

**Office of Chief Counsel
Internal Revenue Service
Memorandum**

Number: 199910010

Release Date: 3/12/1999

CC:EBEO:BR4

WTA-N-116761-98

UILC: 83.00-00, 83.01-00, 83.02-01, 83.02-02, 83.02-03, 83.03-00, 83.04-02, 2511.00-00,
2511.03-00

date: December 4, 1998

to: Group Manager,

from: Assistant Chief Counsel (Employee Benefits and Exempt Organizations)
CC:EBEO

subject: Your request for Technical Assistance,

This responds to your request for technical assistance regarding the treatment of certain stock under section 83 of the Internal Revenue Code. This document is not binding on Examination and is not a final determination. It is not to be cited as precedent.

LEGEND

X =

Y =

Z =

Company A =

Company B =

H =

J =

Country K	=
State	=
<i>n</i> shares	=
<i>m</i> shares	=
<i>o</i> shares	=
<i>p</i> shares	=
Date F	=
Year U	=
Year W	=
Date C	=
<i>d</i> shares	=
Date E	=

ISSUES

(1) When restricted stock, transferred in connection with the performance of services and upon which no elections under section 83(b) of the Code have been filed is canceled more than 30 days after its issuance, are elections filed within 30 days of the issuance of stock replacing the canceled stock timely filed or should an argument be raised that the transfer date of the stock remains its original transfer date in which case the elections would be untimely?

(2) If the transfer date is the date the replacement stock is issued, are the section 83(b) elections filed relative to that stock and additional stock valid, timely elections under section 83(b) of the Code?

(3) Whether the purported gift of stock from X and Y to Z is a valid, completed gift?

CONCLUSIONS

(1) An argument can be made that the cancellation and re-issuance of the stock is a sham and thus should be ignored. The section 83(b) elections filed relative to the reissued stock would thus not be timely.

(2) The Service should also challenge X's claim that the section 83(b) elections were filed timely with respect to the additional stock and the reissued stock if the argument advanced in Issue #1 is rejected, unless X produces more evidence showing that such elections were, in fact, timely filed.

(3) The Service should argue that the purported gift from X and Y to Z was not a completed gift and thus should be ignored.

FACTS

X and Y, husband and wife, are resident aliens who live in State. Z is X's mother-in-law and resides in Country K. For the taxable years at issue, X worked for Company A, a small, closely-held State corporation. Several years after beginning work for Company A, X became its Chief Executive Officer (CEO).

By written consent, a Company A committee determined that before X became CEO, Company A sold n shares of restricted stock at a specified price to X. Neither the plan under which this stock was sold nor X's promissory note given to Company A in payment for the restricted shares was submitted with this request. During the same year X became CEO, when m shares of this initial grant vested, Company A canceled the outstanding grants, approved new grants, and entered into 3 separate agreements with X in which X agreed to purchase Company A restricted stock. The information submitted does not reveal Company A's business purpose in deciding to cancel the restricted stock previously sold to X.

According to the first agreement, X purchased m shares of Company A stock at a price determined by Company A to be its fair market value. X paid the purchase price by delivering a promissory note for the total purchase price to Company A when the agreement was signed, and Company A delivered the stock to an escrow holder. Pursuant to the agreement, X had all of the rights and privileges of a stock holder including the right to vote and receive dividends, however, X was required to deliver any dividends or other distributions of property to the escrow holder. According to the agreement, if X voluntarily terminated employment, Company A had the right to repurchase any unvested shares held by X (repurchase option), and any unvested shares would not vest. The agreement, however, does not specify at what price Company A would be required to pay for the unvested shares in the event it exercised its repurchase option. We assume that since the parties considered the repurchase option to subject the stock to a substantial risk of forfeiture the payment price was the original purchase price. According to the vesting schedule in the agreement, 25 percent of the shares was vested on the purchase date and 25 percent was scheduled to vest annually at a specified date following the purchase date. If X's employment terminated for any reason, other than his voluntary departure prior to the last vesting date, 100 percent of the shares would vest. According to the agreement, X could not assign, transfer, or otherwise dispose of this stock other than by will or the laws of descent and distribution.

