STATE OF NEW YORK

DIVISION OF TAX APPEALS

In the Matter of the Petition	:	
of	:	
RICHARD NIELSEN	:	DETERMINATION DTA NO. 818817
for Redetermination of a Deficiency or for Refund of New York State and New York City Personal Income Tax under Article 22 of the Tax Law and the New York City Administrative Code for the Years 1994 through 1997.	:	

Petitioner, Richard Nielsen, P.O. Box 3859 Greenville, Wilmington, Delaware 19807-0859, filed a petition for redetermination of a deficiency or for refund of New York State and New York City personal income tax under Article 22 of the Tax Law and the New York City Administrative Code for the years 1994 through 1997.

A hearing was held before Dennis M. Galliher, Administrative Law Judge, at the offices of the Division of Tax Appeals, 500 Federal Street, Troy, New York on March 27, 2003 at 10:00 A.M., with all briefs to be submitted by October 27, 2003, which date commenced the six-month period for the issuance of this determination. Petitioner appeared by McDermott, Will & Emery, Esqs. (Peter L. Faber, Esq., and Karen S. Dean, Esq., of counsel). The Division of Taxation appeared by Mark F. Volk, Esq. (Kevin R. Law, Esq., of counsel).

ISSUE

Whether income received from the sale of stock by a nonresident taxpayer who was an officer and director of Johnson & Higgins, a New York business, is New York source income.

FINDINGS OF FACT[1]

1. Petitioner, Richard A. Nielsen, born November 19, 1937, was a nonresident of New York State and timely filed all relevant tax returns for the period at issue.

2. Johnson & Higgins was a corporation organized under the laws of the State of New Jersey. The company's initial certificate of incorporation was filed with the Secretary of State of New Jersey on June 13, 1899. Johnson & Higgins was an insurance broker that was primarily engaged in the business of designing and marketing insurance, risk management programs, and employee benefit plans for its clients. Its principal place of business was at 125 Broad Street, New York, New York.

3. Petitioner was a director of Johnson & Higgins and was its vice chairman and chief operating officer.

4. There was only one class of Johnson & Higgins stock, all of which carried voting rights. Under Article FOURTH of the Johnson & Higgins Certificate of Incorporation, the company's stock could be owned only by persons who were officers, directors, or employees, and who were actively engaged in the company's service. Shares offered to nonofficer/nondirector employees totaled approximately five percent of the company's outstanding shares. These shares were offered to a small number of senior employees and were

[1] The parties entered into a Stipulation of Facts in this matter, enumerating stipulated facts "1" through "25". These stipulated facts are included in the Findings of Fact numbered "1" through "19". The numbering difference results from instances where certain stipulated facts were combined into a single Finding of Fact, or where such stipulated facts were included but were augmented in order to more completely reflect the record. Those stipulated facts which served only to identify evidentiary items included with the Stipulation (i.e., an Affidavit [per Stip. Fact "3"] and the Johnson & Higgins Certificate of Incorporation [per Stip. Fact "8"]), were deemed unnecessary and were not included. In addition to the Stipulation of Facts, petitioner submitted Proposed Findings of Fact numbered "1" through "45". Such proposed facts are supported by the evidence in the record, and have been incorporated in the Findings of Fact set forth in this determination, except for Proposed Findings "40", "41" and "42" which set forth procedural details not necessary for resolution of this matter, and except for the portion of Proposed Finding "30" which states that the elimination of the restrictions on the Johnson & Higgins stock was "not for the purpose of compensating the shareholders for services rendered." Such statement constitutes, ultimately, a conclusion of law germane to the resolution of this matter.

described as being offered as much, if not more, for the "pride" or "prestige" value to such employees of being able to hold themselves out as shareholders of Johnson & Higgins. Typically, the number of shares held by any of such senior employees resulted in dollar amounts of dividends paid to such employees which were comparatively small in relation to the dollar amounts of salary and other compensation paid to such employees.

5. Directors of Johnson & Higgins were required to own a minimum of 500 shares of Johnson & Higgins stock, and a director who ceased for any reason to own at least 500 shares of Johnson & Higgins stock was required to vacate the directorship. As an employee of Johnson & Higgins who was actively employed in the company's service petitioner was, at some point prior to February 1, 1982, given the opportunity to purchase restricted Johnson & Higgins stock for either $10.00 per share or $1.00 per share. Stock purchased at a price of $10.00 per share immediately entitled its holder to receive dividends thereon, whereas stock purchased at a price of $1.00 per share did not entitle its holder to receive dividends until ten years after its purchase.[2] Petitioner purchased the director's requisite 500 shares of stock at a price of $10.00 per share on February 1, 1982, and thereafter purchased additional shares of stock over ensuing years at a price of $1.00 per share. Petitioner's Johnson & Higgins stock purchases were in the following amounts, for the following purchase prices, and on the following dates:

Number of Shares	Purchase Price Per Share	Purchase Date
500	$10.00	February 1, 1982
100	$ 1.00	January 3, 1983
10	$ 1.00	January 2, 1984
55	$ 1.00	January 2, 1984

[2] The $1.00 per share stock was that which had been previously surrendered (sold back) to Johnson & Higgins and which was still in the period under which its retired prior owners were being paid their dividend based on a formula sale price for such stock (***see,*** Finding of Fact "6")

335	$ 1.00	December 31, 1985
185	$ 1.00	December 31, 1986
195	$ 1.00	December 31, 1986
170	$ 1.00	December 31, 1987
180	$ 1.00	December 31, 1988
295	$ 1.00	December 31, 1989
510	$ 1.00	December 31, 1990
625	$ 1.00	December 31, 1991
430	$ 1.00	December 31, 1992
110	$ 1.00	December 31, 1993

The record does not disclose whether there were any limitations on the number of shares any particular employee (who was eligible to acquire shares) could purchase in any given year, whether there were any limitations on the aggregate number of shares any eligible employee could own, or otherwise explain the fluctuations in the number of shares purchased by petitioner over the years spanning 1982 through 1993.

6. Pursuant to restrictions on the Johnson & Higgins stock, petitioner could not sell, assign, transfer, give, pledge, or otherwise dispose of his Johnson & Higgins stock to any other party except, according to petitioner, to parties who were actively engaged in the service of Johnson & Higgins and who were officers, directors or certain designated senior employees, i.e., other qualified or eligible shareholders (***see*** Findings of Fact "4" and "9"). The Johnson & Higgins shares held by retiring, resigning, or deceased persons had to be surrendered to Johnson & Higgins, with Johnson & Higgins repurchasing such shares for a formula price, as follows:

> For Johnson and Higgins stock entitled to dividends, the departing shareholder would receive as the sale price an amount equal to the dividends paid on the stock for each of the next ten years.

> For Johnson & Higgins stock not then entitled to dividends, the departing shareholder would receive as the sale price an amount equal to the dividends paid on the stock for each year of the next ten years in which dividends would have been payable on the stock.

7. The resigning or retiring persons whose shares were being surrendered would receive a Certificate (or Certificates) setting forth the terms of and entitlement to the payments in exchange for their shares. For resigning or retiring persons, such surrender and repurchase for the full repurchase price was contingent on the execution of a noncompetition agreement with a duration of five years. If a retiring or resigning shareholder did not enter into a noncompetition agreement, that shareholder would only receive one year's worth of dividends instead of the ten year's worth of dividends he or she would have otherwise received. Directors of Johnson & Higgins were required to retire at age 60 if they had more than 15 years of service with Johnson & Higgins. In view of his date of birth, petitioner was expected to retire from his positions at Johnson & Higgins in 1997.

8. For estate planning purposes, the Johnson & Higgins shareholders were advised to value their shares of stock using the "Hoskold" formula, which calculated the expected dividend flow of the stock over a period of ten years following death based on the present value of the stock, subject to discounts for business risk, time delay, and lack of marketability.

9. From the day on which petitioner purchased each block of stock from Johnson & Higgins, Johnson & Higgins retained the option to repurchase the stock from petitioner at any time before his death, resignation, or retirement from Johnson & Higgins at the original purchase price of either $10.00 or $1.00 per share. This option, specifically denominated a "forfeiture," was spelled out in the terms of the stock purchase agreements between Johnson & Higgins and the individuals who were entitled to purchase shares of stock (i.e., directors, officers and certain designated senior employees), as follows:

> The Purchaser hereby grants to the Corporation, and the Corporation hereby accepts from the Purchaser, an option to repurchase all the shares [being sold under the agreement] for an amount equal to the total consideration paid by purchaser for all said shares [being sold under the agreement] upon ten (10) days' written notice to the Purchaser given *at any time* during the lifetime of the Purchaser before his resignation or retirement shall have been approved by the Corporation. *The exercise of this option shall constitute a forfeiture of said shares***.** This option is exercisable *for any reason* whatsoever, including *any attempt by the Purchaser to sell, assign, pledge, hypothecate, transfer or otherwise dispose of said shares, or any attempt by the Purchaser to terminate his employment for any reason* . . . . (Emphasis added.)

