INTERNAL REVENUE SERVICE

February 08, 2000

Number: **200021008** Release Date: 5/26/2000

Index Nos.: 83.04-02; 83-08-00; 482.00-00 Control No.: CC:EBEO:4/TAM-102993-00

INTERNAL REVENUE SERVICE

NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

District Director

Taxpayer's Name:	
Taxpayer's Address:	
Taxpayer's Ident. No.:	
Taxable Years at Issue:	
Date of Conference:	
<u>Legend</u> :	
Company A	=
Company B	=
Company C	=

ISSUE:

Whether, under the rules of section 83 of the Internal Revenue Code, Company A was entitled to deduct the compensation income that was includible in its employees' gross incomes as a result of cancellation of certain nonlapse restrictions on their Company A shares. This technical advice memorandum revokes and replaces technical advice memorandum numbered 199943040.

FACTS:

As initially organized, Company A was a professional services corporation that was wholly owned by doctors (as was required by State law). From the outset, all Company A shares were substantially-vested and subject to nonlapse book-value buyback provisions that would be triggered upon a doctor's termination of employment with Company A.

Eventually, the business of Company A came to include the management of medical clinics. In 1994, the doctors decided to sell their clinic-management business to Company C and took the following integrated steps (here, in simplified form) in preparation for the sale:

- They canceled the book-value buyback provisions on their Company A shares;
- (2) They then formed Company B by causing Company A to contribute their employment contracts with Company A to Company B. In exchange therefor, Company A received all of the shares of Company B;
- (3) They then caused Company A to redeem .005 of each outstanding Company A share held by them; and
- (4) 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 then owned by them. When so transferred, the Company B shares were substantially-nonvested (a five-year vesting period) and subject to nonlapse book-value buyback provisions that would be triggered upon the doctor's termination of employment with Company B.

Thus, after completion of these transactions, the doctors' medical practice was housed in Company B, the clinic-management business remained with Company A, and the doctors owned substantially-nonvested shares in Company B in the same proportions that they owned substantially-vested shares in Company A.

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 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 Internal Revenue Service's Examination function and the Companies agree that the doctors' cancellation of the nonlapse restrictions on their Company A shares was compensatory and substantially nonvested. Company A did not reflect the cancellation on its return filed for its short taxable year during which the cancellation

occurred. Rather, Company A treated the transaction as creating a credit to its common stock and a debit to a capitalized asset. As such, Companies A and C, which file a consolidated return, have expensed the asset over time and, thereby, created a net operating loss.

APPLICABLE LAW AND ANALYSIS:

Under section 83(a), if, in connection with the performance of services, property is transferred to anyone other than the service recipient, the excess of the fair market value of the property over the amount paid for the property is included as compensation income in the service provider's gross income for the first taxable year in which the rights to the property are transferable or not subject to a substantial risk of forfeiture ("substantially vested"). For this purpose, the fair market value of the property is determined on the date that the rights to the property become substantially vested and without regard to restrictions that lapse.

Under section 83(d)(2) of the Code and section 1.83-5(b)(1) of the Income Tax Regulations, if a nonlapse restriction imposed on section 83 property is canceled, then, unless the taxpayer establishes (i) that the cancellation was noncompensatory, and (ii) that the person who would be allowed a deduction (if the cancellation were treated as compensatory) will treat the transaction as noncompensatory, the excess of the fair market value of the property at the time of cancellation (determined without regard to the restriction) over the sum of (i) the fair market value of the property immediately before the cancellation (taking the restriction into account), and (ii) the amount (if any) paid for the cancellation, is treated as compensation income for the taxable year in which such cancellation occurs.

Whether there has been a noncompensatory cancellation of a nonlapse restriction under section 83(d)(2) depends upon the particular facts and circumstances. Ordinarily the fact that the service provider is required to perform additional services or that the salary or payment of such person is adjusted to take the cancellation into account indicates that the cancellation has a compensatory purpose. On the other hand, the fact that the original purpose of a restriction no longer exists may indicate that the purpose of the cancellation is noncompensatory. Thus, for 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, the cancellation will generally be regarded as noncompensatory. However, the mere fact that the service recipient is willing to forego a deduction under section 83(h) is insufficient evidence to establish a noncompensatory cancellation of a nonlapse restriction.

The refusal by a corporation or shareholder to repurchase stock of the corporation that is subject to a permanent right of first refusal will generally be treated as a cancellation of a nonlapse restriction. However, the preceding sentence does not apply where there is no nonlapse restriction (for example, where the price to be paid for the stock subject to the right of first refusal is the fair market value of the stock).

Additionally, section 83(d)(2) does not apply where immediately after the cancellation of a nonlapse restriction the property is still substantially nonvested and no section 83(b) election has been made with respect to the property. In such a case the rules of section 83(a) and section 1.83-1 apply to the property.

Under section 1.83-1(b)(1) of the regulations, if substantially-nonvested property is disposed of in an arm's length transaction, the service provider realizes compensation income in an amount equal to the excess of the amount realized on the disposition over the amount (if any) paid for the property. However, compensation is not recognized to the extent that the service provider receives substantially-nonvested property for the disposition. See section 1.83-1(b)(3).

