The Section 83(b) Election and the Fallacy of “Earned Income”

Matthew A. Melone
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let every eye negotiate for itself,
And trust no agent

The less reason a man has to suppose himself in the
right, the more vehemently he asserts that there is no
doubt whatsoever that he is exactly right

The revelation that a significant portion of Mitt Romney’s fortune was generated from income taxed at favorable capital gain rates generated much notoriety and criticism. Facebook’s initial public offering and the scores of millionaires and billionaires that the company spawned has produced fascination with the immense wealth in question, but the fact that Mark Zuckerberg and his minions have somehow earned such unfathomable compensation has largely gone unquestioned. The criticism directed at Mr. Romney and the lack thereof at the Facebook group illustrates the extent to which we have come to believe that investment gains are attributable to the efforts of a few individuals and, consequently, should be taxed as labor income. The tax law provides an election for recipients of equity grants that produces results that counter this belief and, accordingly, has been subject to criticism. This Article asserts that the critics have it precisely backward. The notion that stock price appreciation is somehow labor income is the result of a relatively new social norm that has abdicated hard decisions in corporate governance in favor of a reflexive belief in equity as a panacea for bringing out management’s better angels.

Part I of this Article provides a brief historical overview of the distrust of corporations in colonial times that led legislatures, in the young years of the republic, to imbue corporations with a sense of public purpose. The industrial revolution created enormous capital demands which led to the now-familiar notion of limited liability. Consequently, as corporations grew in size, man-

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* Professor of Law, Lehigh University, Bethlehem, PA.
† WILLIAM SHAKESPEARE, MUCH ADO ABOUT NOTHING act 2, sc.1.
agement became separate and distinct from capital owners. This separation came at the price of agency costs, a subject that has long preoccupied scholars, practitioners, and the business community. Quite naturally, this preoccupation has been focused on methods to reduce such agency costs. Economic, tax, and accounting developments conspired to favor equity-based compensation as the principal solution to the agency cost problem. Initially, stock options were the equity vehicle most favored to align management and ownership incentives, but prominent scandals, economic trends, and accounting rule changes over the past decade or so have shifted equity-based compensation schemes decidedly towards grants of restricted stock.

Part II describes the current tax treatment of equity-based compensation. One unusual feature of the taxing scheme is the election that is provided to recipients of restricted stock awards to subject themselves to current taxation for the privilege of reporting post-grant stock appreciation as tax-favored capital gain. This part analyzes the desirability of such an election, both from an employer and employee perspective. Under current law, this election carries significant risks for the employee and, in most cases, is not desirable. However, in certain situations, the election is very desirable. As a result, the election has been subjected to criticisms that echo the objections to the tax treatment of “carried interests” applicable to investment professionals. In brief, critics characterize the election as a mechanism that enables service providers to convert erstwhile labor income into favorably taxed capital income.

Part III asserts that criticism of the election is misguided because it is premised on the notion that post-grant stock appreciation is attributable to labor and performance. This part examines the rationales for equity-based compensation arrangements, many of which have little or nothing to do with performance. The ostensible agency cost-reducing properties of such compensation schemes fail, for several reasons, to provide adequate justification for the proposition that stock price appreciation should be classified as labor income. The putative benefits of equity compensation arrangements are imbedded in the stock price at the time of grant. Moreover, stock price performance is a poor proxy for labor performance. Finally, these arrangements do little to eliminate agency costs. At best, they merely substitute one form of agency cost for another and, at worst, they exacerbate existing agency costs. Equity compensation has had a deleterious effect on corporate culture and has reduced other sources of employee motivation to quaint relics of a bygone era.

Part IV proposes that the tax law should reflect the true nature of post-grant stock appreciation by eliminating the current elective scheme and mandating the taxation of share grants at the time of grant. This change would constitute a step to accurately portray the economics behind share-based compensation arrangements and eliminate the fallacy that management has reaped
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the rewards of stock appreciation entirely through its labor.

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I. AGENCY COSTS

A. Historical Overview

The corporation, as an institution, has been the subject of controversy in the United States since colonial times. The focus of controversy, quite predictably, has shifted as the country evolved socially and economically over the centuries. In colonial times and in the early years of the republic criticism of the corporate form generally was directed at corporations’ alleged propensity to engage in restraint of trade. That locus of criticism is not surprising since colonial corporations were chartered either by royal decree or by special acts of Parliament for the purpose of extracting natural resources from colonial lands.³

³ Charlie Cray & Lee Drutman, Corporations and the Public Purpose: Restoring the Balance, 4 SEATTLE J. FOR SOC. JUST. 305, 309 (2005).
Charters often granted exclusive trading privileges to corporations whose members were joint stock owners and, more often than not, well-connected politically. Colonial corporations were often seen by the public as quasi-governmental extensions of royal power into the colonies. As a result, they were the subject of public opprobrium.

Mistrust of corporations survived independence and was reflected in a paucity of legislative action to grant charters. Moreover, in contrast to modern notions of shareholder primacy, corporations were imbued with a sense of public purpose as evidenced both by the significant limitations placed on corporations by the legislatures and by the nature of the enumerated powers that they were granted. Legislatures understood and appreciated the need for a vehicle that enabled the pooling of capital that was required to undertake increasingly complex and risky projects. However, this understanding and appreciation was tempered by mistrust and the charters kept a fairly tight leash on the corporation. Problems inherent in any agency relationship—what we now term “agency costs”—were recognized in biblical times and were certainly recognized at this time but were not yet systematically examined. In contrast to the modern concern that agents will behave in a self-interested manner to the detriment of the principal’s objectives, in the infancy of our corporate history the concern was just the opposite—that the corporate form itself was harmful to agents.

Adam Smith, in *The Wealth of Nations*, discussing the power of the marketplace to restrain the worker’s fraud and negligence, opined that the “corporation necessarily weakens the force of his discipline.”

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4. Id.
5. Id.
6. Only 147 corporate charters were issued in the United States between 1781 and 1795. See id. at 311 (citing to ROBERT A. EAST, BUSINESS ENTERPRISE IN THE AMERICAN REVOLUTIONARY ERA 285 (Peter Smith 1964) (1938)).
7. In 1800, 65 percent of corporations were chartered to build turnpikes, canals, and bridges. Id. at 312 (citing to RALPH NADER ET AL., TAMING THE GIANT CORPORATION 34 (1976)); see also LAWRENCE M. FRIEDMAN, A HISTORY OF AMERICAN LAW 178-81 (2d. ed. 1985).
8. The “Parable of the Talents” is a 2000 year old illustration of agency costs. See Matthew 25: 14-30 (King James). Adam Smith recognized the problems inherent in the separation of ownership and management and expressed concern over whether managers of other people’s money could ever exercise the “same anxious vigilance with which partners in a private copartnery frequently watch over their own.” ADAM SMITH, AN INQUIRY INTO THE NATURE AND CAUSES OF THE WEALTH OF NATIONS 606 (Penn State Press ed. 2005) (1776). Agency costs that were a matter of concern were those that arose among the owners of the firm and generally manifested themselves in the looting of the company by some owners at the expense of other owners. See FRIEDMAN, supra note 7, at 513-15. These “horizontal” agency costs exist today although they too often suffer from lack of attention. See infra notes 237-42 and accompanying text. This is not to imply that the classic agency cost problem inherent in the management-shareholder dichotomy was completely ignored. Challenges to allegedly excessive executive compensation did occur. See, e.g., Rogers v. Hill, 289 U.S. 582 (1933) (dealing with putatively excessive bonuses received by an executive of the American Tobacco Co.); George T. Washington, The Corporation Executive’s Living Wage, 54 HARV. L. REV. 733, 737-52 (1941) (describing disputes over executive compensation at Bethlehem Steel and National City Bank). However, the systematic study of this problem would occur later. See infra notes 18-28 and accompanying text.
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feared that the corporate form would destroy individual enterprise and artisanship. 10 Louis Brandeis feared that the separation of ownership and management would concentrate power in the hands of bankers and was primarily concerned not with injury to stockholders but to the public. 11

The rapid industrialization of the United States during the nineteenth century created tremendous capital needs. Among the attributes of Jacksonian democracy were its reflexive mistrust of elites and the belief that such elites curried favor with the political class to obtain lucrative – and exclusive – commercial rights by corporate charter. 12 During this time, the nexus between the corporation and the state began to loosen. The legislative charter gradually gave way to state general incorporation laws. 13 The landmark Supreme Court decisions in Dartmouth College, 14 which restricted New Hampshire’s ability to convert the college into a public institution on primacy of contract grounds, and Santa Clara County v. Southern Pacific Railroad, 15 which conferred constitutional rights upon corporations, erected the legal foundation on which corporate resistance to state meddling would be built. 16 The erosion of the corporate-state link fostered debate about the duties of the corporation and to whom those duties were owed. This debate continues to this day but, with relatively few exceptions, the shareholder primacy model of the corporation has pre-

10. Id. at 311.
15. Santa Clara Cnty. v. S. Pac. R.R.,118 U.S. 394 (1886). The Court recognized corporations as persons within the meaning of the Fourteenth Amendment.

One of the points made and discussed at length in the brief of counsel for defendants in error was that "corporations are persons within the meaning of the Fourteenth Amendment to the Constitution of the United States." Before argument, MR. CHIEF JUSTICE WAITE said: "The Court does not wish to hear argument on the question whether the provision in the Fourteenth Amendment to the Constitution which forbids a state to deny to any person within its jurisdiction the equal protection of the laws applies to these corporations. We are all of opinion that it does." Id. at 396.

The notion that corporations have constitutional rights remains a controversial issue to this day as evidenced by the loud and varied criticism leveled at the Court’s decision in Citizen United v. FEC, 130 S. Ct. 876 (2010). In that case the Court held, in a 5-4 decision, that corporations have a First Amendment right to engage in political speech. This decision prompted President Obama to issue a public rebuke of the decision during his 2010 State of the Union address. See President Barack Obama, Remarks by the President in the State of the Union Address (Jan. 27, 2010), available at http://www.whitehouse.gov/the-press-office/remarks-president-state-union-address. For an analysis of this decision and a history of restrictions on corporate political activity see Matthew A. Melone, Citizens United and Corporate Political Speech: Did the Supreme Court Enhance Political Discourse or Invite Corruption?, 60 DePaul L. Rev. 29 (2010).

16. The notion of corporate personhood carries with it the implication that corporations, like other persons, have the freedom to contract and deploy resources to attain any legal objective. The vitality of the ultra vires doctrine to challenge corporate acts diminished significantly as the courts began to imply corporate powers and general incorporation statutes permitted very broad expressions of corporate power. See FRIEDMAN, supra note 7, at 518-20.
vailed over competing models. Moreover, the concept of limited liability became generally accepted thereby encouraging the diffusion of ownership and ushering in the now familiar separation of the owners of capital from the managers of that capital—a development whose consequences have raptly engaged modern scholars.

B. Managing Agency Costs

The genesis of modern notions of corporate governance is often traced to the seminal work of Adolf Berle and Gardiner Means, *The Modern Corporation and Private Property*. Although not the first scholars disquieted over both the increasing concentration of wealth in corporate solution and the concomitant separation of ownership of that wealth from its management, Berle and Means offered a systematic, empirically-based study of the propensity for management to do harm to shareholders. By no means did Berle and Means settle the debate over the societal purpose of corporations, but they did focus corporate governance on the management-shareholder agency problem. In 1937, Ronald Coase theorized about the nature of the firm and questioned why certain activities were conducted through the market by contract while other activities were conducted within a firm. Coase concluded that firms existed to avoid or ameliorate high costs associated with market transactions and that the exercise of managerial authority to reduce such costs explained why firms undertook these activities. Coase’s insights changed the way economists perceived firms. Inquiries now focused on efficiencies, within firms and within markets. Later scholars expanded upon Coase’s work and the corporation became increasingly viewed as a “nexus of contracts.”

The theory of the corporation as an artificial person began to give way to a view of the corporation as an aggregate of shareholders—a theoretical view that underpins the shareholder maximization model of corporate governance. Consequently, corporate law increasingly became a mechanism to provide a set

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17. See infra note 34 and accompanying text.
19. Id. at 7-8, 47-68, 127-220.
20. Berle and Means themselves understood that the corporation had changed society in a fundamental way and that the purpose of the corporation should be re-examined. See id. at 7-8, 356.
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of efficient default provisions to facilitate contracting among the various participants. However, modern theories of corporate governance have been most informed by the seminal work of Jensen and Meckling.

According to Jensen and Meckling, corporations are comprised of individuals with competing interests who form a web of contracts. The corporation is the nexus for this set of contractual relationships. Agency relationships form among individuals because each individual’s decisions affect the wealth of others, with those decisions often unobservable. The management of this agency relationship results in the incurrence of monitoring costs by the principal, bonding costs by the agent to signal fealty to the principal, or some combination of the two. Neither monitoring nor bonding actions are perfect and, consequently, the divergence between the principal’s interests and the agent’s interests will inevitably result in a loss of welfare to the principal. Thus, agency costs are the sum of monitoring costs, bonding costs, and the residual loss to the principal. Agency costs exist in all agency relationships, but academic focus on corporate governance skews heavily toward analyzing/minimizing agency costs arising from the separation of ownership and management.

The optimal mix of monitoring and bonding activities depends on relative costs and benefits, and consequently varies considerably among firms. Closely-held corporations generally find that their costs of monitoring are relatively low, therefore they are less likely to provide incentive compensation schemes as a mechanism to minimize agency costs. Likewise, non-profit organizations generally find incentive compensation schemes cost prohibitive due to the difficult in creating an agreeable metric to measure performance. Moreover, individual non-profit employees’ often share the commitment to the non-profit’s mission, keeping bonding costs low for non-profit firms.

Publicly-traded corporations are the paradigm entities that incur significant agency costs. However, among these entities various factors will inform the proper mix of monitoring and bonding costs. For example, heavily regulated entities (such as public utilities), entities with engaged boards of directors, with a strong and enduring corporate culture, or with an active, large-stake shareholder may find that the costs of incentive compensation do not justify the benefits. The level of external monitoring of the firm will also affect the opti-

25. Id. at 310.
26. Id. at 309.
27. Id.
29. See generally id.
30. See generally id.
mal mix of internal firm decisions. The friendliness – or unfriendliness – of the legal system toward shareholder action, media scrutiny, debt-holder demands, and the composition and expected behavior of institutional shareholders are all factors that will, and should, influence the firm’s management of its agency costs. To the extent that management is responsible to other constituencies, justification for the almost singular focus on shareholder-management incentive alignment necessarily weakens. The general acceptance of the shareholder primacy model of corporate governance sanctions a laser-like focus on the alignment of management and shareholder incentives.

The advent of Modern Portfolio Theory by Nobel Laureate Harry Markowitz exposed investors to the idea that diversification could reduce a portfolio’s risk without reducing its returns. Conglomerates were a manifestation of Modern Portfolio Theory applied to a firm. A diversified portfolio of companies within the corporate umbrella, it was believed, served to reduce the risk of the firm as a whole thereby leading to more stable earnings, a cheaper cost of capital, and a higher stock price. Management enjoyed the prestige and increased compensation that derived from stewardship of ever-larger entities. However, the landscape began to shift with the abolition of fixed commissions for institutional investors in 1974, which significantly reduced the cost to create a diversified portfolio of stocks. The proliferation of Individual Retire-
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ment Accounts and 401(k) plans beginning in the 1970s provided a growing pool of funds with which to accumulate diversified portfolios of securities. Thus the mutual fund became a major institutional investor.

With the ability to diversify an investment portfolio on their own, shareholders questioned the desirability of diversification within a firm. Conglomeration was no longer necessary as a method of diversification. Moreover, conglomerate tended to diffuse management attention among the corporation’s various constituent parts. In the 1980’s, Drexel Burnham Lambert’s pioneering use of junk bonds ushered in the era of the corporate raiders, who were more than willing to swoop in and reverse conglomerate if the firms themselves proved resistant to doing so. The market insisted that companies focus singularly on their core competencies and leave diversification to the shareholders. Top management faced a more demanding taskmaster – the market – and top management positions now carried more personal risk. Consequently, management demanded greater compensation. Although agency costs can be reduced by a combination of various monitoring and bonding actions, economic, tax, and accounting developments led to the use of equity-based incentive compensation systems as a significant, even preeminent, device for managing agency costs.

C. The Rise of Equity-Based Compensation

Equity-based compensation has proliferated widely during the past quarter century, aided and abetted, in no small part, by tax and accounting rules. At first, economic and political developments conspired, along with existing accounting rules, to skew equity-based compensation toward the issuance of compensatory stock options. Later, economic and political develop-
ments, well-publicized corporate scandals, and accounting rule changes caused a re-assessment of the utility of stock options. Today, equity-based compensation tends toward the grant of shares.

1. The Prevalence of Stock Options

Tax laws and accounting rules all but ensured that management’s compensation demands were satisfied with equity-flavored compensation. I.R.C. § 162(m), enacted as part of the Omnibus Budget Reconciliation Act of 1993,41 imposed limits on the ability of publicly held corporations to deduct executive compensation expenses.42 Compensation in excess of $1,000,000 paid by a publicly traded corporation to the chief executive officer or the four highest paid officers other than the chief executive is not deductible.43 However, performance-based compensation is not subject to this limitation.44 Performance-based compensation is defined as any remuneration payable “solely on account of the attainment of one or more performance goals.”45 Section 162(m) had the effect of shifting top level executive compensation toward equity-based compensation, particularly compensatory stock options.

U.S. Treasury Department regulations provide that compensation is performance-based if the amount of compensation that the employee can receive is based solely on an increase in the value of the stock after the date of grant or award.46 Consequently, a grant of restricted stock, in order to be considered...
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performance-based, had to be predicated on and determined by, the attainment of some performance metric. The compensatory element in the case of a stock grant is not based solely on post-grant appreciation but also includes the value of the stock itself. For example, an employee who is granted stock options to purchase 1000 shares of stock for $100 per share at the time the shares’ fair market value is $100 will be in receipt of compensation only if the shares’ value exceeds $100 at the time the options are exercised. If the shares fall below $100 then the options will expire worthless. However, an employee who is granted 200 shares of restricted stock will be in receipt of compensation regardless of whether the stock price increases post-grant because the employee is entitled to the value of the shares at the time of vesting, regardless of whether those shares have risen or fallen in value. Stock options, on the other hand, are deemed performance-based so long as they are not in-the-money when granted. Moreover, relative to recipients of outright grants of stock, option holders benefit from the inability of corporations to deduct dividends. This discourages corporations from paying dividends in favor of earnings retention. Option holders have no claim to dividends. Consequently, earnings retention shifts value to option holders by foregoing dividends prior to the option’s exercise. Section 162(m) encouraged firms both to substitute performance-based stock grants, options, and other equity-based compensation for salary and to

47. Id. A stock option is "in the money" if the exercise price of the option is less than the fair market value of the underlying stock. Therefore, at-the-money or out-of-the-money options are considered performance-based while in-the-money options are not. Because the regulations make no distinction between stock appreciation caused by market forces and firm-specific events, any appreciation in the stock is considered performance-based. Similar treatment is accorded to stock appreciation rights. Id. This requirement does not apply if the grant of the options itself was contingent on the employee’s meeting of performance-based goals. Id. Senator Carl Levin introduced legislation in 2007 that would have eliminated the exemption of nonqualified stock options from the $1,000,000 expense limitation imposed by I.R.C. § 162(m). See Ending Corporate Tax Favors for Stock Options Act, S. 2116, 110th Cong. (1st Sess. 2007). An in-the-money option may also be subject to the rather draconian deferred compensation rules imposed by I.R.C. § 409A. See infra note 73.

