

**NEW YORK STATE BAR ASSOCIATION
TAX SECTION**

**REPORT ON TREATMENT OF RESTRICTED STOCK IN
CORPORATE REORGANIZATION TRANSACTIONS**

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New York State Bar Association Tax Section

Report on Treatment of Restricted Stock
in Corporate Reorganization Transactions¹

I. Introduction

This report of the New York State Bar Association Tax Section recommends an approach to analyzing the issuance and exchange of stock subject to restriction under Section 83 in corporate reorganization transactions.

Recently there has been a proliferation of transactions in which the tax treatment of restricted stock was critical to the certainty and success of the transaction. The principal uncertainty results from the treatment of restricted stock under Section 83 as not owned by the employee/shareholder; that is, Section 83 adopts an open transaction approach to determining the amount and timing of compensation income resulting from the issuance of restricted stock. The reach of this Section 83 fiction is unclear. An open transaction approach is inconsistent with the objective of having certainty as to the resulting tax consequences at the time of the transaction. We observe that the tax law in the transactional arena generally has developed to favor a closed transaction approach².

¹ The principal drafter of this report was Karen Gilbreath. Helpful comments were received from Andrew Berg, Kimberly Blanchard, Kathleen Ferrell, Megan Fitzsimmons, Robert Jacobs, Karen Krueger, Matthew Rosen, Linda Swartz, Jodi Schwartz, and Andrew Walker.

² See Treas. Reg. Section 1.1001-1(g) (requiring valuation of contingent instruments for purposes of determining the amount realized from a transaction); Installment Sales Act of 1980, expanding the

Historically, the Internal Revenue Service (“IRS”) generally has followed the lead of the Section 83 approach in determining the characterization of a corporate transaction by ignoring the existence of restricted stock unless a Section 83(b) election has been made.³ There is, however, no published guidance in the reorganizations arena. Therefore, there is uncertainty in the marketplace about the tax effects of transactions where restricted stock is present.

Certainly, following the Section 83 fiction has some administrative appeal. However, ignoring the existence of restricted stock does not necessarily result in appropriate characterizations of transactions and does not appropriately balance the competing policies of the corporate tax provisions. In recognition that the intersection of Section 83 with the corporate tax provisions creates perplexing issues, we understand that the IRS and Treasury plan to address the issues that are the subject of this Report.

Part II of the Report sets forth the scope of the Report and the summary of the Section’s recommendations. Part III is a background section detailing the corporate

statutorily deferred payment option to all forms of deferred payment sales with the effect that the open transaction doctrine allowing for cost recovery, as sanctioned by *Burnet v. Logan*, 283 U.S. 404 (1931), would be available only for “rare and extraordinary” cases; T.D. 8858 (2000), eliminating the open transaction regime that had been allowed for Section 338 elections since its enactment in 1982; H.R. 5662, the Community Renewal Tax Relief Act of 2000, enacting Section 358(h) (requiring the valuation of contingent liabilities assumed in Section 351 exchanges); Notice 2001-17 (IRS’ position that the assumption of contingent liabilities may be subject to Section 357(b)(1), and thus, such liability must be valued); Treas. Reg. Section 1.197-2(k), Example 6 (allowing the valuation of a covenant not to compete at the date of the sale).

³ See, e.g., C.C.A. 199944001 (employee restricted stock is not outstanding stock for purposes of the reverse acquisition rules of Treas. Reg. Section 1.1502-75(d)(3) until the stock vests with the employees); PLR 199923027 (presumably in looking at whether Distributing will distribute control to its shareholders in a Section 355 distribution, the IRS required a representation that the amount of Distributing stock owned by its employee was less than twenty percent of the Distributing stock); PLR 9712029 (restricted stock not taken into account for Section 1504 ownership purposes); Treas. Reg. Section 1.1361-1(b)(3) (restricted stock not owned by shareholders for second class of stock rules). *But see*, PLR 9422048 (restricted stock treated as owned for Section 382 ownership change purposes).

reorganization rules and Section 83 rules. Part IV explores the Section's recommendations in detail and Part V illustrates some of the effects our recommendations would have if adopted.

