Exploring the Tax Consequences of Exchanging Unrestricted QSBS (Section 1202 Stock) for Restricted Stock

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Qualified small business stock (QSBS) and non-QSBS issued to founders, employees and independent contractors is generally subject to Section 83.[1] Section 83 deals with the tax consequences of transferring property (including stock) to service providers for services.

Typical tax treatment of stock issued to founders and other service providers

Typically, issuing unrestricted stock to employees triggers compensation income and a corresponding deduction for the issuing corporation. Stock issued to service providers is often subject to transfer restrictions and time and/or performance vesting. Stock is often forfeited or purchased back at the issue price (often $0.0001 per share) if the recipient leaves employment prematurely. QSBS subject to vesting requirements when issued is not treated as owned by the recipient for purposes of Section 1202 (compensation event; holding period) until the stock vests or a Section 83(b) election is filed by the recipient. If a Section 83(b) election is filed within 30 days after issuance, the stock is treated as owned for federal income tax purposes, triggering a taxable compensation event and commencing the recipient's holding period.

Issuance of unrestricted founder stock

Corporations often commence operations and issue stock before investors join the fold demanding that vesting requirements are placed on the stock held by founders and early-stage employees. Standard corporation organization documents often provide for the

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issuance of unrestricted (i.e., fully vested) founder common stock. Founder common stock is often issued for $0.0001 per share (or like amount) and can be considered issued for a mixture of that initial *de minimis* money amount and services, all of which works for purposes of satisfying Section 1202's requirement that QSBS be issued for money, property or services. Founder stock issued at $0.001 per share is usually treated as being worth that *de minimis* amount, so no compensation liability is triggered by the issuance.

Issuance of restricted founder stock

If founder stock is restricted, it is important to file the Section 83(b) election. Typically, the value of a start-up corporation's stock issued to founders and early-stage employees is *de minimis* (e.g., often the $0.0001 issue price). The failure to file the Section 83(b) election can have catastrophic later tax consequences, including triggering ordinary income treatment when a liquidity event occurs and a failure to meet Section 1202's holding period requirements.

Section 83(b) elections

If founder stock is unrestricted when first issued, there is no need to file a Section 83(b) election and the spread between the issue price and fair market value is technically compensation, although founder common stock is generally treated as having no ascertainable value in excess of the *de minimis* issue price. For early-stage employees and independent contractors, common stock is generally restricted (subject to vesting requirements and restrictions on transfer) and is coupled with expectation that the recipient will file a Section 83(b) election. The Section 83(b) election triggers the spread between what is paid ($0.0001 per share?) for the stock and the fair market value of the stock being treated as compensation. For early-stage corporations, the compensation amount, if any, will be modest as the value of the common stock is treated as nominal, so long as no valuable intellectual property has been developed within the corporation or money and/or intellectual property or other property is contributed to the corporation in connection with its organization.

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Placement of restrictions after issuance on previously unrestricted stock

What happens if a significant investor later negotiates for the placing of restrictions on otherwise unrestricted founder/employee common stock, causing outstanding stock to be restricted under Section 83? Investors may want to restrict outstanding service provider stock to protect their investment by (hopefully) incentivizing founders and employees to remain with the corporation. Typical after-issuance restrictions include time and/or performance vesting and transfer restrictions, triggering forfeiture of unvested shares if employment terminates prior to achieving the agreed-upon vesting requirements.

When are after-issuance restrictions imposed on outstanding stock?

The scenario outlined in the previous paragraph could arise without any changes to a corporation's cap table. For example, investors acquire authorized but unissued preferred stock and at the same time successfully negotiate for the imposition of vesting requirements on outstanding common stock. In other cases, a corporation might undergo a recapitalization (a Type E reorganization) or a redomiciling of the corporation to Delaware (a Type F reorganization), in conjunction with adding additional investors who negotiate for restrictions on outstanding common stock. In yet other instances, after-issuance restrictions on the outstanding common stock are introduced when there is a "rollover" of target corporation unrestricted stock into restricted buyer stock in an acquisitive reorganization (Type A, B or C reorganization) (e.g., target stockholders exchange unrestricted target corporation common stock for a mixture of restricted buyer common stock and cash in a Section 351 exchange or Section 368 tax-free reorganization). Each of the instances outlined above requires navigating through Revenue Ruling 2007-49, 2007-2 CB 237.

