

Part I

Section 83.—Property Transferred in Connection with Performance of Services

26 CFR 1.83-3: Meaning and use of certain terms

Rev. Rul. 2007-49

ISSUES

- 1) Is there a transfer of substantially nonvested stock subject to § 83 of the Internal Revenue Code where restrictions imposed on substantially vested stock cause the substantially vested stock to become substantially nonvested?
- 2) Is there a transfer of substantially nonvested stock subject to § 83 where a service provider exchanges substantially vested stock for substantially nonvested stock in a reorganization described in § 368(a)?
- 3) Is there a transfer of substantially nonvested stock subject to § 83 where a service provider exchanges substantially vested stock for substantially nonvested stock in a taxable stock acquisition?

FACTS

Investors form Corporation X in 2004, by contributing \$1,000 each to Corporation X in exchange for 100 shares of Corporation X stock. In exchange for Individual A's agreement to perform services for Corporation X, Corporation X issues 100 shares of its stock to A. The fair market value of the Corporation X stock on that date is \$10 per share. The shares of Corporation X stock transferred to A are "substantially vested" within the meaning of § 1.83-3(b) of the Income Tax Regulations.

For the 2004 taxable year, the amount included in A's income under § 83(a) is \$1,000 (the fair market value of the stock (\$10 x 100 shares) less the amount paid (\$0)). A's basis in the stock is \$1,000.

Situation 1. In connection with its plan to start a new business venture, Corporation X seeks financing from Investor M on July 9, 2007. Investor M agrees to invest funds in Corporation X in exchange for a specified number of shares and the further requirement that A agree to subject A's shares to a restriction that will cause the stock to be "substantially nonvested" within the meaning of § 1.83-3(b). Under this restriction, if the employment of A with Corporation X terminates before July 9, 2009, A must sell the shares to Corporation X in exchange for the lesser of \$150 per share (the fair market value of Corporation X stock on July 9, 2007) or the fair market value at the time of forfeiture. In addition, the shares are nontransferable before that date. A remains employed with Corporation X, and on July 9, 2009, the fair market value of Corporation X stock is \$250 per share.

Situation 2. Corporation Y, a corporation unrelated to Corporation X, agrees to acquire all of the stock of Corporation X. Accordingly, on August 9, 2010, Corporation Y causes Corporation Z (a newly formed wholly-owned subsidiary of Corporation Y) to merge into Corporation X in a transaction that qualifies as a reorganization described in § 368(a). In the merger, the shareholders of Corporation X receive solely Corporation Y voting stock in exchange for their Corporation X stock. The fair market value of the Corporation X stock on August 9, 2010, is \$310 per share.

In the merger, A's 100 shares of substantially vested Corporation X stock are exchanged for 100 shares of Corporation Y stock subject to a restriction that will cause the stock to be "substantially nonvested" within the meaning of § 1.83-3(b). Under this restriction, if A's employment with Corporation X is terminated for any reason before August 9, 2013, A must sell the substantially nonvested Corporation Y shares to Corporation Y in exchange for the lesser of \$310 per share (the fair market value of the shares on August 9, 2010) or the fair market value at the time of forfeiture. In addition, the shares are nontransferable before that date. No other shareholder of Corporation X receives Corporation Y stock subject to a restriction.

A timely files an election under § 83(b) with respect to the substantially nonvested Corporation Y stock A receives in the merger.

A continues to be employed by Corporation X until August 9, 2013 at which time the fair market value of the stock is \$500. A sells the stock on October 31, 2014 when the fair market value of the stock is \$550 per share.

Situation 3. Assume the same facts as in Situation 2 except that in the merger half of the Corporation X stock is exchanged for cash and half is exchanged for Corporation Y stock, the transaction is fully taxable, and all of A's Corporation X stock is exchanged for Corporation Y stock.

LAW

Section 83, provides that if, in connection with the performance of services, property is transferred to any person other than the service recipient, the excess of the fair market value of the property (determined without regard to any restriction other than a restriction which by its terms will never lapse), on the first day that the rights to the property are either transferable or not subject to a substantial risk of forfeiture, over the amount paid for the property is included in the service provider's gross income for the first taxable year in which the rights to the property are either transferable or not subject to a substantial risk of forfeiture.

