Section 83(b) Revised Proposed Regulations and Partnerships

By Leigh Griffith, CPA, JD, LLM

Elections under section 83(b) of the Code ("83(b) election") are commonly thought of in the corporate context. However, 83(b) elections are also applicable to partnerships and LLCs that are not taxable as associations. Often interests are "given" or "awarded" to management ("Managers"). If these are subject to "substantial risk of forfeiture" and the 83(b) election is appropriate. The failure to make an 83(b) election will cause the value of the interest, less amount paid, to be taxable income. On the other hand, the service condition will be at a higher value. This often presents a trap. A Manager may pay the same amount for his or her membership interest as paid by investors, but because the Manager must continue to provide substantial services for a time in order to retain the interest (assuming the buy-back price is not fair market value), there is a substantial risk of forfeiture for the Manager involved. If an 83(b) election is not made under those circumstances when there is no value above basis, later when the risk of forfeiture lapses, the Manager will be taxed on the appreciation while the non-service provider investors will not.

On May 30, 2012 the IRS issued Proposed Treasury Regulations under Section 83 ("Proposed Regulations") purporting to "clarify" what constitutes a "substantial risk of forfeiture" that defers current taxation. Under these proposed regulations:

1. A substantial risk of forfeiture only can be established through (i) a service condition or (ii) a condition related to the purpose of the transfer;
2. Performance conditions must be meaningful (the possibility of forfeiture is substantial) to create a substantial risk of forfeiture; and
3. Generally, restrictions on transfer (even those that carry the possibility of forfeiture) will not create a substantial risk of forfeiture.

A service condition exists when rights in property are conditioned upon the future performance (or refraining from performance) of substantial services. A performance condition is one related to a purpose of the transfer of property. A service condition does not require an analysis of the likelihood of the condition occurring and the interest being forfeited, but it does require the services be substantial. Therefore, a condition that the recipient remain a manager of a LLC performing substantial services for specified time periods does not require a further analysis of the likelihood that the recipient will not.

However, with respect to a performance condition, the proposed regulations require that in order to constitute a substantial risk of forfeiture, both (i) the likelihood that the forfeiture event will occur (for example, by establishing a performance goal that is not substantially certain to occur) and (ii) the likelihood that the forfeiture will be enforced are both analyzed to determine if a substantial risk of forfeiture exists. An example in the Proposed Regulations provides that a condition that the gross receipts of a company decline by 90 percent over three years in a situation where the company is a long standing seller of a product and there is no indication that there will be either a fall in demand or an inability of the employer to sell the product is not a substantial risk of forfeiture. Although arguably related to purpose, the proposed regulations conclude that such a risk is too remote and is not sufficiently a service condition to defer immediate taxation.

While the existing regulations have long provided that "whether the risk of forfeiture is substantial or not depends on the facts and circumstances." The "clarification that with respect to "purpose conditions" the likelihood that the condition will occur must be considered increases the risk of IRS "second guessing" the business decision made by the LLC or partnership at the time of grant. For example, if an LLC that has been growing its profits by 20 percent per year and it prospects do not appear to be changing and the risk of forfeiture is that the profits must increase 10 percent a year for the next three years, is that a substantial risk of forfeiture? The preamble to the Proposed Regulations characterizes the extension of the "substantial" requirement to the likelihood that the forfeiture event will occur as a "clarification".

The Proposed Regulations embody concepts of a 2005 revenue ruling by specifically stating that, with one exception, transfer restrictions generally do not create a substantial risk of forfeiture. This is true even if the transfer restrictions present the real possibility of forfeiture, disgorgement of the property, or other penalties if the restriction is violated. The proposed regulations give examples of transfer restrictions that do not constitute substantial risk of forfeiture as including (i) lock-up periods imposed by an underwriter in connection with an IPO and (ii) Rule 10b-5 insider trading restrictions. Even though a risk of forfeiture exists, it is not as a result of performance or purpose conditions. The proposed regulations provide that the statutorily required forfeiture for violation of Section 16(b) of the Securities Exchange Act of 1934 as amended, is the only provision in the securities law that can delay taxation under Section 83.

Even though the Proposed Regulations are "only" proposed, they state they apply to property transferred on or after Jan. 1, 2013. Therefore, in the IRS view, even if not finalized, these regulations will soon be binding on the taxpayer.

Endnotes
1 At the current time, pursuant to Revenue Procedures 93-27 and 2001-43, 83(b) elections are not required for profits interests. However, proposed regulations would require such elections if such proposed regulations become effective. However, 83(b) elections are required for capital interests.
2 REG-141075-09
3 Section 83(c)(3).

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