Substantial Risk of Forfeiture under the IRC

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This practice note discusses the concept of substantial risk of forfeiture (SRF) under sections 83, 409A, 457(f), 457A, 3121(v)(2), and 4960 of the Internal Revenue Code (referred to hereafter as Section 83, Section 409A, etc.) and the different consequences of the failure to achieve a SRF under each such section. SRF is the standard that the I.R.C. and Treasury Regulations apply to determine when an employee's or an independent contractor's deferred compensation (or transfer of compensatory property) vests, and therefore (depending upon the particular I.R.C. section) may be includable in income for the individual (or deductible for the employer or other controlled group member granting the compensation).

The IRS has issued proposed regulations that help clarify the similarities and differences among the SRF definitions. 81 Fed. Reg. 40,569 (June 22, 2016) (regarding Section 409A); 81 Fed. Reg. 40,548 (June 22, 2016) (regarding Section 457(f) (and by extension Section 4960)). To properly analyze SRF-related issues, you must be aware of the overall rules and the details about the differences among the different definitions.

The practice note is divided into the following main topics:

- Significance of SRF under the Various I.R.C. Sections
- Definition of SRF
- Conditions that Generally Support the Existence of a SRF and Related Requirements
- Conditions that Generally Do Not Support the Existence of a SRF
- Other Rules Relating to SRF

For a chart summarizing the main points contained in this practice note, see Substantial Risk of Forfeiture Definition Comparison Chart. Also see ARTICLE: EQUITY COMPENSATION AND NONQUALIFIED DEFERRED COMPENSATION: RECONCILING WHAT CONSTITUTES A "SUBSTANTIAL RISK OF FORFEITURE" UNDER SECTIONS 83 AND 409A OF THE INTERNAL REVENUE CODE, 51 Creighton L. Rev. 1 and 2009 NYU Review of Employee Benefits § 3.01, "A Transfer Worthy of Taxation."

Significance of SRF under the Various I.R.C. Sections

As discussed further in the next section, SRF generally exists with respect to deferred compensation (or compensatory property governed by I.R.C. § 83) where the right to receive such compensation is subject to a condition—e.g., a requirement that the grantee provide substantial services to the grantor. Also, the lapse of a SRF (or vesting of the compensation) may mean that the compensation is subject to taxation and inclusion in income at that time, depending upon the rules under the applicable I.R.C. section. Finally, the existence of a SRF is an important factor in determining whether the short-term deferral exception to Section 409A applies to an amount that would otherwise be treated as nonqualified deferred compensation (and a similar concept used in analyzing compensation subject to Section 457(f) under the proposed regulations—and by extension remuneration for purposes of Section 4960).

Sections 83, 409A, 457(f), 457A, 3121(v)(2), and 4960 all deal with compensatory arrangements, as follows:

- I.R.C. Section 83governs transfers of compensatory property (such as restricted stock).
- I.R.C. Section 409Agoverns nonqualified deferred compensation.
- I.R.C. Section 457(f) governs deferred compensation paid by tax-exempt and state and local government employers payable to participants under a deferred compensation plan that is not an eligible plan under I.R.C. § 457(b).
- I.R.C. Section 457Agoverns deferred compensation payable by nonqualified entities (i.e., certain tax-haven organizations that do not benefit from a U.S. federal tax deduction for deferred compensation amounts paid/included in income by the payee).
- I.R.C. Section 3121(v)(2)governs when nonqualified deferred compensation is subject to Social Security (FICA) taxation.
- I.R.C. Section 4960governs when remuneration is taken into account for purposes of the excise tax on certain tax-exempt entities that pay "excess" remuneration to covered employees.

Section 83—Transfers of Property and Funded Deferred Compensation Plans

Section 83 governs three situations:

- If an employer transfers property to an employee as compensation (e.g., restricted stock), the employee owes taxes on the fair market value of the property (minus the amount the employee paid for it, if any) for the year the employee's rights in the property become either (1) transferable, or (2) not subject to a SRF (whichever occurs earlier), unless the individual elects for immediate income recognition at the time of transfer from the employer under I.R.C. § 83(b). I.R.C. § 83.
- For purposes of I.R.C. § 280G, dealing with excess parachute payments, a payment is considered made at the same time as under Section 83 (i.e., the earlier of the time the employee's rights in the property become transferable or the SRF lapses), without regard to any section 83(b) election. 26 C.F.R. § 1.280G-1, Q&A-12
- If an employer contributes to a trust insulated from the claims of the employer's creditors to fund a retirement plan that that is not a qualified plan (within the meaning of I.R.C. § 401(a)), the transfer is treated as if it were a transfer of property within the meaning of Section 83. I.R.C. § 402(b)(1). A plan that involves contributions to such a trust is referred to as a funded plan. (Similar treatment occurs for assets designated to pay deferred compensation under a nonqualified deferred compensation plan (within the meaning of I.R.C. § 409A(d)(1)) in certain situations, regardless of whether the trust is insulated from the employer's creditors. I.R.C. § 409A(b)(1)–(3).)