48. Earnings retention offered potential benefits to stockholders. Provided that the corporation earns a rate of return on such retained earnings equal to what the shareholders could have earned, the shareholders benefit in two respects. First, the tax on the corporate earnings that would have been imposed on the dividend is postponed until the stock is sold or exchanged. Second, such return is taxed at favorable capital gain rates whereas, prior to the Bush-era tax cuts, dividend income was taxable at ordinary income rates. Qualified dividends were taxed at a maximum rate of 15 percent until the end of 2012. Qualified dividends are dividends paid by domestic corporations and certain foreign corporations on stock that has been held for more than 60 days and for which no offsetting position exists. I.R.C. § 1(h)(11)(B) (2006). The favorable tax treatment of dividends was extended through 2012 by the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, Pub. L. No. 111-312, § 101(a), 124 Stat. 3296, 3298 (2010). Effective on January 1, 2013 the maximum tax rate imposed on long-term capital gains and qualified dividends increased from 15 to 20 percent for taxpayers whose income exceeds certain thresholds. The American Taxpayer Relief Act of 2012, Pub. L. No. 112-240, §102(b), 126 Stat. 2313 (2013) (codified at I.R.C. § 1(h)). Note that dividends paid on restricted stock may be taxed as compensation to the recipients and deductible as such by the corporation. See infra notes 110-11 and accompanying text. See infra note 111 for changes to the hospital insurance tax that, effective January 1, 2013, would place taxpayers who make the § 83(b) at a disadvantage with respect to dividends on restricted stock.
skew such equity-based compensation toward stock options.

Generally accepted accounting principles created a comparative advantage for stock options relative to other equity-based compensatory schemes. Compensation expense, for purposes of financial reporting, was measured by the difference between the market price of the stock underlying the option and the exercise price of the option, thereby resulting in no reported compensation expense for at-the-money or out-of-the-money stock options. Later, the Financial Accounting Standards Board issued new rules that, effective until 2005, encouraged the expensing of stock options at the time of grant but allowed corporations to account for the grants under existing rules provided that additional footnote disclosures were made. Except for companies that voluntarily valued and expensed issuances of compensatory stock options, the use of such instruments, unlike other forms of compensation, did not result in a charge to reported earnings.

Tax and accounting incentives dovetailed nicely with economic developments in the 1990s, assuring that stock options would become the predomi-

49. Accounting for Stock Issued to Employees, Accounting Principles Bd. Opinion No. 25, § 10a (Am. Inst. of Certified Pub. Accountants 1972). Prior to July 1973, accounting principles were promulgated by the Accounting Principles Board, a unit of the American Institute of Certified Public Accountants (AICPA). U.S. accounting standards have been set by the Financial Accounting Standards Board, a body operating independently of the AICPA, since July 1973. The growth of stock option based compensation led the Financial Accounting Standards Board to revisit its long-standing rules and an exposure draft was issued in 1993 that recommended that stock options be recorded as compensation using fair market value models, such as the Black-Scholes method or binomial valuation methods. The exposure draft generated tremendous controversy. Technology companies were particularly incensed because they were among the most prolific issuers of stock options. Moreover, because technology stocks tend to be volatile, these companies stood to take a greater charge to earnings under the valuation methods proposed. Consequently, they helped mobilize political action against the proposal. Senator Lieberman introduced legislation, The Equity Expansion Act of 1993 that would have required the Securities and Exchange Commission to prohibit the recognition of compensation expense from the issuance of stock options. See S. 1175, 103rd Cong. (1st Sess. 1993).

50. See generally Accounting for Stock-Based Compensation: Transition and Disclosure, Statement of Fin. Accounting Standards No. 148, (Fin. Accounting Standards Bd. 2002); Accounting for Stock-Based Compensation, Statement of Fin. Accounting Standards No. 123 (Fin. Accounting Standards Bd. 1995). The accounting rules were changed in 2005 to mandate expensing of compensatory stock options. See infra note 55 and accompanying text. Several companies had expensed compensatory stock options for years and several corporations elected to do so. See Rachel Emma Silverman, GE to Expense Stock Options Held by Workers, WALL ST. J., Aug. 1, 2002, at A3 (reporting that Boeing Corp. and the Washington Post Corp. accounted for options as an expense for years and that among the prominent corporations that decided to join them were General Electric and Coca-Cola). Several members of Congress attempted to induce corporations to expense compensatory stock options. In February 2002, Senators Levin, Dayton, Durbin, Fitzgerald, and McCain introduced the Ending the Double Standard for Stock Options Act whose provisions would prohibit the tax deductibility of option related expenses if the taxpayer did not account for option-based compensation as an expense. See S. 1940, 107th Cong. (2d Sess. 2002). A similar bill was introduced in 2012 in response to the enormous deductions that are predicted to be generated from Facebook’s initial public offering. See infra note 66.

51. Stock options did reduce earnings per share to a certain extent. For purposes of determining diluted earnings per share stock options are considered exercised at the beginning of the reporting period, or, if later, at time of issuance, despite the existence of vesting restrictions. See generally Earnings Per Share, Statement of Fin. Accounting Standards No. 128, §§ 1, 6, 17a-h, 20 (Fin. Accounting Standards Bd. 1997).
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nant form of equity-based compensation. The seemingly limitless economic possibilities offered by the Internet and the recent breakup of the Soviet Union incubated a pervasive sense of optimism. Dot-com companies proliferated and these companies were often idea-rich but cash poor: options offered a cashless method of compensation. The use of such instruments allowed the firm to avoid a charge to earnings naturally encouraging the issuance of such instruments. Moreover, options, with their inherent leverage, were tailor made for an era in which the market was forecasting tremendous growth.

2. Trending Toward Restricted Stock

The circumstances that favored the issuance of compensatory stock options changed rather quickly. The bursting of the dot-com bubble in the early 2000s fostered a realistic assessment of companies’ economic potential and, consequently, analysts tempered unrealistic growth forecasts. The dramatic decline in internet and technology stock prices brought into sharp focus the downside of option compensation: options can quickly become worthless and stay worthless.52 The terrorist attacks on September 11, 2001 brought a quick end to the decade long optimism that was based, in large part, on the United States’ seemingly unassailable place atop a relatively serene geopolitical landscape. The Enron and Worldcom accounting scandals revealed another downside, stock options created distorted incentives.53 In 2003, tax rates on dividend income assessments of companies’ growth prospects, became important to market participants, further eroding the lure of stock options.54 Finally, perhaps the most significant advantage enjoyed by stock options – their accounting treatment – was eliminated in 2005. Effective for fiscal years beginning after

52. See infra note 65 and accompanying text.
June 15, 2005, stock options were to be accounted for as an expense based on their fair market value when granted.\footnote{See generally SHARE-BASED PAYMENT, Statement of Fin. Accounting Standards No. 123 (Fin. Accounting Standards Bd. revised 2004). This standard conformed U.S. accounting standards with international accounting standards. See generally SHARE-BASED PAYMENT, Int’l Accounting Standards No. 2 (Int’l Accounting Standards Bd. 2004). See infra notes 163-64 and accompanying text for a discussion of the accounting treatment of equity-based compensation.}

These developments led many scholars and management theorists to re-examine the usefulness/efficacy of stock options as an instrument to align managerial and shareholder incentives. The inherent deficiencies of these instruments were no longer masked by a rising stock market. Stock options are typically valued by the use of models such as the Black-Scholes model or the binomial option-pricing model.\footnote{The Black-Scholes model was developed by Fischer Black and Myron Scholes and presented in a paper published in 1973. See Fischer Black & Myron Scholes, The Pricing of Options and Corporate Liabilities, 81 J. POL. ECON. 637 (1973). This model employs five principal variables: the current stock price; the exercise price of the option; the volatility of the stock price; the option’s time to maturity; and the risk-free interest rate. A binomial option pricing model assumes a riskless portfolio and results in the portfolio earning a risk-free rate of return and may be described as a series of decision trees based upon stock price movements during particular segments of an option’s life. See generally JOHN C. HULL, OPTIONS, FUTURES, AND OTHER DERIVATIVES 194-207 (4th ed. 2000). Other methodologies are also available. For example, the intrinsic value method, adopted by A.P.B. Opinion No. 25, values the option by comparing the stock price with the exercise price at a specific point in time. See discussion supra note 49 and accompanying text. It is also possible to value options by simply assuming a certain level of stock appreciation and discounting the value to the present time. Each of these alternative methods is considered inferior to the Black-Scholes and binomial methods because their underlying assumptions are unsound. A relatively novel approach had been proposed by Coca-Cola. Options were to be valued through a market mechanism established and maintained by investment houses. See Floyd Norris & Sherri Day, Coke to Report Stock Options as an Expense, N.Y. TIMES, July 15, 2002, at A1.}

Regardless of what methodology is used to assign a value to an option grant, if the recipient of the option values it at a figure less than the grantor valued it, then the transaction creates deadweight costs.\footnote{The variables that appear in the Black-Scholes model’s equation are independent of risk tolerance. See supra note 56.}

An inescapable problem inherent to compensatory stock options is a consequence of the incentive alignment that such instruments are meant to achieve: the risk of an individual asset is comprised of systematic and unsystematic components. The systematic component cannot be eliminated through diversification.\footnote{For example, if A purchases a birthday present for B that cost 25 dollars but B, because of idiosyncratic factors, values the gift at 10 dollars then the transaction is not efficient. A could have given B cash or another present that B valued at ten dollars but that cost A less than twenty-five dollars. Hence, one party could have been made better off—A—with B suffering any harm. The inefficiency of the original transaction imposes a deadweight cost on A.}

Systematic risk is related to market risk, measured with reference to an asset’s beta, or sensitivity of the asset’s rate of return to changes in
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the market’s rate of return. The residual risk is unsystematic. Diversification will not reduce either risk component inherent in an individual asset, but it will reduce systematic risk in the portfolio of assets as a whole.

In order for stock option compensation schemes to achieve effective incentive alignment, an executive must be exposed to unsystematic, or firm-specific, risk. However, most, if not virtually all, managers will be sub-optimally diversified due to a concentration of capital in their employer. The investment by an employee of her human capital in the firm alone accounts for much of the sub-optimal concentration of wealth in the employer. Existing investments of financial capital in the firm, whether through prior equity awards, 401(k) firm equity holdings, or non-equity based deferred compensation, further exposes managers to unsystematic risk. The enactment of the Sarbanes-Oxley Act of 2002, which further limited managers’ ability to diversify their compensation packages, served to heighten management’s sensitivity to unsystematic risk.

Although deadweight costs are certainly possible with stock grants, the problem is magnified due to the asymmetrical incentives inherent in stock options. A stock grant offers linear incentives. Stock price movements, whether

60. Id.
61. One study estimated that an investor whose wealth is comprised of an investment in the average New York Stock Exchange firm is exposed to more than the twice the volatility than that of an investor whose assets are comprised of a diversified basket of stocks. See Lisa K. Meulbroek, The Efficiency of Equity-Linked Compensation: Understanding the Full Cost of Awarding Executive Stock Options, 30 FIN. MGMT. 5, 7-8 (2001). Obviously, it is not practical to construct a portfolio comprised of “the market.” Consequently, diversification requires that the risks of individual assets comprising the portfolio are not closely correlated with each other. For example, diverse holdings of stock that are concentrated in one industry would not reduce systematic risk as well as a portfolio constructed to hold investments across industries.
62. See id. at 5 (citing a study that estimated that the value of human capital represents between 52 and 87 percent of an individual’s wealth).
63. Traditional defined benefit plans are limited in the amount of plan assets that may be invested in the securities of the plan sponsor. In general, a qualified plan may not hold more than 10 percent of its assets in such securities. See 29 U.S.C. § 1107(a)(3) (2006). However, such limits do not apply to certain defined contribution plans such as 401(k) plans. Many corporations match employee contributions by contributing employer securities. After the Enron debacle, various calls for reform were issued. Among the suggested reforms were proposals that would require plan sponsors to allow plan participants to diversify their holdings or limit the amount of employer stock that may be invested in the accounts of individual participants. See, e.g., S. 2190, 107th Cong., (2d Sess. 2002); H.R. 3762, 107th Cong., (2d Sess. 2002); H.R. 3640, 107th Cong., (2d Sess. 2002). Non-qualified deferred compensation plans expose the employee to the risk of default because the employee’s status with respect to promised future benefits is that of a general creditor. Placing the assets outside the reach of the firms’ creditors exposes the recipient of the deferred compensation to immediate taxation under the doctrine of constructive receipt. See Treas. Reg. § 1.451-2(a) (1979).
64. This legislation imposed a ban on the extension of personal loans to executives. This prevented employees from funding the exercise of the options on a nonrecourse basis through corporate made or arranged loans. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 402, 116 Stat. 745, 787 (2002); see also Andrew M. Sroka, Sarbanes-Oxley Hastily Extinguishes Executive Loans: Recommending Less Drastic Regulatory Alternatives, 38 SUFFOLK U. L. REV. 877 (2005). As a result of the Enron debacle, the legislation also included a prohibition on trading, by directors and executive officers, during any pension fund blackout period—a period during which the ability of plan participants to trade employer securities is temporarily suspended. Sarbanes-Oxley Act § 306, 116 Stat. at 779-84.
up or down, affect the recipient’s payout equally regardless of the point from which the stock price movement is measured. The same linearity is present for an in-the-money option. However, linearity does not hold for out-of-the-money options because unless and until the stock price rises above the option’s strike price, the option produces no payoff. An option can prove worthless due to a minor decrease in the price of the underlying stock. Hence, options are perceived as riskier than the underlying stock by their recipients.65

Additionally, relative to stock, options are leveraged instruments. A grant of options will allow the option recipient to profit from an increase in the stock price on a far greater number of shares relative to a grant of shares of equal value. Options often present their recipients with the possibility of the “home run,” and may therefore encourage excessive risk taking, particularly during frothy economic times.66 Conversely, due to the nonlinear nature of option payoffs, traditional options have a greater propensity to destroy their putative incentive alignment during bear markets. The incentive effect of such options is effectively destroyed once an option is deeply out-of-the-money. Arguably, it is during such periods that the need for managerial excellence is greatest.

During the past decade the components of equity-based compensation have strongly trended toward the use of restricted stock at the expense of stock options. One study of S&P 500 companies indicated that by 2007 stock options fell, as a percentage of executive pay, to twenty-five percent from sixty percent in 2000. Restricted stock, as a percentage of executive pay, grew from approximately ten percent to thirty-three percent during the same period.67 The finan-

65. Harvard Business School Professor Lisa K. Meulbroek estimated that managers at the average New York Stock Exchange firm value their stock options at 70 percent of their market value. This disparity was even greater for certain technology companies. See Meulbroek, supra note 61, at 5. At volatile internet firms managers valued their options at 53 percent of their value. Id; Hall and Murphy have shown that risk-averse, undiversified executives, if given a choice, would prefer an option package with fewer options and a low strike price over an equivalently valued package of more options with a higher strike price, supporting the notion that executives overweight the possibility that options will fall out-of-the-money. Brian J. Hall & Kevin J. Murphy, Stock Options for Undiversified Executives, 33 J. ACCT. ECON. 3, 12, 15-17, 23-26 (2002).

66. One recent “home run” was hit by Mark Zuckerberg, the founder of Facebook. It had been reported that his plans to exercise stock options prior to the company’s initial public offering would result in a personal tax liability to him of approximately $2 billion along with a comparable tax benefit for Facebook. See Kocieniewski, supra note 2. Despite the poor performance of Facebook’s stock in the immediate aftermath of the initial public offering, Mr. Zuckerberg is a very wealthy man. For other examples of large option payoffs see Rolfe Winkler, Stock and Awe for Facebook and Zynga Investors, WALL ST. J., Feb. 17, 2012, at C8; David Kocieniewski, Tax Benefits from Options As Windfall for Business, N.Y. TIMES, Dec. 30, 2011, at A1. Senators Carl Levin and Kent Conrad recently introduced legislation that would limit corporate tax deductions with respect to compensatory stock options to the amount deducted for financial reporting purposes. See Cut Unjustified Tax Loopholes Act, S. 2075, 112th Cong. § 201 (2012). This is not to imply that such large option payoffs are a recent phenomenon. Cisco Systems reported a tax benefit of approximately $2.5 billion for its fiscal year ended July 2000 resulting from compensation deductions attributable to the exercise of employee stock options. See Michelle Hanlon & Terry Shevlin, Accounting for Tax Benefits of Employee Stock Options and Implications for Research, 16 ACCT. HORIZONS 1, 1-2 (2002).

67. See David I. Walker, Evolving Executive Compensation and the Limits of Optimal Contracting,
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cial crisis that began in 2008 has accelerated this trend.68

II. SECTION 83(B) ELECTION

The taxation of equity-based compensation should, in theory, be relatively straightforward. An employer provides property to an employee and the value of that property, at the time that the transaction takes place, should be the measure of both the employee’s income and the employer’s compensation deduction. Any post-grant appreciation or depreciation in the property has no compensatory consequences and is the employee’s concern. In practice, things are not so simple. Equity-based compensation is often subject to vesting restrictions that confuse the issue of when the taxable event should occur. Moreover, the tax law is not horizontally equitable with respect to such compensation, since different tax results are yielded depending on the structure of the compensation. An unusual feature in the taxation of equity-based compensation is an election that provides an employee with the choice of whether to defer income or incur immediate taxation upon the receipt of equity. This election has been subject to much criticism and has been accused of mimicking the unfair advantages enjoyed by holders of “carried interests.” This section describes the taxation of equity-based compensation and examines the desirability of the § 83(b) election from both the employer’s and employee’s perspective. The advantages of the election manifest themselves in rather limited circumstances, the election also exposes the employee to significant tax risks. Moreover, criticism of the election by way of comparison to other forms of compensation is misguided.

A. Section 83 – In General

I.R.C. § 83(a) provides the general rule that the actual or constructive receipt of property in exchange for services is a taxable event at the time the property so received is transferable by the recipient or not subject to a substantial risk of forfeiture, whichever occurs earlier.69 The amount of income recognized from such a transaction is the excess of the fair market value of the property received over the amount paid by the recipient for such property.70 Correspondingly, the trans-

69. I.R.C. § 83(a) (2006). Whether a substantial risk of forfeiture exists is a factual question based on all the facts and circumstances. Subjecting the property to continued employment is expressly deemed a substantial risk of forfeiture. See Treas. Reg. § 1.83-3(c)(1) (1985). Other circumstances evidencing a substantial risk of forfeiture include performance targets and certain covenants not to compete. However, the fact that the grantee of the property must pay consideration does not create a substantial risk of forfeiture. See generally Treas. Reg. § 1.83-3(c)(2) (1985). The fact that an employee is subject to the “short-swing” profit rule of § 16(b) of the Securities Exchange Act of 1934 will cause the property to be deemed to be subject to a substantial risk of forfeiture. Treas. Reg. § 1.83-3(j)(1) (1985).
70. I.R.C. § 83(a)(1)-(2) (2006). The fair market value of the property received is determined at the
Consequently, a grant of employer stock that is immediately vested with the employee results in income, at the time of receipt, equal to the fair market value of the stock received. Compensatory stock grants are not, therefore, an inherent form of deferred compensation. At-the-money or out-of-the money compensatory stock options are an inherent form of deferred compensation due to the Treasury’s interpretation of the application of § 83 to such instruments.

