APPLICATION OF INTERNAL REVENUE CODE SECTION 83 TO NONBARGAIN EMPLOYEE STOCK PURCHASE AGREEMENTS: *ALVES V. COMMISSIONER*

I. INTRODUCTION

On May 22, 1970, Lawrence J. Alves entered into an employment and stock purchase agreement with General Digital Corporation (Company). Pursuant to the agreement, Alves purchased 40,000 shares of common stock of the Company, two-thirds of which were subject to restrictions. At the time of purchase, the purchase price of the shares equaled their fair market value. After the restrictions lapsed in 1974 and in 1975, Alves did not report the difference between the fair market value of the shares when the restrictions lapsed and the purchase price paid for the shares.

The Commissioner of the Internal Revenue Service determined a deficiency in Alves' income tax returns for 1974 and 1975 under section 83(a) of the Internal Revenue Code.[1] The Tax Court sustained

---

1. I.R.C. § 83 (West 1984) provides in pertinent parts:

(a) GENERAL RULE—If, in connection with the performance of services, property is transferred to any person other than the person for whom such services are performed, the excess of—

(1) the fair market value of such property (determined without regard to any restriction other than a restriction which by its terms will never lapse) at the first time the rights of the person having the beneficial interest in such property are transferable or are not subject to a substantial risk of forfeiture, whichever occurs earlier, over

(2) the amount (if any) paid for such property, shall be included in the gross income of the person who performed such services in the first taxable year in which the rights of the person having the beneficial interest in such property are transferable or are not subject to a substantial risk of forfeiture, whichever is applicable. The preceding sentence shall not apply if such person sells or otherwise disposes of such property in an arm's length transaction before his rights in such property become transferable or not subject to a substantial risk of forfeiture.

(b) ELECTION TO INCLUDE IN GROSS INCOME IN YEAR OF TRANSFER—

(1) IN GENERAL—Any person who performs services in connection with which property is transferred to any person may elect to include in his gross income for the taxable year in which such property is transferred, the excess of—

(A) the fair market value of such property at the time of transfer (determined without regard to any restriction other than a restriction which by its terms will never lapse), over

(B) the amount (if any) paid for such property. If such election is made, subsection (a) shall not apply with respect to the transfer of such property,

the Commissioner's determination of deficiency.[2] Alves appealed to the United States Court of Appeals for the Ninth Circuit, which affirmed, holding that "[i]n the present case, the statutory language, legislative history, applicable regulations and the consistent refusal of courts to create exceptions to the statute's coverage, all compels the conclusion that section 83(a) applies to the income Alves received when the restrictions on his stock lapsed in 1974 and 1975."[3]

Employment and stock purchase agreements trigger the application of section 83.[4] Section 83(a) requires an employee who has purchased restricted stock in connection with the performance of services to include as ordinary income the stock's appreciation in value between the time of purchase and the time the restrictions lapse. Section 83(b) allows an employee to include as income the difference between the purchase price and the fair market value of the stock at the time of purchase. If an employee makes a section 83(b) election, section 83(a) does not apply.

Alves[5] presents an unusual issue under section 83. As the Ninth Circuit described it, "The issue here is whether section 83 applies to an employee's purchase of restricted stock, when according to the stipulation of the parties, the amount paid for the stock equaled its full fair market value, without regard to any restrictions."[6] The focus of this comment is on the Ninth Circuit's decision to apply section 83 to an employment and stock purchase agreement in which no bargain element exists.

II. BACKGROUND

The restricted stock plan is an arrangement whereby an employer transfers stock to one or more of his employees at no cost or at a

---

and if such property is subsequently forfeited, no deduction shall be allowed in respect to such forfeiture.

(2) ELECTION—An election under paragraph (1) with respect to any transfer of property shall be made in such manner as the Secretary prescribes and shall be made not later than 30 days after the date of such transfer. Such election may not be revoked except with the consent of the Secretary.

2. Alves v. Commissioner, 79 T.C. 864 (1982). The Tax Court, with two dissenting opinions, held that § 83 applies to all restricted stock that is transferred in connection with the performance of services, regardless of the amount paid for it. *Id.* at 878.

