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TOPIC: Final Regulations and Recent Tax Court Case Clarify Definition of "Substantial Risk of Forfeiture" Under IRC Section 83.

CITES: Treas.Reg. § 1.83-3(c) (2003); *Austin v. Comm'r*, 141 T.C. No. 18 (Dec. 16, 2013).

SUMMARY: The IRS recently issued final Treasury regulations clarifying the definition of "substantial risk of forfeiture" under Code Section 83 which determines when employees will be subject to federal income tax on property (such as insurance policies or shares of stock) transferred to them by their employer in exchange for their services. Since income taxation generally is deferred as long as the transferred property is subject to a substantial risk of forfeiture, the definition of this term is very important.

The final Treasury regulations clarify that a substantial risk of forfeiture may only be established if rights in the property transferred are subject to (1) a "service condition" (i.e., performance of future services) or (2) a "condition related to the purpose of the transfer" (i.e., a performance condition).

In determining whether a substantial risk of forfeiture exists, the final Treasury regulations clarify that both the likelihood that (a) a forfeiture event will *occur* and (b) the likelihood that the forfeiture will be *enforced* must be considered.

The final regulations also clarify that transfer restrictions related to securities limitations generally will not create a substantial risk of forfeiture, even if a violation may result in penalties or disgorgement of some or all the property.

DETAILED DISCUSSION: IRC Section 83 requires an employee to include in ordinary income the value of property, such as an insurance policy or shares of stock, which is transferred

in connection with the performance of services when the property is no longer subject to a substantial risk of forfeiture. If the transferred property is determined to be subject to a substantial risk of forfeiture, the employee will not be required to take the value of the property into income for income tax purposes until the risk of forfeiture lapses. However, the employee may *elect* under IRC Section 83(b) to take the value of the property into income at the earlier time of the transfer (when the value may be lower) to avoid tax on a potentially higher value on the future date when the restrictions lapse.

The recently issued final Treasury regulations make the following three clarifications to the definition of substantial risk of forfeiture:

1. A substantial risk of forfeiture may only be established through (i) a service condition (generally, the employee must continue work for a period of time) or (ii) a condition related to the purpose of the transfer (a performance-based condition), except for certain enumerated exceptions for transfers of securities that could subject the employee to a suit under Section 16(b) of the Securities Exchange Act of 1934.

2. In determining whether a substantial risk of forfeiture exists, *both* the likelihood that a forfeiture condition will occur and be enforced must be considered.

3. Transfer restrictions applicable to stock or securities (such as rights of first refusal, call rights, lock-up provisions, blackout periods and insider trading compliance programs) will not generally create a substantial risk of forfeiture.

The preamble to the final regulations clarifies that a risk of forfeiture which lapses on "involuntary separation from service without cause" may be considered to be "substantial" enough to delay inclusion in income under IRC Section 83 if the facts and circumstances do not demonstrate that such an involuntary separation is unlikely to occur.

The requirement that the risk of a particular type of termination occurring be substantial is consistent with a recent Tax Court decision *Austin v. Commissioner* which concluded that restricted stock which was subject to forfeiture upon termination for cause was subject to a substantial risk of forfeiture under IRC Section 83. Although existing regulations under IRC Section 83 specifically provide that "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," the Tax Court in *Austin* found that stock that an employee was required to forfeit on termination for cause, which under the applicable employment contract included the refusal or failure after receipt of notice to the employee to "faithfully and diligently" perform the "usual and customary duties of his employment" was subject to a substantial risk of forfeiture.

The Tax Court in *Austin* concluded that, as used in the regulation, the term "discharged for cause" refers to termination for serious misconduct that is roughly comparable, in its severity and in the unlikelihood of its occurrence, to criminal misconduct but that the discharged for cause provision in the employment contract constituted a sort of "earn out" requirement intended to

assure that the employee continued to provide services through the vesting period and therefore constituted a "substantial" service condition.

RELEVANCE: Both the final Treasury regulations and the *Austin* case indicate that the existence of a "substantial risk of forfeiture" for purposes of delaying the timing of income taxation will turn on the facts and circumstances of each case.

AALU Members should be aware of the need to focus on the substantiality of forfeiture provisions relied on to delay inclusion in income of insurance policies or other assets transferred by employers to employees in the context of split dollar agreements and other nonqualified deferred compensation arrangements.

***WRNewswire* #14.03.13 was written by Marla Aspinwall of Loeb & Loeb, LLP.**

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