Passthrough Partner

Cancellation of a Nonlapse Restriction
Compensation Surprise?

By J. Leigh Griffith

A large percentage of closely held businesses restrict or even prohibit the owners’ ability to transfer their equity interests. Often these restrictions require the owner to sell the equity back to the entity or the other owners at a formula value, for example, book value, that is not anticipated to be a true fair market value. These and other permanent restrictions on equity interests are called nonlapse restrictions because by their terms they never go away or “lapse.”

The purpose is often to permit new owners who are active in the business to be able to “buy in” but with the downside that upon ceasing to provide services to the entity, the “buy out” then uses the same formula. While book value or a variation is often used, other formulas such as a reasonable multiple of earnings or a combination of book value and multiple of earnings driven by business concerns may be used which are not indicative of the unrestricted fair market value. Since these restrictions are permanent—i.e., do not go away or lapse with the passage of time or any articulated events—such valuation will be considered to be fair market value unless the Secretary of the Treasury establishes otherwise. Thus, the buying in and selling out at a nonlapsing formula value that is business driven, as opposed to tax driven, will ordinarily be respected for tax purposes and will not pose a tax problem.

Surprise Compensation Can Almost Double the Anticipated Tax Cost to the Selling Equity Holder

In the context of a third party purchasing the entity or substantially all of the assets of the entity, but desiring the service provider owners to continue to be involved in the business thereafter, a cancellation of the nonlapse restriction concerning the mandatory “buy out” formula can be a major tax trap for the service provider! If triggered, the service provider may find that he or she has compensation income equal to the difference between the transaction purchase price and the value of the equity owned encumbered by the nonlapse restriction (i.e., the formula buy out price). Rather than the expected federal long term capital gain taxable at 20 percent (or 23.8 percent), the service provider...
owner may find the tax at 39.6 percent plus applicable Social Security and Medicare taxes. Considering both the corporate share of employer taxes and the employee, partner or independent contractor tax increases, Social Security and Medicare taxes, full federal tax cost on the compensation to the service provider can reach 43.4 percent. Essentially, the potential exists for the federal tax “hit” to essentially double what is expected. While the discussion of this column focuses on transactions, the cancellation of a formula purchase price nonlapse restriction with respect to a retiring service provider is equally applicable and perhaps much harder to demonstrate that it is not compensatory. The refusal by the service recipient to repurchase the equity interest in accordance with the terms of the nonlapse restriction can constitute a cancellation or lapse of a nonlapse restriction. An example would be a person who retires and is required to sell the equity back to the entity for book value but the entity pays a far greater fair market value to such person. Unless the taxpayer can carry the burden of proof that such additional amount is not compensation for services and the service recipient is not deducing such amount, the service provider will have compensation income as a result of such payment in excess of the formula amount.

Potential Application of Code Sec. 280G

In addition, if the restriction that is canceled or terminated involves an acquisition of a corporation (other than a corporation that is or could qualify as a “small business corporation”) and if such cancellation were to constitute compensation income, Code Sec. 280G with its disallowance of the corporate deduction for excess parachute payments and the additional 20-percent excise tax on the excess parachute payments to service providers who are classified as “disqualified individuals” could come into play. At this point, the taxes with respect to such individuals are past the confiscatory stage.

Purpose of Column

The purpose of this column is to remind the reader of the possibility of inadvertently and perhaps unknowingly triggering this compensatory income, particularly in the context of a purchase transaction in which buy-sell and transfer restrictions will be terminated. The column also provides an analysis of the existing limited authority that appears to exist. The exact scope of Code Sec. 83(d) is hard to define and apply.

S Corporation Surprise

In the context of S corporations, if there is a compensatory cancellation of nonlapse stock restrictions, the S corporation will not recognize gain (or loss) on dealing with its own stock. However, assuming (i) that all shares are subject to the same nonlapse restriction and (ii) that the context does not require a capitalization of the compensation by the S corporation, the S corporation will have a compensation deduction equal to the shareholder compensation income. The compensation deduction will then flow out to the shareholders on an equal per share amount and the share basis will be correspondingly reduced. Presumably, each shareholder will have an increase in basis equal to the compensation that the shareholder received as the cancellation of the nonlapse restriction represents a property right embedded in the shares. There is no indication that the basis of the shareholder in the shares is relevant for purposes of determining the amount of compensatory income on a cancellation of a nonlapse restriction. Therefore, each shareholder will have an increase in basis equal to the compensation income triggered for the specific shareholder and presumably an offsetting reduction for the allocated deduction. On an aggregate basis, this should result in a net nothing for income tax purposes as a result of the interaction of the compensation income and deduction. However, if some S corporation shareholders are subject to the restriction and others are not, some will have less deduction than compensation income and others will have no income and some deduction. In addition, there will be additional Medicare tax for individuals with compensation above $200,000. There are also required withholding issues for the S corporation and its shareholders. As alluded to above, in the event the restriction does not apply to all shareholders and capitalization is not required, the deduction nevertheless will still be allowed on a per share basis. In such a case, some shareholders will have a deduction and others will have net compensation income. Those shareholders with no income will have a basis decrease in their shares. Ultimately, such shareholder may recognize less capital loss (or more capital gain) one day or, if applicable, as part of the transaction, with respect to the basis decrease caused by the compensation deduction. The converse is applicable to those shareholders who have compensation income greater than their allocable (per share of stock) portion of the deduction. Their share basis will increase as the “property received” by virtue of the cancellation is embedded in the shares.
Application to Entities Taxable as Partnerships

The application of the cancellation of nonlapse restrictions to partnerships is more than somewhat confusing. There is nothing in Code Sec. 83 that provides that Code Sec. 83 does not apply to partnership interests, although there is language in the Code Sec. 721 regulations that draws a distinction between an interest in partnership capital, which is property, and an interest in future partnership profits which is arguably not property for purposes of Code Secs. 61 and 83.18

Since the effect of a cancellation of nonlapse restrictions is under Code Sec. 83, logically if Code Sec. 83 does not apply to a particular partnership interest, a cancellation of a nonlapse restriction would not apply to such partnership interest. At the current time, two revenue procedures appear to take a profits interest (as opposed to a capital interest) outside the realm of Code Sec. 83. Under Rev. Proc. 93-2720 and Rev. Proc. 2001-43,21 a person receiving a profits interest is deemed to be a partner even if the interest is unvested and no Code Sec. 83(b) election has been made. This is contrary to Code Sec. 83 wherein a transfer of property in connection with services subject to a substantial risk of forfeiture remains the property of the transferor until the property becomes substantially vested with the transferee.22 Regulations were proposed in 2005 which would cause profits interests issued after the regulations were finalized to be subject to Code Sec. 83, but these have never been finalized.

