



I Wish That Hadn't Worked—Taxpayer Ruled Correct the First Time
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One More Time

This week we revisit a case we first looked at when it went through the Tax Court back in November of 2006—the case of *Kadillak v. Commissioner*, 127 TC No. 13. Mr. Kadillak appealed the decision of the Tax Court in favor of the IRS to the Ninth Circuit Court of Appeals, and this week the Ninth Circuit ruled, affirming the Tax Court's decision in this matter.

§83 and the Restricted Shares

It's important to remember what the world was like in the latter part of the last decade and the beginning of this one to understand how Mr. Kadillak ended up with the result he did. Much as recently residential real estate in many parts of the country rose rapidly in value, only to deflate similarly rapidly when the bubble burst, back then we had the “dot com” run up, followed by the “dot bomb” crash.

Mr. Kadillak had a set of incentive stock options from his employer. As “everyone” knew back then, such stocks only went up rapidly in value over time, and Mr. Kadillak likely believed that every day he held off exercising his stock options, the spread between the value of the shares and his exercise price would continue to grow. Since that spread would be subject to alternative minimum taxation, he wanted to have that event occur as soon as possible.

Mr. Kadillak therefore exercised his options even though he was not fully vested in the options and, if he left employment (voluntarily or not) before such time as the shares vested he would only be paid back the amount he paid for them. However, the default under the IRC is that such shares would be ignored for tax purposes (including AMT) until such time as the restrictions lapsed. §83(a) applies in this case, and it provides

(a) General rule

If, in connection with the performance of services, *property* is transferred to any person other than the person for whom such services are performed, the excess of--

(1) the fair market value of such property (*determined without regard to any restriction other than a restriction which by its terms will never lapse*) at the first time the rights of the person having *the beneficial interest in such property are transferable or are not subject to a substantial risk of forfeiture*, whichever occurs earlier, over

(2) the amount (if any) paid for such property, shall be included in the gross income of the person who performed such services in the first taxable year in which the rights of the person having the beneficial interest in such property are transferable or are not subject to a substantial risk of forfeiture, whichever is applicable. The preceding sentence shall not apply if such person sells or otherwise disposes of such property in an arm's length transaction before his rights in such property become transferable or not subject to a substantial risk of forfeiture.

Electing to Ignore the Restrictions

The law provides that the recipient can elect to voluntarily ignore such restrictions. He does so by electing in accordance with §83(b)

(b) Election to include in gross income in year of transfer

(1) In general

Any person who performs services in connection with which property is transferred to any person may elect to include in his gross income for the taxable year in which such property is transferred, the excess of--

(A) the fair market value of such property at the time of transfer (determined without regard to any restriction other than a restriction which by its terms will never lapse), over

(B) the amount (if any) paid for such property.

If such election is made, subsection (a) shall not apply with respect to the transfer of such property, and if such property is subsequently forfeited, no deduction shall be allowed in respect of such forfeiture.

(2) Election

An election under paragraph (1) with respect to any transfer of property shall be made in such manner as the Secretary prescribes and shall be made not later than 30 days after the date of such transfer. Such election may not be revoked except with the consent of the Secretary.

A taxpayer makes this election by following the requirements in Reg. §1.83-2. As noted, the election must be made no later than 30 days after the transfer, though it can be made before the transfer [Reg. §1.83-2(b)]. While no IRS form exists to make the election, the taxpayer does have to issue a number of documents in a timely fashion to both the IRS office where he will file his return and to the entity to whom the services were rendered, as well as being attached to the taxpayer's return. Reg. §1-83-2(b) and (c) spell this out

(c) Manner of making election.

The election referred to in paragraph (a) of this section is made by filing one copy of a written statement with the internal revenue office with whom the person who performed the services files his return. In addition, one copy of such statement shall be submitted with this income tax return for the taxable year in which such property was transferred.

(d) Additional copies.

The person who performed the services shall also submit a copy of the statement referred to in paragraph (c) of this section to the person for whom the services are performed. In addition, if the person who performs the services and the transferee of such property are not the same person, the person who performs the services shall

submit a copy of such statement to the transferee of the property.

The content of the election is outlined in Reg. 1.83-2(e) which provides

(e) Content of statement.

The statement shall be signed by the person making the election and shall indicate that it is being made under section 83(b) of the Code, and shall contain the following information:

- (1) The name, address and taxpayer identification number of the taxpayer;
- (2) A description of each property with respect to which the election is being made;
- (3) The date or dates on which the property is transferred and the taxable year (for example, "calendar year 1970" or "fiscal year ending May 31, 1970") for which such election was made;
- (4) The nature of the restriction or restrictions to which the property is subject;
- (5) The fair market value at the time of transfer (determined without regard to any lapse restriction, as defined in section 1.83-3(i)) of each property with respect to which the election is being made;
- (6) The amount (if any) paid for such property; and
- (7) With respect to elections made after July 21, 1978, a statement to the effect that copies have been furnished to other persons as provided in paragraph (d) of this section.

