stock, possessing five percent or more of the total combined voting power or value of all classes of stock of the employer corporation or of its parent or subsidiary corporation. Restricted stock plans have no such requirement.

[10] *See* Neal, *New Law Restricts Use of Nonqualified Plans Except for Close Corporations*, 32 J. Tax. 178 (1970).

[11] Treas. Reg. § 1.421-6(d)(2) (1966). Regulation 1.421-6 specifically governs nonstatutory options and is made applicable to direct compensatory transfers of restricted stock by Treas. Reg. § 1.61-2(d)(5) (1959).

[12] Treas. Reg. § 1.61-2(d)(5) (1959).

[13] 17 T.C. 652 (1951).

[14] *See* Harold H. Kuchman, 18 T.C. 154 (1952), *acquiesced in* 1952-2 Cum. Bull. 2 (restricted stock acquired had no ascertainable fair market value, so no income to petitioner; issue of taxability upon lapse of restrictions not reached).

[15] 17 T.C. at 653. Tbe Tax Court did not discuss the nature of the restrictions, and the only information given was that they lasted from February 1, 1943, to December 31, 1943. *Id.*

the restrictions was not a taxable event[16] because there was no "sale or other disposition" of the stock, which was required under the predecessor of section 1001.[17] The court reasoned that the entire gain upon sale of the stock was properly reported as long-term capital gain.[18] Thus, the holding in *Lehman* favored the taxpayer both as to the timing of income recognition and the type of income recognized.

The Commissioner's initial acquiescence in *Lehman* was withdrawn[19] after the promulgation of the regulations to section 421.[20] Reflecting the Commissioner's objections to *Lehman,* the regulations[21] provided that if property was subject to a restriction which had a significant effect on its value, no income would be realized by the employee until the stock was either sold in an arm's-length transaction or the restriction lapsed. The income then realized was the *lesser* of the fair market value at the time of transfer (computed without regard to the restrictions), or the fair market value at the time the restrictions lapsed, or the consideration received on sale or exchange (whichever was applicable) in excess of the employee's basis in the stock. Any appreciation was not taxed until a subsequent sale and then only at the more attractive capital gain rates. Therefore, although the regulations altered the *Lehman* decision as to the timing of income recognition, they tended to maximize the capital gain element of restricted property by allowing the date of receipt to set a ceiling on ordinary income.

The issuance of Revenue Ruling 68-86,[22] in February 1968, created an upsurge in the use of restricted stock plans. That ruling held that a restriction preventing sale or other disposition during employment had a "significant effect on value" within the meaning of the then existing regulations.[23] Such an approach allowed for easy compliance with the regulations and resulted in substantial tax savings by employees via capital gains.

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[16] *Id.* at 654.

[17] INT. REV. CODE OF 1939, ch. 289, § 111, 52 Stat. 484 (now INT. REV. CODE OF 1954, § 1001).

[18] 17 T.C. at 654.

[19] 1962-2 CUM. BULL. 7, *withdrawing acquiescence in* 1952-1 CUM. BULL. 3, *and substituting nonaquiescence.*

[20] INT. REV. CODE OF 1954, § 421; T.D. 6416, 1959-2 CUM. BULL. 126.

[21] *See* Treas. Reg. §§ 1.61-2(d)(5) (1959), 1.421-6(d) (1966).

[22] 1968-1 CUM. BULL. 184. A private ruling, in late 1967, with a similar holding, received a great deal of publicity and added to the upsurge. *See* Sobeloff, *Payment of Compensation in the Form of Restricted Property: Problems of Employer and Employee—The Rules of New Code Section 83,* N.Y.U. 28TH INST. ON FED. TAX. 1041, 1045 (1970).

[23] Treas. Reg. §§ 1.62-2(d)(5) (1959), 1.421-6(d) (1966).

In an attempt to remedy this preferential tax treatment enjoyed by restricted stock plans, the Treasury Department issued proposed regulations in October 1968.[24] These proposed regulations would have caused the employee to realize as *ordinary income* the excess of the fair market value of the stock on the date the restrictions lapsed, without any reference to the stock's possible lower value when received, over the employee's basis. However, these proposed regulations were never promulgated; they had been doomed at the outset by *Ira Hirsch,*[25] decided by the Tax Court three days prior to their issuance.[26] Hirsch, the petitioner, was an officer of Pacific Vitamin Corporation. In 1961, Hirsch received stock pursuant to his exercise of a nonstatutory stock option,[27] an option which had no ascertainable market value when issued. Upon exercising the option, Hirsch was required to, and did, represent that he would not sell the shares for six months. Subsequently, he was put on notice by the SEC that any sale of the shares without prior registration might be in violation of the Securities Act of 1933.[28] On the basis of these facts the court held that Hirsch acquired and held the stock, at all relevant times, subject to a restriction which had a significant effect on value under section 1.421-6(d)(2)(i) of the regulations and thus was not required to recognize income until the restrictions lapsed. *Hirsch*'s further expansion of the concept of "significant effect on value," as expressed in Revenue Ruling 68-86, caused the Treasury Department to re-evaluate its recommendations. Deciding that the proposed regulations did not go far enough, the Internal Revenue Service announced in June 1969 that the proposed regulations would not be made final pending consideration of tax reform legislation. This legislation ultimately developed into the Tax Reform Act of 1969 and section 83 of the Internal Revenue Code.[29]

III

The Birth of Section 83

As a result of the upsurge in the use of restricted stock plans caused by the liberalization of the concept of "significant effect on

[24] Proposed Treas. Reg. § 1.421-6(d), 33 Fed. Reg. 15,870 (1968).

[25] 51 T.C. 121 (1968).

[26] *See* Blake, *Compensatory Property (Restricted and Unrestricted) Under Section 83 of the Code,* N.Y.U. 29th Inst. on Fed. Tax. 1273, 1277-78 (1971).

[27] A nonstatutory stock option is one which is not a qualified stock option as defined by § 422(b), an option granted under an employee stock purchase plan, as defined hy § 423(b), or a restricted stock option as defined in § 424(b).

[28] *See* SEC Rule 144, 17 C.F.R. § 230.144 (1973) [hereinafter cited as SEC Rule 144].

[29] T.I.R. No. 1017, 1966 CCH Stand. Fed. Tax Rep. ¶ 6836.

value," legislative change began to emerge as the logical solution.[30] The Treasury Department recognized that the increase of restricted stock plans was not a temporary phenomenon; thus, it was only natural that restricted property be included in the Tax Reform Act of 1969.

Legislation was requested by the Treasury Department to conform the method of taxing restricted stock plans to the method of taxing other types of plans under section 402(b) of the Code.[31] From this modest request emerged the all-encompassing section 83.[32]

The new section was designed to prevent a taxpayer from enjoying both the benefits of tax deferral resulting from restrictions and capital gains treatment on the intervening appreciation.[33] Congress expected to realize little, if any, additional revenue from the provision. It was motivated by a concern for equitable treatment among taxpayers and the elimination of unwarranted tax deferral and avoidance.[34]

Proposed regulations under this section were issued by the Treasury Department in 1971;[35] however, they have not yet been promulgated.

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[30] *Hearings Before House Committee on Ways and Means on the Subject of Tax Reform,* 91st Cong., 1st Sess. 5205 (1969) (*Technical Explanation of Treasury Tax Reform Proposals,* April 22, 1969) [hereinafter cited as *House Hearings*].

[31] INT. REV. CODE OF 1954, § 401(b); *see House Hearings* 5498 (statement of Edwin S. Cohen, Assistant Secretary of the Treasury for Tax Policy).

One commentator explained that when property was transferred subject to restrictions of a nonforfeitable nature, the proper analogy was thought to be a nonforfeitable contribution to an individual's account in a nonqualified employees' pension or profit sharing trust. Under § 402(b), the employee would immediately be taxed on such a contribution at ordinary income rates even though he may not be able to enjoy the use of the funds for a considerable length of time. As to forfeitable stock, the proper analogy was thought to be deferred compensation arrangements. Under § 402(b), when the employee's rights had become vested and the stock was no longer subject to forfeiture, the employee would be taxed on the stock's full value and the taxable amount would be included in gross income and taxed at the ordinary income tax rates. *See* Buchhelder, *Executive Compensation After the Tax Reform Act of 1969,* 48 TAXES 652, 673-74 (1970).

[32] The section was originally labelled "Restricted Property" in the House bill (H.R. 13270, 91st Cong., 1st Sess. 321 (1969) (House Ways and Means Comm. version)), but was changed in the Senate bill (*id.* (Senate Comm. version)) to "Property Transferred in Connection with the Performance of Services." In addition, the provision originally aimed at restricted property was, in the end, drafted to provide, for the first time, an express Code provision for compensation paid-in-kind, irrespective of any restrictions, and irrespective of whether received under a stock option, deferred compensation, or some alternative arrangement.

[33] *See* Speech by John S. Nolan, at the University of Pennsylvania Tenth Annual Tax Conference, October 14, 1970 (on file at the *Cornell Law Review*).

[34] *See* HOUSE REPORT, pt. 1, at 89.

[35] 36 Fed. Reg. 10,787-99 (1971).

IV

INTERPRETATION OF SECTION 83 AND THE PROPOSED REGULATIONS

The broad scope of section 83 is best illustrated by its opening phrase: "If, in connection with the performance of services, property is transferred to any person other than the person for whom such services are performed . . . ."[36] The proposed regulations provide that section 83 will be applicable to the transfers of property to employees, individual contractors, or their beneficiaries when the transfer is made in connection with the performance of services, be they past, present, or future services.[37] Section 83 preserves the assignment of income principle expressed in *Lucas v. Earl*,[38] by continuing to tax the employee when the employer has transferred property to a beneficiary in recognition of the employee's services.

In defining a section 83 "transfer," the proposed regulations provide that a transfer of property occurs only when an employee has either no further payments to make for the property, other than the performance of substantial services, or when he is under a binding commitment to purchase the property.[39] Such a definition encompasses the normal restricted stock plan situation.

With regard to the "transferor," neither section 83[40] nor the proposed regulations[41] require that the employer itself make the transfer of property to the employee in order to qualify for the employer's deduction under the section. Indeed, the Senate Committee Report states that if a parent company's or a shareholder's stock is used to compensate employees under a restricted stock plan, the transfer is generally to be treated as a capital contribution to the employer-subsidiary.[42] The subsidiary in turn is entitled to a section 83 employer deduction as if the transfer had been made by it.[43] Prior to the Tax Reform Act of 1969, the position of the IRS was that no deduction was allowed to the employer-company for compensatory transfers made by its shareholders.[44] Such was the

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36 INT. REV. CODE OF 1954, § 83(a).

37 Proposed Treas. Reg. § 1.83-3(f), 36 Fed. Reg. 10,791-92 (1971).

38 281 U.S. 111 (1930).

39 Proposed Treas. Reg. § 1.83-3(a)(1), 36 Fed. Reg. 10,790 (1971).

40 INT. REV. CODE OF 1954, § 83(h).

41 Proposed Treas. Reg. § 1.83-6(d), 36 Fed. Reg. 10,791 (1971).

42 S. Rep. No. 552, 91st Cong., 1st Sess. 119, 123-24 (1969) [hereinafter cited as SENATE REPORT].

43 *Id.*

44 Rev. Rul. 69-369, 1969-2 CUM. BULL. 27.

IRS's position even in the situation where the majority shareholder of a corporation transferred stock to the corporation in accordance with a plan whereby the stock would then be transferred to employees.[45]

The rules of section 83 are not all-encompassing. They do not apply to: (*1*) the transfer of an option to which section 421 applies,[46] (*2*) the transfer to a qualified pension or profit-sharing trust, (*3*) the transfer of an option without a readily ascertainable fair market value, (*4*) the payment for a qualified annuity, or (*5*) the transfer of property pursuant to the exercise of an option with a readily ascertainable fair market value at the date of grant.[47]

Section 83 began as a modest proposal to treat restricted stock plans more equitably and evolved into a provision which includes within its tentacles arrangements for compensation paid in kind, irrespective of any restrictions, and irrespective of whether received under a stock option, deferred compensation, or some alternative arrangement.