The author is unaware of any specific authority concerning the cancellation of a nonlapse restriction on partners in partnerships. As to secondary sources, the leading treatise on partnership taxation does not appear to even discuss the concept of the cancellation of a nonlapse restriction although it does include a short discussion of the effect of lapse and nonlapse restrictions.24

In attempting to logically analyze the impact of the cancellation of a nonlapse restriction that is considered to be compensation with respect to a partner, one should recognize that at the present time it is the IRS’s position that a partner cannot be an employee.25 In the aggregate theory of partnerships, assuming the nonlapse restriction applied to all partners, how is it possible for the partners to have income with respect to a mutual change of rights? Would the cancellation of the nonlapse restriction compensation be a guaranteed payment or a Code Sec. 707(a) payment? Assuming that the compensation is otherwise deductible and not required to be capitalized, such amount would reduce the income of or create a loss to the partnership. Ignoring the complexities of multi-classes of partnership interest, the income should be proportionate to the ownership interest of the partners and the loss or deduction could be allocated accordingly.26 Even if there were multiple classes or some partners whose interest was never subject to such nonlapse restrictions, would a special allocation to each partner equal to the amount of guaranteed payment income or Code Sec. 707(a) income each partner received have substantial economic effect? Unlike the S corporation shareholder, such an allocation would reduce the self-employment taxes whether or not characterized as a guaranteed payment or a Code Sec. 707(a) payment. If, however, the compensation was required to be capitalized under the normal capitalization rules of the Code, the partners would find themselves with self-employment income without an offsetting deduction.

Limited Authority

As will be discussed, the authority for the tax treatment of nonlapse restrictions and their cancellation other than Code Sec. 83 and its regulations is relatively sparse. Only a handful of letter rulings (LTRs), a general counsel memo (GCM) and two technical advice memorandums (TAMs) deal with the same set of facts with the second TAM modifying and replacing the first. The lack of case law authority would tend to indicate that the IRS has not “pushed” this area in the past. However, the past may not always be indicative of the future, and Code Sec. 83(d) and its accompanying regulations exist.

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The remainder of this column examines the application of the general Code Sec. 83(d) cancellation of the lapse restriction rules and the authority that exists whether such cancellation is or is not compensatory. All of the authority discussed deals with C corporations, but the principles should apply to S corporations and, to the extent Code Sec. 83 applies to the partnership interests in question, partnerships. The second portion examines the potential application of Code Sec. 280G to corporate shareholders in the event the cancellation is compensatory and actions that may be considered to void its application to nonpublicly traded corporations.
Statutory Framework of Code Sec. 83 and Cancellation of Nonlapse Restriction

The statutory and regulatory framework for the tax impact of the cancellation or termination of a nonlapse restriction is found in Code Sec. 83 and the regulations thereunder. This framework is set forth in several LTRs that are discussed herein. Pursuant to Code Sec. 83(a), if, in connection with the performance of services, property is transferred to any person other than the person for whom the services are performed, compensation income can be generated. This income is the sum of (1) the fair market value of the property (determined without regard to any restriction other than a nonlapse restriction) less (2) the amount (if any) paid for the property and shall be included in the gross income of the service provider. This recognition occurs at the earlier of the first time the rights of the person having the beneficial interest in the property are (i) transferable or (ii) not subject to a substantial risk of forfeiture. Code Sec. 83(a) applies even if the person pays fair market value for the shares if his or her ability to purchase the shares is dependent on future services where such stock is subject to a substantial risk for forfeiture. The advice to such an executive purchasing stock at its then fair market value subject to vesting requirements is to make a Code Sec. 83(b) election at the time of purchase. The election would indicate no income is recognized as a result.

Code Sec. 83(d)(1) provides that, in the case of property subject to a nonlapse restriction that allows the transferee to sell the property only at a price determined under a formula, such formula price shall be deemed to be the fair market value of the property, unless established to the contrary by the Secretary of the Treasury. With the burden placed on the Secretary, if the restriction has an independent business purpose and is consistently enforced, the formula price will almost always carry the day. The regulations provide:

If stock in a corporation is subject to a non[-]lapse restriction which requires the transferee to sell such stock only at a formula price based on book value, a reasonable multiple of earnings or a reasonable combination thereof, the price so determined will ordinarily be regarded as determinative of the fair market value of such property for purposes of section 83.

However, GCM 39535 illustrates an exception. A stock restriction permitted the executive to acquire publicly traded stock at a 60-percent discount and required a five-day right of first refusal by the corporation at 60 percent of the then fair market value prior to the executive’s ability to sell the stock to a third party. Thereafter for a 90-day period, the stock could be sold free and clear of such restriction. The IRS found such an arrangement, and restriction did not reflect fair market value and would not be honored.

Code Sec. 83(d)(2) provides that if property is subject to a nonlapse restriction and the restriction is canceled, the excess of the fair market value of the property (computed without regard to the restriction) at the time of the cancellation over the sum of (i) the fair market value of the property (computed by taking the restriction into account) immediately before the cancellation and (ii) the amount, if any, paid for the cancellation, shall be treated as compensation for the tax year in which the cancellation occurs. However, if the taxpayer establishes that (i) the cancellation was not compensatory and (ii) the person, if any, who would be allowed a deduction if the cancellation were treated as compensatory will treat the transaction as not compensatory, such amount will not be considered compensation. It is important to focus on the fact that the burden of proof is on the taxpayer to show that the cancellation of a nonlapse restriction is not compensatory on the taxpayer! Subject to the normal rules that would require the capitalization of the compensation expenditure or cause the compensation to be an item of deferred expense, Code Sec. 83(h) provides for the deductibility of the compensation generated by the cancellation of a nonlapse restriction.

