The Business, Entrepreneurship & Tax Law Review

Volume 2 | Issue 1 Article 4

2018

RSP Redux: Is IRC Section 83's Overreach "in [C]onnection with the [P]erformance of [S]ervices" the Real "[U]nwarranted and [U]nintended" Result?

Charles F. McCormick

ARTICLE

RSP Redux: Is IRC Section 83's Overreach "in [C]onnection with the [P]erformance of [S]ervices" the Real "[U]nwarranted and [U]nintended" Result?

Charles F. McCormick[*]

ABSTRACT

This article analyzes the effects of IRC § 83 from the perspective of those most often subject to it. While § 83 remains a critical tax consideration for entrepreneurs, this article concludes that § 83 has become, in practice, a solution searching for a problem that in fact causes more problems than it solves. Drafters of § 83 believed they were closing a significant loophole regarding the taxation of executive compensation. Looking at the problem legislators believed they were solving in the context of contemporary executive compensation structures, it is hard to understand what the actual problem was. Section 83(b) was supposed to offer a convenient solution. In reality, its arbitrary 30-day deadline serves as a potentially devastating trap for the unwary. From a policy perspective, cleverly titled laws, such as the JOBS Act, were enacted under the guise of helping entrepreneurs and small businesses and promoting capital formation. Results have been less than stunning. Real reform lies in simplifying the capital formation process and incentivizing entrepreneurs. If doing that requires going back to the proverbial drawing board, we should admit that and move forward.

Sections I–IV of this article review IRC § 83 from a mechanical, economic, and broader policy perspective. Sections V and VI identify specific, practical, contemporary problems that arise in applying § 83 to entrepreneurial and capital formation activities, particularly in comparison to substantively similar activities, such as issuing incentive stock options. Section VII proposes modest and simple, but effective reforms that remain mindful of the broader goals of tax neutrality.

[*] Charles F. McCormick, JD, University of Chicago Law School, BA, Fordham College, is a founding partner of McCormick & O'Brien, LLP. The author wishes to thank Professor Raymond H. Brescia of Albany Law School for his helpful guidance and suggestions. Gerad Soman assisted in the research and preparation of this article and provided helpful comments and suggestions while serving as a Law Clerk at the Firm. Any errors, omissions or other imperfections are entirely my own.

I. OVERVIEW

Internal Revenue Code ("IRC") § 83 assures that stock compensation paid to company executives is taxed. However, a broad reading of the rule leads to incongruous results and divergent tax treatment of substantively similar executive compensation in the form of stock options. Section 83(b) is intended to provide some relief, but in practice may create an administrative burden that, if ignored, can have significant negative tax consequences. Considerations of consistency, efficiency, incentives, and fairness all support a limited safe harbor for some restricted stock grants. Such a measure could be properly described as revenue neutral, compared to the current structure, and would affirm policy support for entrepreneurial initiatives. It might even be a good example of how "progress" sometimes involves looking at the past in a new light.

II. IRC § 83 STRUCTURE AND MECHANICS

Section 83 of the IRC is a vital aspect of the tax code for startups and their employees.[1] It addresses the tax consequences of issuing and accepting equity as payment for services. Specifically, § 83(a) states if "property" (e.g., stock) is transferred "in connection with the performance of services," then the recipient must include the difference between the fair market value ("FMV") of the stock and the price paid for the stock as ordinary income.[2] In doing so, the Internal Revenue Service ("IRS") is equating the tax treatment of cash and non-cash compensation.[3] If an employee was paid in cash, there would be little dispute that the payment should be included in the recipient's taxable income in the year in which it was paid. With stock issuance, however, the "payment" is the difference between the value of the stock received and the amount the recipient paid for the stock.[4] Call it an "employee discount," but then ask yourself why a discount on the purchase of stock is treated differently than a discount on merchandise (e.g., Ralph Lauren employees getting a 40% discount on clothing purchases),[5] particularly because the former is an investment, and the latter is consumption.

Section 83(a) appears to offer an accommodation to recipients of restricted stock.[6] If the "property" received is subject to a "substantial risk of forfeiture" (such as a vesting schedule) that will terminate at some point (a "lapse restriction"), then the recipient can elect to defer having to pay tax on the recipient's receipt of stock compensation until the first taxable year that the property is not subject to a substantial risk of forfeiture (when the shares vest).[7] After all, why pay taxes on something until you actually have it? Alternatively, under § 83(b), a recipient may elect

1. I.R.C. § 83 (2018).
2. *Id.* § 83(a).
3. Unfortunately, the same IRS does not maintain this equivalency regarding the form of payment that it accepts.
4. I.R.C. § 83(b). For more on this subject, *see generally Raising Money, Issuing Shares and Distributing Assets*, AM. B. ASS'N 63 (2003), http://apps.americanbar.org/buslaw/newsletter/0021/materials/books.pdf.
5. *See* I.R.C. § 132(a)(2).
6. *Id.* § 83(a).
7. *Id.* § 83(a).

to pay tax on the difference between the FMV of the property *at the time of transfer* and the price the recipient paid.[8]

Whether or not it is in the employee's interest to make the election depends in part on her specific financial situation and her assessment of the company's future.[9] Making a § 83(b) election could be viewed as an opportunity to pay a smaller amount of tax right away in favor of possibly having to pay a larger amount of tax in the future. If the employee believes the shares are likely to increase in value, the initial tax payment is manageable, and she will indeed satisfy the vesting requirements, making the § 83(b) election would be tax-efficient (and economically prudent). However, if some or all of the preceding conditions are not present, the benefit of paying the tax right away also creates a risk she will both lose that money and never realize the tax (or other) benefits from owning the stock.

For founders — and others present at the inception of a company — making a § 83(b) election can be an easier choice as the shares of a newly formed company with no revenues or assets may have a low or even *de minimis* FMV. However, even in this instance, founders would need to complete a § 83(b) election.[10] Moreover, the dilemma of whether or not to file a § 83(b) election can arise quickly after a company's launch — particularly if the company accepts seed-equity capital, or acquires a significant customer. Thus, this dilemma may create the wrong incentives when considering company formation and entrepreneurial activity.

