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Navigating the thorny tax issues triggered by the issuance of restricted stock in a rollover transaction

It isn't unusual for shareholders holding vested stock in their target company to roll the stock over into acquiror stock in a taxable or nontaxable exchange.

Typically, the stock received in the exchange is also fully vested stock. But in some rollover transactions, the acquiror demands that the management team exchange their vested stock for nonvested stock. In most cases, the nonvested stock received in the exchange vests over time as the management team members remain employed with the acquiror. There may also be performance vesting requirements, although this is seen less frequently where the stock was fully vested prior to the rollover.

The issuance of restricted stock in a rollover transaction raises several business and tax issues for participants, the seller and the buyer. Rollover participants will need to be concerned with whether they will recognize taxable income in the exchange and whether any of this income will be treated as ordinary compensation income. Each of the parties to the transaction will need to be concerned with whether the issuance of restricted stock will blow the transaction's tax-free reorganization treatment. Both of these issues are addressed below.

From a business standpoint, there are good reasons why an acquiror would like to impose vesting requirements on an executive's rollover equity. Post-acquisition, a key goal is to keep a valuable executive working for the portfolio company. Time vesting requirements coupled with unfavorable buy-out terms are intended to create a disincentive for an executive to prematurely depart employment. An executive should certainly take a hard look before agreeing to these restrictions, particularly where they are imposed on previously unrestricted target company equity. Of course, an

executive won't agree to these restrictions in a vacuum, and in some instances the new restrictions, which might include outright forfeiture of rollover equity or repurchase a price below fair market value, are acceptable when considered in the context of the overall deal terms.

But both buyers and sellers need to be aware of the potential tax consequences associated with issuing restricted stock in a rollover transaction.

Any vesting requirements tied to continued employment, along with any other vesting requirements associated with an executive's (i.e., a service provider's) rollover equity, generally brings the stock within the scope of IRC § 83, an Internal Code Section governing the issuance of compensatory equity to service providers. The general rule under IRC § 83 is that the issuance of vested equity is taxable compensation to the service provider and that nonvested equity is not treated as being owned for tax purposes by the service provider until the restrictions are lifted (i.e., the time or performance vesting requirements are satisfied). If compensatory equity is restricted, an IRC § 83(b) election can be made by the service provider within 30 days after issuance. If this election is made, the holder of the stock is taxed on the net compensation (value over amount paid for the equity) at the time of issuance and is treated as owning the stock as of that date. So, if the election is made, once the one year holding period is satisfied, the holder can sell the equity and take advantage of favorable long-term capital gains rates. If the stock is forfeited or redeemed at a discount, the holder cannot deduct the difference between the upfront compensation amount and the proceeds at the back end.

The basic IRC § 83 rules outlined in the preceding paragraph are clarified in Revenue Ruling 2007-49 for purposes of the issuance of restricted stock issued in rollover transactions.

If vested stock is rolled over in a transaction where the participants continue to hold their target company equity, but post-transaction, there are new vesting requirements placed on the equity, the IRS ruled that there is no "transfer" for IRC § 83 purposes, so that new vesting requirements have no effect for IRC § 83 purposes.

But if fully vested stock is exchanged in an IRC § 368 tax-free reorganization for nonvested acquiror stock, the stock is treated as being transferred in connection with the performance of services. As a result, the stock received in the exchange is subject to IRC § 83. Revenue Ruling 2007-49 provides that the “amount paid” for the stock received in the exchange is the fair market value of the exchanged target company stock. The courts have ruled that property is treated as being transferred in connection with the performance of services even if the employee pays fair value for the stock. Because the “amount paid” is the same amount as value of the stock received, the participant would not be required to report any taxable compensation if an IRC § 83(b) election is made. When the stock is ultimately sold, the rollover participant would recognize capital gain. The most important aspect of Revenue Ruling 2007-49 is the confirmation that subjecting stock to a restriction that will cause it to be “substantially nonvested” within the meaning of Treasury Regulation § 1.83-3(b), bringing the need for making an IRC § 83(b) election into play. So long as the IRC § 83(b) election is made timely, the participants won’t have any gain triggered by the election and the election will begin the capital asset holding period, all favorable results for the participants.

Revenue Ruling 2007-49 addresses the tax impact of imposing new vesting requirements the rollover participants’ stock, but fails to address the potential impact of imposing new restrictions on rollover stock on the qualification of transaction as an IRC § 368 tax-free reorganization. In order to qualify as a tax-free reorganization, a certain percentage of the consideration received in the exchange must be paid in the form of acquiror stock (the continuity of interest requirement). The percentage varies based on type of reorganization, but a floor of at least around 40% applies to a straight merger of the target company into the acquiror (an “A” reorganization), and the percentage of continuity of interest (COI) required increases from there with the other types of tax-free reorganizations. As far back as 2005, the IRS and Treasury announced in the preamble to final continuity of interest (COI) regulations that they were continuing to consider the appropriate treatment of restricted shares in determining the level of COI (i.e., whether or not the restricted shares are outstanding and can count

toward COI). Surprisingly, no subsequent IRS statements or authority has surfaced on this topic.

Most commentators believe that where an IRC § 83(b) election is made and the stock is treated as being issued and owned for IRC § 83 tax purposes, this result should also apply for purposes of determining COI. But there is no definitive authority on the issue to rely upon at this time. So, if the amount of restricted stock could tip the COI scales based on the type of reorganization, it seems to be an open question whether there would be substantial authority to support an opinion that the transaction qualifies as a tax-free reorganization, although the scales do seem to tip in favor of newly imposed restrictions not adversely affecting COI. The water is muddied if no IRC § 83(b) election is made (which should almost never be the case unless the election is botched) or stock that is counted towards COI is subsequently forfeited (query should you re-run the COI analysis excluding the forfeited stock or counting the forfeited stock as non-stock consideration?).

The take-away from all of this is that the parties to a tax-free reorganization that includes the imposition of new vesting requirements on the management team should be aware that there are tax consequences associated with those vesting requirements. A safe approach is to always bring in tax advisors where any transaction includes equity with vesting requirements or equity being issued to service providers.

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