The regulations provide that whether there has been a noncompensatory cancellation of a nonlapse restriction under Code Sec. 83(d)(2) depends upon the particular facts and circumstances. The regulations provide that ordinarily, if an employee is required to perform additional services or the employee’s compensation is adjusted to reflect the cancellation, a compensatory purpose for the cancellation may exist. By contrast, where the original purpose for the restriction no longer exists, the facts and circumstances may indicate that the cancellation is noncompensatory. The regulations provide the following example: “... if a so-called ‘buy-sell’ restriction was imposed on a corporation’s stock to limit ownership of such stock and is being canceled in connection with a public offering of the stock, such cancellation will generally be regarded as noncompensatory.” It should be noted that the regulations do not say that the requirement to perform additional services or the adjustment of compensation absolutely causes the cancellation of the nonlapse restriction to be compensatory nor do they say a cancellation in
connection with an initial public offering is automatically not compensatory. The regulations do not provide a more extensive amount of color as to when a cancellation will or will not be considered compensatory. The Code, regulations and other guidance as to what facts and circumstances the taxpayer can provide that will overcome the presumption that the cancellation of a nonlapse restriction associated with buy-sell agreements is a bit thin.

To the extent the author has found authority that helps to flesh out the facts and circumstances, it is in the form of LTRs and TAMs. As expected, the LTRs are favorable (otherwise the ruling request would likely have been withdrawn and no ruling issued) but a TAM is unfavorable to the service provider taxpayer. Surprisingly and interestingly, the author has not found case law on point.

Some of the favorable LTRs that involve initial public offerings (IPOs) and employee stock ownership plans (ESOPs) are of limited analytical assistance. There are two LTRs that are helpful. One involves an IPO with ongoing obligations of the employee owners, and the other is a recapitalization splitting of a corporation into two and the acquisition by merger of one of the two companies. The TAM which is unfavorable to the taxpayer involved a recapitalization followed by a sale in a scenario that may be more common than most realize.

Analysis of LTRs

LTR 9231009

In this LTR, all of the shareholders were employees of a corporation. Each was subject to a shareholders agreement that restricted the transferability of the shares. Under the shareholders agreement, upon any proposed transfer of shares or upon a termination of the shareholder’s employment, the company and the other shareholders had the right to purchase such shareholder’s shares at a formula price based on book value. In connection with the establishment of an ESOP, the shareholders agreement was canceled and a new agreement was entered into by the stockholders. It appears that the same restrictions on transfer and other retirements were generally maintained except the price was changed from a formula price based on book value to the appraised fair market value of the stock. The pricing change applies to all transfers or retirements and not just sales of stock to the ESOP. The company represented that it would not treat the cancellation of the old shareholders agreement and the entering into the new agreement as compensatory and will not claim any deduction. The representation was made that no shareholder will be required to perform additional services for the corporation as a result of the proposed transaction.

Based on the above facts and circumstances, without further analysis, the IRS cited the applicable sections of the Code and regulations and ruled that the proposed changes to the shareholders agreement would not be considered to be a compensatory cancellation of a nonlapse restriction. All shareholders received the benefit of the release of the buy-sell restriction and the release was not conditioned upon the continuation of the provision of services. The shareholders do not appear to be required to sell to the ESOP but can sell to anyone subject to a fair market value repurchase right. Fair market value repurchase rights are not considered to be a nonlapse restriction.

The author did not find this LTR particularly enlightening but does note that although an ESOP was involved, the shares did not have to be sold to the ESOP to obtain fair market value.

LTR 200649014

This LTR also involves an ESOP and reached the same result as LTR 9231009. All shareholders were employees and parties to a buy-sell agreement with the corporation and each other. In connection with the creation of an ESOP, the buy-sell agreement was amended whereby the company was required to purchase the stock at appraised value rather than book value but was permitted to pay the purchase price over a 10-year period with a floating short-term applicable federal rates (AFRs) interest rate if the shareholder became disabled, died or retired. If the shareholder terminates employment before age 65 other than by death or disability or if the shareholder divorces, pursuant to the buy-sell agreement, the payment would be over 15 years at the same interest rate. Under the buy-sell agreement, retiring shareholders could sell their stock to the ESOP. The other terms of the pre-ESOP shareholder agreement remained the same. The corporation represented it would not take any compensation deductions related to the amendment and represented that no shareholder is required to perform additional services to receive appraised value for his or her shares. Other than a recitation of the operative Code and regulation provisions, no analysis was provided for reaching the conclusion that the changes to the buy-sell agreement did not represent a compensatory cancellation of a nonlapse stock restriction. The LTR also stated that the sale by a retiring shareholder to the company or the ESOP under the agreement would not be a cancellation of a nonlapse restriction.

The request and receipt of a separate ruling within the LTR on the sale of stock by a retired employee to the ESOP
may be a bit surprising on its face. On reflection, however, the corporation may have been concerned that by the corporation not purchasing the shares on an installment basis with the purchase by the ESOP (assuming the ESOP purchase would be an immediate cash purchase) could be a cancellation of a nonlapse restriction at the future time. The failure of a corporation to exercise its right to acquire the shares is considered to be a lapse of a nonlapse restriction. By providing that only a retiring employee had the right to sell to the ESOP, there was a method of “encouraging” employees to continue working after the cancellation of the book value buy-back since it appears the corporation was permitted to use a long installment period with a floating short-term AFR. The language of the agreement is not contained in the LTR, and as a result it is hard for the author to visualize the precise concern or the exact meaning of this aspect of the LTR. This LTR may indicate that the IRS may well consider an immediate payment and a payment over time with an acceptable AFR to be the same for purposes of analyzing lapse and nonlapse restrictions. The employee stockholder was entitled to receive appraised fair market value in all events and the change was associated with the formation of an ESOP.

The following LTRs do not involve an ESOP and may be a bit more enlightening.

LTR 200934020

This LTR involves a nonlapse restriction that was canceled as a result of an IPO, and the cancellation was found to be noncompensatory. Prior to the IPO, all shares of the corporation were owned by employees. All of the shares had been acquired by the payment of book value at the time of purchase. Although the shares were not subject to a substantial risk of forfeiture, the shares could not be transferred except on termination of employment and the corporation was required to purchase such shares at book value with payments over a fixed period of years. For an undisclosed number of years following termination of employment, the shareholders were prohibited from soliciting business from or providing services to any client for whom they provided services previously. If this provision was violated, the remaining installments of purchase price would be based on the shareholder’s original purchase price rather than the book value at the date of the termination event. Presumably, this meant that the entire purchase price of all shares would be recalculated and from the price determined by the new calculation would be subtracted from the prior payments that had been made. The remaining payments would be reduced or potentially totally eliminated.

