

## Proposed U.S. Regulations Clarifying “Substantial Risk of Forfeiture”

The Internal Revenue Service (IRS) recently issued new proposed regulations clarifying when restricted property is granted with a “substantial risk of forfeiture” and allows for the deferral of taxation. These regulations, if finalized, would limit the scenarios in which property is subject to a substantial risk of forfeiture.

The Internal Revenue Service recently issued new proposed regulations (the Proposed Regulations) under section 83 of the Internal Revenue Code of 1986, as amended. Section 83 generally provides that the excess of the fair market value of property transferred to a person (the Service Provider) in exchange for services provided to the transferor (the Service Recipient), over the amount paid (if any) by the Service Provider for such property is immediately taxable to the Service Provider. However, property is not treated as having been transferred to a Service Provider until such property is “transferable” or not subject to a “substantial risk of forfeiture.” Accordingly, a grant of “restricted” property is a common form of compensation which, under the right circumstances, allows for the deferral of taxation by the Service Provider.

There has been some uncertainty surrounding when property transferred to a Service Provider is considered subject to a substantial risk of forfeiture, and thus, whether such transfer is immediately taxable. While the Proposed Regulations provide some clarity, if finalized, these regulations may make it more difficult for Service Providers to defer tax on the receipt of restricted property.

### Current Guidance

Existing Treasury Regulations sections 1.83-1 and 1.83-3 generally provide that a Service Provider is not subject to tax on the receipt of property transferred to such Service Provider in connection with services the Service Provider performs, if at the time of transfer, the property is subject to a “substantial risk of forfeiture” and is not “transferable.” Generally, property is subject to a substantial risk of forfeiture so long as its receipt is conditioned on either the Service Provider’s continued performance of substantial services for the Service Recipient or any other condition related to the purpose of the transfer of property to the Service Provider. For example, if, in exchange for services, stock is transferred to a Service Provider but such stock must be returned if the total earnings of the Service Recipient at the end of the year do not satisfy a predetermined target, such stock is subject to a substantial risk of forfeiture. Property is considered transferable if the Service Provider may freely transfer such property to a person other than the Service Recipient, and the property is not subject to a substantial risk of forfeiture (as discussed above) in the hands of such transferee.

## Proposed Regulations to Section 1.83-3(c)

The preamble to the Proposed Regulations recognizes that currently there is confusion among taxpayers and practitioners as to whether a condition unrelated to the transfer of property to a Service Provider creates a substantial risk of forfeiture. The Proposed Regulations clarify that only conditions related to the purpose of the transfer should be looked at to determine whether a substantial risk of forfeiture exists. An example of a condition that is not related to the transfer of property is where a corporation grants nonstatutory stock options to an employee to purchase its stock and the options are exercisable immediately. Upon a later initial public offering by the corporation of its stock, the employee enters into an agreement not to sell or otherwise dispose of any stock of the corporation during the six months following the IPO (*i.e.*, a “lock-up period”). The “lock-up period” restriction on the corporation’s stock acquired by the employee is a condition that is not related to the transfer of the shares to the employee. Accordingly, the receipt of the shares pursuant to an exercise of the options during the lock-up period would be a taxable event.

The Proposed Regulations also incorporate the conclusions of Revenue Ruling 2005-48, which provides that the short-swing profit restriction of section 16(b) of the Securities Exchange Act of 1934 (the “1934 Act”) is the only provision of securities law that delays taxation under section 83. Section 16(b) of the 1934 Act requires (i) officers, (ii) directors and (iii) shareholders who beneficially own 10-percent or more of the stock, of certain corporations to return any profit on the sale of such corporation’s stock issued to them within the previous six months which has since appreciated in price. The potential liability imposed by section 16(b) of the 1934 Act is considered a substantial risk of forfeiture under the Proposed Regulations. This inclusion is intended to support Congress’ intent that transfer restrictions which are predicated on actions

taken by the taxpayer (such as lock-ups or Rule 10b-5 violations) should not delay taxation on the Service Provider under section 83.

The Proposed Regulations also clarify that, with respect to a condition related to the purpose of the transfer, both the likelihood that the forfeiture event will occur and the likelihood that the forfeiture will be enforced must be considered. For example, if stock transferred to an employee must be forfeited if the gross receipts of the employer fall by 90 percent over the next three years, but it is extremely unlikely that such condition will occur, under the Proposed Regulations such a condition would not defer the taxation of the stock transfer.

Accordingly, the Proposed Regulations, if finalized, would limit the extent to which unrelated conditions or transfer restrictions are taken into account to determine whether property is subject to a substantial risk of forfeiture and thereby accelerate taxation of the Service Provider. If finalized, these proposed regulations would apply to property transferred after December 31, 2012.

## New Sample Language for Elections under Section 83(b)

Separately, the IRS recently released Revenue Procedure 2012-29; 2012-28 IRB 1, which includes a sample election under section 83(b) relating to shares of common stock subject to substantial risk of forfeiture. The language in the sample election would satisfy the content requirements under Treasury Regulations with respect to such elections under section 83(b), and is consistent with the approach set forth in the Proposed Regulations discussed above.

Please contact us if you would like any further guidance regarding the potential implications of the Proposed Regulations.

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## Practice group contacts

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