It is unremarkable that § 83 is one of the many trade-offs found within the current tax code. However, as discussed further in this article, specific applications of § 83 frustrate the legitimate purposes of the law, result in different tax treatment for the same substantive activities, and create the wrong incentives for company formation and entrepreneurial ventures. A reasonable safe harbor (that might actually amount to a return to the *status quo* before § 83 was adopted) would be a welcome addition.

III. THE REAL ECONOMICS OF STOCK COMPENSATION IN STARTUPS

It is worth noting that the universal — perhaps inescapable — practice of an early stage company paying its employees and consultants with stock is, in economic terms, an inefficient choice.[11] Equity remains the highest cost of capital,

8. *Id.* § 83(b) (emphasis added).

9. *See generally* David I. Walker, *Is Equity Compensation Tax Advantaged?*, 84 B. U. L. REV. 695, 708–19 (2004) (discussing various factors affecting the long-term value of equity compensation to employees); Geri Terzo, *Pros & Cons of Issuing Common Stock*, CHRON, http://smallbusiness.chron.com/pros-cons-issuing-common-stock-55949.html (last visited Jan. 29, 2018).

10. 26 I.R.C. § 83(b).

11. Sean F. Reid, Matthew L. O'Connor & Steven J. Shapiro, *The Valuation of Employee Stock Options Issued by Closely Held Firms*, 13 J. LEGAL ECON., 19, 23 (2006) ("Startup firms often lack adequate cash flow to pay competitive salaries for talented employees and executives. To lure these desirable employees and executives to the startup firm, as well as retain their services as the company matures, a lucrative ESO package may be the most critical component of the compensation package."); *see also* Sharon Hannes, *Reverse Monitoring: On the Hidden Role of Employee Stock-Based Compensation*, 105 MICH. L. REV. 1421, 1439-1440 (2007) ("The main reason is that employees, like most people, are risk-averse. Since the value of option grants fluctuates due to factors beyond the employee's control, options are an extremely risky asset from her perspective. Moreover, employees are tied, along with their human capital, to the firm; putting much of their personal wealth in options means putting all their eggs in one basket and further increasing their risk. Taken together, the risk-bearing factor would cause employees

never more so than regarding the first equity issued by a company.[12] Companies use stock to pay employees because they have to, not because they want to.[13] In most cases, stock is simply the only currency available to a startup company to use as payment.[14] That said, this form of payment is only available at all because employees are willing to accept it. Thus (in addition to being a rare example of delayed gratification in our culture), employees accepting stock as payment can be fairly described, in economic terms, as an investment. If company and business formation is indeed a desirable societal goal, the tax code could — as it does in various other places — provide incentives to encourage a practice promoting company formation. At the very least, the tax code could avoid penalizing this form of investment.

IV. Economic and Policy Bases for IRC § 83

There are at least two separate economies in the United States — the "money" economy, and the "barter" (sometimes called the "underground" or "shadow") economy.[15] The money economy is far larger and much better documented.[16] Essentially, all economic statistics (e.g., GDP) are derived from data limited to the money economy.[17] On the other hand, the barter economy remains a black box; although some have estimated the annual size of the U.S.'s barter economy to be

---

to accept much lower compensation in cash over an option grant with equivalent market value. Therefore, payment with options, which employees value less, is expensive currency for firms. Furthermore, since no one can go to the grocery store with options, they cannot replace the employee's entire salary. Thus options usually supplement - at least in part - regular salary, further increasing the cost of options to the firm and its shareholders. The incentives that options create must overcome these costs to make option grants worthwhile."). *See generally* David I. Walker, *Evolving Executive Equity Compensation and the Limits of Optimal Contracting*, 64 VAND. L. REV. 611 (2011).

12. Founders' realization of this fact may well explain the current prevalence of issuing convertible notes rather than priced equity rounds in early stage financings. *See, e.g.*, Charles F. McCormik, *"The Princess Di Problem" of Convertible Note Financings*, MCCORMIK & OBRIEN, LLP, https://www.business.com/images/content/58a/e22af2b87b1a9242b871e/0-0-/ (last visited Apr. 18, 2018) (my previous article).

13. At inception, companies and their founders are often not economically distinct. It is neither economically efficient nor inefficient for a sole founder to issue herself 100% of the stock of the company she forms for her business. Once the founder and the company are economically distinct, however, equity is a costly form of payment. Companies and investors often claim that having employees own the company's stock or stock options better aligns the interests between employees and owners (by blurring this economic distinction). However, this "choice" is also often necessitated by the limited cash available to incipient companies (thus making it less of a choice and more of a necessity).

14. *See generally* Joseph S. Tibbetts, Jr. & Edmund T. Donovan, *Compensation and Benefits for Startup Companies*, HARV. BUS. REV. (Jan.–Feb. 1989), https://hbr.org/1989/01/compensation-and-benefits-for-startup-companies.

15. *See generally* Drew A. Swank, *Welfare, Income Detection, and the Shadow Economy*, 8 RUTGERS J. L. & PUB. POL'Y 614, 626–31 (2011); Marco Rabinowitz, *Rise of the Shadow Economy: Second Largest Economy in the World*, FORBES (Nov. 7, 2011, 11:02 AM), https://www.forbes.com/sites/benzingainsights/2011/11/07/rise-of-the-shadow-economy-second-largest-economy-in-the-world/#51ed09a04a0e.

16. *See* Swank, *supra* note 14, at 630–31 (discussing the difficulty of measuring the shadow economy); Rabinowitz, *supra* note 14.

17. *See* Arnold J. Katz, *An Overview of BEA's Source Data and Estimating Methods for Quarterly GDP*, BUREAU ECON. ANALYSIS 3 (Nov. 6, 2006), https://www.bea.gov/papers/pdf/china_source_data_estimating_methods.pdf; *see also Databases, Tables & Calculators by Subject*, BUREAU LAB. STAT., https://www.bls.gov/data/ (last visited Jan. 29, 2018); *Data*, FED. RES., https://www.federalreserve.gov/data.htm (last visited Jan. 29, 2018).

approximately 5% of the size of the overall U.S. economy.[18] Despite the IRS's best efforts,[19] the U.S. tax system does not have much luck assessing taxes outside of the money economy.[20] Section 83 can thus be seen as an effort to tax *bona fide* employee compensation paid in the form of stock rather than money.