3. Alves v. Commissioner, 734 F.2d 478, 483 (9th Cir. 1984).

4. *See supra* note 1.

5. 734 F.2d 478 (9th Cir. 1984).

6. *Id.* at 479.

bargain price.[7] Prior to the enactment of section 83, the restricted stock plan presented two problems: (1) when does the taxable event occurs; and (2) whether the income realized is capital gain or ordinary income. As a consequence of the confusion generated by these two problems, the taxpayer received favorable treatment, i.e., tax deferral and tax avoidance. This treatment was inconsistent with other sections of the Internal Revenue Code, so Congress passed section 83, which defines when the taxable event occurs and treats the income realized as ordinary.[8]

A. Early Developments

The difficulties concerning the timing of the taxable event and the treatment of the realized income resulted in favorable treatment of the taxpayer prior to the enactment of section 83. These difficulties are best illustrated by two cases, *Lehman v. Commissioner*[9] and *Kuchman v. Commissioner.*[10] In *Lehman*, Robert Lehman received options to buy restricted stock for services performed. Upon the exercise of the option, the Commissioner and Lehman agreed that the acquisition of the restricted stock did not give rise to any income because the stock had no ascertainable fair market value due to the restrictions.[11] Therefore, the Commissioner sought to impose a tax when the restrictions lapsed. The Tax Court rejected the Commissioner's position, stating that "[v]alues fluctuate from time to time and the value on a later date might be out of all proportion to the compensation involved. . . ."[12] The taxable event occurred when the stocks were subsequently sold. The income realized by the sale was taxed as capital gain because no reliable determination of the amount of compensation could be ascertained.[13]

In *Kuchman*, the Commissioner sought to tax restricted stock when the employee exercised his option to buy the restricted stock.[14] The Commissioner attempted to impose a tax by evaluating the stock as if the restrictions had not been present. The Tax Court rejected this

---

7. Hinden, *Internal Revenue Code* § 83 Restricted Stock Plans, 59 CORNELL L. REV. 298, (1974) [hereinafter cited as Hinden].
8. *See supra* note 1.
9. 17 T.C. 652 (1951).
10. 18 T.C. 154 (1952).
11. *Lehman*, 17 T.C. at 653.
12. *Id.* at 654.
13. *Id.*
14. *Kuchman*, 18 T.C. at 162.

approach, as well, because there could be no ascertainment of fair market value of restricted stock.[15]

The decision in *Lehman* indicates that the taxable event does not occur when the restrictions lapse. *Kuchman* indicates that the taxable event does not occur when the employee acquires the restricted stock. In both cases, the employee was taxed when the stock was subsequently sold. *Lehman* further indicated that the income realized was treated as capital gain.[16]

In 1959, Treasury Regulations were introduced which defined the taxable event and the income realized.[17] These regulations provided a compromise between the Commissioner's position and the Tax Court's position. According to the Treasury Regulations, the taxable event occurred either when the restrictions lapsed, or when the stock was sold in an arm's-length transaction, whichever occurred earlier.[18] A tax was imposed upon the difference between the amount paid and the fair market value at either the time of the transfer or when the restrictions lapsed, whichever was less. This amount was taxed as ordinary income.[19] Any appreciation in value of the stock was not taxed until a subsequent sale and then only at the more attractive capital gain rate.[20] The regulations departed from the *Lehman* decision as to the timing of income recognition.[21] However, the regulations tended to increase the capital gain element of restricted stock by allowing the date of receipt to set a ceiling on ordinary income.[22] Therefore, the employee still received favorable tax treatment. The regulations gave

---

15. *Id.* at 163.
16. *Lehman*, 17 T.C. at 654.
17. 26 C.F.R. § 1.421-(6) (1959).
18. *Id.* Treasury Regulation § 1.421-6(d)(2)(i) provides that:

> [i]f property is transferred by an employer to an employee and such property is subject to a restriction which has a significant effect on its value, the employee realizes compensation at the time such restriction lapses or at the time the property is sold or exchanged, in an arm's length transaction, whichever occurs earlier, and the amount of such compensation is the lesser of—
>
> (a) the difference between the amount paid for the property and the fair market value of the property determined without regard to the restriction at the time of its acquisition, or
>
> (b) the difference between the amount paid for the property and either its fair market value at the time the restriction lapses or the consideration received upon the sale or exchange, whichever is applicable.