The promissory note does not indicate that it was secured by any property or that X was not personally liable for the purchase price. Under the terms of the note, all unpaid principal and interest was due on the earlier of X's termination date or the last vesting date. According to the attached escrow agreement, the stock would be held by the escrow holder until Company A gave the escrow holder notice that the note had been paid in full or that X's employment had terminated. The interest rate on the note was 5 percent per annum.

The legend on the back of the certificate representing these shares states that the stock is subject to an employee stockholder agreement which includes a repurchase right, a market stand-off agreement, and a right of first refusal. According to X, this certificate is incorrectly dated.

Pursuant to the second agreement, X purchased o shares of Company A stock for the same amount per share paid by X under the first agreement. The terms of the second agreement are the same as the first agreement, with the exception that no shares were vested on the purchase date. The stock certificate representing these shares is identical to the one described above.

Pursuant to the third agreement, X purchased another p shares of Company A stock under the same terms and conditions as the first and second agreements, with the exception again that no shares were vested on the purchase date.

The stock certificate representing the shares purchased under the third agreement contains a different issue date, but according to X, this stock certificate is incorrectly dated. The legend on the back of this certificate is identical to the two described above.

During the same year, X was paid a bonus equal to the difference between the fair market value and the purchase price of the canceled shares.

According to a letter from X's attorney, X filed elections under section 83(b) of the Code at the Location H Service Center. In an attached document, X stated that he had received Company A stock and that he understood that it was his responsibility to file an election under section 83(b) of the Code with the Internal Revenue Service. This document contains the date the stock was issued. According to X's attorney, X mailed the elections on Date F. To support this statement, a certified mail receipt was attached to the letter. Although X's attorney stated in the letter that the certified mail receipt is dated Date F, the receipt actually is dated 2 years later. X's attorney also stated that X mailed these elections with his Year U return, which were sent to the Location J Service Center. Based on the return receipt submitted to support this statement, we assume X's attorney meant that X attached the elections to his Year W return which was filed in Year U. The date stamp was made by the Location J Service Center, and indicates that the article mailed was a Year U tax return.

Three other statements were provided by X, but not with the above-described letter. According to the first statement, X performed services and received property with

respect to which an election under section 83(b) was being made. This statement indicates that Company A had the right to repurchase the property at the original purchase price if X's employment terminated; that the repurchase right terminated on a specific date; that the fair market value at the time of transfer was the purchase price of the stock, and that the property was transferred within 30 days prior to the filing of the election. The second and third statements are the same, with the exception of the date the repurchase right lapsed.

The Location H Service Center has no record that X filed elections in Year W under section 83(b) of the Code. The Location J Service Center could not locate any elections filed by X under section 83(b) of the Code. According to the incoming memorandum, X filed elections under section 83(b) of the Code with Company A.

According to section 64 of Company A's bylaws, no shareholder could sell, assign, pledge, or in any manner transfer any Company A stock, whether voluntarily, by operation of law, by gift, or otherwise, unless he or she first provided written notice to Company A. For thirty days following receipt of the notice, Company A had the option to purchase the stock specified in the notice at the price and on the terms specified in the notice. In the event of gift or other transfer for less than full price, the price of the stock would be the fair market value of the stock as determined by the Board of Directors.

On Date C, X and Y executed a deed of gift for d shares of Company A stock to Z. The deed of gift was acknowledged and accepted by Z. According to the legend on the back of the certificate representing these shares, the stock was subject to the terms and conditions of an employee restricted stock agreement which included a repurchase right, a market stand-off agreement, and a right of first refusal in favor of Company A. X and Y filed gift tax returns, but based on the fair market value assigned to the stock, no gift tax was due.