It is difficult to tax stock compensation because the value of stock in private companies is not easily calculated.[21] The addition of factors like sale restrictions and vesting provisions only makes these calculations harder.[22] Under the law that existed prior to the enactment of § 83, the recipient of restricted stock would only be taxed when all such restrictions expired, thus, creating a disparity between the taxation of cash compensation, which was taxable immediately, and restricted stock compensation.[23] To make matters worse, there seems to have been some concern that these arrangements, known as "restricted stock plans," were merely a clever scheme concocted by employers and employees to defer (or control the timing of) an employee's tax liability.[24]

Importantly, lawmakers at the time appear to have rejected the familiar contemporary understanding of restricted stock plans as serving the same purpose as stock option plans.[25] Instead, in its report, the Senate Finance Committee ("Committee") found a closer comparison in what it called "nonexempt employees trusts," which it explained may be funded with "stock in the employer corporation, stock of another company — often an unrelated growth company — or even shares of a mutual fund."[26] The Committee's comparative analysis of restricted stock plans and stock option plans is worth quoting in its entirety:

> It has been suggested by some that restricted stock plan[s] are not in fact, deferred compensation arrangements, but rather are a means of allowing

18. Niall McCarthy, *The Countries with the Largest Shadow Economies [Infographic]*, FORBES (Feb. 9, 2017, 8:09 AM), https://www.forbes.com/sites/niallmccarthy/2017/02/09/where-the-worlds-shadow-economies-are-firmly-established-infographic/#64f72d5a742c.

19. *Bartering Tax Center*, INTERNAL REVENUE SERV., https://www.irs.gov/businesses/small-businesses-self-employed/bartering-tax-center (last visited Oct. 18, 2017).

20. *See, e.g.*, Edgar L. Feige, *New Estimates of Overseas U.S. Currency Holdings, the underground Economy and the "Tax Gap"*, MUNICH PERS. REPEC ARCHIVE 1 (Apr. 24, 2011, 5:02 PM), https://mpra.ub.uni-muenchen.de/30353/3/MPRA_paper_30353.pdf (calculating that in 2010, 18-19% of total reportable income in the U.S. was not properly reported to the IRS).

21. Reid, O'Connor & Shapiro, *supra* note 10, at 24 ("The typical pre-IPO startup firm has an extremely uncertain future. Because of this uncertainty in the value of the company, the value of the options on the underlying stock is extremely difficult to estimate."); Elisabeth de Fontenay, *The Deregulation of Private Capital and the Decline of the Public Company*, 68 HASTINGS L. J. 445, 490–92 (2017) (outlining specific difficulties in valuing private securities in the absence of a market price). S*ee generally Private Company Valuation*, CFA INST., https://www.cfainstitute.org/learning/products/publications/inv/.../equity_chapter9.ppt (last visited Apr. 18, 2018); *see also* Elizabeth Pollman, *Information Issues on Wall Street 2.0*, 161 U. PA. L. REV. 179, 203–04 (2012) (describing economic consequences of such difficulty).

22. *See* Reid, O' Connor & Shapiro, *supra* note 10, at 25–26. *See, e.g.*, Robert Heaton, *How to value your startup stock options*, ROBERTHEATON.COM (Nov. 2, 2015), https://robertheaton.com/2015/11/02/how-to-value-your-startup-stock-options/.

23. *See*, *e.g.*, *Tax Reform Act of 1969: Hearing on H.R. 13270 Before the S. Comm. on Fin.*, 91st Cong. 50 (1969) (statement of the Honorable David M. Kennedy, Secretary of the Treasury).

24. *Id.* (In particular, Secretary Kennedy's Statement cited "rapid growth in the number of *so-called* 'restricted stock plans,'" and his view that current tax law "amounted to an unwarranted an unintended benefit.") (emphasis added).

25. *See*, *e.g.*, S. REP. NO. 91-552, at 120–21 (1969).

26. *Id.* at 119.

> key employees to become shareholders in the business. This line of reasoning, however, overlooks the fact that in 1964 Congress specifically dealt with the matter of *the appropriate means* by which key employees could be provided with a stake in the business when it revised the treatment of qualified employee stock options.[27]

In the modern context, it would be fair to say that the distinction the Committee understood between deferred compensation plans and "a means of allowing key employees to become shareholders in the business" is as puzzling as a modern corporate compensation program that offers employees shares of another company.[28]

Given that Congress and the Treasury had specific, well-developed ideas regarding the structure and taxation of employee stock ownership plans, it seems they believed restricted stock plans created a disparity between the tax treatment of restricted stock arrangements and other recognized stock ownership programs.[29] In particular, since they had previously issued the definitive (and apparently exclusive) word on employee stock ownership programs in the form of IRC § 421, *et seq.*, there was no reason to consider (or even recognize) any alternatives.[30]

To summarize, the impetus behind the enactment of IRC § 83 in 1969 appears to have been achieving uniformity and consistency in the taxation of employee stock ownership programs, and closing what was considered at the time to be a glaring loophole in the tax code. While all of these goals sound sensible and rational, by rejecting the idea that restricted stock programs fundamentally are employee stock ownership programs, IRC § 83 has fallen short in these areas. Worse than that, these shortfalls can have unhealthy effects on essential components of company formation and entrepreneurial activity. Fundamentally, it appears policymakers at the time missed, or ignored, the dual economic nature of stock compensation as both compensation and investment — and arguably more so the latter than the former — on the part of the recipient. Let's fix that.

V. THE WIDE NET CAST BY THE WORDS "IN CONNECTION WITH THE PERFORMANCE OF SERVICES": CONTEMPORARY, PRACTICAL PROBLEMS WITH THE APPLICATION OF IRC §83

As a general legal principle, laws that impose restrictions or obligations are interpreted narrowly, while laws that confer or protect rights or benefits are interpreted broadly.[31] At least they should be in a system where the government derives its rights and powers from the people, rather than the other way around.