II. Scope of the Report and Summary of Recommendations.

The Section 83 fiction, intended to determine the tax results for compensation, creates issues in many other areas of the tax law, including the taxation of corporations, partnerships, subchapter S corporations, and consolidated returns. While we conjecture that the Section 83 fiction probably should apply only in determining the timing and amount of compensation, a more thorough appraisal would be required to formulate a concrete recommendation. Thus, this Report focuses on a set of issues that we believe to be most in need of attention - the issues raised by the presence of restricted stock in corporate reorganization transactions. This Report does not address the treatment of compensatory options in the context of reorganizations.⁴

This Report addresses the extent to which restricted stock should be treated as owned by the employee/shareholder for purposes of qualification under Section 368 (i.e., continuity of interest, solely voting stock, Section 368(c) control) and related provisions (i.e., Sections 354, 356, 358). We recognize that it is not ideal for the tax law to treat restricted stock inconsistently for the various provisions of the Code and that anomalies may result.⁵ We believe, however, that adopting the recommendations in this Report, even with the possible resulting anomalies, is preferable over the current state. In addition, we note that the IRS and Treasury recently have shown willingness to depart

⁴ Cf. Treas. Reg. Sections 1.354-1(e), 1.355-1(c), and 1.356-3(b) (treating options as zero principal amount securities for purposes of the reorganization provisions); NYSBA Report Concerning Treatment of Exchanges of Warrants in Reorganization Transactions (July 26, 1996).

⁵ Consider the issues created with the issuance of nonqualified preferred stock under Section 351(g).

from the Section 83 fiction in its published guidance concerning golden parachute payments under Section 280G.⁶

Our principal recommendations are as follows:

1. We recommend that restricted stock that has been transferred within the meaning of Section 83 (i.e., the employee has the beneficial ownership of the stock) should be treated as outstanding and owned by the employee for purposes of characterizing a transaction as a reorganization described in Section 368.
2. Specifically, we recommend that restricted stock be treated as outstanding for purposes of the continuity of interest regulations, the application of the Section 368(c) control test, the solely for voting stock requirement, and the treatment of restricted stock as qualifying property and not “boot”.
3. We recommend that the possibility of forfeiture be ignored for purposes of determining value in the reorganization context.
4. We recommend that a subsequent forfeiture of restricted stock pursuant to the terms of the stock grant not affect the continuity of interest determination.
5. We recommend that special rules would be adopted to harmonize the basis and holding period rules for restricted stock received in exchange for unrestricted stock.

⁶ See Treas. Reg. Section 1.280G-1, Q&A-12 (disregarding a Section 83(b) election for purposes of Section 280G).

III. Background.

a. Corporate Reorganizations

The corporate reorganization provisions except from the general rule of gain recognition certain transactions that are merely readjustments of continuing interests in property under modified corporate forms.⁷ The following discussion focuses on requirements for qualifying as a reorganization described in Section 368 that are called into issue when restricted stock is outstanding. At the core of each of the requirements is the question of who “owns” the corporation at the relevant time for characterizing the transaction.

If the requirements for qualification as a reorganization are satisfied, the target shareholders will recognize gain only if money or property other than acquiring stock is received.⁸ The shareholders’ basis in acquiring stock will be the same as the basis in the target stock surrendered and the holding period for the target stock will be tacked onto the new acquiring stock.⁹ The target corporation will not recognize gain or loss on the transfer of its assets in an asset reorganization and generally will not recognize gain upon the assumption of its liabilities,¹⁰ and the acquiring corporation will have a carryover basis in the assets or stock acquired.¹¹ The effect of these provisions is to defer the

⁷ Treas. Reg. Section 1.368-1.

⁸ Sections 354 and 356.

⁹ Sections 358 and 1223(1).

¹⁰ Sections 357 and 361.

¹¹ Section 362.

taxation on any appreciation in the shareholders' stock or the acquired property until the investment is later liquidated.

Because satisfying the requirements for the various provisions is not elective and the tax consequences and cost of the transaction are dependent on the characterization, it is critical to understand how restricted stock will be treated.

Continuity of Interest. Necessary for acquisitive reorganizations described in Section 368¹² is that “in substance a substantial part of the value of the proprietary interests in the target corporation be preserved in the reorganization” (the continuity of interest requirement).¹³ In general, a proprietary interest is preserved if it is exchanged for a proprietary interest in the acquiring corporation. While “proprietary interest” is not defined in the regulations, it generally is viewed as an equity interest in the company. Under the regulations, post-reorganization dispositions are ignored in measuring continuity. However, to the extent the equity received in the transaction is sold to or redeemed by the issuing corporation (or a related party) “in connection with the reorganization”, continuity of interest is not preserved.