19. Comment, *Taxation of Employment and Stock Purchase Agreements:* Alves v. Commissioner, 37 Sw. L.J. 1025, 1029 (1984) [hereinafter cited as Comment, *Taxation*].
20. Hinden, *supra* note 7, at 301.
21. *Id.*
22. *Id.*

the employee the combined benefits of tax deferral of ordinary income and a tax hedge against future appreciation in value without cost or risk.

B. Legislative Response: The Creation of Section 83

The purpose behind the enactment of section 83 in 1969 was to provide overall consistency in the tax treatment of deferred compensation plans, particularly restricted stock plans.[23] Two underlying reasons justified this purpose. First, Congress felt that the favorable tax treatment given to the taxpayer under the 1959 Treasury Regulations gave restricted stock plans an unfair advantage over other employment compensation methods.[24] Secondly, Congress was concerned that restricted stock plans were a means of allowing key employees to become shareholders in business without adhering to requirements in other sections of the Internal Revenue Code.[25] A brief look at the history of section 83 will clarify the purpose for its enactment.

The 1959 Treasury Regulations allowed the taxpayer to choose the taxable amount.[26] Thus, the ordinary income realized was still an amount favorable to the taxpayer. These regulations had both tax deferral and tax avoidance advantages over other types of deferred compensation arrangements.[27] Under section 83, the taxable event occurred as either when the transfer occurred (section 83(b)), or when the restrictions lapsed (section 83(a)). If a taxpayer elected to be taxed when the transfer occurred, he must have made that choice within thirty days of the transfer.[28] Thereupon, he would be taxed on the difference between the purchase price and the fair market value. If a taxpayer had not elected to be taxed when the transfer occurred under section 83(b), he would be taxed when the restrictions lapsed under section 83(a). The amount taxed would be the difference between the purchase price and the fair market value when the restrictions lapsed. The gain would be taxed as ordinary income.

The taxpayer no longer has the choice to determine the amount

23. *See* Memorandum from Miller & Chevalier (by John S. Nolan) to John E. Chapoton (Treasury) (Apr. 18, 1983), *reprinted in* 1983 Tax Notes 553 (Tax Analysts and Advocates) (Microfiche Data Base DOC 83-3920) [hereinafter cited as Nolan]; Comment, *Property Transferred in Connection with Performance of Services Under* § 83—*Effectuation of Tax Reform Act Purposes*, 17 WAYNE L. REV. 1267 (1971) [hereinafter cited as Comment, *Property*].

24. *See* Comment, *Taxation*, *supra* note 19, at 1031.

25. *See Alves*, 734 F.2d at 481.

26. *See supra* note 18.

27. *Alves*, 734 F.2d at 481. Unlike restricted stock plans, employer contributions to an employee's pension or profit-sharing trust were immediately taxable in the year of receipt.

28. *See supra* note 1.

upon which he is to be taxed. In addition, 1983 Treasury Regulations coincide with section 83.[29] The 1959 Treasury Regulations are now applicable only to restricted stock option plans granted on or after February 26, 1945, and before July 1, 1969.[30] The other justification for the enactment of section 83 was that Congress was concerned that the restricted stock plans were a means of avoiding the strict requirements of other sections of the Code by allowing employees to become shareholders in the business.[31] Prior to enactment of section 83, an employee could obtain an investor status and defer taxation on income under less stringent requirements than those in sections 421-425 of the Code.[32] The effect of a transfer qualifying under section 421 is tax deferral. However, the requirements for qualification

---

29. 26 C.F.R. § 1.83.2(a) (1983) provides in pertinent parts:

> If property is transferred . . . in connection with the performance of services, the person performing such services may elect to include in gross income under Section 83(b) the excess (if any) of the fair market value of the property at the time of transfer . . . over the amount (if any) paid for such property, as compensation for services. The fact that the transferee has paid full value for the property transferred, realizing no bargain element in the transaction, does not preclude the use of the election as provided for in this section.

Note that these regulations were applicable to *Alves* because they were made retroactive to 1969 by the Commissioner pursuant to I.R.C. § 7805(b) (West 1984).