Virtually all plans covered by Section 83 involve transfers of property with deferred vesting rather than funded nonqualified plans. Employers almost never intentionally offer funded nonqualified plans. Such plans typically arise only accidentally (e.g., if a plan meant to be a qualified plan fails to satisfy the requirements for qualified status). Similarly, employers typically structure parachute payments to avoid the harsh penalties of I.R.C. §§ 280G and 4999, so they are seldom concerned about its timing rules. Thus, this practice note focuses on transfers of property subject to I.R.C. § 83.

The value of property transferred for purposes of Section 83 is determined without taking into account any restrictions on the property, other than restrictions that by their terms will never lapse. However, if a forfeiture is certain to occur (e.g., property must be returned whenever the employee terminates employment for whatever reason), the property will not be considered to have been transferred, so the concept of SRF does not apply. 26 C.F.R. § 1.83-3(a)(3).

As noted above, an employee can prevent tax at the time the SRF lapses by electing to include in income the value of the property (less any amount paid for it) for the year of the transfer. I.R.C. § 83(b). Since in this case the taxation occurs at the time the employee receives the property, the SRF concept does not affect the timing of taxation.

Section 409A—Nonqualified Deferred Compensation Plans

Section 409A generally governs the taxation of nonqualified deferred compensation, subject to certain exceptions and exemptions. Unlike Sections 457(f), 457A, and 4950, which apply only to specific types of employers, Section 409A applies to all employers. (For more information on Section 409A, see, generally, Section 409A Fundamentals.)

SRF is important in three areas under Section 409A (each as discussed below):

- Determining whether the plan provides for deferred compensation under the short term deferral rule
- Determining the date on which deferred amounts must be included in income, and additional interest and penalty taxes applied, if the rules of Section 409A are not met
- Determining whether payments under the plan are made on a fixed payment date or schedule, or whether payments may be accelerated or further delayed

Short-term deferral rule. Under the short-term deferral rule (exception to Section 409A), a plan does not provide for deferred compensation if payment is made no later than

the 15th day of the third month following the end of the employee's or employer's taxable year (whichever ends later) in which a SRF lapses. 26 C.F.R. § 1.409A-3(d). Therefore, the timing of the SRF of deferred compensation that qualifies for the short-term deferral rule exception is critical to determining the schedule of payment for amounts that are not subject to Section 409A's rules.

Section 409A penalties. If a deferred compensation arrangement that is not exempt from Section 409A fails to meet the rules of Section 409A, two things happen at the point that amounts deferred under the plan are no longer subject to a SRF:

- The employee must include the amounts deferred under the plan in income for tax purposes.
- The employee is subject to a 20% additional tax on the deferred compensation required to be included in income, plus an interest factor applied to any underpayment of taxes that should have been paid on the deferred amount from the time of income inclusion based on the IRS underpayment rate plus one percentage point (premium interest tax).

I.R.C. § 409A(a)(1)(B). For a further discussion regarding Section 409A, see Section 409A Resource Kit.

Scheduling of payments, deferrals, and accelerations. Unlike Section 83 compensatory property, a compliant Section 409A arrangement does not automatically result in tax liability when the SRF lapses. A deferred compensation plan can avoid the tax consequences of Section 409A if it meets the following conditions:

- With some exceptions, including for performance-based compensation and new hires, elections to defer compensation must be made before the end of the year preceding the year in which the services related to the compensation are rendered. I.R.C. § 409A(a)(4)(B)(i).
- Nonqualified deferred compensation generally may only be paid upon a fixed payment date (or schedule) or upon certain limited, permissible payment events (under I.R.C. § 409A(a)(2)(A)) specified in the original deferral agreement.
- Any acceleration of payment or further deferral of compensation may only be made in accordance with limited special rules. I.R.C. § 409A(a)(3); 26 C.F.R. § 1.409A-3(j); I.R.C. § 409A(a)(4)(C).

A payment will, nevertheless, be considered to be made on a fixed payment date or permissible payment event if it is made in accordance with a fixed schedule that is objectively determinable based on the date the SRF lapses, provided that the schedule must be fixed on the date the time and form of payment are designated. 26 C.F.R. § 1.409A-3(i)(1)(i). For example, suppose that a deferred compensation plan provides for payment contingent on the performance of three years of service, except that the service requirement will be waived in the event of an initial public offering (which is not one of the enumerated permissible payment events under Section 409A). A payment schedule that provides for substantially equal payments on each of the first three anniversaries of the date the SRF lapses will be considered a fixed payment schedule, even though an initial public offering will accelerate the lapse of the SRF and therefore will accelerate the payments.

Effect of other I.R.C. sections. Note that the fact that an arrangement is subject to Section 83, 457(f), 457A, or 4960 will not preclude such arrangement from being subject to Section 409A. You must analyze the arrangement under both sets of rules (e.g., nonqualified deferred compensation arrangements with tax-exempt or government employers may be subject to Section 409A, Section 457, and Section 4960).

Note in this regard that the SRF analysis under each I.R.C. provision will not always be identical because of the differences in the definitions of SRF for purposes of each of the sections.