Section 1.83-3(f) provides that property transferred to an employee or independent contractor (or beneficiary thereof) in recognition of the performance of, or the refraining from performance of, services is considered transferred in connection with the performance of services within the meaning of § 83. However, the existence of other persons entitled to buy stock on the same terms and conditions as an employee, whether pursuant to a public or private offering, may indicate that in such circumstances a transfer to the employee is not in recognition of the performance of, or the refraining from performance of, services.

Subjecting stock to a restriction that will cause it to be “substantially nonvested” (within the meaning of § 1.83-3(b)) indicates that the property is transferred in connection with the performance of services even if the employee pays fair value for the stock. See Alves v. Commissioner, 734 F.2d 478 (9th Cir. 1984), aff’d 79 T.C. 864 (1982).

Section 1.83-1(a)(1) provides that property transferred in connection with the performance of services is not taxable under § 83(a) until it has been transferred (as defined in § 1.83-3(a)) to an employee or independent contractor and becomes substantially vested (as defined in § 1.83-3(b)) in such person. Until such property becomes substantially vested, the transferor is regarded as the owner of the property, and any income from such property received by the employee or independent contractor (or beneficiary thereof) or the right to the use of such property by the employee or independent contractor constitutes additional compensation and must be included in the gross income of such employee or independent contractor for the taxable year in which such income is received or such use is made available.

Section 83(b) provides that any person who has performed services in connection with which property is transferred to any person may elect to include in gross income, for the taxable year in which such property is transferred, the excess of 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 the amount paid for such property.

Section 1.83-2(a) provides, in part, that the fact that the transferee has paid full value for the property transferred, realizing no bargain element in the transaction, does not preclude the use of the election under § 83(b). If this election is made, the substantial vesting rules of § 83(a) and the regulations thereunder do not apply with respect to such property. Thus, with respect to such property, the excess (if any) of the fair market value of the property at the time of transfer (determined without regard to any restriction other than a restriction which by its terms will never lapse) over the amount (if any) paid for such property is includible in gross income as compensation at the time of transfer, and no compensation will be includible in gross income when such property becomes substantially vested. An employee who makes an election under § 83(b) is considered to be the owner of the property. See Rev. Rul. 83-22, 1983-1 C.B. 17.

Section 1001(a) provides that the gain from the sale or other disposition of property is the excess of the amount realized over the adjusted basis provided in § 1011 for determining gain, and the loss is the excess of the adjusted basis provided in such section for determining loss over the amount realized.

Section 1001(b) provides that the amount realized from the sale or other disposition of the property is the sum of any money received plus the fair market value of the property (other than money) received.

Section 1001(c), provides, except as otherwise provided in Subtitle A, the entire amount of the gain or loss, determined under section 1001, on the sale or exchange of the property shall be recognized.

Section 1.83-3(g) provides that for purposes of § 83 and its regulations, the term “amount paid” refers to the value of any money or property paid for the transfer of property to which § 83 applies.

ANALYSIS – Situation 1

In Situation 1, in connection with the new investment, the substantially vested shares of Corporation X stock owned by A are subjected to a restriction causing them to be “substantially nonvested”. Because the substantially vested shares of Corporation X stock are already owned by A for purposes of § 83, there is no “transfer” under § 83. Thus, the imposition of new restrictions on the substantially vested shares has no effect for purposes of § 83.

When the substantially nonvested Corporation X stock becomes substantially vested on July 9, 2009, A does not recognize compensation income under § 83(a). A’s basis in the stock continues to be \$1,000.

ANALYSIS – Situation 2

In Situation 2, A receives 100 shares of Corporation Y stock with an exchanged basis of \$1,000 in the tax-free reorganization. Because the substantially vested Corporation X stock is exchanged for stock that is subjected to a restriction causing the shares to be “substantially nonvested,” the substantially nonvested shares are treated as having been transferred in connection with the performance of services, and thus, are subject to § 83. As a result of the § 83(b) election, A becomes the owner of those shares.

