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NOTES

Deferred Compensation Arrangements Under Section 83 of the Internal Revenue Code: Is Restricted Property Still a Viable Means of Compensation?

When faced with the problem of compensating key executives, employers have tended to avoid the exclusive use of current cash compensation, since this would result in an immediate and substantial income tax to highly paid employees. Deferred compensation plans have been utilized in order to maximize tax benefits for employees, such as deferred recognition of income and capital gains treatment.[1] Although such plans are structured to meet the needs of the particular employer and employee, several forms of deferred compensation are common. Among these are qualified and unqualified pension, profit-sharing, and stock bonus plans; qualified, restricted,[2] and employee stock purchase plans (the so-called statutory stock options); nonstatutory stock options;[3] and the transfer of restricted property. This Note will be limited to an analysis of the new section 83[4] of the Internal Revenue Code, which was intended to eliminate the capricious variations in tax consequences that have accompanied the transfer of restricted property as compensation for over twenty-five years.[5]

Prior to the Tax Reform Act of 1969,[6] the rules respecting the receipt of restricted property were contained in the Treasury Regulations relating to the law of nonstatutory stock options;[7] the Code itself was silent on the point. The establishment of these rules was, in part, a response to the Tax Court's decision in *Robert Lehman.*[8] In that case petitioner was a partner in the firm of Lehman Brothers, which had received stock options that it 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

1. *See generally* Buchhelder, *Executive Compensation After the Tax Reform Act of 1969*, 48 TAXES 652 (1970); Kelsey & Buckheit, *The Impact of the Tax Reform Act of 1969 on Executive Compensation*, 4 IND. LEGAL F. 246 (1970).

2. INT. REV. CODE OF 1954, § 424(b) limits the availability of restricted stock options to plans or contracts adopted before January 1, 1964.

3. A "nonstatutory stock option" is an option which does not meet the statutory requirements of § 421(a), INT. REV. CODE OF 1954.

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

5. *See* HOUSE COMM. ON WAYS AND MEANS, 91ST CONG., 1ST SESS., TAX REFORM PROPOSALS 60 (Comm. Print. 1969) (statement of Assistant Secretary of the Treasury E.S. Cohen).

6. Pub. L. No. 91-172, 83 Stat. 487.

7. Treas. Reg. §§ 1.61-2(d)(5), 1.421-6(d)(2) (1966).

8. 17 T.C. 652 (1951). *Cf.* Commissioner v. LoBue, 351 U.S. 243 (1956); Commissioner v. Smith, 324 U.S. 177 (1945).

fair market value as a result of restrictions upon their sale.[9] 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 a long-term capital gain. Lehman reported his share of the gain as a partner of the firm. The Commissioner contended 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 the restrictions was not a taxable event[10] since there was no "sale or other disposition" of the stock under the predecessor of section 1001.[11] Furthermore, the entire gain upon sale of the stock was properly reported as long-term capital gain.[12] Thus the holding in *Lehman* favored the taxpayer both as to timing of income recognition and the type of income recognized.[13]

The Commissioner's initial acquiescence in *Lehman* was withdrawn[14] after the promulgation of the regulations to section 421.[15] Reflecting the Commissioner's objections to *Lehman*, the regulations provided that the lapse of the restrictions would be a taxable event producing ordinary income and that the later sale would be entitled to capital gains treatment.[16] In general, under the regulations, an individual who received property subject to restrictions having a significant effect on the property's value, whether he received the property as the result of a stock option[17] or as a direct payment from the employer,[18] was deemed to have realized ordinary income at the time the restrictions lapsed. The amount of income was the lower of the value of the property at the time he received it, computed as if the restrictions did not exist, or the value at the time the restrictions lapsed, in either case reduced by the amount the em-

9. 17 T.C. at 653. The 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. 17 T.C. at 653.

10. 17 T.C. at 654.

11. Int. Rev. Code of 1939, § 111. Conceptually, the court's view of the termination of restrictions seems analogous to the tax treatment of property on which a zoning restriction is removed. While there may be an immediate and substantial increase in the value of the property, there is no taxable event until sale or other disposition.

12. 17 T.C. at 654.

13. *Compare* 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).

14. 1962-2 CUM. BULL. 7, *withdrawing acquiescence in* 1952-1 CUM. BULL. 3 *and substituting nonacquiescence.*

15. T.D. 6416, 1959-2 CUM. BULL. 126.

16. *See* Treas. Reg. §§ 1.61-2(d)(5), 1.421-6(d) (1966).

17. Treas. Reg. § 1.421-6(d)(2) (1966).

18. Treas. § 1.61-2(d)(5) (1966). This provision applied generally to restricted property given in compensation, incorporating by reference the regulations under § 421

ployee had paid for the property.[19] This rule, by allowing date of receipt to set a ceiling on ordinary income, tended to maximize the capital gain element of restricted property.

