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Stock Redemption or Payment of Compensation?

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The compensation of corporate managers often takes the form of stock of their employers. Section 83 of the Internal Revenue Code (the "Code") governs the tax treatment of a recipient of such stock or other non-cash "property transferred in connection with the performance of services."

Under section 83, an employee is generally taxable only when a "transfer" has occurred, *i.e.*, when the employee has acquired a beneficial interest in the property, *and* the property has become "substantially vested," *i.e.*, the property is either transferable or not subject to a substantial risk of forfeiture. Once an employee has acquired a sufficient interest to become taxable under section 83, the property transferred to the employee is included in the employee's income at a value determined "without regard to any restriction other than a restriction which by its terms will never lapse" (a "nonlapse restriction").

The tax treatment of the employer is the mirror image of the treatment of the employee—the employer may generally deduct the value of the property transferred at the same time that the employee is required to include it in income.

Thus, two important issues under section 83 are: (i) determining whether a restriction imposed on property transferred in connection with the performance of services, such as a buyback provision, is a "nonlapse restriction" (which will be taken into account in determining the value of the property) or a "lapse restriction" (which is disregarded in determining value) as defined in regulations under Section 83, and (ii) determining whether, in light of restrictions imposed, property has been "transferred" to an employee in the first instance. A recent U.S. District Court decision, *Riverton Investment Corp. v. United States* (W.D. Va., March 6, 2001), addresses these issues.

Background

Riverton Investment Corp. ("Riverton") was formed in 1980 to buy all the stock of another corporation. In connection with the purchase and to gain the support of the target's for the transaction, a Management Stockholder's Agreement ("MSA") was developed to "encourage [the target]'s management to invest in [Riverton], while insulating the investment from the risk of devaluation."

Riverton issued shares of its stock to several managers of the acquired corporation (the "managers") in the 1980's pursuant to the MSA. During the 1990's, when the managers' employment was terminated, their shares were redeemed by Riverton for 60% of book value, also pursuant to the MSA.

The redemption payments were reported on the tax returns of Riverton and the managers "in a manner consistent with such payments being for 'compensation,'" that is to say, the amounts paid to the managers in redemption of their shares were deducted by Riverton. The deductions claimed by Riverton were disallowed by the IRS, however, on the ground that the amounts paid constituted non-deductible payments to redeem stock. Riverton paid the tax claimed to be due, and then commenced an action in the District Court for a refund.

The District Court observed that the parties agreed that the principal issue was whether, taking into account the restrictions imposed by the MSA with respect to the managers' shares, those shares had actually been "transferred," within the meaning of section 83, to the managers at the time of their issuance.

If, by reason of the rights retained by Riverton, no "transfer" had occurred, the managers would not be considered, for tax purposes, ever to have owned the shares and the cash payments made to them in the 1990's would thus not have been made in redemption of stock. Rather, the payments would "relate back" to the original compensatory transaction and could be currently deductible as compensation—consistent with the positions taken on the tax returns of Riverton and the managers.

On the other hand, if the shares had been "transferred" to the managers prior to the time at which they were redeemed, the redemption would be treated for tax purposes as a noncompensatory transaction in shares, with the effect that the managers—who had apparently reported ordinary income and were not now before the court—might qualify for more favorable capital gain treatment, but Riverton would be denied any deduction in the tax years at issue.

In order to determine whether a "transfer" had occurred, the court reviewed the provisions of the MSA restricting the managers' ownership rights with respect to the shares, and then analyzed the effect of those restrictions under section 83.

Terms of MSA

The MSA provided that, in general, stock could not be transferred by a manager except (i) to Riverton, upon the termination of employment of the manager, and (ii) to a family member of the manager, who would be required to sell the shares to Riverton upon the termination of the manager's employment. The amount to be paid by Riverton for a manager's shares upon a termination of employment would be the greater of (x) the original price paid by the manager for the shares and (y) 60% of the book value of the shares at the time of termination of employment.

The MSA also contained a special rule concerning "certain corporate transactions":

> **9. Certain Corporate Transactions.** The provisions hereof relating to Termination of Employment and the effects thereof shall not be effective with respect to any liquidation, merger, acquisition or other reorganization by or affecting [Riverton]. With respect to such transaction, the Management Stockholders then employed shall have the rights and obligations, and only the rights and obligations, of [Riverton] common stockholders of [Riverton] who are not Management Stockholders.
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> The IRS argued that the plain meaning of this paragraph was that, in the context of a liquidation, merger, acquisition, or other reorganization, the restrictions on transfer did not apply and the shares could be transferred for full value. The government further asserted that the restrictions, as so interpreted, constituted a "lapse restriction" that, pursuant to regulations under section 83, must be ignored in determining whether there had been a transfer of stock to the managers in the first instance.[1]

The fact that a restriction may lapse under certain circumstances does not necessarily mean that it is a lapse restriction. The IRS has itself held, in at least one private letter ruling (PLR 9308022), that a buyback provision with respect to stock that would lapse upon a public offering or a "change of control" of the issuer was nonetheless a nonlapse restriction, because the occurrence of such an event was highly speculative. It may be more difficult to conclude that a restriction is a nonlapse restriction, however, where the events (arguably) resulting in a termination of the restrictions are described as broadly as they were in the MSA.