The “amount paid” for the stock under § 83 on the transfer of the substantially nonvested shares is the fair market value of the substantially vested Corporation X stock exchanged for the substantially nonvested Corporation Y stock (\$31,000) on the exchange date, August 9, 2010. On A’s election under § 83(b), \$31,000 is treated as the amount paid for the Corporation Y stock for purposes of applying § 83. On A’s return for the 2010 taxable year, A does not report any taxable income from the transfer of the Corporation Y stock under the § 83(b) election because the fair market value of the stock less the amount paid is \$0. A does not include any amount in compensation income in the 2013 taxable year when the stock becomes substantially vested because of the prior § 83(b) election. A’s basis in the Corporation Y stock continues to be \$1,000. Upon the sale of the shares in 2014, A recognizes capital gain of \$54,000, the amount by which \$55,000 (\$550, the fair market value of the stock, x 100 shares) exceeds A’s \$1,000 basis in the shares.

ANALYSIS – Situation 3

In Situation 3, A holds substantially vested Corporation X stock with a basis of \$1,000 at the time of the merger. A exchanges that substantially vested Corporation X stock for substantially nonvested Corporation Y stock with a fair market value of \$310 per share in a taxable transaction. Because A disposed of the substantially vested Corporation X stock in exchange for substantially nonvested Corporation Y stock in an exchange to which § 1001 applies, A recognizes capital gain on the disposition of the Corporation X stock in the amount of \$30,000 (\$31,000 fair market value of substantially

nonvested Corporation Y stock (\$310 per share x 100 shares) less \$1,000 basis in the Corporation X stock). A's basis in the Corporation Y stock is \$31,000.

Because the substantially vested Corporation X stock is exchanged for Corporation Y stock that is subjected to a restriction causing the shares to be "substantially nonvested," the substantially nonvested shares are treated as having been transferred in connection with the performance of services, and thus, are subject to § 83.

As in Situation 2, the "amount paid" for the stock under § 83 is \$31,000. When A makes an election under § 83(b) with respect to the Corporation Y stock, A does not report any additional amount of income for the 2010 taxable year as a result of such election because the fair market value of the stock less the amount paid for the stock is \$0. A does not include any amount in compensation income in the 2013 taxable year when the stock becomes substantially vested because of the prior § 83(b) election. A's basis in the Corporation Y stock continues to be \$31,000. On the sale of the 100 shares in 2014, A will recognize capital gain of \$24,000, the amount by which \$55,000 (\$550, the sale price, x 100 shares) exceeds A's \$31,000 basis in the shares.

If A had not made an election under § 83(b) with respect to the Corporation Y stock, when the stock becomes substantially vested on August 9, 2013, A would include \$19,000 in gross income as compensation under § 83(a). This is the amount by which the fair market value of 100 Corporation Y shares (\$50,000 or \$500 per share) exceeds the amount paid for those shares (\$31,000). Consequently, A's basis in the Corporation Y stock would be increased by \$19,000 to \$50,000. See § 1.83-4(b). On the sale of the

100 shares, A would recognize capital gain of \$5,000, the amount by which \$55,000 (\$550, the sale price, x 100 shares) exceeds A's basis of \$50,000 in the shares.

HOLDINGS

- 1) There is not a transfer of substantially nonvested stock subject to § 83 where restrictions imposed on substantially vested stock cause the substantially vested stock to become substantially nonvested.
- 2) There is a transfer of substantially nonvested stock subject to § 83 where a service provider exchanges substantially vested stock for substantially nonvested stock in a reorganization described in § 368(a).
- 3) There is a transfer of substantially nonvested stock subject to § 83 where a service provider exchanges substantially vested stock for substantially nonvested stock in a taxable stock acquisition.

DRAFTING INFORMATION

The principal author of this revenue ruling is Jean Casey of the Office of Division Counsel/Associate Chief Counsel (Tax Exempt & Government Entities). However, other personnel from the IRS and Treasury Department participated in its development. For further information regarding this revenue ruling, contact Ms. Casey at (202) 622-6030 (not a toll-free call). For further information regarding issues with respect to subchapter C, contact Ms. Jean Brenner at (202) 622-7790 (not a toll free number).