Working with Revenue Ruling 2007-49

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Prior to the issuance of Revenue Ruling 2007-49, 2007-2 CB 237, most of the tax consequences of placing after-issuance restrictions on outstanding stock were unclear. The appearance of Revenue Ruling 2007-49 clarified some issues but, as discussed below, left unanswered the issue of how to calculate the holding period, which is a critical issue if the stock is QSBS.

Revenue Ruling 2007-49 addresses three separate situations:

Situation 1 involves the placing of after-issuance restrictions on outstanding stock. The ruling provides that there is no "transfer" of new consideration under those circumstances, so not only are Section 83's compensation provisions not triggered, but also no new Section 83(b) election is required. The IRS was apparently comfortable that no property is transferred to the taxpayer for services under these circumstances. This result does beg the question of why the IRS wasn't equally comfortable applying the same reasoning and result for Situations 2 and 3 discussed below.

Situation 2 involves the non-taxable exchange of unrestricted stock for restricted stock in a Section 368 tax-free reorganization. Section 368 spans acquisitive reorganizations (Type A, B and C reorganizations), divisive reorganizations (Type D reorganizations), recapitalizations (Type E reorganizations) and mere change of identity, domicile, etc. (Type F reorganizations). Although not expressly addressed in the ruling, the analysis associated with Situation 2 should also apply to acquisitive Section 351 exchanges involving the formation of a corporate holding company. The ruling concludes that when unrestricted stock is exchanged for restricted stock in a reorganization, the exchange of target stock for buyer stock is governed by Section 83. Within Section 83, where equal consideration (target corporation stock) is exchanged for buyer stock, there will be no triggering of taxable compensation, but a Section 83(b) election must be made so that the buyer stock is treated as being owned by the target stockholder participating in the exchange.

Situation 3 involves a taxable exchange of unrestricted target corporation stock for restricted buyer stock. The ruling concludes that unless the target stockholder makes a Section 83(b) election, gain on the subsequent sale of the buyer stock will be taxable

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compensation. Since the stockholder has a fair market value tax basis in the restricted stock at the time of the exchange, the Section 83(b) election should not trigger any additional tax liability.

Situations 2 and 3 of Revenue Ruling 2007-49 are premised on the assumption that an exchange of unrestricted stock (property) for restricted stock is governed by Section 83. As support for this conclusion, the IRS relied on the Ninth Circuit's decision in *Alves v. Commissioner*, 734 F.2d 478 (9th Cir. 1984) *aff'g* 79 T.C. 864 (1982). In *Alves*, the Ninth Circuit reasoned that "*subjecting stock to a restriction that will cause it to be 'substantially nonvested' . . . indicates that the property is transferred in connection with the performance of services even if the employee pays fair value for the stock.*"

Tax commentators have pointed out that Revenue Ruling 2007-49's conclusion that stock for stock exchanges fall within the scope of Section 83 has weak support in Section 83's regulations.[2] Since Section 83 was intended by Congress to address the tax consequences associated with the receipt of property by a service provider, tax commentators find it difficult to understand why an exchange of target stock for buyer stock of equal value should be considered the payment of compensation, and why the exchange would fall within the scope of Section 83. The IRS's logic when it distinguished the result in Situation 1 from that in Situations 2 and 3, and in turn whether a Section 83(b) election would be required, appears to be that there is no physical transfer of property in Situation 1, which contrasts with the physical transfer of property (stock for stock) in Situations 2 and 3. This reasoning leaves unanswered whether Section 83 was intended by Congress to apply to stock-for-stock exchanges under Sections 351 or 368. While there may be a physical transfer of stock where stock-for-stock exchanges occur, the $64,000 question is whether it makes sense to conclude that the transfer is in connection with the performance of services.

