Proskauer

IRS Issues Proposed Regulations under Internal Revenue Code Section 83 Regarding Substantial Risk of Forfeiture Analysis

June 5, 2012

On May 29, 2012, the Internal Revenue Service issued proposed regulations relating to property transferred in connection with the performance of services under Internal Revenue Code Section 83 (the "Proposed Regulations"). According to the Proposed Regulations, they are not intended to change existing law but, rather, they are intended to clarify the existing Section 83 regulations and resolve some uncertainty and confusion in defining whether a "substantial risk of forfeiture" exists.

As described in more detail below, the Proposed Regulations clarify that:

- a substantial risk of forfeiture may only be established through a service condition or a condition related to the purpose of the transfer, and not otherwise;
- in determining whether a risk of forfeiture is substantial, both the likelihood that a forfeiture condition will occur and the likelihood that the forfeiture condition will be enforced must be taken into consideration; and
- a substantial risk of forfeiture is generally not created by transfer restrictions on securities (such as lock-up provisions, buyback provisions and blackout periods), but only by a period during which the sale or other transfer of securities could subject the seller to a suit under Section 16(b) of the Securities and Exchange Act of 1934.

Generally, Section 83 requires the inclusion in gross income of property transferred in connection with the performance of services when the property is no longer "subject to a substantial risk of forfeiture." Existing Section 83 regulations provide that whether a risk of forfeiture is "substantial" depends upon the particular facts and circumstances. Under these regulations, a substantial risk of forfeiture may exist where vesting of property is subject to (i) a service condition (*e.g.*, employee must work for a specified period to become vested) or (ii) a condition related to the purpose of the transfer (*e.g.*, a performance-based condition). Property that is conditioned upon refraining from service, such as a covenant not to compete, may also establish a substantial risk of forfeiture based on the particular facts and circumstances.

In the preamble to the Proposed Regulations, the IRS acknowledged that there has been some degree of confusion as to whether other types of conditions on property could cause the property to be subject to a substantial risk of forfeiture.[1] The Proposed Regulations clarify that a substantial risk of forfeiture may only be established through a service condition or a condition related to the purpose of the transfer. Thus, a provision requiring a right to repurchase on an improper transfer, even one that could result in the return of some or all of the property for less than its fair market value, would not be sufficient to create a substantial risk of forfeiture for purposes of Section 83.

The Proposed Regulations also clarify that when determining whether a condition related to the purpose of the transfer exists, consideration must be given to both the likelihood that a forfeiture condition would occur and the likelihood that the forfeiture condition would be enforced. The Proposed Regulations use the example of a restricted stock award that is granted to an employee subject to a vesting condition that the employer's gross revenues not fall below 90% over the next three years. Admittedly, the gross revenue restriction is a "condition related to the purpose of the transfer" since it arguably incentivizes the employee to prevent such a fall in revenues. Nevertheless, the Proposed Regulations emphasize that this would not be a substantial risk of forfeiture if the facts and circumstances indicated that the employer is a long-standing seller and there is no expectation that demand for its products would fall.

Finally, the Proposed Regulations make clear that, with one exception, a substantial risk of forfeiture would not be created by transfer restrictions on securities, including transfer restrictions that could, if violated, result in forfeiture or return of some or all of the property or other damages, fees or penalties. By introducing two new examples, the Proposed Regulations illustrate that neither restrictions imposed by lock-up agreements [2] nor relating to insider trading under Rule 10b-5 of the Exchange Act[3] would establish a substantial risk of forfeiture for purposes of Section 83. However, the Proposed Regulations reinforce Section 83(c)(3) and related regulations by clarifying that a substantial risk of forfeiture would exist for so long as the sale or other transfer of property could subject the seller to a suit under Section 16(b) of the Securities and Exchange Act of 1934.

Although the Proposed Regulations remain subject to finalization of a comment period, they apply to transfers of property on or after January 1, 2013, and taxpayers may rely on them for property transferred after May 30, 2012. The IRS and the Treasury Department have requested comments on the Proposed Regulations by August 28, 2012.

The practical implications of the Proposed Regulations may only become clear over time. For example, it is unclear how employers and employees are expected to determine the likelihood that a forfeiture condition will occur (including whether there is a requirement to retest the likelihood of forfeiture following the initial determination), as well as the extent to which such a determination will be reviewed or rejected by the IRS and Treasury. Currently, public companies report the value of performance-based awards at the grant date based on the probable outcome of the applicable performance conditions pursuant to the accounting rules under FASB ASC Topic 718 and the executive compensation disclosure rules under Item 402 of Regulation S-K under the Securities Act of 1933. Disclosure of the likelihood of achieving performance goals is particularly important in light of increased focus on pay-for-performance and say-on-pay by regulators, institutional investors, the media and the public. However, the Proposed Regulations require scrutiny of the likelihood that a forfeiture condition applicable to performance-based awards would occur and be enforced.

Interestingly, the Proposed Regulations do not change the principle that a forfeiture condition tied to a covenant not to compete may constitute a substantial risk of forfeiture under Section 83. However, for such a risk to be sufficient to delay taxation of the underlying property, it would appear that the Proposed Regulations require that there be a substantial likelihood of both the non-competition covenant being breached and the forfeiture condition being enforced under the facts and circumstances. This is different than the substantial risk of forfeiture analysis under Code Section 409A, which specifically provides that a restrictive covenant will not be a substantial risk of forfeiture. It also leaves open the question of what position the Treasury will take in the long-delayed Code Section 457(f) regulations with respect to substantial risk of forfeiture for deferred compensation for executives of tax-exempt entities.

Finally, the Proposed Regulations do not include model language for the making of a Section 83(b) election. Section 83(b) permits a person who receives property in connection with the performance of services to make an election to include in his or her gross income the excess of the fair market value of the property over any amount paid for the property upon his or her receipt of the property. If that election is made, no income would be included in a later tax year when the substantial risk of forfeiture lapses. IRS officials had indicated at the May 2012 American Bar Association's Section of Taxation meeting that this model language would be forthcoming.

Please feel free to contact your Proskauer lawyer or any of the attorneys listed herein with questions regarding this alert.

* * *

IRS Circular 230 disclosure: To ensure compliance with requirements imposed by the IRS, we inform you that any U.S. federal tax advice contained in this document is not intended or written to be used, and cannot be used, for the purpose of (i) avoiding penalties under the Internal Revenue Code, or (ii) promoting, marketing, or recommending to another party any transaction or matter that is contained in this document.

This publication is a service to our clients and friends. It is designed only to give general information on the developments actually covered. It is not intended to be a comprehensive summary of recent developments in the law, treat exhaustively the subjects covered, provide legal advice, or render a legal opinion.

[1] The preamble to the Proposed Regulations cites Robinson v. Commissioner as an example of this confusion. In that case, the First Circuit Court of Appeals held that a substantial risk of forfeiture existed when the recipient of a stock option was required to sell his shares back to the employer at their original cost if the recipient wished to sell his shares within one year from the exercise date. 805 F.2d 38 (1st Cir. 1986).

[2] A common type of lock-up provision is one in which the holder of securities agrees not to sell, otherwise dispose of, or hedge the securities for a specified period (*e.g.*, a no-sale restriction during a six-month period following an initial public offering).

[3] One example of such a policy is an insider trading compliance program which permits insiders to exercise or sell securities only during a specified trading window.

Related Professionals

- **Andrea S. Rattner**
  Partner