Section 457(f)—Unfunded Deferred Compensation Plans of Tax-Exempt or Governmental Employer

Section 457(f) applies to unfunded deferred compensation plans of tax-exempt and governmental employers that are not eligible 457(b) plans. I.R.C. § 457(f)(1). The basic rule under Section 457(f) is that amounts of deferred compensation payable by relevant employers are included in income in the first year in which the amount is not subject to a SRF. Eligible 457(b) plans are not subject to this rule, but they are limited as to the amount of annual compensation participants may defer and other restrictions. Qualified plans, funded plans, and certain other arrangements are excluded by reason of I.R.C. § 457(f)(2).

The rationale for Section 457(f) is that in the case of a taxable employer, the employee's desire to defer taxes is balanced by the employer's desire for an immediate deduction, but similar balancing does not apply in the case of employers that are not subject to tax. In the case of a tax-exempt employer or a nonqualified entity, Section 457(f) essentially subjects an unfunded plan to rules similar to those that would apply under Section 83 if it were a funded plan, imposing a tax as soon as there is no longer a SRF (or, if later, on the date the employee receives a legally binding right to the compensation).

So (by comparison), as discussed above, compensation governed by Section 83 is taxed upon the lapse of the SRF or earlier (e.g., if the property becomes transferable or if the

employee makes a section 83(b) election to be taxed on the initial transfer), and the taxation of compensation governed by Section 409A can be deferred beyond the lapse of the SRF if the plan meets certain criteria. However, if Section 457(f) applies to the employer, the I.R.C. automatically imposes tax upon the lapse of the SRF, regardless of any other factors.

Short-term deferral rule. Note, however, that the proposed regulations under Section 457(f) apply a similar short-term deferral rule (exception) as under Section 409A by incorporating Section 409A's regulations as applied to the Section 457(f) plan (with Section 457(f)'s definition of SRF). See 81 Fed. Reg. 40,555. Therefore, deferred compensation payable within 2 ½ months following the end of the employer's or employee's taxable year (whichever ends later) in which the SRF lapses is not subject to Section 457(f)'s income inclusion rules. 81 Fed. Reg. 40,555. For a discussion of the short-term deferral rule as it applies in the Section 409A context, see Section 409A Fundamentals — Exemptions from Section 409A.

Section 457A—Unfunded Deferred Compensation Plans of Tax Haven Employers

Section 457A is similar to Section 457(f), providing for immediate income inclusion in the first year where there is no SRF, except that it applies to so-called nonqualified entities. The following entities are nonqualified entities:

- Any foreign corporation, unless substantially all of its income is:
  - Effectively connected with the conduct of a trade or business in the United States (within the meaning of I.R.C. § 457A(b)(1)(A)) –or–
  - Subject to a comprehensive foreign income tax (within the meaning of I.R.C. § 457A(d)(2))
- Any partnership, unless substantially all of its income is allocated to persons other than:
  - Foreign persons with respect to whom such income is not subject to a comprehensive foreign income tax –and–
  - Organizations which are exempt from tax

I.R.C. § 457A(b).

In other words, Section 457A applies to employers whose income avoids tax due to tax havens, rather than due to tax-exempt or governmental status. Section 457A provides an exception to its general rule that taxation will occur when the SRF lapses if the value of the deferred amount cannot be determined at that time. In that case, the employee is subject to normal income taxes, an interest factor, and a 20% penalty on the deferral when the value becomes determinable. I.R.C. § 457A(c)(1). Otherwise, if Section 457A applies to the employer, the employee is taxed upon the lapse of the SRF, regardless of any other factors. I.R.C. § 457A(a).

Short-term deferral rule. Like Sections 409A and 457(f), Section 457A also contains a short-term deferral rule (exception) based on the date of the lapse of the SRF (as defined under the more limited definition of SRF provided under Section 457). However, the rule applies to deferred compensation payable within 12 months following the end of the employer's taxable year in which the amount is no longer subject to the SRF. I.R.S. Notice 2008-9, 2008-1 C.B. 277, Q&A 4.

Section 3121(v)(2)—FICA Taxes on Deferred Compensation Plans

Section 3121(v)(2) determines when Social Security and Medicare (FICA) taxes are imposed on an amount deferred under a nonqualified deferred compensation plan (funded or unfunded). The basic rule is that such amounts are taken into account as of the later of:

- When the services are performed –or–
- When there is no SRF of the right to such amount

I.R.C. § 3121(v)(2)(A).

Section 3121(v)(2) applies to a 403(b) plan or a 457(b) plan, as well as to plans that do not have any special tax status. (I.R.C. § 3121(v)(1) imposes similar rules on 401(k) and 414(h) elective contributions, but since those contributions are always fully vested, the SRF analysis does not apply to them.)

Unlike Section 83, Section 3121(v)(2) does not permit an employee to accelerate the time of taxation by making a special election. Unlike Sections 457(f) and 457A, Section 3121(v)(2) applies to all employers, not just those with a special tax status. And unlike Section 409A, an employer cannot defer Section 3121(v)(2) beyond a lapse of SRF simply by structuring a plan appropriately.

