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What is a substantial risk of forfeiture?

A substantial risk of forfeiture is a standard applied by the Internal Revenue Service (IRS) to determine whether deferred compensation and transfers of property should be taxed currently to the payee. Generally, a substantial risk of forfeiture exists if an employee's right to deferred compensation or transferred property is contingent on the performance of substantial services in the future or on the occurrence (or nonoccurrence) of a given event. If these contingencies aren't met, the compensation or property is forfeited. When property is no longer subject to a substantial risk of forfeiture, it is usually said to have "vested."

Tip: For information about deferred compensation in general, see Nonqualified Deferred Compensation Plans .

When does it apply?

Transfers of property and funded NQDC plans--IRC Section 83

Under Internal Revenue Code (IRC) Section 83, property transferred to an employee in connection with the performance of services is subject to federal income tax when the property is no longer subject to a substantial risk of forfeiture (or, if earlier, when the employee has the right to transfer the property to someone else). For example, transfers of restricted stock to an employee are governed by Section 83. In the context of NQDC plans, Section 83 generally comes into play if you formally fund your plan with a secular trust or annuity .

Tip: Section 83 does not apply to unfunded NQDC plans. This is because Section 83 does not apply to an "unfunded and unsecured promise to pay money or property in the future." And most NQDC plans are specifically designed to be unfunded and unsecured obligations of the employer in order to avoid ERISA and adverse tax consequences.

Tip: In some cases your employee can elect to be taxed under Code Section 83 at the time you transfer the property to him or her, instead of when it vests. This may be desirable if your employee thinks the property will appreciate substantially in the future, because any gain in excess of the amount taxed at transfer will be eligible for capital gains treatment.

Unfunded NQDC plans--IRC Section 409A

IRC Section 409A, enacted as part of the American Jobs Creation Act of 2004, contains election, distribution, and funding rules that most unfunded NQDC plans must follow. These new rules generally apply to compensation deferred after December 31, 2004 (although compensation deferred earlier is also covered in some cases). If a NQDC plan fails to satisfy Section 409A's requirements, then participants' accrued benefits are subject to federal income tax and penalties in the year of the failure or, if later, when those benefits are no longer subject to a substantial risk of forfeiture. If a NQDC plan satisfies Section 409A's requirements, then benefits are taxed when paid to participants (regardless of when they vest). In general, Section 409A does not apply to funded NQDC plans or transfers of property governed by IRC Section 83. For more information, see Internal Revenue Code Section 409A .

NQDC plans of governmental and tax-exempt employers--IRC Section 457(f)

IRC Section 457(f) applies to certain NQDC plans established by state and local governments and tax-exempt employers. Employees are taxed under Section 457(f) when their NQDC plan benefits are no longer subject to a substantial risk of forfeiture. The IRS has in the past applied Section 83 principles when examining substantial risk of forfeiture provisions in Section 457(f) plans, even though Code Section 457(f) does not specifically refer to Section 83.



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Caution: Section 457(f) plans must also comply with Section 409A. Consult a benefits professional for more information on the interaction between these two Code sections.

Economic benefit doctrine

Under the economic benefit doctrine, an employee must include in income the value of any economic or financial benefit received as compensation, even though the benefit is not paid in the form of cash. The reasoning behind this doctrine is that even though the employee didn't receive actual cash or property, the employee should nevertheless be taxed if he or she received something that can be reasonably valued. For example, the economic benefit doctrine may apply where the employee's NQDC plan benefit is funded with an annuity contract or an irrevocable trust. However, your employee will only be immediately taxed under the economic benefit doctrine if the funds are beyond the reach of the corporation and its creditors, and the employee doesn't run a substantial risk of forfeiting the funds. In order to avoid the immediate taxation of your employee's NQDC plan benefits under the economic benefit doctrine, your employee should not be given greater rights than those of a general creditor. The economic benefit doctrine originated with the courts. However, today it has largely been codified and refined under IRC Sections 83, 402(b) (dealing with nonqualified trusts), and 403(c) (dealing with nonqualified annuities).

What constitutes "substantial?"

Whether the risk of losing deferred compensation benefits or transferred property is considered substantial is determined by a facts and circumstances test that the IRS administers on a case-by-case basis. There are many ways for an employer to demonstrate that a substantial risk of forfeiture exists. For instance, a NQDC plan might require that the employee continue to work for the company until retirement at age 65 to get a bonus.

Example(s): John's employer transfers 1,000 shares of restricted stock to John as a bonus. John can not transfer the stock, and must return it to the employer if he terminates employment within three years. This restriction constitutes a substantial forfeiture risk; thus, John will not be taxed currently on his receipt of the restricted stock.

In a corporate setting, when determining whether a risk of forfeiture is substantial, the IRS will look at whether an employee's control of the employer through stock ownership is significant enough that the possibility of the corporation enforcing the forfeiture provision is unlikely. If enforcement is unlikely, then the compensation will not be considered subject to a substantial risk of forfeiture.

Caution: While the general definition of substantial risk of forfeiture described earlier applies both to Section 83 and Section 409A, the definition is not identical for both Code sections. For example, an employee's agreement to refrain from performing services (e.g., a noncompete agreement) may create a substantial risk of forfeiture (and therefore defer taxation) under Code Section 83, but it would not be considered a substantial risk of forfeiture under Section 409A. Also, under Section 409A, a risk of forfeiture must exist at the time of the initial deferral of compensation. So-called "rolling risks of forfeiture," where a risk of forfeiture provision is extended by the parties before it lapses, are not permitted under Section 409A. And employee salary deferrals can never be subject to a substantial risk of forfeiture under Section 409A.