Revenue Ruling 2007-49 does provide a workaround (the filing of Section 83(b) election) for the potential compensation issues identified by tax commentators in connection with stock-for-stock exchanges.[3] But as discussed below, Revenue Ruling 2007-49 also

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created a significant "gotcha" problem for unfortunate taxpayers who fall into the trap of not realizing that a Section 83(b) election was required. Also, the ruling leaves unresolved an ambiguous holding period issue to be sorted out by taxpayers, the IRS and the courts.

Revenue Ruling 2007-49's trap for the unwary

The IRS takes the position in Revenue Ruling 2007-49 that an exchange of unrestricted stock for restricted stock in a Section 368 reorganization falls within the scope of Section 83, even though there is an exchange of stock for stock of equal value. As discussed above, the ruling provides a workaround involving filing a Section 83(b) election — no compensation income or capital gain will be triggered if the election is filed and the taxpayer states that the FMV of the target stock and buyer stock are equal. But this approach creates the potential trap for the unwary — the consequence of failing to timely file a Section 83(b) election. If the taxpayer fails for any reason to timely file the Section 83(b) election (and if you don't know that exchanging stock for stock of like value can trigger the need to file the election, missing the issue is perhaps understandable), both the appreciation that occurred prior to the stock-for-stock exchange and any appreciation that occurs after the exchange is transformed from capital gain eligible for offsetting with Section 1202's gain exclusion to compensation subject to ordinary income treatment and employment taxes. The "good news" is that there are solid arguments based on the analysis and tax authorities discussed in the Levin-Rocap-Ginsburg Special Report (see footnote 3) that neither Section 83 nor the Section 83(b) election should be applicable where unrestricted property is exchanged for restricted property of equal value. Nevertheless, taxpayers who have failed to timely file the Section 83(b) election may find themselves fighting an uphill battle with the IRS over the relevance of the Ninth Circuit's *Alves* decision and the guidance provided by Revenue Ruling 2007-49. Perhaps the IRS believed that they were doing taxpayers a favor by issuing Revenue Ruling 2007-49, but the reality is that they created the potential for a tax trainwreck for unfortunate taxpayers who miss making the Section

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83(b) election. Also, to make matters worse, Revenue Ruling 2007-49 failed to address the issue of when the holding period would be deemed to commence for the restricted shares issued in the exchange.

Revenue Ruling 2007-49's holding period problem

Revenue Ruling 2007-49 adopts conclusion in the *Alves* decision that an exchange of unrestricted stock for restricted stock constitutes the issuance of stock falling within the scope of Section 83. As discussed above, so long as a Section 83(b) election is made, the potential compensation problem associated with this approach is avoided. But adopting Revenue Ruling 2007-49's version of what has occurred opens the door for confusion as to what the holding period should be for the restricted stock issued in the exchange. Given that the overall solution offered by the ruling is to make a Section 83(b) election, does the holding period for the stock received in the exchange commence with the issuance of the original stock (a "tacked" holding period) or at the time of the exchange when the replacement stock is issued? Identifying the proper holding period is critical since the conclusion drives both the availability of long-term capital gain treatment and whether Section 1202's holding period requirements are met.[4]

A stroll through conflicting holding period rules

When QSBS is exchanged for other stock in a Section 368 reorganization or Section 351 nonrecognition exchange, Section 1223(1) provides that the holding period of the target stock is tacked onto the holding period for the buyer stock. If a target stockholder has a three-year holding period for his target stock, the stock received in the exchange would start with a three-year holding period. Uncertainty, however, is introduced when the buyer stock is restricted and a Section 83(b) election is made. Revenue Ruling 2007-49 follows the *Alves* decision and concludes that an exchange falls squarely within Section 83 is Treasury Regulation Section 1.83-4(a)'s holding period rule:

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Under section 83(f), the holding period of transferred property to which section 83(a) applies ***shall begin just after such property is substantially vested. However, if the person who has performed the services in connection with which property is transferred has made an election under section 83(b), the holding period of such property shall begin just after the date such property is transferred*** *(emphasis added).*

So, where a taxpayer exchanges unrestricted stock for restricted stock and files a Section 83(b) election, does that taxpayer lose his entire original stock holding period based on a literal reading of Treasury Regulation Section 1.83-4(a)? Does Treasury Regulation Section 1.83-4(a) trump the basic Section 1223(1) rule dictating a tacked holding period?