To remedy this preferential tax treatment, and as part of a continuing effort to attain uniform treatment of property transferred in connection with the performance of services,[20] the Treasury Department in 1968 issued proposed regulations[21] which would have caused the recipient to include in gross income the excess of the fair market value over the cost on the date the restrictions lapsed, without any reference to the possible lower value when the property was received. The regulations were never promulgated[22] because the Tax Reform Act of 1969 in essence codified these proposed regulations in section 83 of the Code.

The genesis of the title of the new section is indicative of its fundamental purpose. Originally labeled "Restricted Property" in the House bill,[23] it was changed in the Senate bill to "Property Transferred in Connection with Performance of Services."[24] Although the provision is aimed at restricted property, it is drafted to provide, for the first time, an express Code section for compensation paid in kind, irrespective of any restrictions, and irrespective of whether received under a stock option, deferred compensation, or some alternative arrangement.

I. Tax Effect upon the Employee

Under section 83(a), a person who receives property either directly or through a beneficiary[25] in connection with the performance of services must include an amount in gross income when the rights of the person having the beneficial interest in such property are transferable *or* are not subject to a substantial risk of forfeiture, whichever comes earlier. Although the conditions for inclusion in income are written in the alternative, the statute expressly provides that property rights are "transferable" only if the rights of the

dealing with stock options. Future citations concerning previous law will be to the latter provisions alone.

19. Treas. Reg. § 1.421-6(d)(2)(i) (1966).

20. This attempt to achieve unified treatment is indicated by the Treasury Department's issuance of proposed regulations and amendments to regulations under Int. Rev. Code of 1954, §§ 61, 83, 162, 402(b), 403(c)-(d), 404(a)(5), 421, 721. *See* Proposed Treas. Reg., 33 Fed. Reg. 15870 (1968), *as corrected by* 34 Fed. Reg. 397 (1969), *withdrawn*, 36 Fed. Reg. 10787 (1971).

21. Proposed Treas. Reg. § 1.421-6(d), 33 Fed. Reg. 15870 (1968).

22. *See* 36 Fed. Reg. 10787 (1971).

23. H.R. 13270, 91st Cong., 1st Sess. § 321 (1969) (House Ways and Means Comm. version).

24. H.R. 13270, 91st Cong., 1st Sess. § 321 (1969) (Senate Finance Comm. version).

25. *See* text accompanying notes 54-55 *infra*.

transferee in such property are not subject to a substantial risk of forfeiture.[26] The statute further defines "substantial risk of forfeiture" as a conditioning of the rights of full enjoyment of property upon future performance of substantial services by any individual.[27] These definitional limitations diminish the independent significance of the term "transferability." Nevertheless, some independent significance remains. If property was given to an employee in a manner that would enable him to transfer it to a bona fide purchaser free of restriction to the transferee, then the tax arises the moment the employee receives the property, even though the property in the employee's hands is subject to a substantial risk of forfeiture.[28] However, if the restriction imposes upon the transferee a substantial risk of forfeiture conditioned upon the employee's continued services, then no tax would arise until the risk of forfeiture is lifted from either the employee or the transferee.

If a recipient disposes of property before "forfeitable" restrictions lapse in an arm's length transaction, realization will occur at the time of disposition.[29] In the case of a transfer of restricted property which is not at arm's length, the proposed regulations to section 83 indicate the probable tax treatment of this transaction.[30] The example given is employee *X*, pursuant to an option, purchasing restricted stock for $50, the fair market value in 1971 being $100. Later in the year, he sells the stock to his wife for $10. When the restrictions lapse in 1972, the fair market value of the stock is $120. *X* would recognize taxable gross income of $10 in 1971. In 1972, he recognizes taxable gross income of $60. This is computed by taking the fair market value ($120) less the amount paid ($50), less the amount already taxed ($10). In this case, the wife would still be subject to the restrictions on the property at the time of transfer, so this result is consistent with the definition of transferability in section 83(c)(2). If this transfer to the wife was a gift, *X* would not recognize any income in 1971, and would recognize $70 in 1972 when the restrictions lapsed ($120 fair market value less the $50 paid for the stock).

The amount included in gross income is the fair market value at the date such property must be included in gross income less any

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26. INT. REV. CODE OF 1954, § 83(c)(2).

27. INT. REV. CODE OF 1954, § 83(c)(1).

28. The Senate Report states that

> an interest in property is to be considered to be transferable only if a transferee would not be subject to forfeitability conditions—for example, where the employee has a forfeitable interest in stock, but the fact of forfeitability is not indicated on the stock certificate, and a transferee would have no notice of it.

