PUBLICATION

Proposed Section 83(a) Regulations Clarify But Also Make Tax Deferral More Difficult

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Under Section 83(a) of the Internal Revenue Code, when property is transferred to a taxpayer in connection with the performance of services, the excess of the fair market value of the property over the amount, if any, paid for the property is included in the taxpayer's gross income in the year of receipt, unless the property is subject to a substantial risk of forfeiture. Common examples of "restricted property" include restricted stock and "non-statutory" stock options.

The IRS has issued proposed regulations that will significantly affect the ability of taxpayers to defer tax on the receipt of property for services they render. The proposed regulations will apply to property transferred on or after January 1, 2013; however, taxpayers may rely on the regulations for property transferred after May 30, 2012.

<u>The "Clarifications"</u>

A taxpayer may defer tax on the receipt of property for services under Section 83(a) only if the property is subject to a substantial risk of forfeiture. The proposed regulations clarify that a substantial risk of forfeiture exists <u>only</u> when conditioned on the future performance of services or a condition related to the purpose of the transfer. Further, in determining whether a substantial risk of forfeiture exists based on a condition related to the transfer, both the likelihood that the forfeiture event <u>will occur</u> and the likelihood that the forfeiture <u>will be enforced</u> must be considered.

The proposed regulations also clarify that transfer restrictions on property <u>do not</u> create a substantial risk of forfeiture. The preamble to the regulations provides that Congress did not intend that transfer restrictions were sufficient to defer the taxable event. As a result, "lock-up agreements," transfer restrictions related to insider trading programs and other transfer restrictions that carry the potential for forfeiture or disgorgement of some or all of the property do not create a substantial risk of forfeiture under the proposed regulations. However, if the sale of the property at a profit could subject the taxpayer to suit under Section 16(b) of the Securities Exchange Act of 1934, receipt of the property is treated as subject to a substantial risk of forfeiture.

<u>Section 83(b) Elections</u>

Under Section 83(b) a taxpayer may elect to not apply Section 83(a) to the receipt of property subject to a substantial risk of forfeiture. Instead of deferring tax, the taxpayer may elect to accelerate the taxable event. By making a Section 83(b) election, the taxpayer may avoid taxation on any appreciation in the value of the property when the restrictions lapse and would be subject to tax on the appreciation only upon disposition of the property. The Section 83(b) election allows the taxpayer the ability to pay tax on the property as compensation income at the time of transfer to the taxpayer. In addition, tax may be calculated at capital gains rates, not ordinary income rates applicable to compensation income, upon disposition of the property.

Of course, the above election assumes that the restricted property appreciates by the time the restrictions lapse. If the property declines in value, the Section 83(b) election normally may not be revoked, and the taxpayer will have accelerated ordinary income inclusion and a capital loss upon disposition, one of the worst of all tax planning results. Further, if the property is actually forfeited, no deduction is allowed for the amount included in income as a result of the Section 83(b) election. Nonetheless, usually the advantage of enjoying capital gains rates, as opposed to ordinary income rates, on the appreciation in the stock provided by the Section 83(b) election outweighs this downside risk.

The proposed regulations do not expressly affect Section 83(b) elections. However the "clarifications" within the proposed regulations may result in expanding the types of restricted property that will not be eligible for deferred tax treatment under Section 83(a), thus effectively creating more situations where a Section 83(b) election should be considered by the taxpayer.

Conclusion

Questions and considerations surrounding the taxation of the receipt of restricted property under Sections 83(a) and (b) demand deliberate and cautious decision-making. The recently proposed regulations by the IRS must be added to the list of such considerations. If you would like to discuss the IRS's proposed regulations under Section 83(a) or have questions as to Section 83(b) elections, please contact one of the attorneys in the Firm's Tax Department.