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Warrants Not Received "In Connection With" Performance of Services

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When structuring the award of equity-based compensation by a corporation to its employees, the various alternative forms of such compensation that should be considered generally include the grant of shares of stock, either without restriction or subject to restrictions on transfer and vesting; stock options and stock appreciation rights; and phantom stock. These alternatives may have significantly different consequences from a legal and business perspective.

They also have different tax consequences. In particular, where an award of shares of stock is made, the fair market value of the stock is generally includible in the recipient's income as compensation either at the time the shares are granted or, if the grant is made subject to a substantial risk of forfeiture, at the time that risk ceases to apply.

Conversely, no tax is imposed upon the grant of a stock option that lacks "readily ascertainable fair market value" at the time of grant (as is usually the case). Compensation income will be recognized by the employee or other service provider, with respect to an option other than an "incentive stock option" as defined in section 422(b) of the Internal Revenue Code of 1986 (the "Code"), at the time the option is exercised, to the extent the value of the shares received exceeds the exercise price.

Often the above timing rule with respect to options that are not qualified options under section 422(b) results in far more ordinary income to the recipient of the option in the long run than would otherwise be the case if (i) an equivalent (as to value) outright grant of shares of stock were made; or (ii) if the option could be valued at the time of transfer for purposes of determining compensation, with any post-option grant appreciation being taken into account as capital gain from the sale of stock or the disposition of the option itself. Recipients of options accordingly have a strong incentive in many instances to attempt to avoid the application of the above timing rule by arguing either that the option had a readily ascertainable fair market value or that it was not issued in connection with the performance of services.

In *Kimberlin v. Commissioner*, a recent decision of the Tax Court,[1] the taxpayers argued successfully, under somewhat unusual circumstances, that warrants to purchase stock were not issued in connection with the performance of services and therefore that Code section 83 did not apply.

Facts in 'Kimberlin'

Kevin Kimberlin ("Kimberlin"), an investment banker, was the majority shareholder of Spencer Trask & Co. (together with its subsidiaries, "Spencer Trask") and also the sole general partner of Kevin Kimberlin Ltd. Partners ("Kimberlin Partners"), a partnership the other interests in which were owned by entities partly or wholly owned by Kimberlin.

Ciena Corp. ("Ciena"), a developer of telecommunications equipment formed in 1992, was provided with seed capital and a letter of credit in 1993 by Kimberlin through an entity controlled by him. Also in 1993, Ciena entered into an exclusive private placement agreement ("PPA") with Spencer Trask whereby Spencer Trask would attempt to raise capital for Ciena though a private placement of shares, in consideration of a cash commission to Spencer Trask equal to 10% of the amount raised plus a quantity of warrants based on the number of shares sold in the offering.

In 1994, the PPA was amended to allow another investment banking firm to serve as the placement agent for an offering of series A convertible preferred stock of Ciena, with Spencer Trask to serve as the placement agent for a subsequent offering of Ciena series B convertible preferred stock. The amended PPA further provided that, if Ciena did not proceed with the series B offering, it would issue to Spencer Trask a warrant to purchase 150,000 shares of the series A stock.

Ciena ultimately sold its series B shares in late 1994 and early 1995 without using Spencer Trask as its sale agent, and did not adhere to the

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amended PPA. Thus, Spencer Trask did not have the opportunity to perform, and did not perform any services for Ciena.

In December, 1994, Ciena sent a notice to Spencer Trask purporting to terminate the amended PPA and enclosing a warrant to purchase 150,000 shares of the Ciena series A stock.

A dispute ensued between Spencer Trask and Ciena, with Spencer Trask arguing that it was entitled to compensatory damages, in excess of the warrant offered, by reason of the breach of the amended PPA by Ciena. The parties settled that dispute in 1995 through a settlement agreement whereby the amended PPA was terminated and warrants were issued to purchase 300,000 shares of the Ciena series B stock. Of these warrants, 250,000 were initially issued to Kimberlin, 45,000 to Spencer Trask, and 5,000 to another individual, with the Kimberlin warrant ultimately being reissued in 1996, at the request of Kimberlin, to Kimberlin Partners.

All the warrants were ultimately exercised in 1997, two days before the initial public offering of Ciena. Taking into account an intervening stock split, the holders of the warrants acquired 1,500,000 shares of Ciena series B stock, worth approximately $44,000,000 on the date of exercise, through the exercise of the warrants and payment of an aggregate exercise price of $600,000.

Neither Spencer Trask nor Kimberlin reported income in 1997 from the exercise of the warrants. However, Spencer Trask did amend, in 1998, its tax return for 1995 to report $13,500 of income by reason of the receipt of warrants in that year; and Kimberlin similarly amended his tax return for 1995 to report $76,500 of income by reason of the receipt of the warrants.

In 2005, the IRS issued a notice of deficiency to Spencer Trask asserting that the exercise of the warrants in 1997 resulted in $43,950,000 of taxable income under Code sections 61 and 83. In addition, notices of deficiency were sent to Mr. Kimberlin and his wife asserting receipt in 1997 of a dividend from Spencer Trask in the amount of $36,250,000 relating to the exercise of the warrants, apparently on the theory that the issuance or transfer of the warrants to Kimberlin or Kimberlin Partners constituted a constructive dividend by Spencer Trask, which had entered into the PPA and amended PPA by reason of which the warrants were issued.