S. REP. No. 91-552, 91st Cong., 1st Sess. 119, 122 (1969).

29. INT. REV. CODE OF 1954, § 83(a).

30. Proposed Treas. Reg. § 1.83-1(c), 36 Fed. Reg. 10789 (1971).

amount paid for the property.[31] "Fair market value" is determined without regard to the effect of any restrictions with the single exception that the effect of a restriction "which by its terms will never lapse" will be taken into account.[32] The reason for this exception is that Congress felt that this type of restriction was not tax-motivated and should be distinguished from restrictions designed to achieve deferral for tax-saving purposes.[33]

From the employee's perspective, the new provision is not as favorable as the rules under prior law. Under prior law the matter was dealt with in the regulations under sections 61(a)(1) and 421. These regulations provided that if property was transferred as compensation for services, and if the property was subject to a restriction which had a *significant effect on value,* nothing was included in income upon receipt of the property. If the employee continued to hold the property, realization was deferred until the restriction lapsed. The amount included at that time was the lesser of the fair market value of the property at the time of transfer without regard to the restriction, or the fair market value at the time of the lapse of the restriction, less the amount paid for the property.[34]

Revenue Ruling 68-86[35] and the pre-section 83 case of *Ira Hirsch*[36] made it clear that even a temporary restriction preventing sale or other disposition could be considered to have a significant effect on value. As a result there was an increase in the number of restricted stock plans under the previous regulations. These plans were attractive as an employee benefit because they permitted the employee to obtain the status of an investor, entitled to capital gain treatment on future appreciation beginning at the time of the transfer of the stock, and, in addition, permitted deferred recognition of income until he was free to sell the stock.

In contrast, although restrictions against sale had a significant effect on value under prior law, they would not be considered forfeitable under section 83(c)(1) of the Code since no future services are required as a condition of ownership. Deferral of recognition requires both restrictions on transferability and risk of forfeiture.[37] The new statute narrows the circumstances under which deferred recognition of compensation income will be permitted. In addition, when recognition is deferred, capital gains treatment for appreciation

31. INT. REV. CODE OF 1954, § 83(a).

32. INT. REV. CODE OF 1954, § 83(a)(1). *See also* S. REP. No. 91-552, *supra* note 28, at 121.

33. *See* H.R. REP. No. 91-413, 91st Cong., 1st Sess., pt. 1, at 86, 88 (1969); S. REP. No. 91-552, *supra* note 28, at 121.

34. Treas. Reg. § 1.421-6(d)(2) (1966).

35. 1968-1 CUM. BULL. 184.

36. 51 T.C. 121 (1968).

37. INT. REV. CODE OF 1954, § 83(a).

between the time of transfer of property and the lapse of restriction is eliminated.

As indicated by the Ways and Means Committee report, the purpose of section 83 was to eliminate the "more generous" tax treatment afforded the transfer of restricted property.[38] Congress sought to channel the transfer of restricted property into previously recognized statutory patterns applicable to other forms of noncash compensation. When property is transferred subject to restrictions of a nonforfeitable type, the proper analogy was thought to be a nonforfeitable contribution to an individual's account in a nonqualified employees' pension or profit-sharing trust.[39] Under section 402(b), the employee would immediately be taxed on such contribution at ordinary income rates even though the funds might be beyond his reach for years. As to forfeitable stock, the proper analogy was thought to be deferred compensation arrangements. One example of this would be phantom stock plans under which the employee would defer income until his rights vested, at which time he would receive payment. At that time, when he had received the deferred compensation and it was no longer subject to forfeiture, the employee would be taxed on the property's full value and it would be included in gross income and taxed at the ordinary income rates.[40] The new rules reflect these analogies.

The Senate Finance Committee added section 83(b), which allows recipients of restricted property to elect, within thirty days from date of transfer, to treat it as compensation in the year it is received, even though it is not transferable and is subject to a substantial risk of forfeiture.[41] In this manner an employee may qualify future appreciation as capital gain, rather than ordinary income, even while the property is forfeitable.

This potential tax benefit is not without risk. Section 83(b) provides that if an election is made and the property is subsequently forfeited, then "no deduction shall be allowed in respect of such forfeiture."[42] It has been noted that the literal language of the provision could be read to preclude a deduction not only in regard to amounts included in income but also in regard to any amount actually paid for the property (for example, if the property was purchased under a favorable option).[43] The proposed regulations to section 83 preclude this unfair result, providing expressly that a forfeiture shall be treated as a disposition, upon which loss is recog-

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38. *See* H.R. REP. No. 91-413 *supra* note 33, pt. 1, at 86.

39. *See id.* at 86-88.

40. *See* Treas. Reg. § 1.61-2(d)(5) (1966); Buchhelder, *supra* note 1, at 673-74.

41. *See* S. REP. No. 91-552, *supra* note 28, at 123.

42. INT. REV. CODE OF 1954, § 83(b)(1).

43. *See* Kelsey & Buckheit, *supra* note 1, at 261.

nized equal to the excess of the amount paid for the property over any amount realized upon forfeiture.[44] Another risk is that the fair market value of the property will decline after the election under section 83(b). The proposed regulations deal with the problem of trying to recoup some of this loss through the less favorable method of a capital loss. The basis of the property when the sale comes after the restrictions have lapsed is the amount actually paid for the property *and* the amount included under section 83(b). If the sale is before any restriction has lapsed and there is a loss, the basis is only the amount actually paid.[45] The apparent justification for this rather unusual distinction is the preservation of the integrity of the provision prohibiting a loss deduction in the event of a forfeiture. Thus a recipient cannot sell his property and take a large capital loss shortly before he would have forfeited the stock. The more fundamental question is why eliminate the loss deduction at all since the recipient has reported the property as compensation. Evidently the provision reflects congressional sentiment that the right to take such an election and with it the prospect of larger long-term capital gain upon sale should be accompanied by some risk of nondeductible loss. Whether this belief is founded in some rational policy is unclear.

