EQUITY COMPENSATION AND NONQUALIFIED DEFERRED COMPENSATION: RECONCILING WHAT CONSTITUTES A "SUBSTANTIAL RISK OF FORFEITURE" UNDER SECTIONS 83 AND 409A OF THE INTERNAL REVENUE CODE

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I. INTRODUCTION

Two provisions of the Internal Revenue Code ("Code") define "a substantial risk of forfeiture" regarding equity compensation and nonqualified deferred compensation.[1] Code § 83 states that the excess of the fair market value of property over the amount paid, if any, for such property that is conveyed in exchange for services is excluded from the gross income of the service provider in the year of the transfer if a substantial risk of forfeiture is included as a restriction to the enjoyment of the property and the rights to property are nontransferable.[2] Code § 409A similarly states that deferred compensation is excludable from a taxpayer's gross income if the compensation is subject to a substantial risk of forfeiture and has not previously been included in the gross income of the taxpayer, provided the requirements of § 409A are satisfied.[3] The Internal Revenue Service ("IRS") has asserted, contrary to commentator suggestions, in the preamble to regulations under Code § 409A that the definition of what constitutes a substantial risk of forfeiture under Code §§ 409A and 83 is not the

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1. *See* Treas. Reg. § 1.83-3(c) (2017) (stating that under § 83, "a substantial risk of forfeiture exists only if rights in property that are transferred are conditioned, directly or indirectly, upon the future performance (or refraining from performance) of substantial services by any person, or upon the occurrence of a condition related to a purpose of the transfer if the possibility of forfeiture is substantial"); Treas. Reg. § 1.409A-1(d) (2017) (explaining that a substantial risk of forfeiture is present when "entitlement to the amount is conditioned on the performance of substantial future services by any person or the occurrence of a condition related to a purpose of the compensation, and the possibility of forfeiture is substantial"); *see also* I.R.C. § 457(f)(3)(B) (2012) (explaining that a substantial risk of forfeiture arises when "such person's rights to such compensation are conditioned upon the future performance of substantial services by any individual").

2. I.R.C. § 83(a) (2012). *See also* Symposium, *Section 83 Fundamentals*, AM. B. ASS'N REAL PROP., TR., & EST. SYMP. 2-3 (2011).

3. I.R.C. § 409A(a)(1)(A)(i) (2012). *See also* I.R.S. Notice 2007-86, 2007-2 C.B. 990.

same.[4] However, this Article will examine three specific examples where a substantial risk of forfeiture is interpreted inconsistently under Code §§ 83 and 409A, and will argue for a uniform interpretive approach as to the three specific examples of what may or may not constitute a substantial risk of forfeiture.

The three situations this Article contemplates are non-compete agreements, termination for cause provisions, and involuntary separation from service provisions. First, the regulations under Code § 83 intimate that a substantial risk of forfeiture may be present when two parties establish a non-compete arrangement.[5] However, in slight but pertinent distinction, the regulations under Code § 409A explicitly state that a non-compete agreement does not constitute a substantial risk of forfeiture.[6] Second, Code § 409A contains no indication as to whether a termination for cause provision creates a substantial risk of forfeiture. Conversely, Code § 83 states that a termination for cause provision does not constitute a substantial risk of forfeiture.[7] Finally, an involuntary separation from service without cause provision constitutes a substantial risk of forfeiture under Code § 409A,[8] but does not constitute a substantial risk of forfeiture under Code § 83.[9]

Although the statutory language in each Code section ostensibly defines a substantial risk of forfeiture, the reality is that Code §§ 83 and 409A do not define substantial risk forfeiture in the same manner.[10] As such, each Code section may carry a differing interpretation as to what constitutes a substantial risk of forfeiture in a given cir-

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4. Application of Section 409A to Nonqualified Deferred Compensation Plan, 72 Fed. Reg. 19234, 19250 (April 17, 2007) (to be codified at 26 C.F.R. pt. 1).

5. Treas. Reg. § 1.83-3(c)(1) ("A substantial risk of forfeiture exists only if rights in property that are transferred are conditioned, directly or indirectly, upon the future performance (or refraining from performance) of substantial services by any person . . . ."). *But see id.* § 1.83-3(c)(2) ("An enforceable requirement that the property be returned to the employer if the employee accepts a job with a competing firm will not ordinarily result in a substantial risk of forfeiture unless the particular facts and circumstances indicate to the contrary.").

6. *Id.* § 1.409A-1(d)(1) ("An amount is not subject to a substantial risk of forfeiture merely because the right to the amount is conditioned, directly or indirectly, upon refraining from the performance of services.").

7. *Id.* § 1.83-3(c)(2) (stating a "requirement[ ] that the [transferred] 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").

8. *Id.* § 1.409A-1(d)(1).

9. Property Transferred in Connection with the Performance of Services Under Section 83, 79 Fed. Reg. 10663-01, 10663 (Feb. 26, 2014) ("Further, Treasury and the IRS believe that these regulations should not be modified to state that an involuntary separation from service without cause may qualify as a substantial risk of forfeiture under section 83.").

10. *See* Gregory L. Needles & Leslie Dupuy, *How the IRS is Changing the Regulation of Deferred Compensation*, 20 TAX'N EXEMPTS 3, 5 (2009) (stating that under Code § 409A, for example, a non-compete restriction will not serve as an adequate substantial risk of forfeiture); *see also* Shawn Richter, *The Changed Rules for Deferred Compensa-*

cumstance.[11] Under the current landscape, the practical significance of subtle distinctions as to what constitutes a substantial risk of forfeiture under Code §§ 83 and 409A may lead to burdensome consequences if a practical application method is incorrect.[12] Therefore, the IRS should apply a uniform interpretive approach to the application of what constitutes a substantial risk of forfeiture under Code §§ 83 and 409A.

First, this Article will discuss what constitutes a substantial risk of forfeiture under Code § 83.[13] Second, this Article will discuss the meaning of a substantial risk of forfeiture under Code § 409A.[14] Third, this Article will argue in favor of applying a uniform interpretive approach as to what constitutes a substantial risk of forfeiture under the aforementioned Code sections.[15]

II. BACKGROUND

A. Substantial Risk of Forfeiture Under Code Section 83

1. Overview of Equity-Based Compensation Under Code Section 83

Section 83 of the Code regulates the income tax consequences of property transfers from service recipients to service providers, namely equity compensation.[16] Recently, equity-based pay, or mixed pay of cash and equity, has burgeoned, showing that the median values of total Chief Executive Officer ("CEO") compensation reached 62.9% in the S&P 500 and 56.3% in the S&P 1500.[17] What is more, the share of CEOs that received any type of equity-based compensation in 2013 was 75.7% in the S&P 500 and 63.8% in the S&P 1500.[18] Interest-

tion Plans, 30 L.A.L. 13, 14 (2007) (stating that Code § 409A does not carry the same definition as § 83 as to a substantial risk of forfeiture).

11. Greg Daugherty, *"Substantial Risk of Forfeiture" Clarification Impacts Tax-Exempt and Governmental Employer Non-Compete Arrangements*, Emp. Ben. L. Rep. (April 30, 2014), http://www.employeebenefitslawreport.com/2014/04/substantial-risk-of-forfeiture-clarification-impacts-tax-exempt-and-governmental-employer-non-compete-arrangements/.

12. *See, e.g.*, I.R.C. § 409A(a)(1) (stating that if the requirements under § 409A are not complied with, and to the extent not subject to a substantial risk of forfeiture or previously included in the gross income of the taxpayer, the deferred compensation is included in the gross income of the taxpayer and an additional twenty percent tax penalty is applied against the taxpayer).

13. *See infra* notes 16-95 and accompanying text.

14. *See infra* notes 96-134 and accompanying text.

15. *See infra* notes 135-226 and accompanying text.

16. Anne Batter & Kai Kramer, *IRS Attempts to Shut the Door on Controversial Option Deduction Issue with Proposed Revisions to 'Next Day Rule' Regulation*, 42 J. Corp. Tax'n 31, 33 (2015).

17. Equilar & Meridian Comp. Partners, LLC, CEO Pay Strategies Report 4 (2014), https://www2.deloitte.com/content/dam/Deloitte/us/Documents/regulatory/us-aers-ceo-pay-strategies-report-2014-equilar-july-2014-020915.pdf.

18. *Id.*

ingly, the median performance-based equity compensation in the S&P 500 reached $3.4 million in 2013, an increase of 52% from 2009.[19]

Property in the form of equity compensation transferred to a service provider, pursuant to Code § 83, is includable in the gross income of the service provider once the property is no longer subject to a substantial risk of forfeiture or when the property becomes transferable, whichever occurs earlier.[20] Code § 83 statutorily defines a substantial risk of forfeiture, "[t]he rights of a person in property are subject to a substantial risk of forfeiture if such person's rights to full enjoyment of such property are conditioned upon the future performance of substantial services by any individual."[21] Numerous options are available to deliver equity compensation, which include, but are not limited to, nonqualified stock options, incentive stock options, stock appreciation rights, restricted stock, restricted stock units, or performance shares.[22] The characterization of the income, capital or ordinary, will depend on the type of equity at issue.[23] For purposes of this Article, and specifically this subsection, the focus is centered upon restricted stock. Under a restricted stock arrangement, once the stock is includable in the taxpayer's ordinary income, the service recipient is entitled to a deduction, in the same taxable year as the inclusion.[24] Under Code § 83(h), the service recipient that transfers the restricted stock is entitled to a deduction under Code § 162 in the year in which the earlier of two events occurs: (1) the stock becomes transferable, or (2) the stock is no longer subject to a substantial risk of forfeiture.[25] The amount of the deduction equals the amount included in the taxpayer's gross income.[26] The most notable characteristic of § 83 is an optional

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19. *Id.*

20. I.R.C. § 83(a). The amount includable in the employees' gross income is the excess of the fair market value of the property at the time of inclusion over the amount paid for the property, if any. *Id.* Importantly, pursuant to the flush language contained in § 83(a), the taxation can be deferred on the equity compensation if the stock is transferred in-kind prior to the earlier of when the substantial risk of forfeiture lapses or becomes transferable. *Id.* "In other words, the employee can defer calculation of the gain realized [on the transfer of stock] until her rights to the stock are relatively secure." Strom v. United States, 641 F.3d 1051, 1056 (9th Cir. 2011). *See also* Theophilos v. Comm'r, 85 F.3d 440, 444 (9th Cir. 1996) (citing Alves v. Comm'r, 734 F.2d 478, 480-81 (9th Cir. 1984)) (stating that § 83 applies to all restricted "property," not just equity).

21. I.R.C. § 83(c)(1).

22. *See generally* MORGAN, LEWIS & BOCKIUS, *Summary of Equity-Based Executive Compensation Programs*, *in* EMERGING LIFE SCIENCES COMPANIES DESKBOOK 99-105 (2d ed. 2008), *available at* http://main.cd3.morganlewis.com/topics/entrepreneurresources/~/media/files/special-topics/erh_pubs/erh_summaryequitybasedexecutivecompensationprograms_elscdeskbook.

23. *Id.*

24. Michael S. Knoll, *The Section 83(b) Election for Restricted Stock: A Joint Tax Perspective*, 59 SMU L. REV. 721, 722-723 (2006).

