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IRS Proposes Tightening Section 83 "Substantial Risk of Forfeiture" for Multiple Compensation, FICA, and Pension Funding Rules

The IRS issued proposed regulations under Code Section 83 that would clarify the definition of a "substantial risk of forfeiture" in connection with compensatory transfers of property (e.g., restricted stock) by employers to their employees. Section 83 also applies to other service providers such as outside corporate directors and independent contractors. The proposed change also affects other tax rules such as (1) the acceleration of minimum funding contributions under Code Section 430, (2) FICA taxes on deferred compensation under Code Section 3121(v), and (3) change-in-control "golden parachutes" under Code Section 280G. The IRS may take a similar approach when dealing with other provisions of the Code that require a substantial risk of forfeiture for certain deferred compensation purposes, such as Sections 409A and 457(f).

Background

Section 83 of the Internal Revenue Code (Code) provides that property transferred to an employee (or other service provider) is taxable as soon as the employee's rights in the property are transferable or are "not subject to a substantial risk of forfeiture" (i.e., are vested).

In addition to determining when property transfers are taxable under Section 83, the definition of "substantial risk of forfeiture" under Section 83 is used for other purposes under the Code. For example:

- Section 430 provides that amounts includible in income in connection with certain grants of employer securities are not considered in determining excess compensation that would result in an acceleration of the minimum funding standards if the grants are subject to a substantial risk of forfeiture (as defined in Section 83(c)) for at least five years from the date of grant.
- Under Section 3121(v), nonqualified deferred compensation becomes subject to FICA taxes on the later of the date the services giving rise to the compensation are performed or the date the compensation is no longer subject to a substantial risk of forfeiture. Section 3121(v) also provides that the determination of whether there is a substantial risk of forfeiture must be made in accordance with the principles of Section 83 and its regulations.

- In determining how Section 280G (relating to golden parachutes) applies to payments that vest on a change in control of the company, the Section 280G regulations specifically define vesting using Section 83's regulations on substantial risk of forfeiture.

Current regulations under Section 83 provide that a "substantial risk of forfeiture" exists when both:

- The rights to transferred property are conditioned on the future performance (or the refraining from performance) of substantial services (i.e., a length-of-service requirement) or the occurrence of a condition related to the purpose of the transfer (e.g., a performance requirement).
- There is a substantial possibility of forfeiture occurring if that condition is not satisfied.

Under the current regulations, a substantial risk of forfeiture also exists if the sale of transferred property at a profit within six months of the transfer could subject the seller to suit under Section 16(b) of the Securities Exchange Act of 1934. The regulations provide that the risk of forfeiture does not lapse (and, therefore, the transfer is not subject to tax) until the end of the six-month period or, if earlier, the first day on which a sale of the shares would not be subject to Section 16(b). The current regulations are silent about other restrictions and limitations on transfers that may apply under U.S. securities laws.

Proposed Regulations

The Internal Revenue Service (IRS) proposes to clarify portions of the current regulations defining what constitutes a "substantial risk of forfeiture." The proposed regulations include examples to illustrate the impact of these changes.

The proposed regulations provide that:

- A substantial risk of forfeiture would occur only through a service condition or a condition related to the purpose of the transfer (such as a performance condition). Other conditions (e.g., a requirement that employees sell shares back to the company at cost if they want to sell the shares within a year from receipt) would not create a substantial risk of forfeiture.
- To determine whether a substantial risk of forfeiture exists, both the likelihood that the forfeiting event will occur and the likelihood that forfeiture will be enforced must be evaluated. This change in the proposed regulations is intended to ensure that only meaningful forfeiture events constitute a substantial risk of forfeiture. For example, an event that would trigger a clawback that either is not likely to occur or would not result in amounts actually being clawed back if it does occur would not constitute a substantial risk of forfeiture.
- Except as specifically provided in the regulations in connection with transfers subject to Section 16(b) of the Securities Exchange Act of 1934, transfer restrictions (including those that require the disgorgement of profits or forfeiture of property) would not create a substantial risk of forfeiture for purposes of Section 83. This effectively eliminates other types of securities law restrictions, such as lock-up agreements and insider trading limits under Rule 10b-5, from constituting a substantial

risk of forfeiture. In other words, in the absence of any other forfeiture restriction meeting the requirements of Section 83, these other types of restrictions would not prevent property from being taxed when transferred. The proposed rule also would clarify that the Section 16(b) six-month period cannot be extended for tax purposes by entering into new purchases that effectively extend the six-month period for securities law purposes.

INSIGHT

The definition of "substantial risk of forfeiture " for purposes of the deferred compensation rules in Code Section 409A, although broader than the definition under Section 83, also provides, in part, that compensation is subject to a substantial risk of forfeiture if the right to the deferred amount is conditioned on either the performance (but not the refraining from performance) of substantial future services (i.e., a length-of-service requirement) or the occurrence of a condition related to the purpose of the compensation (e.g., a performance requirement) and the possibility of forfeiture is substantial. Similarly, Section 457(f) regulations defining "substantial risk of forfeiture" for purposes of determining when amounts contributed to ineligible 457(f) plans are subject to tax provide that compensation is subject to a substantial risk of forfeiture when the rights to the compensation are subject to future performance of substantial services. Although its position is unknown at this point, the IRS ultimately may expand the regulations for Sections 409A and 457(f) to mirror the positions in the proposed Section 83 regulations.

Closing Thoughts

A January 1, 2013 effective date is proposed for the revised regulations. Although changes would only be required for property transfers that occur on or after that date, the IRS stated that employers may rely on the proposals prior to the effective date. Comments submitted to the IRS by August 28, 2012 will be considered in preparing the final rule.

Buck Can Help

- Review equity compensation arrangements and employment agreements to identify forfeiture provisions that may be affected if the proposed regulation is finalized
- Review executive and management compensation programs that would be affected by Section 280G (e.g., those providing acceleration of vesting or early payout in the event of a change in control)
- Evaluate the merits of implementing changes now where appropriate
- Suggest document changes for review by counsel
- Prepare communications to executives explaining how the change will affect income and FICA taxation
- Identify alternative vehicles to meet compensation objectives
- Consider the effect of existing risks of forfeiture on compensation considered in determining excess compensation for pension funding acceleration