In an action by unanimous written consent of Company A's Board of Directors, the Board indicated that X had notified Company A of his desire to transfer d shares of stock, some of which was unvested, to Z. Company A resolved to amend the terms of the stock awards to allow X to transfer the stock to Z, provided Z agreed to be bound by Company A's repurchase right with respect to any unvested stock in the event of X's voluntary termination. Company A also waived any rights, including the right of first refusal, and consented to the transfer to Z, provided that on the transfer Company A retained its right of repurchase with respect to any unvested stock and a first and present security interest in the stock as collateral to secure payments under the promissory notes.

Shortly thereafter, Company A's Compensation Committee adopted a formula to determine the fair market value of Company A for purposes of determining the fair market value of stock awarded to employees. Under that formula, the fair market value of Company A was the product of a multiple of Company A's revenues and a combination factor derived from a risk factor, minority discount factor, and the amount of

cash held by Company A at the time of the valuation of the stock awarded to employees.

The plan under which X purchased the stock was amended on Date E. Under this amendment, X's unvested stock would receive accelerated vesting in the event Company A experienced a change of control as defined in the amendment. Interestingly, the agreement refers only to the shares purchased by X under the first two agreements and not those purchased under the third agreement.

During that same year, Company A agreed to merge with Company B. By unanimous written consent, Company A's Board of Directors resolved that the *d* shares of stock purchased by Z, as transferee of X, vested immediately on consummation of the merger. The Board also approved the extension of the maturity date for the repayment of two of X's promissory notes. According to the Agreement and Plan of Reorganization, on the effective date of the merger all Company A common stock was converted into Company B stock based on a formula contained in this agreement. All Company A stock which, prior to the merger was subject to certain limitations, would be subject to those limitations after the substitution of Company B stock for Company A stock. Certain Company B stock issued in substitution for certain Company A stock would contain a legend stating that the stock was subject to the terms and conditions of an agreement which included a repurchase right of Company B. Any substituted Company B stock would remain subject to any existing escrow agreement.

Sometime the following year, Z sold the Company B stock. According to a letter from Company B, X paid the principal amount on three promissory notes, and payment of these notes was a condition to delivery of the stock certificate to Z.

LAW AND ANALYSIS

Under section 83(a) of the Code, if, in connection with the performance of services, property is transferred to any person other than the service recipient, the excess of the fair market value of the property, on the first day that the rights to the property are either transferable or not subject to a substantial risk of forfeiture, over the amount paid for the property, is included in the service provider's gross income for the first taxable year in which the rights to the property are either transferable or not subject to a substantial risk of forfeiture.

For purposes of section 83 of the Code, property is substantially nonvested when it is both subject to a substantial risk of forfeiture and is nontransferable. Under section 1.83-3(c) of the Income Tax Regulations, a substantial risk of forfeiture exists where rights in property that are transferred are conditioned, directly or indirectly, on the future performance (or refraining from performance) of services by any person, or the occurrence of a condition related to a purpose of the transfer, and the possibility of forfeiture is substantial if such condition is not satisfied. Under section 1.83-3(d) of the regulations, the rights of a person in property are transferable if such person can transfer any interest in the property to any person other than the transferor of the property, but only if the rights in such property are not subject to a substantial risk of

forfeiture. Property is substantially vested when it is either transferable or is not subject to a substantial risk of forfeiture.

If nonvested property is disposed of in a transaction that is not at arm's length and the property remains substantially nonvested, under section 1.83-1(c) of the regulations, the person who performed the services realizes compensation equal to the sum of any money and the fair market value of any substantially vested property received in such disposition. In addition, section 83 and the regulations continue to apply to the property, with the exception that any amount previously includible in gross income under section 1.83-1(c) of the regulations will be treated as an amount paid for the property. Also, it has long been settled that the anticipatory assignment of income does not relieve the earner of the income from tax since income is taxed to the person or entity earning the income. Lucas v. Earl, 281 U.S. 111, 114-115 (1930).