A. *Substantial Risk of Forfeiture and Nontransferability*

Prior to the Tax Reform Act of 1969, an employee participating in a restricted stock plan was able to defer the payment of tax at least until the restrictions lapsed if the stock restrictions had a "significant effect on value." The courts have been quite liberal in their determination as to which restrictions met this criterion.[48] Section 83 has radically changed the underlying premise of the restricted stock area. Under section 83, the major requirement for tax deferral is that the stock must be subject to a "substantial risk of forfeiture."[49] John S. Nolan, Deputy Assistant Secretary for Tax Policy, in reference to the drafting of section 83, said that "the principal interpretative problem is the meaning of the phrase 'substantial risk of forfeiture.' "[50]

The proposed regulations attempt to define substantial risk of forfeiture in the following manner:

> [T]he rights of a person in property are subject to a substantial risk of forfeiture if such person's rights to full enjoyment of such property are conditioned upon the future performance, or the

[45] *See* J.K. Downer, 48 T.C. 86 (1967).

[46] INT. REV. CODE OF 1954, § 421.

[47] INT. REV. CODE of 1954, § 83(e); Proposed Treas. Reg. § 1.83-7, 36 Fed. Reg. 10,793 (1971).

[48] *See* Ira Hirsch, 51 T.C. 121 (1968).

[49] INT. REV. CODE OF 1954, § 83(a)(1).

[50] Speech by John S. Nolan, *supra* note 33.

refraining from the performance, of substantial services by any individual.[51]

Examples of restrictions which appear to fulfill the requirements are: (*1*) a substantial covenant not to compete,[52] (*2*) a requirement that stock be returned if the employee fails to complete an additional period of service,[53] or (*3*) situations in which the employer can compel the employee to return the stock.[54] Examples of restrictions which do not appear to meet the guidelines provided by the proposed regulations are: (*1*) prohibitions on the sale of the stock for a term of years,[55] (*2*) a requirement that the stock be returned to the employer if the employee commits a crime,[56] and (*3*) a covenant not to compete which is designed primarily for the purpose of tax avoidance.[57]

The shift in focus from restrictions which have a significant effect on value to those which entail a substantial risk of forfeiture has had the effect of making tax deferral by restricted stock plans dependent upon the performance or nonperformance of substantial services rather than upon the depressed value of the stock. It is the performance or nonperformance of employee services which must be substantial and not the possibility that the restrictions will not be met.[58]

Although section 83 is silent on the definition of "substantial risk of forfeiture," the proposed regulations give the phrase a narrow definition which does not fully reflect the intent of Congress.[59] Both the House and Senate Committee Reports, after stating that a substantial risk of forfeiture will be dependent upon the future performance of substantial services, conceded that, "in other cases, the question of whether there is a substantial risk of

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[51] Proposed Treas. Reg. § 1.83-3(c)(1), 36 Fed. Reg. 10,790-91 (1971).

[52] Factors to be taken into account are: (*1*) the age of the employee, (*2*) the availability of alternative employment opportunities, (*3*) the likelihood of the employee's obtaining such other employment, (*4*) the degree of skill possessed by the employee, (*5*) the employee's health, and (*6*) the practice of the employer to enforce such convenants. *Id.*

[53] Proposed Treas. Reg. § 1.83-3(c)(1), 36 Fed. Reg. 10,790-91 (1971); *House Hearings* 5205.

[54] *See* SENATE COMM. ON FINANCE, 91ST CONG., 1ST SESS., TAX REFORM ACT OF 1969: COMPILATION OF DECISIONS REACHED IN EXECUTIVE SESSION 14 (Comm. Print 1969) (Press Release, Oct. 14, 1969).

[55] *See* HOUSE REPORT, pt. 2, at 62; Proposed Treas. Reg. § 1.83-3(c)(1), 36 Fed. Reg. 10,790-91 (1971).

[56] *See id.*

[57] *See* note 52 *supra. See also* notes 66-68 *infra.*

[58] *See* Kopple, *Proposed Regulations on Section 83: An Analysis of the Remaining Possibilities,* 35 J. TAX. 130, 133 (1971).

[59] Proposed Treas. Reg. § 1.83-3(c)(1), 36 Fed. Reg. 10,790-91 (1971).

forfeiture *depends upon the facts and circumstances.*"[60] However, by limiting the situations in which there is a substantial risk of forfeiture to the examples contained in the proposed regulations, the proposed regulations[61] have been too narrow in their interpretation of congressional intent. The evidence of congressional intent in this controversial area does undercut the notion that the proposed regulation's definition is to be exclusive.[62]

A restriction subjecting an employee's stock to a substantial risk of forfeiture does not defer the employee's tax under section 83 unless the stock is also nontransferable. The Code provides that income is realized at "the first time the rights of the person having the beneficial interest in such property are *transferable*[63] or are not subject to a substantial risk of forfeiture, whichever occurs earlier."[64] The section continues: "The rights of a person in property are transferable only if the rights in such property of any transferee are not subject to a substantial risk of forfeiture."[65] Therefore, although the employee may be able to transfer the stock, it is nevertheless considered nontransferable, and accordingly nontaxable, if subject in the hands of the transferee to an obligation by the employee to perform substantial services.[66]

If an employer wants to enable an employee to defer taxation, the restriction creating a substantial risk of forfeiture must be stated on the stock certificate.[67] Unless noted conspicuously on the security, a restriction on transfer imposed by the employer, even though otherwise lawful, is ineffective except against a person with actual knowledge of its existence.[68] Therefore, unless the third party has sufficient notice of the restriction, the employee realizes income when the stock is initially transferred to him by the employer even though in his hands it is subject to a substantial risk of forfeiture.

It is important to analyze the relationship between the con-

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[60] HOUSE REPORT, pt. 1, at 88 (emphasis added); *see* SENATE REPORT 121.

[61] *See* Proposed Treas. Reg. § 1.83-3 (c)(1), 36 Fed. Reg. 10,790-91 (1971).

[62] It appears safe to say that the substantial risk of forfeiture requirement has two elements: (*1*) a substantial risk that the "triggering" event will occur, and (2) the likelihood that upon the occurrence of that event, the diminution of the employee's rights in the stock will be sufficiently detrimental to constitute a forfeiture. *See* Blake, *supra* note 26, at 1289.

[63] INT. REV. CODE OF 1954, § 83(a)(1) (emphasis added).

[64] *Id.*

[65] *Id.* § 83(c)(2).

[66] *See* Vernava, *"Cash Now"—The Attractions of Current Compensation After the Tax Reform Act,* 17 WAYNE L. REV. 1055, 1075 (1971).

[67] *See* Field, *Payments in Restricted Property: Recent Developments,* N.Y.U. 30TH INST. ON FED. TAX. 385, 402-03 (1972).

[68] *See* UNIFORM COMMERCIAL CODE § 8-204; SENATE REPORT 122.

cepts of transferability and substantial risk of forfeiture. In a practical sense there is only one relevant criterion.[69] By definition, property is transferable only if not forfeitable.[70] Therefore, if stock is not subject to a substantial risk of forfeiture, it is included in income immediately and transferability is irrelevant.[71] On the other hand, if the stock is subject to a substantial risk of forfeiture, it is not included in income until the restriction lapses since by definition the stock is nontransferable. The key to tax deferral under section 83 is the "substantial risk of forfeiture" restriction.

B. *Realization of Income*

Section 83 provides that income is realized by the employee in the taxable year in which the transfer becomes "complete."[72] The proposed regulations provide that a transfer becomes complete when the employee's rights in the stock cease to be subject to a substantial risk of forfeiture or become transferable, whichever occurs earlier.[73] At that time, the employee realizes ordinary income equal to the difference between the fair market value at the date of completion and the consideration given.[74] The fair market value of the stock is determined without regard to any restriction except one which by its terms will never lapse.[75] When computing the fair market value for the purpose of income realization, the employee is unable to take into consideration restrictions which depress the value of stock unless they conform with the transferability, substantial risk of forfeiture, or nonlapse requirements of section 83.

1. *At Date of Transfer—No Restrictions*

In the traditional bargain purchase, the basic situation involving income realization under section 83, stock is transferred to the employee for less than the fair market value without accompanying restrictions. The lack of restrictions causes the employee to realize income immediately upon the transfer of the stock; at that time the transfer is complete. For example, *X* corporation sells to *E*, an

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[69] *See* Halpern, *The Unexpected Impact of New Section 83—The Restricted Property Provisions*, 24 TAX LAW. 365, 367 (1971).

[70] INT. REV. CODE OF 1954, § 83(c)(2).

[71] *See* Sobeloff, *supra* note 22, at 1053-54.

[72] Proposed Treas. Reg. § 1.83-1(a)(2), 36 Fed. Reg. 10,788-89 (1971).

[73] *Id.* § 1.83-3(b).

[74] *Id.* § 1.83-1.

[75] INT. REV. CODE OF 1954, § 83(a)(1); Proposed Treas. Reg. § 1.83-1(a)(1), 36 Fed. Reg. 10,788 (1971); HOUSE REPORT, pt. 1, at 86-88; *see* notes 97-109 and accompanying text *infra*.

employee, 100 shares of *X* corporation stock for $10 per share. At the time of sale the fair market value of the *X* corporation stock is $50 per share. Under terms of the sale, the stock is subject to no restrictions. Since *E*'s stock is transferable and not subject to a substantial risk of forfeiture, the transfer is complete and *E* includes in his gross income as compensation for the taxable year $4,000 (100 shares of *X* corporation stock × $50 fair market value per share less $10 price paid by *E* per share).

2. *At Date of Transfer—No Qualified*[76] *Restrictions*

Stock may be transferred to an employee subject to restrictions which do not qualify under section 83 for tax deferral.[77] In such situations considerable controversy has arisen regarding the manner in which the stock is valued for purposes of income realization. For example, *X* corporation sells to *E*, an employee, 100 shares of *X* corporation stock for $10 per share. Under terms of the sale, shares of the stock may not be sold for 5 years. At the time of sale the fair market value of the stock, ignoring the 5-year restriction on sale, is $100 per share, while the fair market value of the stock with the 5-year restriction is only $50 per share. Because the 5-year restriction on sale does not subject the stock to a substantial risk of forfeiture,[78] the transfer is complete at the time of sale, and *E* includes in his gross income as compensation for the taxable year $9,000 (100 shares of *X* corporation stock × $100 fair market value per share, determined without regard to the 5-year restriction on sale, less $10 price paid by *E* per share). Of the $9,000 included by *E* in his gross income for the taxable year, $5,000 ($100 fair market value per share, determined without regard to the 5-year restriction on sale, less $50 fair market value per share, determined with regard to restriction, × 100 shares) has not actually been realized by *E* since the stock is not yet worth $100 per share to him.

3. *At Date Qualified Restrictions Lapse*

Under section 83, the date qualified restrictions lapse on transferred stock is the most likely time for realizing ordinary income. At that time the transfer becomes complete, and the employee includes in his gross income for the taxable year the

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[76] The term "nonqualified restriction" is used in this Article to refer to a restriction which is neither nontransferable, nor subject to a substantial risk of forfeiture, nor nonlapsable as required by § 83 in order to obtain income tax deferral.

[77] For example, such restrictions might include a prohibition on sale for a term of years.

[78] *See* HOUSE REPORT, pt. 1, at 86-87.

difference between the fair market value at the date of completion and the value of the consideration given.[79] As always under section 83, fair market value is determined without regard to any restrictions except those which by their terms never lapse.[80] For example, on February 1, 1973, *X* corporation sells to *E*, an employee, 100 shares of *X* corporation stock for $10 per share. Under terms of the sale, shares of the stock cannot be sold for 10 years and are subject to the restriction that if *E*'s employment is terminated before February 1, 1979, the stock is forfeited to the corporation. The latter restriction, but not the former, is a substantial risk of forfeiture as defined by section 83[81] and its proposed regulations.[82] Evidence of the two restrictions is stamped on the face of *E*'s stock certificates, thus making the stock nontransferable[83] as defined by section 83[84] and its proposed regulations.[85] The restriction on sale lapses February 1, 1983.[86] At the time of sale to *E*, the fair market value of the stock without regard to the 10-year restriction on sale is $100 per share and the fair market value with regard to the 10-year restriction on sale is $25 per share. On February 1, 1979, the employment restriction lapses; the transfer is complete;[87] and it is now taxable at that time under section 83. The fair market value without regard to the restriction on sale is $300 per share and the fair market value with the restriction on sale is $200 per share. At this time *E* includes in his gross income for the taxable year $29,000 (100 shares of *X* corporation stock × $300 fair market value per share, determined without regard to the restriction on sale, less $10 price paid by *E* per share). Therefore, of the $29,000 *E* includes in his gross income for the taxable year, $10,000 ($300 fair market value, determined without regard to the restriction on sale, less $200 fair market value, determined with regard to the restriction on sale, × 100 shares) has not yet actually been realized

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[79] Proposed Treas. Reg. § 1.83-1(a), 36 Fed. Reg. 10,788-89 (1971).