30. 26 C.F.R. § 1.421-6(2) (1959).

31. *Alves*, 734 F.2d at 480-81.

32. I.R.C. §§ 421-425 (1982). The relevant parts of section 421 include:

> (a) EFFECT OF QUALIFYING TRANSFER.—If a share of stock is transferred to an individual in a transfer in respect of which the requirements of section 422(a), 422A(a), 423(a), or 424(a) are met—
>
> (1) except as provided in section 422(c)(1), no income shall result at the time of the transfer of such share to the individual upon his exercise of the option with respect to such share;
>
> (2) no deduction under section 162 (relating to trade or business expense) shall be allowable at any time to the employer corporation, a parent or subsidiary corporation of such corporation, or a corporation issuing or assuming a stock option in a transaction to which section 425(a) applies, with respect to the share so transferred; and
>
> (3) no amount other than the price paid under the option shall be considered as received by any such corporations for the share so transferred.

See also Comment, *Property, supra* note 23, where the qualifying provisions for a stock option under section 422 are described as follows:

> (a)(1) The stock received upon exercise must be held for at least three years.
>
> (2) The individual receiving the option must be in the employ of the grantor and remain so until the day 3 months before the date of the exercise of the option.
>
> (b)(1) Option granted pursuant to a plan;
>
> (2) Such option is granted within 10 years from the date the plan is adopted or approved;
>
> (3) Option must be exercised within 5 years after grant;

under section 421 are stringent. For example, section 421 requires the price of the option to be at least eighty-five percent of the fair market value of the stock when the option is granted or exercised.[33] Section 83 eliminates the tax deferral benefit previously enjoyed by employees who purchased restricted stock.[34] It also requires the taxpayer to choose immediately whether to be taxed upon transfer or upon lapse of restrictions.[35] Tax deferral, therefore, is now allowed only under sections 421-425.

Section 83 was motivated by a concern for equitable treatment of taxpayers and the elimination of unwarranted tax deferral and avoidance. Section 83 still gives the taxpayer the choice of either electing to include the excess of fair market value over purchase price in the year of transfer, or being taxed upon the difference between the purchase price and the fair market value when the restrictions lapse.[36] The requirement of immediate choice, however, "effectively ended the practice of deferring realization of income while simultaneously hedging against future appreciation in value."[37]

Constitutional challenges against section 83 based on the fifth and sixteenth amendments have failed. In *Pledger v. Commissioner*,[38] the taxpayer challenged the validity of section 83, asserting, *inter alia*, that its application to restricted stock transfers was arbitrary and violative of due process of law. The Tax Court disagreed and held that application of section 83 was not arbitrary and that the statute was enacted as a reasonable remedy for an area of substantial tax abuse.[39] In *Sakol*

---

(4) Option price cannot be less than fair market value of stock when option is granted;

(5) Option cannot be exercised while the individual possesses another qualified stock option of his employer;

(6) Option must be non-transferable; and

(7) The individual receiving the option cannot own more than five percent of the employer corporation's stock or voting stock.

Stock options received by an employee can either be qualified or non-qualified, restricted or non-restricted, and can be used to purchase either restricted stock or non-restricted stock. If the option meets the qualifying provisions then the exercise of the option is not a taxable event.

Id. at 1268 n.6.

33. I.R.C. § 423(b)(6) (West 1984).

34. *See supra* note 1.

35. I.R.C. § 83(b)(2) (West 1984).

36. *Id.* § 83(b)(1).

37. Comment, *Taxation, supra* note 19, at 1032; *see* Nolan, *supra* note 23, at 553; Hinden, *supra* note 7, at 303.

38. 71 T.C. 618 (1979), *aff'd*, 641 F.2d 287 (5th Cir. 1981), *cert. denied*, 454 U.S. 964 (1981).

39. *Id.* at 628.

v. Commissioner,[40] the taxpayer challenged the validity of section 83, asserting that it exceeded the taxation power granted to Congress by the sixteenth amendment. The Tax Court concluded that the sixteenth amendment is not a limit on congressional taxing power and that section 83 is a valid exercise of that power.[41]

Courts have also refused to make exceptions to section 83 when the results of its application appear unfair. As the Tax Court in *Alves* stated: "[A]lthough 'some unfairness and inequity may result from the operation of section 83, Congress could rationally have concluded that such result was justified by the ease and certainty of the section's operation.'"[42] Section 83 is a "blanket rule"[43] created by Congress to be a "workable, practical system of taxing employees' restricted stock options."[44] Thus, courts have refused to yield to section 83 merely because a taxpayer is treated unfairly.