The election cannot be “undone” without the consent of the IRS, must be conditioned upon a mistake of fact, and the request must be made within 60 days of the date the mistake of fact becomes known to the taxpayer that made the election [Reg. §1.83-2(f)].

An important negative consequence of making an §83(b) election is found the end of §83(b) cited above, where it is noted that “if such property is subsequently forfeited, *no deduction shall be allowed in respect of such forfeiture.*”

Mr. Kadillak's Facts

A quick review of the facts first discussed back in November 2006 is appropriate here. Mr. Kadillak worked for Ariba Technologies at the time, a company whose stock, like

that of many technology companies at the time, had been rapidly appreciating. In fact, such appreciation had occurred fairly consistently from 1998 (when Mr. Kadillak was first granted options) through April 2000 when he exercised the options. At that time he would not be fully vested in all the shares he had exercised until February 2002.

If no Section 83(b) election was made, Mr. Kadillak would have picked up an AMT adjustment each year as the restrictions lapsed on shares. If the stock continued its skyrocketing share price increases, Mr. Kadillak would face continually increasing amounts being added to his income—and, as well, he would not get capital gain treatment on that appreciation for alternative minimum tax purposes. However, if he made the §83(b) election, he would “lock in” the amount he would pay the ordinary AMT rates on, and future appreciation could qualify for capital gain treatment.

At the date he exercised the shares, they were worth \$3,264,000 while his exercise price was only \$3,002 for all of the shares (vested and not vested). Mr. Kadillak incurred a substantial alternative minimum tax liability in 2000.

Past Performance Does Not Guarantee Future Results

Unfortunately, the future was not bright from that point forward for many technology companies and many of those that worked for such entities—and this was true of the fortunes of both Mr. Kadillak and Ariba Technologies. In May of 2001, Mr. Kadillak's employment was terminated by Ariba Technologies. The nonvested shares were purchased by Ariba Technologies for \$642, and the other shares were sold by Mr. Kadillak to third parties at that point.

The §83(b) election had caused Mr. Kadillak to recognize \$680,000 of AMT income on the shares he would eventually be forced to forfeit. He later decided, finding that he did not have the resources available to pay his 2000 tax liability due to the crash in the stock price, that he would amend his 2000 return and claim the amount should not have been included in his income. He advanced two theories in support of this idea:

1. His §83(b) election was not valid, as what he received was not property under California law, and §83 only applies to property *or*
2. He was entitled to a “claim of right” deduction under §1341 upon the forfeiture of his nonvested shares.

He also attempted to claim that the loss on the sale of the vested shares both was not subject to the \$3,000 per year net capital loss limitation and further created an AMT net operating loss he could carry back to 2000—a claim that was as unsuccessful for him as it had been for the taxpayer in *Merlo v. Commissioner*, 126 TC No. 10 (who lost his appeal to the Fifth Circuit). We won't look at that issue here, but you can go back to our podcast of May 5, 2006 for a discussion of that issue.

It's Not Property

Mr. Kadillak argued that his §83(b) election was ineffective since what he received didn't conform to the definition of property found in Reg. §1.83-3(c)

Kadillak does not take issue with the tax court's reasoning that the benefits he received upon acquiring the nonvested shares, including his acquisition of all stockholder rights and his entitlement to receive all regular dividends, constituted a "beneficial interest" under I.R.C. § 83. Instead, he points out that a beneficial interest in assets is not alone sufficient; for such a beneficial interest to be "property," the assets also must have been "transferred or set aside from the claims of creditors of the transferor." Treas. Reg. § 1.83-3(e).

Mr. Kadillak set forth an interesting theory about why the stock was not set aside from the claims of creditors.

In that regard, Kadillak argues that merely depositing his nonvested shares into an escrow account did not adequately protect them from the claims of his employer's creditors. He speculates that if Ariba had filed for bankruptcy, its creditors could have forced it to terminate Kadillak's at-will employment and exercise its right to repurchase his nonvested shares at cost. He further likens an escrow account to a "rabbi trust" and argues that the doctrine of constructive receipt does not require the recognition of income under § 83 where deferred compensation is subject to substantial limitations or restrictions, including the claims of the creditors of the corporation.