[80] INT. REV. CODE OF 1954, § 83(a)(1); *see* notes 75-76 *supra*.

[81] INT. REV. CODE OF 1954, § 83(c)(1).

[82] Proposed Treas. Reg. § 1.83-3(c), 36 Fed. Reg. 10,790-91 (1971).

[83] The term "nontransferable" is used in this Article to indicate that a transferee has knowledge of substantial risk of forfeiture restrictions placed on transferred stock.

[84] INT. REV. CODE OF 1954, § 83(c)(2).

[85] *See* Proposed Treas. Reg. § 1.83-1(d), 36 Fed. Reg. 10,790-91 (1971).

[86] *Id.* § 1.83-8(a)(2). Such a procedure serves to fulfill notice requirements to those who purchase from the employee and allows the employer to take advantage of the substantial risk of forfeiture provision.

[87] The transfer is complete because the ten-year restriction on sale does not qualify as a § 83 substantial risk of forfeiture restriction. *See* note 55 *supra*.

by *E* because the stock cannot be sold for another four years and is thus not yet worth $300 per share to *E*.

4. *At Date Stock with Qualified Restriction Is Sold at Arm's Length*

The employee may choose to sell his restricted stock at arm's length to a third party prior to the time when the restrictions lapse and the transfer becomes complete. At the time of the arm's-length sale, the employee, for the taxable year, includes in his gross income as compensation the excess of the amount realized on the sale over his basis in the stock.[88] The employee's basis is equal to the amount originally paid for the stock.[89] For example, on February 1, 1973, *X* corporation sells to *E*, an employee, 100 shares of *X* corporation stock for $10 per share. Under terms of the sale, the stock is nontransferable and subject to a substantial risk of forfeiture, both of which lapse on February 1, 1978. At the time of sale the fair market value of the stock, determined without regard to the restriction, is $100 per share. On February 1, 1975, *E* sells his 100 shares of *X* corporation stock to *T*, a third party, in an arm's-length transaction for $200 per share, the stock's fair market value at time of sale, determined with regard to the restriction. At this time *E* includes in his gross income as compensation for the taxable year $19,000 (100 shares of *X* corporation stock × $200 amount realized per share less $10 price paid per share by *E*). The timing of income realization in such a situation is equitable because it is at the time of sale at arm's length that *E* realizes the fruits of his bargain purchase and transfers his stock rights to *T*. If the stock is forfeited at a later date, it is *T*, not *E*, who sustains the loss.[90]

5. *At Date Stock with Qualified Restriction Is Sold at Other than Arm's Length*

The employee may decide to dispose of his restricted stock in a nonarm's-length transaction. For example, the employee might dispose of the stock to members of his family for a consideration

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[88] Proposed Treas. Reg. § 1.83-1(b), 36 Fed. Reg. 10,789 (1971).

[89] *Id.* § 1.83-4(b).

[90] In such a case, *T* is entitled to a capital loss if the stock is a capital asset in his hands. *Id.* *T*'s basis is determined under § 1012 and is ordinarily his cost. *See* INT. REV. CODE OF 1954, § 1012; Proposed Treas. Reg. §§ 1.83-4(b)(2), 1.83-1(b), 36 Fed. Reg. 10,792 (1971). *T*'s holding period begins on the date of his purchase. *Id.* § 1.83-4(a). For example, on June 1, 1975, the stock is forfeited. At this time *T*'s holding period is four months and he incurs a short-term capital loss of $20,000 (100 shares *X* corporation stock x $200 price *T* paid per share). *See* INT. REV. CODE OF 1954, § 1222(2).

less than the fair market value, or for no consideration at all. In these situations the employee includes in his gross income for the taxable year in which the disposition occurs the value of the money or other property received for the restricted stock.[91] The proposed regulations limit this amount by providing that the amount included in the employee's gross income not exceed the fair market value at the time of disposition, determined without regard to the restriction, less the price originally paid for the stock.[92] For example, on February 1, 1973, *X* corporation sells to *E*, an employee, 100 shares of *X* corporation stock for $75 per share. Under terms of the sale, the stock is nontransferable and subject to a substantial risk of forfeiture, both of which lapse on February 1, 1978. At the time of sale the fair market value of the stock, determined without regard to the restrictions, is $100 per share. In April 1973 (the stock still having a fair market value of $100 per share), *E* disposes of the 100 shares to *S*, his son, in a nonarm's-length transaction for $30 per share. At this time *E* includes in his gross income as compensation for the taxable year $2,500 (100 shares of *X* corporation stock × $25 per share) even though he received $3,000 (100 shares of *X* corporation stock × $30 per share) from *S*. *E*'s taxable income is limited to $2,500 by the proposed regulations which provide that *E*'s income not exceed the fair market value at time of disposition, determined without regard to the restrictions, less the price originally paid by *E* ($100 fair market value per share, determined without regard to the restrictions, less $75 originally paid per share × 100 shares of *X* corporation stock).[93]

The Treasury's rationale for providing a limitation on the amount to be included in gross income apparently is that the amount *E* realizes as ordinary income in a nonarm's-length transaction should not be allowed to exceed the amount he would have realized if the restrictions had lapsed or the stock had been sold at arm's length. Such a rationale is fair in situations where the stock has increased in value by the time the lapse occurs, because this will result in *E* including in his gross income the amount which had previously been deferred by the limitation. *E*'s basis at the time the transfer becomes complete is the amount *E* paid for the restricted stock plus the amount *E* included in his gross income at the time of the nonarm's-length transaction ($7,500 plus $2,500

[91] Proposed Treas. Reg. § 1.83-1(c), 36 Fed. Reg. 10,789 (1971).
[92] *Id.*
[93] *Id.*

equals a $10,000 basis).[94] Therefore, in the situation where the stock has increased in value between time of disposition to *S* and time of lapse, *E* is taxed on the $500 which he did not include in his gross income at the time of disposition, since this amount is not included in *E*'s $10,000 basis.[95] For example, on February 1, 1978, the restrictions on *E*'s stock lapse and the fair market value is $300 per share. At this time *E* realizes as ordinary income $20,000, this being equal to $30,000 (100 shares of *X* corporation stock × $300 fair market value per share at the time of the restrictions lapse) less $7,500 (100 shares of *X* corporation stock × $75 per share original cost to *E*) less $2,500 (amount realized by *E* upon the nonarm's-length transfer to *S*). If, however, the stock had decreased in value between the time of disposition to *S* and the time of lapse to the point that *E* has no additional income upon lapse, the $500 deferred by limitation loses its ordinary income form forever. Any income or loss occurring after completion of the transfer is realized as a capital gain or loss.[96] For example, assume that on February 1, 1978, when the restrictions on *E*'s stock lapse, the fair market value is $100 per share. At this time *E* realizes no additional ordinary income because the stock's fair market value and *E*'s basis in the stock are both $10,000.

6. *At Date Restriction Which Will Never Lapse Is Cancelled*

The one restriction which affects the restricted stock's fair market value for the purpose of determining the amount of income to be included in an employee's gross income upon realization is a restriction "which by its terms will never lapse."[97] The proposed regulations define a nonlapse restriction as:

> *1*) A limitation on the subsequent transfer of property transferred in connection with the performance of services.
> *2*) Which allows the transferee of the property to sell such property at a price determined under a formula, and
> *3*) Which will continue to apply to, and to be enforced against any subsequent holder (other than the transferor).[98]

Thus, if stock is subject to a restriction whereby the stock may only be sold at a formula price as long as the stock remains outstanding, whether owned by the employee or his transferee, the stock is

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[94] *Id.*
[95] *Id.*
[96] *See* INT. REV. CODE OF 1954, §§ 1221-22; notes 121 and accompanying text *infra.*
[97] *Id.* § 83(a)(1).
[98] Proposed Treas. Reg. § 1.83-5(a), 36 Fed. Reg. 10,792 (1971).

deemed to be subject to a nonlapse restriction and is valued at its formula price for income realization purposes.[99] The proposed regulations provide that a formula price based on book value or a reasonable multiple of earnings will ordinarily qualify the stock for nonlapse treatment.[100] In situations where the above conditions are met, the stock's fair market value for income realization purposes is its formula price unless the Commissioner can establish that another price is more representative of the stock's value.[101] For example, on February 1, 1973, *X* corporation sells to *E*, an employee, 100 shares of *X* corporation stock for $10 per share. Under terms of the sale, the stock can only be disposed of by resale to *X* at the stock's then existing book value. The stock is subject to *no* other restriction. At the time of sale to *E* the fair market value of the stock without regard to the restriction is $100 per share, while with regard to the restriction the value (based on the formula price) is $50 per share. Under these circumstances, the only restriction that the *X* corporation stock is subject to is nonlapse. Consequently, the transfer being complete, the fair market value of the *X* corporation stock less the consideration paid by *E* is includible in *E*'s gross income for the taxable year. However, when determining the fair market value of the *X* corporation stock, the book value formula price of $50 per share is used, rather than the $100 per share fair market value, determined without regard to the nonlapse restriction. Therefore, *E* includes in his gross income for the taxable year only $4,000 (100 shares of *X* corporation stock × $50 per share fair market value, determined by the formula price, less $10 per share consideration paid by *E*). Thus, in the case of the nonlapse restriction the taxpayer is allowed to limit his income realization to the actual value he receives, rather than being compelled to ignore, as in the case of nonqualified restrictions, the effect that the restrictions have on the value of the stock.[102]

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[99] Formula pricing is a method whereby the price at which the stock can be sold is calculated by a predetermined formula, such as a multiple of the employer's earnings.

[100] Proposed Treas. Reg. § 1.83-5(b), 36 Fed. Reg. 10,792 (1971).

[101] *Id.* § 1.83-5(b):

> [T]he price determined under the formula price shall be deemed to be the fair market value of the property unless established to the contrary by the Commissioner, and the burden of proof shall be on the Commissioner with respect to such value.

[102] As a further example, assume the same facts as in the example above except that the stock is *also* subject to a substantial risk of forfeiture which does not lapse until February 1, 1978. Due to the addition of the substantial risk of forfeiture, the transfer is not complete on February 1, 1973, and thus, no income is realized at that time. On February 1, 1978, the substantial risk of forfeiture lapses at a time when the stock's fair market value, without regard to the nonlapse restriction, is $300 per share and $250 per share with regard to the

The rationale for affording stock subject to a nonlapse restriction advantageous treatment is that Congress felt that a recipient of such stock has an inherent limitation on his property rights which should be reflected in his income.[103] Furthermore, Congress felt that a nonlapse restriction is not tax motivated and should be distinguished from restrictions designed to achieve tax deferral.[104]

Although section 83 is silent on possible restrictions which qualify as nonlapse, the proposed regulations include two examples: (*1*) when the formula price is based upon book value, and (*2*) when the formula price is based upon a reasonable multiple of earnings.[105] When considered in light of the House and Senate comments on the subject, the Treasury's examples cannot be considered all-inclusive.[106] Unlike the Treasury, the House Report does not hinge the formula price upon book value or a reasonable multiple of earnings; rather, it portrays the nonlapse restrictions as an arrangement whereby the employee must sell back the stock to the employer at a *formula price.*[107] The Treasury's examples should also be compared with the Senate's illustration of the nonlapse restriction as an arrangement whereby the employee must sell back the stock to the employer at book value or at *some other reasonable price.*[108] It remains to be seen what other restrictive devices the Treasury will deem to be qualified for nonlapse treatment. The proposed regulations do provide examples of arrangements that the Treasury has decided do not qualify for nonlapse treatment: (*1*) situations in which transferred stock is subject to registration requirements imposed by federal or state securities law, or similar legislation affecting sales or dispositions of stock, (*2*) situations in which transferred stock is encumbered with an obligation to resell such stock to the employee at its fair market value at the time of such sale, or (*3*) situations which result in the stock being subject to a substantial risk of forfeiture.[109]

Section 83 provides that in the event a nonlapse restriction is cancelled, the taxpayer realizes as compensation in the taxable year in which the cancellation occurs:

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nonlapse restriction. At this time, *E* includes in his gross income as compensation for the taxable year $24,000 (100 shares *X* corporation stock x $250 per share fair market value determined by formula price less $10 per share consideration paid by *E*).