25. I.R.C. § 83(h).

26. *Id.*

election for the service provider to incur the tax in a year preceding the date on which the tax would otherwise be imposed.[27]

Generally, an election under Code § 83(b) must occur in the year in which the stock is transferred.[28] The same rules under an 83(b) election also apply in the absence of an election; the amount included in the gross income of the taxpayer is characterized as ordinary, and the amount included in the service provider's gross income equals the excess of the fair market value of the property over the amount paid for the property, if any.[29] Furthermore, although the property at the time of inclusion, pursuant to an 83(b) election, is substantially not vested, the subsequent vesting of the restricted stock will not be included in the gross income of the taxpayer, and subsequent stock appreciation is disregarded in determining the tax liability of the service provider.[30] Since the taxpayer incurs a tax liability on the inclusion, the taxpayer will receive basis in the stock equal to the amount paid for the stock increased by the amount that is included in the gross income of the taxpayer upon the 83(b) election.[31] The basis determination is important because the taxpayer will likely sell or exchange the stock at a later date thereby incurring a capital gain or loss, provided the holding period is satisfied.[32] Although an 83(b) election is an effective financial planning tool for individuals who receive restricted stock as part of an equity-based compensation arrangement, such an election is not always advantageous. The 83(b) election cuts both ways; the service provider could elect the 83(b) tax, but the restricted stock could decrease in value after the inclusion, thus creating a tax liability on restricted stock with diminishing value below that which was taxed. In the absence of an 83(b) election, the substantial risk of forfeiture issue must be considered to determine what contractual provisions constitute an acceptable restriction that defers income tax.

2. Application of a Substantial Risk of Forfeiture Under Code Section 83

As previously mentioned, if a service provider receives property in connection with services rendered, the fair market value of the prop-

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27. *Id.* § 83(b).

28. *Id.* Importantly, the election must occur within thirty days of the transfer. *Id.* § 83(b)(2).

29. *Id.* § 83(a).

30. Treas. Reg. § 1.83-2(a). However, if an election is made under § 83, and the stock subsequently decreases in value, the loss will similarly be realized, presumably as a capital asset, provided the holding period is satisfied. *Id.*

31. *Id.*

32. Knoll, *supra* note 24, at 723.

erty transferred over the amount paid for such property, if any, is included in the gross income of the taxpayer, provided the rights in the property are not transferable or are not subject to a substantial risk of forfeiture.[33] Whether a risk of forfeiture is substantial depends upon the facts and circumstances of each situation.[34] A substantial risk of forfeiture arises only if the rights in the transferred property are either directly or indirectly conditioned on the performance, or refraining from the performance, of substantial services, or if a condition arises that is related to a purpose of the transfer.[35] Thus, the regulations essentially enumerate two types of forfeiture risks that are substantial, although in a vague manner.[36] The regulations under § 83 of the Code provide instructions on general arrangements that may or may not constitute a substantial risk of forfeiture.[37]

If the condition on the enjoyment of the equity-based compensation is unlikely to be enforced, then a substantial risk of forfeiture is not present.[38] If the employer is required to repurchase a portion of the property at fair market value once the employee returns the property, then the property is not subject to a substantial risk of forfei-

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33. I.R.C. § 83(a).

34. Treas. Reg. § 1.83-3(c)(1). Factors that are examined in determining whether or not a risk of forfeiture is substantial include: (1) the regularity of the performance of services, and (2) time invested in performing such services. *Id.* § 1.83-3(c)(2). *See also* JASON FACTOR, EQUITY AND EQUITY-RELATED COMPENSATION: A JAUNT THROUGH SECTIONS 83, 409A, 457(f), AND PROPOSED SECTION 710 6 n.13 (2011) (stating that the cases covering the proper test to determine substantiality are inconsistent). For example, *see* Burnetta v. Comm'r, 68 T.C. 387, 405 (1977) (holding "that the possibility that a Burnetta corporation employee would be discharged and convicted for theft or embezzlement of corporation property is too remote to present any substantial risk that the amounts contributed on his behalf will be forfeited . . ." and disregarding whether a contingency would apply to cause forfeiture), *Theophilos*, 85 F.3d at 447 n.18 (concluding that in deciding whether a substantial risk of forfeiture arises, the court must look to whether there is chance of losing the property), and Robinson v. Comm'r, 805 F.2d 38, 41 (1st Cir. 1986) ("[T]he probability [of a substantial risk of forfeiture] should be measured by the likelihood of the forfeiture taking place once the triggering event occurs.").

35. Treas. Reg. § 1.83-3(c)(1). The provision that states "or refraining from performance" indicates that a non-compete agreement may be a permissible substantial risk of forfeiture provision under equity-based compensation arrangements. *Id. But see* FACTOR, *supra* note 34, at 11 (stating that a condition restricting a service provider from performing future services does create a substantial risk under § 83 but does not under § 409A).

36. *Tax Management Portfolio, Restricted Property – Section 83*, BNA Tax & Acct. No. 384-5, at A-12 (stating that the two accepted types of substantial risk of forfeiture provisions include: (1) future performance of substantial services; and (2) other types of substantial risks of forfeiture).

37. *See* Treas. Reg. § 1.83-3(c)(1), (2). For example, "an employee might receive property subject to a condition that it might be forfeited if performance targets are not achieved. *Strom*, 641 F.3d at 1056.

38. Treas. Reg. § 1.83-3(c)(1) (noting that this determination is a facts and circumstances analysis).

ture.[39] There is not a substantial risk of forfeiture connected with the transfer of property merely because a possibility exists that the value of the property will decline during a certain period of time.[40] Standing alone, a nonlapse restriction does not constitute a substantial risk of forfeiture.[41]

Under a non-compete agreement, if an enforceable requirement exists where the service provider must remit the property to the service recipient once the service provider accepts employment with a competing firm, such a requirement "will not ordinarily . . . result in a substantial risk of forfeiture unless the particular facts and circumstances indicate to the contrary."[42] Thus, the regulations create a rebuttable presumption that favors treating a non-compete agreement as insufficient to constitute a substantial risk of forfeiture, absent certain limited facts and circumstances.[43]

For example, in a private letter ruling, the IRS stated that a covenant not to compete and an employment relationship that is terminated for cause does not constitute a substantial risk of forfeiture.[44] A company had a pending amendment to a benefits plan and pursued clarification through the IRS.[45] The plan provided for incentives to employees in any of six different forms, including restricted stock.[46] Pursuant to the proposals, the company desired to implement a "suspension of the exercise, vesting or settlement of all or any specified portion of a grantee's outstanding awards," if the employee "engaged in detrimental activity," or "accepted employment with another employer."[47] The IRS determined that such restrictions on the enjoyment of equity awards "are not 'substantial risks of forfeiture' pursuant to § 83."[48]

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39. *Id.*
40. *Id*.
41. *See id.* (referencing Treas. Reg. § 1.83-3(h) that explains a nonlapse restriction is also referred to as a restriction that will never lapse and is a permanent restriction on the transfer of the property, "(i) [w]hich will require the transferee of the property to sell, or offer to sell, such property at a price determined under a formula, and (ii) [w]hich will continue to apply to and be enforced against the transferee or any subsequent holder (other than the transferor)").
42. *See id.* § 1.83-3(c)(2) (describing factors that may be used to determine whether a non-compete constitutes a substantial risk of forfeiture includes: (1) age of the employee; (2) available alternative employment opportunities; (3) likelihood of obtaining alternative employment opportunities; (4) employee's skill; (5) health of the employee; and (6) whether the employer has enforced such covenants in the past). The factors essentially suggest a general marketability test.
43. *Tax Management Portfolio, Restricted Property – Section 83*, *supra* note 36, at A-13.
44. I.R.S. Priv. Ltr. Rul. 96-15-023 (April 12, 1996).
45. *Id.*
46. *Id.*
47. *Id.*
48. *Id.*

Importantly, property that is transferred to an employee that must be returned to the employer if the employee is discharged for cause or upon the commission of a crime is not subject to a substantial risk for forfeiture.[49] For example, in *Gudmundsson v. United States*,[50] the United States Court of Appeals for the Second Circuit decided, inter alia, that Olafur Gudmundsson's risk of termination if he did not comply with the company's Insider Trading Policy ("Policy") did not constitute a substantial risk of forfeiture on the equity compensation in his possession.[51]

In *Gudmundsson*, the petitioner Gudmundsson was an officer at Aurora Food's, Inc. ("Aurora").[52] Gudmundsson was involved in Aurora's incentive compensation plan whereby he "became entitled to 73,105 unregistered shares" of Aurora stock on July 1, 1999.[53] Gudmundsson received the stock exactly one year after Aurora's Initial Public Offering ("IPO") of 14,500,000 shares of common stock on July 1, 1998.[54] Two other restrictions were imposed on the stock and impeded Gudmundsson's ability to transfer the stock.[55] The operating

49. Treas. Reg. § 1.83-3(c)(2). *See also* Property Transferred in Connection with the Performance of Services Under Section 83, 79 Fed. Reg. 10663-01, 10663 (Feb. 26, 2014) ("Treasury and the IRS believe that these regulations should not be modified to state that an involuntary separation from service without cause may qualify as a substantial risk of forfeiture under section 83"); Austin v. Comm'r, 141 T.C. 551, 564 (2013) (interpreting the meaning of "for cause" under Treas. Reg. § 1.83-3(c)(2) to mean that the regulations "strongly suggest[ ] that discharge 'for cause,' like discharge 'for committing a crime,' refers to a narrow and serious form of employee misconduct that is very unlikely to occur and is thus properly regarded as too remote—as a matter of law—to create a 'substantial risk of forfeiture.'"); Ludden v. Comm'r, 68 T.C. 826, 836 (1977) (stating that benefit plans that provide "'[i]f a participating employee has been discharged by the Company for cause, such as any intentional act of proven dishonesty or any other intentional act which would injure the Company, such participating employee shall forfeit the entire amount allocated to him . . . .' We hold that the probability that either of the petitioners would be discharged for cause from their wholly owned corporation, thereby forfeiting benefits, is too remote to constitute a substantial risk of forfeiture"); Burnetta v. Comm'r, 68 T.C. 387, 403-405 (1977) (stating that the plan provided that if "[an] employee was 'discharged for theft of company property or embezzlement,'" then such a provision is not subject to a substantial risk of forfeiture because the possibility of the discharge is "'too remote to present any substantial risk that the amounts contributed on his behalf will be forfeited'").

50. 634 F.3d 212 (2d Cir. 2011).

51. Gudmundsson v. United States, 634 F.3d 212, 218-19 (2d Cir. 2011). The Policy at Aurora required compliance with waiting periods before disposing of equity and procedural consent requirements prior to trading Aurora's stock. *Gudmundsson*, 634 F.3d at 215-216.

52. *Id.* at 215.

