ation to $4,430,238, using the net asset value of the corporation, with a discount for lack of marketability and lack of supermajority. However, the Service paid a procedural price; it always bears the burden of proving an increased deficiency, as both the Tax Court and Court of Appeals pointed out. *See* Tax Court Rule 142(a)(1). Particularly given that context, the Service's decision to have its expert critique the estate's valuation but not support the Service's own valuation was probably a tactical error.

The Tax Court held that the decedent's stock was worth $2,738,558, weighing the asset-based value 65 percent and the earnings-based value 35 percent. *See* Estate of Dunn v. Commissioner, T.C. Memo. 2000–12. The Service did not appeal but the estate did. As appellee, the Service did not return to its $4,430,238 valuation but instead argued that the Tax Court's holding was correct. Oddly, that tactic angered the Court of Appeals, and the court's ire influenced its decision. Referencing "[t]he Commissioner's abrupt change of position on appeal," the court stated, "[w]e keep this duplicity in mind as we proceed to examine the Tax Court's valuation methodology." The court's misunderstanding of the workings of statutes of limitations on refund claims may also have colored its view; its statement about duplicity immediately follows a lengthy paragraph, quoted in part above, that incorrectly describes the interaction of the statutory period with the statute of limitations on assessment.

This is not the first time that a Court of Appeals has penalized the Service for reconsidering its valuation of a closely held business during the course of litigation. In a trio of cases decided last year, the Court of Appeals for the Ninth Circuit required the Service to bear the burden of proof when it decreased its deficiency subsequent to issuing a notice of deficiency. *See* Estate of Mitchell v. Commissioner, 250 F.3d 696 (9th Cir. 2001); Estate of Simplot v. Commissioner, 249 F.3d 1191 (9th Cir. 2001); Morrissey v. Commissioner, 243 F.3d 1145 (9th Cir. 2001). The message conveyed by these decisions and *Dunn* may be that the Service should carefully determine its valuation methodology, relying on qualified experts, and apply that methodology meticulously. However, the message that the Service might receive is that, at least in valuation cases, it should not deviate from the amount it asserts in the notice of deficiency, even to support a lower valuation.

Ironically, despite the Ninth Circuit's criticism, on remand, the Tax Court upheld its initial valuation in *Mitchell* and reentered its original decision. *See* Estate of Mitchell v. Commissioner, T.C. Memo. 2002–98. (The estate has appealed; *see* docket sheet for docket 21805–93 at www.ustaxcourt.gov). The Tax Court cannot do the same in *Dunn* because the appellate decision left it little discretion. The Fifth Circuit held that the Tax Court must (1) assign a weight of 85 percent to the value that the Tax Court had determined to be $1,321,740 using the earnings-based approach, and a weight of 15 percent to the value that the court determines using the asset-based approach after reducing the market value of the assets by 34 percent of their taxable built-in gain, (2) calculate the estate's 62.96 percent share of that value, and (3) discount the resulting amount by 22.5 percent. The Tax Court had determined that the aggregate value of the corporation's assets was $8,278,342 and that the built-in gains amounted to $7,109,000. Applying the formula to those numbers results in a value of $977,183.43.

The Service may end up owing more than a refund in *Dunn*. The Court of Appeals directed the Tax Court to consider a claim for attorney's fees, if asserted, "if perchance the re-valuation of the Decedent's block of . . . stock should reduce the net worth of the Estate to a sum below the $2 million cap on entitlement to relief . . . ." By effectively locking the Tax Court into a valuation well below that number, the Court of Appeals may have eased the way for a fee award, if the Tax Court finds that the estate's "net worth" is the value of its assets on the date of the decedent's death.[1] Yet, the Fifth Circuit's misunderstanding of tax procedure hardly lends credence to its suggestion that the Service's position was not substantially justified.

SUBSEQUENTLY IMPOSED RESTRICTIONS: THE SERVICE SPEAKS ON SECTION 83

by Donald R. Bly, Atlanta, GA

In a letter ruling released this spring, PLR 200212005 (November 8, 2001), the Service provided a curiously simple answer to a historically troublesome question: Does section 83 apply to a taxpayer who owns outright shares which subsequently become subject to a substantial risk of forfeiture as a result of an arms-length negotiated financing or third-party investment?

