Skadden

Executive Compensation and Benefits Alert

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Proposed Regulations Make It More Difficult to Delay Taxation

Background

On May 29, 2012, the Internal Revenue Service (IRS) and the Treasury Department issued proposed regulations under Section 83 of the Internal Revenue Code. The proposed regulations clarify, and generally narrow, certain aspects of the concept of "substantial risk of forfeiture" under Section 83.

Section 83 requires an individual who receives property in exchange for services to include in gross income an amount equal to the amount by which the property's fair market value exceeds the amount, if any, paid for it by the individual. That amount must be included in the individual's income in the first year in which the individual's rights to the property are transferable or not subject to a substantial risk of forfeiture (unless an election is made under Section 83(b)).

Whether a risk of forfeiture is substantial depends on the facts and circumstances of a particular situation. A substantial risk of forfeiture generally exists where an individual's rights in the property are subject to, directly or indirectly, the future performance (or refraining from performance) of substantial services by the individual. Alternatively, a substantial risk of forfeiture generally exists where an individual's rights in the property are subject to 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.

Supplementary information included with the proposed regulations suggests that issuance of the regulations was in response to, confusion over (1) whether conditions other than those described above could constitute a substantial risk of forfeiture, to which the IRS responded in the negative, and (2) whether the likelihood that a condition will, in fact, occur is relevant in determining whether a risk of forfeiture constitutes a substantial risk of forfeiture, to which the IRS responded affirmatively. These two issues are described more fully in the following section.

The Proposed Regulations

Under the proposed regulations:

- *Only Limited, Specified Conditions May Constitute a Substantial Risk of Forfeiture*. It is not entirely clear whether the existing Section 83 regulations permit conditions that are neither service related nor related to the purpose of the transfer. The proposed regulations clarify that the only conditions that can constitute a substantial risk of forfeiture are (1) "service conditions" that require the individual to remain employed for a specified period of time and (2) conditions that are related to the purpose of the transfer, *e.g.*, a condition based upon achievement of one or more specified financial metrics.

- *Consideration Must Be Given to the Likelihood of the Occurrence of a Forfeiture Event and of Enforcement*. The existing Section 83 regulations can be read to suggest that the likelihood that a condition relating to the purpose of the transfer will be satisfied is not relevant in determining whether such a condition constitutes a substantial risk of forfeiture. The proposed regulations clarify that, in determining whether a condition relating to the purpose of the transfer constitutes a substantial risk of forfeiture, the likelihood that the condition will be satisfied must be considered. Accordingly, issuers of restricted stock and other awards that are subject to Section 83 and that have performance-based vesting conditions should be careful to ensure that the conditions are sufficiently rigorous so as to satisfy this requirement. Unfortunately, the proposed regulations merely provide that the likelihood that the condition will be satisfied must be taken into account, without providing any guidance on how rigorous the condition needs to be in order to be viewed as constituting a substantial risk of forfeiture. It may be that the IRS and/or practitioners will look to similar concepts that exist under Sections 162(m) and 409A of the Internal Revenue Code for guidance with respect to this issue.
- *Transfer Restrictions Are not a Substantial Risk of Forfeiture*. A transfer restriction — including a transfer restriction that, if violated, results in forfeiture or disgorgement of some or all of the property or the imposition of other penalties — does not constitute a substantial risk of forfeiture. Accordingly, neither the possibility that a sale of the property would result in liability under Rule 10b-5 of the Securities Exchange Act of 1934, as amended (the Exchange Act), nor contractual restrictions, such as lock-up agreements or insider trading compliance programs, will constitute a substantial risk of forfeiture. These provisions essentially incorporate the holding of Revenue Ruling 2005-48.
- *Potential Section 16(b) Liability as a Substantial Risk of Forfeiture*. The proposed regulations also add an example illustrating the unlikely circumstances under which potential liability to disgorge profits under Section 16(b) of the Exchange Act will be deemed to constitute a substantial risk of forfeiture. The example indicates that the Section 16 restriction will constitute a substantial risk of forfeiture where an option grant constitutes a non-exempt purchase under Section 16 (possible, but certainly not typical) and the optionee sells the underlying stock within six months of the date the option is granted (typically not permitted under most option awards). Accordingly, it will be only the unusual circumstance in which Section 16 restrictions are deemed to constitute a substantial risk of forfeiture. Although the regulations do not explicitly address the more interesting question of whether stock acquired upon the exercise of an option is deemed to be subject to a substantial risk of forfeiture where the exercise occurs within six months of an open-market, non-exempt, purchase, the logic of the regulations suggests that those option shares should be viewed as being subject to a substantial risk of forfeiture, notwithstanding that the risk of forfeiture was a direct result of the employee's volitional act, *i.e.*, the open-market purchase of shares.

While the full effect of the proposed regulations is not yet known, it is also not clear that they will cause any meaningful change in how most practitioners already view the requirements of Section 83. In any event, particular care should be taken in establishing any compensatory arrangement subject to Section 83 that is reliant upon the existence of a substantial risk of forfeiture because the IRS' proposal of the regulation may signal renewed IRS skepticism of unduly aggressive interpretations of what circumstances may constitute a substantial risk of forfeiture.

Effective Date

The proposed regulations apply to property transferred on or after January 1, 2013.

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