10. Petitioner presented the testimony of Gardner Mundy, a long-term employee, officer, director and shareholder who served as the company's corporate secretary and general counsel. In response to questions concerning the company's option to repurchase the shares for their original price at any time for any reason, petitioner's witness described only one instance where such option was utilized. The situation involved a shareholder who had surrendered his shares in exchange for a Certificate, described as a contract, providing for payment of the formula price for such shares. When the individual later violated the terms of the contract, Johnson & Higgins discontinued payments thereunder. However, by such time, the individual had already received the amount he had originally paid to acquire his stock, and therefore the company made no further payments, a result described by petitioner's witness as "indirectly, that draconian method of valuing [forfeiture option] was used." Petitioner's witness was also questioned concerning whether a shareholder could sell his shares to another shareholder for a price in excess of the original purchase price. He explained that such a transaction would not likely occur in light of Johnson & Higgins' forfeiture option to repurchase the shares for their original purchase price for any reason whatsoever, including any attempt to sell or otherwise dispose of the shares.

11. The Johnson & Higgins stock purchased by petitioner was not traded on any stock exchange at any time, nor was any other stock of Johnson & Higgins. Because of the significant

restrictions on the stock and the lack of a recognized or organized exchange, no market existed for petitioner's shares of Johnson & Higgins stock.

12. In March 1997, all of the Johnson & Higgins stock, including that owned by petitioner, was sold to Marsh & McLennan Companies ("Marsh & McLennan"). Marsh & McLennan's stock is traded on the New York Stock Exchange. The purchase price received by the transferring shareholders was in the form of cash and Marsh & McLennan stock.

13. Prior to the fall of 1996, the sale of the entire company had never been seriously considered as a possible strategic planning option. The sale of the Johnson & Higgins stock to Marsh & McClennan by the Johnson & Higgins shareholders was only possible because Johnson & Higgins removed the restrictions on the sale of its stock. The removal of the restrictions was necessary in order that the sale of the Johnson & Higgins stock to Marsh & McClennan could proceed, and such removal was contingent on the closing of the transaction with Marsh & McClennan.

14. In the sale, petitioner received a sales price of $48,310,625.00, which consisted of $18,393,583.00 of cash and 301,843 shares of Marsh & McLennan stock valued on petitioner's 1997 United States Individual Income Tax Return (Form 1040) at $29,917,042.00. On his accompanying 1997 Schedule D (Capital Gains and Losses), petitioner reported taxable gain on the sale of his Johnson & Higgins stock to Marsh & McLennan of $48,302,425.00.[3] For income tax purposes Johnson & Higgins, taking a conservative position, initially treated petitioner's gain

[3] This taxable gain represents the difference between the sales price received for the shares ($48,310,625.00) and petitioner's aggregate purchase price for his shares ($8,200.00).

from the sale of his Johnson & Higgins stock as compensation income, and income tax was accordingly withheld.[4]

15. On December 24, 1997, Johnson & Higgins, Marsh & McLennan, and petitioner along with the other Johnson & Higgins former shareholders, entered into a closing agreement ("IRS Closing Agreement") with the Internal Revenue Service of the United States ("IRS").

16. Under the IRS Closing Agreement, the IRS, Johnson & Higgins, Marsh & McLennan, and the former shareholders agreed, *inter alia*, to treat the Johnson & Higgins stock sold by the shareholders in the following manner:

> a) the purchases of the stock by the shareholders from Johnson & Higgins for purchase prices of $10.00 or $1.00 per share are treated as substantially-vested transfers of property under section 83 of the Internal Revenue Code;
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> b) no deduction shall be allowed to Johnson & Higgins as compensation with respect to such sales of stock to the shareholders;
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> c) no income shall be reported as compensation to the shareholders with respect to such purchases;
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> d) all dividends paid by Johnson & Higgins to the shareholders shall be treated as dividends and not as compensation and Johnson & Higgins shall not be entitled to deduct them as compensation;
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> e) Johnson & Higgins's cancellation of its option to repurchase and the other restrictions on the Johnson & Higgins stock in connection with the sale of all of that stock to Marsh & McLennan in 1997 resulted in no federal income or payroll tax consequences to Johnson & Higgins, the shareholders, and the holders of ten-year contracts (i.e., shareholders who had previously sold their stock back to Johnson & Higgins and were receiving installment payments in consideration therefor); and
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> f) the gain realized by the shareholders on the sale of their stock to Marsh & McLennan was capital gain income and not compensation income.

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[4] Petitioner also received $272,745.00 upon redemption of some of his stock by Johnson & Higgins, which amount was treated as capital gain income in accordance with the IRS Closing Agreement described in Findings of Fact "15" and "16".

17. Pursuant to the IRS Closing Agreement, petitioner, in filing his 1997 New York State personal income tax return, requested refunds from the New York State Department of Taxation and Finance ("Division") on or about October 22, 1998. Petitioner took the position that the income from the sale of his Johnson & Higgins stock to Marsh & McLennan was capital gain and that since he was a nonresident, such gain was not allocable to or taxable by New York.

18. In September 1998, the Division began an audit of petitioner's income tax returns for the years 1994 through 1997. Thereafter, the Division issued to petitioner a Notice of Deficiency dated December 7, 2000, asserting additional New York State and New York City personal income tax due for the years 1994, 1995, 1996 and 1997 in the aggregate amount of $6,046,459.93, plus interest and penalties. The Division asserted by its Notice of Deficiency that petitioner was a statutory resident of New York for the years 1994 through and including 1997. The Division also asserted that petitioner's income from the 1997 sale of Johnson & Higgins stock was New York source income in the event that petitioner was determined to be a nonresident.

19. Petitioner and the Division have agreed that petitioner was not a resident of New York State in 1994, 1995, 1996 or 1997. They have further agreed that petitioner will pay additional tax of $5,000.00, plus interest for each of the years 1994, 1995, and 1996, based on an additional allocation of his wage income during those years. The parties have also agreed that the only issue to be addressed in this proceeding is whether petitioner's income from the sale of Johnson & Higgins stock in 1997 is New York source income that is taxable to a nonresident. Finally, the parties have agreed that if it is determined that any amount of petitioner's income from the sale of Johnson & Higgins stock in 1997 is derived from or connected with New York sources

within the meaning of Tax Law § 631, then 75 percent of such amount will be subject to personal income tax for New York State and New York City purposes.[5]

20. Petitioner received salary compensation as well as dividends from Johnson and Higgins. During the years in issue, petitioner received the following amounts of pre-tax salary and dividends:

YEAR	PRE-TAX SALARY	DIVIDENDS
1994	$ 667,045.32	$100,040.00
1995	$1,446,697.21	$119,700.00
1996	$1,520,983.32	$133,000.00
1997	$1,625,369.65	$266,625.00

21. Petitioner presented the testimony and report of Mark Brattebo, an expert in the field of valuation of stock in entities, such as Johnson & Higgins, for which there existed no public market. According to Mr. Brattebo, the aggregate discounted fair market value of petitioner's 3,700 shares of Johnson & Higgins stock, which had been purchased for an aggregate price of $8,200.00 (***see*** Finding of Fact "5"), calculated as of the dates of purchase, totaled $1,392,000.00. Mr. Brattebo's method of valuation was based on his conclusion that the only economic benefit of ownership of the stock was in the dividends that might be paid by Johnson & Higgins, that is, the expected flow of dividends over the period of time the stock was held by an individual shareholder, plus the formula amount to be paid upon sale via surrender of the stock back to Johnson & Higgins, as calculated on the basis of the dividends expected to be paid over the next 10 years after such surrender.

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[5] The Division noted in its brief that the agreed upon 75 percent figure represents an approximate average of petitioner's wage allocation percentages for the subject years.

22. Mr. Brattebo's method of calculating the $1,392,000.00 aggregate fair market value of petitioner's stock on the various dates of its purchase involved, as noted, determining the then-present value of the right to receive future dividends expected to be paid on the stock, as follows:

> a) Mr. Brattebo first looked to the dividend history of Johnson & Higgins and calculated an annual growth rate for the dividends which had been paid in years preceding each share purchase date. This annual growth rate was then applied to the year of purchase and to each later year in which petitioner would be entitled to receive dividends, including the 10-year post-retirement period. Thus, the valuation of each block of stock did not remain static but reflected an increase over time.
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> b) After the expected dividend flow was established, Mr. Brattebo computed the present value of each block of stock at its given purchase date under a formula combining a long-term government bond rate and an equity risk premium calculated by Ibbotson & Associates in a generally accepted reference book for the appraisal industry.
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> c) Once the present value of each block of stock was thus established, a marketability discount of fifteen percent was applied to reflect the fact that there was no existing market for trading the shares of Johnson & Higgins stock. The fifteen percent discount was significantly lower than the marketability discounts that have been permitted in other valuation cases, reflecting the fact that in this situation the stockholder was entitled to dividends regardless of the lack of an outside market in which to sell the stock.