THE CONCERN

In general, section 83(a) requires a taxpayer to include in gross income the fair market value of any property received (less the amount, if any, paid for such property) in connection with the performance of services. Thus, if an employee receives stock from her employer as part of her compensation, she will be taxed on the fair market value of such stock on the date of receipt. The result is different, however, if the employee's ability to transfer or keep the stock is conditioned upon her continued employment for a period of time. This is because the income inclusion and the corresponding fair

1 *Cf.* Estate of Woll by Woll v. United States, 44 F.3d 464 (7th Cir. 1994) (apparently using fair market value); Estate of Rao v. United States, 987 F. Supp. 249 (S.D.N.Y. 1997) (same); *but cf.* Wilkes v. United States, 2000 U.S. Dist. LEXIS 12430 (M.D. Fla. 2000) (parties agreed that net worth meant "cost"; court determined that decedent's acquisition cost was relevant measure), *aff'd,* 289 F.3d 684 (11th Cir. 2002) (declining to consider government's argument, first raised on appeal, that net worth should be based on fair market value of estate's property on date of decedent's death); Estate of Lute v. United States, 19 F. Supp. 2d 104, 1061 (D. Neb. 1998) (using "acquisition cost of real estate" to arrive at a figure under $2 million and much lower than that advanced by government).

market value determination under section 83(a) do not occur until the property is either transferable or no longer subject to a "substantial risk of forfeiture." Treas. Reg. § 1.83–3(c) provides that a substantial risk of forfeiture exists where rights in transferred property are conditioned upon the future performance of services. Thus, unless the employee timely makes an election under section 83(b) to include the value of such stock in income immediately regardless of the restrictions, the taxable event will spring at the time the substantial risk of forfeiture lapses.

To understand the problem addressed by PLR 200212005, consider the formation of a corporation that is both owned and operated by several individuals, typically referred to as the founders. The founders, who often form the company on the strength of a good idea and relatively little capital, initially make a relatively small or nominal contribution in exchange for stock in the entity. The stock received is unrestricted and freely transferable, albeit with relatively little value. Once the initial capital runs out, assuming there was any, the founders must look to outside sources of capital, sources that will not invest without assurances that the corporation's most valuable asset, i.e., the employment of the founders, will be retained. The founders provide this assurance by agreeing to forfeit all or a portion of their shares if they resign before an agreed upon vesting date.

The applicability of section 83 in this case depends on whether there was a "transfer" of the restricted stock to the founders "in connection with the performance of services." Many practitioners were concerned that the Service would make one of two arguments in order to bring this transaction within the purview of section 83(a). The first of these would be a constructive exchange argument pursuant to which the founder would be deemed to have transferred his vested stock to the corporation in exchange for restricted stock, thereby providing the requisite section 83 transfer. The second argument is

Unfortunately, the letter ruling provides only a scattershot outline of section 83 and thereby masks the relevance and weight accorded to each provision.

based on the step transaction doctrine. In cases where the corporation has engaged in little or no activity at the time of the founder's acquisition of shares, and where no substantial activity could be expected in the absence of outside investors (who presumably would require that the founders' stock be restricted), the Service could argue that the various stock issuances, loans and subsequent restrictions should be lumped together as a single transaction, regardless of the formal sequence of events. Under this argument, the outside investors would be considered the initial owners of the corporation, with the founders receiving only restricted shares as remuneration for their employment. Although neither of these arguments are any more intellectually appealing than the conclusion that there was no transfer in connection with the performance of services when the restrictions appeared, the mere specter of a challenge led most practitioners to recommend the filing of a protective section 83(b) election.

PLR 200212005

The taxpayer in PLR 200212005, along with other unrelated parties (collectively, the "Founders"), formed Company A. Upon formation, the taxpayer received Company A shares that were substantially vested for purposes of section 83. At some point after the formation of Company A (we are not told how much time had elapsed), a lender agreed to provide financing in exchange for an option to purchase Company A securities issued in Company A's "next equity financing." When the next equity financing occurred, certain restrictions "previously not contemplated" were placed on some of the Founders' shares. These restrictions would have caused some of the taxpayer's shares to be substantially nonvested for purposes of section 83 if there had been a "transfer" in connection with the performance of services. The restrictions were scheduled to lapse in two stages (a portion of the shares would vest on Date 4 and the rest on Date 5), but upon a change in control of Company A 50 percent of the substantially nonvested shares would immediately vest. Before Date 5, Company A was sold to Company B, triggering the vesting of 50 percent of taxpayer's substantially nonvested shares.

The taxpayer in PLR 200212005 had not requested a ruling under section 83, instead requesting only a ruling that the vesting of these shares upon the change in control of Company A was not a "payment in the nature of compensation" for purposes of sections 280G and 4999 (each dealing with golden parachute payments). This is not surprising, as the taxpayer very likely had made a protective section 83(b) election. The regulations under Section 280G, however, provide that a payment for purposes of that section is considered made in the year in which the property transferred is includible in gross income under section 83, ignoring any section 83(b) election. *See* Prop. Reg. § 1.280 G–1(d), Q&A–12. Thus, the taxpayer's ruling depended on an analysis of the transaction under section 83.