In connection with the IPO, the corporation was recapitalized into two classes (perhaps three) of common stock. The shares of each new class of stock had essentially the same rights as the other classes of common stock. Class A represented shares sold pursuant to the IPO, and Class B represented shares to be received by the existing shareholders and would be subject to restrictions. The potential third class was the common stock held by shareholders prior to the IPO which were not exchanged for the Class B shares and therefore remained subject to the old nonlapse restrictions and not the new lapsing restrictions.

The Class B shares had the book value buy-sell provision removed but were nontransferable for a period of time. The Class B shares automatically converted into Class A shares at the rate of Y percent each anniversary of the IPO for X years provided the person remained an employee at each anniversary. If the employee shareholder was no longer an employee on any anniversary, then all remaining Class B shares of such former employee would be converted to Class A shares only on the X-year anniversary of the IPO.

The other restrictions of the prior buy-sell remained in force, including the prohibition on soliciting business from or providing services to any client for whom the employee previously provided services. Exactly how the noncompete and nonsolicitation provision would be enforced once the shares were converted to Class A shares is not disclosed.

In no event, however, was an employee required to provide additional services for the cancellation of the book value buy-out with payments over time. The Class B stock would be converted into Class A at a specific future time even if the employee ceased providing services to the corporation. The corporation represented the cancellation of the repurchase requirement would not be treated as a compensatory event and no deduction would be claimed with respect to (i) the share exchange with the cancellation of the prior nonlapse restriction requiring the shareholder to sell and the corporation purchase the shares for the formula price with payment over time or (ii) (A) the acquisition, (B) the holding or (C) the resale by the employee shareholders of Class A or Class B shares.

The IRS recited the applicable Code Sections and Reg. §1.83-5(b)(1) and concluded that the removal of the repurchase requirement (with its pricing and terms) was not a compensatory cancellation of a nonlapse restriction.

The most interesting aspect of this LTR is the ongoing requirement to provide services in order for the shares to become transferable and marketable before a fixed future date which is apparently a number of years after the transaction. The employee who ceased providing services would continue to be subject to restrictions on transfer of the Class B shares until a future specific time in which
case the “no transfer” restriction by its terms would lapse. Since after the X anniversary the Class B shares automatically converted into Class A shares which could be sold to third parties at fair market value, the cancellation was not dependent on future services. With respect to the noncompete restrictions and the common stock, it is unclear what happened once the stock converted to Class A. However, the regulations provide that an enforceable requirement that property be returned to the employer if the employee accepts a job with a competing firm is not ordinarily considered to result in a risk of forfeiture\(^46\) nor is it a nonlapse restriction as there will be a time at which the noncompete terminates.

In short, the lesson of this LTR is that after cancellation of a buy-sell restriction, if consistent with other business terms, the stock transfer can be restricted for a period of time so long as the service provider is not required to provide services. The transfer restriction did not impact the canceled restriction (i.e., the shares will ultimately become shares that can be sold to third parties at market price). Therefore, the lapse of the original buy-sell restriction was not conditioned on future services.

LTR 200840015\(^48\)

This LTR does not involve an ESOP or an IPO but rather a third-party purchaser acquiring one line of business the corporation owned and conducted prior to a related series of transactions. Prior to the transactions, the target corporation had a stock rights plans for its executives which gave the executives the option to purchase Class A common stock at its then book value as determined by the board of directors and Class B common stock at its par value per share. The executives were required to exercise a specified percentage of the stock rights and acquire the related Class A and Class B common stock annually or such percentage would be canceled. The unexercised stock rights were automatically canceled upon the executive’s termination of employment unless the termination was the result of retirement, disability or death. The corporation had certain rights and obligations to repurchase the Class A common stock at the book value at the time of repurchase and the Class B common stock at par value. Prior to the transactions, an executive did not have the right to receive fair market value of the stock under any circumstances and the corporation represented that its policy has been to consistently enforce the book value restriction. Presumably, the par value restriction remained in place, and the corporate history was enforcing such restriction as the LTR does not discuss modifications to the Class B shares’ restrictions.

The target corporation created a new corporation, contributed the assets and liabilities of line of business two (“Division Two”) to the new corporation and distributed the shares of the new corporation to its shareholders. The other line of business (“Division One”) remained inside the original corporation. The shareholders who were not involved in Division Two were then redeemed out of the new corporation for cash. The original corporation with Division One was then merged into the subsidiary of the buyer with the shareholders of the original corporation either (i) receiving fair market value in cash or (ii) rolling over Class A common stock and unvested stock rights into shares and stock rights that are not subject to the book value restrictions but may be subject to different vesting provisions.\(^49\) The LTR states that the “rolled over” shares or stock rights will no longer be subject to the book value restriction but will be subject to repurchase provisions based on fair market value, a specified discount from fair market value or the transaction consideration.\(^50\)

The book value restriction on the Class A common shares was canceled as a part of the related transactions with the result the selling shareholders (either by redemption from the new corporation or from the merger) appear to have received fair market value for their Class A shares.

The rollover shares and unvested stock rights are most interesting. The future restrictions did not necessarily call for the fair market value or transaction consideration to be paid to the shareholders in the future. The following representation was made:

... any vesting conditions placed on Share Rights and repurchase provisions that apply to shares of common stock that are rolled over are being imposed as a condition of the Transaction in order to retain executives, or discourage them from competing, and are not a condition to the removal of the book value restriction.

Presumably, neither the creation and distribution of the new corporation shares nor the redemption of the shareholders that were not involved in the activities of the new corporation would have happened but for the buyer seeking to acquire the Division One business. Presumably, the buyer would not acquire the target corporation and Division One business if at least a number of the executives did not continue forward running Division One as the logical purpose of the restrictions on the rollover shares was to retain executives and discourage them from competing. Indeed, as the quote above indicates, the buyer was insisting that certain executives continue to provide services and not compete. However, the IRS bifurcated this
obligation to provide future services from the cancellation of the nonlapse restriction.

Representations were given that (i) cancellation of the book value restriction affects all shares of the Class A common stock and stock rights, (ii) cancellation of the book value restriction is occurring pursuant to a negotiated arms-length transaction, (iii) continuing executives at old corporation will not take a salary adjustment in connection with the cancellation and (iv) old corporation will not treat the cancellation of the book value restriction as a compensatory event and will provide such statement in writing to such executives.