---

27. *Id.* at 120 (emphasis added).
28. *Id.*
29. *Id.*
30. *Id.* ("[I]n 1964 Congress specifically dealt with the matter of the appropriate means by which key employees could be provided with a stake in the business when it revised the treatment of qualified employee stock options.").
31. *See generally* Stephanie Hall Barclay, *Retained by the People: Federalism, the Ultimate Sovereign, and Natural Limits on Government Power*, 23 WM. & MARY BILL OF RTS. J. 257, 298–99 (2014); Gary Lawson & Robert Schapiro, *Common Interpretation: The Tenth Amendment*, CONST. CTR., https://constitutioncenter.org/interactive-constitution/amendments/amendment-x (last visited Jan. 29, 2018).

The IRS, unfortunately, interprets the language of § 83, "in connection with the performance of services" broadly,[32] going so far as to clarify that the "performance" of services also includes refraining from the performance of services, and such services include "past, present or future" services.[33] More critically, the language "in connection with" can be applied so broadly as to cover transactions (i.e., "transfers" of stock) that are not compensatory in substance — and may actually be just the opposite. Keeping in mind that an income tax law should probably limit its focus to taxing income — this is an unfortunate result.[34] Secondly, the IRS interprets the term "transfer" so broadly as to include instances that commend form over substance, even where adjacent areas of the tax code clearly impose no immediate taxation.[35] Below are a few specific scenarios worth noting.

A. *Founders Contributing Property at the Formation of the Company*

Assume that, in connection with A and B forming XCorp, A contributes a software program with an agreed FMV of $1MM, and B contributes computer equipment with an agreed FMV of $1MM. A and B each receive 1,000 shares of common stock in exchange for the property they contribute, but each also agrees to subject her shares to a four-year reverse vesting schedule. Under IRC § 351, the exchange of property for stock should not be a taxable event.[36] However, if the vesting schedule is deemed to be evidence of an agreement to remain working for the new company for the vesting period, then a literal application of IRC § 83 — a transfer of property in connection with the performance of services — would require A and B to either recognize ordinary income upon the vesting of their shares, or make a §

32. The seminal case in this area is arguably a Tax Court case that was affirmed by the 9th Circuit, Alves v. Comm'r, 734 F.2d 478 (9th Cir. 1984) (In its decision, the Tax Court notes that approximately one month after Mr. Alves purchased his shares of common stock for $0.10 each, the company sold shares of preferred stock for $3.10 each – equating to a 97% discount for Mr. Alves! Interestingly, the Court did *not* cite this fact in the explanation of its ruling. However, doing so may have better substantiated the Court's decision than reciting the provisions of corporate minutes and Mr. Alves's employment agreement at length. In sum, the *Alves* decision may well have been a sound application of the step transaction doctrine rather than a tortured statutory interpretation.); *see also* Victor Fleischer, *Taxing Founders' Stock*, 59 UCLA L. REV. 60, 103 (2011) (citing *Testimony of Jack S. Levin to the House Ways & Means Committee*, KIRKLAND 3 (Sept. 6, 2007), http://www.kirkland.com/files/Levin_Testimony_090607.pdf) ("Or if an innovative entrepreneur like Bill Gates and his investor group start a company, is (or should) the entrepreneur's long-term capital gain on sale of the computer company's stock be converted into ordinary income because he had many sweaty armpit days? My point is that the Code does not make, and never has made, the absence or presence of activity and ingenuity - or even a bit of bodily dampness - the test for long-term capital gain, nor should we now legislatively adopt a test requiring IRS agents to poke around in Warren Buffett's or Bill Gates' dirty laundry searching for perspirational evidence.").

33. Treas. Reg. § 1.83-3(f) (as amended in 2014); *see also* Fisher v. Comm'r, No. 92-2457, 1993 U.S. App. LEXIS 21018, at *2 (1st Cir. Aug. 20, 1993).

34. And for an interesting suggestion that so imposing income tax on this form of unrealized income may violate the Sixteenth Amendment to the Constitution, *see* Ronald Hindin, *Internal Revenue Code Section 83 Restricted Stock Plans*, 59 CORNELL L. REV. 298 (1974).

35. *Alves*, 734 F.2d at 478 ("Congress . . . has clearly expressed the intention that Section 83 is to have the broadest application.").

36. I.R.C. § 351(a) (2018) ("General rule. No gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock in such corporation and immediately after the exchange such person or persons are in control (as defined in § 368(c) of the corporation.")).

83(b) election.[37] Had the statutory language been more narrowly drafted — perhaps the following: "a transfer of property substantially in exchange for/as compensation for the performance of services" — IRC § 83 would arguably be inapplicable.

An exemption from § 83 here would not be a repugnant result. Here, it is clearer to see the mutually imposed reverse vesting restrictions as a distinct business arrangement between A and B (such as a co-sale or first offer right), rather than a trigger that should cause the underlying issuance of the stock to be taxed as compensation. Each Founder is requiring the other to forego other opportunities, [38] lest one Founder leave it entirely to the other to undertake the substantial work required to launch a new company. In other words, even if A and B respectively contribute the boat and the oars, if they want to get anywhere they both have to row. Accordingly, it is difficult to understand how the mutually-imposed vesting feature should allow the IRS to re-characterize the formation of XCorp as a taxable event.

B. Buying Stock Along with Investors

Here, an investor purchasing preferred stock in a company asks the founders and or other employees to purchase shares of common stock, and that such shares be subject to vesting schedules.[39] For the sake of simplicity, assume that the shares of common stock are sold at a lower price per share than the shares of preferred stock, but that the price was established based on a contemporaneous valuation opinion quantifying the price difference between the preferred and common stock.[40] Were these common shares issued "in connection with the performance of services?" IRS guidance is not helpful. Had the founders or employees purchased the same preferred stock as the investor, they may be outside of the reach of § 83. Treasury Regulation § 1.83-3(f) states the following:

> 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, however, indicate that in such circumstances a

37. § 351(d) ("Services, certain indebtedness, and accrued interest not treated as property. For purposes of this section, stock issued for . . . services . . . shall not be considered as issued in return for property.").