Under section 83(h), the service recipient is allowed a compensation expense deduction, under section 162 of the Code, in an amount equal to the amount included in the service provider's gross income under section 83(a). Under the general rule of section 83(h), the deduction is allowed for the service recipient's taxable year in which or with which ends the service provider's taxable year in which the amount is included in gross income.

However, section 1.83-6(a)(3) of the Income Tax Regulations provides an exception to the general timing rule for the deduction. In cases where the property transferred is substantially vested upon transfer, the deduction is allowed to the service recipient in accordance with its normal method of accounting. Additionally, section 1.83-6(a)(4) provides that no deduction is allowed under section 83(h) to the extent that the transfer of property constitutes a capital expenditure, an item of deferred expense, or an amount properly includible in the value of inventory items. In the case of a capital expenditure, for example, the basis of the property to which such capital expenditure relates is increased at the same time and to the same extent as any amount includible in the service provider's gross income in respect of the transfer. Thus, for example, no deduction is allowed to a corporation in respect of a transfer of its stock to a promoter upon its organization, notwithstanding that the promoter must include the value of the stock in gross income in accordance with the rules of section 83.

Section 482 of the Code provides that, in the case of two or more organizations, trades, or businesses owned or controlled directly or indirectly by the same interests, the Secretary may distribute, apportion, or allocate gross income, deductions, credits, or allowances among such organizations, trades, or businesses, if the Secretary determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of such organizations, trades, or businesses.

Applying the above rules to the facts of the instant case, our threshold conclusion is that, for tax purposes, the described transactions should be viewed as if they were a single, integrated transaction comprised of interdependent steps. Taking that approach, we conclude that the subject 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. In comparison, see the second sentence of section 1.83-6(d)(1) of the regulations.

Additionally, we conclude that, to the extent that, immediately after the cancellation, the doctors could receive an amount in excess of the book-value formula price upon a subsequent sale of their Company A shares (here, that amount was paid to them in cash), the cancellation was substantially vested. In contrast, to the extent that the doctors could only (here did) receive substantially-nonvested property (the Company B shares) upon a sale of their Company A shares, the cancellation was substantially nonvested. See sections 1.83-1(b) and 1.83-5(b).

Accordingly, we also conclude that, to the extent that the doctors received cash in excess of the book-value formula price for their shares, they immediately realized compensation income under the rules of section 83. See section 1.83-1(b)(1). As such, under the rules of sections 83(h) and 1.83-6(a)(3), a deduction was allowed under Company A's normal method of accounting for that compensation expense. In this regard, Company A argues that its normal method of accounting required capitalization of that expense.

We note, however, that we have been presented no facts supporting Company A's conclusion that it *had* a "normal method of accounting" with respect to cancellations of nonlapse restrictions on its shares; or its conclusion that the cancellation created an asset that it owned, which had a useful life extending beyond the end of its short taxable year (after that year, no services were required to be performed by the doctors for any company other than Company B); or its conclusion that Company A's contribution of the doctors' employment contracts to Company B means that Company A is entitled to capitalize the value of those contracts (Company A had no cost basis in the contracts, and they were part of a section 351 transaction); or its conclusion that, under its normal accrual method of accounting, it would delay the deduction of accrued compensation currently includible its employees' gross incomes.

Accordingly, we also conclude that, to the extent that section 83 required compensation income to be immediately includible in the doctors' gross incomes as a result of the cancellation of the restrictions on, and the contemporaneous sales of, their Company A shares, Company A became entitled to an immediate, corresponding compensation expense deduction under the rules of section 83(h). However, in cases such as this, where cancellation of a nonlapse restriction is contemporaneous with a reorganization of the employer corporation into a parent corporation and a subsidiary corporation, the rules of section 482 should be referenced to determine whether the section 83 deduction attributable to the cancellation should be allocated between the resulting corporations under those rules. Compare Revenue Ruling 80-198, 1980-2 C.B. 113. Please note in this regard that no opinion is expressed, and none was requested, as to proper allocation of the deduction under the rules of section 482.

In contrast, we also conclude that any compensation expense deductions resulting from substantial vesting of the doctors' Company B shares may be taken only

by Company B (again, under the rules of section 83). This is because Company B is the sole "recipient of the services" causing such vesting (the doctors' employment contracts are between only them and Company B, and the management services contract is between only Company A and Company B). We note in this regard that 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.

Finally, we conclude that the federal tax treatment of any amount that has been or might be repaid by a doctor to Company A upon a "premature" termination of his employment with Company B is not governed by the rules of section 83. Rather, we agree (as the parties explicitly intended) that such amounts should be considered "liquidated damages" whose tax treatment is governed by other Code sections.

CONCLUSION:

Under the rules of section 83, a deduction was allowable, as explained above, for the compensation income includible in the doctors' gross incomes as a result of the cancellation of the nonlapse restrictions on and the contemporaneous sales of their Company A shares. Section 482 should be referenced to determine whether and (if so) how the deduction should be allocated between Company A and Company B to clearly reflect their incomes.

A copy of this technical advice memorandum is to be given to the Companies. Section 6110(j)(3) of the Code provides that it may not be used or cited as precedent.