¹² Divisive reorganizations (spin-offs) also have a continuity of interest requirement. Thus, similar issues arise.

¹³ Treas. Reg. Section 1.368-1(e). The continuity of shareholder interest test generally requires that a substantial part of the value of the target shareholders' proprietary interest in the target be preserved. The IRS generally interprets this for ruling purposes as requiring at least 50% of the value of the target be exchanged for equity of the acquiring corporation. See Rev. Proc. 77-37, 1977-2 C.B. 568 and Rev. Proc. 86-42, 1986-2 C.B. 722. However, cases have found continuity to have been preserved where stock represents a smaller percentage of the consideration. See, e.g., *Nelson Co. v. Helvering*, 296 U.S. 374 (1935) (38% stock preserved continuity).

Section 368(c) Control. Certain forms of acquisitive reorganization require that “control” be acquired in the transaction.¹⁴ In addition, in order that a stock distribution qualify as tax-free under Section 355, the distributing corporation must control the controlled corporation within the meaning of Section 368(c) and distribute an amount of stock constituting control of the controlled corporation. Finally, in order to qualify for tax-free treatment under Section 351, property must be contributed in exchange for stock and immediately after the exchange, the transferor(s) must control the transferee corporation within the meaning of Section 368(c). Control is defined in Section 368(c) as the ownership of stock possessing at least 80 percent of the voting stock and at least 80 percent of the total number of shares of all nonvoting stock.

Solely for Voting Stock. Certain forms of acquisitive reorganization require that “solely voting stock” be issued in the transaction.¹⁵

Qualifying Consideration v. Boot. No gain or loss is recognized by a shareholder who exchanges stock in the target corporation for stock in the acquiring corporation in a transaction described in Section 368. Under Section 356, the receipt of money or property other than stock or securities will result in gain recognized to the recipient.

b. Restricted Stock

To provide compensation or to ensure the employee’s continued employment, employers transfer restricted stock to employees, often at a discount to fair market

¹⁴ A stock acquisition under Section 368(a)(1)(B) and Section 368(a)(2)(E) each requires that control of the target corporation exist after the reorganization. Further, triangular reorganizations require that the issuing corporation control the acquiring corporation.

¹⁵ Both forms of stock acquisitions, Section 368(a)(1)(B) and Section 368(a)(2)(E), and asset acquisitions described in Section 368(a)(1)(C) contain some form of the solely for voting stock requirement.

value.¹⁶ Typically, restricted stock must be forfeited at less than fair market value to the employer if certain performance goals are not satisfied or a minimum period of employment is not achieved. Restricted stock is by definition non-transferable, usually for a specified period of time or until the employee's retirement. Despite these restrictions, the employee/shareholder possesses the stock and generally has voting rights and dividend rights with respect to such stock. Thus, for corporate law purposes, restricted stock is treated as issued and outstanding and the issuing corporation reflects the equity as owned by the employee/shareholder on its books and records.

When the employee has a sufficient beneficial ownership interest in the stock, as described above, the stock is treated as "transferred" for Section 83 purposes. Stock has not been "transferred" if it is transferred under conditions that require its return upon the happening of an event that is certain to occur (e.g., the termination of employment), or where the employee has not incurred the risks of beneficial ownership that the value of the stock will decline (e.g., the stock is "purchased" for a non-recourse note and the employee does not make payments on the note).¹⁷ For purposes of this Report, the term "restricted stock" refers to stock that has been transferred within the meaning of Section 83 but is not substantially vested (including such stock for which a Section 83(b) election has been made). "Unrestricted stock" refers to stock that is not subject to Section 83 because it is substantially vested.

¹⁶ See H.R. Report No. 413 (Part 1), 91st Cong., 1st Sess. 86 (1969); S. Rep. No. 552, 91st Cong., 1st Sess. 119 (1969); Staff of the Joint Comm. on Internal Revenue Tax'n, 91st Cong., General Explanation of the Tax Reform Act of 1969, 109 (1970).