38. As discussed above, the reference in Treas. Reg. § 1.83-3(f) defines the "performance" of services as including "refraining" from any such performance. However, to describe the affirmative requirement to work for XCorp as the requirement to "refrain" from working anywhere else, ignores the substance of the economic agreement.

39. James K. Baer & Mara Morner-Ritt, *Surviving the Nuclear Winter*, 24 L.A. LAW. 24, 27 (2001) ("Venture capitalists are increasingly requiring that the equity remaining in the hands of the founders vest over a period of time (usually two to four years, with a portion, such as 10%, to vest upon the closing of the initial investment). The stock of the founders will continue to vest only so long as they remain employed over the vesting time period. To implement vesting, the founders grant the company or the investors the option to purchase the founders' unvested stock at a price based upon the purchase price paid by the venture capitalists in their investment. Thus, for example, if the purchase price and the conversion price of the preferred stock purchased by the venture capitalists is $1 per share, the common stock held by the founders would be subject to repurchase at $1 per share."). *See also* Bo Yaghmaie, *Vesting: A Founder's Need to Earn Equity*, ENTREPRENEUR (Jan. 27, 2014), https://www.entrepreneur.com/article/231044.

40. Commonly referred to as a "409A Valuation" or a "409A Opinion".

transfer to the employee is not in recognition of the performance of, or the refraining from performance of, services.[41]

As highlighted, the "same terms and conditions" requirement may be hard to apply where the employees are purchasing a different class of stock for a different price per share. If so, then the IRS may view this "transfer" of common stock to be "in connection with the performance of services," and thus susceptible to § 83.[42]

This result makes little sense. A likely reason for such a series of transactions is that the investors required the founders or employees to purchase stock alongside them in order to align incentives, but were unwilling to afford them the privileges and preferences of the preferred stock the investors bought.[43] In particular, the common rationale for a preferred stock liquidation preference — that actual dollars invested should have greater downside protection than "sweat equity" — does not apply.[44] Both the investors and the employees would pay actual dollars for their shares, but in a liquidation scenario, only the preferred stockholders would have the benefit of a liquidation preference.[45]

To claim that the vesting condition was in exchange for the "lower" price per share misses the point since the common shares should indeed have a lower price than the preferred shares, given the preferred stock's additional preferences and privileges. In sum, there is no colorable "compensatory" aspect of the common stock transfer,[46] yet current IRS rules characterize this purchase of common stock as a taxable event to the employee purchaser.[47] A preferable treatment would be to not penalize founders or employees who purchase stock in their own companies so long as they pay FMV for their shares.

C. Agreeing to Vesting in Connection with a Later Third-Party Investment

Here, a group of founders may have issued stock to themselves at the inception of their company, but chose not to impose vesting schedules on themselves or one

41. "May" is the operative term here, as Treas. Reg. § 1.83-3(f) should not be interpreted as a safe harbor. (emphasis added).

42. *See* Montelepre Systemed, Inc. v. Comm'r, No. 30290-88, 1991 Tax Ct. Memo LEXIS 65, at *29–30 (T.C. Feb. 6, 1991) (Section 83 applies to the grant of an option to pay the same price as an outsider agrees to pay, even when terms and conditions are different.).

43. *See* Baer & Morner-Ritt, *supra* note 38, at 27–28; *see also* Mark Suster, *First Round Funding Terms and Founder Vesting*, BOTH SIDES TABLE (Aug. 17, 2009), https://bothsidesofthetable.com/first-round-funding-terms-and-founder-vesting-3ff81f55c7bd.

44. *See* Gregg D. Polsky & Brant J. Hellwig, *Examining the Tax Advantage of Founders' Stock*, 97 IOWA L. REV. 1085, 1092 (2012). *See also* Charles Yu, *The Ultimate Guide to Liquidation Preferences*, MEDIUM (Jan. 1, 2017), https://medium.com/@CharlesYu/the-ultimate-guide-to-liquidation-preferences-478dda9f9332.

45. Yu, *supra* note 43.

46. Other than the possible argument that only the founder/employees were afforded the opportunity to purchase the shares at all.

47. The language of the second sentence of Treas. Reg. § 1.83-2(a) (2016) has been read to codify this incongruity (i.e., taxing investment as compensation). Note, however, the timidity (but perhaps temerity) with which this idea is presented: "realizing no bargain element in the transaction *does not preclude* the use of [a Section 83(b)] election . . ." (emphasis added). It is true but nonetheless disappointing that the IRS's position is that it is not impermissible to pay tax where no income is realized.

another.[48] An outside investor leading a significant round (or making a significant investment) may require the founders to accept vesting of their founder shares.[49] Should the founders make a § 83(b) election at this time? If not, would they be subject to tax when their shares vest?

In this instance, IRS guidance is helpful. Under IRS Revenue Ruling 2007-49, a "post grant restriction," such as a vesting schedule, would not bring the original transfer of stock to the founders within the ambit of § 83.[50] The basis for this conclusion is that the imposition of a vesting schedule alone does not constitute the "transfer" of stock that triggers § 83.[51] That said, if both the original issuance to the founders and subsequent third-party investments are close in time, or otherwise connected (e.g., substantive correspondence between the founders and investors regarding vesting of founder stock that predates the original issuance of the founder stock), the IRS may apply either the "substance over form" or "step transaction" doctrine.[52] In either instance, the IRS's position would be that the founders received cheap stock (relative to the price of the preferred stock sold to the investor) subject to vesting, and had to pay tax on the difference between the value of the stock they received and the amount they paid for it, either within 30 days of the date of grant, or upon vesting of the stock.[53] Of course, if this problem is not identified and resolved within that 30-day post-issuance period, § 83(b) may not be available, and the tax would be based on the FMV of the stock at the time of vesting.[54]

D. *Exchanging Vested for Unvested Shares in Connection With "Tax Free" Reorganization*

Revenue Ruling 2007-49 explains that if employees with unrestricted stock are asked, or required, to subject their shares to vesting in connection with a "tax free" transaction under IRC § 368(a), the restriction is a "transfer" (presumably of pre- or post-transaction shares) "in connection with the performance of services."[55] As such, § 83 would apply. This treatment captures the form but not the substance of the transaction.