[103] *See* HOUSE REPORT, pt. 1, at 88; SENATE REPORT 121.

[104] *Id.*

[105] Proposed Treas. Reg. § 1.83-5(b), 36 Fed. Reg. 10,792 (1971).

[106] *See* HOUSE REPORT, pt. 1, at 88; SENATE REPORT 121.

[107] *See* HOUSE REPORT, pt. 1, at 88.

[108] *See* SENATE REPORT 121.

[109] Proposed Treas. Reg. § 1.83-5(a), 36 Fed. Reg. 10,792 (1971).

> [T]he excess of the fair market value of the property (computed without regard to the restrictions) at the time of cancellation over the sum of—
> (C) the fair market value of such property (computed by taking the restriction into account) immediately before the cancellation, and
> (D) the amount, if any, paid for the cancellation.[110]

For example, on February 1, 1973, *X* corporation sells to *E*, an employee, 100 shares of *X* corporation stock for $10 per share. Under terms of the sale, the stock can only be disposed of by resale to *X* at the stock's then existing book value. The stock is also subject to a substantial risk of forfeiture which lapses on February 1, 1978. At the time of sale to *E* the fair market value of the stock without regard to *any* restriction is $100 per share, while with regard *only* to the restriction on resale, the value (based on the formula price) is $50 per share. Under these circumstances, the stock is subject to a nonlapse restriction. Since the stock is also subject to a substantial risk of forfeiture, *E* realizes no income as compensation in the year of transfer. On March 1, 1975, *X* corporation cancels the nonlapse restriction for consideration paid by *E* of $10 per share. The fair market value of the *X* corporation stock before cancellation of the nonlapse restriction, determined without regard to the substantial risk of forfeiture, is $150 per share. After cancellation of the nonlapse restriction the fair market value of the *X* corporation stock, determined also without regard to the substantial risk of forfeiture, is $200 per share. At this time *E* includes in his gross income as compensation for the taxable year $4000 (100 shares of *X* corporation stock × $50 per share increase in the fair market value due to cancellation of the nonlapse restriction less $10 per share consideration paid for the cancellation).

Section 83 further provides that income realization upon the cancellation of a nonlapse restriction may be avoided if the taxpayer establishes:

> (A) [T]hat such cancellation was not compensatory, and
> (B) [T]hat the person, if any, who would be allowed a deduction if the cancellation were treated as compensatory, will treat the transaction as not compensatory.[111]

With regard to subsection (B), the Code provides that the employee must establish, in the manner prescribed by the regulations, that the employer (or whoever else may be entitled to the deduction) will not take a deduction upon cancellation of the

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[110] INT. REV. CODE OF 1954, § 83(d)(2).
[111] *Id.*

nonlapse restriction.[112] The proposed regulations provide that in order to establish this fact the employee must obtain from the party entitled to a deduction a written statement indicating that such party will not treat the cancellation as a compensatory event, and that no deduction will be taken with respect to the cancellation.[113] In addition, the employee must file the written statement with his income tax return for the taxable year in which the cancellation occurred.[114]

With regard to subsection (A), the proposed regulations provide that whether or not there has been a noncompensatory cancellation of a nonlapse restriction depends upon the particular facts and circumstances of each case; however, the mere fact that the employer is willing to forego a deduction is insufficient evidence to establish that a cancellation is noncompensatory.[115] In addition, the proposed regulations provide that ordinarily the fact that the employee is required to perform additional services or that the employee's salary is adjusted to take the cancellation into account will be an indication that that cancellation has a compensatory purpose.[116] Furthermore, the fact that the original purpose of the cancellation no longer exists may well be an indication that the purpose of the cancellation is noncompensatory.[117] For example, the proposed regulations provide that when a so-called "buy-sell" restriction is imposed on a corporation's stock for the purpose of limiting ownership and then is cancelled in connection with the public offering of the stock, the cancellation will ordinarily be regarded as noncompensatory.[118] It remains to be seen what other situations will qualify for noncompensatory treatment. However, it seems reasonable to conclude that cancellations due to legitimate business needs, such as public issuances or reorganizations, will so qualify.[119]

Another nonlapse restriction that merits analysis is the situation in which the employee purchases stock from his employer subject to the requirement that if the stock is ever resold, it must be sold to the employer for its book value at the time of resale. Section 83 is not explicit on the employee's tax treatment at time of sale; however, it does appear that even if the stock is sold at a price

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[112] *Id.*

[113] Proposed Treas. Reg. § 1.83-5(c)(2), 36 Fed. Reg. 10,792 (1971).

[114] *Id.*

[115] *Id.* § 1.83-5(c)(1).

[116] *Id.*

[117] *Id.*

[118] *Id.*

[119] *Cf. id.*

above purchase price, the income realized receives capital gains rather than ordinary income treatment.[120] In addition, the Code does not provide for treatment upon resale of the difference between the amount originally paid for the stock and its formula value at the time of the original purchase; therefore, one presumes that this amount will also receive capital gains treatment upon resale.[121] For example, on February 1, 1973, *X* corporation sells to *E*, an employee, 100 shares of *X* corporation stock for $50 per share. Under terms of the sale, the stock can only be disposed of by resale to *X* at the stock's then existing book value. The stock is subject to *no* other restriction. At the time of sale to *E* the fair market value of the stock without regard to the restriction on resale is $100 per share while the fair market value with regard to the restriction (based on formula price) is $50 per share—also the price *E* originally paid for the stock. Under these circumstances, the stock is subject to a nonlapse restriction. Since the price *E* originally paid for the stock was equal at that time to its formula price, *E* does not realize any income as compensation in the taxable year that the sale occurred. On March 1, 1975, *E* resells the stock to *X* at its then book value formula price of $200 per share. Presumably, at this time *E* realizes a long-term capital gain of $15,000 (100 shares of *X* corporation stock × $200 per share amount realized on sale less $50 per share consideration paid by *E*). *E*'s income receives capital gains rather than ordinary income treatment because section 83 only provides for ordinary income treatment in situations where a nonlapse restriction is cancelled. In this example, there is *no* cancellation; *E* is thus able to avoid ordinary income treatment on the appreciation in value between the time of purchase and time of sale. It remains to be seen whether the courts and the Treasury will so interpret such arrangements. Indeed, such an interpretation would be inconsistent with section 83's treatment, in similar situations, of stock subject to nonqualifying restrictions. It is not, however, inconsistent with the section's purpose; for as long as tax avoidance schemes are excluded from the definition of the nonlapse restriction, there is no reason why the above arrangement should be treated differently from the usual investment situation, in which an investor enjoys capital gains treatment on the gain or loss realized upon the open market purchase and sale of stock.[122]

[120] *Cf.* INT. REV. CODE OF 1954, § 83.

[121] *See id.* §§ 1221-22; Cordes, *supra* note 6, at 82.

[122] The arrangement described above, modified to provide that the employee must resell his stock to the corporation upon termination of his employment at its then book value formula price, is of significant value to the close corporation which desires to retain control over the future ownership of its shares. In such a situation, the close corporation can sell

7. *At Date Stock Is Sold After Transfer Is Complete*

After qualified restrictions have either lapsed or been cancelled and income has been realized in accordance with section 83, transferred stock is no longer subject to the section, and no additional income will be realized until the stock is sold. At this time, if the stock is a capital asset in the hands of the taxpayer, the gain or loss upon sale will receive capital gains treatment. Whether the capital gain or loss will be short- or long-term depends on the length of the taxpayer's holding period,[123] which begins upon the transfer's completion.[124] At the time of sale the taxpayer realizes as capital gain or loss the difference between his adjusted basis in the stock and its fair market value at the time of disposition.[125] For example, on February 1, 1973, *X* corporation sells to *E*, an employee, 100 shares of *X* corporation stock for $10 per share. Under terms of the sale the stock is nontransferable and subject to a substantial risk of forfeiture, both of which lapse on February 1, 1978. At the time of sale the fair market value of the *X* corporation stock, determined without regard to the restriction, is $100 per share. On February 1, 1978, the restrictions lapse when the fair market value of the stock is $300 per share. At this time *E* includes in his gross income as compensation for the taxable year $29,000 (100 shares of *X* corporation stock × $300 amount realized per share less $10 price paid per share by *E*). *E* continues to own the stock until March 1, 1983, when he sells it to a third party for its fair market value on the date of sale of $500 per share. At this time *E* realizes a long-term capital gain (*E*'s holding period began on February 1, 1978, the date the transfer became complete, and is in excess of the required 6 months on March 1, 1983, the date of the sale to the third party) of $20,000 (100 shares of *X* corporation stock × $500 per share less *E*'s adjusted basis of $30,000).[126]

stock to an employee at its approximate fair market value (based on book value), lock the stock away for safekeeping, and then upon the employee's termination or retirement exercise its right to repurchase the stock at its appreciated fair market value (based on book value). The end result is that the employee receives what amounts to a cash bonus upon his termination, taxed at capital gain rates. However, the employee is still subject to the ordinary risks that go along with stock investments, *i.e.*, whether the stock will increase or decrease in value. *See* Sobeloff, *supra* note 22, at 1052-53.

[123] Holding periods in excess of six months are long-term and those of six months or less are short-term. INT. REV. CODE OF 1954, § 1222.

[124] Proposed Treas. Reg. § 1.83-4(a), 36 Fed. Reg. 10,792 (1971).

[125] The proposed regulations provide that the taxpayer's adjusted basis is determined by totalling his cost and any income already realized as compensation due to the lapse of restrictions on cancellation. *Id.* § 1.83-4(b).

[126] *E*'s adjusted basis is determined as follows: 100 shares *X* corporation stock x $10 per share paid by *E* plus $29,000 realized by *E* as compensation in 1978 upon lapse of the restriction.

In the situation where a gain is realized upon the sale of previously restricted stock such tax treatment is reasonable. But such is arguably not the case where there is a loss. For example, assume the same facts as appear in the above example except that on March 1, 1983, the stock is sold to a third party for its then fair market value of $150 per share. At this time *E* realizes as a long-term capital loss $15,000 (100 shares of *X* corporation stock × $150 per share less *E*'s adjusted basis of $30,000). The inequity in this situation is evidenced by the fact that prior to sale, as a result of the restrictions' lapse, *E* realized as compensation subject to the progressive tax rates $29,000; whereas his eventual $15,000 loss upon sale is subject to the less attractive capital loss treatment.[127] The rationale behind this treatment is nowhere discussed by the Treasury or Congress.

8. *At Date of Forfeiture After Transfer Is Complete*

Although section 83 is silent on the tax treatment of forfeitures which occur after a completed transfer, the proposed regulations treat such forfeitures as capital losses whenever the stock is a capital asset in the hands of the taxpayer.[128] Such an event can occur in only two situations: (*1*) when property subject to a substantial risk of forfeiture becomes transferable free of such restriction, that is, when third parties do not have notice of the restriction, or (*2*) when the risk of forfeiture ceases to be substantial, the transfer thus being complete, and the stock is still subject to another risk of forfeiture which does not qualify for section 83 treatment.[129] In such situations, the taxpayer may be subject to disadvantageous tax treatment; for upon completion of the transfer prior to the forfeiture, the taxpayer, in that taxable year, is taxed at ordinary income tax rates on any gain then existing, whereas upon its subsequent forfeiture the taxpayer's loss is only allowed less advantageous capital loss treatment on the amount that had previously been taxed at ordinary income rates. For example, on February 1, 1973, *X* corporation sells to *E*, an employee, 100 shares of *X* corporation stock for $10 per share. Under terms of the sale, the stock is nontransferable and subject to a substantial risk of forfeiture, both of which lapse on February 1, 1978. In addition, the stock is subject to the restriction that *E* will forfeit the stock if *X* corporation does

[127] *See* INT. REV. CODE OF 1954, §§ 1211(b), 1212(b).

[128] Proposed Treas. Reg. § 1.83-1(a), 36 Fed. Reg. 10,788 (1971).

