Lackey v. Commissioner, 129 T. C. 193 (2007)

In Lackey v. Commissioner, the U. S. Tax Court upheld the validity of a taxpayer's section 83(b) election for non-vested incentive stock options (ISOs), ruling that the election was valid even though the stock was subject to a substantial risk of forfeiture. The case clarified that beneficial ownership, not legal title, is the key factor for a valid transfer under section 83(b). This decision impacts how taxpayers recognize income for alternative minimum tax (AMT) purposes upon exercising ISOs and has significant implications for tax planning involving stock options.

Parties

Plaintiff: Robert M. Lackey, the taxpayer, was the petitioner at both the trial and appeal stages before the U. S. Tax Court. Defendant: The Commissioner of Internal Revenue, representing the Internal Revenue Service (IRS), was the respondent at all stages of the litigation.

Facts

Robert M. Lackey was employed by Ariba Technologies, Inc. (Ariba) as a sales assistant from April 24, 1997, to April 4, 2001. On March 2, 1998, Ariba granted Lackey an incentive stock option (ISO) under its 1996 stock option plan, allowing him to purchase 2,000 shares of Ariba common stock at $1. 50 per share, later adjusted to 32,000 shares due to stock splits. Lackey exercised this option on April 5, 2000, acquiring 17,333 vested shares and 14,667 non-vested shares placed in escrow. The fair market value (FMV) of the stock on the exercise date was $102 per share, resulting in a total FMV of $3,264,000 for the 32,000 shares. Lackey timely filed a section 83(b) election in May 2000, electing to include the excess of the stock's FMV over the exercise price in his gross income for alternative minimum tax (AMT) purposes. Lackey's employment was terminated on April 4, 2001, and Ariba repurchased 6,667 non-vested shares at their exercise price on May 30, 2001. Lackey sold the remaining 25,333 vested shares to a third party on December 30, 2002.

Procedural History

Lackey filed his 2000 and 2001 federal income tax returns, which were initially accepted by the IRS. He later filed amended returns asserting that his section 83(b) election was invalid, claiming no AMT income should be recognized for the non-vested shares. The IRS rejected these amended returns. Lackey sought a collection due process hearing under section 6330, challenging the underlying tax liabilities. After an initial hearing, the case was remanded for further review of the underlying liabilities. The U. S. Tax Court reviewed the case de novo, as Lackey had not received a statutory notice of deficiency, and ultimately upheld the validity of the section 83(b) election.

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Issue(s)

Whether the transfer of non-vested stock to Lackey, subject to a substantial risk of forfeiture, was valid under section 83(b) of the Internal Revenue Code, thereby allowing Lackey to recognize AMT income based on the FMV of the stock on the date of exercise.

Rule(s) of Law

Section 83(b) of the Internal Revenue Code allows a taxpayer to elect to include in gross income the excess of the value of property transferred over the amount paid for it, even if the property is subject to a substantial risk of forfeiture. Section 1. 83-3(a)(1) of the Income Tax Regulations states that a transfer occurs when a taxpayer acquires a beneficial ownership interest in the property, disregarding any lapse restrictions. A beneficial owner is one who has rights in the property equivalent to normal incidents of ownership, as defined in section 1. 83-3(a)(1) of the Income Tax Regulations.

Holding

The U. S. Tax Court held that Lackey's section 83(b) election was valid because he acquired a beneficial ownership interest in the non-vested stock upon exercising the ISO, despite the stock being subject to a substantial risk of forfeiture. Therefore, Lackey was required to recognize AMT income based on the FMV of the stock on the date of exercise.

Reasoning

The court's reasoning focused on the concept of beneficial ownership under section 1. 83-3(a)(1) of the Income Tax Regulations. The court determined that Lackey acquired beneficial ownership of the non-vested stock held in escrow upon exercising the ISO, as he had rights equivalent to normal incidents of ownership, including the right to receive dividends. The court rejected Lackey's argument that the transfer was invalid because the stock was subject to a substantial risk of forfeiture, emphasizing that the regulations focus on beneficial ownership rather than legal title. The court also considered the lapse restriction on the stock, concluding that it was not a condition certain to occur because the stock could vest before Lackey's termination. The court's decision was influenced by prior case law and the policy behind section 83(b), which allows taxpayers to elect to recognize income early when the stock's value is low, betting on future appreciation. The court's analysis of the section 83(b) election's validity was thorough and aligned with the purpose of the statute and regulations.

Disposition

The U. S. Tax Court entered a decision for the respondent, upholding the validity of Lackey's section 83(b) election and affirming the AMT income recognition for the

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non-vested stock.

Significance/Impact

Lackey v. Commissioner is significant for its clarification of the requirements for a valid section 83(b) election, particularly in the context of ISOs. The case established that beneficial ownership, rather than legal title, is the key factor in determining whether a transfer has occurred under section 83(b). This decision has practical implications for taxpayers and tax practitioners, as it affects how income is recognized for AMT purposes upon exercising ISOs. The case has been cited in subsequent decisions and is an important precedent in the area of tax law related to stock options and the AMT. The court's emphasis on the policy behind section 83(b) and its application to non-vested stock provides valuable guidance for tax planning involving stock options.

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