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

Section 83 of the Internal Revenue Code applies to property transferred in connection with the performance of services, even if the property is purchased at its fair market value.

Summary

Lawrence Alves purchased 40,000 shares of stock in General Digital Corp. (later Western Digital Corp.) at fair market value as part of his employment agreement. The stock included restrictions that lapsed over time. The IRS argued that Section 83 of the IRC applied, requiring Alves to report the difference between the fair market value at the time the restrictions lapsed and his purchase price as ordinary income. The Tax Court agreed, holding that Section 83 applies even when stock is bought at fair market value if the transfer is connected to the performance of services. This ruling has significant implications for how employee stock plans are structured and taxed.

Facts

Lawrence Alves was employed by General Digital Corp. in 1970 and purchased 40,000 shares of the company's stock at 10 cents per share, the fair market value at the time of purchase. The stock purchase was part of an employment agreement that included restrictions on one-third of the shares for four years and another third for five years. If Alves left the company before these periods ended, the company could repurchase the restricted shares at the original purchase price. Alves sold some of these shares in 1974 and 1975, and the restrictions on the remaining shares lapsed in those years.

Procedural History

The IRS determined deficiencies in Alves' income tax for 1974 and 1975, asserting that the income from the stock sales and the lapse of restrictions should be taxed as ordinary income under Section 83. Alves petitioned the U. S. Tax Court, which upheld the IRS's position, applying Section 83 to the stock transfers despite their purchase at fair market value.

Issue(s)

1. Whether Section 83 of the Internal Revenue Code applies to stock purchased at its fair market value when the purchase is connected to the performance of services?
2. Whether the income realized from the sale of restricted stock and the lapse of restrictions on other stock should be treated as ordinary income under Section 83?

Holding

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1. Yes, because Section 83 applies to any property transferred in connection with the performance of services, regardless of whether it was purchased at fair market value.
2. Yes, because the difference between the fair market value at the time the restrictions lapsed and the amount paid for the stock is taxable as ordinary income under Section 83.

Court’s Reasoning

The court reasoned that the stock was transferred to Alves in connection with his employment, as evidenced by the employment and stock purchase agreement. Despite Alves’ argument that the stock was purchased as an investment, the court found that the legislative history of Section 83 indicated a broad application intended to cover all transfers related to service performance. The court emphasized that the absence of a bargain element (i. e. , purchasing at fair market value) did not preclude the application of Section 83. The court also noted that Alves could have elected under Section 83(b) to include the stock’s value in income at the time of purchase, but he did not do so. The dissenting opinions argued that Section 83 was intended to address bargain purchases and deferred compensation, not fair market value transactions.

Practical Implications

This decision has significant implications for structuring employee stock plans. It means that employers and employees must consider the tax consequences under Section 83 even when stock is sold at its fair market value. Employees should be aware of the potential for ordinary income tax on stock appreciation when restrictions lapse and consider making a Section 83(b) election to potentially mitigate this tax. The ruling influences how similar cases are analyzed, requiring courts to apply Section 83 broadly. It also affects legal practice by highlighting the importance of clear documentation and understanding of tax implications in employment agreements involving stock. Later cases have continued to apply and refine this ruling, particularly in assessing whether stock transfers are connected to service performance.

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