71. I.R.C. § 83(h) (2006). If appreciated or depreciated property is transferred to compensate for services received then the transferor will recognize a gain or loss on the transfer as if the property were sold for its fair market value. Because a corporation recognizes no gain or loss on the transfer of its stock, or options thereon, this issue does not present itself in this context. See id. § 1032(a).

72. Any amount paid by the employee for the shares would, of course, reduce the amount of compensation. Employer stock is a capital asset and any gain or loss from the sale or exchange of such stock is capital in nature. See generally id. § 1221(a). Capital assets are subject to favorable tax rates upon their sale or exchange at a gain provided that such assets are held for the statutorily required holding period so as to qualify the income as long-term capital gains. See id. § 1222. However, the deductibility of capital losses is limited, in the case of individual taxpayers, to the amount of capital gains plus $3,000. Unused capital losses are carried over to subsequent tax years. Id. §§ 1211(b), 1212(b).

73. The American Jobs Creation Act of 2004, Pub. L. No. 108-357, § 885(a), 118 Stat. 1418, 1634-41 (2004), added § 409A to the Internal Revenue Code to curb deferred compensation practices that were perceived as abusive. The statute imposes certain operational and design requirements on deferred compensation plans within its scope. The statute has a broad reach encompassing any plan, other than those specifically exempted, that provides for the deferral of compensation. See I.R.C. § 409A(d)(1)-2 (2006). Section 409A(a)(1) requires that all compensation deferred under the plan for the taxable year and all preceding taxable years be included in gross income during the taxable year in which the deferred compensation plan fails to meet the requirements specified in the statute. Id. § 409A(d)(5). Moreover, interest is imposed on the amount of compensation included in gross income pursuant to this provision in addition to a 20 percent penalty on the amount so included. Id. § 409A(a)(1)(B)(i). However, the regulations provide a broad exemption for certain equity based compensation arrangements. The receipt of stock subject to a substantial risk of forfeiture is generally not considered to result in a deferral of compensation for purposes of § 409A. See Treas. Reg. § 1.409A-1(b)(6) (2007). Moreover, Treas. Reg. § 1.409A-1(b)(5)(i)(A) exempts, from the application of § 409A, options to purchase service recipient stock subject to taxation under I.R.C. § 83 provided that the number of shares subject to the option is fixed at the time of grant, the exercise price of the stock is not less than the fair market value of the stock on such date, and that no deferral feature, other than the deferral of income until exercise, is provided. In effect, provided that the option, at the date of grant, is not in the money and no deferral feature is provided, it will be exempt from § 409A. Similar rules are applicable to stock appreciation rights. See Treas. Reg. § 1.409A-1(b)(5)(i)(B) (2007). A detailed analysis of I.R.C. § 409A is beyond the scope of this work.

74. The application of I.R.C. § 83 is postponed until the time that the option is exercised or is otherwise disposed of provided that, at the time the option is granted, it has no readily ascertainable fair market value. Treas. Reg. § 1.83-7(a) (1978). The regulations make clear that the incidence of taxation is postponed until the date of exercise even though the option’s value is readily ascertainable prior to exercise but after the date of grant. The regulations further provide that an option has an ascertainable fair market value if it is actively traded on an established market. Treas. Reg. § 1.83-7(b)(1) (1978). In the absence of active trading, an option has a readily ascertainable value only if it is transferable by the option holder, is immediately exercisable, and the underlying property that is the subject of the option is not subject to any restriction that has a significant effect on such property’s value. Treas. Reg. § 1.83-7(b)(2)(i).
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If, however, the stock is subject to a substantial risk of forfeiture then income recognition is postponed until such time that the risk of forfeiture lapses.75 A substantial risk of forfeiture may be present either as a result of performance targets that must be met or by the presence of a continuing employment requirement.76 Performance-based restrictions are typical for executives whose compensation is subject to the $1 million deduction limitation.77 For other employees, a continuing employment restriction may be the extent of the forfeiture risk. Therefore, an employee who has received a grant of 10,000 shares of stock subject to a four year vesting schedule, pursuant to which twenty-five percent of the stock vests on each of the first four anniversary dates of the grant date, would recognize income in each of the succeeding four years equal to the fair market value, determined at the time of vesting, of 2,500 shares of employer stock.

B. Section 83(b) Election

The postponement of taxation until the lapse of vesting restrictions could expose the employee to a very large tax liability if the stock’s value increases significantly between the time that the property is received and the time that such property is no longer subject to a substantial risk of forfeiture.78 Moreover, in order to pay the tax, the employee may be forced to sell the stock thereby diminishing the incentive alignment that motivated the stock’s issuance. The governing statute provides the property recipient with an alternative to the general rule.79 I.R.C. § 83(b) offers the property recipient an election to accelerate the incidence of taxation to the time that the property is transferred.80

75. See supra note 69 and accompanying text.
76. See Treas. Reg. § 1.83-3(c) (2005). Proposed regulations were issued recently that would, if and when finalized, would limit the circumstances under which a substantial risk of forfeiture exists. The proposed regulations provide that transfer restrictions, subject to certain exceptions, would not create a substantial risk of forfeiture. For example, lock-up restrictions or restrictions related to insider trading would not constitute a substantial risk of forfeiture. See Prop. Treas. Reg. § 1.83-3, 77 Fed. Reg. 31783 (May 30, 2012).
77. See supra notes 42-47 and accompanying text for a discussion of the $1,000,000 deduction limitation and the exception to such limitation for performance-based compensation. A grant of stock that is awarded without regard to some performance-based measurement will not qualify for the exception. See Treas. Reg. § 1.162-27(c)(2)(v)(A) (1995). Stock options, on the other hand, are deemed performance-based provided that they are not in-the-money when granted. See supra note 47 and accompanying text.
78. See supra notes 69, 75 and accompanying text.
80. Id. § 83(b). Section 83 applies to any property transferred in connection with the performance of services regardless of whether the service provider has paid fair market value for the property. See Alves, 734 F.2d at 479. Therefore, in the absence of an I.R.C. § 83(b) election, appreciation in the stock
Subsequent appreciation would be taxable at capital gain tax rates, if, and when, the taxpayer disposes of the stock. This election also accelerates the employer’s compensation deduction.\textsuperscript{81}

The election is not risk-free for several reasons. First, in a declining market the stock recipient will have recognized an amount of compensation income based on the value of the stock at the date of grant. Any subsequent decline in the value of the stock will generate a capital loss upon disposition of the stock.\textsuperscript{82} Second, no loss is recognized upon the forfeiture of the shares due to the employee’s failure to meet the vesting requirements.\textsuperscript{83} Finally, if the grant is subject to clawback, the employee may be confronted with an extremely unpalatable tax situation if all or part of the grant is subsequently clawed back.

Clawbacks of compensation may be triggered by statutory rules, common law principles, or contractual requirements.\textsuperscript{84} In their most basic form, compensation clawbacks are triggered if the performance metrics upon which the compensation was based turn out to have been misstated.\textsuperscript{85} Section 304 of the Sarbanes-Oxley Act provides for the clawback of compensation in limited circumstances. Section 304 is applicable only to chief executive and chief financial officers of publicly traded entities and only if the company is required to restate its financial results as a result of material noncompliance with any financial reporting requirement under the federal securities laws.\textsuperscript{86} Moreover, the material misstatement must have occurred as a result of misconduct – a term left undefined by the statute.\textsuperscript{87} The courts have held that there is no im-

\begin{itemize}
\item 81. I.R.C. § 83(h) (2006).
\item 82. The election is irrevocable, except with the permission of the Commissioner. \textit{Id.} § 83(b)(2) (2006); Treas. Reg. § 1.83-2(f) (1978).
\item 85. Financial restatements are particularly common among companies that have recently gone public. One study has concluded that almost 31 percent of such companies have restated their financial results since 2004. \textit{See} Emily Chasan, \textit{The Big Number}, 563, WALL ST. J., Mar. 27, 2012, at B5 (reporting on the findings of consulting firm Lord & Benoit).
\item 87. Sarbanes-Oxley Act of 2002, \textit{supra} note 86, at § 304(a). The statutory language also fails to make clear whether this provision is triggered by the misconduct of any person or whether such misconduct must be perpetrated by the chief executive or chief financial officer. A federal district court, however, held that the Securities and Exchange Commission could impose § 304 against the former
\end{itemize}
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plied private right of action under section 304 and its impact to date has been relatively modest.88 However, the enactment of Sarbanes-Oxley did bring public awareness to the lack of willingness on the part of corporate boards to insist on the disgorgement of bonuses and other incentive compensation that, in hindsight, had not been earned. The Emergency Economic Stabilization Act of 2008 contained restrictions on executive compensation applicable to financial institutions that sold troubled assets to the U.S. Department of the Treasury pursuant to its provisions and requires that compensation arrangements for senior executive officers provide for the recovery of any bonuses or incentive compensation paid that were based on earnings, gains, or other criteria that are later proven to be materially inaccurate.89 Most recently, the Dodd-Frank Wall Street Reform and Consumer Protection Act requires that the national securities exchanges and associations institute a listing standard that requires a three-year clawback provision for executive officers’ compensation.90

Long-standing legal and equitable principles in state law support the clawback of compensation. Active participation by executives in the material misstatement of financial or other information presented to the board of direc-


89. Emergency Economic Stabilization Act of 2008, Pub. L. No. 110-343, § 111(b)(2)(B), 122 Stat. 3765, 3777 (2008). A senior executive officer is defined as one of the top five highly paid officers whose compensation is required to be disclosed pursuant to the Securities Exchange Act of 1934 and non-public company counterparts. Id. at (b)(3). The legislation also amended I.R.C. § 162(m) to limit the tax deduction for compensation to covered executives to $ 500,000. Id. at § 302(a). Unlike § 304 of the Sarbanes-Oxley Act, this clawback requirement is intended to be enforced by the affected companies, does not require that the restatement be due to misconduct, is applicable to non-public institutions, and is triggered by restatements of any performance metrics. Moreover, the legislation does not require the clawback of gains realized from the sale of securities. Id. at § 111(b)(1)). Section 111(b)(1) requires that “financial institutions meet appropriate standards of executive compensation . . . .” This language appears to require that the financial institution itself institute the clawback provisions and, therefore, such clawbacks should be enforceable by the institutions themselves. The American Recovery and Reinvestment Act of 2009 expanded the clawback provisions to include retention bonuses and made those provisions applicable to, in addition to senior executive officers, the next twenty most highly-compensated employees. American Recovery and Reinvestment Act of 2009, Pub. L. No. 111-5, § 7091, 123 Stat. 115, 517 (2009). These provisions are to remain in effect for as long as the Treasury holds a meaningful equity or debt position in the company. Emergency Economic Stabilization Act of 2008, at § 111(b)(1).

tors or shareholders constitutes a breach of the duties of candor, good faith, and loyalty necessitates the clawback. Contractual clawback provisions, typically used as part of non-compete and non-disclosure agreements, have withstood most legal challenges. Clawback provisions have become a more prominent feature in executive compensation arrangements. A recent study indicated that eighty-four percent of Fortune 100 companies have instituted some form of clawback provision.

The annual accounting concept precludes the individual target of a clawback from amending her tax return for the year in which the compensation was reported. Instead, a deduction is available in the year that such compensation is repaid. However, in many or most cases, the tax benefit that results from the deduction will not yield the benefit that would have been obtained had the compensation income been reduced in the year it was reported.

I.R.C. § 1341 provides relief for such unequal tax treatment in limited circumstances. Enacted in 1954 in an effort to mitigate the potential inequities that may arise from the strict adherence to the annual accounting principle, §


93. John Bussey, An Employee Messes Up. Time to Unleash the Claw?, WALL ST. J., May 25, 2012, at B1 (referring to a study conducted by Equilar, Inc.). This represents a substantial increase from Equilar’s finding that that 42.1 percent of the Fortune 100 companies had instituted clawback policies in 2006. See GIBSON, DUNN & CRUTCHER, LLP, CLAWBACKS OF EXECUTIVE COMPENSATION (July 9, 2008), available at http://www.gibsondunn.com/Publications/Pages/ClawbacksOfExecutiveCompensation.aspx. Shareholders have become increasingly assertive in proposing that clawback policies be adopted or strengthened. Recently, as a result of pressure exerted from a large institutional shareholder, Morgan Stanley and Goldman Sachs extended clawback provisions to cover a broader range of employees. See Liz Moyer, On ‘Bleak’ Street, Bosses in Cross Hairs, WALL ST. J., Feb. 8, 2012, at C1. See also Deborah Ball, A First for UBS: Bonus Clawbacks, WALL ST. J., Feb. 9, 2012, at C3 (reporting that the Swiss bank, following a significant trading scandal, decided to clawback 50 percent of share-based bonuses). The recent trading debacle at J.P. Morgan, resulting in over $2 billion of losses to the bank, may result in compensation clawbacks for the individuals deemed responsible for the losses. See Monica Langley & Dan Fitzpatrick, Claw is Out for ‘Whale’ Officials, WALL ST. J., July 11, 2012, at C1; Suzanne Kapner & Aaron Lucchetti, Pay Clawbacks Raise Knotty Issues, WALL ST. J., May 17, 2012, at C1.

94. U.S. income taxes are determined on the basis of an annual accounting period. I.R.C. § 441(a) (2006). As noted by the Supreme Court in Burnet v. Sanford & Brooks Co., 282 U.S. 359 (1931), the annual accounting concept is an artifice borne out of administrative convenience. According to the Court “[t]he Sixteenth Amendment was adopted to enable the government to raise revenue by taxation. It is the essence of any system of taxation that it should produce revenue ascertainable, and payable to the government, at regular intervals.” Id. at 364-65. Due to the numerous idiosyncrasies of the Internal Revenue Code, the segmentation of a taxpayer’s tax obligations into annual compartments virtually assures that two taxpayers with identical incomes over an extended period of time will incur different tax obligations.

95. In addition to the possibility that the tax rates to which the taxpayer is subject may change between the year of income recognition and the year of the reported deduction, the tax code places a number of restrictions on deductions. For example, an individual’s deduction for repaid compensation would be classified as a miscellaneous itemized deduction, deductible only to the extent that such deductions exceed two percent of adjusted gross income. I.R.C. § 67(a) (2006). Moreover, miscellaneous itemized deductions may not provide much, if any, benefit if the taxpayer is subject to the alternative minimum tax. See generally id. §§ 55-59.
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1341 provides that the tax benefit resulting from the deduction for the return of previously taxed income will at least equal the reduction in tax that would have resulted had the income reported in a previous year or years been excluded from income. Section 1341 imposes three requirements. First, an item must have been included in gross income for a prior taxable year because it appeared that the taxpayer had an unrestricted right to such income. Second, a deduction must be allowable in the taxable year because it was established, after the close of the prior taxable year, that the taxpayer did not in fact have an unrestricted right to all or a portion of the income. Finally, the deduction must exceed $3,000.

The requirement that the taxpayer have had an apparent unrestricted right to the income in the year of receipt precludes the applicability of § 1341 to deductions arising from the repayment of funds to which the taxpayer had no right, apparent or otherwise - for example, embezzled funds or monies received as a result of arithmetic errors in billing. At the other end of spectrum, § 1341 is unavailable for deductions attributable to restorations of income for which the taxpayer had an actual, as opposed to an apparent, right. If the obligation to restore income arises from a subsequent transaction, then the taxpayer’s right to income may be deemed to have been absolute at the time of its receipt.

In the absence of a § 83(b) election, the clawback of compensation pri-
or to the lapse of vesting requirements will result in no tax consequences to the employee because no income would have yet been reported and, concomitantly, no deduction will be taken. The clawback of compensation that was reported as income at the time that the vesting restrictions lapsed will, in most cases, allow for the application of § 1341. However, the tax consequences of a clawback could prove draconian for the taxpayer for whom a § 83(b) election is in effect. If the clawback occurred prior to the lapse of the forfeiture restriction that the taxpayer elected to ignore, then no loss is available and the application of § 1341 is a moot point. If the clawback occurred after the property in question vested, then the no-loss rule of § 83(b) will not apply. Unfortunately for the taxpayer, neither will § 1341 apply because the employee had no apparent right to the income in the year of the election. A § 83(b) election causes the employee to recognize income in the face of a substantial risk of forfeiture. At the time of the election the employee is fully aware of such risk and, therefore, cannot claim that such income was received under an apparent claim of right. Consequently, a § 83(b) election places the recipient of a compensatory stock grant at risk of failing to meet the vesting requirements and obtaining no tax benefit as a result and, should the compensation be clawed back after vesting, the possibility of a meager tax benefit due to the inapplicability of § 1341.

C. Desirability of the § 83(b) Election – An Analysis

Ignoring for the moment the no-loss rule of § 83(b) and the possibility of a clawback, the decision to elect or not elect the application of § 83(b) is very similar to the decision to defer or not defer cash compensation. The

102. The applicability of I.R.C. § 1341 in such circumstances is not, however, a foregone conclusion. Repayments pursuant to retroactive clawback provisions whose reach extend to periods antedating the agreement may not be eligible for I.R.C. § 1341 treatment—at least with respect to compensation earned prior to the execution of the agreement. See Blanton v. Comm’r, 46 T.C. 527 (1966). If a clawback is triggered by a restatement of earnings and the taxpayer had a hand in fraudulently reporting the earnings then, arguably, the taxpayer had no right, apparent or otherwise, to the income. Difficult questions are also posed by clawback provisions that are triggered with the benefit of hindsight but that do not result in restatements. For example, if income must be restored because of subsequent losses or because it is found that the taxpayer took undue risk, then it is unclear whether I.R.C. § 1341 should apply. It is arguable that, at the time the compensation was received, the taxpayer had more than an apparent right to the income and that the triggering of the clawback was precipitated by subsequent events.

103. See supra note 83 and accompanying text. Section 1341 does not create independent grounds for deducting an expense or loss. Although the statutory language is relatively clear, the regulations unambiguously lead to this conclusion. Section 1341 will apply only “[i]f, during the taxable year, the taxpayer is entitled under other provisions of Chapter 1 of the Internal Revenue Code to a deduction of more than $3,000 . . . .” Treas. Reg. § 1.1341-1(a)(1) (1996) (emphasis added). The Supreme Court has similarly interpreted I.R.C. § 1341. See United States v. Skelley Oil Co., 394 U.S. 678, 683 (1969).