Finally, section 83(f) prescribes the holding period for property to which subsection (a) applies. The holding period begins when the taxpayer's rights in the property are either transferable or are not subject to a substantial risk of forfeiture. In contrast, under previous law the holding period began at the time of transfer of the property to the employee.[46]

II. Tax Treatment of the Employer

The tax treatment of the party who pays compensation in property is governed by section 83(h), which provides that "there shall be allowed as a deduction under section 162" the amount included in the gross income of the person who performs the services. But under this section that party is allowed the deduction only when the person performing the services includes the amount in his income. Thus deduction under section 162 is delayed until the risk of forfeiture is lifted or the interest in the property is transferable.

One commentator has suggested that the statute's express provision that a deduction "shall be allowed" under section 162 in the amount included in the income of the taxpayer appears to make the

44. Proposed Treas. Reg. § 1.83-2(a), 36 Fed. Reg. 10789-90 (1971).

45. Proposed Treas. Reg. § 1.83-2(a), 36 Fed. Reg. 10789-90 (1971).

46. *See* Treas. Reg. § 1.421-6(d)(2)(i) (1966). This regulation dates the holding period from the time of exercise of the option. Since the employee was taxed on the lesser of the fair market value at the time of exercise or at the time the restrictions lapsed, the differential was eligible for capital gain treatment in any subsequent sale of the property. Section 83 now eliminates this possibility.

usual "reasonable allowance" limitation of section 162(a)(1) inapplicable.[47] But despite the statute's literal language, a more likely interpretation is that the employer must fulfill all requirements of section 162, including the "reasonable allowance" limitation, in order to obtain a deduction under section 83(h). The legislative history suggests an intention only to eliminate preferential tax treatment regarding the transfer of restricted property,[48] and an interpretation of section 83(h) which would expand the established limitations on permissible trade or business expense deductions under section 162 appears unfounded.

This conclusion that all the requirements of section 162 must be met takes on greater significance in light of a recent revenue ruling[49] disallowing a deduction under section 162. The Internal Revenue Service contended that a willful payment of salaries in excess of the maximums set by the wage-price control guidelines cannot be deducted because such payment is punishable by fine and thus a deduction would contravene section 162(c)(2).[50] Assuming that this ruling will be upheld by the courts, a holding that section 83(h) must be read literally would mean that an employer could circumvent the ruling's limitations simply by compensating his employees with property rather than with cash. This possibility alone should be enough to cause courts to require that all requirements of section 162 be met before a deduction will be allowed.

The new rules improve the after-tax impact of restricted stock plans for employers by accelerating the deduction in the case of nonforfeitable restrictions, and by increasing the amount of deduction in the case of forfeitable restrictions. This is because under prior law, the deduction allowed the employer in the case of forfeitable restrictions was the *lesser* of the fair market value of the property, without regard to the restriction, at the time of transfer or the fair market value at the time the restrictions lapsed.[51] Under present law the employer will benefit from any appreciation in value through an increased deduction. If the property declines in value he will receive the same deduction that he would have under previous law. In the case of nonforfeitable restrictions, since present law taxes these at the time of transfer the employer will receive his deduction then. Previously he had to wait until the nonforfeitable

47. D. Herwitz, Business Planning 149 (Supp. 1971).

48. *See* H.R. Rep. No. 91-413, *supra* note 33, pt. 1, at 86-87; S. Rep. No. 91-552, *supra* note 28, 120-21.

49. Rev. Rul. 72-236, 1972 Int. Rev. Bull. No. 20, at 7.

50. Int. Rev. Code of 1954, § 162(c)(2), *as amended by* Revenue Act of 1971, Pub. L. No. 92-178, § 310(a), 85 Stat. 497, provides: "No deduction shall be allowed . . . for any payment . . . made, directly or indirectly, to any person, if the payment constitutes . . . [an] illegal payment under any law of the United States . . . which subjects the payor to a criminal penalty . . . ."

51. Treas. Reg. § 1.421-6(f) (1966).

restrictions lapsed if the nonforfeitable restriction was deemed to have a significant effect on value. With respect to forfeitable stock, section 83(h) allows the employer to deduct full value, including any appreciation, when the restrictions lapse.

Despite these accelerated deduction benefits to employers, the new rules may not operate to their benefit. Assuming that employees are ultimately concerned with after-tax income, and in light of the fact that section 83 is less favorable to the employees than prior law, employers may be forced to provide a greater magnitude of benefits to their executives in order to give an after-tax income equivalent to that obtainable under prior law. Increased compensation costs to the employer may more than offset benefits from the new rules relating to deductions.

III. The Scope of Section 83 and Some Problems Under the New Rules

A. *If in Connection with the Performance of Services*

Section 83(a) states that income results to the person who performs the services when property is transferred "in connection with" services rather than when property is transferred "as compensation for" services. This language includes within its coverage property transferred to an independent contractor. Surely it is not intended to override the standards for a gift exclusion under section 102 enunciated by the Supreme Court in *Commissioner v. Duberstein.*[52] If the transferor's intention is essentially donative, proceeding from a "detached and disinterested generosity,"[53] then income should be excluded under section 102 even though literally it may have been transferred "in connection with the performance of services."

