Tax Report #984

New York State Bar Association

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December 7, 2000

The Honorable Charles O. Rossotti
Commissioner
Internal Revenue Service, Room 3000 IR
1111 Constitution Avenue, N.W.
Washington, D.C. 20224

Jonathan Talisman, Esq.
Acting Assistant Secretary (Tax Policy)
Treasury Department, Room 1330 MT
1500 Pennsylvania Avenue, N.W.
Washington, D.C. 20220

Re: <u>Report on Possible Reforms to Section 83</u>

Dear Commissioner Rossotti and Mr. Talisman:

I am enclosing a Tax Section report[1] on possible reforms to section 83 of the Code and the regulations thereunder. Section 83, which governs the tax treatment of transfers of property in connection with the performance of services, was enacted in 1969. Despite significant changes in market practice, the rules of section 83 have generally been unchanged since that time. Because of changes in the ways in which employees acquire property—principally stock—from employers, some of the assumptions on which the rules of section 83 were based may no longer hold true. We believe

[1] The principal drafter of the enclosed report was Kimberly S. Blanchard, co-chair of the Section's Committee on Individuals.

that these developments in market practice necessitate re-examination of the rules of section 83.

Section 83 was enacted in part to limit the tax benefits previously available when employers issued restricted stock to employees at a deep discount in order to defer recognition of compensation that had already been earned. It generally taxes as compensation the value of property (less any amount paid) at the time of transfer unless the property is subject to a substantial risk of forfeiture. In that case, recognition of the transfer for tax purposes generally is deferred—with the result that appreciation is treated as ordinary compensation income rather than capital gain—until the property first is not subject to such a risk. An employee can, however, elect under section 83(b) to recognize a transfer immediately notwithstanding forfeiture risk in order to secure capital gain treatment of appreciation. The tax interests of the employer and employee under section 83 are generally adverse, since amounts treated as ordinary compensation income are deductible.

Due to the success of section 83 in limiting benefits from the deferred compensation plans it was enacted to address, these plans have largely been supplanted by plans that enable employees to participate in future appreciation but rarely involve current issuances of stock at a deep discount. In fact, it may be common for employees to be required as a condition of employment to buy restricted stock at market value. Grants of employer stock options are now widespread, and such options may have become more susceptible of valuation. Meanwhile, the coverage of equity-based compensation plans has expanded greatly over the years, increasing the number of individual taxpayers affected by section 83's sometimes arcane provisions.

The enclosed report begins by reviewing the original purpose of section 83 and the context in which it was enacted. In the second part of the report, we examine some of the theoretical and practical issues presented by the government's success in the case of Alves v. Commissioner, which was decided in the early 1980s. Alves established the counterintuitive rule that an employee who pays fair market value for restricted property must make a section 83(b) election to avoid recognizing ordinary compensation income when the property vests.

The third part of the report recommends that the statutory 30-day period for filing a section 83(b) election be replaced by a grant of authority to the Secretary to prescribe the time for filing. It also recommends repeal of the statutory rule that disallows any deduction for the economic loss suffered by the employee upon the forfeiture of property following a section 83(b) election.

Part four of our report discusses the current treatment under section 83 of grants of options to buy employer stock. A grant of an option is not treated as a transfer of property unless the option has a "readily ascertainable fair market value". As interpreted by current regulations, this condition generally will never be met except by a publicly traded option. While we do not recommend any particular changes in current law, we suggest that current standards for determining whether an option has a "readily ascertainable fair market value" may be due for re-examination.

Finally, our report addresses some fundamental problems with current regulations that attempt to distinguish between transfers of property and mere rights to receive future income. While we agree that this distinction needs to be drawn, we believe the regulations are incomplete and ambiguous as applied to several common forms of equity-based compensation. We therefore make some suggestions for modifying and clarifying those regulations.

Please let me know if we can be of any assistance in your consideration of the issues discussed in the enclosed report.

Sincerely,

Robert H Scarborough

Robert H. Scarborough

Enclosure

cc: Internal Revenue Service

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