[129] *See* Kopple, *Proposed Regs. on Section 83: How They Treat Dispositions; Employer's Consequences*, 35 J. TAX. 310 (1971).

not average a profit of $5 per share over the next six years, ending December 31, 1979. The latter restriction, not being "conditioned upon the future performance of substantial services,"[130] does not comply with the requirements of section 83, as interpreted by the proposed regulations, and does not qualify the stock for tax deferral under the section. At the time of sale the fair market value of the *X* corporation stock, determined without regard to any restriction, is $100 per share. On February 1, 1978, the restrictions of transferability and substantial risk of forfeiture lapse; the transfer becomes complete. At the time of lapse the fair market value of the stock, determined without regard to the nonqualifying restriction based on future earnings, is $200 per share. At this time *E* includes in his gross income for the taxable year $19,000 (100 shares of *X* corporation stock × $200 fair market value, determined without regard to the nonqualified restriction, less $10 per share paid by *E*). On December 31, 1979, *X* corporation reports that it did not average a profit of $5 per share for the prior 6 years, and as a result *E* forfeits his stock. At this time *E* takes a long-term capital loss[131] of $20,000 (this being *E*'s adjusted basis consisting of 100 shares of *X* corporation stock × $10 per share price paid by *E* plus $19,000 included in *E*'s gross income in 1978 when the transfer became complete).

In effect, *E* is only being allowed a long-term capital loss deduction for the $19,000 upon which he previously paid tax at ordinary income tax rates. However, there is no statutory authority providing that such a forfeiture be treated as a "sale or exchange"[132] of stock subject to capital loss treatment. Furthermore, there is some question as to whether case law supports such a conclusion. In *Leh v. Commissioner,*[133] and *Commissioner v. Pittston Co.,*[134] it was held that the forfeiture of contractual rights does not

[130] INT. REV. CODE OF 1954, § 83(c)(1).

[131] *E*'s holding period began on February 1, 1978, the date § 83 restrictions lapsed and is thus in excess of six months on December 31, 1979, the date of forfeiture.

[132] INT. REV. CODE OF 1954, §§ 1221-22.

[133] 260 F.2d 489 (9th Cir. 1958). In *Leh,* a partnership in which the taxpayers were members was party to a contract with an oil company. The contract gave the partnership the right to purchase, up to a stated maximum, its gasoline requirements. The court held that when the contract was mutually terminated by an agreement releasing the oil company from its obligation to furnish gasoline in exchange for a stated consideration, there was no "sale or exchange" of assets by the partnership. Thus, the consideration received for termination of the contract was taxable as ordinary income rather than as capital gains.

[134] 252 F.2d 344 (2d Cir. 1958). In *Pittston,* it was held that the cancellation of a taxpayer's exclusive right to purchase a coal company's entire coal output in exchange for payment of $500,000 by the coal company did not constitute a "sale or exchange." The amount was to be treated as ordinary income rather than long-term capital gains.

constitute a "sale or exchange"; therefore, ordinary income rather than capital gains or loss treatment is warranted.[135] A more equitable result would be to allow the employee, upon forfeiture, a section 165(c)[136] ordinary "trade or business" deduction to the extent of ordinary income previously included in his gross income when the transfer became complete, and a capital loss deduction equal to the amount originally paid for the stock.[137] Such an approach would separate the investment portion, which should be subject to capital treatment, from the previously realized income portion, which should receive ordinary income treatment.

9. *At Date of Employee's Death*

If an employee dies in possession of restricted stock, subject to a substantial risk of forfeiture and nontransferable, two possible situations may arise: (*1*) the stock remains subject to its restrictions, or (*2*) the restrictions lapse.

In the situation where the stock remains subject to its restrictions, the transfer is incomplete, and no tax is paid by either the decedent, his estate, or his beneficiaries. Although section 83 is silent on this point, the proposed regulations[138] provide that income subsequently realized from such restricted stock is income "in respect of a decedent" to which the rules of section 691[139] apply. Section 691 provides that such income is included in the beneficiary's gross income for the taxable year in which received.[140] Section 83's proposed regulations further qualify this by providing that such income must also be taxed in accordance with section 83 and the regulations thereunder.[141] Presumably, the intent is to treat the stock in the hands of the beneficiaries in the identical manner that it would have been treated in the hands of the employee had he not died. For example, on February 1, 1973, *X* corporation sells to *E*, an employee, 100 shares of *X* corporation stock for $10 per share. Under terms of the sale, the stock is nontransferable and subject to a substantial risk of forfeiture, both of which lapse on February 1, 1978. At the time of sale the fair

[135] *But see* Commissioner v. Ferrer, 304 F.2d 125 (2d Cir. 1962).

[136] INT. REV. CODE OF 1954, § 165(c).

[137] *See* Rev. Rul. 67-48, 1967-1 CUM. BULL. 50. In that ruling an amount paid by a taxpayer as liquidated damages to a former employer for breach of an employment contract was held to qualify as a business loss under § 165(c) of the Code because such amount was attributable to compensation received and reported for services rendered.

[138] Proposed Treas. Reg. § 1.83-1(d), 36 Fed. Reg. 10,789 (1971).

[139] INT. REV. CODE OF 1954, § 691.

[140] *Id.* § 691(a)(1).

[141] Proposed Treas. Reg. § 1.83-1(d), 36 Fed. Reg. 10,789 (1971).

market value of the stock, determined without regard to the restrictions, is $100 per share. *E* dies on February 15, 1975, when the stock's fair market value, determined without regard to the restrictions, is $150 per share. At this time the stock is still subject to qualified restrictions, the transfer is not complete, and no income is realized. Through *E*'s last will and testament sale rights are transferred to *B*, *E*'s beneficiary. On February 1, 1978, when the fair market value of the stock is $200 per share and *B* still has sale ownership rights, the restrictions lapse and the transfer becomes complete. At this time *B* includes in his gross income $19,000 (100 shares of *X* corporation stock × $200 fair market value per share less $10 price paid by *E* per share). On February 1, 1979, *B* sells his stock for its fair market value of $250 per share. At this time *B* realizes a long-term[142] capital gain of $5,000 (100 shares of *X* corporation stock × $250 per share less *B*'s adjusted basis of $20,000 which is comprised of $19,000 previously realized by *B* as compensation plus $1000 price originally paid for the stock by *E*).

Section 83 is silent on the latter situation where the employee's death causes the qualified restrictions to lapse and the transfer to become complete. The proposed regulations, however, provide that any income so realized is not section 691 income with respect to a decedent and is to be included as gross income in the decedent's final tax return.[143] For example, on February 1, 1973, *X* corporation sells to *E*, an employee, 100 shares of *X* corporation stock for $10 per share. Under terms of the sale, the stock is nontransferable and subject to a substantial risk of forfeiture, both of which lapse on February 1, 1978; however, an additional term provides that in the event of *E*'s death prior to February 1, 1978, the restrictions lapse and the transfer becomes complete. At the time of sale the fair market value of the stock, determined without regard to the restrictions, is $100 per share. On February 15, 1975, when the fair market value of the stock is $150 per share, *E* dies. Under terms of the sale, the restrictions lapse, and the transfer becomes complete. *E*'s executor includes in the gross income of *E*'s final return $14,000 (100 shares of *X* corporation stock × $150 per share less $10 price paid by *E* per share).

The treatment provided by section 83's proposed regulations for restrictions which do not lapse upon the employee's death

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[142] *B*'s holding period began on February 1, 1978, when the transfer became complete and thus is in excess of six months.

[143] Proposed Treas. Reg. § 1.83-1(d), 36 Fed. Reg. 10,789 (1971).

differs from the normal inheritance situation in which the beneficiaries assume ownership of the inherited property on a stepped-up basis—ordinarily the actual fair market value at the date of the decedent's death—without later having to realize income upon the difference between the decedent's basis and the fair market value at the date of death.[144] For example, in the two hypotheticals discussed immediately above, the fair market value, determined without regard to the restrictions, at the date of *E*'s death was $150 per share; in the normal inheritance situation this would be *B*'s basis in the stock, and *B* would not be taxable on the difference between *E*'s basis of $10 paid per share and the value at *E*'s death of $150 per share.[145] Under section 83 and its proposed regulations, upon lapse of the restrictions, *B* includes in his gross income $140 per share ($150 fair market value at date of death less $10 per share paid by *E*) which he would not have to include in the normal inheritance situation. Neither section 83 nor the congressional statements relating to the section provide any rationale for the position taken by the proposed regulations in regard to the tax treatment of transfers upon death. However, this position is consistent with the section 691 provisions which prevent compensation from escaping taxation at ordinary tax rates by means of death or inheritance.[146] It remains to be seen how the courts will treat the proposed regulations if they are promulgated in their present form.

10. *At Date of Transfer in the Event of an Election*

Under section 83, an employee may elect to include in his gross income for the taxable year in which restricted stock is transferred to him by his employer the difference between

> (A) the fair market value of such property at the time of transfer (determined without regard to any restriction other than a restriction which by its terms will never lapse), over
> (B) the amount (if any) paid for such property.[147]

In addition, section 83 provides that in the event of an election, section 83(a) does not apply to the transfer. The proposed regulations provide that any subsequent appreciation in the value

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[144] INT. REV. CODE OF 1954, § 1014.
[145] *Id.*
[146] *Id.* § 691.
[147] *Id.* § 83(b)(1).

of the stock between the date of transfer and the date of completion is taxed as a capital gain.[148]

The election is a voluntary, affirmative action enabling an employee to disregard transferred stock's restrictions and realize ordinary income before the transfer is complete. Upon later disposition, any subsequent appreciation is subject to the more attractive capital gains rates.[149] In order to qualify for such treatment, the employee must file a written statement with the IRS not later than thirty days after the stock is transferred by the employer.[150] For example, on February 1, 1973, *X* corporation sells to *E*, an employee, 100 shares of *X* corporation stock for $10 per share. Under terms of the sale, the stock is nontransferable and subject to a substantial risk of forfeiture, both of which lapse on February 1, 1978. At the time of sale the fair market value of the *X* corporation stock, determined without regard to the restrictions, is $100 per share. Within 30 days of the transfer, *E* files a statement with the IRS opting to make an election. *E* then includes in his gross income for the taxable year $9,000 (100 shares of *X* corporation stock × $100 per share fair market value, determined without regard to the restrictions, less $10 per share price paid by *E*). *E* realizes ordinary income at the time of transfer even though the stock is still nontransferable and is still subject to a substantial risk of forfeiture. If not for the election, *E* would not have realized ordinary income at the time of transfer, but would have had to wait until the restrictions lapsed, at which point the fair market value of the stock would have been $250 per share. If not for the prior election, *E* would then have realized as ordinary income $24,000 (100 shares of *X* corporation stock × $250 per share fair market value less $10 per share price paid by *E*). However, since *E* has made an election, the lapse of the restrictions on February 1, 1978, is not a taxable event. On March 1, 1979, *E* disposes of the stock for its current fair market value of $300. At this time *E* realizes as a long-term capital gain $20,000. *E*'s gain is long-term because his holding period is in excess of six months. The proposed regulations provide that in the case of an election, the holding period begins on the date of transfer from the employer—in this example February 1, 1973.[151] By means of an election, *E* realizes substantial

[148] Proposed Treas. Reg. § 1.83-2(a), 36 Fed. Reg. 10,789 (1971).

[149] *Id.*

[150] INT. REV. CODE OF 1954, § 83(b)(2); Proposed Treas. Reg. §§ 1.83-2(b)-(c), 36 Fed. Reg. 10,790 (1971).

[151] Proposed Treas. Reg. § 1.83-4(a), 36 Fed. Reg. 10,792 (1971).

tax savings by receiving capital gains rather than ordinary income treatment on the appreciation between the date of transfer and the date of completion.

The apparent attractiveness of an election is substantially reduced by section 83(b)(1), which provides that in the event of a forfeiture subsequent to an election, no deduction will be allowed for the loss sustained. The proposed regulations lighten the effect of section 83(b)(1) by providing that if elected property is later forfeited or sold at arm's length before the transfer becomes complete, such forfeiture or sale will be treated as a disposition upon which there is a capital loss of the difference between:

> (1) The amount that the taxpayer actually paid for such property, over
> (2) The amount realized (if any) upon such forfeiture or sale.[152]

In effect, the proposed regulations allow the taxpayer to recoup his out-of-pocket investment, but prohibit him from taking a deduction for the amount he previously realized as ordinary income. For example, assume the same facts as in the hypothetical immediately above, except that on January 1, 1978, one month prior to the date that the restrictions lapse and the transfer becomes complete, *E*'s employment with *X* corporation is terminated and his restricted stock forfeited. At this time *E* incurs a long-term capital loss of $1,000 (100 shares of *X* corporation stock × $10 per share price paid by *E*). Thus, after realizing $9,000 as ordinary income upon election, *E* is only allowed a $1,000 long-term capital loss deduction upon the subsequent forfeiture. Likewise, if *E*'s employment had not been terminated on January 1, 1978, and instead, *E* had sold the stock for its fair market value, determined with regard to the restriction, of $10 per share (the stock's original cost to *E*), he would not have a deductible loss and would once again be unable to offset the $9,000 previously included in his gross income as a result of the election.