B. *Transfer to a Person Other Than the One Who Performs the Services*

Section 83(a) provides that if property is transferred to *any* person (except the person for whom the services were performed) and the requirements of section 83 are met, income will result to the person who performed the services. This preserves the assignment-of-income principles of *Lucas v. Earl.*[54] The employee will be taxed if the employer transfers property to a third party in recognition of the employee's services.[55]

52. 363 U.S. 278 (1960).
53. 363 U.S. at 285, *quoting* Commissioner v. LoBue, 351 U.S. 243, 246 (1956).
54. 281 U.S. 111 (1930).
55. Proposed Treas. Reg. § 1.83-3(f), 36 Fed. Reg. 10791 (1971).

C. *The Fair Market Value of Such Property*

One prerequisite to determining an amount to be included in gross income under section 83(a) is to ascertain the fair market value of the property without regard to any restrictions except those which by their terms will never lapse. The Internal Revenue Service has generally contended that property received for services lacks an ascertainable fair market value only in "rare and extraordinary cases."[56] Options, however, are often almost impossible to value. For this reason, section 83(e)(3) expressly provides that the new rules shall not apply to the transfer of an option without a "readily ascertainable fair market value." The proposed regulations state that the value of an option is ordinarily not readily ascertainable unless the option is actively traded on an established market.[57]

One final valuation matter is that section 83(d)(1) provides that if a "no lapse" restriction allows the transferee to sell the property only at a price determined under a formula, the formula price shall be deemed to be the fair market value of the property, unless the Service establishes otherwise, with the burden of proof on the Service. Congress felt that such a restriction is an inherent limitation on the recipient's property rights, and that his income should be determined accordingly.[58]

D. *Determined Without Regard to Any Restrictions*

The computation of fair market value without regard to restrictions raises the question whether income can be measured for taxation in an amount greater than the actual present fair market value of the property received. *Eisner v. Macomber*[59] established the principle that Congress may only impose tax upon realized "income" under the sixteenth amendment. Under the definition of income set forth in *Macomber,* and assuming that even nonforfeitable restrictions decrease the value of property received, it is arguable that gain has not been "derived" on the *total* market value without respect to restrictions.[60]

The Supreme Court has stated, however, that the *Macomber* definition of income "was not meant to provide a touchstone to all future gross income questions."[61] It is unlikely, therefore, that a court would find the section in violation of the realization doctrine

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56. Treas. Reg. § 1.1001(a) (1957); Rev. Rul. 58-402, 1958-2 CUM. BULL. 15.

57. Proposed Treas. Reg. § 1.83-7(b), 36 Fed. Reg. 10793 (1971).

58. S. REP. No. 91-552, *supra* note 28, at 121.

59. 252 U.S. 189 (1920). *See also* Stanton v. Baltic Mining Co., 240 U.S. 103 (1916).

60. *See* 252 U.S. at 207.

61. Commissioner v. Glenshaw Glass Co., 348 U.S. 426, 430-31 (1955).

in light of the policies underlying section 83. In an attempt to force all deferred compensation arrangements through statutorily approved, nondiscriminatory plans, Congress has removed the tax advantages allowed previously in the nonstatutory methods. Under sections 421-25, Congress has set out the requirements for nondiscriminatory plans which receive favorable tax treatment. While Congress has not completely forbidden the use of discriminatory restricted stock plans, it has made the policy judgment that deferred tax treatment will not be allowed when the property is not subject to a substantial risk of forfeiture or is transferable. Even in the case of property subject to forfeiture and nontransferable, Congress took away a portion of the former advantages of these plans by taxing the entire amount as ordinary income rather than allowing capital gains treatment from the date of exercise.[62] This is consistent with other areas of tax law in which discriminatory plans are allowed.[63] Congress has tried to ensure equal tax treatment of all deferred compensation arrangements, and since these tax policies have not been assailed as unconstitutional in other contexts, it is unlikely that such an assault on section 83 would be upheld. Moreover, when there are two possible constructions, only one of which would render the statute unconstitutional, the construction sustaining the constitutionality will prevail.[64] If faced with a case where the doctrine of realization appears to be contravened, the courts could construe the substantial risk of forfeiture test of section 83(c)(1) to encompass the challenged restriction, thereby deferring taxation within the purview of the statutory scheme and rendering the issue of realization moot.

E. *Substantial Risk of Forfeiture*

Section 83(c)(1) provides that the rights of a person are subject to a substantial risk of forfeiture "if such person's rights to full enjoyment of such property are conditioned upon the performance of substantial services by an individual." This, according to the Senate Finance Committee, was not intended as an exclusive definition.[65] A Finance Committee press release indicated that the substan-

62. INT. REV. CODE OF 1954, § 83(a).

63. A primary example is the tax treatment given nonqualified pension, profit-sharing, and stock bonus plans. If the contribution to such a plan is vested, the employee will include in his ordinary income the contributions of the employer, even though he may have to wait forty years or more until he receives the property. INT. REV. CODE OF 1954, § 402(b). However, if the contribution is forfeitable when made, even though it later becomes nonforfeitable, the employee will not pay any tax until actual distributions are made. *See* Treas. Reg. § 1.402(b)-1(a) (1956).