Nevertheless, except in the case of a governmental or church plan, or a private school or university, Section 3121(v)(2) typically has minimal effect on an employee's taxes. To avoid constraints imposed by ERISA, other employers typically only offer unfunded deferred compensation plans to a select group of managers and highly compensated employees. Such employees typically have salaries in excess of the Social Security wage base, so Section 3121(v)(2) imposes only the 1.45% Medicare tax on employers and employees. See I.R.C. § 3121(v)(2)(B).

Even for a governmental plan, Section 3121(v)(2) has minimal effect on an employee's taxes if the employment is not subject to Social Security. I.R.C. § 3121(a)(5)(E); I.R.C. § 3121(v)(3). About one-fourth of all public employees are not

subject to Social Security, so Section 3121(v)(2) applies only to Medicare taxes.

Section 4960—Tax on Excess Tax-Exempt Organization Executive Compensation

Section 4960 imposes a 21% excise tax on certain tax-exempt organizations to the extent the remuneration of a covered employee exceeds $1 million for a taxable year. I.R.C. § 4960. For this purpose, remuneration that is subject to a substantial risk of forfeiture (within the meaning of I.R.C. § 457(f)(3)(B)) is treated as paid when the SRF ceases and the amount becomes vested. I.R.C. § 4960; Prop. Treas. Reg. § § 53.4960-2(c)(2), 85 Fed. Reg. 35,746 (June 11, 2020).

A covered employee is one who:

- Is one of the five highest compensated employees of the organization for the taxable year –or–
- Was a covered employee of the organization (or any predecessor) for any preceding taxable year beginning after December 31, 2016

I.R.C. § 4960(c)(2).

Section 4960 applies to any organization that is:

- Exempt from taxation under I.R.C. § 501(a)
- A farmers' cooperative organization described in I.R.C. § 521(b)(1)
- A governmental instrumentality that has income excluded from taxation under I.R.C. § 115(1) –or–
- A political organization described in I.R.C. § 527(e)(1)

I.R.C. § 4960(c)(1).

Unlike Section 457(f), Section 4960 does not apply to all governmental employers, but only to a governmental instrumentality that has income excluded from taxation under section 115(1). An integral part of government is constitutionally tax-exempt, and thus does not have income excluded from taxation under section 115(1). An instrumentality of government has income excluded from taxation under section 115(1), In many instances, it may be difficult to discern whether a governmental organization is subject to Section 4960. And IRS guidance has often neglected to make a clear distinction between integral parts of government and governmental instrumentalities, often holding that one organization is an integral part of government while what appears to be an almost identical one is a governmental instrumentality.

Although all Section 457(b) plans are excluded from Section 457(f), only Section 457(b) plans of governmental entities (not those of private tax-exempt entities) are excluded from the definition of remuneration in Section 4960.

For more information on Section 4960, see Executive Compensation Arrangements for Tax-Exempt Organizations — Excise Tax on Excess Executive Compensation.

Definition of SRF

Although the general concept of SRF (and the statutory definition) is the same for each of Sections 83, 409A, 457(f), 457A, 3121(v)(2), and 4960 implementing regulations have varied the definitions as applied to each of the I.R.C. sections. This section sets forth the varying definitions pursuant to the regulations.

Statutory Definition of SRF

SRF has the same statutory definition for Sections 83, 409A, 457(f), 457A, and 3121(v)(2), as follows:

> The rights of a person to compensation are subject to a substantial risk of forfeiture if such person's rights to such compensation are conditioned upon the future performance of substantial services by any individual.

I.R.C. §§ 83(c)(1), 409A(d)(4), 457(f)(3)(B), and 457(d)(1)(A). I.R.C. § 3121(v)(2) does not define SRF, but 26 C.F.R. § 31.3121(v)(2)-1(e)(3) provides that the definition will be the same as for Section 83. I.R.C. § 4960(a) includes a cross-reference to the definition under I.R.C. § 457(f)(3)(B).

So, for purposes of Sections 83, 409A, 457(f), 457A, 3121(v)(2), and 4960, whether compensation is subject to a SRF generally involves two components:

- The amounts will be forfeited if certain conditions do or do not occur –and–
- The risk of such forfeiture is substantial

The substantiality of the risk is measured in two ways:

- Likelihood of the occurrence
- Likelihood of enforcement

A simple example of a SRF involves a deferred compensation plan in which an employment contract provides that the employer will put aside $5,000 today. The amount will be put into a trust (either one insulated from the claims of creditors, in the case of a funded plan, or a rabbi trust, in the case of an unfunded plan). The amount is payable only if the employee remains employed for the entire five years, and the employer routinely enforces this condition. In this situation, there is a risk of forfeiture (because the employee will lose the deferred compensation in the event the employee does not stay for five years), and that risk is substantial (because the employee has no guarantee that employment will continue). Conversely, a SRF does not exist if the amount, though deferred for five years, is payable regardless of any continuing service requirement or any other conditions.