First, the IRS interprets the word "transfer" broadly in § 83, which elevates administrative aspects over economic ones.[56] In particular, although the transaction

---

48. For a general introduction on this topic, *see* Guimar Vaca Sittic, *Startup founder vesting: Here's what it is and why it's your best friend*, NEXT WEB (July 21, 2013), https://thenextweb.com/entrepreneur/2013/07/21/startup-founders-heres-why-vesting-is-your-best-friend/. For an example of founders imposing vesting on one another, see Charles F. McCormick, *Introducing the Founder Accord*, MCCORMIK & O'BRIEN LLP, https://www.mcoblaw.com/founder-accord (last visited Apr. 19, 2018) (cited in DAVID S. ROSE, THE STARTUP CHECKLIST: 25 STEPS TO A SCALABLE, HIGH-GROWTH BUSINESS (2016)).

49. Perhaps with "credit for time served" on the customary 4 year vesting schedule, such that if the company were founded one year before its first significant investment, the founders would be asked to agree to a 3 year vesting schedule with no initial 1 year cliff.

50. Rev. Rul. 2007-49, 2007-2 C.B. 237.

51. *Id.*

52. *See* Gregory v. Helvering, 293 U.S. 465 (1935).

53. *See* I.R.C. § 83(a) (2018).

54. *Id.* § 83(b)(2).

55. Rev. Rul. 2007-49, 2007-2 C.B. 237.

56. *See Transfer of Ownership Guidelines*, MICH. ST. TAX COMMISSION 4 (Oct. 30, 2017), https://www.michigan.gov/documents/treasury/TransferOwnershipGuidelines_423898_7.pdf. ("Central to the concept of transfer of ownership is a change in the beneficial use of the property.").

would involve administratively exchanging shares of the target company for shares of the acquiring company, there would be no economic "transfer" — no conveyance of additional or incremental value — that might fairly be deemed to be compensation.[57] Had the vesting worked the other way, and the employee's shares been transformed from unvested to vested in connection with the reorganization, the case would seem much stronger to require the employee to recognize compensation from the benefit received, as would be the case if IRC § 280G applied. Instead, an application of Rev. Rul. 2007-49 imposes a curious conformity with the application of § 280G[58] — if your unvested shares become vested, you are taxed, but if your vested shares become unvested, you are taxed!

Second, treating a post-grant restriction imposed in connection with a reorganization as being within the scope of § 83 creates disparate tax treatment from the simpler post-grant-restriction scenario discussed above. In the first situation, the employee's shares are made subject to vesting when a new investor invests in the company, and § 83 expressly does not apply. In the second, the employee's shares are made subject to vesting when a business partner joins the company, and § 83 expressly does apply. The substantive distinction between an investment and a business combination — particularly here where the target business is not being liquidated, but instead is continued in combination with another business, is hard to appreciate.

The example given in the Revenue Ruling may also raise more questions than it answers. For instance, a state reincorporation merger (e.g., re-incorporating a New York corporation in Delaware) is often done at the insistence of a new investor, and is effected through a merger that would technically qualify under § 368(a).[59] Under the Revenue Ruling, imposing vesting in connection with the reincorporation transaction, falls within the scope of § 83.[60] Again, such a re-domiciliation transaction amounts to little more in economic terms than a company changing its name, and the compensatory aspect of such an administrative event remains a mystery.

Moreover, if the post-grant restrictions were imposed prior to the transaction (such that the employee was exchanging unvested shares for unvested shares),[61] or even at some point after the completion of the transaction, it is not clear that § 83 would apply. Arguably, applying Situation 1 of the Revenue Ruling (agreeing to vesting in connection with a later third party investment), the employee would be outside the scope of § 83 in both instances.[62] A similar argument exists in the instance of a formless conversion of a limited liability company ("LLC") to corporate form.

Third, the IRS's proposed treatment creates a disparate characterization under IRC §§ 368(a) and 83.[63] If the express purpose of applying § 368(a) is to defer a

---

57. *Id. See* Barry A. Gerhart, Harvey B. Minkoff & Ray N. Olsen, *Employee Compensation: Theory, Practice, and Evidence*, CORNELL U. CTR. FOR ADVANCED HUM. RESOURCE STUD. (May 1994), http://digitalcommons.ilr.cornell.edu/cgi/viewcontent.cgi?article=1193&context=cahrswp (for an overview of compensation theory).

58. I.R.C. § 280G.

59. Rev. Rul. 80-56904, 2015-41 I.R.B. 528.

60. Rev. Rul. 2007-49, 2007-2 C.B. 237.

61. *Id.* (does not address a scenario where unvested shares are exchanged for unvested shares in I.R.C. § 368(a) reorganization).

62. Imposing the vesting restrictions either in advance of or at some time after the transaction.

63. *See generally* I.R.C. § 83 (compare with Rev. Rul. 2007-49, 2007-2 C.B. 237).

taxable event,[64] why is § 83 being applied to impose a taxable event in connection with an economic detriment (imposition of a vesting restriction) as opposed to an economic benefit?[65]

Finally, and fundamentally, it is hard to understand the exchange of vested shares for unvested shares as being in any way compensatory. If anything, it could be described in the opposite way. Thus, by focusing on the issue of whether the exchange of shares in a business combination is a "transfer," (which it arguably is not, since the transferor and transferee are the same person) the IRS appears to miss the larger issue of whether imposing the vesting restriction should make the original issuance of the shares compensatory (which it much more clearly is not).[66]

VI. Section 83 Creates a Disparity in the Taxation of Stock Options and Restricted Stock

If one of the Treasury Department's goals was to maintain consistent tax treatment of substantively similar activities, then a comparison of the current taxation of two comparable structures might be informative.[67] The first is the case of incentive stock options ("ISOs") granted by a corporation.[68] And, the second is the case of profits interests granted by an LLC.[69] As a preliminary note, while the LLC structure is increasingly popular for early stage companies today, it did not come into existence until years after § 83 was adopted.[70] To further convolute matters, many in today's entrepreneurial community use the terms "LLC," "company," and "corporation" interchangeably despite the significant technical differences between the corporate and LLC forms.