The Levin-Rocap-Ginsburg Special Report (footnote 3) concludes that given the fact that Section 83 was not written with a tax-free reorganization in mind, a literal reading of the statute and regulations "*would reach a clearly wrong answer*." These esteemed authors go on to suggest that it would far more rational to read Section 83 as resulting in a tacked holding period in connection with tax-free reorganizations, assuming the Section 83(b) election was duly made. Unfortunately, the conclusion reached by these authors and other tax professionals are grounded more in pointing out the difference between what must be the "right" versus "wrong" answer, rather than an analysis grounded in specific tax authorities. The Levin-Rocap-Ginsburg Special Report does go on to provide a solid analysis of why *Alves* and Section 83 should not apply at all to circumstances where full FMV property is exchanged for stock in a reorganization. This additional analysis supports the position that no Section 83(b) should be required, but following this advice exposes taxpayers to the IRS argument that the ruling is applicable, and the IRS might argue that the filing of a "protective" Section 83(b) election signals taxpayer acceptance. Years after the Levin-Rocap-Ginsburg Special Report article was published and Revenue Ruling 2007-49 issued, another well respected tax commentator made similar arguments specifically addressing Revenue Ruling 2007-49. Jasper Cummings argued that the IRS should not have hung onto

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the Ninth Circuit's conclusion in *Alves* that any unrestricted stock for restricted stock exchange should fall within the scope of Section 83.[5] When all of the tax authorities and commentary addressing this issue are unpacked, the best that can be said is that when determining a taxpayer's holding period for capital gains purposes, the correct result seems obvious but there are currently no tax authorities definitively supporting that conclusion. Most taxpayers will elect to file the Section 83(b) election and take the position that the holding period should be tacked.

Does the holding period analysis become clearer when the target stockholder exchanges QSBS for QSBS or non-QSBS?

Yes. Section 1202(h)(4)(A) unambiguously states when the holding period commences for stock received in an exchange for QSBS in a transaction governed by Sections 351 or 368:

> *In the case of a transaction described in section 351 or a reorganization described in section 368, if qualified small business stock is exchanged for other stock which would not qualify as qualified small business stock but for this subparagraph,* ***such other stock shall be treated as qualified small business stock acquired on the date on which the exchanged stock was acquired*** *(emphasis added).*

There is an argument based on principles of statutory interpretation that since Section 1202(h)(4)(A) establishes a rule explicitly providing for a tacked holding period when any QSBS is exchanged (without limiting the QSBS to circumstances where no Section 83(b) election was filed), this rule trumps the Treasury Regulation Section 1.83-4(a) rule addressing the holding period of stock when a Section 83(b) election is made.[6] The IRS could argue that Treasury Regulation Section 1.83-4 and Section 83(f) provide more specific guidance, but taxpayers in turn should point out that the overall IRS argument that property has been transferred in connection with the performance of services is tenuous at best where target stock is exchanged for replacement stock of equal value. In that case, the argument that services are involved doesn't make sense. Section 1202(h)(4) can be read to address within its scope both QSBS for

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QSBS exchanges and QSBS for non-QSBS exchanges governed by Sections 351 or 368.

Addressing Situation 3 and the possible rollover of proceeds under Section 1045

If Situation 3 in Revenue Ruling 2007-49 potentially applies to an exchange because unrestricted QSBS is exchanged for restricted non-QSBS in a taxable transaction, the holding period for the buyer stock would either commence at the time of the exchange if a Section 83(b) election is made, with capital gain triggered by the exchange, or when the replacement stock vests or is sold (assuming no Section 83(b) election is made), with the FMV of the stock or proceeds paid at that time treated as ordinary compensation income. Where the replacement stock constitutes "sales proceeds" for purposes of Section 1045 (Section 1045 does not provide that sales proceeds are limited to money), a taxpayer should have the option of rolling proceeds over into a replacement QSBS investment in connection with making a Section 1045 election.