Sections 83 and 3121(v) SRF Definition

Based on legislative history, the regulations under Section 83 expand the statutory definition of SRF, treating compensation contingent on the following conditions as subject to a SRF:

- Performing substantial services (i.e., a service condition)
- Refraining from performing services (e.g., a covenant not to compete)
- The occurrence of a condition related to a purpose of the transfer

26 C.F.R. § 1.83-3(c). These conditions (and related requirements) are discussed below under Conditions that Generally Do Not Support the Existence of a SRF

Section 409A SRF Definition

The Section 409A regulations treat only compensation contingent on the following as subject to a SRF:

- Performing substantial services
- The occurrence of a condition related to a purpose of the compensation (i.e., relating to the services performed or the business activities or organizational goals of the service recipient)

26 C.F.R. § 1.409A-1(d)(1).

Unlike for Sections 83 and 3121(v)(2) (and the proposed Section 457(f) regulations), compensation contingent on refraining from the performance of services is not subject to a SRF for purposes of Section 409A. 26 C.F.R. § 1.409A-1(d); 81 Fed. Reg. 40,574.

Section 457(f) and Section 4960 SRF Definition

Until 2016, there was no formal regulatory definition of SRF for purposes of Section 457(f), although some guidance existed in the form of a 1997 EO CPE article, Section 457 Deferred Compensation Plans of State and Local Government and Tax-Exempt Employers, I.R.S. Notice 2007-62, 2007-2 C.B. 331, and some private rulings (e.g., I.R.S. Priv. Ltr. Rul. 200321002, 2003 PLR LEXIS 201 (Feb. 11, 2003), and I.R.S. Priv. Ltr. Rul. 199943008, 1999 PLR LEXIS 1173 (July 20, 1999)). Thus, the proposed regulations provided much needed guidance on the issues involved.

The Section 457(f) proposed regulations treat compensation contingent on the following as subject to a SRF:

- Performing substantial services
- Refraining from performing services, but only if certain conditions are met
- The occurrence of a condition related to a purpose of the transfer

Prop. Treas. Reg. §§ 1.457-12(e)(1)(i), 1.457-12(e)(1)(iv), 81 Fed. Reg. 40,548, 40,567 (June 22, 2016).

Section 457A SRF Definition

The Section 457A definition is narrower than under any of the other sections. Only compensation contingent on the performance of substantial services is subject to a SRF for purposes of Section 457A. I.R.C. § 457A(d)(1)(A). Compensation contingent on either the occurrence of a condition that is related to a purpose of the compensation or refraining from the performance of services will not be considered subject to a SRF. I.R.S. Notice 2009-8, 2009-9-1 C.B. 347, Q&A 3(a).

Conditions that Generally Support the Existence of a SRF and Related Requirements

Service Condition

As mentioned above, for purposes of all of the relevant I.R.C. sections, a SRF exists where the right to the compensation is conditioned upon the performance of (future) substantial services. For this purpose, two factors must be considered: whether the services themselves are substantial (e.g., a requirement of an hour a week is not sufficient) and the duration of services. 26 C.F.R. §§ 1.83-3(c)(2), 1.409A-1(d); 31.3121(v)(2)-1(e)(3). For purposes of the duration component of the test, the IRS has treated a period of at least two years of service as substantial for purposes of Sections 83, 457(f), and 3121(v)(2). 26 C.F.R. § 1.83-3(c)(4), Example (1); I.R.S. Priv. Ltr. Rul. 9713014, 1996 PLR LEXIS 2336 (Dec. 24, 1996); I.R.S. Priv. Ltr. Rul. 9723022, 1997 PLR LEXIS 334 (Mar. 7, 1997); I.R.S. Priv. Ltr. Rul. 9211037, 1991 PLR LEXIS 2582 (Dec. 17, 1991); I.R.S. Tech. Adv. Mem. 199903032, 1998 PLR LEXIS 1828 (Oct. 2, 1998). The same rules would apply for purposes of Section 4960.

Consulting Agreements

A requirement of future consulting services (as requested for a period of time) will create a SRF for purposes of Section 83, 457(f), 3121(v)(2), or 4960 where the employee is in fact expected to perform services that are substantial relative to the payment. 26 C.F.R. § 1.83-3(c)(2); Prop. Treas. Reg. § 1.457-12(e)(3), Example 1, 81 Fed. Reg. 40,568. While there is no guidance under Section 409A or 457A on this point, it appears likely that the IRS would take a similar approach for purposes of those sections.

Condition Related to a Purpose of the Transfer or Compensation

For purposes of Section 83, a condition related to the purpose of the transfer can create a SRF. Two examples:

- Stock is transferred to an underwriter prior to a public offering and the full enjoyment of such stock is expressly or impliedly conditioned upon the successful completion of the underwriting
- An employee receives property from an employer subject to a requirement that it be returned if the total earnings of the employer do not increase

26 C.F.R. § 1.83-3(c)(2). The regulations provide several other examples of conditions. See 26 C.F.R. § 1.83-3(c)(4). However, not all limitations based on such conditions will give rise to a SRF. The likelihood the forfeiture conditions will occur (and will be enforced) must be taken into account. The preamble to the proposed (now finalized) Section 83 regulations stated that no SRF would likely exist where a plan provided that stock would be forfeited if gross receipts of the employer fall by 90% over the next three years at a time when there is no indication that any fall in demand is anticipated. Notice of Proposed Rulemaking 2012-1 C.B. 1028.

