IRC Section 83 Update

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IRC Section 83 affects many types of transactions, but it most frequently dictates the tax treatment of various forms of deferred compensation, including stock grants. Section 83 provides generally that if property is transferred to a person in connection with the performance of services, the excess of the fair market value of the property at the first time the transferee's rights in the property are transferable or are not subject to a substantial risk of forfeiture over the amount (if any) paid for the property is included in that person's gross income.

Under Section 83, there is normally no taxable event when a taxpayer is granted stock subject to some sort of restriction (*i.e.* he must remain employed for 5 years). Rather, he incurs tax only when his right to the stock becomes substantially vested and the restriction lapses. At that time, the taxpayer must include as ordinary income the excess of the fair market value at the time his right is substantially vested over the amount (if any) he paid at the time of the grant. This ordinary income represents the compensatory element of the taxpayer's choice to receive such deferred compensation.

However, under the appropriate circumstances, a taxpayer may lock in the compensatory side of the stock grant before his right to the stock becomes vested. This is called a Section 83(b) election and allows a taxpayer to accelerate the time at which he must include the stock in income. By making the election, the taxpayer effectively becomes an investor (rather a worker receiving compensation) and may be subject to tax at capital gains rates (rather than ordinary rates) after his right to the stock vests and he thereafter disposes of it.

In operation, Section 83 has many subtleties that must be observed. Recently, the IRS promulgated new guidance on two important aspects of the Section 83 calculations. First, the IRS issued proposed regulations, 77 Fed. Reg. 31783 (May 30, 2012), clarifying when a risk of forfeiture is substantial. Second, the IRS issued Revenue Procedure 2012-29 (June 26, 2012) that provides, for the first time, concrete guidance on the acceptable format for making a Section 83(b) election.

Substantial Risk of Forfeiture

One of the two key elements of deferral provided by Section 83 involves the substantial risk of forfeiture requirement. If the transferee's right to property is subject to a substantial risk of forfeiture, the transferor will still be regarded as the owner of such property. A worker may be incentivized to remain with a company by receiving the right to purchase stock at a reduced price, but subject to the condition that if he leaves the company within a certain period of time (say 5 years), he must sell the stock back to the company at the reduced price.

The requirement that he sell the stock back if he does not fulfill the 5 year obligation is a substantial risk of forfeiture, preventing immediate taxation of the compensation at the time he acquires the shares. After the 5 year period is exhausted, the worker's right to the stock becomes vested and he is subject to tax on the fair market value of the stock (less any amount previously paid by the worker for the shares).

Having to sell back shares is clearly a risk of forfeiture within the meaning of Section 83. However, there are many more subtle limits on the right to deferred compensation that test the substantial risk of forfeiture requirement. The proposed regulations attempt to clarify – and limit – what qualifies as a substantial risk of forfeiture by altering the definition contained at Treasury Regulation Section 1.83-3(c)(1) in at least three important ways.

First, the proposed regulations clarify that a substantial risk of forfeiture exists *only* where rights in property are conditioned upon the future performance of substantial service or upon the occurrence of a condition related to the purpose of the transfer. The current regulations do not contain the adverbial modifier "only." The proposed regulations indicate that only these two conditions – (1) a condition based on future performance of services (*e.g.* to ensure continued performance and loyalty); or (2) a condition related to the purpose of the transfer (*e.g.* the transferee invented a new device, performed some essential task, or brought some needed expertise to the organization) can constitute a substantial risk of forfeiture.

In addition, the proposed regulations parse the meaning of a substantial risk of forfeiture that is predicated on the occurrence of a condition related to the purpose of the transfer. The proposed regulation clarifies that *both* the likelihood that the forfeiture event will occur *and* the likelihood that the forfeiture will be enforced must be considered. Thus, according to the Supplemental Information provided with the proposed regulations, a substantial risk of forfeiture will *not* exist where the overall facts show there is no *real* risk of forfeiture, despite the fact that risk of forfeiture is tied to the transferee's individual personal performance.

As an example, the IRS provides the following situation: stock has been transferred by an employer to an employee and is nontransferable and subject to a condition that the stock be forfeited if the gross receipts of the employer falls by 90% over the next 3 years. The employer is a longstanding seller of a product and there is *no* indication that demand for the product will fall or the employer will be unable to sell the product. Although there is a condition related to the purpose of the transfer that would, to some degree, incentivize the employee to prevent such a fall in gross receipts, the IRS asserts that such a risk of forfeiture is illusory and not within the ambit of Section 83.

Finally, the proposed regulations add an entirely new sentence to Treasury Regulation 1.83-3(c)(1), stating that a transfer restriction, including a transfer restriction which carries the potential for forfeiture or disgorgement of some or all of the property if the restriction is violated, does *not* normally create a substantial risk of forfeiture. This was the holding in Revenue Ruling 2005-48 (2005-2 C.B. 259), which provides that various transfer restrictions (*e.g.* restrictions imposed by lock-up agreements or restrictions relating to insider trading under Rule 10b-5 of the Securities Exchange Act of 1934) do not create a substantial risk of forfeiture. Only the prospect of being subject to suit under section 16(b) of the Securities Exchange Act of 1934 creates the requisite substantial risk of forfeiture. See Section 83(c)(3).

83(b) Election

Undertaken properly, the Section 83(b) election allows a taxpayer to convert compensation for services – taxed as ordinary income – into an equity interest in the company – taxed at capital gains rates. Take for example, a taxpayer who is granted the right to purchase stock at $5 a share, at which time the shares have a fair market value of $10 a share, but on the condition that he remains with the company for 5 years. If at the end of the 5 year period, the shares are trading at $20 a share, he will be treated as receiving $15 of ordinary income, representing difference between the fair market value at the time the restriction lapsed ($20) and the amount he originally paid for the shares ($5).

If, however, at the time of the grant, he makes a Section 83(b) election, he will be treated as receiving $5 of ordinary income, representing the difference between the fair market value at the time of grant ($10) and the amount paid ($5). When the restriction lapses, and he sells the stock, he enjoys capital gain treatment on the $10 gain representing the difference between the fair market value at the time of lapse ($20) and his basis in the shares ($10) because of the Section 83(b) election. In such a situation, the worker transforms himself into an equity owner with the related tax benefits on final disposition of the shares.

Given the importance and prevalence of the Section 83(b) election, it is surprising that the IRS has never produced a form to allow taxpayers to make the election. Treasury Regulation Sections 1.83-2(b) through (e) do provide detailed guidance on the timing, manner and contents of such an election. However, giving the countless IRS forms, one would assume that a more standardized procedure would be in place.

Recently released Revenue Procedure 2012-29 provides a helpful format that may be used (although is not required to be used) to make the Section 83(b) election. Taxpayers and practitioners should study the IRS's proposed model and ensure that their current forms for making the election comport with the format provided in Revenue Procedure 2012-29. These requirements include the 30 day filing period and the necessary information about the taxpayer making the election and the property subject to the election. In addition, Revenue Procedure 2012-29 provides six helpful examples of various Section 83 situations and their potential tax treatment.

Conclusion

Recent published guidance demonstrates that the IRS is well aware of the many complex ramifications of Section 83. Taxpayers should bear in mind that the IRS's increase focus on Section 83 means that the statutory and procedural requirements of the code section must be carefully observed.

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