53. *Id.*

54. *Id.*

55. *See id.* (stating that: (1) the stocks were restricted pursuant to Securities and Exchange Commission ("SEC") Rule 144 whereby Gudmundsson could not sell the stock on a public exchange until the holding period of one year was satisfied, and (2) an agreement was in effect that disallowed anyone holding Aurora's stock from making a public disposition of the stock before the second anniversary of the IPO).

conditions at Aurora eventually deteriorated between the time when Gudmundsson received the stock and when the restrictions regarding Securities and Exchange Rule 144 and the employment agreement were no longer in effect.[56] Eventually the stock price fell from $17.68 per share to $3.83 per share in less than one year.[57]

Aurora provided Gudmundsson with a W-2 calculating his income from the entitlement of the stock at approximately $1.3 million.[58] However, after the violative conditions were discovered at Aurora and the precipitous decline in the stock price, Gudmundsson filed an amended return seeking a $301,834 refund.[59] The IRS disallowed the claim, and upon appeal to the United States District Court for the Western District of New York, the district court granted the government's motion for summary judgment.[60]

On appeal, the Second Circuit addressed multiple arguments; however, pertinent for purposes of this Article, the appellate court rejected the appellants' argument that "the [s]tock was subject to a substantial risk of forfeiture on July 1, 1999. Plaintiff[ ] . . . argue[d] that . . . the risk of termination Gudmundsson faced if he failed to comply with the Policy constituted a substantial risk of forfeiture."[61] The Second Circuit reasoned that § 83 of the Code is not concerned with the termination of rights in employment, but rather is concerned with the termination of rights in property, and that "a substantial risk of forfeiture requires that those property interests be capable of being lost."[62] Therefore, employment termination is relevant under § 83 of the Code only when the employment termination has a causal connection to the "loss or potential loss" of property rights provided as compensation.[63] Because no such connection was present in the case of *Gudmundsson*, there was no substantial risk of forfeiture.[64]

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56. *See id.* at 216 (referring to the two previous restrictions in footnote fifty-five).

57. *Id.* (stating that upon an internal audit irregularities were discovered in Aurora's financial statements resulting in an $81 million downward adjustment in Aurora's pretax earnings).

58. *Id.* at 215.

59. *Id.* at 216.

60. *See id.* at 216 (stating that the parties "disagreed as to when the [s]tock became taxable income. The government argued that the original tax return had properly reported the [s]tock on July 1, 1999, and properly used the exchange price that day as the measure of value. Plaintiff[ ] contended that [he] had been premature to treat the stock as income on July 1, 1999, given the restrictions still encumbering it at the time").

61. *Id.* at 218-19.

62. *Id.* (emphasis omitted) (citing Merlo v. Comm'r, 492 F.3d 618, 622 (5th Cir. 2007); *Theophilos*, 85 F.3d at 447 n.18).

63. *Id.*

64. *Id.*

Furthermore, existing authority interprets termination for cause provisions as inadequate to create a substantial risk of forfeiture.[65] Therefore, "[g]enerally, only forfeiture conditions that relate to performing, or refraining from performing, services for the employer are considered substantial risks of forfeiture," which demonstrates the narrow and ambiguous interpretation of recognized forfeitures under Code § 83.[66]

Conversely, in a Private Letter Ruling, the IRS took a contrary approach regarding the regulatory interpretation of Code § 83.[67] The facts of the ruling are as follows. A company transferred restricted stock to an employee, A.[68] The restricted stock shares were awarded cost free to A in connection with the performance of services.[69] Pursuant to the agreements entered into, "the restricted shares, when issued, were to bear a legend indicating that they were to be forfeited if A's employment terminated for any reason other than retirement, death, or permanent disability."[70] Furthermore, amendments were inserted that stated any shares not vested "will be forfeited if A voluntarily terminated employment with the Company prior to retirement or if the Company terminates A's employment for cause."[71] The IRS ruled that "under the subject agreements, [the shares of restricted stock] did not cease to be subject to a substantial risk of forfeiture for purposes of section 83(a) of the Code when those amendments were amended as set out above."[72]

Similarly, and in collision with the regulations, the United States Tax Court in *Austin v. Commissioner*[73] laid down a tenuous position when it decided whether stock that had to be returned to the employer if the employee was discharged for cause constituted a substantial

65. *Tax Management Portfolio, Restricted Property – Section 83*, *supra* note 36, at A-13 n.86 (citing *Burnetta*, 68 T.C. 387 (stating forfeiture upon discharge for a theft of company property or upon conviction for such a crime held not a substantial risk of forfeiture); Ludden v. Comm'r, 68 T.C. 826 (1977) (stating forfeiture upon discharge for cause triggered by dishonesty or other act injurious to employer, held too remote to be substantial risk of forfeiture)).

66. *Tax Management Portfolio, Restricted Property – Section 83*, *supra* note 36, at A-13.

67. I.R.S. Priv. Ltr. Rul. 93-17-010 (Jan. 22, 1993).

68. *Id*.

69. *Id*.

70. *Id*.

71. *See id*. (stating further that, pursuant to the amendments, the balance of the nonvested shares will vest if A's employment is vitiated for any reason "other than voluntary resignation prior to retirement or termination by the Company for cause," which includes retirement, death, or permanent disability).

72. *Id*.

73. 141 T.C. 551 (2013).

risk of forfeiture.[74] The petitioners, Larry Austin and Arthur Kechijian, transferred their interests in a group of entities to a corporation with an S election pursuant to a legitimate Code § 351 transaction.[75] Under the 351 transaction, each petitioner received 47,500 shares of the S corporation stock while the S corporation simultaneously transferred 5000 shares of its stock to an Employee Stock Ownership Plan ("ESOP").[76] Under the employment agreement, if the petitioners were terminated for cause they would be compelled to sell their shares back to the corporation.[77] If the petitioners were terminated for cause before January 1, 2004, they would receive, at most, fifty percent of the fair market value of the S corporation stock.[78] Generally, when an employee is required to perform future services in order to obtain enjoyment of restricted property, an "earnout restriction" is present.[79] Furthermore, if the petitioners were terminated for cause after January 1, 2004, then they would receive one-hundred percent of the fair market value of the outstanding stock.[80] Thus, the sole issue on appeal was "whether [the] stock petitioners received . . .[,] which was labeled 'restricted stock,' was subject to a substantial risk of forfeiture when issued to them or rather was 'substantially vested' within the meaning of section 83 . . . ."[81]

After the IRS assessed a deficiency against the petitioners, the petitioners contended that the stock was subject to a substantial risk of forfeiture and was substantially nonvested, thus they claimed they

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74. *See* Austin v. Comm'r, 141 T.C. 551, 560 (2013) ("In short, it seems clear that the term 'for cause,' as used in § [83] does not necessarily have the same meaning as, and may have a narrower meaning than, the terminology employed by particular parties during private negotiations.").

75. *Austin*, 141 T.C. at 553.

76. *Id*.

77. *Id.* at 556. The employment agreement defined cause as:

> A. Dishonesty, fraud, embezzlement, alcohol or substance abuse, gross negligence or other similar conduct on the part of the Employee. Upon termination of this Agreement, Employee shall be entitled to receive compensation through the date of termination.
>
> B. Failure or refusal by Employee, after 15 days written notice to Employee, to cure by faithfully and diligently performing the usual and customary duties of his employment and adhere to the provisions of this Agreement.
>
> C. Failure or refusal by Employee, after 15 days written notice to Employee, to cure by complying with the reasonable policies, standards and regulations applicable to employees which . . . [S Corporation] may establish from time to time.

Id. at 555.

78. *Id.*

79. Laurence F. Casey, *A Treatise of the Laws and Procedures Governing the Assessment and Litigation of Tax Liabilities*, 1 CASEY FED. TAX PRAC. § 3:07.14 (2016).

80. *Austin*, 141 T.C. at 555.

81. *Id.* at 552.

incurred no tax liability on the transfer of property.[82] However, the IRS argued that if the employee is discharged for cause, then a substantial risk of forfeiture cannot be present pursuant to Treasury Regulation § 1.83-3(c).[83] The tax court explained that the only provision under the employment agreement that could possibly create a substantial risk of forfeiture was the provision that mandated if one of the petitioners was terminated for cause and he received fifty percent or less of the fair market value of the stock.[84]

The tax court stated that the phrase "discharged for cause," as interpreted in the regulations, is not always consistent with the meaning parties attach to the phrase in employment agreements.[85] The tax court took the position that "discharged for cause" equates to "termination for serious misconduct that is roughly comparable—in its severity and in the unlikelihood of its occurrence—to criminal misconduct."[86] Under the facts of the case, the court stated that the provision the petitioners relied upon is commonly employed to discharge at-will employees for an unsatisfactory job performance.[87] From this, such a condition is not a remote possibility that is unlikely to arise.[88]

The tax court denied the IRS's partial summary judgment motion and concluded that the section relied upon by the petitioners did indeed create a "restriction that may give rise to a substantial risk of

82. *Id*. at 556 (explaining that under the subchapter S tax regime, "stock that is issued in connection with the performance of services . . . 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," and therefore, all of the outstanding stock was owned by ESOP). Under general tax principles of subchapter S and the tax laws surrounding ESOPs, a corporation with an S election creates a pass-through tax regime, and furthermore, an ESOP is a tax exempt entity, thus the allocable share of the income of the S corporation passed through to the ESOP, which in turn will not have any tax liability. *Id.* The petitioners relied on subsection (b), which they argued was the provision that created the substantial risk of forfeiture. *Id.* at 558.

83. Treas. Reg. § 1.83-3(c). Specifically, the regulation states that if the property must be returned to the employer if the employee is discharged for cause, then such a provision will not be deemed to constitute a substantial risk of forfeiture. *Id.*

84. *Austin*, 141 T.C. at 558. *See* I.R.S. Priv. Ltr. Rul. 96-15-023 (April 12, 1996) (stating that the alternate provision of the employment agreement stated that the S corporation would purchase the stock at 100% of the fair market value). *But see* Treas. Reg. § 1.83-3(c) ("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 . . . to the employee upon the return of such property."). Therefore, the S corporation purchasing the stock back at 100% of the fair market value does not constitute a substantial risk of forfeiture. *Austin*, 151 T.C. at 558.

85. *Id.* at 563.

86. *See id.* (explaining that the statutes must be read in context with the other provisions surrounding it and the tax court relied on two previous rulings).

87. *Id.* at 566-67.

88. *Id.* at 567.

forfeiture under § 83."[89] Moreover, the court opined that the definition of discharge for cause in the employment agreement, under the relied upon provision, "falls outside the scope of discharge 'for cause or for committing a crime' within the meaning of § 1.83-3(c)(2)."[90] Although the tax court narrowed the interpretation of "for cause" in the regulations substantially, pursuant to its interpretation of the employment agreement, there are explicit situations where a substantial risk of forfeiture will arise, notwithstanding the tenuous holding in *Austin*.

A substantial risk of forfeiture may arise under a transfer of property when it is conditioned upon the performance of substantial services or "a condition related to the purpose of the transfer."[91] Moreover, a substantial risk of forfeiture exists if the equity is transferred to an underwriter prior to a public offering and the enjoyment of the shares is either directly or indirectly conditioned upon the successful completion of the underwriting.[92] If an employee is required to return the equity-based compensation to the employer when the total earnings of the employer do not increase, then a substantial risk of forfeiture is present.[93] Equity compensation transferred to a retiring employee with the codicil that the retiree perform consultant services is subject to a substantial risk of forfeiture if the employee is in fact "expected" to perform the substantial services; otherwise, if the employee is not in fact "expected" to perform the consulting services, then the property will not be subject to a substantial risk of forfeiture.[94] Also, the Code deems certain transactions subject to a substantial risk of forfeiture and nontransferable "[s]o long as the sale of property at a profit could subject a person to suit under § 16(b) of the Securities Exchange Act of 1934 . . . ."[95]

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89. *Id.* at 568.

90. *Id.* The court's reasoning seems tenuous at best in explaining that the petitioners' "inability or disinclination" to perform services for the agreed term is not remote or unlikely. *Id.*

91. *Id.* (noting, however, that if the vesting of property is accelerated due to an involuntary separation without cause from service, or as a result of death or disability, then the substantial risk of forfeiture that would otherwise be present will not be deemed to fail as a substantial risk of forfeiture, as long as the involuntary separation from service is not likely to occur during the agreed upon service period).