¹⁷ See Treas. Reg. Section 1.83-3(a).

c. Section 83

Section 83 is the exclusive statutory provision governing the transfer of property in the compensatory context (other than statutory stock options).¹⁸ In general, Section 83 applies to transfers of property in connection with the performance of services if the property is subject to restrictions.

Timing of Compensation Income under Section 83. Unless a Section 83(b) election has been made, when restricted stock is transferred in connection with the performance of services, the employee¹⁹ is taxed on the excess of the fair market value of the restricted stock when it first becomes transferable or is no longer subject to a substantial risk of forfeiture (“substantially vested”), over the amount (if any) paid for the restricted stock.²⁰ In order for Section 83 to apply, there must be a “transfer” of “property” “in connection with the performance of services”. Restricted stock is “property” for Section 83 purposes.²¹ A “transfer” occurs when a person acquires a beneficial ownership interest in the property.²² Satisfaction of the “in connection with the

¹⁸ Treas. Reg. Section 1.61-2(d)(6) recognizes that Section 83 applies to all property transfers in connection with the performance of services after June 30, 1969. Before the enactment of Section 83, Treas. Reg. Section 1.421-6(c) contained rules for taxation of nonstatutory stock options. These regulations were substantively identical to the current Section 83 regulations.

¹⁹ Section 83 is drafted broadly to apply to all service providers. All references herein to employees include references to independent contractors.

²⁰ Treas. Reg. Section 1.83-1(a)(1).

²¹ “Property” includes all property other than money and an unfunded and unsecured promise to pay money or property in the future. Because cash contains no bargain element, it is easily taxable under Section 61. An unfunded unsecured promise to pay compensation in the future lacks any clear prospect of a future transfer of property and thus is outside the scope of Section 83.

²² Treas. Reg. Section 1.83-3(a).

performance of services” standard requires a facts and circumstances examination and has been interpreted broadly by the IRS and the courts.²³

Until restricted stock becomes substantially vested, the transferor is treated as the owner of the property and any income received by the employee constitutes additional compensation.²⁴ Whether a risk of forfeiture is substantial depends upon the facts and circumstances, but generally, a substantial risk of forfeiture exists where rights in property are conditioned upon the future performance of substantial services.²⁵

Holding Period. The holding period for restricted stock begins after the stock is substantially vested. If the employee makes a Section 83(b) election, the holding period begins after the date the stock is transferred.²⁶

Employer’s Deduction. The employer (the service recipient) is entitled to a deduction under Section 162 or Section 212. In general, the timing and amount of such deduction is determined with respect to the timing and amount of the employee’s income inclusion.²⁷ This rule operates independently of general tax principles, in that the employer’s regular accounting method is irrelevant when there is a delay in the taxation

²³ See, e.g., Treas. Reg. Section 1.83-3(f) (standard applies when property is transferred “in recognition of the performance of, or the refraining from the performance of, services...”); *Alves v. Comm’r*, 79 T.C. 864 (1982), *aff’d*, 734 F.2d 478 (9th Cir. 1984) (Section 83 can apply even where there is no bargain element as long as there is a clear indication that the transfer is with respect to past, present, or future services).

²⁴ If, after the property becomes substantially vested, the employee’s interest is forfeited pursuant to a lapse restriction, the employee realizes an ordinary loss to the extent of previously included income. Treas. Reg. Section 1.83-1(e).

²⁵ Treas. Reg. Section 1.83-3(c). The regularity of the performance of services and the time spent in performing such services are relevant in determining whether services are considered substantial.

²⁶ Treas. Reg. Section 1.83-4.

²⁷ Section 83(h); Treas. Reg. Section 1.83-6(a).

of the employee. Consistent with the fiction of Section 83, any dividends paid on restricted stock (for which no Section 83(b) election has been made) will be deductible to the issuer/employer as compensation.