The IRS further determined that Kimberlin Partners was entitled, by reason of the income to Spencer Trask and/or Kimberlin under section 83 upon exercise of the warrants, to an increased basis for the shares purchased by Kimberlin Partners under its warrant. Kimberlin, Kimberlin Partners and Spencer Trask filed petitions in the Tax Court for review of these determinations, and the cases were consolidated by the court.

Discussion

The Tax Court characterizes the Commissioner's contentions in this case as "inconsistent, confusing, and unconvincing," and the government's position or positions are not entirely clear from the opinion. The circumstances and the discussion indicate, however, that the government viewed the warrants as having been received by Spencer Trask "in connection with the performance of services" within the meaning of Code section 83, and the court discussed whether that characterization was correct.

Section 1.83-3(f) of the Treasury regulations under section 83 provides:

> Property transferred to an employee or an independent contractor . . . in recognition of the performance of, or the refraining from performance of, services is considered transferred in connection with the performance of services within the meaning of section 83. . . . The transfer of property is subject to section 83 whether such transfer is in respect of past, present, or future services.

Other regulations under section 83 provide, in substance, that the receipt by an employee or independent contractor of a stock option in connection with the performance of services is not a taxable event unless the option has a "readily ascertainable fair market value."[2] An option which is not itself actively traded will not have a readily ascertainable fair market value unless: it is transferable by the optionee and exercisable immediately; the option or the underlying property is not subject to any restriction having a significant impact on the fair market value of the stock; and the fair market value of the option privilege is readily ascertainable.

Except in those unusual situations where a stock option has a readily ascertainable fair market value under the standards summarized above, the recipient of the option is taxed when the option is exercised, with the transfer of shares pursuant to the exercise of the option being treated as a transfer of property subject to section 83. The recipient of the option is then considered to have compensation income equal to the excess of the fair market value of the shares acquired over the exercise price.

The taxpayers in *Kimberlin* asserted, however, and the government stipulated that Spencer Trask never performed any services for Ciena; and the court concluded that the warrants were not issued either for services performed or for Spencer Trask's agreeing not to perform services. Rather, the warrants were issued under a settlement agreement that superseded the PPA, to resolve a claim for compensatory damages by reason of Ciena's breach of the PPA; and the court concluded, on this basis, that the warrants were not issued in connection with the performance of services. Therefore, section 83 did not apply to the transfers of stock pursuant to the exercise of the warrants.

Since section 83 did not apply, the warrants were taxable in the year of grant if they had an ascertainable fair market value at that time as determined under relevant case law and regulations under Code section 1001. Those regulations state that "only in rare and extraordinary cases will property be considered to have no fair market value."[3]

The Commissioner's expert testified that the warrants had no ascertainable fair market value on the date of grant, but the court found his testimony not to be credible.

The taxpayers' expert, who was found to be credible, relied on the price of the series B convertible preferred shares as sold by Ciena in 1994 and 1995, and on valuation techniques focusing on benchmark rates of return sought by venture capitalists, in concluding that the warrants had a fair market value on the date of grant of 90 cents per share.

The court therefore concluded that the value of the warrants was includible in income in 1995, the year of grant. Taking into account that, outside the context of section 83, the exercise of a warrant or other option generally does not result in taxable income to the person exercising the option, the court further concluded that IRS erred in determining tax deficiencies for 1997.

Observations

The conclusion of the court that the warrants were outside the scope of section 83 is open to question.

There are other, analogous contexts in which a payment made to a service provider would generally be characterized as compensation even though no services are directly attributable to the payment: for example, where a lawyer or other professional receives a payment from a client for being available to provide services during a period of time and is authorized to retain the payment whether or not any services are provided. Although such arrangements typically involve payments of cash and therefore are not subject to section 83 (which is generally limited to transfers of property other than cash), the receipt of stock or other property (other than cash) in such circumstances should also be subject to section 83.

At least one court has also observed that the legislative history of section 83 indicates an intention that section 83 "is to have the broadest application"; and it is clear that a payment made to terminate an option is to be treated as compensation under section 83 so long as the option was granted in connection with the performance of services.[4]

Further, the Tax Court's conclusion in *Kimberlin* seems to invite a somewhat arbitrary distinction between a situation where no services are provided at all and a situation where some service, however trivial, is provided before an agreement to provide services is terminated – with a transfer of property presumably remaining subject to section 83 in the latter context even if all or almost all of the value of the property transferred is attributable to compensation for the cancellation of the services arrangement and related damages, rather than to the services actually performed.

Clearly, the original and amended PPA entered into by Kimberlin or entities under his control contemplated the provision of services, and the warrants were ultimately received by reason of the settlement of claims arising from an alleged breach of the PPA by Ciena. Under these circumstances, it would not appear difficult, or at odds with the policies underlying section 83, to reach a conclusion contrary to that of the Tax Court, i.e., that the warrants at issue were received "in connection with the performance of services" within the meaning of section 83.

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1 No. 24499-04, 128 T.C. No. 13 (May 8, 2007).

2 Reg. §1.83-7(a).

3 Reg. §1.1001-1(a).

4 See *Alves v. Commissioner*, 79 T.C. 864 (1982), at 876; and *Bagley v. Commissioner*, 85 T.C. 663 (1985), aff'd *per curiam* 806 F.2d 169 (8th Cir. 1986). *Kimberlin* is consistent with *Bagley*, because the Tax Court concluded in *Kimberlin* that the PPA was not granted in connection with the performance of services; but that conclusion is somewhat difficult to reconcile with the thrust of cases such as *Alves* that generally favor an expansive interpretation of the "in connection with the performance of services" requirement of Code section 83.