The LTR referenced potentially different vesting provisions for the rollover shares and stock rights. It is not known whether the executives made Code Sec. 83(b) elections. Although the LTR listed different potential stock repurchase rights, the delta between fair market value and the applicable (i) discount from fair market value or (ii) transaction consideration is unknown. Also unknown is the delta, if any, between (A) the mathematical repurchase prices determined under the applicable new method and (B) the book value formula that applied before the transaction. The author assumes that the modification to the buy-sell terms represented an increase in the amount the executive would receive. If that assumption is correct, it does not appear that a change of negotiated nonlapse terms triggered any immediate income or gain (compensatory or not). Presumably, the rollover of existing common shares formerly subject to the canceled nonlapse restrictions was an exchange of stock via a Code Sec. 351 transaction.

Again the LTR walks through the relevant provisions of Code Sec. 83 and applicable regulations and reaches the conclusion that the removal of the book value restriction with respect to the Class A common stock was a noncompensatory cancellation of a nonlapse restriction.

The Code Sec. 83 take away from this LTR is future services can be required so long as the requirement is not a condition of the cancellation of the otherwise nonlapse restriction. The author suspects that the fact some shareholders were “cashed out” at the fair market value after the cancellation of the nonlapse restriction was strong evidence that the cancellation of the nonlapse restriction was noncompensatory. The “rollover” shareholders may well have an ongoing duty to provide services, and their stock is encumbered by new nonlapse restrictions imposed on them by virtue of going forward with the buyer in the transactions and not as a result of the cancellation of the nonlapse restriction. This pattern, a cancellation of a nonlapse restriction for all and a subsequent (although undoubtedly related) transaction that ties up a subset of executives with ongoing services as a means of establishing that the cancellation of the nonlapse restriction is noncompensatory is an important transaction tool. Unfortunately, as the discussion of the next TAM indicates, it is not always possible to have a meaningful number of former shareholders “cashed out” when a nonlapse restriction is canceled and the buyer desires to tie up the service providers of the acquired business.

**TAM 200021008 Revoking and Replacing TAM 199943040**

As discussed below, the first interesting point of this TAM is it involves a corporation that is seeking to have the cancellation of the nonlapse restriction treated as compensatory. The real issue in the TAMs was whether the compensation deduction for the cancellation of the nonlapse restriction should be capitalized (and if so when) by the corporation such that the purchaser of the entity received the benefit of the amortization of the intangible created by such capitalized compensation. To the author, the puzzling aspect of the cancellation of the nonlapse restriction discussed in this TAM is why the IRS, after determining that the various transactions were a single integrated transaction comprised of interdependent steps, did not simply state the cancellation was compensatory because the canceling corporation failed to agree not take the compensation deduction and simply cite Code Sec. 83(d)(2) and Reg. §1.83-5(b)(ii). Instead, the IRS goes through a convoluted analysis resulting in a determination that the cancellation was compensatory for different reasons.

Company A was a professional services corporation (PC) providing, among other things, medical services. Prior to the related series of transactions, Company A was wholly owned by doctors. The shares of Company A were subject to a nonlapse book value buyback provision that was triggered upon a doctor's termination of employment with Company A. According to the TAM, over a period of time Company A's business came to include the management of medical clinics as well as the original provision of medical services to patients by doctors. The TAM states the doctors determined to separate the management of medical clinics from the medical practice. At the conclusion of the TAM, the IRS recognized that the reorganization and structure was to facilitate the series of transactions to comply with state licensing and practice laws:

if, under their contracts with Company B, the doctors were properly considered to be performing medical practice services for Company A (rather than Company B), they and Company A would seemingly be
committing numerous violations of applicable State licensing and corporate laws. In fact, it seems clear that the subject corporate reorganization was structured the way it was in order to avoid such violations.\textsuperscript{54}

According to the TAM, Company A (i) canceled the book value buyback provisions; (ii) formed a new PC, Company B, by contributing its employment contracts with the physicians to Company B in exchange for all of the shares of Company B; and (iii) distributed in a pro rata redemption of the doctors’ shares in Company A the Company B shares to the physician shareholders. The physicians then sold their Company A shares to a third-party corporation for cash. In association with the Company B shares received by the doctors in redemption of a portion of their Company A shares, such shares of Company B had a five-year vesting period and were subject to a nonlapsing book value repurchase restriction.

The 1999 TAM (which was revoked by the 2000 TAM) states “[t]he Service and the Companies agree that Company A’s cancellations of the non-lapse restrictions on the doctors’ Company A shares were compensatory.” Company A deducted the compensation income attributable to the cancellation of the nonlapse restrictions using the “normal method of accounting” exception to the general timing rule for deductions governed by Code Sec. 83(h). Under the general rule for the timing of the deduction, the deduction is allowed for the service recipient’s tax year in which or with which ends the service provider’s tax year in which the amount is included in the gross income of the service provider. The 1999 TAM states “[i]n cases (such as here) where the property transferred (here, cancellation of the restrictions) is substantially vested upon transfer, the deduction is allowed to the service recipient in accordance with its normal method of accounting.”

The TAM then notes that Code Sec. 482 provides that the Secretary can allocate gross income, deductions, credits or allowances among two or more business organizations controlled directly or indirectly by the same interests if the Secretary determines such allocation is necessary to clearly reflect the income of the respective organizations. The TAM states in cases where the cancellation of a nonlapse restriction is contemporaneous with a reorganization of the employer into a parent and a subsidiary, the rules of Code Sec. 482 should be referenced to determine whether the Code Sec. 83 deductions attributable to the cancellation should be allocated between the resulting corporations. Since a request was not made to address Code Sec. 482, the TAM indicated no opinion is expressed as to the allocation deductions under Code Sec. 482.