Sales of Restricted Stock. If restricted stock that has been transferred in connection with the performance of services is subsequently sold or otherwise disposed of to a third party in an arm's length transaction at a time when the stock is substantially nonvested, the employee realizes compensation income equal to the amount realized on such sale over the amount paid for the stock, if any.²⁸ If the property received by the employee in exchange for substantially nonvested stock is itself substantially nonvested stock, no gain or loss is recognized.²⁹ Instead, under a substitution theory, Section 83 applies with respect to the restricted stock received. If, instead, restricted stock that has been transferred in connection with the performance of services is subsequently sold or otherwise disposed of in a transaction that is not at arm's length and the stock remains substantially nonvested, the employee realizes compensation equal to the fair market value of the consideration received, not to exceed the value of the stock disposed of. Section 83 continues to apply to the stock, so that further income inclusions will be required when the stock becomes substantially vested (or is transferred in a non-arm's length transaction) and the value of the stock exceeds the amount that has already been taken into income.

²⁸ If, instead, the substantially nonvested property is forfeited, the employee will realize ordinary gain or loss equal to the difference between the amount paid and the amount received upon forfeiture, if any.

²⁹ Section 83(g).

Section 83(b) Election. An employee who receives substantially nonvested stock may elect under Section 83(b) to recognize income in the taxable year in which such stock is transferred instead of subjecting the stock to the open transaction regime of Section 83. The amount of income is equal to the fair market value of the stock over any amount paid for such stock and no later adjustment is made when the stock becomes substantially vested. The election is not revocable without the consent of the IRS.³⁰ If an employee fails to make a timely Section 83(b) election, the IRS generally will not grant relief and allow the election to be made.³¹ If the employee later forfeits restricted stock for which a Section 83(b) election was made, the employee is not entitled to a loss.

IV. Considering the Future Treatment of Restricted Stock – Recommendations.

The tax treatment of restricted stock is relevant for purposes of analyzing the reorganization requirements described in the Background section of this Report. Specifically, the following questions are raised by the unclear status of restricted stock as outstanding for tax purposes:

1. For continuity of interest purposes, whether the target shareholders (or shareholders of the distributing and controlled corporations in a Section 355 distribution) hold a “proprietary interest” before the transaction and whether such shareholders receive a “proprietary interest” in the transaction. In addition, if restricted stock were viewed as a “proprietary interest”, whether a later forfeiture

³⁰ Treas. Reg. Section 1.83-2(f).

³¹ Treas. Reg. Section 301.9100.

of the stock pursuant to the restrictions upon grant could result in a continuity of interest problem at that time.

2. Whether restricted stock is “stock” for purposes of the control definition of Section 368(c).
3. Whether restricted stock that carries a vote qualifies as stock for the “solely voting stock” requirement.³² If the stock does not carry a vote, does it count against the satisfaction of the requirement or is it simply ignored?
4. Whether restricted stock is “stock” for purposes of Sections 354 and 354 or could it instead be treated as boot, thereby affecting the tax-free status of the reorganization or incorporation?

a. Treatment of Restricted Stock as “Stock” that Is Outstanding and Owned by the Employee.

The open transaction policy of Section 83 was intended to affect the timing and amount of ordinary compensation income and deduction. By necessity, generally, there is a closed transaction policy for characterizing corporate transactions as reorganizations. Therefore, either restricted stock must be treated as owned by the employer and therefore ignored for purposes of characterizing reorganization transactions, or treated as outstanding and owned by the employee/shareholder.

Where restricted stock has been “transferred” for Section 83 purposes, the employee/shareholder is the beneficial owner of the stock.³³ Further, for state corporate

³² Rev. Rul. 71-80, 1971-1 C.B. 132, may be read to suggest that restricted stock does count toward the voting stock requirement. In that ruling, as part of a Type B reorganization, restricted stock in Target was exchanged for restricted stock in Acquiring. As considered in the issuance of Treas. Reg. Sections 1.354-1(e), 1.355-1(c), and 1.356-3(b), it is likely, however, that this exchange was viewed as outside of the reorganization exchange.

³³ Treas. Reg. Section 1.83-3(a).

law purposes, the stock is issued and outstanding and the issuer reflects that equity on their books and records. In the typical case, the holder has rights to dividends and voting rights. Presumably there is typically sufficient benefit to the employee/shareholder to fulfill the vesting conditions that one can infer an expectation that the employee will satisfy the conditions in order to retain the stock.