III. ANALYSIS

A. Factual Background

In April 1970, the Company was formed to manufacture and market micro-electronic circuits. The board of directors, at its first meeting, decided to sell 264,000 shares of common stock to seven named individuals, including Alves, all of whom became Company employees. Alves was appointed the Company's vice-president for finance and administration.[45]

On May 22, 1970, Alves signed an employment and stock purchase agreement. The agreement provided that the Company would sell to Alves 40,000 shares of common stock at ten cents per share "in order to raise capital for the Company's initial operations while at the same time providing the Employee with an additional interest in the Company . . . ."[46] The agreement divided Alves' shares into three categories: one-third were subject to repurchase by the Company at ten cents per share if Alves left the Company within four years; one-third were likewise subject to repurchase if he left the Company within five years; and one-third were unrestricted.[47]

40. 67 T.C. 986 (1977), *aff'd*, 574 F.2d 694 (2d Cir. 1978), *cert. denied*, 439 U.S. 859 (1978).

41. *Id.* at 991-96.

42. 79 T.C. at 878 (quoting Sakol v. Commissioner, 67 T.C. 986, 996 (1977)).

43. *Sakol*, 574 F.2d at 699.

44. *Id.* at 700.

45. *Alves*, 79 T.C. at 866-67.

46. *Id.* at 867.

47. *Alves*, 734 F.2d at 480. The court of appeals described an additional feature of the agreement in that "the Company retained an option to repurchase up to one-

On July 1, 1974, and March 24, 1975, the restrictions on the four-year and five-year shares lapsed, respectively.[48] Alves did not report the difference between the purchase price paid and the fair market value of the four and five year shares when the restrictions lapsed. The Commissioner treated the difference as ordinary income, pursuant to section 83(a),[49] and determined tax deficiencies in Alves' 1974 and 1975 income.[50]

B. Tax Court

Alves petitioned the Commissioner's findings to the Tax Court.[51] The parties stipulated the Company's common stock had a fair market value of ten cents per share on the date of purchase.[52] The stock restrictions were imposed to provide some assurance that key personnel would remain with the Company for a number of years,[53] Alves did not make an election under section 83(b) when the restricted stock was received,[54] the unrestricted shares were not includable in gross income under section 83,[55] and the four and five year restricted shares were subject to a substantial risk of forfeiture until July 1, 1974, and March 24, 1975, respectively.[56] The Tax Court, with two dissenting opinions, sustained the Commissioner's determination of deficiencies and held, as a matter of fact, that the stock was transferred to Alves in connection with the performance of services for the Company.[57] As a matter of law, the court held that section 83(a) applies even where the transferee paid the full fair market value for the stock.[58]

In a dissenting opinion, Judge Fay[59] asserted that section 83 should

---

half of the shares for their fair market value at any time between July 1, 1973 and July 1, 1975." *Alves*, 734 F.2d at 480.

48. *Id.* When the restrictions on the four-year shares lapsed, Alves still owned 4,667 four-year shares that had a fair market value at that time of $6 per share; when the restrictions on the five-year shares lapsed, Alves still owned 7,093 five-year shares that had a fair market value at that time of $3.43 per share. *Id.*

49. *See supra* note 1.

50. *Alves*, 79 T.C. at 864.

51. Alves v. Commissioner, 79 T.C. 864 (1982).

52. *Id.* at 869. The Tax Court doubted that each share had a fair market value of ten cents per share but accepted it as fact because the stipulation went to the heart of the controversy and was obviously entered into freely. *Id.* at n.2.

53. *Id.* at 873.

54. *Id.* at 872 n.2.

55. *Id.* at 871.

56. *Id.* at 872.

57. *Id.* at 879.

58. *Id.* at 877.