**TAM 199943040 Was Repealed and Replaced by TAM 200021008**

TAM 200021008 repeated the factual statement of TAM 199943040 except the fourth fact was revised from reading:

(4) \text{[I]n consideration for the redemption, they caused Company A to transfer to each of them the number of Company B shares equal to the number of Company A shares owned by them ... . Almost immediately thereafter, the doctors sold their Company A shares to Company C.}

To:

(4) \text{In consideration for the redemption, they caused Company A to transfer to each of them the number of Company B shares equal to the number of Company A shares owned by them. When so transferred, the Company B shares were substantially-nonvested (a five-year vesting period) and subject to non[-]lapse book-value buyback provisions that would be triggered upon the doctor’s termination of employment with Company B.}

Almost immediately thereafter, the doctors sold their Company A shares to Company C for cash (Company A became a wholly owned subsidiary of Company C). As part of this arrangement, each doctor was required to repay an annually decreasing portion of his Company A shares’ sales price to Company A, as “liquidated damages,” if he or she terminated employment with Company B earlier than five years from the date of sale of the shares. Additionally, an agreement was entered into between Company A and Company B, under which Company A agreed to perform specified management services for Company B in exchange for stipulated annual fees. In summary, the results of these transactions were that the doctors had to continue their employment with Company B so that (1) Company B could generate the management fees that it owed to Company A, (2) their Company B stock would substantially vest and (3) they could avoid having to repay the sales price of their Company A shares.

The TAM goes on to state that the IRS and the Companies agree that the doctors’ cancellation of the nonlapse restrictions on their Company A shares was compensatory and substantially nonvested. The nonvested aspect, however, was not in TAM 199943040.

As noted above, the primary thrust of the dispute with the IRS appears to be the capitalization of the compensation and amortization in the hands of the buyer (\textit{via a consolidated return}). In the IRS’s analysis, however, the IRS applied the step transaction doctrine to treat the described transactions as a single integrated transaction
comprised of interdependent steps and concluded that the cancellation was compensatory, “if for no other reason than the fact that substantially-nonvested Company B shares were received by the doctors as one of the conditions of the cancellation.”

The IRS did agree that the amounts the doctor may have to repay Company A upon a “premature” termination of his employment with Company B is not governed by the rules of Code Sec. 83. Rather, even in the context of a step transaction, the IRS agreed that such amounts should be considered “liquidated damages” whose tax treatment is governed by other Code Sections.

Care should be taken in structuring and documenting the cancellation of nonlapse restrictions where some or all of the holders of equity interests subject to such restrictions provide services to the entity after the cancellation.

TAM 200021008 seemed to “refine” the theory as to why the cancellation of the nonlapse restrictions on the Class A shares was compensatory. In TAM 199943040, there was simply the statement that the companies agree that the cancellation of the nonlapse restrictions on the doctors’ Company A shares were compensatory. This could easily be simply because Company A did not agree to treat the cancellation as something other than compensatory. In other words, the requirements of Code Sec. 83(d)(2) (B) and Reg. §1.8-5(b)(2) were not met. The articulation of the receipt of nonvested shares of Company B stock as a basis for determining that the cancellation was compensatory because the doctors had to remain employed and providing services for a number of years to vest in the Class B Shares is troubling and represents a potential trap for shareholders in various service businesses (many of which will be professional practices) in their transactions. The receipt of ordinary compensation income subject to the high rates applicable to ordinary income as well as the self-employment or employment taxes rather than capital gains will be most unpleasant and expensive.

In today’s world of physicians, dentists and other licensed service providers practicing in industries where such services must be provided by entities exclusively owned or at least controlled by licensed persons, investor-owned entities are acquiring tangible and intangible assets or equity interests for significant dollars and for compensation are thereafter providing management services. This duo of TAMs coupled with Code Sec. 83(d) is extraordinarily important in the context of such transactions and poses a potential tax risk to the professional service providers if great care is not exercised. Even if as part of the transaction or related series of transactions the canceling corporation and the buyer agree that the cancellation of the nonlapse restrictions is noncompensatory and no deduction is or will be taken, the cancellation can result in ordinary income equal to the value of the equity without the nonlapse restriction over the value with the nonlapse restriction! In these cases, the value without the nonlapse restriction may be established by the buyer transaction and generally there will be a very large difference. Because of the regulatory rules, as in the case of the TAM, often there is a requirement that the practice entity be split into a management entity and a practice entity if the transaction is to go forward. Specifically, there must be a separation of the medical assets such as patient records and certain drugs from those nonmedical assets which can be owned by nonlicensed persons. All patient services must be performed by a professional entity. Not infrequently, a restructuring of the physician entity is involved. A management company affiliated with the buyer will contract to provide various assets and services to the professional practice. The buyer will desire that the physicians remain engaged. This presents situations potentially similar to those of the doctors described in the TAM.

An additional troubling aspect of these two TAMs is the reference to the application of Code Sec. 482 that permits the Secretary to distribute, apportion or allocate gross income, deductions, credits or allowances among organizations owned or controlled directly or indirectly by the same interests if the Secretary determines such is necessary in order to prevent evasion of taxes or clearly to reflect the income of such organizations, trades or businesses. Both TAMs indicate that Code Sec. 482 should be applied to determine whether and (if so) how the deduction should be allocated between Company A and Company B to clearly reflect their incomes. However, no indication is given as to how the IRS viewed the actual application of Code Sec. 482.

The lesson in these two TAMs is that the IRS may utilize the step transaction rules to cause the steps to be considered a single transaction rather than independent steps. Requirements to provide future services as evidenced by vesting requirements should not be imposed by the entity or a split-off portion of an entity as that
may indicate the cancellation of the nonlapse restriction had a compensatory element. Any action demonstrating the cancellation of the nonlapse restriction by the entity is in connection with the requirement of future services must be avoided. The TAMs seem to indicate liquidated damages to protect the buyer may be acceptable as the cancellation of the nonlapse restriction applies to all and it is the third-party buyer of the equity interest that is imposing the obligation.

**Conclusion of Lessons from the LTRs and TAM**

The potential compensatory compensation results from the cancellation of a nonlapse restriction does not simply apply to restrictions associated with C corporations. Compensation also can be generated by the cancellation of nonlapse restrictions with respect to S corporations and partnerships. The failure of an entity to enforce a nonlapse buy-back restriction at a formula price on a retiring shareholder (particularly one that has been providing services) may be a compensatory cancellation. Although LTRs and TAMs are non-precedential and cannot be cited as “authority,” they do indicate the thinking of the IRS’s national office. The blend of principles that may be gleaned from the LTRs and TAMs discussed above indicate that a cancellation of a nonlapse restriction may be able to avoid classification as compensatory upon a sale of the stock of the corporation to a third party (or the sale of all or substantially all of the assets of the corporation and its liquidation) by careful documentation. Transaction documentation should demonstrate that any future required services are not a condition of the cancellation of the nonlapse restriction. Similarly, there should be clear documentation that any salary reductions are a result of arm’s-length dealing with a third party and not a condition of the corporation’s cancellation of the nonlapse restriction.

