Tax

Tax Alert

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Final Regulations Illustrate That Lock-Up Arrangements Do Not Prevent Current Taxation Under Section 83

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A transfer restriction on its own is not sufficient to defer tax on a compensatory equity grant. This proposition is highlighted by final regulations[1] issued by the IRS on Feb. 25th under Internal Revenue Code[2] section 83. The Final Regulations clarify whether a "substantial risk of forfeiture" exists for purposes of taxing a transfer of property to a service provider. These regulations essentially confirm (with a few modifications) the proposed regulations (the "Proposed Regulations") issued on May 30, 2012.[3] The enactment of the Final Regulations, while not necessarily a dramatic development in the section 83 area, does serve to remind practitioners of a fundamental aspect of the rules — namely, that in order for property to be treated as not vested, it must be nontransferable *and* subject to a forfeiture risk.

Generally, under section 83, property that is transferred in connection with the performance of services is not taxable until it has become "substantially vested."[4] Although many practitioners and businesspeople may use the term "vested" to refer to a recipient's unconditional enjoyment of property, it is critical to keep in mind that for purposes of section 83, property can be fully "vested" even if it is subject to a significant transfer restriction such as a lock-up arrangement. This is a result of the disjunctive test articulated in Treas. Reg. section 1.83-3(b), which provides that "for purposes of section 83 and the regulations thereunder…[p]roperty is substantially vested for such purposes when it is *either* transferable *or* not subject to a substantial risk of forfeiture" (emphasis added). Accordingly, a grant of equity compensation may be fully taxable under section 83 even though (1) the recipient is contractually barred from disposing of such stock for a significant period of time, and (2) the penalty for an attempted transfer is the complete forfeiture of the equity.

The Final Regulations (like the Proposed Regulations) effectuate this result by adding language to Treas. Reg. section 1.83-3(c)(1). The added language provides that "A restriction on the transfer of property, whether contractual or by operation of applicable law, will result in a substantial risk of forfeiture only if" the restriction relates to two specific exceptions contained in the regulations.[5] The regulation then goes on to confirm that "transfer restrictions that will not result in a substantial risk of forfeiture include, but are not limited to, restrictions that if violated, whether by transfer or attempted transfer of the property, would result in the forfeiture of some or all of the property, or liability by the employee for any damages, penalties, fees, or other amount." A recipient's enjoyment of property may be severely curtailed during a lock-up period, for no reason other than the fact that the value of the property may decline dramatically during the lock-up. Nevertheless, garden variety lock-ups do not create a "substantial risk of forfeiture," and under Treas. Reg. section 1.83-3(c)(1), the risk that the value of property will decline does not constitute a forfeiture risk.

An example added by the Final Regulations (which is nearly identical to the example contained in the Proposed Regulations) illustrates this aspect of section 83. Under the facts of Treas. Reg. section 1.83-3(c)(4), Example 6, an employee ("E") is granted a nonstatutory option to purchase stock of his employer.[6] The option has no readily ascertainable fair market value, and therefore section 83 is applicable at the time the option is exercised. While the

option is outstanding, however, the employer conducts an IPO, and E agrees to a six-month lock-up period on the shares underlying the option.[7] E then exercises the option during the lock-up period. The example concludes that the underwriting agreement does not impose a substantial risk of forfeiture on the shares acquired by E. Accordingly, E will be taxed under section 83 when the shares are transferred upon exercise.

The key takeaway from this example, as well as the added language in Treas. Reg. section 1.83-3(c)(1), is that equity may not be "restricted" for U.S. federal income tax purposes (and therefore may be subject to immediate taxation) even if it is subject to an onerous lock-up restriction, so long as there are no other conditions placed on the grant that would rise to the level of a "substantial risk of forfeiture." In these situations, employees may confront liquidity concerns and may need to resort to other arrangements, such as loans from their employers, in order to cover their tax liabilities.

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Endnotes

[1] T.D. 9659 (the "Final Regulations").

[2] All "section" references herein are to the Code, unless otherwise specified.

[3] REG-141075-09.

[4] Treas. Reg. section 1.83-1(a)(1). This general rule is subject to an election that a service provider can make under section 83(b) in order to accelerate the taxability of the transfer. The rules governing this election are contained in Treas. Reg. section 1.83-2.

[5] The exceptions refer to situations in which a transfer would subject the transferor to liability under the securities laws and to situations in which a transfer restriction is imposed in order to comply with certain accounting rules. In these limited circumstances, a transfer restriction is treated (at least for a limited period of time) as a substantial risk of forfeiture for section 83 purposes.

[6] Nonstatutory options are options that are not "incentive stock options" or "statutory stock options." These latter categories of options are governed by special rules under section 421, and are not governed by section 83. Nonstatutory stock options, on the other hand, are governed by section 83 (and by Treas. Reg. section 1.83-7). The precise application of section 83 to these options depends on whether the option has a "readily ascertainable fair market value. "

[7] In connection with IPOs, it is commonplace for an issuer to enter into a lock-up agreement with its underwriter or underwriters. These agreements prohibit company insiders from selling their shares for a set period of time, and ensure the banks that shares owned by these insiders don't enter the public market too soon after the offering.

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