59. Fay, J., entered a dissenting opinion with which Featherson, Goffe, and Hamblen, JJ., concurred. *Id.* at 881.

apply only when there is a bargain element in the transfer which is in consideration or recognition of the performance of services.[60] Judge Fay further stated that "[w]hen fair market value is paid for the stock, [it is] conclusive that no part of the transfer was made in recognition of the performance of services."[61] He concluded that this transfer of stock was "nothing more than an equity investment in the corporation."[62]

In another dissenting opinion, Judge Whitaker[63] believed section 83 was inapplicable in this situation. Noting that the phrase "in connection with the performance of services," was not defined,[64] Judge Whitaker examined the legislative history of the statute. He determined that "it is apparent that property is not to be deemed to be issued in connection with the performance of services except where on the date of issue there is a discrepancy between the fair market value of the property subject to the restrictions and its fair market value without restrictions."[65] He concluded that since the parties had stipulated that the restrictions did not affect the fair market value on the date of issue, the case was removed from section 83.[66]

C. Ninth Circuit Court of Appeals

Alves appealed the Tax Court decision to the Ninth Circuit.[67] The court determined that section 83 "applies when property is: (1) transferred in connection with the performance of services; (2) subject to a substantial risk of forfeiture; and (3) not disposed of in an arm's length transaction before the property becomes transferable or the risk of forfeiture is removed."[68] The court also stated that "it is undisputed that the stock in question was subject to a substantial risk of forfeiture, that it was not disposed of before the restrictions lapsed, and that Alves made no section 83(b) election."[69] Alves maintained three arguments on appeal: (1) the stock was not issued in connection with the perfor-

---

60. *Id.* at 881.
61. *Id.* at 880.
62. *Id.*
63. Whitaker, J., entered a dissenting opinion with which Featherson and Goffe, JJ., concurred. *Id.* at 881.
64. *Id.* at 881-82.
65. *Id.* at 884.
66. *Id.* at 885.
67. 734 F.2d 478 (9th Cir. 1984).
68. *Id.* at 481.
69. *Id.*

mance of services;[70] (2) section 83(a) does not apply to nonbargain transfers of stock;[71] and (3) section 83 is a trap for the unwary.[72]

1. Stock Was Not Issued in Connection With the Performance of Services

Alves contended that because he paid the full fair market value for the shares, they were purchased as an investment, rather than in connection with the performance of services. The court rejected this contention, stating that the Tax Court had found, as a matter of fact, that Alves obtained the stock in connection with the performance of services as the Company's vice-president. The court concluded that this finding of fact was not clearly erroneous.[73] Although the payment of full fair market value may have been an indication that the stock was not transferred in connection with the performance of services, it was not conclusive. The employment and stock purchase agreement explicitly linked the purchase to employment. In addition, the parties had stipulated that the purpose of the restricted stock was to ensure that key personnel would remain with the Company.[74]

Alves contended that, as a matter of law, section 83(a) was not intended to extend to purchases for full fair market value.[75] Alves maintained that where an employee pays the same amount for restricted and unrestricted stock, the restriction has no effect on value, and, therefore, is not an element of compensation. The court, however, rejected this contention.[76]

The court relied upon the plain language and legislative history of section 83 in its response to Alves' contention. The plain language of the statute does not refer to "compensation." The court concluded that if Congress intended to apply section 83 only to situations where the restricted stock compensated the employee, it could have used much narrower language.[77] The legislative history of the statute indicates that Congress was concerned that restricted stock plans were a means of allowing key personnel to become shareholders in the business without

---

70. *Id.*
71. *Id.*
72. *Id.* at 483.
73. *Id.* at 481.
74. *Id.* at 480.
75. *Id.* at 481.
76. *Id.* at 482.
77. *Id.*

adhering to the requirements of other sections of the Internal Revenue Code.[78] The court further concluded that the legislative history demonstrates an intent to apply section 83 to taxpayers, like Alves, who alleged that they purchased restricted stock as an investment.[79] Overall, the court relied upon the employment and stock purchase agreement, the parties' stipulations, and the plain language and legislative history of section 83 to reject Alves' first contention.