For purposes of Section 409A, a condition relating to the purpose of the compensation will give rise to a SRF if the possibility of forfeiture is substantial. The purpose of the compensation, however, must relate to either (1) the employee's performance for the employer, or (2) the employer's business activities or organizational goals (e.g., the attainment of an earnings goal). 26 C.F.R. § 1.409A-1(d)(1).

The proposed Section 457 regulations (which also apply for purposes of Section 4960) do not specifically discuss a condition relating to earnings, presumably because employers subject to that section are nonprofit or governmental employers, and thus are not focused on overall profitability. However, they recognize an employer's governmental or tax-exempt activities (as applicable) or organizational goals as potential conditions related to the purpose of the compensation. Prop. Treas. Reg. 26 C.F.R. § 1.457-12(e)(iii), 81 Fed. Reg. 40,567.

Conditioning compensation on a condition relating to the purpose of the transfer will not create a SRF for purposes of Section 457A, as only a condition based on future services suffices for purposes of that section. I.R.S. Notice 2009-8, Q&A-3(a).

Likelihood of Enforcement

Even if an employment agreement or deferred compensation plan contains provisions that would otherwise give rise to a SRF, no SRF will exist if the employer is unlikely to enforce the forfeiture condition. Of particular concern is a situation in which the employee has such influence over the employer that the forfeiture condition is likely to be waived. If an employee owns a significant amount of the total combined voting power or value of all classes of stock of the employer or its parent, the following factors will be taken into account in determining the likelihood of enforcement:

- The employee's relationship to other stockholders and the extent of their control, potential control, and possible loss of control of the corporation
- The position of the employee in the corporation and the extent to which the employee is subordinate to other employees
- The employee's relationship to the officers and directors of the corporation
- The person or persons who must approve the employee's discharge
- Past actions of the employer in enforcing the provisions of the restrictions

26 C.F.R. § 1.83-3(c)(3); 26 C.F.R. § 1.409A-1(d)(3)(i); 26 C.F.R.§ 1.457-12 (e)(1)(v); I.R.S. Notice 2009-8, Q&A-3(c).

Due to the inherently factual nature of the problems involved and other reasons, the IRS will not issue letter rulings on whether a restriction constitutes a SRF if the employee is a controlling shareholder of the employer under Section 83. Rev. Proc. 2016-3, 2016-1 C.B. 126.

Conditions that Generally Do Not Support the Existence of a SRF

Transfer Restrictions on Section 83 Property

Restrictions on transfers of property (alone) typically do not constitute a SRF of the right to such property for purposes of Section 83, with two exceptions:

- I.R.C. § 83(c)(3)provides that a SRF exists if the employee's sale of the compensatory property at a profit could subject the employee to a lawsuit under section 16(b) of the Securities Exchange Act of 1934 (Exchange Act), until the end of the 16(b) period. 26 C.F.R. § 1.83-3(j).
- Property is subject to SRF and is not transferable so long as the property is subject to a restriction on transfer to comply with the Pooling-of-Interests Accounting rules set forth in Accounting Series Release 130. 26 C.F.R. § 1.83-3(k). However, this rule is obsolete due to FASB Statement No. 141, which eliminates the pooling of income accounting method.

The Section 83 rules treating a 16(b) trading restriction as generating a SRF are interpreted narrowly. For example, the purchase of shares in a transaction not exempt from section 16(b) of the Exchange Act prior to the exercise of a stock option that would not otherwise give rise to section 16(b) liability, would not defer the taxation of the stock option at exercise. 26 C.F.R. § 1.83-3(j)(2), Example 4.

Transfer restrictions other than under Exchange Act section 16(b) will also not create a SRF. 26 C.F.R. § 1.83-3(c)(4). Transfer restrictions which do not represent a SRF would include:

- Lock-up agreements
- Insider-trading compliance programs
- Rule 10b-5insider-trading restrictions

The concept of transfer restrictions applies only to the SRF analysis for Sections 83 and 3121(v)(2), as the other sections involve unfunded deferred compensation, not transferred property.

Termination for Cause or Crimes, or Clawbacks

In general, a provision that deferred compensation or unvested property will be forfeited in the event of termination for cause, committing a crime, or as a result of a clawback due to securities violations, does not constitute a SRF. The likelihood of such a termination is not "substantial." 26 C.F.R. § 1.83-3(c)(2). The same rule applies for purposes of Sections 457(f) and 4960. See I.R.S. publication Section 457 Deferred Compensation Plans of State and Local Government and Tax-Exempt Employers (C. Press and R. Patchell, 1997), p. 205 (hereafter Section 457 Plans 1997). It would most likely apply for purposes of Sections 409A and 457A as well, although the proposed Section 409A regulations discuss the issue only in the context of determining whether a stock right that provides for a clawback is treated as deferred compensation, and I.R.S. Notice 2009-8 concerning Section 457A does not discuss it at all.

However, at least one case, Austin v. Commissioner, 141 T.C. No. 18 (Dec. 16, 2013), has treated a forfeiture-for-cause provision as creating a SRF. In that case, the employment agreement defined cause to include "failure or refusal by Employee, after 15 days of written notice to Employee, to cure by faithfully and diligently performing the usual and customary duties of their employment and adhere to the provisions of this Agreement." The court held that while a requirement to forfeit the money for serious (akin to criminal) misconduct did not impose a SRF, a requirement to forfeit it for what amounted to the employer's decision to fire an at-will employee did.

