

Tax Alert

IRS Proposes Clarifications to Substantial Risk of Forfeiture Definition

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On May 29, 2012, the Internal Revenue Service (IRS) issued proposed regulations (available [here](#)) under Section 83 of the Internal Revenue Code that are intended to clarify the meaning of “substantial risk of forfeiture” for property transferred in connection with the performance of services. The proposed regulations affect employees and contractors who receive property, such as shares of restricted stock, for the performance of services. The regulations are proposed to apply as of January 1, 2013, with respect to property transferred on or after that date, although taxpayers may rely on the proposed regulations for property transferred after publication in the Federal Register on May 30, 2012. If finalized, the new regulations will result, under certain circumstances, in transfers of property being taxable earlier than might have otherwise previously been the case.

Section 83(a) provides rules on inclusion in gross income of property transferred in connection with the performance of services. Under Section 83, if property is transferred to any person in connection with the performance of services, the excess of (i) the fair market value of the property (determined without regard to lapse restrictions) 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 first, over (ii) the amount (if any) paid for such property, is included in the gross income of the service provider 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.

The proposed rules seek to clarify:

- A substantial risk of forfeiture may be established **only** through a service condition or a condition related to the purpose of the transfer.
- In determining whether a substantial risk of forfeiture exists based on 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.
- Transfer restrictions, other than restrictions under Section 16(b) of the Securities Exchange Act of 1934, do not create a substantial risk of forfeiture.

Under existing regulations, the rights of a person in property are subject to a substantial risk of forfeiture if such person’s rights to full enjoyment of the property are conditioned on the future performance of substantial services by any individual, or the occurrence of a condition related to the purpose of the transfer, and the possibility of forfeiture is substantial if this condition is not satisfied.

The proposed regulations are intended to negate any implication that a condition other than a service condition or a condition related to the purpose of the transfer can create a substantial risk of forfeiture. The IRS apparently was concerned that case law has created confusion as to whether other conditions may also give rise to a substantial risk of forfeiture, citing *Robinson v. Commissioner*, 805 F.2d 38 (1st Cir. 1986). In *Robinson*, an employee stock option had a provision that required the employee to sell his shares back to the employer, at the employee’s original cost, if he



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wished to dispose of them in less than one year after the day he exercised the option. On appeal from the United States Tax Court, the First Circuit held that the sellback provision, which was intended to prevent insider trading, created a substantial risk of forfeiture because it served a significant business purpose, even though the restriction was not conditioned on performance of future services and the Tax Court had held that the provision was not related to the purpose of the transfer. The proposed regulations clarify that a substantial risk of forfeiture may be established **only** through a service condition or a condition related to the purpose of the transfer.

The IRS also expressed concern over confusion as to whether, in determining whether a substantial risk of forfeiture exists, the likelihood that a condition related to the purpose of the transfer will occur must be considered. In *Robinson*, the First Circuit held that where the substantiality of risk depends on probability, the probability should be measured only by the likelihood of forfeiture once the condition has occurred. Thus, the First Circuit ruled that even though the likelihood of the employee selling his stock in less than one year was very low, there nevertheless was a substantial risk of forfeiture because the probability of the employer enforcing the sellback provision was very high. The proposed regulations clarify that, in determining whether a substantial risk of forfeiture exists based on a condition related to the purpose of the transfer, the likelihood that the forfeiture event will occur, as well as the likelihood that the forfeiture will be enforced, must be considered. The particular facts and circumstances could affect the analysis of whether a substantial risk of forfeiture exists for a significant owner, and may need to be taken into consideration in structuring the type of restriction that is intended to constitute a substantial risk of forfeiture.

The proposed regulations also clarify that, except as specifically provided in Section 83(c)(3) and Section 1.83-3(j) and (k) of the Treasury Regulations (relating to short-swing profits under Section 16(b) of the Exchange Act), transfer restrictions do not create a substantial risk of forfeiture, including transfer restrictions that carry the potential for forfeiture or disgorgement of some or all of the property, or other penalties, if the restriction is violated. This addition appears to effectuate congressional intent and further is intended to incorporate the holding in Revenue Ruling 2005-48 (2005-2 C.B. 259), which provides that the only provision of the securities law that would delay taxation under Section 83 is Section 16(b) of the Exchange Act.

The proposed regulations add several new examples, including an example of the application of Section 16(b) to an option and two examples illustrating that neither potential liability under Rule 10b-5 of the Exchange Act nor a lock-up agreement is sufficient by itself to create a substantial risk of forfeiture.

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