2. Section 83(a) Does Not Apply to Nonbargain Transfers of Stock

Alves contended that the language of section 83(b) indicates congressional intent to apply that section only to bargain purchases.[80] He further contended that section 83(a) should be interpreted in the same way. Section 83(b) allows a taxpayer to elect to include as income the "excess" of the full fair market value over the purchase price in the year of transfer.[81] Alves maintained that a taxpayer who had paid the full market value would have "zero excess" and would, therefore, fall outside the terms of section 83(b). Rejecting this contention, the court held that section 83(b) was not a limitation upon section 83(a), but instead was designed merely to add flexibility and not to condition section 83(a) on the presence or absence of an "excess."[82] The court found nothing in section 83(b) that precluded a taxpayer who had paid full fair market value for restricted stock from making a section 83(b) election. Treasury Regulation section 1.83-2(a) supports the court's reasoning.[83] Section 1.83-2(a) specifically provides that section 83(b) is available in situations of "zero excess." Therefore, relying upon legislative history and applicable regulation, the court rejected Alves' second contention.

3. Section 83 is a Trap for the Unwary

Alves contended that every taxpayer who paid the full fair market value for restricted stock, if well informed, would choose the section 83(b) election to hedge against any appreciation.[84] Therefore, the ap-

78. *See Alves*, 734 F.2d at 482 (Ninth Circuit refers to Senate report at 120-21, *reprinted in* 1969 U.S. CODE CONG. & AD. NEWS 2027, 2152. *Accord* House Report at 90, *reprinted in* 1969 U.S. CODE CONG. & AD. NEWS 1645, 1735).

79. *Id.*

80. *Id.*

81. *See supra* note 1.

82. *Alves*, 734 F.2d at 482.

83. *See supra* note 29.

84. *Alves*, 734 F.2d at 483.

plication of section 83(a) to the unfortunate taxpayer who makes no election simply creates a trap for the unwary. In rejecting this contention, the court stated that tax laws often make an affirmative election necessary.[85] Accordingly, a taxpayer who wishes to avoid the treatment of appreciation as ordinary income must make an affirmative election under section 83(b) in the year in which the stock was acquired.[86] In rejecting this contention, the court cited several cases in which other courts refused to make exceptions to the broad application sought by Alves.[87]

IV. EVALUATION

The basis of Alves' contentions in the Ninth Circuit was that the restricted stock was purchased as an investment rather than in connection with the performance of services. The Ninth Circuit, however, held that section 83 was properly applied to the income Alves realized when the restrictions lapsed.[88] Although the Ninth Circuit attempted to clarify the scope of this section, the *Alves* decision poses some unresolved questions concerning section 83 and its application to nonbargain restricted stock purchases by employees. The following discussion will show that *Alves* does not effectuate good tax law policy, and is also inconsistent with the legislative purpose of section 83.

Alves reveals a problem concerning the definition of the phrase "in connection with the performance of services." Section 83 incorporates specific rules for the realization of gain from property that is transferred to an employee in connection with the performance of services, which, at the time of transfer, is subject to certain restrictions that do not meet the requirements of qualified stock option plans.[89] Judge Whitaker, in his dissent to the Tax Court opinion, correctly noted that the phrase "in connection with the performance of services" was not defined.[90] Turning to the legislative history, Judge Whitaker concluded that property was not deemed to be issued in connection with the performance of services unless, on the transfer date, there existed a discrepancy between the fair market value of the pro-

85. *Id.*

86. *Alves*, 734 F.2d at 483.

87. *See* Pledger v. Commissioner, 641 F.2d 287 (5th Cir.), *cert. denied*, 454 U.S. 964 (1981); Cohn v. Commissioner, 73 T.C. 443 (1979); Cassetta v. Commissioner, 39 T.C.M. (CCH) 188 (1979); Sakol v. Commissioner, 574 F.2d 694 (2d Cir.), *cert. denied*, 439 U.S. 859 (1978).

88. *Alves*, 734 F.2d at 483.

89. Comment, *Property*, *supra* note 23, at 1267-68; *see* I.R.C. § 421.

90. *Alves*, 79 T.C. at 882.

perty subject to restrictions and the full fair market value without the restrictions.[91] This conclusion is consistent with the purpose of section 83, namely, to prevent a taxpayer from enjoying both the benefits of tax deferral resulting from such restrictions and of capital gains treatment due to the intervening appreciation.[92] Accordingly, if no discrepancy in value existed on the transfer date, then there was no tax to defer and no tax avoidance motive to combat. Therefore, an employee like Alves, who has paid the fair market value for his shares, is an investor.

