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WHAT HAPPENS WHEN VESTED STOCK IS TRADED FOR NONVESTED STOCK?

by
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The IRS has issued guidance on the tax consequences to an employee (or other service provider) of trading vested stock for nonvested stock. The Service did so in Revenue Ruling 2007-49.

Vesting Restrictions Added. The ruling addresses three situations. In the first, and most straightforward, substantially vested stock had been granted to an individual in exchange for his or her agreement to perform services for the employer. The fair market value of the stock on the date of grant was $1,000. In connection with its plan to start a new business venture, the employer later sought financing from an investor. The investor agreed to provide financing in exchange for stock in the company, but only if the employee agreed to subject the employee's vested shares to a restriction that would cause the shares to become substantially nonvested. Under the agreed upon arrangement, if the employment of the employee were to terminate before a specified date, the employee would be required to sell his or her shares back to the corporation in exchange for the lesser of (a) the value of the stock at the time the corporation sought financing from the investor, or (b) the fair market value of that stock at the time of forfeiture. The shares would also be nontransferable prior to the vesting date.

The IRS concluded that if the employee were to remain employed to the required date, the employee would not be taxed at that time under Section 83, even though the employee would vest then. That is because the stock had previously been substantially vested and therefore already owned by the employee for purposes of Section 83, which meant there was no transfer under Section 83 at the time of the later vesting event. The imposition of vesting restrictions on the previously vested shares had no effect for purposes of Section 83.

Tax-Free Reorganization. The IRS also considered the tax consequences to an employee where, instead of trading vested stock in a corporation for nonvested stock in the same corporation, the employee exchanges his or her vested stock for substantially nonvested stock in another corporation through either a tax-free reorganization (under Section 368(a)) or a taxable stock acquisition. In those circumstances, unlike the first situation, the nonvested shares the employee receives are subject to Section 83. In the case of the tax-free reorganization, the IRS considered a corporation's agreement to acquire all of the stock of the employer through the creation of a newly formed wholly-owned subsidiary that would merge into the employer. The transaction would qualify as a reorganization under Section 368(a). As a result, the shareholders of the employer would receive voting stock in the acquirer in exchange for their stock. The employee's new shares would, however, be subject to an employment requirement causing the shares to be substantially nonvested (to vest, the employee must not terminate employment for any reason prior to a particular date).

In this circumstance, the new nonvested shares would be treating as having been transferred in connection with the performance of services, and therefore subject to Section 83. In a sense, this scenario, unlike the first situation in which an employee retained stock in the same corporation (albeit subject to new restrictions), might be understood by thinking of the vested shares as if they were cash. The amount paid for the new stock under Section 83 would, therefore, be the fair market value of the vested stock exchanged for the nonvested stock of the acquirer. The ruling considered the possibility of the employee making a Section 83(b) election to be taxed on the nonvested shares. In that event, the employee would not, at that time, report any taxable income on the transfer of the nonvested shares. That is because the fair market value of the new nonvested stock would be the same as the amount paid (which would be the value of the vested shares exchanged). Because of the Section 83(b) election, the employee also would not include amounts in income in the year in which the stock would vest.

Taxable Acquisition. In the third situation, rather than a tax-free exchange, the original corporation is acquired in a taxable stock acquisition. In that circumstance, the employee will have exchanged vested stock for substantially nonvested stock of the acquirer in an exchange to which Section 1001 applies. As a result, the employee will recognize capital gain in the amount of the difference between the value of the nonvested stock (determined without regard to the requirement that the employee continue working through a particular date) and the $1,000 basis the employee has in the vested stock. The amount paid by the employee for the stock of the acquirer under Section 83 will be the fair market value of that stock on the date of the exchange. If the employee were to make a Section 83(b) election, the employee would not report any additional income for that year because the fair market value of the new nonvested stock less the amount paid for that stock would be $0. The employee also would not include any amount in income in the year in which the restriction lapses (that is, the year to which the employee must continue to work to vest) because of the employee's prior Section 83(b) election.

If the employee does not make a Section 83(b) election with respect to the stock of the acquirer, when that stock becomes substantially vested (by reason of the employee working through the required date), the employee would include in gross income as compensation under Section 83 the excess of the fair market value of the stock at that time over the amount paid (which, again, was the fair market value of the stock at the time of the exchange).

"The IRS also considered the tax consequences to an employee where, instead of trading vested stock in a corporation for nonvested stock in the same corporation, the employee exchanges his or her vested stock for substantially nonvested stock in another corporation . . . ."

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