104. In such situations two risks of forfeiture are present. The first risk is that the performance metrics are not met. This clearly is deemed a substantial risk of forfeiture under the regulations. The second risk is that, after vesting, the clawback provision is triggered by some event, such as a restatement of the metrics. This risk does not appear to constitute a substantial risk of forfeiture under the regulations. See generally Treas. Reg. § 1.83(c) (2005).
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83(b) election will accelerate both the recognition of the employee’s income and the employer’s compensation deduction. Section 83(b) is an unusual elective provision because it is exclusively provided to the employee although the election directly affects a third party’s tax consequences.105 Employers and employees may contract away the employee’s discretion by requiring or prohibiting the election or, alternatively, structuring the equity-based compensation so as to preclude the applicability of § 83 entirely.106

1. Employer’s Perspective

In general, from an employer’s perspective, whether an immediate or a deferred deduction for compensation is preferable depends principally on two factors – the employer’s current and expected marginal tax rates and the after-tax rates of return on employer capital and the deferred compensation liability. If marginal tax rates are expected to rise then deferral, all things being equal, will prove beneficial and vice versa. If the employer has promised a ten percent rate of return to the employee on the deferred compensation then deferred compensation is preferable if, all things being equal, the employer expects to earn a greater rate of return from the investment of the compensation it otherwise would have had to pay the employee. Conversely, if the investment of the funds that would have been expended as compensation yields less that the promised return to the employee, deferral is not economical.107

The question of whether current or deferred recognition of deductions from restricted stock issuances is preferable requires a similar but not identical analysis. Unlike traditional deferred compensation arrangements, the issuance of restricted stock implicates no cash outlay. The stock is issued whether or not the § 83(b) is made. The only effect on the employer’s cash position is the tax savings generated by the deduction. Moreover, unlike standard deferred compensation plans, the rate of return that accrues on the deferred compensation is uncertain for it is solely a function of the stock’s performance. Therefore, the variables that determine whether or not a current or postponed deduction is desirable are the current and expected marginal tax rates and the after-tax rates of return that could be earned on the tax savings in comparison to the rate of re-

105. See supra note 81 and accompanying text.
106. See infra note 265 and accompanying text.
107. For example, assume the choice presented is whether to pay $100,000 in a cash bonus or defer the bonus for three years with an 8 percent rate of return and the current and expected future corporate tax rate is 30 percent. The immediate payment of the compensation would cost the employer $70,000 after-tax ($100,000 * (1-.30)). Deferred compensation would result, three years hence, in a compensation payment of $125,971 ($100,000 * 1.08^3) and an after-tax cost to the corporation of $88,180 ($125,971 * (1-.30)). Assuming the corporation earned 8 percent after-tax on the cash savings that resulted from the decision to defer the compensation, the corporation will be indifferent between the choice of whether to defer or not defer compensation. At an 8 percent after-tax rate of return, the $70,000 in cash generated from the deferral of the compensation would grow to $88,180 ($70,000 * 1.08^3). If the corporation believes it can deploy its capital to achieve a greater rate of return or it expects its marginal tax rate to increase in three years then deferral would be warranted.
turn earned on the stock. 108

Professor Michael Knoll has shown that, in a stable tax rate environment, the corporation can assure its indifference to whether or not a § 83(b) is made by simply deploying the cash savings generated from a § 83(b) election to repurchase its shares. If it does so, its after-tax cash position will be unchanged regardless of whether the stock increases or decreases in value during the vesting period and regardless of the magnitude of such increases or decreases. 109

However, circumstances may vary from theoretical niceties. Corporations may anticipate changes to their marginal tax rates. Moreover, a § 83(b) election disadvantages corporations with respect to dividends on restricted stock. In the absence of the election, dividends on unvested stock are deemed compensation and, therefore, deductible by the corporation. 110 In the event that the election is made those dividends are treated as just that, dividends, and, consequently, non-deductible by the corporation. 111 Privately-held corporations may not have the ability to repurchase their shares. An additional consideration is the incentive effect of the election to the employee. 112 These variables may explain why many corporations are not indifferent to whether an employee makes the § 83(b) election as evidenced by contractual requirements or restrictions regarding the § 83(b) election. 113 In any event, the investment of the

108. For example, assume $100,000 in restricted stock is issued and the stock is subject to a three-year cliff-vesting schedule pursuant to which the entire grant vests at the end of the third year. If a § 83(b) election is made then the corporation’s cash position, due to the immediate deduction, will increase by $30,000 ($100,000 * .30). Assuming a constant marginal tax rate, whether the corporation prefers to defer the deduction will depend on whether the after-tax rate of return it earns on these funds exceeds the rate of growth in the stock it granted. If the corporation earns 8 percent after-tax and the stock increases at a similar rate, then the corporation will be indifferent to whether or not a § 83(b) election is in effect. The $30,000 will grow to $37,791 in three years ($30,000 * 1.08^3). In the absence of a § 83(b) election, the corporation would obtain a deduction at the end of the third year of $125,971 yielding a cash benefit of $37,791 ($125,971 * .30).


110. Treas. Reg. § 1.83-1(f), Example 1 (2003). The corollary to this result is that the employee is disadvantaged with respect to dividends on unvested stock not subject to a § 83(b) election. See supra note 48.

111. See Rev. Rul. 83-22, 1983-1 C.B. 17; Rev. Proc. 83-38, 1983-22 I.R.B. 21. Note that, effective on January 1, 2013, dividends received by taxpayers whose adjusted gross income exceeds $250,000 or $200,000 for joint and single filers, respectively, will be subject to a 3.8 percent hospital insurance tax. I.R.C. § 1411 (2006). Also effective on January 1, 2013 is a .9 percent hospital insurance payroll tax on wages in excess of $250,000 or $200,000 for joint and single filers, respectively. Id. § 3101(b). The latter provision was enacted as part of the Patient Protection and Affordable Care Act of 2010, Pub. L. No. 111-148, 124 Stat. 119 (2010), whose constitutionality was recently upheld by the Supreme Court in National Federation of Independent Business v. Sebelius, Nos. 11-393, 11-398, 11-400, 2012 U.S. LEXIS 4876 (June 28, 2012). Consequently, for taxpayers whose income meets the statutory threshold, a § 83(b) election will subject dividends to an additional 3.8 percent tax versus an additional .9 tax had no election been made.

112. See infra notes 123-25 and accompanying text.

113. See, e.g., Jennifer L. Blouin & Mary Ellen Carter, The Economics of Restricted Stock and the
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proceeds resulting from the tax savings of a § 83(b) election in a corporation’s own shares is a form of hedge. Similar to any share repurchase, whether it proves beneficial depends on whether the return on the stock exceeded the after-tax return that the corporation could have earned from alternative investments.114

2. Employee’s Perspective

From an employee’s perspective, the decision to defer income to later years generally is driven by liquidity needs and expectations about future tax rates.115 Another factor that should be considered by employees is whether any investment returns would be taxed as capital gains outside the deferred compensation plan, because such gains will be converted to ordinary income inside the plan.116 Assuming that no portfolio constraints are present within the deferred compensation vehicle, the rate of return earned by the deferred compensation assets will typically exceed the rate of return earned with after-tax dollars. This result can be assured merely by investing the deferred compensation in the same investment that would have been utilized outside the deferred compensation setting. The most common deferred compensation vehicles for individuals are 401(k) plans and Individual Retirement Accounts. The employee is presented with the choice of either deferring a portion of her compensation or foregoing such opportunity. If the employee can afford to defer income and expects no increases in her marginal tax rate, then the choice to defer is beneficial.117

An employee’s choice to either defer income from a grant of restricted stock or accelerate the income via a § 83(b) election is analogous to the choice


114. Corporations have not had a stellar record with respect to the timing of their share repurchases. See Maxwell Murphy, CFO Journal: Buying Shares, Buying Trouble, WALL ST. J., Oct. 12, 2011, at B1; Robert Cyran & Christopher Hughes, A Bad Record on Buybacks, N.Y. TIMES, Mar. 30, 2011, at B2.

115. Many deferred compensation vehicles offer incentives to induce employee participation, such as company matching funds on a portion of the employee’s contribution. These inducements skew the choice toward deferral.

116. See infra note 158 and accompanying text.

117. For example, assume an individual faces the choice of whether to defer $10,000 of her compensation by contributing to a 401(k) plan. The employee pays tax at a marginal rate of 30 percent and she could invest the money in the 401(k) plan in the same vehicle that she would use to invest the after-tax portion of her salary, which yields 8 percent pre-tax. If the employee foregoes the opportunity to defer income then she will retain $7,000 after-tax ($10,000 * .70), which, compounded at an after-tax rate of 5.6 percent (8 percent * .7) will grow to $9,192 in five years ($7,000 * 1.0565). An election to defer income would yield $10,285 (($10,000 * 1.085) * .7). The resultant difference is due entirely to the fact that the 8 percent yield compounds at its pre-tax amount within the deferred compensation vehicle, but outside the plan, compounds at its after-tax amount. With respect to nonqualified deferred compensation plans in a corporate setting, the benefits of deferral are not due to the difference between the employee’s pre and post-tax yields but to the difference between the employee’s after-tax rate of return and the corporation’s after-tax rate of return. See generally Hall & Liebman, supra note 40.
presented by traditional deferred compensation plans, with some important distinctions and additional considerations. Income deferral in this context is unusual because there is no change in the employee’s pre-tax cash position. The difference in the employee’s after-tax cash position results from the taxes on the compensation income. Moreover, investment returns on the restricted stock are capital in nature if no deferral is elected but ordinary compensation income if the income is deferred until vesting. Similarly, dividends will be favorably taxed if the election is made but treated as compensation in the absence of an election. Finally, an election to accelerate the income exposes the employee to the no-loss rule in the event that the stock is forfeited prior to vesting and potentially draconian tax consequences if the stock is subject to clawback. Conventional wisdom is that a § 83(b) election is desirable if the stock yields generous returns between the date of grant and the date of vesting because the election converts those returns from compensation income to favorably taxed capital gains. However, this is too simplistic an approach.

In general, the principal determinant of whether a § 83(b) election is desirable is the difference between the rates of return on the funds that are used to pay the tax resulting from the election and the rate of return on the stock. If the employee will liquidate low-yielding investments to pay the tax or can borrow cheaply to pay the tax, then the election is generally warranted because deferral of income under such circumstances is not beneficial. For example, assume that an employee receives a grant of $100,000 of restricted stock subject to three year cliff-vesting. If the employee demurs on the § 83(b) election then no tax is due at the date of grant. Assuming a thirty percent marginal tax rate and ten percent growth in the value of the stock per annum, at the end of three years the stock will be worth $133,100 ($100,000*1.10^3) and a tax of $39,930 will be owed ($133,100 * .30). If the stock is sold at that time no further tax is due. If the § 83(b) election is made then the employee will still own $100,000 of stock that will grow to a value of $133,100 in three years. Assuming the stock is sold at the end of three years and assuming a fifteen percent capital gains tax rate, a capital gains tax of $4,965 is owed ($33,100 * .15). Moreover, $30,000 of taxes were owed at the grant date ($100,000 * .30). The rate of return on this foregone $30,000 is critical to the decision to defer. If the employee could have earned three percent after-tax on these funds then, at the end of three years, the employee will forego $32,781 ($30,000 * 1.03^3). In this case acceleration of income makes sense due to the low rate of return on the funds used to pay the tax. The combination of the opportunity cost on the funds used to pay the tax and the capital gains tax due upon the sale of the stock

118. See supra notes 110-11 and accompanying text.
119. See supra notes 83-104 and accompanying text.
120. The same result will arise if the funds used to pay the tax were borrowed at a similarly low rate.
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($37,746) is less than the tax that would be due at vesting had no election been made ($39,930).

However, if the employee had to liquidate company stock that she already owned to pay the tax, then the § 83(b) is unwise. In that case, the $30,000 used to pay the tax at the grant date would have grown to $39,930 ($30,000*1.103). Assuming this stock were sold at the end of three years, a capital gains tax of $993 would have been owed ($9,930* .15). Thus, the opportunity cost of the § 83(b) election is $38,937 ($39,930 - $993). The sum of this figure and the capital gains tax of $4,965 resulting from the sale of the stock at vesting ($43,902) exceeds the tax cost that would be imposed at the time of vesting had no § 83(b) election been made ($39,930). Of course, the employee does not have to sell the stock at vesting in which case there would be no capital gains tax imposed at that time. However, unless the stock is held until death, the tax remains inchoate, albeit less burdensome due to the time value of money. In general, if the employee sells company stock to pay the tax imposed at the time grant, the § 83(b) is unwise if one assumes the stock will rise. This is because, in the absence of any sales at the time of vesting, the opportunity cost of selling existing shares to pay the tax due at the time of grant will exactly equal the tax that would have been imposed at the time of vesting — $39,930 in the above example. However, the election results in the employee having a lower tax basis in the vested stock on which, in the absence of holding the stock until death, an additional tax will be imposed upon the stock’s disposition.

In summary, the salient factors to consider regarding the § 83(b) election are the rates of return on the funds that would be used to pay the tax, the capital gains tax rate, the length of time that the capital gains may be postponed, whether dividends are paid during the vesting period, and predictions about future marginal tax rates. If one anticipates a rising stock price then the election is not desirable under circumstances in which tax rates are stable and the rate of return on the assets used to pay the tax due at grant approximate or exceed the rate of return on the stock itself. Despite whatever optimism an employee may have regarding his employer’s prospects, § 83(b) elections are

121. The opportunity cost of making the election would be greater if the sale of the company stock to pay the tax generated its own tax obligation. Although this tax would be owed upon the sale of the stock at some point, the § 83(b) election accelerates the obligation.

122. At death, the stock’s basis will be stepped-up to its fair market value. See I.R.C. § 1014(a)(1) (2006).

123. In the just-described example, the employee’s tax basis in the stock at the time of vesting would be $100,000 had she made the § 83(b) election. Her tax basis in the stock would be $133,100 in the absence of such election.

not made often in public company settings due to the factors just discussed. Moreover, the risks of making the election – the stock decreases in value, the stock is forfeited, or the stock is clawed back – further heightens the reluctance to pay a tax today that could be paid tomorrow.125

One benefit of the § 83(b) election is of more concern to the employer than to the employee. The election increases the employee’s sensitivity to stock price increases, which, from an incentive standpoint, should interest the employer. This heightened sensitivity is due to the fact that any increase in the stock price is subject to capital gains tax rates if the election is made, but such increase is subject to ordinary marginal tax rates in the absence of the election. In this example, the employee would retain eighty-five percent of the value of future stock price increases if the election were made but only seventy percent if the election were foregone.

3. Criticism of the § 83(b) Election: Analogies to Options and “Carried Interests”

There is, however, one situation in which the § 83(b) is always warranted – when the value of the stock grant is zero or virtually zero.126 This situation typically arises in a start-up company setting and is the genesis for much of the criticism directed at the § 83(b) election.127 Entrepreneurs, often unable to self-finance or obtain traditional debt financing, seek funding from private equity or venture capital investors. The investors commonly exchange financing for convertible preferred stock and the founders of the venture contribute assets, including know-how and other intellectual capital, in exchange for restricted stock subject to a time-based vesting schedule. The vesting restrictions placed on the stock are designed to function both as incentive and retention devices. These arrangements are often quite complex. In addition to limiting traditional management-shareholder agency costs, the vesting restrictions are crafted to address horizontal agency cost issues that arise from the often disparate interests of the investors, particularly if subsequent rounds of financing are contemplated.128

Because the preferred stock has liquidation and dividend preferences

125. A decreasing stock price will generate a capital loss in the hands of the employee if the § 83(b) election is made. Capital losses must offset capital gains and excess losses are available to offset a very limited amount of ordinary income. Unused capital losses are carried over to subsequent tax years. See I.R.C. §§ 1211(b), 1212(b)(1) (2006). See supra notes and accompanying text for a discussion of the no-loss rule upon forfeiture and the potential tax consequences of a claw back. See also supra note 111 for changes to the hospital insurance tax that will go in effect on January 1, 2013 that will provide a further disincentive to making the § 83(b) election.

126. The fact that the employee has paid full value for the stock at the time of grant does not eliminate the need to affirmatively elect § 83(b). See supra notes 83-104 and accompanying text.

127. See infra notes 129-31 and accompanying text.

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over the common stock, the value of the founders’ stock at the time of grant generally does not exceed the value of the capital that the founders had contributed to any significant degree, if at all, thereby resulting in either a very low or zero compensatory element at the time of grant. A § 83(b) election under these circumstances, critics assert, unjustifiably converts income from the founders’ labor to favorably taxed capital gains when the founders dispose of their stock.129 Thus, § 83(b) provides the founders with the ability to arbitrage the regulatory regime and achieve a result that would not have been achievable through other forms of compensation, including stock options.130 The tax advantage offered by the § 83(b) election also has been compared to the putatively unreasonable tax treatment of income earned from partnership “carried interests.”131

The incongruence between the taxation of restricted stock to a recipient who has made the § 83(b) election and the taxation of compensatory stock options is difficult to justify on normative grounds. After all, both instruments compensate the recipient on the basis of stock price movements. However, from a normative perspective, one could make a compelling case that this incongruence should not be rectified by elimination of the § 83(b) election but by disabuse of the illusion that compensatory stock options have no ascertainable fair market value when issued.132 Compensatory stock options are taxed differently not due to any principled distinction between these instruments and restricted stock but due to valuation issues. The fundamental question is how the regulatory arbitrage that exists due to the availability of the § 83(b) election for one instrument and not the other should be eliminated. Whether the taxation of stock grants should conform to the taxation of compensatory stock options or vice-versa depends on whether an accretion of wealth due to stock price increases represents income from labor – an issue addressed later in this work.133

The similarity between the taxation of restricted stock that is subject to a § 83(b) election and the taxation of “carried interests” is due to the fact that

130. See id. at 64, 74. Section 83(b) generally is inapplicable to compensatory stock options. See supra notes 46-47 and accompanying text. Regulatory arbitrage refers to the exploitation of the gap between the economic substance of a transaction and its legal or regulatory treatment. Opportunities for such arbitrage occur due to inconsistencies in the treatment of identical transactions by different regulatory authorities, inconsistencies in the treatment of economically equivalent transactions by the same regulatory authority, or inconsistencies between present and future regulation of a transaction. See Victor Fleischer, Regulatory Arbitrage, 89 TEX. L. REV. 227, 243-44 (2010).
132. Compensatory stock options are valued at the date of grant under generally accepted accounting principles. See infra note 163 and accompanying text. Moreover, the notion that these instruments are incapable of reasonable measurement is not credible after one considers the complex valuation issues that are routinely dealt with under the tax law – for example, estate and gift tax valuation issues, pension liabilities, and contingent installment sales.
133. See infra notes 146-241 and accompanying text.
both instruments ostensibly convert labor income to capital income. Because the taxation of “carried interests” to be grossly unfair by the public - as Mitt Romney has painfully discovered 134– the § 83(b) election suffers from guilt by association. A detailed discussion of the taxation of “carried interests” is beyond the scope of this work.135 Briefly, a “carried interest” is an interest in a partnership that, at the time of its creation, has no claim to the capital of the entity but is entitled to a specified percentage of future profits.136 These interests are held by active participants in the business of the entity. Accordingly, critics of the current tax treatment of such instruments believe that the income generated by such interests is income from labor and should be taxed accordingly.137 In many cases, this result is achieved and the tax treatment of these interests is not objectionable. For example, in service partnerships, such as law and accounting firms, the income that is allocated to the service partners is ordinary income. However, in hedge funds and other investment partnerships, the entities generate, for the most part, capital gain income. Thus, the service partner’s share of that income is taxed as capital gain.