Because the owners of restricted stock enjoy the indicia of ownership of such stock, subject only to transfer restrictions and a risk (largely within the owner's control) that the stock will be forfeited, we believe that the restricted stockholders should be viewed in their capacity as shareholders and owners of the corporation for purposes of characterizing a corporate transaction as a reorganization. In our view, the actual rights the employee shareholder enjoys under relevant non-tax law should be the determining factor for purposes on reorganization treatment. We do not believe that the Section 83 fiction that treats the employee as not the owner of the stock until the compensation transaction is closed is relevant for purposes of the reorganization provisions.

Thus, we recommend that if restricted stock has been "transferred" to an employee/shareholder, regardless of whether a Section 83(b) election is made, such stock would be treated as outstanding and owned by the employee/shareholder for purposes of Section 368 and the related provisions. As a corollary, we do not believe that the making of a Section 83(b) election is relevant to the determination of ownership for these purposes. The election is merely a further fiction created to affect the timing and amount of compensation resulting from an issuance of equity. An 83(b) election has no non-tax economic consequences -- the stock is subject to the same forfeiture restrictions.

While we are not aware of any reason why this recommendation should not extend to all provisions of the Code (other than compensation), we have not adequately studied the policies and intricacies of all the provisions that may be implicated outside of the reorganization provisions. Thus, our recommendation is limited to the characterization of corporate transactions as tax-free reorganizations.

Consistent with this recommendation, restricted stock (that has been “transferred” for Section 83 purposes) would:

- a. be treated as a “proprietary interest” for purposes of the continuity of interest regulations;
- b. be treated as stock for purposes of determining whether Section 368 control is satisfied in the various contexts;
- c. be treated as stock for purposes of determining whether the solely voting stock requirement is satisfied (depending upon whether the restricted stock carries a vote);³⁴ and
- d. qualify as “stock” for purposes of Sections 354 and 355.³⁵

If this recommendation is adopted, it would be necessary to formulate a rule that would provide that if a transaction involving restricted stock qualifies as a tax-free

³⁴ If restricted stock has diminished or deferred voting rights until vesting, an analysis will need to be made under common law principles to determine whether it is treated as voting stock. *See, e.g.*, Rev. Rul. 72-72, 1972-1 C.B. 104 (where stockholder had granted an irrevocable right to vote stock for five years, stock was treated as nonvoting stock automatically convertible to voting stock in five years); Rev. Rul. 73-28, 1973-1 C.B. 187 (voting stock treated as voting stock even though local law restriction prevented shareholder from voting).

³⁵ This result is consistent with the guidance holding that for purposes of the reorganization provisions contingent stock does not constitute boot. *See, e.g.*, *Carlberg v. U.S.*, 281 F.2d 507 (8th Cir. 1960); *Hamrick v. Comm’r*, 43 T.C. 21 (1964); Rev. Proc. 84-42, 1984-1 C.B. 521; Rev. Rul. 66-112, 1966-1 C.B. 68.

reorganization under section 368, it will be treated as such by all parties involved in the transaction. Thus, it should not be possible, for example, for a transaction to qualify as a tax-free stock reorganization and also qualify as a qualified stock purchase under Section 338. Such a rule would be necessary to provide certainty to taxpayers and to avoid possible whipsaw resulting from different treatments of restricted stock.

b. Value of Restricted Stock Should Not Be Discounted.

The possibility of forfeiture of restricted stock raises an issue of valuation in measuring whether continuity of interest is satisfied (and potentially whether control has been acquired). We believe that as a general matter, requiring a discount for the possibility of forfeiture is not desirable as it undermines the goal of providing certainty to taxpayers. It will be difficult at best for employers to determine the likelihood of forfeiture as it is an event often largely within the control of the employee/shareholder. Thus, we recommend that the possibility of forfeiture be ignored for purposes of determining value in the context of tax-free reorganizations.³⁶ Otherwise, we do not recommend providing a special valuation rule for restricted stock for purposes other than the reorganization rules.

c. Subsequent Forfeiture Does Not Affect COI.

A subsequent forfeiture of restricted stock pursuant to the normal terms of its employment conditions is not made “in connection with the reorganization”, but is instead in connection with the employment relationship. Accordingly, we recommend that such a forfeiture not be taken into account for purposes of the continuity of interest

³⁶ While outside the scope of this Report, we recommend providing the same rule for stock with other types of forfeiture risks.

rules of Treas. Reg. Section 1.368-1(e). We do not believe that there would be resulting abuse potential because our recommendations only apply to restricted stock that is “transferred” and, thus, stock that is certain to be forfeited would not be treated as outstanding.

d. Need to Harmonize the Basis and Holding Period Rules for

Restricted Stock Received in Exchange for Unrestricted Stock.

