# WRMarketplace
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## TOPIC: Substantial Risk of Forfeiture: What Is It and What Does It Do?

**MARKET TREND:** Employers are increasingly compensating executives with non-cash compensation and maintaining deferred compensation plans that supplement executives' incomes while allowing them to defer taxation on their income according to appropriate and longstanding tax principles. Imposing a "substantial risk of forfeiture" on the non-cash or deferred compensation can help delay taxation of that compensation and otherwise facilitate deferred compensation arrangements – a big plus, especially while tax reform remains stalled.

**SYNOPSIS:** Substantial risk of forfeiture is a concept relevant to the taxation of non-cash compensation under Internal Revenue Code ("Code") §83 and to the taxation of deferred compensation under Code §§409A and 457(f). To create a substantial risk of forfeiture, an employer must generally impose a service- or performance-based restriction on the employee's right to the compensation; other restrictions may not be sufficient. In addition, it must be reasonably likely that these conditions could occur and will be enforced if they do.

**TAKE AWAYS:** Executive compensation plans are important recruiting and retention tools. The key to implementation is often a clear understanding of the rules surrounding the concept of a "substantial risk of forfeiture." The employer must ensure that the substantial risk of forfeiture is effective, and that it balances tax goals and strategic business considerations with respect to the compensation of executives.

“Substantial risk of forfeiture” is a concept that comes up frequently in connection with compensation arrangements, particularly when used with key executives. It governs when: (1) non-cash compensation is taxable, (2) arrangements are subject to complex rules regulating, and penalties applicable to, deferred compensation programs, and (3) amounts deferred by executives of tax-exempt employers become taxable. Given the importance of this concept to employee compensation planning, the following summarizes the impact of a substantial risk of forfeiture and the circumstances under which a substantial risk of forfeiture will be considered to exist.

***RELEVANT CODE PROVISIONS***

**Code §83**

Code §83 governs the payment of compensation in the form of property (as opposed to cash). It most commonly comes into play with restricted stock awards or stock option exercises. Under §83, the property recipient is taxed on the current fair market value of the property (less any amount the recipient paid for the property) at the time the property is transferred or, if later, when the recipient’s rights to the property cease to be subject to a ***substantial risk of forfeiture***.

**Code §409A**

As discussed in prior WR Marketplaces (see e.g., *Nos. 15-21* and *14-45*), Code §409A restricts the time at which nonqualified deferred compensation can be paid, defines when an election to defer compensation must be made, and limits the ability to accelerate or further defer the time of payment of previously deferred compensation. Failure to comply with Code §409A requirements will subject the employee to significant adverse tax consequences.

Generally, deferred compensation for purposes of §409A encompasses all compensation paid in a year after the year in which the recipient acquires a legally binding right to the payment. However, an arrangement will be considered a “short-term deferral” and, thus, **not** deferred compensation subject to §409A restrictions if it is paid before the date that is 2-1/2 months after the end of the year in which the payee’s rights to the payment cease to be subject to a ***substantial risk of forfeiture***.

> ***NOTE:*** While a violation of §409A can subject the employee to significant penalties, those penalties do not apply if the employee’s right to the deferred compensation is subject to a ***substantial risk of forfeiture*** throughout the year in which the violation occurs and the violation is corrected before the year in which the amount ceases to be subject to a ***substantial risk of forfeiture***.

**Code §457(f)**

Code §457(f) generally governs deferred compensation plans maintained by a governmental or tax exempt employer that is not an “eligible” deferred compensation plan under section 457(b) (see e.g., *WRMarketplace No. 13-23*). Amounts deferred under such a plan are includible in the participant's taxable income in the year in which the participant's right to the deferred amount ceases to be subject to a ***substantial risk of forfeiture***.

## *WHAT CONSTITUTES A SUBSTANTIAL RISK OF FORFEITURE*

### Generally

The definition of what constitutes a substantial risk of forfeiture under Code §§83, 409A, and 457(f) are fairly similar, though there are some significant differences. Essentially, a substantial risk of forfeiture exists if compensation is conditioned on the employee performing substantial services or the occurrence of a condition related to the purpose of the transfer or payment of compensation.

- ***Substantial Services***. Whether the employee is required to perform substantial services is determined at the time of the transfer of the property or the deferral of compensation. Requiring an individual to perform an hour of service a week or to perform services for a period of a few weeks or perhaps months would not be considered "substantial" services.

- ***Occurrence of a Condition***. An example of the occurrence of a condition related to the purpose of the transfer or payment of compensation would be the employee's or the employer's achievement of a specified performance goal (*e.g.*, achieving a certain level of sales). In determining whether this type of condition creates a substantial risk of forfeiture, it must be concluded that there is a significant likelihood that the forfeiture condition both could occur and would be enforced.

For purposes of Code §§83 and 457(f), a substantial risk of forfeiture also can arise from an individual's refusing to perform services; that said, complying with a non-compete provision will give rise to a substantial risk of forfeiture only if a number of criteria set forth in the applicable regulations are satisfied to overcome the presumption that a substantial risk of forfeiture does not exist. On the other hand, for purposes of Code §409A, a substantial risk of forfeiture is **not** created by an individual's refraining from performing services.

### Common Scenarios

***Forfeiture Related to Termination of Services.*** A substantial risk of forfeiture will exist if rights to property or compensation are forfeited if an individual ceases to perform services for any reason before the specified period of service is completed. However, no substantial risk of forfeiture will exist if the rights are forfeited only if the individual is terminated by the employer for cause.

***Restrictions on the Right to Transfer Property.*** If property cannot be transferred because such a transfer would subject the employee to short-swing liability under §16(b) of the Securities Exchange Act of 1934 during the initial six-month period after the transfer of the property, a substantial risk of forfeiture will be considered to exist during that six-month period. Other restrictions on the transfer of property (including lock-up agreements and insider-trading restrictions) do **not** create a substantial risk of forfeiture. This rule is relevant under Code §83, but not for purposes of Code §§409A or 457(f) because compensation deferred subject to those sections is not transferrable without giving rise to current income taxation.

## *TAKE AWAYS*

Executive compensation plans are important recruiting and retention tools. The key to implementation is often a clear understanding of the rules surrounding the concept of a "substantial risk of forfeiture." The employer must ensure that the substantial risk of forfeiture is effective, and that it balances tax goals and strategic business considerations with respect to the compensation of executives.

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