92. Treas. Reg. § 1.83-3(c)(2).

93. *Id.*

94. *See id.* (explaining, specifically, that the retiring employee must be expected to perform substantial services is interesting when reading the regulations and the absence of any requirement that the retiring employee actually perform the consulting services). Ostensibly, this provision appears ripe for abuse.

95. I.R.C. § 83(c)(3)(A), (B). This provision "remedies a tension" inadvertently established with the creation of tax laws and securities laws—without § 83(c), a taxpayer would be required to realize income upon exercising equity rights when the taxpayer

B. Substantial Risk of Forfeiture Under Code Section 409A

1. Overview of Nonqualified Deferred Compensation Under Code Section 409A

The advent of the American Jobs Creation Act of 2004[96] established nonqualified deferred compensation arrangements.[97] A nonqualified plan is an arrangement, or promise, to pay an employee or independent contractor sometime in the future for services performed prior to such payments.[98] Nonqualified plans do not provide employers and employees with similar tax benefits conferred under qualified plans because nonqualified plans, by definition, do not satisfy the requirements of Code § 401(a).[99] Nonqualified plans are generally used in conjunction with a qualified plan in order to allocate a greater amount of compensation for key employees in lawful circumvention of the limitations regulating qualified plans.[100] Code § 409A governs nonqualified deferred compensation plans and the thrust of a nonqualified deferred compensation plan is to allow an employee who earns income in one year to defer the recognition of income until a later year.[101] Nonqualified deferred compensation subject to Code § 409A is broadly construed to include "any arrangement or agreement that defers compensation."[102]

A nonqualified deferred compensation plan can be used to attract and retain integral or key employees.[103] Because a nonqualified plan by definition does not, and is not required to, meet the requirements of Code § 401(a), such plans are not subject to the contribution and par-

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would not be able to convert the equity to cash without incurring a loss of forfeiting the cash in a § 16(b) lawsuit under the Exchange Act. *Strom*, 641 F.3d at 1056.

96. American Jobs Creation Act of 2004, Pub. L. No. 108-357, 118 Stat. 1418 (2004).

97. Philip J. Gutwein II, *Nonqualified Deferred Compensation Plans – Will You Know One When You See One?*, 15 Ind. Emp. L. Letter 3 (2005).

98. The phrase "promise to pay" is used loosely in this context. Nonqualified deferred compensation plans are required to be in writing and cannot be verbal promises to pay sometime in the future.

99. Dissimilar to Code § 83, under a nonqualified deferred compensation plan, the employer may utilize a deduction once the employee is taxed on the income from the nonqualified deferred compensation plan.

100. *Id.*

101. Marcia S. Wagner, *Taxation of Deferred Compensation: Overview of 409A and 457*, 42 Compensation & Benefits Rev. 239 (2010).

102. Jeffrey Lewis, Myron D. Rumeld & Ivelisse Berio LeBeau, Employee Benefits Law 6-54 (3d ed. 2012). "Deferred compensation is any legally binding right (whether or not subject to a substantial risk of forfeiture) to compensation that is or may be payable in a subsequent taxable year." *Id.* (citing Treas. Reg. § 1.409A-1(b)(1)).

103. MetLife, Nonqualified Compensation Plans & Code Section 409A 1 (2013), https://metlifepro.metlife.com/RPP/Public/StaticFiles/SHARED/BO/EB/BsOw_ExBnft_NQDC_LegalTaxTrends.pdf.

ticipation limitations otherwise placed upon qualified plans.[104] The nonqualified plan must also be unfunded and unsecured; the employer is precluded from placing assets in trust, which are outside the reach of the creditors of a corporation.[105]

For example, a deferred compensation plan subject to Code § 409A would include, but is not limited to, nonelective supplemental retirement plans, severance plans, discount stock options,[106] long-term incentive plans,[107] salary reduction arrangements, bonus deferral plans, top-hat plans, and excess benefit plans. Generally, Code § 409A halts the acceleration of paying out deferred compensation, restricts the timing of initial compensation deferral elections and subsequent payment deferral elections, and imposes stiff penalties for noncompliance.[108] Interestingly, the IRS refuses to issue guidance in the form of letter rulings or determination letters regarding Code § 409A, thus specific guidance remains elusive.[109]

Code § 409A states that compensation deferred pursuant to a nonqualified deferred compensation plan "for the taxable year" and for "all preceding taxable years" is includable in the gross income of the taxpayer in the current year "to the extent not subject to a substantial risk of forfeiture" and that was not "previously included in the gross income of the taxpayer," provided "[the] nonqualified deferred compensation plan–(I) fails to meet the requirements of [subsequent applicable provisions], or (II) is not operated [pursuant to] such requirements."[110] Although not directly relevant for purposes of this Article, the penalty regime is worth mentioning for noncompliance; if

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104. *Id.*

105. *Id.* at 2. An exception does exist where an employer can circumvent the general rule and utilize a rabbi trust wherein the employer then places funds to pay out the obligation.

106. Discount stock options that are not subject to Code § 409A are those options that qualify under Code § 423.

107. LEWIS ET AL., *supra* note 102. However, certain arrangements are specifically excepted from 409A, which include:

> (1) bona fide plans providing vacation or sick leave, disability pay, pay for compensatory time, or death benefits, and (2) health care arrangements that provide nontaxable benefits, qualified plans, and similar arrangements (including 403(b) annuities, SIMPLE plans, SEPs, and governmental plans) and eligible 457(b) plans, certain broad-based foreign retirement plans, short-term deferrals, and certain separation pay plans and window programs.

Id.

108. *Id.*

109. *See* Rev. Proc. 2016-3, 2016-1 I.R.B. 126 (stating that Code § 409A is one of many provisions in the Code where the IRS will not issue rulings or determination letters).

110. I.R.C. § 409A(a)(1)(i). The subsequent provisions of 409A include: (1) distribution compliance, (2) acceleration of benefits restrictions, and (3) elections. *See* § 409A(a)(2), 409A(a)(3), and 409A(a)(4) (stating ancillary requirements of 409A, which are outside the scope of this Article).

compensation is included in the gross income of the taxpayer, then such amount shall be increased by interest as defined in the Code plus "an amount equal to [twenty] percent of the compensation required to be included in gross income."[111]

The specific areas of concern for compliance with Code § 409A include: (1) distributions; (2) acceleration of benefits; and (3) elections.[112] First, distributions from a nonqualified plan may commence not earlier than: (i) a separation from service;[113] (ii) the occurrence of an unforeseeable emergency;[114] (iii) death of the recipient; (iv) "a specified time (or pursuant to a fixed schedule) specified under the plan" at the deferral date of the compensation; (v) "a change in the ownership or effective control of the corporation, or in the ownership of a substantial portion of the assets of the corporation;" or (vi) the date upon which the recipient becomes disabled.[115] Second, the requirement of Code § 409A is deemed satisfied regarding accelerated benefits as long as the plan does not allow for the acceleration of time or of the schedule of payments.[116] Third, under § 409A, the election requirements must also be satisfied. Generally, the election to defer compensation

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111. *Id.* § 409A(a)(1)(B)(i), (ii). The second provision provides:

> The interest determined . . . is the amount of interest at the underpayment rate plus one percentage point on the underpayments that would have occurred had the deferred compensation been includable in gross income for the taxable year in which first deferred or, if later, the first taxable year in which such deferred compensation is not subject to a substantial risk of forfeiture.

Id. § 409A(a)(1)(B)(ii).

112. *Id.* § 409A(a)(2)-(4).

113. A separation from service occurs if an employee "dies, retires, or otherwise has a termination of employment with the employer." Treas. Reg. § 1.409A(h)(1)(i). Moreover, the employment relationship remains intact, and thus no separation from service is present when the employee commences "military leave, sick leave, or other bona fide leave of absence" provided the period of leave does not exceed six months; if the leave exceeds six months, the employment relationship remains intact provided the employee "retains a right to reemployment with the service recipient" pursuant to applicable laws or under a binding contract. *Id.* There is a special rule for specified employees, or key employees, that further restricts when such an employee may receive distributions from a nonqualified plan. The requirements under Code § 409A(a)(1)(A)(i) are satisfied for specified employees, or key employees, as long as distributions are not made before six months following the separation from service, or the death of the employee if the latter occurs before the former. I.R.C. § 409A(a)(2)(B)(i).

114. An unforeseeable emergency is defined as:

> a severe financial hardship to the participant resulting from an illness or accident of the participant, the participant's spouse, or a dependent . . . of a participant, loss of a participant's property due to casualty, or other similar extraordinary and unforeseeable circumstances arising as a result of events beyond the control of the participant.

Id. § 409A(a)(2)(B)(ii)(I). The distributions that result from a participant claiming an unforeseeable emergency cannot exceed the amount necessary to satisfy the unforeseeable emergency in addition to amounts needed to pay the taxes that accompany such a distribution. § 409A(a)(1)(B)(ii)(II).

115. *Id.* § 409A(a)(2)(A)(i)-(vi).

116. *Id.* § 409A(a)(3).

in exchange for services rendered must occur before the close of the preceding taxable year.[117] If a plan permits a subsequent election, which delays payments or changes the form of payments, the election requirement is satisfied if: (1) the subsequent election will not take effect before the expiration of twelve months after the election is made; (2) for distributions pursuant to a separation from service, a change in ownership or control of a corporation or of ownership of a substantial portion of assets of a corporation, or for distributions subject to a specific time, or under a fixed schedule, the election defers the payment for at least five years following the date upon which the payment would otherwise be made; and (3) for any payment required at a specified time, or under a fixed schedule, specified under the plan, the deferral election cannot be made within a twelve-month period before the date of the first scheduled payment.[118]

As previously noted, deferred compensation under a nonqualified deferred compensation arrangement is includable in the taxpayer's gross income in the current taxable year if the compensation is not subject to a substantial risk of forfeiture and if it was not already included in the taxpayer's gross income.[119] Under Code § 409A, a substantial risk of forfeiture carries an explicit definition: "[t]he 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."[120] However, Code § 409A also grants the IRS the power to "disregard[ ] a substantial risk of forfeiture in cases where necessary to carry out the purposes of this section."[121] As with many provisions of the Code, the details are contained in the regulations.

2. Application of a Substantial Risk of Forfeiture Under Code Section 409A

The treasury regulations shed light, to a limited extent, on what provisions constitute a substantial risk of forfeiture under Code § 409A.[122] As a general rule, a substantial risk of forfeiture is present and staves off tax liability if "entitlement to the amount is conditioned on the performance of substantial future services by any person or the

117. *Id.* § 409A(a)(4)(A). Alternatively, an election to defer compensation may be made thirty days after a participant becomes eligible to participate in a nonqualified deferred compensation plan if the participant is in the first year of participation. § 409A(a)(4)(B)(ii).
118. *Id.* § 409A(a)(4)(C)(i)-(iii).
119. *Id.* § 409A(a)(1)(A)(i).
120. *Id.* § 409A(d)(4).
121. *Id.* § 409A(e)(5).
122. *See* Treas. Reg. § 1.409A-1(d)(1).

occurrence of a condition related to a purpose of the compensation, and the possibility of forfeiture is substantial."[123] A condition must relate to the services that will be provided or to the "service recipient's business activities or organizational goals."[124] Whether a forfeiture condition is substantial depends on the facts and circumstances of a given situation.[125] For example, a promised bonus is subject to a substantial risk of forfeiture if the service provider must remain as an employee for a certain number of years or until the occurrence of an event.[126]

A substantial risk of forfeiture is present when the service provider's full enjoyment of the compensation is conditioned on an involuntary separation from service without cause provision.[127] The statutes and regulations under Code § 409A are silent as to whether a substantial risk of forfeiture is present when a termination for cause provision is in place. There are defined instances when a substantial risk of forfeiture is not present for certain imposed restrictions on the compensation.