23. The valuation method used by Mr. Brattebo is similar to and produced a higher value than the Hoskold method used by Johnson & Higgins shareholders for estate tax purposes. Mr. Brattebo also noted that at the times the shares were purchased, the risk (or expectation) that the company would be sold and the risk (or expectation) that the company would buy back the stock at its original purchase price pursuant to the forfeiture option were low, and he concluded that such factors would not have a material effect on the value of the stock. Mr. Brattebo's value calculations relied primarily upon the terms of the restrictions on the shares and the stable history of growing dividends paid by Johnson & Higgins.

24. The dividends paid by Johnson & Higgins on those shares entitled to dividends were as follows:

YEAR	DIVIDEND AMOUNT PER SHARE
1972	$ 50.50
1973	$ 51.22
1974	$ 53.00
1975	$ 59.50
1976	$ 64.50
1977	$ 75.00
1978	$ 82.50
1979	$ 88.50
1980	$102.75
1981	$112.50
1982	$117.50
1983	$123.50
1984	$129.00
1985	$142.00
1986	$149.00
1987	$149.00
1988	$157.00
1989	$162.00
1990	$157.00
1991	$160.00
1992	$160.00
1993	$164.00
1994	$180.00
1995	$200.00
1996	$225.00

SUMMARY OF THE PARTIES' POSITIONS

25. Petitioner asserts that he purchased a capital asset, to wit, shares of stock, from his employer Johnson & Higgins, that such shares were vested in him at the time of purchase, and that he thereafter sold such capital asset at a gain. In turn, petitioner maintains such gain was properly treated as capital gain for Federal tax purposes, a result with which the IRS concurred as set forth in the IRS Closing Agreement. Petitioner goes on to argue that since his stock was not an item employed in his business, trade, profession or occupation in New York, and since he was a nonresident of New York, the gain upon his sale of the stock was not New York source income subject to tax by New York State or New York City.

26. Petitioner argues that IRC § 83, which governs the treatment of property transferred to any person in connection with the performance of services, does not require a conclusion that any part of the gain must be treated as compensation. In this regard petitioner recognizes that the stock was subject to two significant nonlapse restrictions, to wit, a) the forfeiture option right of Johnson & Higgins to repurchase the stock for any reason and at any time at the original purchase price petitioner paid for the stock and, b) the requirement that the stock had to be surrendered to Johnson & Higgins in exchange for a formula sales price upon termination of a shareholder's active employment with Johnson & Higgins. However, petitioner maintains that notwithstanding these restrictions, the stock was vested upon purchase, in that it was transferable and was not subject to a substantial risk of forfeiture. In this regard, petitioner posits that he could have transferred his shares to any other person actively engaged in the service of Johnson & Higgins, or could have transferred (by assignment) his rights to dividends in the stock to anyone, and that under the facts and circumstances of this case, such transferred rights (i.e., stock ownership or assigned dividends) were not subject to a substantial risk of forfeiture in the hands

of the transferee. Petitioner goes on to assert that the price he paid per share for such vested stock was properly viewed, in light of the restrictions and the resultant lack of any market for such shares, as the fair market value per share, thus leaving no amount of bargain element subject to tax as compensation income at the times of purchase or thereafter. Petitioner relies upon the Treasury Regulations promulgated with regard to IRC § 83, the nature of the restrictions on the stock and the manner in which Johnson & Higgins was structured, and (most directly) on the IRS Closing Agreement, as support for this position.

27. Petitioner also argues that Johnson & Higgins' cancellation of the nonlapse restrictions in connection with the sale of the stock to Marsh & McClennan was not a compensatory event, but rather was done for the sole purpose of allowing the sale to Marsh & McClennan to be consummated. Petitioner asserts that if the sale had not closed, the restrictions would have remained in place. He further points out that Johnson & Higgins did not treat the cancellation of the restrictions as a compensatory event, that any tax withholding in connection therewith by Johnson & Higgins was merely a conservative position, consistent with and reflective of the very conservative nature of the company in its dealings with governmental agencies.

28. Finally, petitioner asserts that if any portion of the gain on his stock constitutes compensation income, the same should be limited to the aggregate fair market value of each block of stock at the time of purchase less the purchase price paid by petitioner for each such block of stock (i.e., $1,392,000.00 less $8,200.00). According to petitioner, any gain exceeding such amount properly constitutes capital gain realized on an investment and is thus not subject to New York tax. Petitioner cites ***Michaelsen v. New York State Tax Commn***. (67 NY2d 579, 505

NYS 2d 585) and a Division memorandum (TSB-M-95 [3] I), in support of this alternative position.

29. The Division maintains, in contrast, that all of the gain on the sale of the stock represents compensation income to petitioner properly treated as New York source income subject to tax in accordance with petitioner's income allocation percentage (here stipulated as 75 percent of such income). The Division asserts that there was no transfer of the stock to petitioner at the times of purchase, in light of the restrictions which accompanied the stock. Apparently, the Division views the stock, as encumbered by the restrictions, to be a means of providing additional compensation to petitioner during the period of his employment with Johnson & Higgins and thereafter (apparently in recognition of his ongoing and prior services). This position might be viewed as petitioner's being given, at most, a right to receive a calculable stream of compensation income to be paid over a defined period of time. Accordingly, the Division asserts that petitioner never received the true benefit of the vested ownership of the stock of his employer at any time prior to the March 1997 release of the nonlapsing restrictions in connection with the sale of Johnson & Higgins to Marsh & McClennan.

30. The Division points out that at all times prior to March 1997, the stock was subject to the restriction that it had to be surrendered back to Johnson and Higgins upon cessation or termination of petitioner's employment with Johnson and Higgins. Furthermore, the stock could be repurchased by Johnson and Higgins at its original cost at any time for any reason. The Division maintains that the stock was therefore, according to its own acquisition terms, not transferrable and subject to a substantial risk of forfeiture at all times prior to the release of the restrictions. The Division goes on to argue that the stock was made available to petitioner in connection with his performance of services, but was not vested in petitioner and hence was not

"transferred" to petitioner until the removal of the restrictions, that such removal (and transfer) was compensatory, and that all of the gain on petitioner's sale of the stock was therefore compensation income properly subject to New York tax (as allocated by agreement). Finally, the Division maintains that it is not bound by, and is not required to follow the result reached between petitioner and the IRS as set forth in the IRS Closing Agreement.

31. Petitioner argues in response that all of the Johnson & Higgins stock was subject to the same restrictions and that, in selling its stock to petitioner, the company was simply extending to him the same terms it extended to all of its shareholders and was not attempting to compensate him for services. Petitioner points out that he enjoyed all of the rights of owning stock in this particular company, in that he could vote his shares, could receive dividends, and could sell the stock back to the company for a formula reasonably approximating fair market value. Petitioner also notes that the only economic value of the stock, given the restrictions and the lack of any market in which it could be traded, was its potential to pay dividends. Petitioner points out that he bore the risk that the value of the stock would decline over time, i.e., that Johnson & Higgins could become less profitable and as a result could pay less, or even no, dividends over time, or could become bankrupt. As it turned out, these risks did not materialize, and eventually petitioner reaped a large reward upon sale of the company, a situation not initially expected or seriously contemplated at the times petitioner was buying his shares. Petitioner argues that his stock was fully vested at the times of purchase, that he paid fair market value and thus there was no bargain element to be treated as compensation income in such purchases. Petitioner also maintains that at the times of purchase, there was no indication or intent that the company would be sold or as a consequence thereof his shares would be able to be sold other than to Johnson & Higgins pursuant to the usual retirement surrender circumstances. In turn,

petitioner asserts that he anticipated selling his shares for their fair market value, as determined by the formula surrender price which was the only available market for his shares. Ultimately, petitioner maintains that he held, via his shares, a vested capital asset. As a consequence, petitioner maintains that upon his sale of such asset, either via surrender back to Johnson & Higgins, as was anticipated at the time of his share purchases, or in a market based transaction, as actually occurred, any gain should be viewed as capital gain income realized by a nonresident and not subject to tax by New York. Finally, with regard to the release of the restrictions so as to allow the sale to Marsh & McLennan, petitioner argues that given such sale, the original purpose for the restrictions, to wit to assure that the management of the company should remain in its directors, officers and key employees, no longer existed. Hence, petitioner asserts that the cancellation or release of the restrictions was noncompensatory.

CONCLUSIONS OF LAW

A. It is well settled that a nonresident, such as petitioner, is subject to income tax by New York only on such income as is "derived from or connected with New York sources" (Tax Law § 631[a]), including compensation income that is "attributable to . . . a business, trade, profession or occupation carried on in this state" (Tax Law § 631[b][1]). Compensation income earned by a nonresident is, generally, allocated between business conducted in New York and business conducted elsewhere based on the number of days worked within and without New York and is subjected to tax by New York accordingly (Tax Law § 631[c]; 20 NYCRR 132.18).

B. Tax Law § 631(b)(2) further provides that:

> Income from intangible personal property, including annuities, dividends, interest, and gains from the disposition of intangible personal property, shall constitute income derived from New York sources only to the extent that such income is from property employed in a business, trade, profession, or occupation carried on in the state.

