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Tax Court Provides Color on "For Cause" Termination Under Code Section 83

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On December 16, 2013, the Tax Court decided a case that sheds important light on the meaning of the term "substantial risk of forfeiture" under section 83 of the Internal Revenue Code of 1986, as amended (the "Code").[1] The case, *Austin v. Commissioner*,[2] also serves as a warning to taxpayers that borrowing terms from Treasury regulations does not ensure that the contractual provisions will be construed in a manner identical to the applicable regulations.

Facts

The petitioners in *Austin* were business partners engaged in distressed debt investing. In 1998, the petitioners contributed various equity interests to a newly formed S Corporation (the "Company") in exchange for 95% of the stock of the Company.[3] Both taxpayers assumed active and significant roles in the operation of the Company's business. As part of the incorporation of the Company, both petitioners entered into a "Restricted Stock Agreement" ("RSA") and an "Employment Agreement" ("EA," and together with the RSAs, the "Agreements") that purported to govern the Company stock they received. According to the Tax Court's opinion, "the stated purpose of these agreements was to incentivize petitioners to exchange their [S Corporation] stock and require them to perform future services in order to secure their full rights in the stock." The EAs provided that the Company could terminate the Agreements at any time "for cause." Importantly, the Agreements defined "cause" to include three categories of employee conduct, the first of which generally involved "bad acts" by the employee.[4] One of the other two categories of termination "for cause" was:

- "Failure or refusal by the employee, after 15 days written notice to the employee, to cure by faithfully and diligently performing the usual and customary duties of his employment and adhere to the provisions of this Agreement."

The RSAs described the consequences of termination. In the case of termination for cause after December 31, 2003, the employee would receive 100% of the fair market value of his stock; for termination for cause prior to January 1, 2004, the employee would receive a formula value ranging from zero to 50% of the fair market value of the stock.

On their tax returns, the taxpayers took the position that under section 83, the Company stock was subject to a "substantial risk of forfeiture" and was therefore "substantially nonvested" and was properly treated as not outstanding for purposes of the rules governing S Corporations.[5] As a result, the taxpayers claimed that during the relevant periods, the ESOP was the owner of 100% of the stock of the Company. The IRS challenged the arrangement on a number of grounds, and the sole issue before the Tax Court was whether the IRS had correctly asserted that the stock was in fact "substantially vested" under section 83.

Holding

The IRS relied on Treas. Reg. section 1.83-3(c)(2) in support of its position. That regulation provides, in relevant part, that "requirements that the property be returned to the employer if the employee is discharged for cause or for committing a crime will not be considered to result in a substantial risk of forfeiture."[6] The taxpayers, on the other hand, argued that termination "for cause," as used in the regulation, is not identical to the "for cause" label used in the Agreements. Specifically, while the taxpayers conceded that the "bad acts" prong of the "cause" definition did not cause a cognizable forfeiture risk under the regulations, the prong containing the "usual and customary duties" language did in fact give rise to a forfeiture risk since it did not constitute "cause" under the regulation.

The Tax Court agreed with the taxpayers and considered the provision in the Agreements calling for a substantially discounted repurchase of the restricted stock in the event either taxpayer left his employment during the four-year period following the Company's incorporation a "classic" earnout restriction. Accordingly, the taxpayers properly treated the stock as "substantially nonvested" under section 83. The court characterized the section 83 "risk of forfeiture" rules as turning on whether there is a "real possibility that the condition may not be fulfilled." An example from the regulations of a quintessential "earnout" restriction is a requirement that an employee surrender stock back to the employer at cost in the event the employee leaves the employ of the employer "for any reason" within a 2-year period. The court concluded that the "for cause" terminology in the regulation (together with the explicit reference to commission of a crime) was intended to identify situations where "the risk of forfeiture rests upon a single possibility which is very unlikely to happen." The court also cited Tax Court precedents holding that forfeiture risks were absent because of the "remote" likelihood of certain forfeiture events. In the words of the Tax Court, "as used in the regulation, 'discharged for cause' refers to termination for serious conduct that is roughly comparable – in its severity and in the unlikelihood of its occurrence – to criminal misconduct…and is thus properly regarded as too remote — as a matter of law — to create a 'substantial risk of forfeiture.'"

Takeaway

The Tax Court in *Austin* provided a helpful clarification of the meaning of termination "for cause" under Treas. Reg. section 1.83-3(c)(2). Specifically, that regulation describes forfeiture conditions that are as unlikely (or nearly as unlikely) as the commission of a crime or other "bad act" by the employee.[7] The taxpayers in *Austin* were victorious despite some "inartful" drafting. Indeed, they were forced into a litigating position in which they had to argue *against* the language of their own agreements (namely, that what they designated as termination "for cause" was not in fact "for cause" under the regulations). Despite the outcome of the case in favor of the taxpayer, *Austin* serves as a reminder that self-serving language in employment or other agreements that track the applicable tax regulations will not always hold sway when weighed against the substance of the arrangement.

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Endnotes

[1] Unless otherwise indicated, all "section" references are to the Code.

[2] 141 T.C. No. 18 (12/16/13).

[3] An employee stock ownership plan, or ESOP, received the other 5% of the stock.

[4] Specifically, the first category included "dishonesty, fraud, embezzlement, alcohol or substance abuse, gross negligence or other similar conduct."

[5] Specifically, Treas. Reg. section 1.1361-1(b)(3) states that "For purposes of subchapter S, stock that is issued in connection with the performance of services (within the meaning of §1.83-3(f)) and that is substantially nonvested (within the meaning of § 1.83-3(b)) is not treated as outstanding stock of the corporation, and the holder of that stock is not treated as a shareholder solely by reason of holding the stock, unless the holder makes an election with respect to the stock under section 83(b)."

[6] Under Treas. Reg. section 1.83-3(c)(1), "Property is not transferred subject to a substantial risk of forfeiture to the extent that the employer is required to pay the fair market value of a portion of such property to the employee upon the return of such property." Accordingly, the various scenarios requiring a payment of full value to the taxpayers (namely, termination without cause or termination for cause after December 31, 2003) were not at issue in the case because these eventualities clearly did not give rise to a risk of forfeiture as defined by the regulations.

[7] Query the result where the employee is himself or herself a convicted criminal with a predisposition for recidivism.

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