The tax consequences that flow from the ownership of a “carried interest” are derived from the nature of the partnership relationship, which differs fundamentally from the nature of an employment relationship.138 Similar to

134. Mr. Romney attained much of his wealth through carried interests from his days at Bain Capital. Not only has his low effective tax rate caused controversy but the fact that much of his wealth is held in a deferred compensation arrangement has also proved controversial. See Mark Maremont, Romney’s Unorthodox IRA, WALL ST. J., Jan. 19, 2012, at A1.

135. For a comprehensive analysis of the structure and taxation of such interests see STAFF OF THE JOINT COMM’N. ON TAXATION, PRESENT LAW AND ANALYSIS RELATING TO TAX TREATMENT OF PARTNERSHIP CARRIED INTERESTS 37 (Comm. Print 2007) [hereinafter TAX TREATMENT OF CARRIED INTERESTS].

136. Limited liability companies are taxed as partnerships and, therefore, the same tax treatment is applicable to members of such entities. Limited liability companies may elect to be taxed as corporations under Treas. Reg. § 301.7701-3(a) (2006), the so-called “check the box” regulations.

137. Calls for reform have come from various quarters, including academics, the popular press, and Congress. See generally Victor Fleischer, Two and Twenty: Taxing Partnership Profits in Private Equity Funds, 83 N.Y.U. L. REV. 1 (2008); Postlewaite, supra note 131; Samuel D. Brunson, Taxing Investment Fund Managers Using a Simplified Mark-to-Market Approach, 45 WAKE FOREST L. REV. 79 (2010); Alan S. Blinder, Op-Ed., The Under-taxed Kings of Private Equity, N.Y. TIMES, July 29, 2007, § BU, at 4. H.R. 2834 was introduced in the House of Representatives in 2007 by Congressman Sander M. Levin (D-Mich.). The bill taxes any net income derived an interest in an investment services partnership as ordinary income earned from the performance of services. H.R. 2834, 110th Cong. § 1(a) (2007). Moreover, any gain on the disposition of such interest is treated similarly. Id. H.R. 2834 is a recharacterization provision. Technically, it does not treat the income earned from the carried interest as compensation in the true sense of such term. This is because it merely recharacterizes capital gain income instead of treating the income as direct compensation with a concomitant compensation deduction to the partnership. See H.R. 3970, 110th Cong. (2007); H.R. 6275, 110th Cong. (2008). A similar bill was introduced on February 14, 2012 by Congressmen Levin and Rangel. See Carried Interest Fairness Act of 2012, H.R. 4016, 112th Cong. § 3 (2012).

138. For federal income tax purposes a partnership is not a taxpaying entity. I.R.C. § 701 (2006). Instead, items of partnership income, gain, deductions, and losses are passed through to the partners. Id. § 702(a). The character of the partnership’s income tax items are retained at the partner level and any item that may have an effect on a partner’s income tax liability must be separately stated. See id. § 702(b).

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The taxation of compensatory stock options, the taxation of carried interests is predicated on valuation issues. However, where options are deemed to have an unascertainable fair market value, carried interests are valued based upon a hypothetical liquidation of the entity at the time of the receipt of the interest.\textsuperscript{139} Because these interests, at issuance, have no claim on capital, they are deemed to have a zero value when received.\textsuperscript{140} Unlike compensatory stock options, however, reform of the taxation of carried interests implicates much broader issues than valuation. Due to the nature and structure of Subchapter K of the Internal Revenue Code, reformation of the taxation of carried interests would require an examination of collateral issues such as the establishment of mechanisms both to avoid double taxation on the income recognized from the issuance of the interests and to provide a deduction to the capital-providing partners.\textsuperscript{141} Therefore, valuation issues are part, but not all, of the problems posed by the taxation of carried interests. Whether tax reformation of carried interest

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\item \textsuperscript{139} The taxation of a receipt of a profits interest in a partnership was fraught with uncertainty. It was unclear whether the refusal to tax such interests was categorical or based on valuation issues. The courts issued conflicting guidance and, although it was believed that such interests would not result in a taxable event, certitude was lacking. See Campbell v. Comm’r, 943 F.2d 815 (8th Cir. 1991) rev’g T.C.M. (CCH) 1990-236 (1990); Nat’l Oil Co. v. Comm’r, T.C.M. 1986-596 (1986); Diamond v. Comm’r, 56 T.C. 530 (1971), aff’d, 492 F.2d 286 (7th Cir. 1974). The Internal Revenue Service clarified the status of profits interests with the issuance of Rev. Proc. 93-27, 1993-24 I.R.B. 63, which provided that the receipt of a profits interest for services rendered would not be treated as a taxable event. The Internal Revenue Service subsequently clarified, in Rev. Proc. 2001-43, 2001-34 I.R.B. 191, that neither the grant of a substantially non-vested profits interest nor the event that causes the interest to become vested are to be treated as taxable events provided the transaction met the requirements of Rev. Proc. 93-27. Rev. Proc. 2001-43. Proposed regulations were issued in 2005 that subject partnership interests, both capital and profits interests, to section 83. Prop. Treas. Reg. § 1.83-3(e), 70 Fed. Reg. 29675, 29680 (May 24, 2005). Consequently, the categorical non-recognition treatment afforded compensatory profits interests pursuant to Rev. Proc. 93-27 would, if and when the proposed rules are finalized, no longer apply. The proposed regulations do, however, provide for an election that would allow the interest to be valued based on a hypothetical liquidation value. Prop. Treas. Reg. § 1.83-3(l)(1), 70 Fed. Reg. 29675; 29680-81 (May 24, 2005). The liquidation value of a partnership interest is determined by the amount of cash the holder of the interest would receive if the partnership, immediately after the interest is transferred, sold all of its assets for cash equal to their fair market value and liquidated. Consequently, a profits interest valued in this fashion will obtain a zero value. The recipient of a partnership interest that is subject to a substantial risk of forfeiture will be subject to tax in an amount equal to the fair market value of the interest at the time that the partner’s interest substantially vests and, concomitantly, the partnership may deduct a corresponding amount as a guaranteed payment. If the partnership has made the liquidation value election then the fair market value of partnership interest will be determined assuming a hypothetical liquidation of the partnership at the time the partner’s interest substantially vests. Alternatively, the recipient partner may elect, pursuant to § 83(b), to include the value of the partnership interest upon receipt despite the existence of a substantial risk of forfeiture. In such case, assuming the partnership has made the liquidation value election, the value of a profits interest would be valued at zero. The § 83(b) election will also result in the service provider obtaining the status of a partner at the time the interest is received. Prop. Treas. Reg. § 1.761-1(b), 70 Fed. Reg. 29675 (May 24, 2005).

\item \textsuperscript{140} For alternative methods of valuing carried interests see Peter R. Orszag, Dir. of the Cong. Budget Office, The Taxation of Carried Interests: Hearing Before the S. Comm. on Finance, Address Before the Senate Comm. on Fin. (Jul 11, 2007), available at http://www.cbo.gov/publication/200707/5195.pdf, see also The Treatment of Carried Interests, supra note 135, at 31-32.

\item \textsuperscript{141} See generally Matthew A. Melone, Success Breeds Discontent: Reforming the Taxation of Carried Interests – Forcing a Square Peg Into a Round Hole, 46 DUQ. L. REV. 421, 468-71 (2008).
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income is desirable depends on whether one believes that the income earned by such interests is derived from labor or capital.

In the majority of cases where the stock grant has value, the § 83(b) election is, an unappealing prospect for the employee. The value of the deferral of the tax otherwise due at the date of grant until the time of vesting will typically exceed the tax benefit of converting future appreciation from compensation income to capital gain. Moreover, the potentially draconian tax consequences that can result from a share forfeiture or clawback further diminish the prospects of making the election. From an employer’s perspective, the tax consequences of an employee’s decision to make or forego the § 83(b) election can be virtually neutralized simply by purchasing stock in an amount equal to the amount of stock granted as compensation. However, the § 83(b) election does heighten an employee’s sensitivity to post-grant stock movements since the election will allow the employee to retain a greater portion of the appreciation on an after-tax basis. To the extent that the equity grant was meant to incentivize an employee, this is desirable. However, under circumstances in which the stock is valueless at the time of grant – in start-up or fledgling companies, for example - the employee should always make the § 83(b) election because the opportunity cost of the election is zero. Of course, under such circumstances, the corporation will be denied any compensation deduction.

Whether, on a normative basis, the current tax scheme is justified depends on whether the wealth accruing to an employee due to future price appreciation in the employer’s stock is considered to have been earned from the employee’s labor or from her capital investment. If the accretion of wealth is derived from the former, then the § 83(b) election is unwarranted and results in undue advantages to those for whom the election is favorable. If the accretion of wealth is derived from the latter, then the § 83(b) election yields the proper result. In such cases, the failure to require immediate taxation is unwarranted and § 83(b) treatment should be mandated.

III. POST-GRANT APPRECIATION: THE FALLACY OF “EARNED INCOME”

The federal income tax treatment of accretions of wealth that inure to employees as a result of post-grant equity appreciation should reflect the source of that wealth. The tax law should disabuse itself of the notion that capital appreciation, because it occurred during such time that the capital holder was also an employee, is derived from labor. The inherent difficulties in determining whether labor or capital was responsible for the increase in wealth at issue are absent in this context for there is a transactional basis that enables la-

142. See supra notes 115-25 and accompanying text.
143. See supra notes 83-104 and accompanying text.
144. See supra note 109 and accompanying text.
145. See supra notes 123-25 and accompanying text.
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bor-capital distinctions to be drawn. Additionally, several rationales exist for the issuance of compensatory equity which either do not implicate the future performance of the employee or whose effects are reflected in the grant date value of the shares. The ostensible incentive alignment properties of such compensation arrangements also do not justify the classification of post-grant gains as compensation because share price is a very poor proxy for performance. Moreover, the grant date value of the shares should reflect the supposed incentive alignment properties of such compensation. Finally, these compensation schemes do not reduce agency costs. Instead, they create new forms of agency costs. These compensation arrangements are a manifestation of an exaggerated view of the impact that a few individuals have on corporate success and have led to the self-fulfilling notion that motivation can be had only at the price of equity. The tax treatment of equity gains as compensation for labor of the employee serves to reinforce the fallacy that has provided cover for these arrangements for the past several decades.

A. Labor-Capital Dichotomy: General Observations

The distinction between income earned from labor and income derived from capital is necessitated by the favorable treatment afforded to the latter by the Internal Revenue Code. Not all, but most, income derived from the sale or exchange of capital is taxed at favorable capital gain rates. Whether, as a matter of policy, the advantages that accrue to capital providers in comparison to labor providers is justified has been, and continues to be, subject to much debate, a synthesis of which is beyond the scope of this work. The fact is, for

146. The distinction between labor and capital is also relevant in other contexts, oftentimes to determine whether favorable tax rules applicable to service providers are applicable. For example, earned income of certain dependent children is taxed at the dependent’s tax rates while unearned income is taxed at the parent’s tax rates. See generally I.R.C. § 1(g) (2006). Losses from certain activities in which the taxpayer does not materially participate are limited. See generally id. § 469. Distinctions have been made between earned and unearned income since the early days of the income tax. See Lester B. Snyder, Taxation With an Attitude: Can We Rationalize the Distinction Between “Earned” and “Unearned” Income?, 18 VA. TAX REV. 241 (1998).

147. Favorable capital gains tax rates apply to gains derived from the sale or exchange of capital assets held for more than one year. See I.R.C. §§ 1(h), 1222 (2006). Income generated from capital, such as interest income or rents and royalties, are not taxed as capital gains. Dividends, however, are favorably taxed – although not quite as favorably after 2012. See supra note 48. Certain assets are defined residually as all assets except those assets that are categorized within enumerated exceptions. Assets not eligible for capital gain treatment include inventory, accounts receivables, supplies, and certain types of intellectual property held by a taxpayer whose personal efforts created such property. See generally I.R.C. § 1221(a) (2006). Capital gains generated from the sale or exchange of collectibles are taxed at a less favorable rate. See id. § 1(h)(4)-(5).

148. Various justifications for a capital gain tax preference have been put forth including the encouragement of entrepreneurial activity, the mitigation of the taxation of inflationary gains, and the reduction of the “lock-in” effect caused by the realization principle. See generally Noel B. Cunningham & Deborah H. Schenk, The Case for a Capital Gain Preference, 48 TAX L. REV. 319 (1993). Critics of the capital gain tax preference dispute the utility of the preference and assert that the preference has contributed to the growing income and wealth inequality in the United States. See Victor Fleischer, supra note 129, at 76-77.
good or ill, the tax law makes a clear distinction between income from labor and capital, favors the latter over the former, and necessitates the identification of the source of income. In many cases, such as income from salaries, interest, or the sale of mutual fund holdings, this distinction barely rates a thought.

However, in other cases a clean categorization of the income in question is difficult, if not nearly impossible. Oftentimes what appears to be income generated from capital appreciation is, in reality, income partly derived from labor. Conversely, what is generally considered labor income may also contain, in fact, a significant dose of capital appreciation. For example, the price appreciation realized from the sale of a parcel of real property may be attributable in part to the sweat equity of the owner who labored to make improvements to the property during her holding period. In contrast, the so-called labor income realized by a taxpayer from distributions from an Individual Retirement Account may represent, in reality, mostly the capital appreciation of the investments within the account.

The failure of the tax law to bifurcate income in those situations is principally attributable to two features of our tax system. First, the tax law does not impute income to taxpayers based on the value of the services they provide to themselves. Second, the price for tax deferral is often the recharacterization of erstwhile capital income into labor income. The first attribute is defensible on various grounds while the latter is difficult to square with any principle other than administrative convenience.

With very few exceptions, earnings are not subject to tax until they are realized on some transactional basis. Earnings potential and inchoate ability do not occasion the imposition of tax. Justification for the requirement of a realization event is generally rooted in libertarian grounds. Taxation of human potential would tend to force persons to engage in occupations for which the compensation is commensurate with their potential earning power. Such a system is generally rejected due to the loss of autonomy it would engender. 149 The choice to work or not work is subject to many factors, some idiosyncratic and some circumstantial, and the tax law provides an individual with some semblance of autonomy in making that choice. The choice to avoid taxation by foregoing earnings is, in large part, the extent of the autonomy provided by the tax system to individuals whose economic contributions are limited to the provision of their labor. 150 Moreover, measurement and liquidity issues would

149. One argument in favor of such a scheme is that it would cause the gravitation of the labor supply to more productive uses and, therefore, provide societal benefits. For a discussion of taxation of human potential see Lawrence Zelenak, Taxing Endowment, 55 DUKE L.J. 1145 (2006). Not all scholars believe that the taxation of human endowment is inappropriate. See Louis Kaplow, Human Capital Under an Ideal Income Tax, 80 VA. L. REV. 1477 (1994) (arguing that an ideal income tax system would tax the sum of consumption and change in net wealth during a measuring period and would define wealth to equal the present value of future earnings).

150. To a limited extent, labor providers may choose to defer a portion of their earnings through participation in qualified profit-sharing plans or Individual Retirement Accounts. See infra note 156 and
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impose severe difficulties in the administration of a system that taxed human potential.151 Determining how one measures human potential, when such measurements would take place, and how a taxpayer would obtain the funds to pay tax on such income are some of the difficult questions that would be put to such a system.152 In addition, taxing the “expectancy value” of a taxpayer would require a reevaluation of the present dichotomy between for-profit and personal expenditures and the non-deductibility of the latter.153

The failure to carve out the labor component embedded in the appreciation of self-improved property does not appear justified on libertarian grounds because the taxpayer has voluntarily taken on whatever task she deems worthwhile. However, administrative complexities and liquidity issues provide such justification. For example, assume a would-be Warren Buffett spends forty hours per week studying the stock market and making investment decisions based on the results of her studies. At present, all of the income derived from those efforts is deemed attributable to capital. To tax the income otherwise would require some method of determining and tracking the value of that person’s labor. This would entail answering questions such as: Is she good at her work or just lucky? How good is she - Goldman Sachs good or amateur good? How do we keep track of this information? When do we tax the labor – when the income is realized or as the labor is performed? The tax law reflects the belief that the difficulties that such a system would encounter provides ample justification for ignoring whatever labor component exists within the appreciation of a capital asset. Such a system no doubt favors – and provides an incentive to undertake – such labor.154

One modicum of autonomy provided to labor suppliers is the choice to defer income. Generally, the choice is limited to a modest portion of earned income.155 For example, an individual may contribute up to a statutorily deter-

accompanying text. Moreover, a modicum of autonomy is provided to labor providers by allowing them to choose to be compensated by the provision of certain tax-favored employee benefits such as medical insurance and certain educational assistance. See, e.g., I.R.C. §§ 106, 127 (2006). However, the autonomy provided to labor is insignificant in comparison to the choice offered to capital providers. See generally Alice G. Abreu, Taxes, Power, and Personal Autonomy, 33 SAN DIEGO L. REV. 1 (1996).


152. See, e.g., Postlewaite, supra note 131, at 831-34.

153. Educational expenses are deductible in certain circumstances. In general, educational expenses that maintain or improve skills that are required by an individual in his employment or trade or business or expenses that are incurred to meet express employer, legal, or regulatory requirements that are necessary for the maintenance of employment or compensation levels are deductible. However, expenses for education that is required to meet minimum educational requirements for a trade or business or employment are not deductible. See generally Treas. Reg. § 1.162-5(a)-(b) (1967).

154. For example, a person earning $50 per hour on a pre-tax basis would have to work, at a 33 percent tax rate, three hours to pay a $100 plumbers bill. If the same taxpayer did the work herself then she is, in essence, paying for the service with pre-tax dollars – her foregone income or the value of her leisure time is not taxed.

155. Highly compensated employees are often offered the opportunity to defer a more significant portion of their income in supplemental, non-qualified deferred compensation plans. However, these
mined maximum amount of her earned income to a defined contribution plan such as a 401(k) plan or an Individual Retirement Account.\textsuperscript{156} Income, to the extent of such contributions, is not taxable during the accounting period in which it was earned. Instead, it is taxed at the time that the contributions are withdrawn.\textsuperscript{157} However, all withdrawals are taxed as deferred income from labor with no distinction drawn between income earned from prior labor and income earned from capital appreciation.\textsuperscript{158} For example, assume a taxpayer contributed $5,000 for several years to a 401(k) plan in the late 1990s and had the good sense to invest all of those funds in Apple Inc. stock. Today, she has a tidy sum of wealth but, when withdrawn, it will be taxed as compensation income despite the fact that the compensatory element may be negligible in comparison to the capital appreciation in her stock investment.\textsuperscript{159} The just described example is very similar to the situation in which Mitt Romney and several of his former colleagues at Bain Capital find themselves.\textsuperscript{160}

The most notable exception to the general rule is the receipt of a distribution of employer stock from certain qualified plans. The recipient of a qualified stock distribution is not taxed on the appreciation of the employer securities at the time of the distribution.\textsuperscript{161} This result is ironic because, if the

\textsuperscript{156} Elective contributions to qualified defined contribution plans are limited to a statutorily determined amount, adjusted for cost of living increases. Taxpayers aged 50 or older can defer additional amounts. For 2012, the limitation is $17,000 and taxpayers 50 years old or older may contribute an additional $5,500. See I.R.C. §§ 402(g)(1)(A)-(C), 402(g)(4), 414(v) (2006); I.R.S. News Release IR-2011-103, (Oct. 20, 2011). Deductions for contributions to such plans are also limited to 25 percent of income. I.R.C. § 404(a)(3)(A) (2006). Contributions to Individual Retirement Accounts are limited to $5,000 per year with an additional $1,000 available for taxpayers aged 50 or older. See id. §§ 219(b), 408. Note that individuals may contribute, within statutory limits, to a Roth I.R.A. Contributions to these vehicles are not deductible but, if the statutory requirements are met, distributions from such accounts are not taxable. See id. § 408A. Deferred compensation provided through defined benefit plans do not raise any character of income issues because benefits payable under such plans are determined by formula and the investment risks and rewards inure entirely to the plan sponsor.