Thus, gain on the sale of shares of stock (i.e., intangible personal property) owned by a nonresident and not employed in a business, trade, profession or occupation carried on in New York ordinarily escapes taxation by New York. However, the Division argues, based on IRC § 83, that petitioner's shares of stock were not, in light of the restrictions thereon, vested in or transferred to him until such time as the restrictions were canceled. In turn, the Division asserts that such cancellation served to vest the stock in petitioner and constituted the transfer of the stock to petitioner. The Division contends the cancellation was a compensatory event, that the difference between the fair market value of the stock at the time the restrictions were canceled and the amount petitioner paid to purchase the stock was thus compensation income properly subject to tax by New York under Tax Law § 631(b)(1)(B) to the extent of the 75 percent allocation thereof as agreed to by stipulation.

C. As a starting point, there is no dispute between the parties that if a nonresident taxpayer, such as petitioner, employed by a New York employer, simply received unrestricted shares of stock in his employer and paid fair market value for such stock, the same would be a capital asset in the employee taxpayer's hands. The dividends paid thereon (if any) over the period of subsequent ownership, as well as the gain upon sale of the stock (if any) would not be subject to tax by New York (with the gain on sale allowed preferential capital gain treatment assuming the relevant holding period was met). Similarly, there is no dispute that if the same taxpayer received unrestricted shares of stock in his employer from such employer, but paid a price less than fair market value for such stock, the same would (absent other factors) still be a capital asset in the employee taxpayer's hands. However, the difference between such fair market value of the stock and the purchase price paid would, under the terms of IRC § 83, represent compensation income to the nonresident employee, and as compensation income

would be subject to New York tax in accordance with that taxpayer's income allocation percentage. As before, the dividends paid on such stock (if any) over the period of subsequent ownership, as well as the gain upon sale of the stock (if any), would not be subject to tax by New York (with the gain on sale allowed preferential capital gain treatment again assuming the relevant holding period was met). The distinction between the two situations is clearly the "bargain element." In simple terms, an employee's payment of less than fair market value in exchange for property received from his employer gives rise to the receipt of compensation income by the employee required to be recognized and subjected to tax, absent some specific exemption pertaining thereto (***see Commissioner v. LoBue***, 351 US 243; IRC § 83[a]).

D. In general terms then, the receipt of property in connection with the performance of services constitutes compensation income to the recipient to the extent that the fair market value of the property received exceeds the amount paid for the property by the recipient. Generally, such compensation income is recognized and reported at the point in time when such property vests in the recipient. IRC § 83, which governs such situations, provides as follows:

> (a) GENERAL RULE.–If, in connection with the performance of services, property is transferred to any person other than the person for whom such services are performed, the excess of–
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> (1) the fair market value of such property (determined without regard to any restriction other than a restriction which by its terms will never lapse) at the first time the rights of the person having the beneficial interest in such property are transferable or are not subject to a substantial risk of forfeiture, whichever occurs earlier, over
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> (2) the amount (if any) paid for such property,
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> shall be included in the gross income of the person who performed such services in the first taxable year in which the rights of the person having the beneficial interest in such property are transferable or are not subject to a substantial risk of forfeiture, whichever is applicable. The preceding sentence shall not apply if such person sells or otherwise disposes of such

> property in an arm's length transaction before his rights in such property become transferable or not subject to a substantial risk of forfeiture.[6]

E. In instances where property is transferred from an employer to an employee in connection with the performance of services, but such property is subject to restrictions, additional considerations come into play. In such instances, IRC § 83(c) and (d) go on to provide, in relevant part, as follows:

> (c) SPECIAL RULES.-- For purposes of this section–
>
> (1) SUBSTANTIAL RISK OF FORFEITURE.-- The rights of a person in property are subject to a substantial risk of forfeiture if such person's rights to full enjoyment of such property are conditioned upon the future performance of substantial services by any individual.
>
> (2) TRANSFERABILITY OF PROPERTY.-- The rights of a person in property are transferable only if the rights in such property of any transferee are not subject to a substantial risk of forfeiture.
>
> * * *
>
> (d) CERTAIN RESTRICTIONS WHICH WILL NEVER LAPSE.--
>
> (1) VALUATION.–In the case of property subject to a restriction which by its terms will never lapse, and which allows the transferee to sell such property only at a price determined under a formula, the price so determined shall be deemed to be the fair market value of the property unless established to the contrary by the Secretary, and the burden of proof shall be on the Secretary with respect to such value.
>
> (2) CANCELLATION.-- If, in the case of property subject to a restriction which by its terms will never lapse, the restriction is canceled, then, unless the taxpayer established–
>
> (A) that such cancellation was not compensatory, and
>
> (B) that the person, if any, who would be allowed a deduction if the cancellation were treated as compensatory, will treat the transaction as not

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[6] IRC § 83(b) permits a taxpayer to make an election to include the entire value of the property (including any bargain element) in taxable income in the year in which the property is received. Petitioner did not make an election under IRC § 83(b) with respect to any of the shares he received.

> compensatory, as evidenced in such manner as the Secretary shall prescribe by regulations, the excess of the fair market value of the property (computed without regard to the restrictions) at the time of cancellation over the sum of–
>
> (C) the fair market value of such property (computed by taking the restriction into account) immediately before the cancellation, and
>
> (D) the amount, if any, paid for the cancellation,
>
> shall be treated as compensation for the taxable year in which such cancellation occurs.

F. In the matter at hand, petitioner, a nonresident taxpayer, was among the limited number of employees designated as eligible to purchase stock from Johnson & Higgins, his New York employer. However, unlike the two earlier described situations of employees receiving unrestricted stock and paying either fair market value (no compensation income received) or less than fair market value (compensation income received to the extent of the "bargain element"), the Johnson & Higgins stock was subject at all times to two significant and complicating restrictions, as follows:

> 1) that Johnson & Higgins could, via forfeiture option, at any time and for any reason repurchase the stock at the initial purchase price paid by petitioner and,
>
> 2) that the stock had to be sold back to Johnson & Higgins upon the cessation of petitioner's employment with Johnson & Higgins (by termination [either voluntary or forced], retirement or death) at a formula sales price based on dividends of Johnson & Higgins.

Furthermore, petitioner's stock was purchased at prices per share which, at least in light of the valuation report submitted by petitioner's expert witness, appear to have been less than fair market value at the times of purchase, thus indicating the possible existence of a bargain element potentially treatable as compensation income either at the times of purchase, if the stock was then vested, or at the time when the restrictions on the stock were released. Thus, to resolve this

matter, it is necessary to consider whether petitioner's shares of stock were received in connection with the performance of services, whether such shares were vested in petitioner at the times of purchases, whether there was a bargain element in connection with petitioner's receipt of the shares, and when and how much of such bargain element (if any) was includible in income as compensation. Ultimately, these matters turn on the nature and impact of the restrictions on the stock.

G. The parties' opening positions are directly opposing. Petitioner maintains that he simply purchased stock from his employer for fair market value and that the gain realized on its subsequent sale was capital gain not subject to tax by New York.[7] The Division asserts, in stark contrast, that there was no transfer of the stock from Johnson & Higgins to petitioner within the meaning of IRC § 83 at any of the various times when petitioner purchased his shares. Instead, the Division maintains that the stock was not transferred to petitioner until March 1997, at which point in time the nonlapse restrictions on the shares were removed in connection with the sale of the company to Marsh & McClennan. The Division goes on to assert that the removal of the restrictions constituted the transfer of the property to petitioner, that such removal was compensatory, and that the proper measure of the value of the property then being received by petitioner from his employer and constituting compensation income was the sale price paid by Marsh & McClennan.

H. The first question to be addressed is whether the property in question (stock) was "transferred" to petitioner, within the meaning of IRC § 83(a) on the various dates of purchase,

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[7] Distilled to its essence, petitioner's position is that with each share purchase, he bought an asset at its actual and fair value purchase price. In turn, because of the restrictions on such asset, he anticipated selling the asset upon cessation of his employment and receiving in return a price upon sale, albeit determined in advance pursuant to a formula, which would be the fair market value for such asset being sold in the only market existing for such asset.

rather than at the time the nonlapse restrictions thereon were removed. Treas Reg (26 CFR) §1.83-3(a) provides in relevant part, with respect to the meaning of the term "transfer," as follows:[8]

> (a) Transfer:
>
> (1) In general. – For purposes of section 83 and the regulations thereunder, a transfer of property occurs when a person acquires a beneficial ownership interest in such property (disregarding any lapse restriction, as defined in § 1.83-3[i]).
>
> * * *
>
> (3) Requirement that property be returned.-- Similarly [to the grant of an option], no transfer may have occurred where property is transferred under conditions that require its return upon the happening of an event that is certain to occur, such as the termination of employment. In such a case, whether there is, in fact, a transfer depends upon all the facts and circumstances. Factors which indicate that no transfer has occurred are described in paragraphs (a)(4), (5) and (6) of this section.
>
> * * *
>
> (5) Relationship to fair market value. – An indication that no transfer has occurred is the extent to which the consideration to be paid the transferee upon surrendering the property does not approach the fair market value of the property at the time of surrender. For purposes of paragraphs (a)(5) and (6) of this section, fair market value includes fair market value determined under the rules of § 1.83-5(a)(1), relating to the valuation of property subject to nonlapse restrictions. Therefore, the existence of a nonlapse restriction referred to in § 1.83-5(a)(1) is not a factor indicating no transfer has occurred.
>
> (6) Risk of loss. – An indication that no transfer has occurred is the extent to which the transferee does not incur the risk of a beneficial owner that the value of the property at the time of transfer will decline substantially. Therefore, for purposes of this (6), risk of decline in property value is not limited to the risk that any amount paid for the property may be lost.