64. *See* United States v. Bennett, 232 U.S. 299, 303 (1914); Stratton's Independence, Ltd. v. Howbert, 231 U.S. 399 (1913).

65. S. REP. No. 91-552, *supra* note 28, at 121.

tial risk of forfeiture exists only if the employer can compel the employee, or other holder, to return the identical property.[66]

There is certainly a gray area in which it is difficult to determine whether a restriction involves a "substantial risk of forfeiture." For example, what is meant by "performance of substantial services by an individual"? Is continued employment for six months substantial? Two years? Five years? There may also be a problem whether the event which causes the return of the restricted property amounts to a "forfeiture." For example, is a requirement that the employee return the property in exchange for the fair market value at the time of return a forfeiture? A proposed regulation lists some of the circumstances that may be taken into account in determining whether property is subject to a substantial risk of forfeiture: employee's age, availability of alternative employment opportunities, likelihood of obtaining other employment, employee's degree of skill, employee's health, and the practice of the employer.[67]

Advance rulings will not be available for employers to determine whether planned restrictions constitute a "substantial risk of forfeiture."[68] The vagueness of the standard is not necessarily a defect in drafting, as Congress may have intended the provision to have an *in terrorem* effect in order to discourage the transfer of restricted property.

F. *Restrictions Which Will Never Lapse*

The no-lapse rule of section 83(d)(1) was probably intended to deal with the type of restriction often found in closely-held corporations requiring sale at a formula price when the shareholder leaves the employ of the corporation, retires, or dies. A restriction which never lapses is defined in the proposed regulations 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).[69]

A requirement resulting in substantial risk of forfeiture, however, will not be considered to result in a no-lapse restriction.[70] It can be

66. SENATE COMM. ON FINANCE, 91ST CONG., 1ST SESS., TAX REFORM ACT OF 1969; COMPILATION OF DECISIONS REACHED IN EXECUTIVE SESSION 17 (Comm. Print 1969) (Press Release, Oct. 14, 1969).

67. Proposed Treas. Reg. § 1.83-3(c), 36 Fed. Reg. 10790 (1971).

68. Rev. Proc. 69-6, 1969-1 CUM. BULL. 396.

69. Proposed Treas. Reg. § 1.83-5, 36 Fed. Reg. 10792 (1971).

70. Proposed Treas. Reg. § 1.83-5, 36 Fed. Reg. 10792 (1971).

expected that troublesome issues will arise in drawing the line between forfeitable restrictions and restrictions which never lapse.[71]

Section 83(d)(2) provides for realization of income when a restriction which never lapses is cancelled. If cancellation occurs, the employee will be taxed on the element of compensation which escaped taxation under ordinary income rates when the property was originally transferred. This rule does not apply if the employee can establish that the cancellation was not compensatory and that the person who would be entitled to a deduction if it were compensatory will not treat the transaction as compensatory.

If the property is subject to both a substantial risk of forfeiture and a restriction which never lapses and the cancellation of the latter occurs before the substantial risk of forfeiture lapses, an interpretive problem arises under section 83(d)(2). The provision is not limited expressly to a situation where *only* a restriction which never lapses exists prior to cancellation. The amount determined as compensation is the excess of the fair market value (computed without regard to "the restrictions") at the time of cancellation, over the fair market value immediately prior to cancellation (computed by taking "the restriction" into account) and the amount, if any, paid for cancellation. If "the restrictions" includes even forfeitable restrictions, then 83(d)(2) might seem to impose a tax, notwithstanding the continuing existence of a substantial risk of forfeiture. Such a result seems contrary to the thrust of section 83(a) and the congressional intention to defer compensation where a substantial risk of forfeiture exists. Thus 83(d)(2) might well be construed to be inapplicable so long as a substantial risk of forfeiture remains.

It has been suggested that a tax advantage might be obtained

71. *Compare* S. REP. No. 91-552, *supra* note 28, at 121: "a requirement that an employee sell his stock back to his employer at book value or some other reasonable price if he terminates his employment" is an example of a restriction that never lapses, *with* INT. REV. CODE OF 1954, § 83(c)(1): "The 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 of substantial services by any individual."

One commentator has noted:

> Perhaps the critical point in the Senate Report is the reference to a "reasonable price," so that forfeitability would depend upon how far from market value the resale price was. But unless there is some significant difference between the resale price and market value, the resale requirement is hardly a restriction worth taking into account at all; indeed, the pre-1969 regulations specifically stated that a restriction requiring resale of stock to the employer at fair market value was not a restriction having a significant effect on value. On the other hand, if forfeitability is to turn on how large the difference between the resale price and fair market value is, a very troublesome uncertainty would be introduced into a statutory pattern that was supposed to bring a high degree of predictability.