In any event, the District Court pursued a different analysis. After discussing various possible interpretations of the quoted language, it concluded (i) that paragraph 9 as quoted above was ambiguous and (ii) that, because of the ambiguity, other evidence was admissible to determine the intent of the parties.

Riverton introduced affidavits and deposition testimony to the effect that paragraph 9 was intended to permit managers to sell their shares in the context of certain corporate transactions regardless of whether their employment was terminated, and to permit them to receive, in the context of such transactions, the same form of consideration as other stockholders. Even in such circumstances, however, it was intended that the managers could still sell only to Riverton (or to a family member) and only for the greater of the amount paid for their shares and 60% of the book value at the time of the transaction.

The court concluded that the evidence established that, under the MSA, the managers "were permanently restricted from selling their shares to anyone but Riverton or its successor for any more than 60% of the shares' book value."

The court then observed that regulations under section 83 provide that a person who is the owner of record of stock or other property may not be treated as having acquired a beneficial ownership interest in such property, at least for purposes of section 83, if the property must ultimately be returned to the transferor upon an event certain to occur, and for an amount "not approaching the fair market value of the property at the time of surrender." This led the court to the conclusion that, under the MSA as interpreted in light of the evidence as to intent, a manager could not realize an amount approaching the full value of the manager's shares, and therefore that the managers never acquired beneficial ownership of the shares.

Thus, no "transfer" had occurred, and the District Court granted summary judgment in Riverton's favor.

The court also observed that the commitment by Riverton to pay not less than the original purchase price meant that the managers "did not incur the risk of a beneficial owner that the value of the property at the time of transfer [would] decline substantially"—quoting another factor from the section 83 regulations relating to the determination of beneficial ownership.

Notwithstanding the court's analysis, however, it is fairly clear from the regulations that, if shares are purchased for an amount substantially less than fair market value, a buyback provision providing for payment of not less than the amount invested may *still* be consistent with a finding of an initial transfer for tax purposes, because the transferee would bear the burden of depreciation in value to the extent of the excess of the fair market value at the time of purchase over the amount paid for the shares. The opinion has no discussion regarding the consideration paid by the managers for the shares.

As noted above, the District Court's opinion appears to be grounded in the notion that the buyback provisions constituted a "nonlapse restriction," that is, a limitation on the transferability of property that by its terms will never lapse. The main significance of a "nonlapse restriction" is typically that such a restriction—most commonly, a formula buyback provision based on book value, earnings, or some other reasonable basis for determining fair market value—must be taken into account in determining the amount of income, if any, realized under section 83 by the person to whom the property is transferred.

However, the existence of a nonlapse restriction is generally consistent with a conclusion that property *was* "transferred" for purposes of section 83. By contrast, in this case, the court believed that the "nonlapse restrictions" would under all circumstances prevent the managers from realizing the full value of their shares, supporting its conclusion that the managers never truly became, from a tax perspective, the owners of the shares.

Observations

It is not clear whether, in the context of addressing the interpretation of paragraph 9 of the MSA, the government discussed or the court considered the purposes generally served by such provisions. Frequently, the non-management shareholders of a corporation are more willing to allow the managers to share fully in the value of the equity of the corporation in the context of an event creating liquidity for the shareholders, such as a sale, than in the context of a redemption triggered by a termination of employment in a non-sale context.

Thus, it is commonly provided that restricted shares cease to be restricted upon a sale of the assets of a corporation or a sale of a controlling interest in its stock. From that perspective, the government's interpretation of the MSA seems more plausible than that of the taxpayer, and one wonders whether the government might have prevented a loss at the summary judgment stage by offering or proposing to offer expert testimony as to the goals and typical terms of restricted share plans.

Also, the opinion has no indication of whether the managers were to be treated as owners of the shares for tax purposes immediately upon their acquisition of the shares, or only at some point thereafter. If, for example, dividends were paid to the managers and were treated by the corporation and the managers as such rather than as compensation, that circumstance would imply that the parties to the MSA intended to effect a completed transfer for tax purposes when the shares were issued.

Finally, it should be noted that the matter might never have been contested in an audit or been the subject of a court decision, if only the MSA had been drafted to address more clearly the consequences to the managers of corporate transactions such as a liquidation or merger.

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[1] This position was essentially the same as that set forth in a 1997 technical advice memorandum, TAM 9744001, that appears to have been issued by the IRS in the context of the audit of Riverton.