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[8] The omitted portions of Treas Reg (26 CFR) § 1.83-3(a), namely paragraphs (2) and (4), relate specifically to options, i.e., the transfer of a right to acquire property, rather than the transfer of the property itself as is the situation in this case.

I. It is clear that petitioner acquired beneficial ownership interests in the shares of Johnson & Higgins stock on the dates he purchased such stock. First, petitioner was entitled to vote his shares at all time after his purchases. By virtue of his initial acquisition of 500 shares, petitioner became entitled to hold the position as a member of the board of directors, and to receive the benefits accompanying such position. Petitioner also acquired the right to income in the form of the dividends declared by Johnson & Higgins on its stock, the impact of which was immediate with respect to the ten dollar per share stock and which, though delayed for a period of ten years with respect to the one dollar per share stock, was nonetheless a right held by petitioner from the moment he acquired his shares.

J. Notwithstanding petitioner's clear acquisition of beneficial ownership interests as detailed above the Division urges, primarily in view of paragraph (3) of Treas Reg § 1.83-3(a), that no transfer occurred because of the nonlapse restriction that petitioner had to return the stock to Johnson & Higgins upon the cessation of his employment with Johnson & Higgins. The issue of whether a "transfer" has occurred requires, as specified under Treas Reg § 1.83-3(a), an inquiry into all of the facts and circumstances, and thus the impact of paragraph (3) must be read in light of the entire regulatory framework, including specifically paragraph (5). Paragraph (5) of Treas Reg § 1.83-3(a) explains that no transfer may have occurred where the price to be paid (here the formula surrender price) to the transferee upon surrender of the property does not approach fair market value, as such is determined pursuant to Treas Reg (26 CFR) § 1.83-5(a)(1), which speaks to the valuation of property (such as petitioner's shares) subject to nonlapse restrictions. Thus, the anticipated surrender price of property subject to nonlapse restrictions must, when viewed at the time of the initial acquisition of the property, approach fair

market value in order for the property to be considered transferred, and its failure to do so would speak strongly against a conclusion that a transfer of property actually occurred.

K. Treas Reg (26 CFR) § 1.83-5(a), dealing with the valuation of property subject to nonlapse restrictions, provides as follows:

> Restrictions that will never lapse
>
> (a) Valuation.-- For purposes of section 83 and the regulations thereunder, in the case of property subject to a nonlapse restriction (as defined in § 1.83-3[h]), the price determined under the formula price will be considered to be the fair market value of the property unless established to the contrary by the Commissioner, and the burden of proof shall be on the Commissioner with respect to such value. If stock in a corporation is subject to a nonlapse restriction which requires the transferee to sell such stock only at a formula price based on book value, a reasonable multiple of earning or a reasonable combination thereof, the price so determined will ordinarily be regarded as determinative of the fair market value of such property for purposes of section 83. However, in certain circumstances the formula price will not be considered to be the fair market value of property subject to such a formula price restriction, even though the formula price restriction is a substantial factor in determining such value. For example, where the formula price is the current book value of stock, the book value of the stock at some time in the future may be a more accurate measure of the value of the stock than the current book value of the stock for purposes of determining the fair market value of the stock at the time the stock becomes substantially vested.[9]

[9] Treas Reg (26 CFR) § 1.83-3(h), defining nonlapse restrictions, provides, in relevant part, as follows:

> (h) Nonlapse restriction. – For purposes of section 83 and the regulations thereunder, a restriction which by its terms will never lapse (also referred to as a "nonlapse restriction") is a permanent limitation on the transferability of property –
>
> (i) Which will require the transferee of the property to sell, or offer to sell, such property at a price determined under a formula, and
>
> (ii) Which will continue to apply to and be enforced against the transferee or any subsequent holder (other than the transferor).

L. In this case petitioner, though required to surrender his shares, was entitled to receive a Certificate granting him payments equal to ten years worth of dividends on his shares. Petitioner's expert witness testified that, because of the lack of a market for the shares, the only economic value to be expected from the shares was the payment of dividends. In turn, his accompanying report based its calculation of fair market value at the times of purchase of the shares on the discounted present value of the expected flow of dividends from the shares. The Division has not challenged the validity of the method employed by petitioner's witness or the resulting determination of fair market value based thereon. Thus, it would appear that dividend flow should be the prime measure of the economic value of the shares.[10] It follows, then, that the surrender price calculation formula which based its payout directly on dividends would, absent other factors or challenge, result in a reasonable determination of fair market value to be received for the shares. In fact, the relevant regulation (Treas Reg § 1.83-5[a]) places the burden of proof on the Commissioner to establish that the result of such a formula is not representative of fair market value, and there is no evidence in the record to contradict the conclusion that the surrender formula price did not result in fair market value to be received upon surrender of the shares. In fact, it might be said, in simplest terms, that since there was no market other than the surrender "market" with its dividend based formula price, the same had to result in and be fair market value.

M. In summary of the foregoing, the Division has pointed, per Treas Reg § 1.83-3(a)(3), to the nonlapse restriction that required petitioner's shares to be transferred back to Johnson & Higgins upon cessation of employment to support the position that, despite petitioner's

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[10] Although petitioner's witness was called upon to determine the fair market value of the shares at the times of purchase, while Treas Reg § 1.83-3(a)(5) and § 1.83-5(a) aim toward the fair market value to be received at the time of surrender, the reliance on dividend flow as the prime measure of value is the common link in this matter.

acquisition of beneficial ownership interests in the shares at the times of purchase, no transfer of property occurred per Treas Reg § 1.83-3(a)(1). However, Treas Reg § 1.83-3(a)(5) provides that the existence of the nonlapse restriction itself is not a factor indicating no transfer has occurred, but rather that the critical factor is whether or not the price to be paid upon surrender approaches fair market value. Given that at the time the shares were purchased they were subject to the described restrictions, and that there was no intent to release such restrictions, the price petitioner could anticipate being paid upon surrender, per formula, was in fact fair market value. Thus, the existence of the mandatory surrender provision does not support the argument that no transfer occurred.

Furthermore, Treas Reg § 1.83-3(a)(6) does not lend support to the position that no transfer occurred in this case. Such regulation provides that no transfer may have occurred where the transferee (here petitioner) does not incur the risk of a beneficial owner that the value of the property at the time of transfer will decline substantially, with such risk of decline not limited to the risk that the price paid for the property might be lost. Notwithstanding Johnson & Higgins' apparent record of financial strength and its history of paying dividends on an increasing or growth basis, petitioner was clearly subject to the risk that the value of the company, and hence of its stock, would decline over time. In fact, Johnson & Higgins' fortunes could, for any number of reasons, reverse leaving petitioner to receive far less than his anticipated surrender price based on ten years worth of dividends. So too, as petitioner points out, Johnson & Higgins could go bankrupt, leaving petitioner with nothing. The fact that neither of these eventualities was anticipated, and that neither in fact occurred, is irrelevant for purposes of Treas Reg § 1.83-3(a)(6), which requires an analysis focused on the situation at the time of the

property transfer. Accordingly, it is concluded that petitioner's purchase of the stock of Johnson & Higgins at the various times was a transfer of property for purposes of IRC § 83.

N. Some of the difficulty in resolving the foregoing portion of this matter may be attributable to the use of the terms "transfer" and "vested" in an interchangeable fashion. These terms are clearly not synonymous and each has a different impact vis-a-vis the tax treatment of property. In fact, property may be transferred, as here, but may not be substantially vested in the transferee due to the existence of nonlapse restrictions accompanying the transferred property. This fact is borne out by the provisions of Treas Reg § 1.83-1(b) (which discusses in detail the impact of the "Subsequent sale, forfeiture, or other disposition of nonvested property"); Treas Reg § 1.83-1(c) (which discusses "Dispositions of nonvested property not at arm's length"); and Treas Reg § 1.83-3(d) (which discusses "Certain transfers upon death"). In each of the noted paragraphs, the property being sold, forfeited, disposed of, or transferred is described as "substantially *nonvested*" property that *has been transferred* in connection with the performance of services." The use of the past tense, *has,* bears out that property can be "transferred" to, but not be "vested in," the recipient. In sum, then, both petitioner's primary argument (that the property in question was simply a capital asset purchased and owned by petitioner such that the gain upon sale was not New York source income subject to New York tax), as well as the Division's primary argument (that the property was not transferred until March 1997 because the property was, until such time, subject to nonlapse restrictions), oversimplify the circumstances of this case and do not, without further analysis, allow for proper resolution.