D. HERWITZ, *supra* note 47, at 146.

It has also been suggested that the example given in the Senate Report may allow some element of compensation income to escape inclusion in ordinary income if the resale condition becomes operative only by voluntary termination of employment and not by death or normal retirement. *Id.* at 146-47.

through the transfer of property subject to a no-lapse restriction in anticipation of sharp appreciation, perhaps by virtue of a foreseeable public offering.[72] Since no-lapse restrictions are taken into account in determining the measure of compensation income at time of transfer, the employee might be given substantial opportunity for capital gain while holding ordinary income to a minimum. A difficulty in this approach is that Congress excepted no-lapse restrictions from the general rule that restrictions are not considered in determining the value of nonforfeitable property because no-lapse restrictions were considered "not tax-motivated."[73] Thus, despite the literal language of the statute, it could be argued that an obviously tax-motivated

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72. [T]here may still be some advantages in arrangements involving restrictions which never lapse . . . particularly in situations where stock is expected to appreciate sharply, perhaps by virtue of a foreseeable public offering or the like, and the purpose of the arrangement is to make it possible for an employee to acquire substantially more stock than he could afford even at the current value. Suppose, for example, a corporation has 50,000 shares outstanding, with a current value of $10 per share, and because of prospects that the stock might be worth as much as $30 per share in the not too distant future the corporation wishes to make 5000 shares available to a key employee who has only limited outside resources. The shares might be issued to the employee subject to a perpetual restriction that prior to any sale or transfer of the shares the employee must offer them to the corporation at, say, $8 less than the current fair market value. Assuming that this does not constitute forfeitability . . . the stock would be included in the employee's income upon receipt; but since the stock is subject to a restriction which never lapses, the restriction would be taken into account in valuing the stock at the time of receipt. Whether this restriction would reduce the current fair value of this stock all the way down to $2 per share is not clear. Under § 83(d)(1) a perpetual restriction "which allows the transferee to sell such property only at a price determined under a formula" fixes the fair value at that price, unless the Government can sustain the burden of proving the contrary. Assuming that pegging the price at $8 less than fair market value represents a "formula", does a right of first refusal in the corporation constitute a restriction "which allows the transferee to sell such property only at" the formula price? Theoretically, the answer would seem to be "no", since if the corporation does not exercise its right of first refusal the employee would be free to sell to others at full value. But as a practical matter the corporation is virtually certain to take advantage of such a bargain price (absent some legal restriction on the repurchase of stock). Moreover, this would seem to be the type of restriction contemplated by § 83(d)(1); indeed, one that literally conformed to the words of that provision and flatly prevented the employee in perpetuity from selling to anyone except at a formula price below market value would leave the employee in a position to decide whom he wished to favor with this bargain purchase, which would in and of itself be an indirect form of value to the employee. In any event, even if a right of first refusal does not fix the value of the stock under § 83(d)(1), it would be likely to reduce the value to a figure close to the formula price; though the recipient of the stock is not required to sell and can therefore enjoy the full value of the other elements of the stock, the fact remains that at least in the case of a minority interest in a publicly-held stock, the price at which the stock can be sold is the dominant factor in valuation. Assuming a $2 value for the stock when received, and assuming further that the stock was issued for only nominal consideration, the employee would have to pay tax on compensation income of only approximately $10,000 as the price of being able to reap the rewards of appreciation at capital gains rates on 5,000 shares; without the restriction the same tax bite would be incurred upon the receipt of a mere 1000 shares.

D. HERWITZ, *supra* note 47, at 147-48.

Additional benefits from the use of no-lapse restrictions may arise from the usual power of the corporation to cancel the restrictions, if careful timing is exercised. *See id.* at 148.

73. S. REP. No. 91-552, *supra* note 28, at 121.

no-lapse restriction should not be held to be a "restriction which will never lapse" for purposes of section 83. On the other hand, Congress arguably made a judgment regarding no-lapse restrictions as a *class*, and thus case-by-case inquiry into motive may be unwarranted.

G. *Nonexempt Trusts and Nonqualified Annuities*

Under prior law, if an employer contributed an amount to a nonqualified employee trust or annuity, and the employee's rights were nonforfeitable, the employee was required to include the full amount of the contribution in income at the time it was made.[74] If the employee's rights were forfeitable, the employee was not taxed until he received actual payment.[75] The employer was allowed a deduction for nonforfeitable contributions made in the year paid.[76] Under section 402(b) and section 403(c) and (d), if a previously forfeitable contribution became vested, the employee was not taxed until he actually received payment.[77] In this case, and in the case where the contribution was forfeitable, the employer would not receive any deduction.[78]

The Tax Reform Act of 1969 placed the tax treatment upon expiration of the forfeitable restriction under section 83 so that the employee will be taxed when the contribution becomes nonforfeitable.[79] The Finance Committee report indicates that this will end the Service's contention that the employer is not entitled to a deduction when the contribution becomes nonforfeitable, even though this meant that he would never receive a deduction.[80] The employer is now permitted to take a deduction in the taxable year in which the employee includes the compensation in his gross income.[81]