A substantial risk of forfeiture is not present when a service provider, either directly or indirectly, is precluded from enjoyment of the deferred compensation based on refraining from performing services.[128] In subtle language, Code § 409A states that a non-compete agreement does not constitute a substantial risk of forfeiture.[129] For example, in an IRS Notice, the IRS determined that:

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123. *See id.* (stating that a condition that restricts the enjoyment of the compensation that relates to a purpose of the compensation if "the compensation . . . relate[s] to the service provider's performance for the service recipient or the service recipient's business activities or organizational goals"). An example of such a restriction includes obtaining a certain amount of earnings or completing an initial public offering. *Id.*

124. *Tax Management Portfolio, Deferred Compensation Arragements*, BNA Tax & Acct. No384-5, at D(2)(e), A-27 (2012).

125. Treas. Reg. § 1.409A-1(d)(3).

126. *Id.*

127. *Id.* § 1.409A-1(d)(1). *See also* MICHAEL L. ROSEN & TERESA A. MARTLAND, SECTION 409A (DEFERRED COMPENSATION) ISSUES IN EMPLOYMENT AGREEMENTS 3 (2012) (stating that an amount payable upon a voluntary separation from service does constitute a substantial risk of forfeiture).

128. *Id. See also* FACTOR, *supra* note 34, at 11 (stating that a condition restricting a service provider from performing future services may create a substantial risk under § 83, but does not under § 409A); William A. Drennan, *Einstein's Theory of Taxation Explains the Nonqualified Compensation Rules*, 40 U. TOL. L. REV. 53, 96 (2009) (citing Treas. Reg. §§ 1.409A-1(d)(1), 1.83-3(c)(2)) (stating that compliance with a non-compete agreement does not constitute a substantial risk of forfeiture under Code § 409A, whereas a regulation under Code § 83 finds a substantial risk of forfeiture present when a non-compete agreement is in place, under certain factual circumstances); *Tax Management Portfolio, Deferred Compensation Arrangements*, *supra* note 124, at D(2), A-27.

129. Treas. Reg. § 1.409A-1(d).

> the term "substantial risk of forfeiture" is ascribed a somewhat narrower meaning [under Code § 409A] than the same term has under section 83 (and is generally thought to have under section 457(f)), although the statutory definition is the same in each instance . . . . Q/A-10(a) would appear to establish a per se rule that non-compete and similar restrictions do not constitute substantial risks of forfeiture under section 409A . . . .[130]

The previous example is extracted from the Public Comment Letter in response to IRS Notice 2005-1. The pertinent notice at issue stated in question and answer ten that, similar to the regulations, "[a]n amount is not subject to a substantial risk of forfeiture merely because the right to the amount is conditioned, directly or indirectly, upon the refraining from performance of services."[131]

Furthermore, imposing any risk of forfeiture after a "legally binding right to the compensation" comes to fruition is disregarded; this sentiment applies equally to any extension of a period during which the compensation is subject to a substantial risk of forfeiture.[132] Compensation is not subject to a substantial risk of forfeiture after a previously determined time which the recipient otherwise could have elected to receive the compensation, provided the present value of the compensation is not "materially greater" than the present value of the compensation a service provider otherwise could have elected to receive in the absence of a substantial risk of forfeiture.[133] Specifically, for purposes of stock rights, the rights are not subject to a substantial risk of forfeiture at the earlier of: "[1] the first date the holder may exercise the stock right and receive cash or property that is substantially vested . . . or [2] the first date that the stock right is not subject to a forfeiture condition that would constitute a substantial risk of forfeiture."[134]

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130. I.R.S. Notice 2005-1, Skillman Pub. Cmt. Ltr. (May 25, 2005) (emphasis omitted).

131. I.R.S. Notice 2005-1, 2005-1 C.B. 274 (Dec. 20, 2004).

132. *Id.*

133. *See id.* ("Compensation . . . the service provider would receive for continuing to perform services regardless of whether the service provider elected to receive the amount . . . subject to a substantial risk of forfeiture is not taken into account in determining whether the present value of the right to the amount subject to a substantial risk of forfeiture is materially greater than the amount the recipient otherwise could have elected to receive absent such risk of forfeiture.").

134. *See* Treas. Reg. § 1.409A-1(d)(2) (explaining further that a stock option recipient may immediately exercise and receive "substantially vested" stock is not subject to a substantial risk of forfeiture, even when the option terminates automatically upon the recipient's separation from service).

III. ARGUMENT

"The Code must be given as great an internal symmetry and consistency as its words permit. All sections of the Code must be read consistent with one another."[135] Code §§ 83 and 409A contain virtually identical statutory definitions of what constitutes a substantial risk of forfeiture.[136] As such, presumably Code §§ 83 and 409A would carry a substantially similar, if not identical, interpretive definition of what constitutes a substantial risk of forfeiture.[137] Although the previous syllogism would seem to be a logical approach to an interpretation of the tax code, such is not the absolute result.

Based on the inherent inconsistencies of the Code and the consequences that flow from such inconsistencies, a uniform interpretation should be applied to Code §§ 83 and 409A as to what constitutes a substantial risk of forfeiture. The interpretative approach as to specific instances of the substantial risk of forfeiture provisions in Code §§ 83 and 409A have eroded a general principle of the tax code, consistent interpretations of the same or similar phraseology. This Article will first highlight the inconsistency contained in Code §§ 83 and 409A regarding the treatment of non-competition agreements between employers and employees.[138] Second, this Article will examine the inconsistencies inherent in the two Code sections regarding termination for cause provisions.[139] Third, this Article will point to the inconsistent treatment regarding involuntary separation from service provisions under the general substantial risk of forfeiture definition contained in Code §§ 83 and 409A. These three specific categories fall under the general umbrella of what constitutes a substantial risk of forfeiture, among other specific provisions. A substantial risk of forfeiture carries the same, if not identical, general statutory definition under Code §§ 83 and 409A. Therefore, a uniform interpretive approach must be imposed to reconcile what constitutes a substantial risk of forfeiture under Code §§ 83 and 409A.[140]

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135. Comm'r v. Lester, 366 U.S. 299, 304 (1961).

136. Robert B. Schwartz, *New Section 409A Creates New Rules Governing Nonqualified Deferred Compensation*, 19 PRAC. TAX LAW. 7, 11 (2005).

137. *Compare Lester*, 366 U.S. at 304 (stating that provisions in the tax code must be regarded as consistent as its words permit), *with* Schwartz, *supra* note 136 ("[§ 409A] contains . . . the same definition of when deferred compensation is subject to a 'substantial risk of forfeiture' as does [§ 83] when a [recipient's] right to the property transferred in connection with the performance of services is no longer subject to 'a substantial risk of forfeiture.'").

138. *See infra* notes 175-191 and accompanying text.

139. *See infra* notes 192-215 and accompanying text.

140. *See infra* notes 216-226 and accompanying text.

A. Consistent Interpretation of the Same Language

1. Statutory Interpretation

"A duty of administrative consistency certainly exists; the tax laws must be interpreted and applied as uniformly as possible."[141] When a term or a statutory phrase appears in multiple places in the United States Code, the phrase is ordinarily interpreted as carrying the same meaning every time it appears.[142] The threshold inquiry utilizes the plain meaning approach: "[t]he beginning . . . of statutory interpretation should be the apparent meaning of the statutory language."[143] In determining the meaning of a statute, "[t]here is, of course, no more persuasive evidence of the purpose of a statute than the words by which the legislature undertook to give expression to its wishes."[144] Examining the statute is the first step in statutory interpretation, followed by an examination of the legislative history.

Code § 83 states the statutory definition of a substantial risk of forfeiture: "[t]he rights of a person in property are subject to a substantial risk of forfeiture if such person's rights to full enjoyment of such property are conditioned upon the future performance of substantial services by any individual."[145] Code § 409A states that a substantial risk of forfeiture means "[t]he 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."[146] The twin definitions are virtually identical in language except for two groupings of words. In the first instance, Code § 83 uses the phrase "[t]he rights of a person *in property* . . . ," whereas Code § 409A uses the phrase "[t]he rights of a person *to compensation* . . . ."[147] In the second grouping, Code § 83 uses the phrase, "[t]he rights of a person *in property* are

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141. Bunce v. United States, 28 Fed. Cl. 500, 508 (1993).

142. Larry M. Eig, *Statutory Interpretation: General Principles and Recent Trends*, Cong. Res. Serv. 6 n.25 (2011).

143. William N. Eskridge, Jr. & Philip P. Frickey, *Statutory Interpretation as Practical Reasoning,* 42 Stan. L. Rev. 321, 340 (1990).

144. Eskridge & Frickey, *supra* note 143, 341 n.73 (quoting United States v. Am. Trucking Ass'ns, 310 U.S. 534, 543 (1940) and Huffman v. W. Nuclear, Inc., 488 U.S. 663 (1988)).

145. I.R.C. § 83(c)(1).

146. *Id.* § 409A(d)(4).

147. *Compare id.* § 83(c)(1) (referring to rights in property, which presumably denotes that the property rights are currently in existence based on the fact that, for example, stock has been allocated to an individual), *with* § 409A(d)(4) (referring to a right, or rights, to compensation, which seemingly imports the notion that the entitlement to the compensation is not yet enforceable and may be captured at a later date, consistent with the operation of nonqualified deferred compensation plans where the compensation is an unfunded promise to pay in the future, and that such amounts cannot be shielded from the corporation's creditors).

subject to a substantial risk of forfeiture if such person's rights to *full enjoyment of such property . . .* ," whereas Code § 409A utilizes the phrase, "[t]he rights of a person *to compensation* are subject to a substantial risk of forfeiture if such person's rights to *such compensation . . .*."[148] The remainder of the definition under both Code sections following the second groupings of differing words is identical: "are conditioned upon the future performance of substantial services by any individual." The difference in the statutory language reflects the inherent difference in the property that is at issue under each compensation arrangement.

The slight alterations in the statutory language of the two Code sections are the result of the nature of the property that each Code section regulates. The property under Code § 83 refers to property that is allocated to the service provider in trust and in which the service provider has existing property rights upon providing the service. The property that is governed by Code § 409A is merely an unfunded and unsecured promise to pay; the service provider does not have existing property rights until the compensation is paid out under Code § 409A. Outside of the property-specific language, the definition of a substantial risk of forfeiture is identical in each of the two Code sections.[149] The operative language in both definitions is that the rights in property or to compensation "are conditioned upon the future performance of substantial services by any individual."[150] Because the only difference in the statutory language reflects the inherent nature of the property at issue, the practical application of what constitutes a substantial risk of forfeiture must remain the same, if not substantially similar, as between the two statutory provisions of Code §§ 83 and 409A. As such, what constitutes a substantial risk of forfeiture for both Code §§ 83 and 409A must be interpreted and applied in a consistent manner.[151] However, the plain meaning cannot be the sole

148. *Compare id.* § 83(c)(1) (creating the corollary that because the property rights in the stock are already in existence, therefore the logical conclusion of satisfying the substantial risk of forfeiture requirement is the absolute control of the stock), *with* § 409A(d)(4) (appearing to state that, similar to the previous language "to compensation," "such compensation" is referring to the identical rights which may be obtained at a later date based on similar reasoning for the first set of differing language under Code [§] 409A").