Other Risks Considered Not Substantial for SRF Purposes

For ruling purposes, the IRS takes the position that a risk of forfeiture based upon the employee's death, living to a specified age, or the employer's insolvency fall short of the Section 83, 457(f), and 4960 requirements. Section 457 Plans 1997, p. 206. It is likely that the IRS would take the same position for Sections 409A and 457A.

However, as discussed later in this practice note, an acceleration provision that allows for payment upon the employee's death will not negate a SRF arising from an otherwise applicable service-based condition to payment.

Non-compete Agreements

Non-competes and SRF under Sections 83 and 3121(v)

The presumption is that non-compete agreements will **not** result in a SRF, but this presumption can be overcome based on facts and circumstances. Factors to be considered are:

- The age of the employee
- The availability of alternative employment opportunities
- The likelihood of the employee's obtaining such other employment
- The degree of skill possessed by the employee
- The employee's health
- The practice (if any) of the employer to enforce such covenants

26 C.F.R. § 1.83-3(c)(2).

Non-competes and SRF under Sections 409A and 457A

A non-compete agreement will never create a SRF for purposes of Section 409A (26 C.F.R. § 1.409A-1(d); 81 Fed. Reg. 40,574) or Section 457A (I.R.S. Notice 2009-8, Q&A-3(a)).

Non-competes and SRF under Sections 457(f) and 4960

The proposed Section 457(f) regulations provide that a non-compete agreement will result in a SRF only if all of the following conditions are satisfied:

- The covenant not to compete must be an enforceable written agreement.
- The employer must make reasonable ongoing efforts to verify compliance with non-competition agreements in general, and with the specific non-competition agreement applicable to the employee.
- The employer must have a substantial and bona fide interest in preventing the employee from performing the prohibited services.
- The employee must have a bona fide interest in, and ability to, engage in the prohibited competition.

Prop. Treas. Reg. 26 C.F.R. §1.457-12(e)(iv), 81 Fed. Reg. 40,567.

Other Rules Relating to SRF

Effect of Employee's Election to Receive or Defer Compensation on SRF

An employee's election to receive current compensation or to defer receipt until a later date presents special issues in determining whether a SRF exists. For example, the IRS takes the position that salary reduction plans must be placed under closer scrutiny because few employees would voluntarily accept subjecting their compensation to a SRF as an acceptable alternative to current compensation, unless perhaps they are very near retirement and feel secure in their jobs. See, e.g., Section 457 Plans 1999, pp. 188-89. IRS guidance on this issue under Sections 409A, 457A, 457(f), and 4960 is discussed below.

Extension of SRF under Sections 409A and 457A

The Section 409A regulations and Section 457A guidance make clear that an employee can be permitted to choose between receiving an amount of compensation either on a current basis or at a later time in a manner so that the deferred payment option would still be considered to be subject to a SRF, but only if there is additional consideration paid for the extension. The rules state that an amount cannot be subject to a SRF beyond the time that the employee could have elected to receive it, **unless** the present value of the amount subject to the SRF is materially greater (disregarding the risk of forfeiture) than the present value of the current compensation the recipient could have elected to receive without the SRF. The regulations do not provide guidance on the meaning of "materially greater." 26 C.F.R. § 1.409A-1(d)(1); I.R.S. Notice 2009-8, Q&A-3 (a). Also note that the agreement to the deferral would have to be made prior to the time the amount was paid or made available to the employee to avoid immediate taxation under constructive receipt principles.

As an example, consider a bonus plan that permits a participant to elect to receive either (1) a cash payment payable at the end of the performance period, or (2) restricted stock units (RSUs) having a materially greater present value than the cash payment, provided that the RSUs will only be paid if and after the employee remains in continuous service with the company for a period of years. Even though the employee could have elected to receive the cash payment when bonuses are normally paid, the full amount of the RSU award would generally be considered to be subject to a SRF during the retention period. On the other hand, a straightforward salary deferral election to have compensation that is earned in one year be paid in a later year cannot be made subject to a SRF and would be subject to the rules for nonqualified deferred compensation under Section 409A (and Section 457A, if applicable). Id.

It is not clear whether an employer and employee could agree to further extend a SRF for current compensation amounts that have already been deferred once in accordance with the rules discussed in the preceding paragraphs. However, any such arrangement would at a minimum have to (1) occur before the compensation was paid or made available so as to avoid taxation under constructive receipt principles pursuant to I.R.C. § 451, and also (2) meet the materially greater value requirement as compared to the amount the employee currently has a right to receive.

Addition or Extension of SRF under Sections 457(f) and 4960

The proposed Section 457(f) regulations explicitly allow for the addition or an extension of a SRF, subject to certain conditions.