H. *Transactions to Which the New Rules Are Not Applicable*

Section 83(d)(1) provides that the new rules are not applicable to a transaction to which the qualified stock option provision, section 421, applies. Section 421 contains the rules governing qualified stock options, employee stock purchase plans, and restricted stock options, and sets stringent requirements to qualify for favorable tax treatment. Except for a case in which the option price is less than the fair market value of the stock, no ordinary income is realized at the time of either grant or exercise, and the employer is not entitled to

74. Treas. Reg. §§ 1.402(b)-1(a), 1.403(c)-1(a), 1.403(d)-1(a)-(b) (1964).
75. *See* authorities cited in note 74 *supra*.
76. Treas. Reg. § 1.404(a)-1(c) (1964).
77. Treas. Reg. §§ 1.402(b)-1(a), 1.403(c)-1(a), 1.403(d)-1(a)-(b) (1964).
78. Treas. Reg. § 1.404(a)-12 (1964).
79. INT. REV. CODE OF 1954, § 402(b).
80. S. REP. No. 91-552, *supra* note 28, at 123.
81. INT. REV. CODE OF 1954, § 83(h).

a deduction under section 162.[82] When the stock is disposed of, the employee will be entitled to capital gain treatment on the appreciation of the stock between the time of exercise and the time of sale.[83]

Section 83(e)(2) states that the new rules are not applicable to a trust under a qualified pension, profit-sharing or stock bonus plan described in section 401(a), or a transfer under an annuity plan which meets the requirements of section 404(a)(2).

As noted above, section 83(e)(3) makes the section inapplicable to the transfer of an option without a readily ascertainable fair market value.[84] Section 83(e)(4) provides that the section shall not apply to the transfer of property pursuant to the exercise of an option with a readily ascertainable fair market value at date of grant. The purpose of these complementary provisions is to ensure that the compensation element of property or options transferred will be taxed at ordinary income rates at one time only.[85]

I. *Tax Free Exchanges*

Section 83(g) covers the treatment of property received in certain tax free exchanges for restricted property to which the general restricted property rule applies. When the property received is subject to restrictions and conditions substantially similar to those to which the property given up was subject, the exchange is to be disregarded for purposes of section 83(a). The property to be received in effect replaces the traded property as restricted property in the hands of the recipient subject to the provisions of section 83.

IV. CONCLUSION

Section 83 will, to a large extent, accomplish its primary purpose of making the tax consequences uniform in cases of deferred compensation, regardless of the form of the arrangement. In so doing, however, Congress has severely diminished the ability of closely held corporations to attract and keep management talent. The qualified stock option plans are not attractive, as they are limited to indi-

82. INT. REV. CODE OF 1954, §§ 421(a), 422(c)(1).

83. Treas. Reg. § 1.421-5(a)(4) (1961). The examples indicate that an employee must hold the property for two years in order to qualify for the favorable tax treatment.

84. *See* text accompanying notes 56-57 *supra.*

85. If there is a transfer of an option without a readily ascertainable value, the option will be taxed at exercise, if the property acquired upon exercise is not subject to a substantial risk of forfeiture or is transferable. Treas. Reg. § 1.421-6(d)(1) (1966). If the property is subject to a substantial risk of forfeiture and is not transferable at the time of exercise, section 83 will apply, and the person exercising the options will not be taxed until the restrictions lapse. If the option has a readily ascertainable fair market value, the recipient will include the excess of the value over cost in ordinary income at the time the option is granted. Subsequent acquisition of property pursuant to the option will not be a taxable event. At the time of sale, the recipient will receive capital gain or loss treatment pursuant to the usual capital gain rules.

viduals holding less than five per cent of the total combined voting power or value of all stock of the corporation,[86] and in many closely held corporations, the majority of management personnel are also major stockholders. The qualified pension, profit-sharing, and stock bonus plans offer some help, but the closely held corporation may have difficulty funding these plans.[87] The best remaining avenue for achieving their goals of compensating and keeping management talent may well be through the provisions of section 83(b), which will enable the corporation to transfer property conditioned on future employment to executives, and to have the executives elect to include this income in the year of receipt. This would provide both substantial security for the corporation in regard to continuity of management and potential capital gains treatment for the employee on future appreciation. On the other hand, employees may find this approach undesirable since they run the risk of forfeiture and cannot use the stock to meet their immediate tax obligation.

86. INT. REV. CODE OF 1954, § 422(b)(7). The 5% limitation applies to corporations having more than $2,000,000 of equity capital; for smaller corporations the percentage limitation varies with equity, but the maximum permissible ownership is 10%. Qualified stock option plans would seem to be of greatest advantage to the large publicly-held corporations, in which stock ownership is widely dispersed. Its utility for the closely held corporation would not seem to be that great, as the executives will often exceed the 5% holdings limit in the case of corporations having more than $2,000,000 in equity capital, or the additional percentage allowed if there is less than $2,000,000 in equity capital.

87. INT. REV. CODE OF 1954, §§ 401(a), 401(d).