If restricted stock is received in exchange for unrestricted stock in a corporate reorganization, there is an issue as to whether Section 83 should apply to the restricted stock where fair market value has been paid.³⁷ This Report does not make recommendations regarding the application of Section 83 in this context, as it is beyond the scope of the Report.³⁸

If the IRS and Treasury adopt the recommendations in this Report and if it is determined that Section 83 applies to restricted stock received in exchange for unrestricted stock, special rules would be necessary to determine the basis and holding period for the restricted stock. In a reorganization, under Sections 358 and 1223(1), the target shareholder’s basis in the acquiring corporation’s stock is equal to the basis in his target stock, and the holding period for the acquiring stock includes the holding period for the target stock. In sharp contrast, under Section 83(f), the holding period for restricted stock begins after the stock is substantially vested, and under the regulations, the shareholder’s basis in the stock will be equal to the amount paid for the stock,

³⁷ See *Alves v. Comm’r*, 79 T.C. 864 (1982), *aff’d*, 734 F.2d 478 (9th Cir. 1984).

³⁸ See NYSBA Report on Possible Modifications to Section 83 and the Regulations Thereunder (Dec. 7, 2000) (recommending that the Section 83 regulations should be amended to provide that a transfer to an employee who pays fair market value for restricted property would be treated as not being in connection with the performance of services).

increased by any amount includible in income when the stock is vested.³⁹ Since the “amount paid” for the stock is the fair market value of the property surrendered⁴⁰ (here, the target stock) it seems clear that the gain inherent in the target stock at the time of the reorganization is not taxed as compensation at the time the stock is substantially vested.

The reorganization and compensation rules need to be harmonized to ensure that:

- (i) assuming such gain has not been taxed, the employee/shareholder does not obtain an artificially high basis in the acquiring stock, and
- (ii) the holding period of the stock reflects the policies of both Section 83 and the reorganization rules.⁴¹

Possible models to address these issues are thoroughly outlined by Ginsburg and Levin in their treatise.⁴² Absent turning off Section 83 in this context, any solution inevitably would bring complexity. One additional approach to consider is the deeming of a Section 83(b) election so that less complex rules could be adopted, as described below.

If the employee makes a Section 83(b) election, the holding period begins after the date the stock is transferred and the shareholder’s basis will equal the amount paid for the stock (the value of the target stock) increased by any amount includible in income as

³⁹ Treas. Reg. Section 1.83-4.

⁴⁰ Treas. Reg. Section 1.83-3(g).

⁴¹ For example, if, at the time of the reorganization exchange, the target shareholder has a basis of \$60 in his stock with a value of \$100, and when the restrictions lapse the stock has a value of \$120, the shareholder should have \$20 of ordinary income. The language of the regulations may be read to provide that the shareholder would have a basis of \$120 in his stock (\$100 paid at the time of the reorganization + \$20 income); however no tax would have been paid on the amount of built-in gain (\$40) at the time of the reorganization. The holding period rule of Section 83(f) would provide that the shareholder’s holding period begins after the restrictions lapse, which would not recognize the policies of the reorganization rules.

⁴² See Ginsburg and Levin, *Mergers, Acquisitions, and Buyouts*, Vol. 2, ¶ 604.1.6 (June 2003).

compensation. However, because Section 83(a) technically would not apply where a Section 83(b) election has been made, the reorganization rules providing for carryover basis and tacked holding period should apply. We recommend a clarification to provide that the holding period of the target stock would be tacked onto the acquiring corporation stock to fulfill the reorganization policies. In order to prevent an employee/shareholder from obtaining an artificially high basis in the stock with no corresponding tax charge and thereby preserve the built-in gain at the date of the reorganization, we recommend that guidance should provide that the carryover basis rule of Section 358 will apply.

V. Examination of Recommendations.

The examples below illustrate the effects of the recommendations made in this Report. The results are consistent with general reorganization policy and provide certainty to taxpayers.

Stock Acquisition

Restricted Stock received in Exchange for Restricted Stock.