The election is a risk which should not be opted for lightly. The major advantage of an election is that a taxpayer may be able to increase capital gains while decreasing ordinary income. In addition, the taxpayer's holding period is increased in the case of an election. The holding period begins on the date the stock is transferred from the employer to the employee rather than on the date at which the transfer becomes complete. An increased holding period may result in the realization of a long-term capital gain

[152] *Id.* § 1.83-2(a), 36 Fed. Reg. at 10,790.

upon sale of the stock rather than a less advantageous short-term capital gain.

The major disadvantage of an election is that if a subsequent loss from sale or forfeiture ensues, the taxpayer is only allowed to recoup his out-of-pocket investment. In addition, the taxpayer is not allowed a deduction for the amount previously realized upon election as ordinary income, even though this amount was nothing more than a "paper" gain.

Once an employee has made an election, he may find it difficult to revoke. Section 83, as interpreted by the proposed regulations, provides that an election may not be revoked except with the consent of the Commissioner.[153] However, neither section 83 nor its proposed regulations give the taxpayer any clue as to what rationale the Commissioner will use for granting consent. The proposed regulations do indicate that a decline in the stock's value or the failure to perform an act contemplated at the time of transfer will not alone constitute grounds for revocation.[154] It remains to be seen what the Commissioner will consider a valid reason for revocation. Such a dilemma makes it all the more risky for a taxpayer to make an election at this time.[155]

The election provision was not a part of the House version of section 83;[156] however, it was inserted by the Senate Finance Committee[157] "[t]o add flexibility."[158] Unfortunately, by allowing

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[153] INT. REV. CODE of 1954, § 83(b)(2).

[154] Proposed Treas. Reg. § 1.83-2(f), 36 Fed. Reg. 10,790 (1971).

[155] There are a number of factors which the possessor of restricted stock should take into consideration when determining whether or not to make an election. *See* Blake, *supra* note 26, at 1303-04. One practical factor to consider is whether sufficient cash is available to pay the amount of tax that will shortly become due as the result of the election. Naturally, the taxpayer should not make an election if he is currently unable to meet the resulting tax obligation. Another consideration that a taxpayer must weigh is the probable likelihood that a forfeiture or decrease in stock value will occur in the future. In either event, the taxpayer will find himself limited to recouping his out-of-pocket investment in the form of a capital loss. In addition, the taxpayer should consider the relationship between his probable future earnings and the tax ramifications of making an election. Since most taxpayers are unable to make realistic estimates as to the outcome of most of these factors, one concludes that an election is closely akin to a gamble. The most attractive situation in which to make an election is one in which the difference between the purchase price and the fair market value of the stock is small. In such a situation, the taxpayer has little to lose upon a forfeiture or decrease in value since the amount he previously realized upon election is slight as a result of the small difference between the purchase price and the fair market value at the time of purchase. In the case of a forfeiture or a decrease in value, the taxpayer is still able to recoup his out-of-pocket investment as a capital loss. In addition, if there is no forfeiture and the stock increases in value, upon sale, the taxpayer realizes a capital gain rather than ordinary income.

[156] *See* HOUSE REPORT, pt. 1, at 86.

[157] *See* SENATE REPORT 123.

[158] *See id.*

the taxpayer to take a chance on transforming ordinary income into capital gain, the election provision allows an unwarranted gamble which serves no rational purpose. The election provision unnecessarily complicates the section and may result in dissatisfaction among taxpayers who unwisely elect or fail to elect. Congress should delete it; the Code should not be used to encourage gambling. Provisions of the Code should enable a taxpayer to make intelligent tax decisions after careful analysis of reasonably ascertainable factors. This the election provision fails to do.

11. *At Date of a Tax-Free Exchange*

As an amendment to section 83, as proposed by the House bill,[159] the Senate Finance Committee included a provision for application of the tax-free exchange sections of the Code in the context of section 83.[160] Section 83 provides that in situations where qualified restricted stock subject to section 83 is exchanged for stock subject to substantially similar restrictions and conditions, the exchange is not a taxable event and the stock received in the exchange is to be treated as qualified restricted stock to which section 83 applies.[161] The exchange first has to qualify for tax-free treatment under the applicable Code sections.[162] For example, on February 1, 1973, *X* corporation sells to *E*, an employee, 100 shares of *X* corporation nonvoting common stock for $10 per share. Under terms of the sale, the nonvoting common stock is nontransferable and subject to a substantial risk of forfeiture, both of which lapse on February 1, 1978. At the time of sale the fair market value of the *X* corporation nonvoting common stock, determined without regard to the restrictions, is $100 per share. On February 1, 1975, *X* corporation exchanges with *E* 100 shares of *X* corporation voting stock for the 100 shares of *X* corporation nonvoting common stock which *E* has been holding.[163] The stock *E* receives from *X* corporation in the exchange is also nontransferable and subject to a substantial risk of forfeiture, both of which lapse on February 1, 1978. At the time of exchange the fair market value of the *X*

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[159] *See* HOUSE REPORT, pt. 1, at 86.

[160] *See* SENATE REPORT 123.

[161] INT. REV. CODE OF 1954, § 83(g).

[162] *Id.* Section 354 of the Code provides for tax-free exchange treatment in situations involving exchanges of stock and securities in certain types of reorganizations; § 355 provides for such treatment in situations involving the distribution of stock and securities of a controlled corporation; and § 1036 provides for such treatment in situations involving the exchange of stock for a similar class of stock of the same company.

[163] Such an exchange qualifies as a tax-free exchange. Treas. Reg. § 1.1036-1(a) (1962).

corporation stock given up by *E*, determined without regard to the restrictions, is $225 per share and the fair market value of the *X* corporation stock received by *E*, determined without regard to the restrictions, is also $225 per share. Section 1036 of the Code, in conjunction with section 83, provides that such a transaction is a tax-free exchange in which *E* is not to be taxed, at the time of exchange, on the nonvoting common stock's appreciation between the date of purchase and the date of exchange. As provided by section 1031(d), *E*'s basis in the stock received is the same as that of the stock given up, $10 per share—the price originally paid by *E*. On February 1, 1978, the restrictions lapse, and the transfer becomes complete. At this time the fair market value of *E*'s stock is $350 per share, and *E* includes in his gross income $34,000 (100 shares of *X* corporation stock × $350 fair market value less $10 per share—*E*'s basis in the exchanged stock).

Another amendment to section 83 by the Senate Finance Committee[164] included a provision that the exchange of restricted stock not covered by section 83, because of receipt prior to the section's July 1, 1969, effective date,[165] for stock covered by section 83 and subject to substantially the same restrictions, if otherwise qualified for the tax-free exchange provisions of the Code, is a nontaxable event. In addition, the stock received in such an exchange does not become covered by the restricted property rules of section 83.[166] Thus, in essence, section 83 provides that a taxpayer need not worry about losing advantageous pre-section 83 restricted stock treatment as a result of a tax-free exchange, so long as the stock received is subject to substantially the same restrictions as the stock given up.

C. *Valuation of Restricted Stock for Purpose of Realizing Income*

When nonqualified restricted stock[167] is transferred to an employee, the amount of ordinary income he realizes is the excess of the fair market value of the stock at the date of transfer, determined without regard to any restrictions other than those which will never lapse, over the amount paid for the stock.[168] When qualified restricted stock is transferred to an employee, no

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164 *See* SENATE REPORT 124.
165 INT. REV. CODE OF 1954, § 83(i).
166 *Id.* § 83(i)(5).
167 *See* note 76 *supra.*
168 INT. REV. CODE OF 1954, § 83(a).

income is realized; but when the transfer becomes complete, the amount of ordinary income realized is the excess of the fair market value of the stock at the date of completion, determined without regard to any restrictions other than those which will never lapse, over the amount paid for the stock.[169] Nonqualified restrictions, such as restrictions on sale for a term of years, are at all times disregarded when determining fair market value for the purpose of calculating the amount of ordinary income to be realized. This is true even if the nonqualified restriction has a significant effect on value.[170] When completed, a transfer of stock subject to such a nonqualified restriction results in inclusion in gross income of the difference between the amount paid for the stock by the employee and the fair market value of the stock determined *without* regard to the nonqualified restriction. A restriction on sale for a term of years, which is nonqualified, unquestionably has a significant effect on the stock's value. However, disregard of this restriction results in inclusion in the employee's ordinary income of an amount which has not yet been realized.

Another situation in which the section 83 stock valuation problem arises is that of the investment letter restriction. This restriction existed prior to the adoption of section 83 and is currently a part of SEC Rule 144.[171] Effective April 15, 1972, Rule 144 now affords the only practicable means by which holders of unregistered securities, as is very often the situation under an employer-employee restricted stock plan, can sell such securities in a traded market. In order to do so, the issuer must comply with the reporting requirements of the Securities Exchange Act of 1934, the holder must have owned the securities for two years, and sales must be made in limited quantities and in normal broker's transactions.[172] Rule 144 provides that the two-year holding period cannot begin until "the full purchase price or *other consideration shall have been paid or given.*"[173] Therefore, a section 83 restriction based on future performance of substantial service will prevent the Rule 144 holding period from running until the transfer becomes complete. When the transfer is completed, the holder realizes as

[169] *Id.*

[170] *See* HOUSE REPORT, pt. 1, at 61-62.

[171] SEC Rule 144.

[172] *Id.*

[173] Emphasis added. SEC Rule 144(d)(1) provides that the

person for whose account the securities are sold shall have been the beneficial owner of the securities for a period of at least two years prior to the sale and, if the securities were purchased, the full purchase price or other consideration shall have been paid or given at least two years prior to the sale.

ordinary income the difference between the amount paid for the stock and its fair market value, determined without regard to the investment letter restriction. For example, on February 1, 1973, *X* corporation sells to *E*, an employee, 100 shares of unregistered stock subject to an investment letter restriction for $10 per share. Under terms of the sale, the shares are nontransferable and are subject to a substantial risk of forfeiture, both of which lapse on February 1, 1978. On February 1, 1978, when the transferability and the substantial risk of forfeiture restrictions lapse, the transfer becomes complete. The fair market value of the stock, determined *without* regard to the investment letter restriction, is $200 per share, while *with* regard to the investment letter restriction the fair market value is $125 per share. At this time *E* includes in his gross income $19,000 (100 shares of *X* corporation unregistered stock × $200 per share fair market value, determined without regard to the investment letter restriction, less $10 per share paid by *E*). Because *E* cannot sell the unregistered stock until February 1, 1980, when he will have satisfied Rule 144's two-year holding period, the stock's actual fair market value at the date of income realization is $125 per share. Of the $19,000 *E* included in his gross income at the transfer's completion, $7,500 (100 shares of *X* corporation unregistered stock × $200 per share fair market value, determined without regard to the investment letter restriction, less $125 per share fair market value, determined with regard to the restriction) has not actually been realized by *E*. Once again, the valuation rules of section 83 force the employee to include in his tax return more income than he has actually realized.

Prior to the enactment of section 83, the law provided that investment letter stock was to be valued at a discount for income tax purposes. In *Hirsch v. Commissioner*,[174] the Tax Court held that investment letter restrictions had a substantial effect on the value of stock options within the meaning of Treasury Regulation 1.421-6(d)(2)(i),[175] thus deferring income recognition until the restriction lapsed. Prior to the enactment of section 83, SEC restrictions were considered sufficient not only to limit the amount to be included in gross income, but also to defer all income until the restrictions lapsed.

In this light, let us examine the legislative history of section 83's treatment of the investment letter restriction. The Treasury's proposal for tax reform recommended that both the investment

[174] 51 T.C. 121 (1968).

[175] Treas. Reg. § 1.421-6(d)(2) (1966).

letter and the nonlapsing restrictions should be considered when determining the value of restricted property for the purpose of income realization.[176] Both the House Ways and Means Committee and the Senate Finance Committee ignored the Treasury's recommendation and in their respective versions of section 83 provided that *only* a nonlapse restriction will affect a stock's fair market value for the purpose of income realization.[177] The Treasury, having no choice but to comply with the wishes of Congress, provided in the proposed regulations to section 83 that registration requirements imposed by federal or state securities laws do not qualify as either nonlapse or substantial risk of forfeiture restrictions,[178] with the result that the effect of the investment letter restriction is to be disregarded when determining the fair market value of investment letter stock for the purpose of income realization.