O. Having concluded that petitioner's stock purchases were transfers of property, it must next be determined whether the same were transfers made "in connection with the performance of services" by petitioner, for it is such transfers which are subject to the governing rules of IRC

§ 83 (***see,*** Treas Reg [26 CFR] § 1.83-1[a]). In this respect, Treas Reg (26 CFR) § 1.83-3(f) provides as follows:

> Property transferred in connection with the performance of services. – Property transferred to an employee or an independent contractor (or beneficiary thereof) in recognition of the performance of, or the refraining from performance of, services is considered transferred in connection with the performance of services within the meaning of section 83. The existence of other persons entitled to buy stock on the same terms and conditions as an employee, whether pursuant to a public or private offering may, however, indicate that in such circumstances a transfer to the employee is not in recognition of the performance of, or the refraining from performance of, services. The transfer of property is subject to section 83 whether such transfer is in respect of past, present, or future services.

P. In this case, the stock at issue could only be purchased and held by persons who were actively engaged in the service of Johnson & Higgins. Hence, there were no "other persons entitled to buy such stock on the same terms and conditions as an employee." In fact, it was not even all employees actively engaged in the service of Johnson & Higgins who were entitled to purchase such stock. Rather, the stock was only available to those employees who were in the position of a director or officer of the company, or were among the relatively small group of senior employees designated by the board of directors as eligible to purchase shares. This latter group of employees was a limited group, and there was a limited and relatively small amount of stock made available to this group. A shareholder thus had to be a designated employee and remain in the active service of Johnson & Higgins in order to be eligible to acquire and to continue in ownership of Johnson & Higgins stock. Indeed, directors were specifically required to purchase and hold a minimum of 500 shares in order to be qualified to hold the position of a director. But for petitioner's prior, ongoing and future active service (i.e., employment) with Johnson & Higgins, he could neither have acquired his stock in the first instance, nor continued

to own such stock or receive the benefits resulting therefrom. It follows therefore that the stock was transferred in connection with the performance of services, per Treas Reg § 1.83-3(f).

Q. The conclusion that IRC § 83 applies to the subject transfer of property, reduces the issue to proper application of such section. In this respect, Treas Reg (26 CFR) § 1.83-1(a) provides as follows:

> Property transferred in connection with the performance of services
>
> (a) Inclusion in gross income
>
> (1) General rule. – Section 83 provides rules for the taxation of property transferred to an employee or independent contractor (or beneficiary thereof) in connection with the performance of services by such employee or independent contractor. *In general, such property is not taxable under section 83(a) until it has been transferred (as defined in § 1.83-3[a]) to such person and become substantially vested (as defined in § 1.83-3[b]) in such person.* In that case, the excess of –
>
> (i) The fair market value of such property (determined without regard to any lapse restriction, as defined in § 1.83-3(i)) at the time the property becomes substantially vested, over
>
> (ii) The amount (if any) paid for such property,
>
> shall be included as compensation in the gross income of such employee or independent contractor for the taxable year in which the property becomes substantially vested. *Until such property becomes substantially vested, the transferor shall be regarded as the owner of the property, and any income from such property received by the employee or independent contractor (or beneficiary thereof) or the right to the use of such property by the employee or independent contractor constitutes additional compensation and shall be included in the gross income of such employee or independent contractor for the taxable year in which such income is received or such use is made available.* This paragraph applies to a transfer of property in connection with the performance of services even though the transferor is not the person for whom such services are performed. (Emphasis added.)

R. In this matter, the fair market value of the stock transferred to petitioner in connection with the performance of services was clearly greater than the purchase price paid for the stock by petitioner. This question is largely answered by the Brattebo testimony and report concerning

the value of the shares at the times of acquisition, as well as by the analysis of fair market value in the context of whether a transfer had occurred (***see*** Conclusions of Law “K” through “M”, wherein it was concluded that the formula price petitioner could expect to receive upon surrender of his shares upon cessation of employment with Johnson & Higgins, as required under the nonlapse provision, approached fair market value). Further, there is no apparent link between the amount paid per share and the value of such shares at the times of purchase. In fact, the amount paid per share ($10.00 per share or $1.00 per share, depending upon the waiting period until dividends would be paid) could fairly be said to be *de minimis* at best, at least in light of the dividend history of the company. Moreover, the record includes no evidence of the imposition of any time limitation before petitioner would be entitled to receive the formula amount upon share surrender, whether the same occurred one year after his acquisition of the shares or at some date far later in time. Thus, the difference between the purchase price paid per share and the fair market value of the shares at the time of their purchase, clearly leaves a bargain purchase element present, and the timing, recognition, characterization and reporting rules of IRC § 83 apply to this situation.

S. Pursuant to the terms of IRC § 83 and Treas Reg § 1.83-1(a), the difference between the fair market value of the property and its purchase price is not taxable until two criteria are satisfied, to wit, the property is transferred and has become substantially vested in the transferee. It has already been concluded that the property has been transferred to petitioner. However, it remains to be determined when the property became substantially vested in petitioner, that is whether the stock was immediately vested upon transfer or rather was not so vested until the nonlapse restrictions were removed. In turn, resolution of this issue will allow a determination of the proper tax status of the property, including the income and gain to petitioner flowing

therefrom and the proper reporting and taxation thereof. On this score, if property is not substantially vested in the transferee at the time of transfer, then for tax purposes the transferor (here Johnson & Higgins) is considered to remain the owner of the property, any dividends received on the stock until the same vests would be considered compensation income taxable as ordinary income (Treas Reg § 1.83-1[a][1]) and subject to tax by New York (Tax Law § 631[b][1][B]), and any difference between fair market value and purchase price would, in the year the property vests, likewise be considered compensation income subject to tax by New York.[11]

T. With respect to the question of when transferred property is considered vested, Treas Reg (26 CFR) § 1.83-3(b) provides as follows:

> Substantially vested and substantially nonvested property. – For purposes of section 83 and the regulations thereunder, property is substantially nonvested when it is subject to a substantial risk of forfeiture, within the meaning of paragraph (c) of this section, *and* is nontransferable, within the meaning of paragraph (d) of this section. Property is substantially vested for such purposes when it is *either* transferable *or* not subject to a substantial risk of forfeiture. (Emphasis added.)

It is worth noting that the standard for nonvested is conjunctive, requiring that the property is both nontransferable *and* subject to a substantial risk of forfeiture, whereas the standard for vested is disjunctive, such that the property is considered vested when it is *either* transferable *or* is not subject to a substantial risk of forfeiture.

U. Further guidance on the issue of vested versus nonvested property is found in Treas Reg (26 CFR) § 1.83-3(c) and (d), which discusses risk of forfeiture and transferability of property, as follows:

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[11] This very specific "tax purposes" view of property ownership, per Treas Reg § 1.83-1(a)(1)(ii), differs from general legal concepts, claims, principles and consequences concerning the ownership of property, including the impact of the transfer of beneficial ownership interests in property.

(c) Substantial risk of forfeiture

(1) In general. – For purposes of section 83 and the regulations thereunder, whether a risk of forfeiture is substantial or not depends upon the facts and circumstances. A substantial risk of forfeiture exists where rights in property that are transferred are conditioned, directly or indirectly, upon the future performance (or refraining from performance) of substantial services by any person, or the occurrence of a condition related to a purpose of the transfer, and the possibility of forfeiture is substantial if such condition is not satisfied. Property is not transferred subject to a substantial risk of forfeiture to the extent that the employer is required to pay the fair market value of a portion of such property to the employee upon the return of such property. The risk that the value of property will decline during a certain period of time does not constitute a substantial risk of forfeiture. A nonlapse restriction, standing by itself, will not result in a substantial risk of forfeiture.

(2) Illustrations of substantial risks of forfeiture. – The regularity of the performance of services and the time spent in performing such services tend to indicate whether services required by a condition are substantial. The fact that the person performing services has the right to decline to perform such services without forfeiture may tend to establish that the services are insubstantial. Where stock is transferred to an underwriter prior to a public offering and the full enjoyment of such stock is expressly or impliedly conditioned upon the successful completion of the underwriting, the stock is subject to a substantial risk of forfeiture. Where an employee receives property from an employer subject to a requirement that it be returned if the total earnings of the employer do not increase, such property is subject to a substantial risk of forfeiture. On the other hand, requirements that the property be returned to the employer if the employee is discharged for cause or for committing a crime will not be considered to result in a substantial risk of forfeiture. An enforceable requirement that the property be returned to the employer if the employee accepts a job with a competing firm will not ordinarily be considered to result in a substantial risk of forfeiture unless the particular facts and circumstances indicate to the contrary. Factors which may be taken into account in determining whether a covenant not to compete constitutes a substantial risk of forfeiture are the age of the employee, the availability of alternative employment opportunities, the likelihood of the employee’s obtaining such other employment, the degree of skill possessed by the employee, the employee’s health, and the practice (if any) of the employer to enforce such covenants. Similarly, rights in property transferred to a retiring employee subject to the sole requirement that it be returned unless he renders consulting services upon the request of his former employer will not be considered subject to a substantial risk of forfeiture unless he is in fact expected to perform substantial services.

