On February 26, 2014, the Internal Revenue Service released final regulations that have codified existing IRS interpretations regarding transfer of stock to service providers on or after January 1, 2013. (https://www.federalregister.gov/articles/2014/02/26/2014-03988/property-transferred-in-connection-with-the-performance-of-services-under-section-83).

Section 83 Generally

Section 83 generally taxes employees and other service providers on the spread value on property (such as stock) only at the time of vesting where the vesting condition constitutes a "substantial risk of forfeiture." (An employee may elect within 30 days of transfer to make an election to disregard vesting and pay tax on any spread at the time of the election.)

Final Regulations – February 26, 2014

Service-Related Conditions or Conditions Related to the Purpose of the Property Transferred—In the final regulations, the IRS clarified that in evaluating whether property is subject to a substantial risk of forfeiture, the only events that will defer taxation are a service-related condition or a condition related to the purpose of the property transferred. In this context, the IRS stated that it will consider both (1) the likelihood that the forfeiture will occur and (2) the likelihood that the forfeiture will be enforced. This clarification is consistent with the IRS position that a substantial risk of forfeiture exists only if the facts and circumstances of an arrangement indicate that a risk of forfeiture is substantial pursuant to the terms of that arrangement and that there is a substantial likelihood that the terms of that arrangement will be enforced.

It is our view that the IRS's clarification is intended to ensure that forfeiture provisions that the company does not intend to enforce will not be treated as a "substantial risk of forfeiture." If the facts and circumstances indicate that the company intends to enforce the restriction, then it should be respected. Thus, for example, if an employee has an agreement that provides full vesting upon termination other than for cause, the substantial risk of forfeiture should be given effect unless the company has a pattern of providing vesting upon termination even where the company has not terminated the employee other than for cause, i.e., where the employee simply goes to work for another employer.

Alternatively, if the forfeiture condition is based on the employee achieving a non-service condition related to the purpose of the transfer, such as the achievement of an economic result, this should be recognized as a valid substantial risk of forfeiture unless the facts and circumstances indicate that the economic result is substantially likely, or there is a substantial likelihood that the employee would be permitted to vest the stock even when the economic result is not attained.

Transfer Restrictions—The final regulations also address whether a "substantial risk of forfeiture" exists as a result of a transfer restriction imposed by (1) a lock-up agreement, (2) an insider trading policy, or (3) Section 16(b) of the Securities Exchange Act of 1934. The IRS clarified that a transfer restriction imposed by a lock-up agreement does not subject the property to a substantial risk of forfeiture, because the service provider's rights are not conditioned on continued services or the purpose of the property transfer. Similarly, the IRS clarified that neither an insider trading policy nor potential Rule 10b-5 liability would be sufficient to subject property to a substantial risk of forfeiture, because the insider trading policy and/or potential liability are not conditions of continued services or the purpose of the property transfer.

By contrast, the IRS confirmed that stock would be subject to a substantial risk of forfeiture for up to six months if the seller was subject to liability under Section 16(b), but only if the grant of the equity award is a non-exempt grant. A subsequent equity award or transaction that could, because of its non-exempt status, extend the potential Section 16(b) liability period does not extend the substantial risk of forfeiture.

Effective Date—The final regulations are effective January 1, 2013.

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