\textsuperscript{157} See id. §§ 72, 402(b)(2), 408(d).

\textsuperscript{158} Id.

\textsuperscript{159} To be fair, had she invested all her funds in Enron instead of Apple Corp., these rules would be to her favor because she would not be taxed at all on her deferred income due to the complete loss of her investment. Had she invested in Enron stock outside of the deferred compensation plan she would have been taxed on her income and her losses would be capital losses and subject to strict rules on their availability. See supra note 72.

\textsuperscript{160} Bain Capital structured several of their investments to permit employee participation through their Individual Retirement Accounts. The returns on the investments have been very good resulting in enormous balances in the accounts of the participants. See Mark Maremont, Bain Gave Staff Way to Swell IRAs by Investing in Deals, WALL ST. J., Mar. 29, 2012, at A1.

\textsuperscript{161} See I.R.C. § 402(c)(4) (2006). Employee Stock Ownership Plans (ESOPs) are a particular form of qualified defined contribution plan that hold employer stock on behalf of the participants in the plan. These plans are exempted from the limitations imposed by the Employee Retirement Income Security Act of 1974 on the holding of employer securities. The plans offer several benefits to the sponsoring employer, including the ability to deduct contributions of company stock and dividends paid thereon, the placement of shares in management-friendly hands, and the potential for tax deferral by sellers of stock to the plan. For an overview of these plans including their advantages and disadvantages see Sean M. Anderson, Risky Retirement Business: How ESOPs Harm the Workers They are Supposed to Help,
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assertion that equity ownership aligns employee incentives is true, appreciation in an employer’s stock should be more closely tied to labor efforts than other assets held in a deferred compensation plan. One would therefore least expect such an exception for this asset.

In essence, the price for tax deferral in these circumstances is the morphing of capital income into labor income. An argument can be made that the deferred compensation vehicle allows the income on the assets to compound at a pre-tax rate over lengthy time periods and that this advantage is justification for the current tax treatment of withdrawals. However, this often overstates the compensatory element inherent in the deferral, which is the risk-free rate of return on the deferred income. Returns in excess of this rate are from capital – be they interest, dividends, or capital appreciation. The uniform treatment of the entire deferred compensation asset pool may be supported on administrative grounds, for it avoids the recordkeeping costs of tracking returns from interest, dividends, and capital gains over what may be very long periods of time. However, this justification for exacting a similar price in the case of tax deferrals due to the application of § 83 is weak at best.

The bargain between the employee and employer with respect to restricted stock is established on the date of grant. Despite the fact that the shares are subject to time-based vesting restrictions, property has been transferred and a transactional basis exists for closing the transaction at this time. The Financial Accounting Standards Board has chosen to view the transaction in this way. Under generally accepted accounting principles, a grant of restricted shares is valued at the date of grant and such amount is charged to expense over the vesting period. Consequently, time-based or performance-based vesting restrictions do not, for accounting purposes, preclude a determination of the compensation amount at the time of grant. Instead, such restrictions


162. The amount of compensation deferred, compounded at the risk-free rate of return, should be taxed upon withdrawal as compensation. The risk-free rate of return is the consideration that is expected from the decision to defer income. Returns in excess of this rate represent returns that are required for relinquishing control of capital and for undertaking the risk of non-payment. See James R. Repetti, Democracy and Opportunity: A New Paradigm, 61 VAND. L. REV. 1129, 1179-80 (2008).

163. SHARE-BASED PAYMENT, supra note 55, at §§ 16, 39. Restrictions that stem from the forfeitability of the shares are ignored in determining the fair market value of the shares at the date of grant. Id. at § 18. Thus, shares that are issued subject to a time-based vesting restriction are valued without consideration of the vesting restriction. Moreover, certain contingent features, such as a clawback provision, are not considered at the time of grant. Instead, such contingencies are accounted for if, and when, they occur. Id. at § 27. Special rules are provided if, in addition to time-based restrictions, the award also contains performance-based restrictions. The existence of performance-based restrictions does not disturb the valuation of the shares at the date of grant. Instead, such restrictions may impact the time over which the grant is charged to expense. See id. §§ 40-49. Stock options are valued at the date of grant pursuant to one or more option pricing models. See id. Appendix A at §§ A13-A37. A bill was recently introduced by Senators Levin and Conrad that would limit a corporation’s tax deduction with respect to stock options to the amount deducted for financial statement purposes. See supra note 66.
merely affect the time over which such amount is charged to expense.\textsuperscript{164} Implicit in the accounting treatment of share-based compensation is the notion that post-grant changes in the market value of the stock are not compensatory in nature.

Myriad differences exist between generally accepted accounting principles and tax accounting principles that reflect the different purposes of the financial reporting and tax systems, the different political machinations to which each system is subjected, and the particular prudential considerations that inform the choices made under each system. Consequently, the treatment of a transaction under generally accepted accounting principles is not, and should not, be dispositive of the preferred method to account for a transaction for income tax purposes. However, a close examination of the nature of compensatory stock grants supports the position that the compensatory element should be fixed at the date of grant.

\textit{B. Non-Performance Based Rationales for Equity Compensation}

There are three rationales for compensating employees with restricted employer stock that have little to do with incentivizing employees’ future performance. Grants of such stock are awarded either as a reward for past performance, as a retention device, as a liquidity preservation device, or some combination thereof.

A grant of equity to an employee is, quite often, the proverbial carrot – a reward for a job well done. In many industries such as law, accounting, and other professional service businesses, admission into the “partnership” is based on the effort, quality of work, and personality traits that the employee has displayed. Because the aforementioned businesses generate income from services and are taxed, almost invariably, as partnerships, the issue of whether the equity stake should be valued at grant is mooted.\textsuperscript{165} Not until partnership interests began proliferating in investment partnerships that generated the bulk of their income from capital gains did the taxation of such arrangements – the “carried interests” - generate controversy.\textsuperscript{166}

Many corporate equity compensation arrangements base the number of shares granted on a metric or metrics of past performance. Corporations generally limit stock grants to employees that have attained a certain level within the

\textsuperscript{164} See \textit{SHARE-BASED PAYMENT}, \textit{supra} note 55, at §§ 39-42.

\textsuperscript{165} Many service entities operate in the form of limited liability companies. For federal income tax purposes, these entities are taxed as partnerships unless they elect to be taxed as corporations. See \textit{supra} note 136. The grant of a profits interest in a service partnership does raise questions regarding the timing of income but, because the partnership’s income is ordinary income, issues regarding the character of income are not implicated. The structure of Subchapter K of the Internal Revenue Code presents difficulties with respect to the acceleration of the recognition of income to the time that such interests are granted. See Melone, \textit{supra} note 141, at 446-52. See also \textit{supra} note 141 and accompanying text.

\textsuperscript{166} See Melone, \textit{supra} notes 134-38 and accompanying text.
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management structure of the corporation. The attainment of this threshold level is analogous to “making partner” and is predicated on what the employee has done to date. Predictions about future performance are most heavily influenced by past performance, but the fact remains that the grant of equity, in such circumstances, was based, to a large extent, on the employee’s past performance. The exclusion of time-based restrictions from the performance-based compensation exception provided in I.R.C. § 162(m) lends support to this view of time-based restricted stock awards.\(^{167}\)

However, the imposition of time-based vesting restrictions in such circumstances belies the fact that the grant of stock was wholly motivated by rewarding past performance. Otherwise there would be no need for a time-based restriction. A significant motivation for time-based restrictions is their utility as an employee retention device. The prospect of a significant share forfeiture has a remarkable ability to convince an employee that the grass is greener where she currently stands. Such restrictions operate as a form of a covenant not to compete without the attendant baggage carried by such agreements.\(^{168}\) But the employee retention properties of such vesting restrictions do not support the assertion that future stock price appreciation is compensatory in nature.

The retention value inherent in a time-based vesting restriction is determinable simply by taking notice of the discount to market of restricted shares. The value of restricted shares is necessarily lower than the value of unrestricted shares due to the presence of the time-based restriction. The discount attributable to time-based restrictions does not find its way into the valuation of the shares at the time of grant because § 83 ignores restrictions that will lapse.\(^{169}\) Consequently, the value of the shares at the time of grant reflects any retention value inherent in the granted shares.

For example, assume that an employee is granted 1000 shares of stock with a market value at the date of grant, determined by public trading, of $20,000. Assume further that the shares will cliff-vest in three years and that the shares, subject to the three year vesting restriction, are valued at $15,000. Section 83 ignores the $5,000 discount because it is a restriction that will lapse. Accordingly, the full value of the shares is subject to tax if the employee elects, pursuant to § 83(b), to close the transaction at the grant date. The full effect of any retention valuation is thereby captured without the need to appraise this feature separately. Future appreciation in the shares does not reflect the reten-

\(^{167}\) See Melone, supra note 45 and accompanying text.

\(^{168}\) Covens not to compete commonly foster varying degrees of resentment because, by their very nature, they reduce an employee’s autonomy. In contrast, time-based vesting restrictions—euphemistically referred to as “golden handcuffs”—are often viewed as benign despite the fact that they also serve to reduce an employee’s autonomy. Also, a prospective employer can overcome a prospective employee’s resistance to leave behind unvested shares by compensating such employee for the value of any shares forfeited. Overcoming a well-drafted covenant not to compete generally is difficult without the former employer’s cooperation.

tion value of an equity-based grant – it is built into the grant date valuation.

A third set of motivations for equity-flavored compensation is based on the particular needs of the employer, generally relating to liquidity, that similarly have nothing to do with employee performance. Young or troubled companies may not have the liquidity to retain the talent they desire and resort to equity-based compensation out of necessity. Other idiosyncratic reasons may also exist, such as loss aversion tendencies. 170 Such reasons are the only plausible motivations for granting equity to one-off service providers that will have little or no future connection to the company, as when Facebook granted options to an artist in exchange for painting murals on company property. 171 To the extent that companies grant shares based on such motivations, the assertion that future appreciation of the stock is a compensatory reward is unsupportable.

C. Equity Compensation as an Incentive Device

The most forceful argument for taxing all future stock appreciation as compensation is the alleged incentive alignment propensity of equity-based compensation. According to the critics of the § 83(b) election, despite whatever other motivations may have existed for granting equity, the fact that this form of compensation concentrates the mind of employees to act in the interests of the shareholders is justification enough for taxing all returns from such equity as compensation. However, this reasoning is flawed on two accounts. First, the employee is a capital holder – labor efforts that result in capital appreciation are, under the current tax system, attributable to capital. 172 Second, any divergence from this norm can be justified only by a demonstration that a close nexus exists between the labor effort and the resultant capital appreciation. Stock price appreciation is an extremely poor proxy for labor performance.

1. Employee as Capital Holder

Compensation in the form of equity is a substitute for cash compensation and, to the extent that a grantee of equity has foregone cash compensation,

170. Research in cognitive psychology has shown that most people have loss aversion tendencies and that those tendencies manifest themselves in various ways. For example, the decision to compensate an attorney on a contingent fee basis is generally thought to provide the client with both liquidity and an incentivized lawyer. However, research has also shown that such arrangements are also motivated by loss aversion. See generally Eyal Zamir & Ilana Ritov, Revisiting the Debate over Attorneys’ Contingent Fees: A Behavioral Analysis, 39 J. LEGAL STUD. 45 (2010). Prior to the relatively recent revisions in generally accepted accounting principles, the decision to issue stock options were often motivated, at least in part, by the fact that such compensation was not reflected as an expense. See supra notes 49-51 and accompanying text.

171. The artist David Choe was compensated for painting murals by the then-fledgling Facebook with stock options. Based on Facebook’s initial public offering projections, his options are worth in the neighborhood of $200 million. See Jessica Silver-Greenberg, Too Rich, Too Soon, WALL ST. J., Feb. 25, 2012, at B7.

172. See supra notes 146-53 and accompanying text.
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she has invested capital in the firm. The value of the equity received at the date of grant tends to overstate the employee’s investment in the firm because the valuation placed on the shares will not reflect a discount due to the time-based vesting restrictions. To Moreover, to the extent that an employee places an idiosyncratic discount on the shares due to risk-aversion, diversification concerns, or similar reasons, this discount will be likewise ignored. As discussed above, the value of the shares at the time of grant will capture the reten-tive attributes of the grant. Moreover, the value of the shares should also reflect any incentivizing effects they engender. In addition, successful incentive alignment will prompt employee behavior that is akin to the behavior of a sole shareholder – the very person for whom the tax law discourages attempts to place a labor label on wealth accretion.

Efficient capital markets price in all available information into share value. The putative incentive effects of the share grant should be factored into the value of the shares at the date of grant. There are several variants of the efficient market hypothesis that can be used to analyze whether incentive effects on the share price exist. The weak-form hypothesis asserts that all security market information is fully reflected in the stock’s value. The semi-strong-form hypothesis posits that, in addition to security market information, all public information is priced into the stock. The strong-form hypothesis goes one step further and asserts that non-public information is fully reflected in the stock’s price. For publicly-traded companies, compensation practices are public information. Therefore, under either a semi-strong or strong-form hypothesis, the incentive value of equity-based compensation should be re-flected in the stock price at the date of grant.

Tests of the semi-strong-from hypothesis have yielded mixed results overall, but the hypothesis has tested well with respect to event-related stock price movements, such as corporate specific information, political events, and

173. See supra note 169 and accompanying text.
174. See supra notes 57-65 and accompanying text.
175. See supra note 169 and accompanying text.
176. The efficient market hypothesis underpins the “fraud on the market” theory that has diminished the reliance element in securities fraud class action lawsuits. A showing that each individual plaintiff’s action was caused by actions of the defendant is not necessary if, under the efficient market hypothesis, misleading statements by the defendant were priced into the securities in question and, therefore, resulted in harm to the plaintiff regardless of whether such plaintiff directly relied on the misleading statement in question. See Basic Inc. v. Levinson, 485 U.S. 224, 245-47 (1988); Justin Tyler Hughes, Equity Compensation and Informant Bounties: How Tying the Latter to the Former May Finally Alleviate the Securities Fraud Predicament in America, 82 S. CALIF. L. REV. 1043, 1045-47 (2009). An alternative branch of finance economics, behavioral finance, appeared in the 1990s and proffered that investor behavior is affected by psychological traits and that certain biases negatively impact investment decisions. See REILLY & BROWN, supra note 59, at 189-90.
177. Id. at 171-72.
178. Id. at 172.
179. Id.
economic developments.\textsuperscript{180} In essence, the answer to a simple question would yield tremendous insight into investor perceptions of equity-based compensation: what would happen to the value of the shares if the firm in question eliminated all equity-based compensation? If the shares’ value remained constant or increased then this would be a damning indictment of the efficacy of such compensation schemes. If the shares decreased in value then investors have priced this property into the shares.

Additional support for the treatment of post-grant capital appreciation as capital income can be found in the asserted agency-cost minimization property of equity grants. If the efficient market hypothesis provides insufficient evidence to support the notion that all the putative benefits of incentive compensation are reflected in the value of the shares at the time of grant, then support for such notion is provided by an examination of the incentive alignment fostered by equity-based compensation. No compensation scheme can eliminate 100 percent of the agency costs inherent in an employment relationship. The perfect compensation contract in this respect will cause the employee to act in a manner that one would expect a 100 percent owner of the business to act. However, it is precisely in the 100 percent owner case that no effort is made to separate a labor component from capital appreciation.\textsuperscript{181} The sole owner of a business incurs no agency costs when expending labor because she bears all the consequences, good or bad, of her actions. As previously discussed, no attempt is made to carve out a labor component from the capital appreciation of the business despite the fact that labor was expended to achieve such capital appreciation.\textsuperscript{182} Moreover, not only does the tax law not require such an attempt, it actually discourages such efforts.

Assume that a taxpayer owned 100 percent of the stock of a corporation and worked full-time for the corporation for a relatively modest salary. Assume further that the taxpayer’s efforts led to significant appreciation in the value of the business. If, for whatever reason, the taxpayer sought to capture a significant portion of this capital appreciation in the form of labor income, then our taxpayer would be susceptible to a claim that the corporation paid unreasonable compensation.\textsuperscript{183} A service recipient is entitled to a deduction for reasonable

\textsuperscript{180.} Id. at 175-85. Tests of the strong-from hypothesis have yielded decidedly mixed results and did not hold up well with respect to corporate insiders due to their monopolistic access to important information. Id. at 185-89. This fact calls into question whether the incentive properties of equity-based compensation arrangements are priced into the shares of privately-held corporations. However, appraisers of grants of non-publicly traded shares should, in theory, have access to the insider information regarding the grants and fully capture the insiders’ insights into the incentive attributes of the shares.

\textsuperscript{181.} See supra notes 146-53 and accompanying text.

\textsuperscript{182.} Id.

\textsuperscript{183.} The most common motivation to extract compensation from the business by the owner of a closely-held corporation is to obtain cash from the corporation in a form deductible by the corporation. Otherwise, such payments would be deemed dividends and nondeductible by the corporation. However, such payments would be subject to favorable tax rates to the shareholder. See supra note 48.
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salaries or other compensation. 184 Treasury regulations require that the amount of compensation be reasonable and that the compensation paid represent, in fact, payment for services. 185 Although the regulations appear to establish a two-prong test for the deductibility of compensation payments—reasonableness in amount and compensatory in character—the test has been applied solely as a characterization provision. 186 In other words, if the relationship between the parties is truly compensatory then the amount of the compensation will not be challenged. 187 In effect, the reasonable compensation test is limited in its application to closely-held corporations which, the I.R.S. fears, may disguise nondeductible dividend payments as compensation. Therefore, it is in the very situations in which labor efforts are unimpeded by agency problems, and consequently, a close nexus is expected to exist between such efforts and capital appreciation, that the law is tendentiously skewed to characterize the returns as derived from capital. In the above example, it is very likely that incentive compensation payments to the employee-shareholder would be challenged on unreasonable compensation grounds.

The reasonable compensation requirement is, in reality, a tool to prevent the mischaracterization of a transaction and is not designed to test the reasonableness of what is, without dispute, a compensatory relationship. The reasonable compensation standard, therefore, will not apply to deny corporate deductions for traditional equity-based compensation, no matter how large the numbers become. 188 The reasonable compensation test challenges the characterization of a transaction and, in the sole shareholder situation, will seek to recast compensation as a capital transaction. However, the fact that this test is imposed on the very relationships that the equity-based compensation scheme aspires to mimic is ironic if critics of the § 83(b) election are right that future stock appreciation ought to be taxed as labor compensation.