**Code Sec. 280G**

The cancellation of nonlapse restrictions on the transfer and/or the termination of a required buy-sell agreement for a formula price that is not a reasonable proxy for fair market value often occurs in the context of a corporate acquisition that constitutes a change in control. If a corporation, other than a small business corporation or a corporation that would qualify as a small business corporation but for the presence of a nonresident alien shareholder or certain trusts qualifying but not electing to be classified as electing small business trusts, is involved, additional care should be taken to safeguard against the possible application of Code Sec. 280G.

In the case of most private corporations involved in a change of control, Code Sec. 280G should be fairly easy to avoid with respect to the cancellation of nonlapse restrictions. The controlling shareholders are generally on board with the transaction and the cancellation of the nonlapse restrictions. LTR 200840015 addressed Code Sec. 280G in the context of a cancellation of a nonlapse restriction and some of the following text tracks portions of that LTR.

Code Sec. 280G provides that no deduction will be allowed to a corporate taxpayer for any excess parachute payment. An excess parachute payment is defined as an amount equal to the excess of any parachute payment over the portion of the base amount (as defined in Code Sec. 280G(b)(3)) allocated to such payment. A “parachute payment” includes any payment in the nature of compensation to (or for the benefit of) a disqualified individual if (i) such payment is contingent on a change in the ownership of a substantial portion of the assets of the corporation and (ii) the aggregate present value of the payments in the nature of compensation to (or for the benefit of) such individual that are contingent on such change equals or exceeds an amount equal to three times the base amount. The cancellation of a nonlapse restriction is considered to be a payment in an amount equal to the difference in the value of the shares without the canceled restriction and with the canceled restriction.

A disqualified individual is defined to be an employee or independent contractor who performs services for a corporation and is an officer, shareholder or highly compensated individual. A highly compensated individual is one who is (or would be if the person was an employee) a member of the group consisting of the highest paid one percent of the employees of the corporation or, if less, the highest paid 250 employees of the corporation. The base amount is the annualized includible compensation for base period (generally the most recent five tax years (or shorter period during which the disqualified person performed services for the corporation) ending before the date of the change of ownership).

In addition to the loss of the compensation deduction for the excess parachute payment, Code Sec. 4999(a) imposes a 20-percent tax on the service provider receiving an excess parachute payment.

The regulations provide that, for purposes of Code Sec. 280G, all payments—in whatever form—are payments in the nature of compensation if they arise out of an employment relationship or are associated with the performance
of services. Payments in the nature of compensation include (but are not limited to) wages and salary, bonuses, severance pay, fringe benefits, life insurance, pension benefits and other deferred compensation (including any amount characterized as interest thereon). The regulations provide that transfers of property are treated as payments in the nature of compensation for purposes of the golden parachute rules.

The regulations provide that a payment (a cancellation of a nonlapse restriction) is treated as contingent on a change in ownership or control if the payment would not, in fact, have been made had no change in ownership or control occurred, even if the payment is conditioned upon another event. Generally, a payment is treated as one that would not in fact have been made in the absence of a change in ownership or control unless it is substantially certain, at the time of the change, the payment would have been made whether or not the change occurred. A payment that becomes substantially vested as a result of a change in ownership or control will not be treated as a payment that was substantially certain to have been made whether or not the change occurred. Even payments that would in fact have been made if no change of control occurred are treated as contingent on a change in ownership or control if the change accelerates the time at which the payments are made.

If a payment is treated as contingent on a change in ownership or control, the full amount of the payment generally is treated as contingent on such change. In certain circumstances, however, only a portion of the payment is treated as contingent on the change. For example, a special rule exists for payments that are contingent on the continued performance of services for a specified period of time whose vesting is accelerated by a change of ownership or control and is attributable, at least in part, to services performed before the date payment is made or certain to be made. The portion of the payment that is treated as contingent on the change in ownership or control is generally the amount by which the payment exceeds the present value of the payment that was expected to be made absent the acceleration (determined without regard to the risk of forfeiture for failure to continue to perform services), plus an amount to reflect the lapse of the obligation to continue to perform services. The amount reflecting the lapse of the obligation to continue to perform services (but not an acceleration of the timing of the payment) is one percent of the amount of the accelerated payment multiplied by the number of full months between the date that the individual’s right to receive the payment is actually vested and the date that, absent the acceleration, the individual’s right to receive the payment would have been vested. In addition, if the timing of the payment is accelerated as a result of the change in control the service provider is deemed to have received additional compensation as a result of the change of control equal to difference in the amount paid less the present value of payment if it had been made at the previously scheduled time.

The compensation income from the cancellation of the nonlapse restriction as well as any other compensation that is triggered by or accelerated by virtue of the change of control can be exempt from Code Sec. 280G if the corporation whose stock is involved is not readily tradable on an established securities market and the shareholders approve of the payment. This is referred to as the “no market” exception. To qualify the payment (i.e., cancellation of the nonlapse restriction), it must be approved by more than 75 percent of the voting power of all outstanding stock of the corporation entitled to vote immediately before the “change in ownership or control” associated with the compensation. Before the vote, there must be adequate disclosure to all persons entitled to vote of all material facts concerning the otherwise parachute payments to the disqualified individuals but for this exception.

Pursuant to the regulations, stock owned (actually or constructively) by disqualified individuals who receive (or are to receive) parachute payments is not counted as outstanding stock. If all persons who hold voting power in the corporation undergoing a change of control are disqualified individuals or related persons to disqualified individuals, then such stock is counted as outstanding and votes by such persons are considered in determining whether 75 percent or more vote has been obtained.

In order to have “adequate disclosure” under the shareholder approval requirements the disclosure must be a full and truthful disclosure of all material facts and include such additional information as is necessary to make the disclosure not materially misleading at the time the disclosure is made. For each disqualified individual, material facts that must be disclosed include, but are not limited to, (i) the event triggering the payments, (ii) the total amount of payments that would be parachute payments if the approval requirements are not met and (iii) a brief description of each payment (the cancellation of the nonlapse restriction). An example in the regulations illustrates that the failure to disclose the material facts to all shareholders will void the protection of the shareholder vote even if shareholders holding more than 75 percent of the vote receive the disclosure and vote to approve.
Great care should be taken to have written proof that full disclosure was made to all shareholders entitled to vote and that the complex rules concerning disqualified individuals that are shareholders and the vote of entities that are shareholders are carefully followed and documented if Code Sec. 280G is to be avoided in the context of a change of control and the cancellation of nonlapse restrictions. Even for corporations that are believed to qualify to be small business corporations, it is recommended that the procedures for approving the parachute payments be followed in case the corporation does not qualify for some reason.