Moreover, the ordinary meaning of "connection" suggests the existence of a causal or logical relationship. An employee who has paid less than fair market value for the restricted stock realizes a bargain element in the transfer. His employment has thereby caused his employer to transfer the shares to him. However, an employee who has paid fair market value for the restricted stock does not realize a bargain element in the transfer. Accordingly, his employment has not caused his employer to transfer the shares to him. Instead, his payment of the purchase price was the cause and consideration for the transfer.[93] Judge Fay, in his dissent to the Tax Court opinion, conclusively found that when fair market value was paid for the stock, no part of the transfer was made in recognition of the performance of services.[94]

Alves paid the fair market value for the stock, restricted or unrestricted. The consideration for the transfer was the purchase price. The Ninth Circuit decision implies that, since Alves paid fair market value, the services he rendered were an additional cause or consideration for the stock transfer.[95] This conclusion implies that fair market value is not the real value of the stock; rather, the real value of the stock equaled its fair market value plus the value of the services Alves performed for the Company. The court presumed a real price for the transfer of more than fair market value.[96] Such a presumption, however, is unfounded, and, generally, bad tax law.

The legislative purpose of section 83 indicates that it was not intended to reach the employee who purchased stock at its full fair market value. Section 83 was enacted to eliminate the then existing favorable tax treatment for bargain sales of property to employees. As Judge

91. *Id.* at 884.
92. Hinden, *supra* note 7, at 303.
93. Nolan, *supra* note 23, at 555.
94. *Alves*, 79 T.C. at 880.
95. Nolan, *supra* note 23, at 555.
96. *Id.*

Fay pointed out, in his dissent to the Tax Court, section 83 "applies only when there is a bargain element in the transfer which is in consideration or recognition of the performance of services."[97] In *Alves*, there was no bargain element. Since Alves paid full fair market value for the stock, he was an investor in a fledgling company. An employee-investor who has purchased stock for full fair market value is not taxed under section 83 because he realizes no income as a result of the transaction. In *Alves*, there was no element of compensation, no realization of gross income under section 61[98] and no realization of income at anytime under section 83.[99] Thus section 83 is inapplicable to nonbargain employee stock purchase agreements.

Alves does not advance any tax policy or objective. The result of *Alves* is that every informed employee, in this situation, will file a section 83(b) election within the required thirty-day period. The employee will simply elect to include zero excess in his gross income in the year of the transfer, thereby avoiding ordinary income taxation on subsequent stock appreciation.[100] Thus, the decision results in tax avoidance and places the taxpayer in a favorable position. Since section 83 was designed to prevent such a result, it should not apply to employees, like Alves, who have paid the fair market value. Such employees should be taxed as investors. Section 83, as read by the *Alves* court, serves only to distinguish between employees who receive sophisticated and prompt tax advice and those who do not.[101] Where only one informed choice is possible, section 83 ceases to serve any purpose and becomes merely a trap for the uninformed.[102]

V. CONCLUSION

The Ninth Circuit's decision in *Alves* leaves many unsettled questions. Section 83 was designed to prevent tax deferral and tax avoidance. However, the legislative purpose of section 83 will not be fulfilled by applying it to an employee who has paid the full fair market value for restricted stock. The employee received the stock because he paid the fair market value, not because of his employment. Such an employee is an investor in the company. By applying section 83 to such an

97. *Alves*, 79 T.C. at 880.

98. *See* I.R.C. § 61 (gross income defined).

99. Nolan, *supra* note 23, at 554.

100. *Id.* at 556; *see also Alves*, 79 T.C. at 881. Judge Fay's dissent: "I do not think Congress intended to require a taxpayer to elect to include something in gross income when that taxpayer had nothing to include in gross income."

101. Nolan, *supra* note 14, at 555.

102. *Id.*

employee, the Ninth Circuit implied that the real price for the restricted stock was more than its fair market value. It is not good tax policy to apply section 83 to the employee who purchases restricted stock for its fair market value.

Dawn T. Furgele