For an initial addition of SRF on an amount of compensation not otherwise subject to a SRF, all of the following requirements must be met:

- The present value of the amount to be paid upon the lapse of the added SRF must be materially (at least 25%) greater than the amount the employee otherwise would be paid in the absence of the additional SRF. Note that the IRS has indicated that this provision does not imply that same materiality standard applies for purposes of determining whether an elective deferral could give rise to a SRF under Section 409A as described in the previous section. 81 Fed. Reg. 40,557.
- The SRF must be based upon the future performance of substantial services, or adherence to an agreement not to compete (in accordance with the rules noted above under "Non-competes and SRF under Sections 409A and 457A"), for a period of at least two years after the employee could have received the compensation had there been no additional SRF. Note:
    - The SRF may not be based solely on the occurrence of other types of conditions (e.g., a performance goal for the organization). However, if there is a sufficient service condition, the arrangement can also impose other conditions. For example, the SRF could continue until the later of two years or when an organizational goal was met.
    - Notwithstanding the two-year minimum, the service condition may lapse upon the employee's death, disability, or involuntary severance from employment.
    - If the foregone current compensation is allocable to separate payments (e.g., a percentage of each semi-monthly payroll amount during a designated period), then the two-year minimum is measured from the time each payment would otherwise have been made.

- The agreement subjecting the amount to a SRF must be made in writing before the beginning of the calendar year in which any services giving rise to the compensation are performed, subject to a special rule for recent hires:
    - If the employee was not providing services to the employer within 90 days prior to the addition of SRF, then the written agreement may be entered into as late as the 30th day after hire, but only with respect to compensation related to services provided after the agreement date.

Prop. Treas. Reg. § 1.457-12(e)(2), 81 Fed. Reg. 40,567-68.

For a second or subsequent extension of a SRF, the following rules apply:

- The materially greater value and two-year minimum forfeiture period apply, as described above (i.e., the new amount must be at least 25% more than the current amount and the extended SRF must be based on an additional two years of performing (or refraining from performing) substantial services) –and–
- A written agreement reflecting the new SRF must be entered into at least 90 days before the lapse of the existing SRF, subject to the same special rule for recent hires as noted above for an initial deferral

Id.

The regulations clarify that the same rules apply for substitution arrangements, that is, where an amount of compensation is forfeited or relinquished and is replaced (in whole or in part) by a right to receive another amount (or benefit) that is subject to a risk of forfeiture, as a substitution for the first amount. Unless the above conditions are met, any SRF on the substituted amount will be ignored and, consequently, the amount may be subject to tax for the year in which the substituted right arises. Prop. Treas. Reg. § 1.457-12(e)(2)(v), 81 Fed. Reg. 40,568.

Extending or Modifying SRF in Connection with a Corporate Transaction under Section 409A

One exception to the rule that second or subsequent extension of a SRF must meet the written agreement, materially greater value, and two-year minimum forfeiture period requirements described above is found in 26 CFR § 1.409A-3(i)(5)(iv)(B). Under that regulation, an extension of vesting otherwise due to occur upon a change in control is permissible without meeting those tests, if:

- The transaction constituting the change in control event is a bona fide arm's length transaction between the service recipient or its shareholders and one or more parties who are unrelated to the service recipient and employee –and–
- The modified or extended condition to which the payment is subject would otherwise be treated as a substantial risk of forfeiture for purposes of section 409A

Vesting Acceleration Provisions that Do Not Negate SRF

An amount can be considered to be subject to a SRF based on a requirement to provide future substantial services despite the fact that the compensation arrangement contains certain common provisions that allow for an accelerated payment in certain circumstances. Specifically, agreements that provide for all or a portion of an amount of compensation to be paid (or all or a portion of unvested property to become vested) in the event of the employee's death, disability, or involuntary termination without cause can still be considered to be subject to a SRF, even though the service-based conditions are not fulfilled.

A number of private letter rulings support this position for Section 457(f) purposes. I.R.S. Priv. Ltr. Rul. 200321002, 2003 PLR LEXIS 201 (Feb. 11, 2003) and I.R.S. Priv. Ltr. Rul. 199943008, 1999 PLR LEXIS 1173 (July 20, 1999).

In addition, the proposed Section 457(f) regulations explicitly provide that a right to receive compensation conditioned on an involuntary severance from employment without cause (including a voluntary termination for good reason) is subject to a substantial risk of forfeiture if the possibility of forfeiture is substantial. Prop. Treas. Reg. § 1.457-12(e)(1)(i), 81 Fed. Reg. 40,567. This approach is consistent with the Section 409A rule for involuntary separations from service without cause under 29 C.F.R. § 1.409A-1(d)(1). The terms involuntary severance from employment (Section 457) and involuntary separation from service (Section 409A), as well as what constitutes a good-reason termination, are defined in the respective regulations. Although the Section 457A guidance is not explicit, the determination of the period over which a substantial risk of forfeiture is considered to exist for purposes of a transition rule indicates that the same rules would apply in this context. I.R.S. Notice 2009-8, Q&A 23(a)(c).

Similarly, the preamble to final regulations under Section 83 clarifies that a provision that accelerates vesting upon an involuntary separation from service without cause (or separation from service as a result of death or disability) will not cause a service-based requirement that constitutes a SRF to fail to qualify as such so long as the facts and circumstances do not demonstrate that an involuntary separation from service without cause is likely to occur during the service period. 79 Fed. Reg. 10,663 (Feb. 26, 2014).

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