Section 83's disregard of the effect that such restrictions have on the value of stock in the income realization situation may be open to attack on constitutional grounds.[179] More specifically, section 83's conclusive presumption of a fictitious fair market value may be in violation of the sixteenth amendment of the Constitution. The United States Supreme Court, in *Eisner v. Macomber*,[180] established the principle that Congress, in accordance with the sixteenth amendment, may only impose a tax upon realized "income." In section 83, Congress, by ignoring for income realization purposes restrictions which have substantial effects on a stock's value, has imposed a tax upon income which has not yet actually been realized. The *Eisner* rationale applies with added force in restricted stock cases because the taxpayer, unlike the situation in *Eisner*, has not yet even received any value.[181]

In the case of an election, the taxpayer is again forced to include unrealized income in his gross income. However, in an election, the taxpayer may make a voluntary, affirmative choice and may be estopped from later claiming that his constitutional rights were violated.[182]

In essence, if section 83's valuation provisions are contested on

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[176] *See House Hearings* 5206.

[177] *See* HOUSE REPORT, pt. 1, at 86; SENATE REPORT 119.

[178] Proposed Treas. Reg. §§ 1.83-5(a), (d) (example (3)), 36 Fed. Reg. 10,792 (1971).

[179] *See generally*, Field, *supra* note 67, at 413-16; Sobeloff, *supra* note 22, at 1051.

[180] 252 U.S. 189 (1920).

[181] In *Eisner*, the taxpayers received a stock dividend which was not subject to any restriction.

[182] In Wilson v. United States, 376 F.2d 280 (Ct. Cl. 1967), an inequity contested by the taxpayer was held to be excluded from constitutional protection since it was self-imposed and not mandated by statute. *Id.* at 285-86.

constitutional grounds, the Supreme Court will have to decide whether that section is a reasonable method of handling the tax avoidance problems which existed prior to the enactment of section 83.[183] As pointed out by the Supreme Court in *Commissioner v. Glenshaw Glass Co.*,[184] the *Eisner* definition of income was not meant to provide a touchstone for all future gross income questions. It is likely that the Supreme Court would uphold section 83's valuation provisions as a necessary and reasonable means of preventing tax avoidance.

Even if the valuation provisions of section 83 are necessary to prevent tax avoidance, the section could be made more equitable to the taxpayer by broadening the proposed regulation's definition of "substantial risk of forfeiture" and amending section 83 so that investment letter restrictions receive the treatment now given to nonlapse restrictions. The investment letter restriction is not the type of restriction which is used for tax avoidance purposes. Section 83 should be amended to prevent undue taxation of unrealized income.

D. *Employer Deduction*

1. *Prior to Section 83*

Prior to the Tax Reform Act of 1969, and presently under section 83, an employer is allowed a deduction equal to the amount that an employee includes in his gross income as the result of a restricted stock plan. The employer takes the deduction in the taxable year in which the employee realizes ordinary income as a result of the restricted stock plan.[185]

Prior to the enactment of section 83, the employer was allowed a deduction equal to the *lesser* of the fair market value of the stock at the time of transfer, determined without regard to the restrictions, or the fair market value at the time the restrictions lapse, less any consideration paid by the employee.[186] The employer's deduc-

[183] Prior to § 83, employers would use the restricted stock plan because it was significantly more generous than the treatment specifically provided in the law for other types of similarly funded deferred compensation arrangements. Section 83 was enacted to equalize the treatment. *See* SENATE REPORT 120. If § 83 were not strict as to the requirements for tax deferral, the section's force would be greatly reduced by having to resort to Internal Revenue rulings and court cases to decide whether the almost limitless number of restriction variations tbat could be employed in this area would qualify the plan for tax deferral. The fear is that the exceptions would swallow the rule.

[184] 348 U.S. 426, 430-31 (1955).

[185] INT. REV. CODE OF 1954, § 83(h).

[186] *See* Treas. Reg. § 1.421-6 (1966).

tion, under prior law, could not increase above the difference between the fair market value of the stock at the time of transfer, determined without regard to the restrictions, less the consideration paid by the employee, even if the stock had appreciated in value by the time the restrictions had lapsed and the employee had realized income. On the other hand, under prior law, the employer's deduction could fall below the difference between fair market value of the stock at the time of transfer, determined without regard to the restrictions, and the consideration paid by the employee if the stock had decreased in value by the time the restrictions lapsed and the employee had realized income. For example, on February 1, 1973, *X* corporation sells to *E*, an employee, 100 shares of *X* corporation stock for $10 per share. The stock is subject to a restriction which has a significant effect on value[187] but which lapses on February 1, 1978. At the time of sale the fair market value of the *X* corporation stock, determined without regard to the restriction, is $100 per share. On February 1, 1978, when the fair market value of the stock is $200 per share, the restriction lapses. At this time *E* realizes as ordinary income $9,000 (100 shares of *X* corporation stock × $100 per share, the *lesser* of the fair market value at the time of transfer, determined without regard to the restriction, or the fair market value at the time the restriction lapses, less $10 per share paid by *E*). *X* corporation takes a $9,000 deduction in the taxable year in which *E* includes that amount in his gross income. Note that *E*, in the same circumstances under section 83, includes $19,000 (100 shares of *X* corporation stock × $200 fair market value at the time of lapse less $10 per share paid by *E*) in his gross income for the taxable year in which the restriction lapses. Under section 83, *X* corporation is allowed a $19,000 deduction (equal to the amount *E* includes in his gross income under section 83) rather than a $9,000 deduction as provided under prior law.[188]

2. *Under Section 83*

Under section 83, the employer is allowed a deduction equal to the difference between the fair market value of the stock at the

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[187] *Id.*

[188] As a further example, assume the same facts except that the fair market value of the stock at the time the restrictions lapse is $50 per share. At this time, under prior law *E* realizes as ordinary income $4,000 (100 shares *X* corporation stock × $50 per share, the *lesser* of the fair market value at the time of transfer, determined without regard to the restrictions, or the fair market value at the time the restrictions lapse, less $10 per share price paid by *E*). Also, at this time, *X* corporation takes a $4,000 deduction in the taxable year in which *E* includes that amount in his gross income. Under § 83 the result is the same.

time the restrictions lapse and the amount paid for the stock. Such a deduction is taken in the taxable year in which the restrictions lapse, and corresponds exactly to the amount the employee includes in his gross income in that taxable year.[189] For example, on February 1, 1973, *X* corporation sells to *E*, an employee, 100 shares of *X* corporation stock for $10 per share. The stock is subject to a substantial risk of forfeiture and is nontransferable—both restrictions lapse on February 1, 1978. At the time of sale the fair market value of the stock, determined without regard to the restrictions, is $100 per share. On February 1, 1978, the restrictions lapse, and the fair market value of the stock is $200 per share. At this time *E* realizes as ordinary income $19,000 (100 shares of *X* corporation stock × $200 per share less $10 per share paid by *E*). Under prior law, *E* only would have included $9,000 in his gross income at the time of lapse, and upon subsequent sale of the stock would have enjoyed capital gains treatment on the other $10,000 of appreciation. Under section 83, *X* corporation is allowed a $19,000 deduction in the taxable year in which *E* includes that amount in his gross income.

Under section 83, the employer is allowed greater deductions than he was allowed under prior law.[190] The prior law limits the amount that an employee realizes and an employer deducts to no more than the difference between the fair market value of the transferred stock at the date of transfer, determined without regard to the restrictions, and the consideration paid by the employee. This amount decreases if the fair market value of the stock decreases between the time of transfer and the time of completion; but it never increases even if the stock appreciates. Any appreciation receives capital gain treatment upon subsequent sale by the employee. At such time, the employer is not allowed a deduction for the appreciation since it is no longer considered compensation to the employee.[191]

Currently, section 83 provides that the amount included in an employee's gross income upon the lapse of restrictions and, correspondingly, the amount allowed as a deduction to the employer, is the difference between the fair market value at the time the restrictions lapse and any consideration paid by the employee.[192] Section 83, in contrast to the prior law, does not look to the *lesser* of the fair market value at the date the restrictions

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189 INT. REV. CODE OF 1954, § 83(h).
190 *See* Treas. Reg. § 1.421-6 (1966).
191 INT. REV. CODE OF 1954, §§ 1221-22.
192 *Id.* § 83(h).

lapse or the fair market value at the time of transfer. Rather, it looks only to the fair market value at the date the restrictions lapse. Any appreciation in value between the date of transfer and the date of completion is ordinary income in the hands of the employee, thus being a valid deduction for the employer. The result under section 83 is that an employer is very often able to take a larger deduction than would have been allowed under the prior law.

Section 83 makes an additional change. Under prior law, the employer was entitled to a deduction only if he transferred the restricted stock to the employee.[193] However, under section 83, an employer is allowed to take a deduction even if a shareholder, corporation, or some other person transfers the employer's restricted stock to the employee.[194] The Senate Finance Committee Report[195] and the proposed regulations[196] both provide that when a shareholder of the employer corporation or the parent company of the employer corporation transfers stock to an employee in consideration of services performed for the employer corporation, the transfer is a contribution of capital to the employer corporation by the person making the transfer. The parent company or shareholder merely treats the contribution as an increase in the equity of the employer corporation.

Section 83 and its proposed regulations[197] provide that the employer corporation is only allowed a deduction which meets the requirements of sections 162[198] or 212[199] and their regulations. In essence, so long as the employee is not unreasonably compensated for services rendered, the employer is allowed the full deduction to which it is entitled under section 83. Sometimes employees are reasonably compensated by their salary alone and the transfer of restricted stock to them is found to be unreasonable.[200] In such a

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[193] *See* Treas. Reg. § 1.421-6(f) (1966).

[194] INT. REV. CODE OF 1954, § 83(h); Proposed Treas. Reg. § 1.83-6(a)(d), 36 Fed. Reg. 10,793 (1971).

[195] SENATE REPORT 123-24.

[196] Proposed Treas. Reg. § 1.83-6(d), 36 Fed. Reg. 10,793 (1971).

[197] *Id.* § 1.83-6(a).

[198] INT. REV. CODE OF 1954, § 162.

[199] *Id.* § 212. Section 162 provides that deductions are allowed only for ordinary and necessary expenses paid during the taxable year in connection with carrying on a trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered. *Id.* § 162(a). Section 212 provides that in the case of an individual there is a deduction allowed for all ordinary and necessary expenses paid during the taxable year for production or collection of income. *Id.* § 212.

[200] *Cf.* Van's Chevrolet, Inc., 26 T.C.M. 809 (1967).

situation, the employer is not allowed to take a deduction for the amount of compensation that is deemed unreasonable.

Because the employer is allowed to take its deduction when the employee realizes ordinary income, an election results in an acceleration of the employee's income realization as well as the employer's deduction. However, in the case of an election, the employer is unable to take a deduction on any appreciation of the stock's value subsequent to the election. Such appreciation receives capital gains treatment in the hands of the employee and is therefore ineligible for the employer deduction.[201]

If a forfeiture occurs subsequent to the time that the employee has realized income and the employer has taken its deduction, the proposed regulations provide that the employer, in the taxable year in which the forfeiture occurs, must include in its gross income the excess of the fair market value of the stock at the time of the forfeiture over the amount paid (if any) to the employee upon the forfeiture. In addition, when the forfeited stock is returned to the employer corporation, the amount includible in the employer's gross income is limited to the amount of its previous deduction taken when the employee realized ordinary income from the restricted stock transaction.[202] For example, on February 1, 1973, *X* corporation sells to *E*, an employee, 100 shares of *X* corporation stock for $10 per share. Under terms of the sale, the stock is nontransferable and subject to a substantial risk of forfeiture, both of which lapse on February 1, 1978. At the time of sale the fair market value of the *X* corporation stock, determined without regard to the restrictions, is $100 per share. *E* makes an election and includes in his gross income for the taxable year $9,000 (100 shares of *X* corporation stock × $100 per share fair market value, determined without regard to the restrictions, less $10 per share price paid by *E*). At this time *X* corporation takes a $9,000 deduction—equal to the amount *E* included in his gross income as a result of the election. On January 1, 1978, one month prior to the date when the restrictions lapse and the transfer becomes complete, *E*'s employment with *X* corporation is terminated and *E* forfeits the restricted stock to *X*. At this time *E* incurs a long-term capital loss of $1,000 (100 shares of *X* corporation stock × $10 per share price paid by *E*). At the time of the forfeiture the fair market value of the *X* corporation stock is $200 per share. As a result of the forfeiture *X* corporation is required to

[201] INT. REV. CODE OF 1954, § 83(h).