The test will not apply under circumstances for which there is no alternative explanation for the transaction, regardless of the absolute amount of compensation in question. 189 However, equity-based compensation schemes do

186. See generally Andrew W. Stumpff, The Reasonable Compensation Rule, 19 VA. TAX REV. 371 (1999). The courts examine several factors in determining whether compensation is reasonable including the employee’s qualification and training, the compensation of comparable employees, and the nature and extent of the employee’s duties. See id. at 392-93.
187. Therefore, neither the I.R.S. nor the courts will challenge compensation that, with the benefit of hindsight, appears to have been grossly inflated in relation to the value of the services provided.
188. The I.R.S. attempted to disallow compensation deductions to NYSE Euronext for payments made to its chief executive officer, Richard Grasso, between 2001 and 2003. Mr. Grasso’s pay generated much controversy and drew the ire of then New York Attorney General Elliot Spitzer who filed an ultimately unsuccessful civil suit against Mr. Grasso that demanded the return of a major portion of his compensation. The I.R.S. has now forsaken its position. See Jacob Bunge, IRS Ends Effort to Regain Grasso-Related Compensation, WALL ST. J., Mar. 2, 2012, at C2; Jacob Bunge, NYSE Fights With the IRS Over Its Pay For Grasso, WALL ST. J., Mar. 2, 2010, at C3.
189. See supra note 187 and accompanying text.
offer an alternative explanation for the wealth accretion to the employee – she is a capital holder.\textsuperscript{190} In fact, the more capital she holds, the greater is her propensity to act in the manner that the other shareholders desire. Moreover, an analysis along these lines leads to another problem with the current tax scheme – it fails to account for the employee’s existing stockholdings. The greater an employee’s existing stockholdings, the closer the similarity of the employee to the sole shareholder employee. This Article does not propose that equity-based compensation be subjected to the reasonable compensation test. Rather, this Article suggests that the tax law draw comparisons to the situations to which this test applies. It appears disingenuous to insist that capital appreciation is labor income because the incentives that led to the capital appreciation caused an employee to act like the owner whose very labor efforts the law ignores. Equity may motivate an employee, but that motivation springs from the same source that provides motivation for the sole owner of a business – her capital investment in the employer.

2. \textit{Share Price – A Poor Performance Proxy}

The tax law does not attempt to bifurcate capital returns into labor and capital components for various reasons, some doctrinal and others practical.\textsuperscript{191} Divergence from this norm could be justified in the case of compensatory equity grants if a close nexus exists between labor efforts and equity returns. However, returns on employer stock are a very poor proxy for any single employee’s labor effort. If one believes that the tax law should make efforts to strip out a labor component from capital income then this is the wrong place to start. Stock appreciation is a “noisy” metric, and stock price movements are a poor metric for measuring labor’s value. For middle managers, division heads, and subsidiaries’ upper management personnel, stock price movements capture business developments on which such employees have had no impact. Although top management is responsible for the enterprise’s results as a whole, stock price movements are a similarly poor proxy for their labor quality. Federal Reserve interest rate policies, political developments, currency movements, market sentiment, natural disasters, and other developments outside the control of management can and do impact the stock price, either adversely or beneficially. Moreover, the notion that top management’s efforts are singularly responsible for the corporation’s stock price appreciation is not only hubristic, it also diminishes the contributions of others within the firm and provides the foundation for a distorted and oft-times destructive corporate culture.\textsuperscript{192}

The asserted nexus between managerial efforts and stock price move-

\textsuperscript{190}. See \textit{supra} note 173 and accompanying text.
\textsuperscript{191}. See \textit{supra} notes 146-53 and accompanying text.
\textsuperscript{192}. See \textit{infra} notes 243-58 and accompanying text.
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ments is belied by the retentive aspects of restricted stock. The closer the correlation between labor efforts and an asset’s value, the less one would expect a need to force labor providers to hold onto the asset. After all, if one knows that an asset will rise in value on the basis of my efforts, then she will be very reticent to sell that asset. For example, it is very unlikely that a musician will need any prompting to retain his creative work.

Additionally, no labor provider is immune from market forces that could overwhelm her efforts. For example, it is improbable that persons who self-improved real estate in 2007 and 2008 reaped any reward for their efforts, regardless of the quality of those efforts. However, for many assets there is a somewhat close relationship between labor expended and asset appreciation and experiences to the contrary are unusual. With respect to the stock of one’s employer, such experiences are the norm. The desire to diversify holdings, liquidity concerns, and other justifications put forth by management for reducing corporate stock holdings, valid as they may be, are tacit admissions that management has little control over the market price of its company’s stock.

The ability to hedge employer stock holdings is another admission of the tenuous connection between labor efforts and stock price movements.193 Hedging such stock holdings obviously diminishes the putative incentive alignment properties of such stock. Moreover, similar to resale restrictions, the very practice of hedging speaks to the weak connection between the stock’s value and managerial effort. Why would an asset be hedged if the service provider exercised any significant control over its value? Conceivably, any asset can be hedged but it is rarely done for most assets.194 If stock price movements are compensatory in nature then hedges against unfavorable stock price movements are a post-contractual hedge against poor labor efforts – an unheard-of phenomenon.195 Regardless of whether the compensatory stock is hedged or not, the fact that it can be hedged calls into question the nexus between labor efforts and stock price performance.196 Executives are often quick to point out

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193. The hedging of employer stock holdings was not prohibited by the Dodd-Frank legislation despite the controversial nature of such practices. The legislation merely requires corporate disclosures as to whether such practices are permitted. See infra note 220.

194. Perhaps the most ubiquitous form of hedge is insurance against damage to the property. However, it is not common for owners of property other than inventory, securities, or assets exposed to foreign currency fluctuations to hedge against market value fluctuations.

195. It is common for service providers to hedge against the possibility of a diminution in their earnings capacity. Life insurance and disability insurance are the most common form of such hedges. Education and networking can also be considered a form of hedge against the possibility that one’s skills become obsolete or that they are no longer valued by an employer. Hedging the quality of one’s labor is possible ex-ante by contract. For example, a set salary for a term of years provides such a hedge. These types of hedges are common in professional sports where long-term guaranteed contracts are common. Of course, such contracts provide an offsetting hedge against above market performance for the counterparty to the contract.

196. Hedges against stock price declines can take many forms including short sales, sales of call options, purchases of put options, and derivative contracts. A short sale is the sale of borrowed shares. A short seller profits from a stock price decline because the shares borrowed are replaced at a lower
that significant stock price declines were caused by factors not within their control – as was frequently heard during the financial crisis. It would be most refreshing to hear admissions that similar factors caused significant price increases.

3. Agency Cost Redux

Equity grants do not resolve agency cost problems. Instead, they merely present those problems in a different form. The belief that equity-based compensation serves to align the interests of management with those of company shareholders presupposes that the compensatory arrangement under which the equity is granted is the result of optimal bargaining between the employee and employer. To believe otherwise is to concede that the compensatory arrangement itself is a result of rent extraction by management. If that is the case, then the assertion that the arrangement will serve incentive alignment purposes should be met with a great deal of skepticism because the agreement itself is a product of a failed corporate governance system. Such compensation arrangements are not a solution to agency cost problems – they are evidence of such problems. Indeed, there is ample evidence to suggest that many compensatory arrangements are the result of sub-optimal bargaining.

The optimal bargaining model posits that various forces serve as constraints on management and directors, thereby placing significant barriers to the extraction of excessive compensation by management. Labor markets, shareholders, the media, the market for the corporation’s goods and services, and the market for corporate control are factors that together should result in compensation schemes whose terms one would expect from arm’s length bargaining among persons with adverse interests.

A competing theory asserts that executive compensation arrangements are often the result of the exercise of managerial power and result in managerial rent extraction. The most prominent proponents of this theory are Lucian Bebchuk, Jesse Fried, and David Walker, who set forth their theory in a seminal article a decade ago. Several factors call into question whether incentive price than that at which the shares were originally sold. Derivatives are very flexible instruments that can be designed to provide a party with profits that will partly or wholly offset the decline in the hedged stock holdings. The Securities and Exchange Act of 1934 prohibits directors, officers, and 10 percent shareholders from short selling company stock. See 15 U.S.C. § 78p(a)(c) (2010); see also 17 C.F.R. § 240.16a-1(f) (2011). However, the regulations implementing the statute allow an insider to utilize put-equivalent derivative contracts to insulate herself entirely or partly from stock price declines. See 17 C.F.R. § 240.16c-4 (1991). Employers may prohibit hedging by contract although these contractual restrictions are unlikely to apply to shares owned outright by the employee. Hedges often come with not insignificant transaction costs and unfavorable tax consequences. See generally David M. Schizer, Executives and Hedging: The Fragile Legal Foundation of Incentive Compatibility, 100 COLUM. L. REV. 440, 466-94 (2000).
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compensation contracts are the result of optimal bargaining, as defects pervade the corporate governance infrastructure. For example, the chief executive officer often retains considerable influence in the director nomination process, and independent compensation committees operate with the knowledge that the chief executive has influence over their membership on the board. In addition, information asymmetries between management, the board and the board’s compensation committee often hinder a proper vetting of compensation proposals. Compensation consultants, often hired by management to advise the committee, usually have clear incentives to favor management in their recommendations.

In addition to structural defects in the corporate governance machinery, behavioral theory may also explain a lack of optimal bargaining. Board members are often chief executive officers or high-ranking officers of other corporations and are predisposed to support high levels of compensation for the chief executive--either to establish higher benchmark levels for future negotiation of their own pay or to justify their current pay levels. Warren Buffett stated that “there is a tendency to put cocker spaniels on compensation committees, not Doberman pinschers.” The propensity to empathize with the insider group is not unique to compensation decisions and has been used as justification by courts to refuse deferential treatment of the findings of special litigation committees. A corporate governance authority once noted:

Even if the independent directors are not actually biased in favor of insiders, the former often are predisposed to favor the latter. Most of the learning on this phenomenon, known as structural bias, arises out of the use of special litigation committees to terminate shareholder derivative litigation against officers and directors...Independent directors tend to be corporate officers or retirees who share the same views and values as the insiders. A sense of “there but for the grace of God go


198. See Bebchuk et al., supra note 197, at 766. Independent compensation committees are required in order for corporations to obtain tax deductions for performance-based compensation. See supra note 45 and accompanying text.

199. Bebchuk et al., supra note 197, at 772.


201. Bebchuk et al., supra note 197, at 768-69 (citing Brian G.M. Main et al., The CEO, the Board of Directors, and Executive Compensation: Economic and Psychological Perspectives, 11 INDUS. & CORP. CHANGE 293, 302-08 (1995)).


203. Special litigation committees are charged by the board of directors to determine whether a pending derivative shareholder lawsuit should go forward. Delaware courts do not give deference to the findings of such committees. See Zapata Corp. v. Maldonado, 430 A.2d 779, 786-89 (Del. 1981).
I” is the likely response to litigation against fellow directors.204 Shareholder oversight is also a relatively poor method of control over managerial rent extraction. The market for corporate control is often cited as a check on inefficient management, but corporate takeovers, due to their enormous transaction costs, are practical only in response to gross inefficiencies.205 Shareholders are subject to the same, or worse, information asymmetries as the board. Congress did little to shift power to shareholders by enacting the Sarbanes-Oxley Act of 2002. Much of the legislation focused on the accounting profession.206 In terms of establishing constraints on management in exercising power in setting compensation, these provisions do very little.207 In order for shareholders to prevail in a challenge to compensation policies, they would have to prove that the directors breached their duties of care or loyalty or committed waste.208 Directors will be found to have met their duty of care if the approval of a compensation plan was the result of due deliberation undertaken after consideration of all material, relevant information.209 Once having met their duties of care and loyalty, the substance of the director’s action will be protected by the business judgment rule.210 Moreover, the Securities and Exchange Commission’s attempt to provide shareholders with greater rights to nominate directors under its proxy access regulations was recently struck down by the D.C. Circuit.211

A critical factor that mitigates shareholder constraints on managerial power is the ability of management to camouflage rent-seeking behavior. The exercise of

204. See Amanda K. Esquibel, A Guide to Challenging Option Repricing, 37 SAN DIEGO L. REV. 1117, 1155 n.204 (2000) (quoting Stephen M. Bainbridge, Independent Directors and the ALI Corporate Governance Project, 61 GEO. WASH. L. REV. 1034, 1059-60 (1993) (emphasis added)). The costs of posing a challenge, which includes the possible failure to be re-nominated and the stigma that attaches to a “CEO unfriendly” director, are significant. Bebchuk et al., supra note 197, at 770-71.

205. Id. at 777-78.


207. Bebchuk et al., supra note 197, at 779.

208. Id. at 779-80.

209. See id. at 780708.

210. The business judgment rule manifests the reality that directors, not shareholders, manage the corporation. See Orman v. Cullmann, 794 A.2d 5, 19-20 (Del. Ch. 2002). A party challenging the board’s decision must overcome a presumption that “the directors of a corporation acted on an informed basis in good faith and in the honest belief that the action was in the best interest of the company.”’ Id (quoting Aronson v. Lewis, 473 A.2d 805, 812 (Del. Ch. 1984)). In addition to substantive legal hurdles, shareholders also encounter procedural challenges. Bebchuk et al., supra note 197, at 779-80. Shareholder challenges to executive compensation would come in the form of derivative litigation. As such, the shareholders must first, with one exception, make a demand on the Board to investigate the claim and consider whether further action is appropriate. Id. at 870.

211. See Bus. Roundtable & Chamber of Commerce of the U.S. v. SEC, 647 F.3d 1144 (D.C. Cir. 2011) (holding that the Securities and Exchange Commission failed to assess adequately the economic effects of the new rule). The regulations entitled shareholders that met certain ownership and holding period thresholds to nominate directors using the corporate proxy. See generally 17 C.F.R. 240.14a-11 (2010) (VACATED). An unopposed slate of management’s directors assures the election of the nominated directors unless the corporate bylaws require a majority of votes to be cast in favor of the director. Many corporations have adopted such requirements but plurality voting remains common. See Maxwell Murphy, Snubbed by Holders, Directors Keep Posts, WALL ST. J., June 12, 2012, at B1. Some corporations, as a result of shareholder pressure, have voluntarily provided increased proxy access. See Joann S. Lublin & Ben Worthen, H-P Activist Investors Make Proxy Progress, WALL ST. J., Feb. 6, 2012, at B4.
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Managerial power is constrained by “outrage” costs.\(^212\) Outrage costs increase the possibility that market forces will lead to actions hostile to the interests of management.\(^213\) Sufficient breadth and intensity of outrage over executive compensation could bring significant reputational harms to individual directors, cause shareholders to mount proxy contests or entertain takeover proposals, and jeopardize future employment prospects for the executive.\(^214\) Yet compensation arrangements are susceptible to camouflage.\(^215\) The involvement of independent compensation committees and consultants in the compensation process provides a modicum of cover.\(^216\) High levels of performance-based compensation are much more palatable to outsiders because high payouts are generally accompanied by concomitant gains to the shareholders.

The Dodd-Frank Wall Street Reform and Consumer Protection Act did provide shareholders with an advisory vote on executive compensation.\(^217\) Prior to the enactment of this legislation, only recipients of federal assistance under the Troubled Asset Relief Program had to provide shareholders with a non-binding “say on pay,” although some corporations did so voluntarily.\(^218\) Dodd-Frank requires corporations to provide a shareholder vote on executive compensation at least once every three years.\(^219\) Moreover, corporations must provide, with the proxy material, a clear de-
scription of the relationship between pay and performance. Implementing regulations recently adopted by the Securities and Exchange Commission require that the proxy material include a separate vote on pay. It remains to be seen if the proxy disclosures required by this legislation will alleviate to any significant extent the information asymmetries and other impediments that make it difficult for outside constituencies to ascertain whether, and to what extent, the amount of reward is commensurate with executive effort. It is quite possible that the recently enacted “say on pay” requirement will serve as further cover for sub-optimal compensation arrangements. Arguably, the economic crisis has appeared to lower the threshold of tolerable outrage costs. However, whether increased shareholder assertiveness is to be a permanent fixture in corporate governance or merely a temporary phenomenon in response to ugly economic conditions remains to be seen.

The managerial power model is not universally accepted. It is certainly plausible that compensation arrangements for employees other than top management personnel tend to be the result of optimal bargaining rather than managerial power. Compensation arrangements for top-level management most likely contain elements of both optimal bargaining and rent extraction. However, the past twenty years, with its parade of scandals and skewed incentives, has provided ample evidence that many compensation schemes are the evidence of, not the cure for, agency costs.
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The efficacy of incentive compensation schemes is premised on their propensity to reduce vertical agency costs—those costs that are a function of the separation of ownership and management. However, these schemes cannot eliminate agency costs because the agent will bear only a proportionate share of such costs while reaping all the benefits of actions harmful to the corporation. The schemes’ effect on minimizing managerial rent extraction is minimal because management tends to hold an insignificant percentage of shares. Therefore, managerial rent extraction, if possible, loses little of its attraction. In fact, such arrangements offer another avenue for rent extraction—the compensation schemes themselves. Compensatory equity grants create a select class of shareholders that have the power to direct corporate resources to themselves.

The gravitation away from stock options and toward restricted stock as the vehicle to deliver equity coincided with economic factors that tended to favor the latter over the former. The market began to place increased emphasis on dividends and stock growth prospects waned. The Bush tax cuts early in the last decade, and the change in the accounting treatment for stock options a bit later, further encouraged the ascendency of restricted stock. The advantages and drawbacks of stock options were well-known, yet compensation structures did not adjust until such time that the landscape changed to management’s advantage. Moreover, common sense dictates that, if the metrics on which compensation were determined are subsequently revised, then the compensation itself should be revised. Yet clawback requirements had to be legislated via the Sarbanes-Oxley Act and the federal bailout legislation, and clawbacks have only now become somewhat commonplace.

The rise of equity compensation has coincided with several of the largest accounting scandals in U.S. history. In fact, the nature of the U.S. accounting system allows managers to camouflage rent-seeking activities. Moreover, the regulatory

226. The stock options backdating scandals are evidence that equity-based compensation arrangements offer a new avenue for managerial rent extraction. Stock options were granted just after sharp price declines in the stock price at a rate that exceeded what one would expect if such fortuitous timing of the grants was merely coincidental. University of Iowa professor Erik Lie conducted a comprehensive study of option grants and concluded that many of the seemingly well-timed issuances of options were, in reality, retroactively set. See Erik Lie, On the Timing of CEO Stock Option Awards, 51 MGMT. SCI. 802 (2005).

