Pledger v. Commissioner, 72 T. C. 478 (1979) and Fuentes v. Commissioner, 72 T. C. 478 (1979)

Section 83 of the Internal Revenue Code includes restrictions imposed by law when determining the fair market value of stock received as compensation, while Section 933 excludes income derived from Puerto Rican sources for bona fide residents.

Summary

In Pledger v. Commissioner, the Tax Court held that restrictions imposed by law must be disregarded under Section 83 when calculating the fair market value of stock received as compensation, affirming the constitutionality of the section. In Fuentes v. Commissioner, the court ruled that compensation from a stock option exercised by a Puerto Rico resident was excluded from U. S. income under Section 933(2), as it was attributable to services performed in Puerto Rico. These cases clarify the application of Sections 83 and 933, impacting how compensation from restricted stock and Puerto Rican income are treated for tax purposes.

Facts

In Pledger, Thomas R. Pledger received a stock option from Burnup & Sims as compensation for services, which he exercised in 1971. The stock was subject to restrictions due to securities laws, reducing its value by 35%. Pledger reported income based on the discounted value, but the IRS included the full fair market value, disregarding the restrictions. In Fuentes, Fausto A. Fuentes, a resident of Puerto Rico, received a stock option from Burnup & Sims in 1968, exercised it in 1972, and sold shares in 1974 after moving back to the U. S. The IRS argued that the income from the stock should be taxable upon the lapse of restrictions in 1974.

Procedural History

The cases were consolidated for trial. Pledger challenged the IRS’s determination that Section 83 required disregarding restrictions imposed by law, and argued its unconstitutionality. Fuentes contested the IRS’s position that he should be taxed on the compensation from his stock option in 1974, asserting it should be excluded under Section 933(2).

Issue(s)

1. Pledger: Whether the term “restriction” in Section 83(a)(1) applies to restrictions imposed by law or only to contractual restrictions.
2. Pledger: Whether Section 83 violates the Fifth and Sixteenth Amendments.
3. Fuentes: Whether compensation from a stock option granted and exercised while a resident of Puerto Rico is excluded from U. S. income under Section 933(2).

Holding

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1. Pledger: No, because Section 83(a)(1) applies to any restriction, including those imposed by law, as Congress intended to prevent tax avoidance.
2. Pledger: No, because Section 83 is within Congress's taxing power and does not violate due process.
3. Fuentes: Yes, because the compensation was for services performed in Puerto Rico and thus excluded under Section 933(2).

Court's Reasoning

In Pledger, the court relied on the plain language of Section 83, which states that the fair market value should be determined "without regard to any restriction. " The court cited legislative history and prior regulations indicating that restrictions imposed by law were included to prevent tax avoidance schemes. The court also rejected Pledger's constitutional challenges, citing precedent that upheld the taxing power of Congress and the validity of Section 83. In Fuentes, the court found that the stock option was granted and exercised while Fuentes was a bona fide resident of Puerto Rico, and the compensation was for services performed there. The court concluded that Section 933(2) applied, as it excludes income attributable to the period of Puerto Rican residency.

Practical Implications

Pledger clarifies that all restrictions, whether contractual or statutory, must be disregarded when calculating the fair market value of stock under Section 83, affecting how companies structure stock compensation plans. This decision impacts tax planning and the timing of income recognition for employees receiving restricted stock. Fuentes establishes that compensation from stock options granted and exercised by Puerto Rico residents for services performed there is excluded from U. S. income, influencing tax treatment for individuals moving between Puerto Rico and the U. S. These cases guide attorneys in advising clients on the tax implications of restricted stock and Puerto Rican sourced income.

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