[202] Proposed Treas. Reg. § 1.83-6(c), 36 Fed. Reg. 10,793 (1971).

include in its gross income $9,000 (100 shares of *X* corporation stock × $200 per share fair market value at the time of forfeiture, which is equal to $20,000, limited to the $9,000 deduction that *E* took at the time of *E*'s election). As a result of the forfeiture, the employer is put in the same position it would have been if it had never transferred stock to the employee. On the other hand, the employee has suffered a loss. The employee included $9,000 in his gross income upon election but is only allowed a $1,000 long-term capital loss upon forfeiture. Although an election is a voluntary, affirmative decision on the part of the employee, the difference in the treatment afforded the employee and employer is unwarranted.

Further inequity is found in the situation where the employee receives qualified restricted stock which does not have the restrictions stamped on the face of the stock certificates. In such a situation the transfer is complete and the employee includes in his gross income the difference between the fair market value at the time of transfer, determined without regard to the restrictions, and the price paid for the stock.[203] Subsequently, his employment is terminated before the restrictions lapse, and he forfeits the stock to his employer. At this time the employer includes in his gross income the excess of the fair market value of the stock at the time of forfeiture over the amount (if any) paid by the employer to the employee upon the forfeiture. However, this is limited to the amount the employer previously took as a deduction when the employee realized ordinary income as a result of the transfer's completion. As a result, the employer finds itself in the same position it would have been in had the entire transaction not taken place, but the employee is limited to a capital loss deduction equal to his adjusted basis in the stock.[204]

Neither the congressional committee reports[205] on section 83 nor section 83 itself provide any basis for the decision of the Treasury, in section 83's proposed regulations,[206] to treat the employer and employee so differently in the same situation.

A few commentators have hypothesized that an employer may be able to deduct from its gross income amounts which are paid to an employee prior to the time a transfer becomes complete as a dividend on the transferred restricted stock.[207] The basis for such a

[203] *See id.* § 1.83-3(a)(2) (Example (1)).

[204] *Id.* § 1.83-1(a).

[205] *See* HOUSE REPORT, pt. 1, at 86; SENATE REPORT 119.

[206] *See* Proposed Treas. Reg. § 1.83-6, 36 Fed. Reg. 10,793 (1971).

[207] *See Can Dividends on Restricted Stock be Deducted?*, 35 J. TAX. 63, 64 (1971); *Restricted Stock: Treating Dividends as Compensation*, 35 J. TAX. 264 (1971).

hypothesis stems from the fact that the proposed regulations provide that

> [u]ntil such transfer becomes complete, the transferor shall be regarded as the owner of such property, and any income from such property received by the employee . . . constitutes additional compensation and shall be included in the gross income of such employee . . . for the taxable year in which such income is received or such use is made available.[208]

An employer is allowed a deduction for restricted stock in the same year as its employee is deemed to have received compensation, and in an amount equal to the employee's compensation.[209] It follows that as the employee receives the dividends for the restricted stock, the employer is allowed a deduction as ordinary income. This proposition is further strengthened by the proposed regulations which provide that the employer is to be regarded as the owner of the restricted stock until the transfer becomes complete.[210] Whether the Treasury or the courts will adopt such a theory remains to be seen.

V

REVENUE EFFECT

Although section 83 does much to reform the restricted stock plan area, it is recognized by Congress that its effect on tax revenue is negligible.[211] Basically, section 83 merely shifts tax liability from the employer to the employee.[212] Under section 83, as compared to the results under the prior law, the employer's deduction increases as does the employee's ordinary income. Such an effect leads to a trade-off of tax liability between the employer and employee, which results in a negligible effect on tax revenue.

Section 83 should not be evaluated in terms of its effect on tax revenue, but rather in terms of its congressional purpose—to bring the tax treatment of restricted stock plans more in line with that afforded similar types of deferred compensation arrangements.[213]

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[208] Proposed Treas. Reg. § 1.83-1(a), 36 Fed. Reg. 10,789 (1971).

[209] *House Hearings* 5208.

[210] Proposed Treas. Reg. § 1.83-1(a), 36 Fed. Reg. 10,789 (1971).

[211] *See* HOUSE REPORT, pt. 1, at 89; SENATE REPORT 124.

[212] HOUSE REPORT, pt. 1, at 89; SENATE REPORT 124.

[213] HOUSE REPORT, pt. 1, at 86; SENATE REPORT 119-20. The overall theme of the Tax Reform Act of 1969 was expressed by President Nixon:

> Reform of our Federal income tax system is long overdue. Special preferences in the law permit far too many Americans to pay less than their fair share of taxes. Too many other Americans bear too much of the tax burden.
>
> This Administration, working with the Congress, is determined to bring equity

VI

ADVISABILITY OF RESTRICTED STOCK PLANS

At first glance, one would probably conclude that section 83 will greatly diminish future use of the restricted stock plan as a form of deferred compensation. Such a conclusion might be based on the fact that for the employee, section 83 has changed what was largely capital gains under prior law into ordinary income. However, in addition to section 83, the Tax Reform Act of 1969 included new section 1348.[214] This section provides that "earned income" is subject to a maximum tax rate of 50 percent[215] as compared to a 70 percent maximum rate[216] on income not qualifying as "earned income." Section 1348 includes in its definition of "earned income" income from deferred compensation plans which qualify for section 83 treatment and which is paid to the employee before the end of the taxable year following the first year in which the transfer becomes complete.[217] Thus, under normal circumstances, section 83 income is subject to a maximum tax rate of 50 percent.[218] The Tax Reform Act of 1969 further weakened the ultimate effect of section 83 by changing capital gains rates for long-term capital gains in excess of $50,000. While long-term capital gains of less than $50,000 are still subject to a maximum tax rate of 25 percent,[219] long-term capital gains in excess of $50,000 are now subject to a maximum tax rate of only 35 percent.[220] Taking into consideration the maximum tax rate of 50

> to the Federal tax system. Out goal is to take important first steps in tax reform legislation during this first session of Congress.

Message by President Richard M. Nixon to the Congress on April 21, 1969, 115 CONG. REC. 9685, 9827 (1969).

[214] INT. REV. CODE OF 1954, § 1348.

[215] *Id.*

[216] *Id.* § 1.

[217] *Id.* § 1348(b)(1).

[218] John S. Nolan had this to say about whether restricted stock is "earned income" for § 1348 purposes:

> Restricted property subject to the new section 83 should always qualify for the earned income rate limitations; by its nature it is deemed to have been received at the time it is treated as becoming nonforfeitable.

Speech by John S. Nolan, *supra* note 33. *But see* INT. REV. CODE OF 1954, § 1348(b)(1).

[219] INT. REV. CODE OF 1954, § 1201.

[220] *Id.* This is the result of the combined effect of the elimination of any ceiling rate on that one-half of net long-term gains which exceeds $50,000, and the maximum 70% rate on an individual's ordinary income. In addition, the new tax on items of tax preference may further weaken the effect of § 83 by taxing certain capital gains at an additional 10%. *See id.* §§ 57-58.

percent on section 83 "earned income" and the capital gains tax rate of 35 percent on long-term capital gains in excess of $50,000, the fact that section 83 has changed what was capital gain under prior law into ordinary income becomes less significant. Whereas prior to the Tax Reform Act of 1969, a taxpayer enjoyed a maximum 52 percent tax advantage by realizing long-term capital gains rather than ordinary income (77 percent maximum tax rate on ordinary income less 25 percent maximum tax rate on long-term capital gains), now a taxpayer may only enjoy a maximum 25 percent tax advantage in the same situation (50 percent maximum tax rate on "earned income" less 25 percent maximum tax rate on the first $50,000 of long-term capital gain) and only a 15 percent advantage for capital gains in excess of $50,000 (50 percent maximum tax rate on "earned income" less 35 percent maximum tax rate on long-term capital gains in excess of $50,000).

Thus, when section 83 is considered in conjunction with section 1348 and the new capital gains rates, although the recipient of restricted stock is in a less attractive position than prior to the Reform Act, the position is not so unattractive that restricted stock plans will be significantly curtailed. Any decision to cut back restricted plans will probably come as a result of employee requests for cash rather than restricted stock. Employees will be able to take advantage of the 50 percent maximum tax rate on cash payments made currently and may opt for such compensation in lieu of waiting until stock restrictions lapse in order to realize gains.

In addition, section 83 has made the restricted stock plan more attractive to employers than under the prior law. Under section 83, the employer will enjoy larger deductions from restricted stock than prior to the Reform Act, and they will still be able to retain favored employees, at least until the restricted stock becomes nonforfeitable.

As was the case prior to the Reform Act, restricted stock plans still enjoy several advantages not available to other forms of deferred compensation. The restricted stock plan is still useful in controlling the timing of income recognition. Such a result can be obtained by manipulating the date upon which the restrictions lapse and income is realized. In addition, the restricted stock plan still provides the employee with investment opportunities without the need for an immediate cash outlay. As a result, the employee has a chance for investment appreciation as well as security and equity with his employer. Finally, the restricted stock plan still enjoys the flexibility not available to qualified compensation plans.[221]

On the other hand, section 83 has made the restricted stock plan less attractive in several respects. Formerly, an employee could calculate, in advance of realization, the maximum amount of ordinary income that he would realize as a result of a restricted stock plan. Under section 83, this is no longer possible. The employee, except in the case of an election, is at all times prior to the completion of the transfer uncertain as to the amount of ordinary income he will realize. Another drawback to section 83 is that an employee may be compelled to include in his gross income amounts which have not yet been realized. In addition, an employee is limited to a capital loss deduction upon a forfeiture occurring after completion. Finally, section 83 may result in an employee having to include substantial amounts in his gross income before he has received any cash with which to pay the resulting tax.

The long-term effect that section 83 will have on restricted stock plans remains to be seen, but it is safe to say that the restricted stock plan will retain its place of prominence in the deferred compensation area.[222]

Conclusion

Although section 83 is a step in the right direction in the restricted stock plan area, many problems remain. The regulations proposed for section 83 have not been promulgated, which leaves interpretation and compliance with certain portions unclear. In addition, certain aspects of the proposed regulations, if promulgated as proposed, leave much to be desired. In providing interpretation of such areas as "substantial risk of forfeiture" and the amount and type of deduction allowed in the case of a forfeiture, the Treasury has overstepped its reach by providing regulations which bear no relation to the congressional intent of section 83.[223]

The decision of the Senate Finance Committee to include the

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[221] *See generally id.* §§ 421-25.

[222] *See generally* Blake, *supra* note 26, at 1273; Childs, *Compensating the Executive After the Tax Reform Act with Stock Options, Restricted Stock, Deferred Pay—and Even Cash,* 48 TAXES 801 (1970); Lewellen & Hettenhouse, *Impact of the Tax Reform Act on the After-Tax Cost of Executive Compensation,* 33 J. TAX. 240 (1970); Patton, *Top Executive Pay: New Facts and Figures,* 44 HARV. BUS. REV. 94, 97 (Sept.-Oct. 1966); Reichler, *The Impact of the Maximum Tax on Earned Income on Compensation Planning,* N.Y.U. 29TH INST. ON FED. TAX. 1321, 1333-35 (1971); Rice, *supra* note 7.

[223] *See generally* HOUSE REPORT, pt. 1, at 86; SENATE REPORT 119.

election provision[224] may constitute the section's major fault.[225] There is no logical reason why a taxpayer should be allowed to gamble in a tax situation. In addition, the election provision is a device that can be used to circumvent one of the major purposes of the section which is to transform the appreciation on restricted stock from capital gain to ordinary income.

One of the more controversial aspects of section 83 is that a taxpayer is compelled to include in his gross income amounts which have not yet actually been realized. Although a constitutional issue is certainly present, it is important to realize that without such treatment, the tax avoidance that existed in the restricted stock plan area prior to section 83 would resurface. It is likely that the Supreme Court, in light of the tax avoidance possibilities in this area, will deem the valuation provisions of section 83 to be reasonable. Finally, in regard to section 83's valuation problem, the singling out by Congress of the nonlapse restriction for special treatment, while at the same time ignoring other legitimate restrictions, has resulted in a serious inequity.[226]

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224 *See* notes 147-58 and accompanying text *supra.*

225 SENATE REPORT 123.

226 *See* notes 176-84 and accompanying text *supra.*