On the first issue, the Ninth Circuit panel did not disagree with his outline of the facts, but concluded that it did not bring about the result claimed:

We have no quarrel with Kadillak's hypothesis. Given the terms of Kadillak's employment contract and the Ariba stock plan, it is conceivable that the creditors of a bankrupt Ariba could force it to terminate Kadillak and then repurchase his nonvested shares at cost. But Kadillak misses the point, as the scenario he envisions only incidentally involves the claims of Ariba's creditors. The real culprits are Ariba's rights of termination and repurchase, which Ariba could exercise of its own accord, at any time and for any reason, regardless of any financial difficulty or pressure from creditors. Viewed in that light, Kadillak's hypothesis demonstrates nothing more than that his nonvested shares were "subject to a substantial risk of forfeiture" and therefore would be ordinarily excluded from income under I.R.C. § 83(a), not that they were outside the scope of § 83 altogether. As the very purpose of a taxpayer's § 83(b) election is to realize income on assets that otherwise would not be included in income under § 83(a) due to a substantial risk of forfeiture, the mere fact that an asset is subject to a substantial risk of forfeiture is no justification either for excluding it from the definition of "property" and the coverage of § 83, or for invalidating an otherwise valid § 83(b) election.

The “theoretical creditor” ended up only with the rights that Ariba already had to terminate Mr. Kadillak's services, rather than having a direct right to seize the shares from the escrow account.

The panel had less regard for the alternative “like a rabbi trust” theory:

Also without merit is Kadillak's suggestion that, even aside from Ariba's right of repurchase, depositing the nonvested shares into an escrow account was insufficient to satisfy Treasury Regulation § 1.83-3(e). Despite Kadillak's manifest and repeated misquotations of the regulation in his briefs, the regulation quite plainly enumerates "a trust or escrow account" as the prototypical vehicles for "transferr-[ing] or set[ting] aside [assets] from the claims of creditors." *Id.* Moreover, even if Kadillak might be correct that certain types of trusts or escrow accounts could fail to satisfy the regulatory requirements, because he has provided no evidence that the escrow account used by Ariba was, in fact, inadequate to protect his shares from Ariba's creditors, we have no reason to depart from the general rule in this case.

Thus, the election was held to be valid.

It's a Claim of Right Issue

The claim of right doctrine under §1341 allows for special treatment where a taxpayer includes an item in income in one year, but the taxpayer later has to pay back that income. If the amount exceeds \$3,000, rather than having to accept only a deduction in the year of forfeiture, the taxpayer can get a credit by recalculating the tax for the year of inclusion.

Three conditions are outlined for a claim of right, found in §1341(a)

(a) General rule

If--

- (1) an item was included in gross income for a prior taxable year (or years) because it appeared that the taxpayer had an unrestricted right to such item;
- (2) a deduction is allowable for the taxable year because it was established after the close of such prior taxable year (or years) that the taxpayer did not have an unrestricted right to such item or to a portion of such item; and
- (3) the amount of such deduction exceeds \$3,000,

Mr. Kadillak clearly had an item that was included in income in 2000. The amount also clearly exceeded \$3,000 and it was established after the year end that he did not have a right to retain that income. So he's home free on this one, right?

Well, not so fast, as the Ninth Circuit points—there's that little clause that states “a deduction is allowable for the taxable year...” at the start of §1341(a)(2). The panel notes

Section 1341(a) indeed permits taxpayers to compute their tax differently where they reported income on the receipt of property in one tax year and then forfeited that property in a later tax year. But the statute applies only if "*a deduction is allowable* for the taxable year because it was established after the close of such prior taxable year (or years) that the taxpayer did not have an unrestricted right to such item or to a portion of such item," among other requirements. I.R.C. § 1341(a)(2) (emphasis added). As clarified in the accompanying regulation, the deduction must be allowable "under other provisions" of the tax code. Treas. Reg. § 1.1341(a)(1).

In this case, Kadillak fails to satisfy § 1341(a)(2) because the flush language of § 83(b)(1) expressly disallows any deduction respecting the forfeiture of his nonvested shares that were subject to his valid § 83(b) election. The statute plainly states: "If such election is made, . . . and if such property is subsequently forfeited, no deduction shall be allowed in respect of such forfeiture." I.R.C. § 83(b)(1).

The Court noted that he rather had to live with the calculation under Reg. §1.83-2(a):

Besides being ineligible for a "claim of right" deduction under I.R.C § 1341, his deduction was also limited under Treasury Regulation § 1.832(a) to the excess, if any, of the amount paid for the shares over the amount realized upon the forfeiture. Of course, as Ariba repurchased the shares at cost, there was no excess and therefore no deduction.

Conclusion

We are revisiting this because it is useful to remember that many tax elections and strategies have downsides when the future doesn't pan out as expected. In recent years we've had clients that believed various investments simply could not go down in value (stocks in the late 1990s, residential real estate in the middle of this decade, and whatever it is that comes next) and made tax decisions based on those beliefs. As advisers, we need to be the “voice of reason” and remind our clients of the assumptions they are making, and the bad (sometimes very bad, as in the case of Mr. Kadillak) results that may take place if their assumptions don't turn out to be valid.