149. *See id.* §§ 83(c)(1), 409A(d)(4).

150. *Id.* § 409A(d)(4).

151. *Compare id.* § 83(c)(1) (stating that a substantial risk of forfeiture means property rights or compensation rights that "are conditioned upon the future performance of substantial services by any individual"), *and* § 409A(d)(4) (asserting that a substantial risk of forfeiture means property or compensation rights that "are conditioned upon the future performance of substantial services by any individual"), *with* Eig, *supra* note 142 (stating that each time provisions appear, the same meaning must ordinarily attach to the identical provisions).

source of statutory interpretation; the legislative intent of the statutes must be further analyzed.

2. Legislative History

The legislative history reflects the intended interpretive application of what constitutes a substantial risk of forfeiture under Code §§ 83 and 409A. The impetus for enacting Code § 83 was that there was no tax law on the books regulating deferred compensation arrangements, which were also known restricted stock plans.[152] As a result, the House of Representatives stated:

> For the [stated] reasons, [the] committee's bill provides that a person who receives a beneficial interest in property by reason of the performance of services is to be taxed with respect to the property at the time of receipt, either if his interest in the property is transferable or if it is not subject to a substantial risk of forfeiture.[153]

Further, House Report 413 merely stated that, regarding what constitutes a substantial risk of forfeiture, "[a] substantial risk of forfeiture will be considered to exist where the person's rights to the full enjoyment of the property are conditioned upon his future performance of substantial services."[154] As an example, the House Report commented that "a requirement that an employee sell the stock back to the employer at book value or a formula price if he terminates his employment, [is] not . . . tax motivated and should be distinguished from restrictions designed to achieve deferral for tax savings purposes."[155] This example highlights the general purpose of a substantial risk of forfeiture and the appropriate usage of a substantial risk of forfeiture; that a substantial risk of forfeiture is valid provided the individual who has rights in property cannot exclusively control the timing of the income inclusion. Under the previous example, a substantial risk of forfeiture will not exist if the individual "terminates his employment," which confers effective control over the forfeiture condition because the individual can terminate his own employment. From this, pursuant to the House Report's reasoning, if the individual does not have effective control over the forfeiture condition, then, depending on the condition, the forfeiture condition is valid. The House Report regarding Code § 409A states a similar purpose and interpretation.

House Report 548 states:

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152. H.R. REP. NO. 91-413, at 1733 (Dec. 22, 1969).
153. *Id.* at 1735.
154. *Id.*
155. *Id.*

> The Committee is aware of the popular use of deferred compensation arrangements by executives to defer current taxation of substantial amounts of income. The Committee believes that many nonqualified deferred compensation arrangements have developed which allow improper deferral of income. Executives often use arrangements that allow deferral of income, but also provide security of future payment and control over amounts deferred.[156]

The general sentiment regarding nonqualified deferred compensation was that certain arrangements conferred too much control or access to amounts deferred to participants in such plans and the amounts should not result in the deferral of income inclusion.[157] The House of Representatives further asserted that substantial risks of forfeiture were prohibited from being used as a means to manipulate the timing of income inclusion.[158] Interestingly and persuasively, the legislative history states that "[a]s under section 83, the rights of a person to compensation are subject to a substantial risk of forfeiture if the person's rights to such compensation are conditioned upon the performance of substantial services by any individual."[159] The House Report continues on to state that "[i]t is intended that substantial risk of forfeitures may not be used to manipulate the timing of income inclusion."[160]

As a major premise, therefore, the more pronounced legislative history under Code § 409A intimates that as long as an individual cannot control the manner in which the risk of forfeiture can be accelerated or decelerated, then a valid substantial risk of forfeiture is present. This notion similarly applies under Code § 83. Alternatively, if an individual is able to effectively control the timing of income inclusion when a purported substantial risk of forfeiture is present, then a substantial risk of forfeiture should not be present, under both Code sections.[161] As a minor premise, Code § 409A adopts, pursuant to legislative history, the precise definition of what constitutes a substantial

156. H.R. REP. NO. 108-548, at 343 (June 16, 2004).

157. *Id.* One reason for the enactment of Code § 409A was a consequence of ENRON executives utilizing unregulated deferred compensation arrangements.

158. H.R. REP. NO. 108-548, at 348 (June 16, 2004).

159. *Id.* at 343-44 n.455. *See* H.R. REP. NO. 91-413, at 1735 (Dec. 22, 1969) (defining what constitutes a substantial risk of forfeiture under Code § 83).

160. H.R. REP. NO. 108-548, at 348 (June 16, 2004). For example, if an individual is able to accelerate the lapse of a substantial risk of forfeiture the risk of forfeiture should be disregarded and the income inclusion should not be postponed. *Id.*

161. This argument simply points out the alternate interpretation, when a substantial risk of forfeiture is present, and stays within the general argument of this Article, not that a certain set of words or phrases used as a forfeiture condition is substantial, but rather each discrete interpretation of what constitutes a substantial risk of forfeiture be interpreted consistently as between Code §§ 83 and 409A.

risk of forfeiture under Code § 83; as a result, the major premise applies equally in both Code sections. Moreover, the legislative intent and proposed interpretive application are substantially similar, if not identical, under both Code sections. Thus, Code §§ 83 and 409A should carry the same interpretive approach, pursuant to the legislative history.

The legislative history of Code §§ 83 and 409A further corroborates the statutory interpretation analysis that the practical applicable definition of a substantial risk of forfeiture should be interpreted in the same manner, or at least a substantially similar manner, under both Code sections.[162] The statutory definition of a substantial risk of forfeiture under Code §§ 83 and 409A are identical, save the distinctions as a result of the inherent property that each provision governs.[163] Moreover, the subsequent legislative history regulating Code § 409A, which was issued after the legislative history governing Code § 83, is identical to the legislative history of Code § 83.[164] In fact, the legislative history issued under Code § 409A explicitly adopts the exact definition of what constitutes a substantial risk of forfeiture in effect for Code § 83.[165]

3. Practical Considerations

Code § 7803(c)(1)(A) established the Office of the Taxpayer Advocate.[166] The National Taxpayer Advocate ("NTA") is an employee of the IRS and is charged with: (1) "assisting taxpayers in resolving problems with the [IRS]"; (2) "identify[ing] areas in which taxpayers have problems in dealing with the [IRS]"; (3) "to the extent possible, [is charged with] propos[ing] changes in the administrative practices of the [IRS] to mitigate problems identified"; and (4) "identifying po-

162. *Compare* I.R.C. § 83(c)(1) (stating that a substantial risk of forfeiture is defined as property rights that "are conditioned upon the future performance of substantial services by any individual"), *and* § 409A(d)(4) (stating that a substantial risk of forfeiture is defined as compensation rights that "are conditioned upon the future performance of substantial services by any individual"), *with* H.R. REP. NO. 91-413, at 1735 (Dec. 22, 1969) ("A substantial risk of forfeiture under Code section 83 will be considered to exist where the person's rights to the full enjoyment of the property are conditioned upon his future performance of substantial services."), *and* H.R. REP. NO. 108-548, at 343-44 n.455 (June 16, 2004) ("As under section 83, the rights of a person to compensation are subject to a substantial risk of forfeiture if the person's rights to such compensation are conditioned upon the performance of substantial services by any individual.").

163. *See* I.R.C. §§ 83(c)(1), 409A(d)(4).

164. H.R. REP. NO. 108-548, at 343-44 n.455 (June 16, 2004) ("As under section 83, the rights of a person to compensation are subject to a substantial risk of forfeiture if the person's rights to such compensation are conditioned upon the performance of substantial services by any individual.").

165. *See* H.R. REP. NO. 91-413, at 1735 (Dec. 22, 1969); H.R. REP. NO. 108-548, at 343-44 n.455 (June 16, 2004).

166. I.R.C. § 7803(c)(1)(A).

tential legislative changes which may be appropriate to mitigate such problems."[167] Additionally, the NTA shall compile and submit a comprehensive analytical report to the Ways and Means Committee in the House of Representative and the Senate Finance Committee.[168]

In 2012, the annual report that the NTA presented to Congress stated that the most serious problem facing all taxpayers of the United States was the complexity of the tax code.[169] Specifically, among others, the NTA noted that the tax code "makes compliance difficult, requiring taxpayers to devote excessive time to preparing and filing their returns" and "[r]equires the significant majority of taxpayers to bear monetary costs to comply, as most taxpayers hire preparers . . . ."[170] The report goes on to assert that the current tax code "inflicts significant, even unconscionable" burdens and Congress is in the position to alleviate the burden by "vastly simplifying the tax code."[171] For example, the NTA found that individuals and businesses spend approximately 6.1 billion hours annually attempting to comply with the tax code.[172] Moreover, if tax compliance were its own industry, it would equate to one of the largest industries in the United States.[173] Code §§ 83 and 409A are two provisions that fall within the ambit of this critique. The Code sections outlined in this Article are precisely the type of provisions that "[u]ndermine . . . trust in the system" because of the inconsistent interpretation of virtually identical statutory Code provisions.[174] As such, Code §§ 83 and 409A are two sections that add to the incoherent complexity of the tax code.

Therefore, based on virtually identical language in Code §§ 83 and 409A, adoption of the same definition of what constitutes a substantial risk of forfeiture in the legislative history, and the practical consequences facing the American public that results from an inconsistent interpretation, a uniform interpretive approach should be applied to Code §§ 83 and 409A. The foregoing reasons demonstrate that

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167. *Id.* § 7803(c)(2)(A)(i)-(iv).
168. *Id.* § 7803(c)(2)(B)(ii).
169. NAT'L TAXPAYER ADVOCATE, 2012 ANNUAL REPORT TO CONGRESS 3 (2012).
170. *Id.*
171. *Id.* at 3-4.
172. *Id.* at 5.
173. *Id.*
174. *Compare* NAT'L TAXPAYER ADVOCATE, *supra* note 169 (stating that the complexity of the tax code "[u]ndermines trust in the system"), *with* I.R.C. § 83(c)(1) (stating that despite virtually identical language, non-compete agreements create a rebuttable presumption that a substantial risk of forfeiture is not present, termination for cause provisions do not create a substantial risk of forfeiture, and involuntary separation from service agreements do not create a substantial risk of forfeiture), *and* § 409A(d)(4) (stating that despite essentially the same language as § 83(c)(1), non-compete agreements do not create a substantial risk of forfeiture, § 409A is silent as to whether termination for cause agreements create a substantial risk of forfeiture, and involuntary separation from service agreements do create a substantial risk of forfeiture).

a consistent interpretive approach must generally be utilized, especially in the tax code, for similar, if not the same, language used in statutory text. Such an interpretation method applies directly to Code §§ 83 and 409A regarding three specific instances outlined below.