Section 83(b) of the Code and section 1.83-2(a) of the regulations provide that, if property is transferred in connection with the performance of services, the service provider may elect to include in gross income the excess (if any) of the fair market value of the property at the time of transfer (determined without regard to any lapse restriction, as defined in section 1.83-3(i)) over the amount (if any) paid for the property, as compensation for services. If this election is made, the substantial-vesting rules of section 83(a) and the regulations thereunder do not apply to the property, and (with an exception not applicable here) any subsequent appreciation in the value of the property is not taxable as compensation to the service provider. Thus, the value of property with respect to which a section 83(b) election is made is includible in gross income as of the date that the property is transferred, even though the property is substantially nonvested when transferred, and no compensation is includible in gross income when the property becomes substantially vested. In computing the gain or loss from the subsequent sale or exchange of such property, its basis is the amount paid for the property increased by the amount included in gross income under section 83(b).

Under section 1.83-2(b) of the regulations, an election under section 83(b) must be filed no later than 30 days after the date the property was transferred. Under section 1.83-2(c) of the regulations, the election under section 83(b) is made by filing one copy of a written statement with the internal revenue officer with whom the person who performed the services files his or her return. In addition, one copy of such statement shall be submitted with his or her income tax return for the taxable year in which such property was transferred.

Under section 1.83-2(e) of the regulations, the statement must be signed by the person making the election and it shall indicate that it is being made under section 83(b) of the Code. The election must contain the name, address, and taxpayer identification number of the taxpayer; a description of each property with respect to which an election is being made; the date on which the property was transferred and the taxable year for which such election was made; the nature of the restriction or restrictions to which the property is subject; the fair market value at the time of the transfer; the amount paid for the property; and a statement that copies have been furnished to other persons as provided in section 1.83-2(d) of the regulations. Under section 1.83-2(d) of the

regulations, the person who performed the services must submit a copy of the statement referred to in section (c) to the person for whom the services are performed.

Under section 83(f) of the Code, the holding period of transferred property to which section 83(a) applies begins just after the property is substantially vested. However, if the person who has performed the services in connection with which property is transferred has made an election under section 83(b), then the holding period of such property begins just after the date that the property is transferred. If property to which section 83 and the regulations thereunder apply is transferred at arm's length, the holding period of such property in the hands of the transferee is determined in accordance with the rules provided in section 1223 of the Code. See section 1.83-4(a) of the regulations.

The determination of whether a transaction is a sham involves consideration of first, whether the transaction is a factual sham, and second, whether the transaction is an economic sham. A factual sham is one in which the alleged transaction never took place. Krumhorn v. Commissioner, 103 T.C. 29 (1994). See also Forseth v. Commissioner, 85 T.C. 127, 165 (1985), aff=d, 845 F.2d 746 (7th Cir. 1988), aff=d, 800 F.2d 266 (11th Cir. 1987), aff=d, 808 F.2d 1219 (6th Cir. 1987), aff=d, 810 F.2d 197 (5th Cir. 1987), aff=d, 813 F.2d 293 (9th Cir. 1987). Whether a transaction amounts to a sham is a factual determination.

Even if a transaction has a factual basis, the transaction may still lack economic substance, and thus, the transaction is an economic sham. In Frank Lyon Co. v. United States, 435 U.S. 561 (1978), the Supreme Court applied a two-prong test to determine whether the transaction considered therein (a sale and leaseback) should be considered a "sham" and, therefore, ignored for tax purposes:

(1) there must be a finding that the taxpayer was motivated by no business purpose other than the obtaining of tax benefits;

(2) there must be a finding that the transaction had no economic substance because there was no reasonable possibility of a profit.