* * *

> (d) Transferability of property, – For purposes of section 83 and the regulations thereunder, the rights of a person in property are transferable if such person can transfer any interest in the property to any person other than the transferor of the property, but only if the rights in such property of such transferee are not subject to a substantial risk of forfeiture. Accordingly, property is transferable if the person performing the services or receiving the property can sell, assign, or pledge (as collateral for a loan, or as security for the performance of an obligation, or for any other purpose) his interest in the property to any person other than the transferor of such property and if the transferee is not required to give up the property or its value in the event the substantial risk of forfeiture materializes. On the other hand, property is not considered to be transferable merely because the person performing the services or receiving the property may designate a beneficiary to receive the property in the event of his death.

V. In this case, the stock was subject to both a substantial risk of forfeiture and was not transferable within the contemplation of Treas Reg § 1.83-3 (c) and (d), until the point in time when the nonlapse restrictions were removed in connection with the sale of Johnson & Higgins to Marsh & McClennan. Hence, until such time, the property was not substantially vested in petitioner. First, it is clear that the stock was at all times, legally and in fact, subject to a substantial risk of forfeiture. This restriction was spelled out directly in the stock purchase agreement by which the shares in question were transferred to petitioner. The restriction, very broadly and inclusively drafted, was specifically denominated a forfeiture option in such agreement, and it was exercisable at any time and for any reason whatsoever, including any attempt to sell, assign, pledge, hypothecate, transfer or otherwise dispose of the shares, or any attempt to terminate employment with Johnson & Higgins for any reason (***see***, Finding of Fact "9"). A substantial risk of forfeiture is present when the right to full enjoyment of the property is conditioned upon future performance of substantial services (Treas Reg [26 CFR] § 1.83-3[c][1]). Given the extremely broad range of circumstances or events under which, for any reason and at any time, the forfeiture option could be invoked by the transferor (Johnson & Higgins), and given that the holding of Johnson & Higgins' stock was conditioned upon being

within a designated class of persons (officers, directors and certain specific senior employees) who remained in the active service of Johnson & Higgins, it follows that the forfeiture option constituted a substantial risk of forfeiture. Finally, it is also noteworthy that retiring shareholders were required to execute a covenant not to compete in order to receive the full ten-year dividend- based formula price (which has been accepted as fair market value) in exchange for the surrender of their shares, and that the failure or refusal to do so would result in a much lower surrender price of only one year's dividends (***see***, Findings of Fact "6" and "7"). Such a result, while not a forfeiture of the shares, *per se*, is at the least a forfeiture of a very substantial portion of the formula-based surrender value for such property.

W. Turning to transferability, the other requisite criterion for determining whether property was or was not vested, the record bears out that the stock was not transferable by petitioner to anyone other than the transferor (Johnson & Higgins). In this regard, Treas Reg § 1.83-3(d) provides that property is transferable if any interest therein may be transferred to any person other than the transferor, but only if such rights in such property in the hands of the transferee are not subject to a substantial risk of forfeiture. Transferable to "any person" has been defined to mean that the property must be transferable to at least "one person" (out of all possible persons) as opposed to "anyone" (meaning transferable to all persons) (***see, Schulman v. Commissioner***, 93 TC 623). Petitioner admits that while the shares of stock were not transferable to "anyone" (or "everyone") in general, they nonetheless could, in fact, have been transferred to any other qualified Johnson & Higgins shareholder, i.e., any officer, director or designated senior employee actively engaged in the service of Johnson & Higgins.[12] Petitioner

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[12] The record does not include evidence from which it could be determined which Johnson & Higgins employees might have been designated in any given year as qualified and, as a consequence, offered the opportunity to buy shares. Perhaps more importantly, the record does not disclose if there were any limits imposed on any

also argues that the right to receive dividends, one of the beneficial ownership interests accompanying the shares, could have been assigned by petitioner to anyone (presumably meaning "everyone"). However, these claims are not borne out by the record. First, any transferee, including any other qualified Johnson & Higgins shareholders, as well as any assignees of the right to receive dividends, would have been subject to the same substantial risk of forfeiture of their rights in or derived from the stock as was petitioner. In this regard, the forfeiture option would be triggered by any attempt to sell, assign, pledge, hypothecate, transfer or otherwise dispose of the shares, terminate employment or, even more broadly, could be invoked for any reason whatsoever. Such a broad risk of forfeiture clearly and effectively leaves the shares nontransferable. In fact, the testimony supports this conclusion. Petitioner's witness testified that it was unlikely one shareholder would buy or even accept transfer of another shareholder's stock, at least for a price in excess of the original purchase price for such stock, in view of the company's broad forfeiture option to negate such a sale or transfer (***see***, Finding of Fact "10"). In addition, and although no exemplar of a ten year or other duration Certificate issued upon surrender of shares was provided in evidence, it appears that the forfeiture terms may have been incorporated therein. Again, the testimony spoke to at least one instance where the equivalent valuation method of the forfeiture option was applied (***see***, Finding of Fact "10"). This, at the least, lends credence to the position that the company would in fact exercise its forfeiture rights. Ultimately, it was not until the restrictions were removed that petitioner became free of the risk that he would forfeit the shares or their value. In sum, then, the shares of stock were not transferable and were subject to a substantial risk of forfeiture at all times until

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shareholders or potential shareholders as to the number of shares they could acquire in any given year or the total number of shares they were entitled to hold.

the restrictions on transfer and forfeiture were removed in March 1997, and thus were not substantially vested in petitioner until such time. Accordingly, for purposes of IRC § 83 and Treas Reg § 1.83-1(a), the stock is considered owned by Johnson & Higgins, and the excess of the fair market value of the stock over the purchase price paid by petitioner (the bargain element) was not includible in income or taxable to petitioner until the stock vested in petitioner via the release of the nonlapse restrictions in March 1997.[13]

X. As detailed above, petitioner's stock was not vested until the restrictions were released in March 1997. At such point in time, the stock became vested in petitioner and, pursuant to IRC § 83(a), the excess of the fair market value of the property over the amount paid by petitioner would be included as compensation in gross income unless the provisions of IRC § 83(d) and Treas Reg (26 CFR) § 1.83-5(b), which pertain to cancellations of nonlapse restrictions, lead to a conclusion that the cncellation was not compensatory. On this final issue, Treas Reg § 1.83-5(b) provides, as follows:

> (b) Cancellation
>
> (1) In general. – Under section 83(d)(2), if a nonlapse restriction imposed on property that is subject to section 83 is canceled, then, unless the taxpayer establishes –
>
> (i) That such cancellation was not compensatory, and
>
> (ii) That the person who would be allowed a deduction, if any, if the cancellation were treated as compensatory, will treat the transaction as not compensatory, as provided in paragraph (c)(2) of this section, the excess of the fair market value of such property (computed without regard to such restriction) at the time of cancellation, over the sum of –

[13] Consistent with this result, any income from the property (in this case dividends) would properly be considered compensation income in the years received, and properly subject (in this case) to tax by New York to the extent of the nonresident taxpayer's income allocation percentage. The issue of petitioner's treatment of dividends in prior years has not been placed in issue in this matter, and this determination therefore makes no conclusion concerning the propriety of the manner in which petitioner treated such dividends in prior years or the potential New York tax liability (if any) resulting therefrom.

> (iii) The fair market value of such property (computed by taking the restriction into account) immediately before the cancellation, and
>
> (iv) The amount, if any, paid for the cancellation,
>
> shall be treated as compensation for the taxable year in which such cancellation occurs. Whether there has been a noncompensatory cancellation of a nonlapse restriction under section 83(d)(2) depends upon the particular facts and circumstances. Ordinarily the fact that the employee or independent contractor is required to perform additional services or that the salary or payment of such a person is adjusted to take the cancellation into account indicates that such cancellation has a compensatory purpose. On the other hand, the fact that the original purpose of a restriction no longer exists may indicate that the purpose of such cancellation is noncompensatory. Thus, for example, if a so-called "buy-sell" restriction was imposed on a corporation's stock to limit ownership of such stock and is being canceled in connection with a public offering of the stock, such cancellation will generally be regarded as noncompensatory. However, the mere fact that the employer is willing to forego a deduction under section 83(h) is insufficient evidence to establish a noncompensatory cancellation of a nonlapse restriction. The refusal by a corporation or shareholder to repurchase stock of the corporation which is subject to a permanent right of first refusal will generally be treated as a cancellation of a nonlapse restriction. The preceding sentence shall not apply where there is no nonlapse restriction, for example, where the price to be paid for the stock subject to the right of first refusal is the fair market value of the stock. Section 83(d)(2) and this (1) do not apply where immediately after the cancellation of nonlapse restriction the property is still substantially nonvested and no section 83(b) election has been made with respect to such property. In such a case, the rules of section 83(a) and section 1.83-1 shall apply to the property.