B. Inconsistent Interpretations Regarding a Substantial Risk of Forfeiture

1. Non-compete Agreements

The regulations under Code § 83 state that "[a]n enforceable requirement that the property be returned to the employer if the employee accepts a job with a competing firm will not ordinarily be considered to result in a substantial risk of forfeiture unless the particular facts and circumstances indicate to the contrary."[175] Such phrasing creates a rebuttable presumption that ordinarily a non-compete clause does not create a substantial risk of forfeiture. For example, in a private letter ruling, the IRS stated that a non-compete clause does not constitute a substantial risk of forfeiture.[176] In that specific circumstance, a company had a pending amendment to a benefits plan and pursued clarification by the IRS.[177] The plan provided for incentives to employees in any of six different forms, including restricted stock.[178] Pursuant to the proposals, the company desired to implement a "suspension of the exercise, vesting or settlement of all or any specified portion of a grantee's outstanding awards," if the employee "may have accepted employment with another employer."[179] The IRS determined that such a restriction on the enjoyment of equity awards "[is] not [a] 'substantial risk . . . of forfeiture' pursuant to section 83."[180]

However, the regulations explicitly state certain factors that can be used to analyze whether the presumption of a lack of a substantial risk of forfeiture is rebutted.[181] These factors include: (1) the age of employee, (2) the available alternative employment opportunities, (3) the likelihood of obtaining the other employment opportunities, (4) the degree of skill that the employee possesses, (5) the health of the employee, and (6) the employer's practice of enforcing any non-compete agreements.[182] The regulations provide an example of when a substantial risk of forfeiture, pursuant to a non-compete agreement, may

175. Treas. Reg. § 1.83-3(c)(2).
176. I.R.S. Priv. Ltr. Rul. 96-15-023 (April 12, 1996).
177. *Id.*
178. *Id.*
179. *Id.*
180. *Id.*
181. Treas. Reg. § 1.83-3(c)(2).
182. *Id.*

arise under Code § 83.[183] The example provides that a person is transferred stock of the employer company and the retention of the stock is conditioned on the employee refraining from engaging in competition with the former employer for five years.[184] The employee is precluded from engaging in competition with the former employer in the three states in which the employee previously engaged in sales activities.[185] The employee is forty-five and would have to "expend a substantial amount of time and effort in another industry or market to establish the necessary business contacts" to earn a comparable salary.[186] In such circumstances, a substantial risk of forfeiture would be present.[187]

The fact that a non-compete clause will ordinarily not result in a substantial risk of forfeiture is based on the fact that such a condition is "wholly within the employee's control"; however, a substantial risk of forfeiture will be present if the forfeiture condition represents "a major constraint on the employee's normal working activities and sources of income under circumstances where he could otherwise be expected to compete."[188] Thus, the presumption against a non-compete clause as a substantial risk of forfeiture represents the fact that such forfeiture conditions are within the employee's control and may be used to actually delay the income of property. The control over the acceleration or deceleration of income, including under a non-compete agreement, follows the general principles outlined in the legislative history. However, Code § 83 also takes care to weigh the economic detriment that may be imposed on a taxpayer with a non-compete agreement and allows for possible income deferral in certain limited circumstances. Code § 409A operates differently; a non-compete clause does not constitute a substantial risk of forfeiture.

The regulations under Code § 409A state that "[a]n amount is not subject to a substantial risk of forfeiture merely because the right to the amount is conditioned, directly or indirectly, upon the refraining from the performance of services."[189] Unlike Code § 83, Code § 409A provides for a hard and fast rule that a non-compete clause does not constitute a substantial risk of forfeiture. For example, the IRS has stated that:

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183. *Id.* § 1.83-3(c)(4) Ex. (5).

184. *Id.*

185. *Id.*

186. *Id.*

187. *Id.*

188. I.R.S. Gen. Couns. Mem. 38,739 (June 1, 1981) (quoting I.R.S. News Release I.R. 70-707 (Oct. 1, 1970)).

189. Treas. Reg. § 1.409A-1(d)(1).

> the term "substantial risk of forfeiture" is ascribed a somewhat narrower meaning [under Code § 409A] than the same term has under section 83 (and is generally thought to have under section 457(f)), although the statutory definition is the same in each instance . . . . Q/A-10(a) would appear to establish a per se rule that non compete and similar restrictions do not constitute substantial risks of forfeiture under section 409A . . . .[190]

Notwithstanding the lack of consistency between Code §§ 83 and 409A as to what constitutes a substantial risk of forfeiture for purposes of a non-compete clause, the statutory definition of a substantial risk of forfeiture is identical.[191] A non-compete agreement operates in the same manner under Code § 409A as it does under Code § 83. Similar to Code § 83, compliance with a non-compete agreement is wholly under an employee or service provider's control. As such, it would seem appropriate to interpret such a provision in a contract in the same manner under both sections. The interpretation can take one of four forms: (1) follow the current interpretation under Code § 83 and institute a rebuttable presumption that a substantial risk of forfeiture is not present under both Code sections, (2) establish that a rebuttable presumption arises under both Code sections that a substantial risk forfeiture is present, (3) create an absolute rule that non-compete clauses do not establish a substantial risk of forfeiture, or (4) interpret non-competes as creating a substantial risk of forfeiture. A non-compete agreement is not the only instance of concern regarding an inconsistent interpretation of a substantial risk of forfeiture provision. Termination for cause provisions and involuntary separation from service clauses also raise consistent interpretation issues.

2. Termination for Cause Provisions

The regulations under Code § 83 state 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."[192] Although this language clearly indicates that termination for cause provisions or for committing a crime

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190. I.R.S. Notice 2005-1, Skillman Pub. Cmt. Ltr. (May 25, 2005) (emphasis omitted).

191. *Compare* I.R.C. § 83(c)(1) (stating that a substantial risk of forfeiture is defined as a right "conditioned upon the future performance of substantial services by any individual"), *and* I.R.C. § 409A (stating that rights in property are subject to a substantial risk of forfeiture if such rights "are conditioned upon the future performance of substantial services by any individuals"), *with* Treas. Reg. § 1.83-3(c)(2) (creating a rebuttable presumption that a substantial risk of forfeiture is not present when a non-compete agreement subjects an employee to rights in property), *and* Treas. Reg. § 409A-1(d)(1) (stating that a non-compete agreement does not create a substantial risk of forfeiture).

192. Treas. Reg. § 1.83-3(c)(2).

are not considered acceptable substantial risks of forfeiture clauses, rulemaking bodies struggle to apply a consistent interpretive approach for language within the ambit of Code § 83, even without considering the broader inconsistency with Code § 409A. For example, in *Gudmundsson v. United States*,[193] the United States Court of Appeals for the Second Circuit decided, inter alia, that Gudmundsson's risk of termination if he did not comply with the company's Insider Trading Policy ("Policy") did not constitute a substantial risk of forfeiture on the equity compensation in his possession.[194] On appeal, the Second Circuit addressed the appellants argument that "the [s]tock was subject to a substantial risk of forfeiture . . . . Plaintiff[ ] . . . argue[d] that . . . the risk of termination Gudmundsson faced if he failed to comply with the Policy constituted a substantial risk of forfeiture."[195] The appellate court rejected this argument.[196] The Second Circuit reasoned that "a substantial risk of forfeiture requires that those property interests be capable of being lost."[197] Therefore, employment termination is relevant under § 83 of the Code when the termination has a causal connection to the "loss or potential loss" of property rights given as compensation.[198] Because no such connection was present in *Gudmundsson*, there was no substantial risk of forfeiture.[199]

Similarly, in *Burnetta v. Commissioner*[200] and *Ludden v. Commissioner*,[201] the United States Tax Court stated that forfeiting property upon termination for theft of company property or upon a conviction for theft of company property does not constitute a substantial risk of forfeiture and discharge for cause, rendering a forfeiture of property, triggered by dishonesty or another act that injures the employer, is too remote to constitute a substantial risk of forfeiture, respectively.[202] As previously noted, inconsistencies have developed within the ambit of Code § 83.

The IRS took a contrary interpretive approach to that which the regulations prescribe in a private letter ruling.[203] Under the agreement at issue, "the restricted shares, when issued, were to bear a legend indicating that they were to be forfeited if A's employment

193. 634 F.3d 212 (2d Cir. 2011).
194. Gudmundsson v. United States, 634 F.3d 212, 218-19 (2d Cir. 2011).
195. *Gudmundsson*, 634 F.3d at 218-19.
196. *Id.* at 219.
197. *Id.* (emphasis omitted) (citing Merlo v. Comm'r, 492 F.3d 618, 622 (5th Cir. 2007)); Theophilos v. Comm'r, 85 F.3d 440, 447 n.18 (9th Cir. 1996).
198. *Id.*
199. *Id.*
200. 68 T.C. 387 (1977).
201. 68 T.C. 826 (1977).
202. Burnetta v. Comm'r, 68 T.C. 387 (1977); Ludden v. Comm'r, 68 T.C. 826 (1977).
203. I.R.S. Priv. Ltr. Rul. 93-17-010 (Jan. 22, 1993).

terminated for any reason other than retirement, death, or permanent disability."[204] Subsequently, the company added amendments that stated any shares not vested "will be forfeited if A voluntarily terminated employment with the Company prior to retirement or if the Company terminates A's employment for cause."[205] The IRS opined that "under the subject agreements, [the shares of restricted stock] did not cease to be subject to a substantial risk of forfeiture for purposes of section 83(a) of the Code when those amendments were amended as set out above."[206]

In *Austin v. Commissioner*,[207] the tax court compounded this inconsistency. There the tax court decided whether stock that had to be returned to the employer if the employee was discharged for cause constituted a substantial risk of forfeiture.[208] Under an employment agreement, if the petitioners were terminated for cause they would be required to sell their shares back to the corporation.[209] A provision in the employment agreement stated that if an employee was terminated for cause at a certain time he would receive fifty percent or less of the fair market value of the stock; this provision, among others, was the clause at issue in the case.[210] The court asserted that the definition of

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204. *Id*.

205. *See id*. (stating further that, pursuant to the amendments, the balance of the nonvested shares will vest if A's employment is vitiated for any reason "other than voluntary resignation prior to retirement or termination by the Company for cause," which includes retirement, death, or permanent disability).

206. *Id*.

207. 141 T.C. 551 (2013).

208. *See* Austin v. Comm'r, 141 T.C. 551, 560 (2013) ("In short, it seems clear that the term 'for cause,' as used in § [83] does not necessarily have the same meaning as, and may have a narrower meaning than, the terminology employed by particular parties during private negotiations.").

209. *Austin*, 141 T.C. at 556. The employment agreement defined cause as:

> A. Dishonesty, fraud, embezzlement, alcohol or substance abuse, gross negligence or other similar conduct on the part of the Employee. Upon termination of this Agreement, Employee shall be entitled to receive compensation through the date of termination.
>
> B. Failure or refusal by Employee, after 15 days written notice to Employee, to cure by faithfully and diligently performing the usual and customary duties of his employment and adhere to the provisions of this Agreement.
>
> C. Failure or refusal by Employee, after 15 days written notice to Employee, to cure by complying with the reasonable policies, standards and regulations applicable to employees which . . . [S Corporation] may establish from time to time.

Id. at 555.