Conclusion

Care should be taken in structuring and documenting the cancellation of nonlapse restrictions where some or all of the holders of equity interests subject to such restrictions provide services to the entity after the cancellation.

Although the authority that exists deals with corporations, the Code Sec. 83 rules appear to apply to at least partnership capital interests and perhaps all partnership interests. The burden of proof will be on the taxpayers that such cancellation was not compensatory. This risk is particularly acute in a change of control from the cancellation of nonlapse restrictions on their equity interests would also tend to demonstrate that the cancellation is not compensatory. Liquidated damages between the service recipient and other owners to exercise the right to purchase at formula price can result in a cancellation of such restriction with respect to the service provider and can, under a facts and circumstances analysis, result in compensation income.

As will be discussed infra, the failure of the service recipient or other owners to exercise the right to purchase at formula price can result in a cancellation of such restriction with respect to the service provider and can, under a facts and circumstances analysis, result in compensation income.

Proper documentation is critical to assist in demonstrating that the cancellation of the nonlapse restriction and the obligation to provide future services are not linked. Just as in the cases of an IPO or the establishment of an ESOP, the cancellation of the nonlapserestription should be to facilitate a transaction—the change of control and sale of stock—and not be compensatory. The potential for compensation income exists whenever a person ceases providing services and is required to offer his or her or its interest back to the service recipient or the other owners at less than a fair market value price or in the context of a transaction in which equity is acquired and existing owners are released from some or all of the nonlapse restrictions.

Proof that the cancellation of the nonlapserestription is not conditioned on providing future services may be found in the fact that some service provider equity holders sell their equity interests at fair market value after the cancellation of the nonlapse restriction and cease providing services. The existence of nonservice provider owners who will benefit from the cancellation of nonlapse restrictions on their equity interests would also tend to demonstrate that the cancellation is not compensatory. Liquidated damages between the buyer and the selling shareholders, if the selling shareholders cease providing services within specified time frames, appear not to be linked to the cancellation of the nonlapserestrictions. This demonstrates that the buyer is imposing a condition on the payment and that the entity did not impose the requirement as a condition of the cancellation.

ENDNOTES

1 Reg. §1.83-3(b) provides:
[A] “non-lapse restriction” ... is a permanent limitation on the transferability of property—(1) Which will require the transferee of the property to sell, or offer to sell, such property at a price determined under formula, and (2) Which will continue to apply and to be enforced against the transferee or any subsequent holder (other than the transferor).
2 Code Sec. 83(d)(1).
3 Reg. §1.83-3(a).
4 Code Sec. 83(d)(2).
5 Code Secs. 83(h) (providing the capital gains rate) and 1411(a) (imposing a 3.8-percent net investment income tax).
6 Code Sec. 1(a)-(d) (providing the tax rates imposed on individuals’ taxable income).
7 Code Secs. 1301 (tax on employees) and 1401 (tax on self-employment income).
8 Individual income tax of 39.6 percent, capped Medicare tax of 2.9 percent (self-employed or employee/employer tax) and, if compensation is greater than $200,000 for the year, an additional Medicare tax of 0.9 percent. [39.6 + 2.9 + 0.9 = 43.4]. See supra notes 6 and 7.
10 Code Sec. 83(d)(2).
11 Code Secs. 1361(b) (whether or not an S election was made) or a corporation that would meet the definition of a small business corporation if it did not have a nonresident alien as a shareholder. Code Sec. 280C(b)(5)(A)(1). Also per LTR 200817007 (Dec. 3, 2007), the exemption applies to an otherwise eligible corporation with trusts as shareholders that are eligible to make the eligible small business trust elections, even if such elections have not been made.
12 Code Sec. 280C(b)(2).
13 Code Sec. 280C(a).
14 Code Sec. 4999.
15 Code Sec. 280C(c).
16 Code Sec. 1032(a); Reg. §1.1032-1(a).
17 Code Sec. 1361(b)(1).
18 See Reg. §1.83-3(b).
21 Code Sec. 4999.
22 But see 1996 FSA.LEXIS 13 (Jan. 16, 1996) (concluding that, under the factual circumstances, the restrictions related to partnership interests were arguably nonlapse and noncompensatory such that cancellation of the restrictions in the transactions at issue would not result in an income adjustment under Code Sec. 83(d)(2) and application of Code Sec. 83(a), and that entering into the sale and charitable donation was similar to a cancellation in connection with a public offering).
23 See William S. McKee, William F. Nelson, Robert L. Whitmire, Gary R. Huffman & James P.


22 A protective amendment to the partnership or operating agreement providing for such an allocation might be in order.


24 GCM 39535 (July 17, 1986).

25 The analysis cited the 1969 legislative history of Code Sec. 83(d). Id.

26 Reg. §1.83-5(b)(2) requires the service provider to request the employer or service recipient to furnish the service provider with a written statement indicating such employer or service recipient will not treat the cancellation of the nonlapse restriction as a compensatory event and that no deduction will be taken with respect to such cancellation. The service provider shall file such written statement with his or her income tax return for the tax year in which or with which such cancellation occurs. Surprisingly, 1996 FSA LEXIS 13 characterized the failure of the corporation and the partnership to provide a written statement that each would not treat the cancellation as a compensatory event and would not claim a deduction as a technical defect that does not alter the fact that the corporation and the partnership treated the cancellation as noncompensatory. See supra note 23.

27 Reg. §1.83-6(a)(4).


29 Although the regulations speak in terms of employee, this is equally applicable to an independent contractor and presumably a partner.


31 Id.


33 The LTR characterizes the company’s right as a right of first refusal but then states the stock of X shall be purchased at a formula price based on the book value of the company.

34 Reg. § 1.83-5(b)(iv).

35 LTR 200649014 (Sept. 1, 2006).

36 It is unclear if a sale to the ESOP was an imme-