In a potential tax-free reorganization described in Section 368(a)(1)(B), venture capitalists, who own 60 percent of the target corporation, will receive voting stock from the acquiring corporation. Employee/Shareholder (“E/S”) owns the remaining 40 percent of the target stock and will receive acquiring voting stock in the exchange. Both E/S’s target stock and acquiring stock are each subject to a substantial risk of forfeiture.

If the recommendations in this Report are adopted, assuming all judicial requirements are satisfied, this transaction would qualify as a reorganization described in Section 368(a)(1)(B). The acquiring corporation controls the target corporation after the transaction and acquiring issued solely voting stock to the target shareholders. If the acquiring stock received by E/S has diminished voting rights until vesting, an analysis will need to be made under common law

principles to determine whether it is treated as voting stock. E/S would have a basis in the acquiring shares equal to the basis in his target shares (\$0, assuming he did not pay for the target restricted stock).

If the recommendations in this Report are not adopted and restricted stock is not treated as outstanding, E/S could receive cash or non-voting stock from acquiring and the transaction would presumably still qualify as a Type B reorganization.

Asset Acquisition

In a merger of target with and into acquiring pursuant to state corporation law, venture capitalists, who own 50 percent of the target corporation, will receive cash from acquiring. E/S owns the remaining 50 percent of the target stock and will receive acquiring stock in the exchange.

a. Restricted Stock Received in Exchange for Unrestricted Stock.

E/S' target stock is unrestricted. Acquiring wants to ensure that E/S will continue his employment and, thus, E/S will be required to forfeit the acquiring stock if he does not continue employment for five years.

If the recommendations in this Report are adopted, assuming all other relevant requirements are satisfied, this transaction would qualify as a reorganization described in Section 368(a)(1)(A). The continuity of interest requirement would be satisfied, regardless of whether a Section 83(b) election was made. A subsequent forfeiture would not affect the continuity analysis. The basis and holding period for the restricted shares would depend upon the model adopted to harmonize the two sets of rules. If the deemed Section 83(b) election model is adopted, the basis and holding period for E/S's unrestricted shares would carry over to the new restricted shares.

b. Restricted Stock Received in Exchange for Restricted Stock. E/S's target stock is subject to a substantial risk of forfeiture. The acquiring stock issued to E/S is subject to similar restrictions based on his continued employment.

If the recommendations in this Report are adopted, assuming all other relevant requirements are satisfied, this transaction would qualify as a reorganization described in Section 368(a)(1)(A). The restricted stock exchange would constitute a Section 354 exchange and the continuity of interest requirement would be satisfied, regardless of whether a Section 83(b) election was made for the acquiring stock. Section 83(g) would also apply so that Section 83 would continue to apply to the acquiring restricted stock to determine the timing and amount of compensation income.⁴³

c. Cash Received in Exchange for Restricted Stock.

E/S, who owns target stock subject to a substantial risk of forfeiture, is cashed out and the venture capitalists receive unrestricted stock of acquiring for half of their target stock and cash for the other half.

If the recommendations in this Report are adopted, this transaction would not be characterized as a reorganization because continuity of interest would not be satisfied. Instead, it would be characterized as a taxable asset acquisition.⁴⁴

If the recommendations in this Report are not adopted, assuming all other relevant requirements are satisfied, this transaction may qualify as a reorganization described in Section 368(a)(1)(A), even though 75 percent of the holders of target stock receive cash in the transaction.

⁴³ Under Section 83(g), the acquiring stock is treated "as if it were substituted for the property disposed of". Thus, it does not appear that E/S could make a Section 83(b) election for his acquiring stock.

⁴⁴ See Rev. Rul. 69-6, 1969-1 C.B. 104.

d. Unrestricted Stock Received in Exchange for Restricted Stock.

E/S's target stock is subject to a substantial risk of forfeiture. The acquiring stock issued to E/S is unrestricted.

If the recommendations in this Report are adopted, and assuming all other relevant requirements are satisfied, this transaction may be characterized as a reorganization described in Section 368(a)(1)(A). Under Section 83, because E/S disposed of his restricted stock in an arm's length transaction, he would recognize compensation income at the time of the reorganization. E/S would have a basis in the unrestricted stock equal to the amount included in his income plus any amount paid for the restricted stock and his holding period would begin at the date of the reorganization.