Issue	**Restricted Stock**	**ISOs**	**LLC Profits Interest**
Taxable on grant?	Yes (§ 83(b)) election)	No	No
Taxable on vesting?	Yes	No	No
Taxable on Exercise?	N/A	No	N/A
Recipient filing requirements?	Yes	No	No

So much for consistency. Instead of the current rules, what if grants of restricted stock were exempted from § 83 if the shares were purchased at their FMV? Support for such a position actually lies within the pages of §§ 421 and 409A of the tax code, which provides, collectively that so long as the exercise (or "strike") price of the

64. Rev. Rul. 2007-49, 2007-2 C.B. 237.

65. As noted above, while it is the case (e.g., I.R.C. § 280G) that the tax code imposes income tax on compensation received in connection with a reorganization transaction that qualifies under I.R.C. § 368(a), the compensatory aspect of such other instances is far more obvious. § 280G applies, the recipient is gaining a benefit (accelerated vesting). Where the Revenue Ruling applies, the recipient is losing a benefit (subjecting vested shares to vesting).

66. *See generally* I.R.C. § 83 (compare Rev. Rul. 2007-49, 2007-2 C.B. 237).

67. *See generally* Feige, *supra* note 19.

68. *See generally* I.R.C. § 422.

69. *See generally* I.R.S. Notice 2005-43, 2005-1 C.B.1221.

70. Warren H. Johnson, *Limited Liability Companies (LLC): Is the LLC Liability Shield Holding Up Under Judicial Scrutiny?*, 35 New Eng. L. Rev. 177, 184 (2000).

option is equal to at least 100% of the underlying stock's FMV, as of the date the option is granted, the employee pays no tax upon the grant, vesting or exercise.[71]

A reasonable extension of this concept might be to finally quantify, and tangibly credit, entrepreneurs for their "sweat equity." Here is a simple example: an engineer leaves a job (or even declines an alternative offer) paying her $150,000 to accept a job offering a $50,000 salary, would be deemed to have a "credit" of $100,000, such that the proposed exemption would apply up to the point where the FMV of the restricted stock granted to her exceeded the price she paid for it upon grant by that same $100,000.[72]

As such, the taxation and administration of restricted stock grants would more closely track that of stock option grants.[73] If anything, restricted stock grants better achieve an important goal for stock based compensation — to align the interests and incentives of owners and managers — because restricted stock typically confers all of the rights, preferences and privileges of stock ownership, including governance and economic participation in the form of voting rights, and the rights to receive dividends immediately when the stock is issued.[74] This is not the case with stock options, which confer no voting, dividend, or other corporate rights until the options are exercised.[75] Further, restricted stock grants can involve an immediate investment by the employee, whereas options can only be exercised after they have vested.[76] A consistent treatment of restricted stock grants would similarly exempt an employee from paying tax *or having to make a § 83(b) election*, so long as the employee purchases the stock for at least 100% of its FMV as of the date that the stock is issued.[77]

VII. Conclusion and Recommendations

Complaining about § 83 in the above situations could understandably be criticized as making a mountain out of a molehill. After all, in many (or even all) of the instances cited above, under § 83(b) the tax due would be zero (being the difference between the FMV of the property on the date of transfer and the amount paid by the recipient).[78] The problem is a practical and meaningful one. What if you do not believe, or are simply not aware that § 83 should apply, or if you simply fail to make a timely (within 30 days of the issuance of the stock — no exceptions, no excuses) § 83(b) election? In that case, tax would be due at the time of vesting, in an amount equal to the difference between the FMV of the stock at that time and the original price paid.[79] In other words, *all* of the appreciation in the value of the stock during

---

71. I.R.C. §§ 421, 409A (ignoring, for purposes of this article, the application of alternative minimum tax rules).

72. *See id.* §§ 83(a)–(b). Whether such a practice would run afoul of recently enacted salary history bans or simply creates a wrinkle in that movement is beyond the scope of this article and remains to be considered.

73. *See id.* §§ 83(a)–(b), 421.

74. For an overview of stockholder rights, *see* Julian Velasco, *The Fundamental Rights of the Shareholder*, 40 U.C. DAVIS L. REV. 407 (2006).

75. *See, e.g.*, *What is an Option? – Part I*, OPTIONS INDUSTRY COUNCIL, https://www.optionseducation.org/getting_started/options_overview/what_is_an_option/part_1.html (last visited Apr. 19, 2018).

76. Tibbetts & Donovan, *supra* note 13.

77. *See* I.R.C. § 422(b)(4).

78. *Id.* § 83(b).

79. *Id.* §§ 83(a)–(b).

the vesting period would effectively be taxable to the founder or employee at ordinary income rates. Again, the fact that a timely § 83(b) election would result in zero tax due is *not* the same as exempting the transaction from the filing requirement altogether because substantial tax could be due upon the vesting of restricted stock if a timely election were not made.[80] While some may consider this predicament to be merely a trap for the unwary, if substantive economic and policy considerations would favor such an exemption, what then becomes the purpose of a "trap" in the first place? Current rules under § 83 merely create an increased administrative burden that essentially serves to penalize employees who make an economic investment in an entrepreneurial venture.[81]

IRS rules provide that whether or not a particular issuance of stock falls within the scope of § 83 depends on the totality of the facts and circumstances.[82] At best, this is cold comfort. As a practical matter, factual analyses are time consuming, expensive, and ultimately subjective and inconsistent. In other instances, where policy considerations prevail, the law creates safe harbors.[83] Here, the policy considerations would be to create incentives for company formation and entrepreneurial activity by affording clarity around a prevalent and integral element of that process. Moreover, while the administrative requirements are not overwhelming, they do fall predominantly on a category of taxpayers, entrepreneurs, and those still on the "labor" side of the labor and capital continuum,[84] that are less able to bear them.[85]

It is not necessarily the case that paying employees with stock is merely a clever, superficial scheme concocted between companies and employees to cheat the government out of tax revenues. Stock is often the only currency available to startup companies,[86] and as such, it is a critical ingredient for company formation and development. The costs (to the company) and the risks (to the employee) that accompany this practice are real and significant. In this light, § 83 appears to be an attempt to apply the substance over form doctrine that ends up applying form over substance. It cannot be a reasonable interpretation that any issuance of stock to employees should be a "transfer of property . . . *in connection with the performance of services*" that falls within the ambit of IRC § 83, but the practical burdens of testing

80. *Id.*

81. *But see* T.D. 9779, 2016-33 I.R.B. (eliminating the requirement that a copy of a § 83(b) election be submitted with the taxpayer's income tax return for the taxable year in which the property is transferred).