227. See supra notes 52-54 and accompanying text.

228. See supra notes 54-55 and accompanying text.

229. See supra notes 86-93 and accompanying text.

230. U.S. accounting standards have been criticized as overly rules-based thereby allowing management to circumvent the spirit of the rules by clever gamesmanship. This was certainly the case with Enron but many of the major scandals in the past decade, including WorldCom, Qwest Communications, and AOL, were based on the abuse of principles-based standards that provided for much managerial discretion. Principles-based standards regarding earnings recognition, reserves for losses, and cost capitalization were often abused. See, e.g., Julia Angwin, A Bulk-Sales Initiative by AOL May Have Inflated Subscriptions, WALL ST. J., July 25, 2003, at A1; Simon Romero, Internal Notes Questioned Qwest’s Swaps, N.Y. TIMES, Sept. 25, 2002, at C4; Kurt Eichenwald & Simon Romero, Turmoil at WorldCom: The Decision Making; The Latest Corporate Scandal Is Sudden, Vast and Simple, N.Y. TIMES, June 27, 2002, at A1. During the “bubble years” leading up to the recent economic crisis, investment firms commonly overvalued mortgage-backed securities. For an excellent analysis of the mortgage-backed securities fiasco see ANDREW ROSS SORKIN, TOO BIG TO FAIL (Penguin Books
landscape itself provides evidence that two decades of ostensible incentive alignment efforts have done nothing to deter managerial rent seeking. Compensation disclosure rules have been strengthened and, most recently, a "say on pay" requirement instituted.231 It seems eminently reasonable to expect that two decades’ worth of incentive alignment would have resulted in the need for less, not more, regulation over compensation. Equity-based compensation arrangements provide no benefit with respect to management that possesses no inclination toward rent extraction. They will do little to deter management with a proclivity toward such behavior.

In addition to serving as a deterrent to managerial rent seeking, these arrangements purportedly serve to foster an appropriate level of risk-taking by otherwise risk averse employees. However, risk aversion is a multi-faceted issue that tends to defy generalizations. Managers’ risk aversion will be impacted by firm specific factors such as the degree to which the firm is regulated, the extent to which the company is leveraged, and the constraints that are imposed on the firm by debt covenants. The level of risk aversion that a particular individual exhibits is also dependent on personal factors as varied as the extent of an individual’s outside stock holdings, her basic personality traits, and her susceptibility to behavioral stimuli.232 Contrary to the conventional wisdom that employees tend to devalue equity due to risk aversion, how an employee perceives equity compensation is often influenced by whether such equity is granted during a time that the market is rising or falling and other psychological factors.233 Some managers have a “bet the ranch” mentality – Jon Corzine, for example – and others do not.234 Generous - some would say obscene - severance pay


232. A recent study by researchers at the California Institute of Technology found that the efficacy of incentives varied based on the loss aversion tendencies of the subjects tested and that incentives lost their effectiveness for all subjects after a certain point. See generally Vikram S. Chib et al., Neural Mechanisms Underlying Paradoxical Performance for Monetary Incentives are Driven by Loss Aversion, 74 NEURON 582 (2012).


234. Jon Corzine, the former New Jersey senator and governor, was the chief executive officer of MF Global and led the firm to its demise by his decision to invest heavily on European sovereign debt. The firm is also mired in a scandal involving over $1 billion dollars in missing customer funds. Aaron Lucchetti & Mike Spector, The Unraveling of MF Global – With $1.2 Billion Still Missing, Corzine’s Aggressive Strategy Comes Into Focus, WALL ST. J., Dec. 31, 2011, at B1.
arrangements work at cross purposes with the purported incentive alignment properties of equity compensation.\textsuperscript{235} Hedging techniques can virtually destroy such properties outright.\textsuperscript{236} Finally, even if one concedes that equity-based compensation achieves its aim to encourage an appropriate level of risk taking, it fails to account for varied shareholder risk tolerances.

The creation of a managerial shareholder class brings into focus the fact that the so-called incentive alignment justification of equity-based compensation assumes homogenous shareholder objectives with which to align managerial efforts. However, they do little to solve, and instead tend to exacerbate, horizontal agency cost problems — those costs derived from the competing objectives of the ownership class. The proliferation of equity-based compensation has created a managerial-shareholder class of owner. The utility of equity-based compensation is premised on the notion that management’s objectives, in the absence of ownership, are misaligned with those of shareholders and that such misalignment is reduced by inviting management into the shareholder class. Implicit in this line of reasoning is the notion that shareholders share the same objectives. They do not.

Shareholders are assumed to share one objective – an increase in the stock price that provides acceptable risk-adjusted compensation for their capital. Even if this objective is, in fact, universally shared, it tells us nothing about the time horizon in which to meet that objective.\textsuperscript{237} Among the shareholder class are members that have fundamentally different viewpoints on what constitutes an acceptable return. A university endowment or pension fund would be expected to have a long-term horizon. Mutual funds will have different time horizons depending on their investment goals and philosophies. An index fund, which is obligated to hold an investment so long as it is part of the index it seeks to replicate, will have a longer term view than a mutual fund designed to capture short-term price movements. Investors that employ sophisticated quantitative trading strategies often seek to profit from short-term discrepancies that they perceive to exist in market prices. Short-term institutional shareholders are often better informed than long-term holders, are more often momentum traders, and pressure management to maximize short-term profits.\textsuperscript{238}

\textsuperscript{235} One scholar has used the term “severance pay pirates” to describe certain executives subject to such provisions. See William A. Drennan, \textit{The Pirates Will Party On! The Nonqualified Deferred Compensation Rules Will Not Prevent CEOs From Acting Like Plundering Pirates and Should Be Scuttled}, 33 Vt. L. Rev. 1, 11-13 (2008) (enumerating the terms of several severance arrangements). Recently, a $100 million severance pay package was foregone, due to shareholder outrage, by the chairman of Nabors Industries. The corporation’s severance pay obligation was due despite the fact the recipient was retaining his chairmanship of the company. See Mark Maremont & Joann S. Lublin, \textit{The $100 Million Giveback}, WALL ST. J., Feb. 7, 2012, at B1.

\textsuperscript{236} See supra notes 193-96 and accompanying text.

\textsuperscript{237} Certain types of shareholders may have different objectives. For example, a labor union’s primary concern may be members’ job security or wage levels while a non-profit corporation’s principal objective may be the advancement of its mission.

\textsuperscript{238} See Xuemin (Sterling) Yan & Zhe Zhang, \textit{Institutional Investors and Equity Returns: Are
Michael Jensen has posited that, in situations in which the market has overvalued the firm, agency costs are actually exacerbated by equity-based compensation.\textsuperscript{239} Actions to correct this imbalance will adversely impact short-term shareholders more than long-term holders. Certain shareholders, such as labor unions, state employee pension funds, and activist groups may seek to influence corporate behavior in order to serve their own objectives.\textsuperscript{240} Time-based vesting restrictions are intended, in part, to focus management toward long-term shareholder value and to avoid a myopic, short-term focus. However, such restrictions necessarily align management’s incentives with those of a subset of, but not all, the shareholders.\textsuperscript{241} Moreover, any myopia-reducing effect of time-based vesting restrictions are diminished, and often overwhelmed, by the existence of freely alienable pre-existing shareholdings.

To a certain extent, shareholder diversity is analogous to employee diversity. It makes little sense to state categorically that all employees favor more employee benefits without distinction among the employees to whom those benefits are directed. A better retirement plan may have little meaning to a twenty-two year old employee, better family medical coverage may draw shrugs from a single employee, and free Mets tickets may not be considered a benefit at all by a Yankee fan.\textsuperscript{242} Equity-based compensation fails to direct management to a singular objective because the shareholders hold no such objective. However, such compensation does have the propensity to focus management on a very specific investment horizon – its own.

D. Equity Compensation: Spawned by Unchallenged Consensus

The proliferation of equity-based compensation is a manifestation of a culture of shareholder wealth maximization that has had a corrosive influence on corporate governance. In a sense, this culture has become the social norm over the past several decades and has led to the general acceptance of the belief, despite evidence to the contrary, that only by receiving equity can management be properly incentivized. Criticism of equity-based compensation has

\textsuperscript{239} Michael C. Jensen, \textit{Agency Costs of Overvalued Equity}, 34 \textit{FIN. MGMT.} 1 (2005).
\textsuperscript{240} See, \textit{e.g.}, Editorial, \textit{The Corporate Disclosure Assault}, \textit{WALL ST. J.}, Mar. 19, 2012, at A16 (criticizing the numerous attempts by shareholders seeking to require corporate disclosure of political activities).
\textsuperscript{241} Shareholder conflicts are sometimes transparent as is the case when a separate class of voting shares exists. The tensions between the shareholder classes often emerge when the firm is sold. See, \textit{e.g.}, Anupreeta Das et al., \textit{Court Casts Wary Eye on CEOs’ Deal Roles}, \textit{WALL ST. J.}, Mar. 8, 2012, at B6 (reporting, in part, on a recent Delaware case in which shareholders alleged that the holder of a certain class of stock negotiated a higher price for those shares relative to the price negotiated for other shares).
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been focused on its structure, but a general consensus has emerged during the past twenty or so years that some form of equity compensation is necessary to mitigate the problems of agency costs. The notion that managers have earned, through their labor, the wealth accretion derived from rising stock prices is the result of the consensus belief and not proof of its validity. Moreover, slavish adherence to such a notion lends credence to both the “stock market” culture and the personality cult of management that have emerged over the past several decades.

Underpinning the current consensus is the belief that shareholder wealth maximization is the foremost objective of corporate governance. However, is the ultimate purpose of the corporation to maximize the wealth of its owners? Various constituencies of the firm have their own purposes, including government, consumers, labor, and suppliers. The selection of one ultimate goal requires consensus among all constituencies to lend it legitimacy, and such a goal will be one that “is useful to all members of the firm and to the public.” Because all members of the firm and society are consumers, the ultimate purpose of a corporation is to optimally produce goods or services that satisfy the needs of its customers. “[S]hareholder wealth is a condition to the realization of the main purpose of the firm….” Shareholder value is but one goal among many other goals and, like the others, is subordinate to the ultimate purpose of the firm. Shareholder value may be dominant among the subordinate goals of the firm, but it is nonetheless only the evidentiary proof of the extent to which the firm is achieving its ultimate goal.

Shareholder wealth could be substituted for the firm’s ultimate goal if such wealth correlated perfectly with the firm’s principal goal. However, the connection between share prices and firm performance is loose because “the price of shares in the stock market does not just reflect the real value of the firm’s productivity and performance but is also subject to mere speculation . . .” Instead of focusing on first principles, shareholder wealth maximization is the proverbial tail wagging the dog - primacy is placed on the means, not the end. As a consequence, perverse incentives are created for management to

244. Id. Adolf Berle also recognized that increasing societal demands would test the shareholder primacy model of corporate governance. See Erika George, See No Evil? Revisiting Early Visions of the Social Responsibility of Business: Adolf A. Berle’s Contribution to Contemporary Conversations, 33 SEATTLE U. L. REV. 965, 979-80 (2010).
245. Koslowski, supra note 243, at 139.
246. Id. Michael Jensen has put forth the goal of “enlightened value maximization.” Long-term value maximization of the firm, which includes the sum of the values of all financial claim on the firm, is the criterion for making the requisite tradeoffs among the firm’s stakeholders. Jensen, supra note 34, at 9.
247. Koslowski, supra note 243, at 141.
248. Id.
249. Facebook is very likely to experience tension caused by the possible incongruence between the demands of the stock market and its corporate mission. See Somini Sengupta & Claire Cain Miller,
take more interest in speculation and stock price movements than in the productive function of the firm. Peter F. Drucker, perhaps the preeminent management theorist of the twentieth century, stated that a focus on shareholder wealth:

. . . forces the corporation to be managed for the shortest term. But that means damaging, if not destroying, the wealth-producing capacity of the business. . . . Long-term results cannot be achieved by piling short-term results on short-term results. . . . [M]anaging a business exclusively for the shareholders alienates the very people on whose motivation and dedication the modern business depends: the knowledge workers.251

The assumption that stock market gains are compensation for managerial services is a result of, and further encourages, the exaggeration of the roles of certain individuals and the devaluation of the contributions of others. As Drucker noted, the value of a person’s efforts should be determined by “its contribution to the common task rather than by any inherent superiority or inferiority.”252 During most of corporate history the role of one individual or a small group of individuals was considered much less a determinant of corporate success that other industry and firm-specific factors.253 However, a cult of leadership began to emerge during the 1980s. As one scholar noted, General Electric, a company founded by Thomas Edison that had operated successfully for almost a century, had suddenly become “The House that Jack Built” in reference to the efforts of Jack Welch.254 Note the blatant inconsistency in the justifications for increased compensation to management. The exaggerated value that is placed on the efforts of a particular individual necessarily implies that such individual is valuable and that the supply for such talent is meager. As noted earlier, a significant driver of increased management compensation is the increased risk placed on executives as a result of assertive shareholders.255 However, common sense dictates that a person in possession of skills that are in short supply and in great demand incurs very little risk because the market for her services provides job security. Perhaps the Economist’s observation that


250. Koslowski, supra note 243, at 141-42.
252. Id. at 56. A more recent, if less eloquent, criticism of the current state of affairs came from an official of organized labor who stated that the “[h]igh disparity devalues the work of rank-and-file employees. It creates the perception that the CEO is creating all the value.” Leslie Kwok, Firms Resist New Pay-Equity Rules, WALL ST. J., June 27, 2012, at B8 (quoting Brandon Rees, deputy director of the AFL-CIO’s office of investment).
253. Snyder, supra note 224, at 160-61.
254. Id. at 162.
255. See supra notes 35-39 and accompanying text.
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The laws of supply and demand do not apply to the banking industry is applicable to executive suites writ large. Moreover, the notion that a person under a term contract that provides extraordinary compensation, often buttressed by generous severance provisions, incurs employment risk is, quite frankly, insulting to the intelligence of those not similarly situated.

The outsized influence of equity-based compensation as an incentivizing mechanism has pretty much relegated other motivations to quaint relics of another time. The motivational properties of status, job retention, and reputational concerns are no longer sufficient. Moreover, the pre-existing duty of loyalty is, if the conventional wisdom is to be believed, diminished because the faithless servant is the default assumption that can be set right only by equity. This is the conventional wisdom and a self-fulfilling one. If one hears a story often enough she will tend to believe in its veracity and act accordingly. Over-reliance on incentives to alter behavior may have destructive effects on other forms of motivation. Incentives have “learning effects” that encourage self-interested behavior. One scholar has aptly noted the effects of the present state of affairs:

Corporate law demands that managers simultaneously be self-less servants and selfish master. On the one hand, it directs managers to be faithful agents, setting aside their own interests entirely in order to act only on behalf of their principals, the shares. But on the other hand, in the service of this extreme altruism, they must ruthlessly exploit everyone around them, projecting onto the shares an extreme selfishness that takes no account of any interest but the shares themselves, narrowly understood. Having maximally exploited their fellow human participants, managers are then expected to hand over their gains, ill and justly gotten, to the faceless legal abstraction of the fictional shareholder. Altruism and rationally self-interested exploitation are extreme and radically opposed positions, psychologically and politically. The managerial role is deeply unstable and unlikely to hold.

IV. PROPOSAL AND CONCLUSION

The tax law should reflect that post-grant stock appreciation is capital

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257. For an interesting article on the effect of such motivational factors see Steven M. Davidoff, Federal Reserve as a Hedge Fund: Higher Profits, Lower Pay, N.Y. TIMES, Jan. 18, 2012, at B5.


in nature and discontinue the fallacy that gains from such appreciation are earned income. The § 83(b) election should be eliminated, but not because it provides equity recipients with an unfair advantage in comparison to other employees and service providers. Rather, § 83(b) treatment should be mandatory. Restricted stock grants should be taxable at the time that the number of shares subject to the grant is determined despite time-based vesting restrictions. Correspondingly, the corporation’s compensation deduction should be determined at a similar time. As discussed above, in most cases this will diminish the desirability of equity-based compensation to the recipient.\footnote{See supra notes 105-25 and accompanying text.} Moreover, mandatory § 83(b) treatment will sharpen the alleged incentive effects of such grants.\footnote{See supra note 125 and accompanying text.} In situations where the election is highly desirable – when the stock has no value at the time of grant – this rule will merely retain the status quo and reflect economic reality.

Elimination of § 83(b) as an elective provision, however, will also require several equitable and practical adjustments. First, if recipients of nonvested stock are taxed upon receipt then the no-loss rule upon forfeiture should be eliminated.\footnote{See supra note 83 and accompanying text.} Moreover, any loss upon forfeiture should be fully available and not subject to adjusted gross income limitations and other such barriers to full deductibility.\footnote{See supra note 95 and accompanying text.} Second, the benefits of I.R.C. § 1341 should be available for losses due to clawbacks, as long as the clawback did not result from the wrongdoing of the grant recipient.\footnote{See supra notes 94-104 and accompanying text.} Because current taxation would no longer be elective, equity dictates that losses due to forfeiture or clawback neither be prohibited nor diminished in value.

The current taxation of restricted stock grants does raise issues with respect to liquidity. Some recipients will have no problems paying the tax owed at the time of the grant, while others will face significant difficulty. Liquidity concerns are surmountable by providing the equity recipient with an election to defer payment of the tax due until the time that the grant vests. The tax due would accrue interest, at a statutorily determined rate, until it is paid.\footnote{See supra notes 94-104 and accompanying text.}

It is possible that the parties to an equity compensation arrangement could avoid immediate taxation merely by recasting the equity award in the form of a cash-settled arrangement.\footnote{Cash-settled arrangements are not subject to I.R.C. § 83 because such transactions do not involve the transfer of property in exchange for services.} For example, instead of a grant of 1,000
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shares subject to a three-year vesting requirement, an employer could grant an employee 1,000 restricted stock units. Such units would entitle the recipient to the cash value of the shares at the end of three years. However, there are real distinctions between a grant of equity and its cash-settled counterpart. Most significantly, financial accounting rules would require the corporation to expense the entire cash award whereas an equity grant would fix the compensation expense at the value of the stock at the date of grant.267 Moreover, an equity grant provides for the possibility that the recipient holds the stock well after the vesting date. It is also possible that revision of the current taxing scheme will encourage the substitution of stock options for outright share grants. However, options are a fundamentally different type of instrument with a unique risk profile.268 In any event, stock options should be subject to similar rules and the tax law should be disabused of the notion that these instruments have no value at the date of grant.269

Equity-based compensation is perceived as the panacea to ameliorate agency cost issues in employment. Despite ample evidence to the contrary, this perception has become firmly ingrained in the corporate world and has resulted in a massive transfer of wealth from stockholders to management. Firmly-rooted beliefs are resistant to change. The fallacy that management has reaped the rewards of stock appreciation entirely through its labor only serves to reinforce current perceptions. The tax law should take a step to accurately portray the economics behind share-based compensation arrangements, as a step in the long-overdue reassessment of executive compensation practices. Equity compensation practices, which have now become ubiquitous, concentrate benefits within a small managerial class while diffusing their costs over large shareholder bases. Under such circumstances, adjustments will be difficult and slow.

We must bear in mind, then, that there is nothing more difficult and dangerous, or more doubtful of success, than an attempt to introduce a new order of things in any state. For the innovator has for enemies all those who derived advantages from the old order of things while those who expect to be benefited by the new institutions will be but lukewarm defenders. . . . Hence it is that, whenever the opponents of the new order of things have the opportunity to attack it, they will do so with the zeal of partisans, while the others defend it but feebly, so that it is dangerous to rely upon the latter.270

267. See supra notes 163-64 and accompanying text. For financial accounting purposes, cash settled awards are treated as liabilities and the measurement date is the date of settlement. Liabilities incurred under such arrangements are re-measured at the end of each reporting period. See SHARE-BASED PAYMENTS, supra note 55, at § 36.
268. See supra notes 56-66 and accompanying text.
269. See supra note 74 and accompanying text.