If the buyer stock issued in a taxable exchange is QSBS, then the target stockholder is eligible to make a Section 1045 in connection with the rollover of the stockholder's target QSBS into buyer QSBS. The usual benefits of rolling over original QSBS proceeds into replacement QSBS include keeping the QSBS status of the shares alive and a tacked holding period for the replacement QSBS (i.e., tacking on the holding period of the original QSBS to the holding period of the replacement QSBS). Section 1223(13) provides that "*in determining the period for which the taxpayer has held property the acquisition of which resulted under section 1045. . . in the nonrecognition of any part of the gain realized on the sale of other property, there shall be included the period for which such other property has been held as of the date of such sale*." Like Situation 2, Situation 3 also creates a potential "gotcha" situation for unsuspecting service provider stockholders who fail to file a Section 83(b) election in connection with their exchange of unrestricted target corporation stock for restricted buyer stock in a taxable transaction. Also, as in Situation 2 above, the exchange of unrestricted for restricted stock and making of a Section 83(b)

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election brings into the picture the potential application of Section 83(f) and Treasury Regulation Section 1.83-4(a) and the conflict between those provisions and Section 1223(13). Again, the best that can be argued based on existing tax authorities is that the "correct" result should be a tacked holding period, a result supported by the express language of Section 1223(13).

Conclusions

Taxpayers and practitioners must be aware of situations where Revenue Ruling 2007-49 dictates the filing of a Section 83(b) election. The failure to stay on top of this issue can lead to the proverbial tax trainwreck.

Taxpayers have solid arguments that the holding period of target stock should tack onto the holding period of replacement stock where a Section 83(b) election is made, particularly if the target stock is QSBS. Nevertheless, some degree of ambiguity will continue to exist until the IRS or the courts clarify the scope of Revenue Ruling 2007-49 and *Alves* in connection with stock-for-stock exchanges.

Please contact Scott Dolson if you want to discuss any Section 1202 and Section 83(b) issues by video or teleconference. You can also visit the **QSBS & Tax Planning Services page** to read our latest insights and analysis.

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[1] References to "Section" are to sections of the Internal Revenue Code of 1986, as amended.

[2] See Treasury Regulation Section 1.83-2(a) and Jasper L. Cummings, Jr.'s article "*Restricting Stock in Reorganizations*" in Tax Notes, June 17, 2013.

[3] See the article authored by Jack S. Levin, Donald E. Rocap, and Martin D. Ginsburg titled "*Surprising Tax Issues for Shareholder-Execs Receiving Unvested Stock for Vested Stock in Reorg,*" published as a Special Report in Tax Notes, December 4, 2000 (the "Levin-Rocap-Ginsburg Special Report").

[4]Section 1202 requires a five-year holding period for a 100% gain exclusion. For stock issued after July 4, 2025, a 50% gain exclusion

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is available for stock held for at least three years and a 75% gain exclusion for stock held at least four years.

[5] See Jasper L. Cummings, Jr. article "*Restricting Stock in Reorganizations*" at Tax Notes, June 17, 2013.

[6] In *Bulova Watch Co. v. United States*, 365 U.S. 753 (1961), the Supreme Court addressed a situation where a taxpayer argued that a general statutory rule (and its corresponding regulation) should apply, but the government argued that a more specific statutory provision governed. The Supreme Court held that "*a specific statute controls over a general one 'without regard to priority of enactment* .'" The Supreme Court further explained that this principle applies even if the general rule is found in a regulation interpreting a different or more general statutory provision citing *Townsend v. Little*, 109 U.S. 504, 512, *Ginsberg & Sons v. Popkin*, 285 U.S. 204, 208; *MacEvoy Co. v. United States*, 322 U.S. 102, 107; *Fourco Glass Co. v. Transmirra Corp.*, 353 U.S. 222, 228-229.

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