See also Casebeer v. Commissioner, 909 F.2d 1360, 1363 (9th Cir. 1990), aff=g, T.C. Memo. 1987-628; Bail Bonds by Marvin Nelson, Inc. v. Commissioner, 820 F.2d 1543,1549 (9th Cir. 1987), aff=g, T.C. Memo. 1987-23. These prongs represent related factors, both of which are considered to determine whether the transaction had sufficient substance, apart from its tax consequences, to be respected for tax purposes. Casebeer at 1363.

Under the business purpose prong, the court determines whether the taxpayer has shown that he or she had a business purpose for engaging in the transaction other than tax avoidance. Casebeer at 1363. This factor involves an examination of the subjective factors which motivated a taxpayer to make the transaction at issue. Id. Under the economic substance prong, the court determines whether the transaction had economic substance beyond the tax benefits. Bail Bonds at 1549. This factor involves

a broader examination of whether the substance of a transaction reflects its form, and whether from an objective standpoint the transaction was likely to produce economic benefits. Id.

Note that it is well established that a taxpayer has the legal right to minimize his or her taxes or avoid them totally by any means which the law permits. Gregory v. Helvering, 293 U.S. 465, 469 (1935). However, the right to minimize or avoid taxes does not include the right to engage in transactions that have no economic substance but are solely for the purpose of avoiding or evading taxes. Zmuda v. Commissioner, 79 T.C. 714, 719-720 (1982), aff'd, 731 F.2d 1417 (9th Cir. 1984). If the purported transaction does not alter the economic relationship of the parties, the court will look beyond the form in which the transaction is cast to determine whether the transaction has any substance. Id. at 720.

1. What was the effect of the cancellation of n shares of stock?

Based on the facts submitted, it is probably safe to surmise that what transpired in this case is that, after X was initially awarded restricted stock, he was advised that, since a timely section 83(b) election was not filed, at each vesting date he would be in receipt of ordinary compensation income and, due to the provisions of section 1.83-1(c) of the regulations dealing with non-arm's length transfers of nonvested stock, income would be taxable to him even if he gifted the stock to Z. Facing this unattractive prospect, X, with Company A's approval, took steps to have n shares of restricted stock canceled and reissued so that he could file a timely section 83(b) election.

Because the cancellation was engineered solely for tax purposes and has not been shown to have any business purpose or to have altered the economic positions of the parties (taking into account that X was paid a bonus equal to the increase in the face amount of the promissory note), we think a reasonable argument can be advanced, based on the above-referenced authorities, that the form of the transaction, meaning the cancellation and repurchase, should be ignored. Under this argument, we would contend that the transfer date for purposes of determining whether the section 83(b) elections were timely, relative to the n shares, is the date those shares were initially transferred to X.

No documents were presented to indicate that X filed timely and valid elections under section 83(b) of the Code with respect to the n shares issued under the initial grant. If this argument prevails, then X received ordinary compensation as those shares vested.

2. Regarding the full block of d shares of stock, whether X filed valid, timely elections under section 83(b) of the Code even if the cancellation and repurchase of the n shares is honored?

In the event we do not prevail on the argument that the transfer date occurred earlier with regard to the n shares purchased under the first and second agreements (and with regard to the p shares purchased under the third agreement), the documents

submitted by X and his representative do not indicate that the section 83(b) elections were filed within the 30-day requirement.

X's representative stated that X mailed the elections to the Location H Service Center and that X attached the elections to his filed return. To support the latter representation, X's representative submitted a copy of a certified mail receipt. However, this certified mail receipt is dated two years later, clearly beyond the 30-day requirement. It is possible that X's representative accidentally included this receipt and that X has a timely dated receipt. More facts are needed to determine whether X mailed elections or included them with his return within the 30-day requirement.

We note that the facts indicate that X filed elections under section 83(b) of the Code with Company A. Even if those elections were filed with Company A within the 30-day requirement, filing elections with Company A is not filing with the Service and would not satisfy the requirements of the regulation.