210. *Id.* at 558. *See* I.R.S. Priv. Ltr. Rul. 96-15-023 (April 12, 1996) (stating that the alternate provision of the employment agreement stated that the S corporation would purchase the stock at 100% of the fair market value). *But see* Treas. Reg. § 1.83-3(c) ("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 . . . to the employee upon the return of such property."). Therefore, the S corporation purchasing the stock back at 100% of the fair market value does not constitute a substantial risk of forfeiture. *Austin*, 151 T.C. at 558.

discharge for cause in the employment agreement, under the provision at issue, "falls outside the scope of discharge 'for cause or for committing a crime' within the meaning of section 1.83-3(c)(2)."[211] The tax court stated that "discharged for cause" in the regulations is not always consistent with the meaning that parties attach to the term in a private context.[212] The meaning of the phrase "termination for cause or for committing a crime" is substantially distinct under Code § 409A where the regulations are silent on the issue.[213]

Although it is unreasonable to expect that the IRS will issue rules that cover most conceivable scenarios, it is not unreasonable to expect the IRS to issue guidance regarding the treatment of a substantial risk of forfeiture for purposes of termination for cause provision. As previously noted, the statutory definition of a substantial risk of forfeiture is essentially identical under Code §§ 83 and 409A.[214] More specifically, the Code sections at issue do not consistently interpret a substantial risk of forfeiture for purposes of termination for cause provisions, either within Code § 83 itself or as interpreted between both Code §§ 83 and 409A.[215]

The legislative history regarding both Code §§ 83 and 409A characterizes the primary purpose of substantial risks of forfeiture as restrictions that do not allow an employee or service provider to accelerate or decelerate the timing of income inclusion. The primary inquiry should be focused on whether an employee or service provider can manipulate the forfeiture condition. As such, termination for cause provisions can ostensibly be controlled or utilized to control the timing of income inclusion. Consequently, it appears Code § 83 is more likely than not correct in its interpretation of such provisions,

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211. *Id.* The court's reasoning seems tenuous at best in explaining that the petitioners "inability or disinclination" to perform services for the agreed term is not remote or unlikely. *Id.*

212. *Austin*, 141 T.C. at 563.

213. *Compare* Treas. Reg. § 1.83-3(c)(2) ("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."), *with* § 1.409A-1(d)(1) (noting the absence of any language indicating whether a termination for cause or for committing a crime provisions does or does not constitute a substantial risk of forfeiture).

214. *See* I.R.C. § 83(c)(1) (stating that a substantial risk of forfeiture is defined as a right "conditioned upon the future performance of substantial services by any individual"); § 409A(d)(4) (stating that rights in property are subject to a substantial risk of forfeiture if such rights "are conditioned upon the future performance of substantial services by any individual").

215. *Compare* Treas. Reg. § 1.83-3(c)(2) (stating that termination for cause provisions do not constitute a substantial risk of forfeiture), *with* § 1.409A-1(d)(1) (indicating the lack of language suggesting whether a termination for cause provisions or discharge for committing a crime provision may or may not constitute a substantial risk of forfeiture).

that termination for cause provisions or committing a crime do not constitute substantial risks of forfeiture. Code § 409A should be modified to state that a termination for cause provision or committing a crime should not constitute a substantial risk of forfeiture, which is a departure from its current state of remaining silent on the issue.

3. Involuntary Separation from Service Provisions

The statute and the regulations under Code § 83 do not directly speak to whether an involuntary separation from service without cause provision constitutes a substantial risk of forfeiture. However, the preamble to the final regulation released on February 26, 2014 states the "Treasury and the IRS believe that these regulations should not be modified to state that an involuntary separation from service without cause may qualify as a substantial risk of forfeiture under section 83."[216] Conversely, the regulations under Code § 409A state that if "a service provider's entitlement to the [compensation] is conditioned on the occurrence of the service provider's involuntary separation from service without cause, the right is subject to a substantial risk of forfeiture . . . ."[217] Involuntary separation from service without cause provisions represent an additional inconsistent interpretation explicitly added to the regulations under Code § 409A, and read into the regulations under Code § 83 by the IRS.[218] Similar to the analysis in the preceding two subparts of this subsection, the analysis should turn on whether the employee or service provider has the ability to control the timing of the income inclusion when an involuntary separation from service forfeiture condition restricts equity compensation or nonqualified deferred compensation. An involuntary separation from service is, by definition, outside the scope of an employee's service provider's control. The separation from service is the result of external actions not within the volitional aspects of an individual. Because an employee or service provider cannot control when he or she is separated from service due to involuntary reasons, an involuntary separation from service provision under Code § 83 should conform to the interpretation applied to Code § 409A.

Despite the identical statutory definition of a substantial risk of forfeiture under Code §§ 83 and 409A, the IRS and other rulemaking

216. Property Transferred in Connection with the Performance of Services Under Section 83, 79 Fed. Reg. 10663-01 (Feb. 26, 2014).

217. Treas. Reg. § 1.409A-1(d)(1).

218. *Compare id.* (stating that an involuntary separation from service without cause provisions does constitute a substantial risk of forfeiture), *with* Property Transferred in Connection with the Performance of Servies Under Section 83, 79 Fed. Reg. 10663-01 (stating that an involuntary separation from service without cause provision does not constitute a substantial risk of forfeiture under Code § 83).

bodies continuously assign inconsistent interpretations of what constitutes a substantial risk of forfeiture. A consistent interpretation of what constitutes a substantial risk of forfeiture should be applied to Code §§ 83 and 409A in light of current statutory interpretation, legislative history, and practical considerations represented by the complexity of the tax code.

C. "Substantial Risk of Forfeiture" Should be Ascribed a Consistent Interpretative Approach

The statutory definition of what constitutes a substantial risk of forfeiture under Code §§ 83 and 409A is identical, in that each statutory definition states that the rights in property or compensation are subject to a substantial risk of forfeiture if the rights "are conditioned upon the future performance of substantial services by any individual."[219] "A term appearing in several places in a statutory text is generally read the same way each time it appears."[220] The variations between the two statutory definitions as to what constitutes a substantial risk of forfeiture under Code §§ 83 and 409A arise only with respect to the nature of the property regulated by each Code section. In actuality, the true definition of a substantial risk of forfeiture is identical in the rights to property or compensation under both provisions; they are subject to a substantial risk of forfeiture if the rights "are conditioned upon the future performance of substantial services by any individual."[221] Under traditional statutory interpretation principles, the plain meaning of the text must be utilized to decipher the meaning of the statute. As such, it would appear that both Code §§ 83 and 409A carry the same definition of a substantial risk of forfeiture.[222] Other factors militate in favor of reconciling what constitutes a substantial risk of forfeiture under Code §§ 83 and 409A.

Not only are the definitions of what constitutes a substantial risk of forfeiture virtually identical in Code §§ 83 and 409A, but the legislative history is telling as to the adoption of the same as well. In determining the meaning of a statute, "[t]here is, of course, no more persuasive evidence of the purpose of a statute than the words by

219. I.R.C. § 83(c)(1); *id.* § 409A(d)(4).

220. Ratzlaf v. United States, 510 U.S. 135, 143 (1994).

221. I.R.C. § 83(c)(1); *id.* § 409A(d)(4).

222. *Compare* Eskridge & Frickey, *supra* note 143 ("The beginning . . . of statutory interpretation should be the apparent meaning of the statutory language."), *with* I.R.C. § 83(c)(1) (stating that a substantial risk of forfeiture is defined as rights that "are conditioned upon the future performance of substantial services by any individual"), *and* § 409A(d)(4) (stating that a substantial risk of forfeiture is defined as rights that "are conditioned upon the future performance of substantial services by any individual").

which the legislature undertook to give expression to its wishes."[223] From this, because the legislative history for Code § 83 was developed prior to that for Code § 409A, the legislative report under Code § 409A adopts the exact definition of a substantial risk of forfeiture for Code § 83. In footnote 455 of a report, the House of Representatives stated "[a]s under § 83, the rights of a person to compensation are subject to a substantial risk of forfeiture if the person's rights to such compensation are conditioned upon the performance of substantial services by any individual."[224] Thus, the basis upon which the statute was drafted, the legislative history, contemplated virtually identical drafting. Not only was the drafting and language virtually identical, the purpose of the legislative history and the appropriate interpretive application are also identical. The purpose and suggested interpretive approach is to regulate the control and access certain individuals possess over restricted stock, specifically, and nonqualified deferred compensation and, thus, whether or not an individual can control the timing of the income inclusion is the primary inquiry under Code §§ 83 and 409A, regarding whether a substantial risk of forfeiture is present.

Finally, there are practical consequences that result from the operation and interpretation of the tax code generally, but specifically, for purposes of this Article, Code §§ 83 and 409A. The practical consequences as outlined above by the NTA demand that a uniform interpretation of what constitutes a substantial risk of forfeiture be applied to the provisions at issue.[225] The demand arises based on the complexity of the Code and such a result manifests itself, in one of many ways, through the two provisions examined in this Article.

As a result of virtually identical statutory drafting, the legislative history wherein the House of Representatives adopted the definition of a substantial risk of forfeiture under Code § 409A that was applicable to Code § 83, and from practical considerations resulting from the complexity of the tax code as America's number one problem with the tax code, the IRS should reconcile what constitutes a substantial risk

223. Eskridge & Frickey, *supra* note 143, at 341 n.73 (quoting United States v. Am. Trucking Ass'ns, 310 U.S. 534, 543 (1940) and Huffman v. W. Nuclear, Inc., 488 U.S. 663 (1988)).

224. H.R. REP. NO. 108-548, at 343-44 n.455 (June 16, 2004). *See* H.R. REP. NO. 91-413, at 1735 (Dec. 22, 1969) (stating the definition of what constitutes a substantial risk of forfeiture under Code § 83).

225. *Compare* NAT'L TAXPAYER ADVOCATE, *supra* note 169 (the number one most serious problem facing all taxpayers of the United States was the complexity of the tax code), *with* I.R.C. § 83(c)(1) (stating that a substantial risk of forfeiture is defined as rights that "are conditioned upon the future performance of substantial services by any individual"), *and* § 409A(d)(4) (stating that a substantial risk of forfeiture is defined as rights that, "are conditioned upon the future performance of substantial services by any individual").

of forfeiture by adopting a uniform interpretive approach. Specifically, the regulatory description of non-competition agreements, termination for cause or for the commission of crime provisions, and involuntary separation from service agreements should be modified to render each consistent under Code §§ 83 and 409A.[226]

IV. CONCLUSION

Code §§ 83 and 409A govern the regulation of equity compensation and nonqualified deferred compensation, respectively. Each Code section has an identical statutory definition as to what constitutes a substantial risk of forfeiture. Although the statutory definition is the same, the regulations promulgated by an Executive Branch agency diverge sharply as to, specifically, what provisions qualify as a valid substantial risk of forfeiture. It has become apparent in analyzing the legislative history that both Code provisions were designed to carry a substantially similar, if not identical, definition of a substantial risk of forfeiture.

"The plain, obvious, and rational meaning of a statute is always to be preferred to any curious, narrow, hidden sense that nothing but the exigency of a hard case and the ingenuity and the study of an acute and powerful intellect would discover."[227] The definition of Code §§ 83 and 409A are as follows in their respective order: "[t]he rights of a person *in property* are subject to a substantial risk of forfeiture if such person's rights to *full enjoyment of such property* are conditioned upon the future performance of substantial services by any individual"; and "[t]he 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." As a result of the foregoing argument, a uniform interpretive approach should be applied to the definition of a substantial risk of forfeiture, specifically to non-compete agreements, termination for cause provisions, and involuntary separation from service clauses in order to reconcile what constitutes a substantial risk of forfeiture under Code §§ 83 and 409A of the Code.

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226. This Article does not take a position on whether each of the three provisions under the umbrella of what constitutes a substantial risk of forfeiture for Code §§ 83 and 409A should or should not be determined to, or not to constitute a substantial risk of forfeiture. Such a discussion is outside the scope of this Article.

227. King v. Burwell, 135 S. Ct. 2480, 2497 (2015) (Scalia, J., dissenting) (quoting Lynch v. Alworth-Stephens Co., 267 U.S. 364, 370 (1925)).