82. 26 C.F.R. § 1.83-3(a)(2) (2018).

83. For specific examples, *see, e.g.*, 17 C.F.R. §§ 230.501, 230.144 (2015). For a more general overview of safe harbors, *see* Jean Murray, *What is a Safe Harbor Law or Provision?*, BALANCE SMALL BUS. (Mar. 7, 2018), https://www.thebalance.com/what-is-a-safe-harbor-law-or-provision-398457.

84. It is worth noting that the very concept of a labor/capital "continuum" is itself empowered by equity ownership programs.

85. Emily Ann Satterthwaite, *Entry-Level Entrepreneurs and the Choice-of-Entity Challenge*, 10 PITT. TAX REV. 139, 145 (2013) ("The entry-level entrepreneur is forced to engage in a complicated forecasting exercise precisely at the point at which she faces maximum uncertainty about her business's future. These costs of deliberating about the appropriate entity are deadweight-they are burdensome to the entrepreneur and add nothing productive or valuable to her business or to society at large. In addition, the incidence of these deliberation costs is distributionally regressive, because the costs are borne by the group of entrepreneurs that has fewest resources to manage them, either by hiring legal counsel or investing in the self-education necessary to navigate the choice."). *See also* Ryan Doody, *Piketty on Capital and Inequality*, MIT (Mar. 25, 2015), http://www.mit.edu/~rdoody/Economic%20Justice%20Handouts/EconJusticePIKETTY.pdf.

86. *See* Tibbetts & Donovan, *supra* note 13.

or challenging such a classification make it so.[87] While IRS guidance does limit the scope of § 83, there remains room for improvement.

In that spirit, perhaps a reasonable adjustment would be for the IRS to adopt a safe harbor that would limit § 83 to circumstances where cash and stock compensation are true substitutes — as may be the case with companies whose stock trades publicly. Second, because there are administrative costs associated with obtaining the potential benefits of a § 83(b) election, perhaps § 83's applicability itself (as opposed to the arithmetic result of its application) could be limited to circumstances where recipients pay less than FMV for company stock. This would be consistent with the favorable tax treatment given to incentive stock options, which have an exercise price equal to at least 100% of the FMV of the underlying stock on the date of the option grant.[88] Finally, § 83 should not apply in the context of administrative activities, such as a reincorporation merger or formless conversion from LLC to corporate form.

A. Revenue Neutrality

As with any tax relief proposal, revenue neutrality merits some consideration. Here, adopting a safe harbor would only be revenue negative for projected taxes from "inadvertent" failures to make § 83(b) elections. An "apples to apples" comparison would properly be the (zero) tax due on a properly and timely made § 83(b) filing and the (zero) tax due under the safe harbor. While this effect should not be overstated, a § 83(b) safe harbor might actually be tax revenue accretive if the safe harbor spurs a surge in "stock loans" that generate interest income for the lender.[89] A further (non-tax) benefit from such a surge in stock loans would only further align manager and owner interests, as the promissory note would equate to proverbial "skin in the game."

B. Epilogue: An "[U]nwarranted and [U]nintended [B]enefit" Reconsidered

The irony of our collective experience with IRC § 83 may well be that it could serve as an interesting example of the solution becoming the problem. IRC § 83 was intended to eliminate a perceived loophole in the form of stock compensation being taxed in later periods based on the value of the stock back at the time of grant (albeit at ordinary income rates), and interim or subsequent appreciation being taxed at

---

87. I.R.C. § 83 (2018).
88. I.R.C. § 422(b)(4).
89. Stock loans are cashless transactions in which the restricted stock recipient "purchases" her stock in exchange for issuing promissory note to her company. While the predominant lender is currently the company itself (which may generate sufficient operating losses to negate any interest income from the loans), private lenders through peer to peer loan platforms may well find these types of loans appealing (as has been the case recently with education loans). For a general overview of the use of loans used to exercise stock options, *see* Jeffrey A. Martin & G. Edgar Adkins Jr., *Unexpected Tax Consequences of Buying Employer Stock with Loan Proceeds*, TAX ADVISER (Jan. 31, 2010), https://www.thetaxadviser.com/issues/2010/feb/unexpectedtaxconsequencesofbuyingemployerstockwithloanproceeds.html.

capital gains rates.[90] An illustrative example of the pre-Section 83 regime might be as follows:

Year	Action	Tax Consequences
1	Grant of stock worth $100, subject to restrictions lapsing in 3 years	None
3	Restrictions Lapse, Stock worth $300	Taxable income of $100 at ordinary income rates
4	Sell stock for $400	Taxable income of $300 at capital gains rates

From a contemporary perspective, I find it hard to see this as an example of a tax loophole. In particular, if we incorporate the illustration immediately above into the chart below comparing today's restricted stock, ISOs and LLC profits interests, I see more similarities than differences:

Issue	Restricted Stock	ISOs	LLC Profits Interest	Pre-Section 83
Taxable on grant?	Yes (§ 83(b) election – OI based on value at grant)	No	No	No
Taxable on vesting?	Yes (OI based on value at vesting)	No	No	Yes (OI based on value at grant)
Taxable on Exercise?	N/A	No	N/A	N/A
Recipient filing requirements?	Yes	No	No	No

If anything, the pre-§ 83 regime is still less tax advantageous than either of the other two comparable structures used today. Intentions aside, what would be so unwarranted about that? Thus, if the above-proposed safe harbor proves unworkable (and reliably quantifying "sweat equity credits" may realistically prove so), a return to the pre-§ 83 regime may ultimately prove to be a step back (in time), but in the right direction (in policy).

90. S. REP. NO. 91-552, at 120 (1969) ("General reasons for change – The present tax treatment of restricted stock plans is significantly more generous than the treatment specifically provided in the law for other types of similarly funded deferred compensation arrangements.").