Unfortunately, the letter ruling provides only a scattershot outline of section 83 and thereby masks the relevance and weight accorded to each provision. Several of the highlighted provisions are of unknown relevance (e.g., "the grant of an option to purchase property does not constitute a transfer of such property"). Nevertheless, the most significant provisions can be gathered: (i) property is not taxable under section 83 until it is transferred to and substantially vested in a service provider; (ii) property is substantially nonvested when it is both subject to a substantial risk of forfeiture and is nontransferable, and (iii) once a service provider's rights in property are substantially vested and are taxed under section 83, any

subsequent income or gain with respect to that property is not compensation income.

Turning to the facts before it, the Service noted that each Founder's rights in its Company A shares were already "transferred to and substantially vested in them" at the time that the lender required that such shares be restricted. The Service thus concluded that "the subsequent imposition of the forfeiture provisions on the founders' Company A shares must necessarily have been accomplished in the absence of a section 83 'transfer' (i.e., the shares were already owned for section 83 purposes), and that, therefore, those provisions had no effect for section 83 purposes." Because it concluded that the Founders already owned their Company A shares for section 83 purposes on the date the restrictions were first placed on the stock, the Service subsequently concluded that the substantial vesting of the Founders' shares resulting from the change of control of Company A was not a "payment in the nature of compensation" for purposes of sections 280G and 4999.

THE IMPACT

How will PLR 200212005 affect the advice of practitioners presented with similar facts? Perhaps not as much as the favorable conclusion might initially suggest. Aside from section 6110(k)(3)'s mandate that letter rulings may not be used or cited as precedent, the letter ruling does not specifically alleviate the initial concerns. None of the potential arguments described above are considered or dismissed. On one hand, since PLR 200212005 serves up ideal facts if the Service were inclined to raise the constructive exchange argument, perhaps some practitioners will get comfortable that this argument is no longer a concern. However, the letter ruling does not specifically consider the argument, so it is difficult to tell whether the Service considered and rejected the argument or simply failed to consider it. In addition, the letter ruling provides no evidence that the Service would not consider raising the more problematic step-transaction argument. Because the letter ruling does not provide dates, we cannot ascertain when the financing occurred relative to the date of Company A's founding, nor what Company A's financial situation was when negotiations with the lender began. In short, PLR 200212005 provides no comfort that a step-transaction argument would not be available to the Service under the right set of facts.

While the conclusion that the subsequent imposition of forfeiture restrictions "must necessarily" have been accomplished in the absence of a section 83 transfer is comforting, further guidance is needed. Until a revenue ruling is issued on this topic, most careful practitioners will continue to plan around the problem. Given the potential trap and ease of cure at the front end, many practitioners will continue to file protective 83(b) elections until more formal guidance is issued.

GOOD NEWS FOR FINANCIERS: THE SERVICE ANNOUNCES A **SAFE HARBOR FOR CAPITAL COST REDUCTION PAYMENTS**

by Wayne A. S. Hamilton, Deerfield Beach, FL

In response to the controversy between the Service and financiers surrounding the proper tax treatment of capital cost reduction (CCR) payments made by purchasers of leased vehicles, the Service has issued Rev. Proc. 2002–36. As discussed in greater detail below, the Procedure offers a safe harbor method pursuant to which the amount of the CCR payment received from a lessee will not be includible either in the finance company's gross income or in the basis of the purchased vehicle. The Procedure also provides the manner in which taxpayers may obtain the Service's automatic consent to change to the safe harbor method of accounting. In a win for both taxpayers and the Service, the Procedure provides audit protection for those taxpayers who may currently have this issue under consideration, and for those taxpayers who switch to the safe harbor method.

BACKGROUND – CCR PAYMENTS

Individuals who lease a vehicle may in some cases make an up-front payment to the dealer. The payment has the effect of reducing the total amount of rent they pay as lessees after the inception of the lease. These payments are commonly referred to as capital cost reduction, or CCR, payments. For federal income tax purposes, most finance companies that purchased leased vehicles from auto dealers did not treat the CCR payments as income. This approach was consistent with the position taken by the Service in the July 1997 Market Segment Specialization Program ("MSSP") paper on commercial banking. However, about two years ago the Service began taking the position in audits that the CCR payment was income to the finance company at the inception of the lease despite the fact that the finance company had no entitlement to and could never receive such payments. The Service also took the position that CCR payments would increase the finance company's basis in the purchased vehicle by the amount of the payment. (*See*, Field Service Advice 200103006 (Sept. 28, 2000); IRS Chief Counsel Memorandum 200048001 (Dec. 1, 2000); IRS Chief Counsel Memorandum 200030931 (May 11, 2000) and IRS Chief Counsel Memorandum 200123047 (March 12, 2001)). In July, 2001 the Service released a revised MMSP paper on commercial banking adopting its new position. The 2001 MSSP paper did not identify any change in laws or regulations as a basis for the new position.

The Service's position had a number of results that were detrimental to finance companies. For instance, finance companies had what was in