Y. The cancellation of the restrictions on petitioner's stock was, under the circumstances, properly considered a compensatory cancellation. Petitioner has argued that the cancellation only occurred in order to allow the sale to Marsh & McClennan to take place, and likens such circumstance to that where restrictions are canceled in connection with a public offering of a company's stock. Here, the purpose for the sale of Johnson & Higgins to Marsh & McClennan was described only in terms of being a "viable strategic planning option." Prior to the latter part of 1996, there had been no intent to sell the company and the same had not been seriously

considered. Unlike a public offering, there has been no indication or evidence that the subject sale was for the purpose of raising capital for the company. There is in fact no clear evidence to support a conclusion that the cancellation here was anything other than compensatory. Treas Reg § 1.83-5(b)(1) is written in the conjunctive, requiring a showing that the cancellation is, in the first instance, noncompensatory and, thereafter, that the employer will not take a compensation-based deduction in connection therewith. Thus, as the regulation goes on to explain, it is not enough that the employer is willing to forgo a deduction in connection with the cancellation of a nonlapse restriction. Similarly, there is no clear evidence of the original purpose or purposes for which the restrictions in this case were put in place. Hence, it is not enough to simply state that the original purpose for the restrictions no longer applies and that therefore the cancellation should be considered noncompensatory.

Z. In sum, then, the cancellation of the restrictions in this case pursuant to which the stock became vested in petitioner was a compensatory event. As a result, the difference between the fair market value of the shares in the year they became substantially vested, here 1997, and the price petitioner paid for such shares, was properly includible in gross income as compensation in 1997. The sale price petitioner received for his shares was properly viewed as the fair market value of the shares at the time the restrictions were canceled and the stock vested in petitioner. The difference between such amount and the aggregate price paid by petitioner to acquire the shares was compensation income paid to a nonresident by his New York employer, and the Division properly treated the same as New York source income subject to New York tax.

AA. As to petitioner's argument that great deference should be accorded the IRS Closing Agreement, a review of the same reveals no detail as to the underlying foundation for the conclusion and treatment afforded the parties under such document. Under its terms, the obvious

advantage to the shareholders is that their gain on sale is treated in a tax advantaged manner, that is as capital gain income subject to the application of more favorable tax rates. The IRS, at the same time, while accepting taxation of the individual taxpayers' gain at lower capital gains rates, was able to tax the gain as calculated from the lowest basis for the shares (i.e., original purchase price), thus producing the greatest amount of capital gain income subject to tax. Furthermore, the IRS accepted an agreement where the income of the corporation was not reduced by any deduction at the corporate level for compensation paid to corporate employees. Moreover, both the IRS and the taxpayers (corporate and individual) gained the benefit of closing a matter expeditiously, thus avoiding the possibility, if not likelihood, of protracted and contentious litigation. While the IRS and the Division share many similar concerns, it remains that the IRS does not face the additional question of whether the income is subject to tax at all, a concern of unique and direct consequence to the Division. Ultimately, the IRS Closing Agreement, without more, represents simply the memorialization of a settlement, primarily informed by Federal tax considerations and agreeable to the parties at the Federal level. While such settlement and its terms is a factor to be considered, it is not a matter to be accorded great weight in arriving at the resolution of the matter presented herein, nor is it binding upon the Division or upon this forum (***see***, 20 NYCRR 159.4).

BB. Petitioner also relies directly on ***Estate of Marshall v. Commissioner*** (20 TC 979), a case involving a deceased former director, officer and employee of Johnson & Higgins who had surrendered his stock to Johnson & Higgins upon retirement in exchange for the formula sale price measured by dividends payable over ten years. The Tax Court held that the taxpayer properly treated the formula-derived amounts he received, in installments post-retirement, as capital gain rather than as ordinary income, notwithstanding the use of the term "dividend" in

measuring the amount of the payments or the fact that the payments were made over a period of years (and were indefinite in amount at the time of surrender of the stock because they were to be determined by the company's annual dividends). However, the Court's holding was premised upon the underlying stipulated facts that the stock was a capital asset and that its surrender to the company was a sale. Thus, the primary thrust of the Court's holding, i.e., its conclusion that neither the payment of the sales price for a capital asset in installments, nor the use of dividends or the nomenclature "dividend" as the determinant of that sales price, nor the indefinite dollar amount of the sales price as results from its measurement via future dividends, served to deny capital gain treatment of such sale price as received. In view of the stipulated facts, the Court therefore did not engage in a full review or discussion of whether the restricted stock acquired by the decedent from Johnson & Higgins might properly have been considered, in any part or in whole, compensation for services performed, nor the impact of the restrictions on the stock. In fact the Court noted simply that "Respondent [Commissioner] does not seriously contend that this was not a sale or exchange of petitioner's [Marshall's] stock, nor that the stock had not been a capital asset." Given these circumstances, and the fact that ***Marshall*** was decided well before the enactment of IRC § 83 which, as detailed, provides specific rules for the amount and timing of compensation income derived from property transferred (on or after June 30, 1969) in connection with the performance of services, the result in ***Marshall*** is of little persuasive value in resolving the instant matter.[14]

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[14] Those cases cited by petitioner in response to the Division's claim that ***Marshall*** appears to have been overruled by ***Commissioner v. LoBue*** (351 U.S. 243), stand, generally, for the same proposition as does ***Estate of Marshall***, to wit, that where there is a sale of a capital asset, the measurement of the sale price for such asset by reference to the seller's dividends or based on the seller's general profitability, or payment of the sale price for such asset in installments over time, will not necessarily defeat the right to capital gain treatment of such sale proceeds (***see e.g., Ayrton Metal Co. v. Commissioner***, 299 F2d 741; ***Grinnell Corp. v. U.S.***, 390 F2d 932; ***Townsend v. Commissioner***, 37 TC 830).

In the same manner, there are certain similarities under IRC § 83 in the treatment of stock options and in the treatment of property (as opposed to an option) transferred in connection with the performance of services, specifically with regard to when and to what extent compensation income is to be recognized. However, it remains that this case involves the transfer of property (stock) and not the transfer of the right to acquire property (a stock option), and thus the guidance provided by the stock option cases cited by the parties is limited. Finally, the Division's argument that the fact that Johnson & Higgins chose to withhold tax on the gain from the sales of shares indicates that such gain was compensation income, countered by petitioner's claim that such withholding was simply reflective of the conservative nature of the company and the uncertainty over how the IRS would treat the gain, has little probative value in establishing the proper treatment of the gain. In fact, such treatment is no more probative than would be a claim that an employer's failure to withhold is conclusive evidence that gain is in fact not properly subject to withholding.[15]

CC. Petitioner has also presented the alternative argument that if it is determined there was a bargain element at the time of petitioner's purchase of his shares, i.e., a value for such shares which exceeded the price per share paid by petitioner, the same should be the only amount to be treated as compensation income in this case (as opposed to the entire amount of gain on sale). This position appears to represent, in essence, a request to implement an IRC § 83(b) election retroactively. Petitioner, for the sake of this alternative argument, presented the testimony and report of Mark Brattebo to establish the fair market value of each block of shares

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[15] In fact, review of petitioner's New York State nonresident and part-year resident income tax returns filed for the years in issue reveals that dividends paid to petitioner (including the dividends paid on the Johnson & Higgins stock) and included in the Federal Amount column (line "3") of such returns, were not included in the "New York Amount" column of such returns. This reporting reflects a position consistent with the view that the stock was a capital asset not employed in petitioner's business, trade or profession in New York, thus leaving such dividends not subject to New York tax. In turn, such reporting and position is consistent with the argument advanced herein that, notwithstanding any employer withholding, the stock was a capital asset held by a nonresident leaving the gain on the sale thereof not subject to tax by New York.

purchased by petitioner at the times such purchases were made. As described, he calculated such value at $1,392,000.00. The Division, for its part, has not challenged either the method used by Mr. Brattebo, or the resulting aggregate fair market value attributed to the shares pursuant to Mr. Bratebo's report, but rather has asserted that in light of the restrictions on the shares, the compensation element was properly established at the time the restrictions were lifted, which was at the time the shares were sold to Marsh & McClennan. Inasmuch as there is neither obvious error in either the method of valuation chosen or in the result derived therefrom by Mr. Brattebo, nor any challenge thereto, it is appropriate to accept such value as the fair market value of the shares at the times of their purchases by petitioner. However, as set forth in detail earlier, since the shares were not vested in petitioner until the restrictions were canceled, petitioner's alternative argument must fail.

DD. The petition of Richard Nielsen is hereby denied and the Notice of Deficiency dated December 7, 2000, as recomputed in accordance with this determination and with the terms of the parties' stipulation (***see***, Findings of Fact "18" and "19"), is sustained.

DATED: Troy, New York
April 22, 2004

/s/ Dennis M. Galliher
ADMINISTRATIVE LAW JUDGE