Aside from the timeliness issue, an election must meet the requirements of section 1.83-2(e) of the regulations to be a valid election. The document submitted by X's representative does not meet the requirements of section 1.83-2(e) of the regulations, and thus, does not constitute a valid election. This document appears to be the type of document that would have been filed with Company A rather than the Service because, among other things, the document does not contain a statement that an election under section 83(b) of the Code is being made, it does not describe the property transferred, and it does not describe any restrictions with respect to the property. However, this document may not have been the document purportedly filed with the return or at the service center. Accordingly, more facts are needed to determine whether X timely filed the elections, and if so, whether the elections were valid.

If it is determined that X did not file timely, valid section 83(b) elections, section 83(a) of the Code applied to each of the blocks of stock purchased under the three agreements as they became substantially vested, and X received ordinary compensation as the stock vested. This would be the case even if it is determined that X and Y made a valid gift of the stock to Z (see section 1.83-1(c) of the regulations), though we think that not to have been the case.

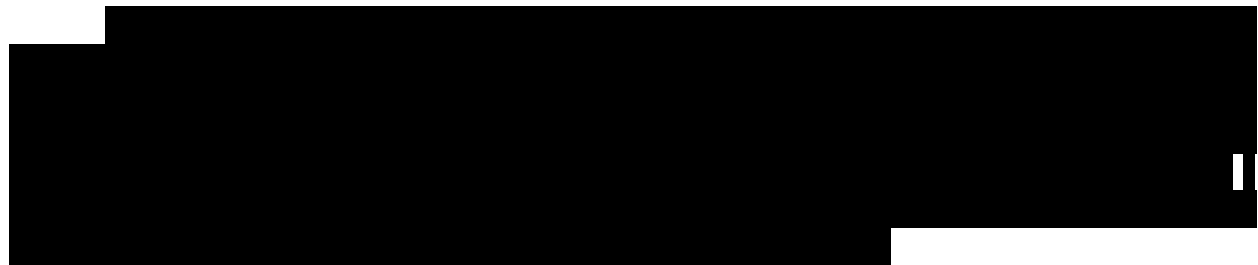
3. For purposes of determining whether the amounts paid to Z to redeem the stock should have been reported by X, did X and Y make a valid gift of the stock to Z?

Under section 25.2511-1(a) of the Gift Tax Regulations, the gift tax applies to a transfer by way of gift whether the transfer is in trust or otherwise, whether the gift is direct or indirect, and whether the property is real or personal, tangible or intangible. Under section 25.2511-2(b), a gift is complete as to any property, or part thereof or interest therein, of which the donor has so parted with dominion and control as to leave in him no power to change its disposition, whether for his own benefit or for the benefit of another.

Even though the name on the stock certificates was changed to Z and X and Y filed a gift tax return, further development of the facts may show that X did not relinquish control of the n shares of stock, and that X actually acted as owner of the stock. If there was no valid and effective gift, then a sham transaction argument should be raised and capital gain income should be charged to X. If it is determined that X failed to make timely, valid section 83(b) elections and that X received ordinary compensation as the stock vested, then the capital gain income generated by the sale of the stock is attributable to X, but X's basis is increased by the amount includible in gross income as compensation. Alternatively, if it is determined that there were timely, valid section 83(b) elections and X did not receive ordinary compensation as the stock vested, then the capital gain generated by the sale of the stock is attributable to X, but the basis is only the amount paid for the stock.

CASE DEVELOPMENT AND OTHER HAZARDS

Regarding the issue of whether X timely filed elections under section 83(b), a showing that the parties intended that X would file the elections is not enough evidence to show that elections were actually filed. However, if X filed elections with his return and the return was filed within 30 days after the stock was transferred or if X demonstrates that elections were timely filed, but that they were mailed to the wrong service center, we recommend that the elections be accepted on the basis that X substantially complied with the regulations. See Estate of Gunland v. Commissioner, 88 T.C. 1453 (1987); Taylor v. Commissioner, 67 T.C. 1071 (1977).



If you have any questions about this memorandum, please call (202) 622-6060.

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