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Tax Alert

Founders and Substantial Risk of Forfeiture: What, Me Worry?

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In this article, Wood and Board examine two cases that illustrate some of the surprising nuances taxpayers, the IRS, and the courts may need to address when dealing with founders of companies and the grant of stock.

This discussion is not legal advice.

Ordinary income or capital gain? It is one of those classic and evergreen subjects that never go out of style. Company founders don't go out of style, either, and they sometimes do not focus too much on exactly how they end up with stock. Amazingly, companies may also not be thinking about taxes or tax deductions, at least not when stock is issued. That is where our story begins.

When a corporation grants stock to a service provider, section 83(a) requires the recipient to report ordinary income equal to the fair market value of the shares, reduced by the amount, if any, the recipient paid for them. Frequently, however, the shares will be subject to forfeiture if the recipient does not perform significant future services for the corporation. If this risk is substantial, the value of the stock is not included in income until the risk has abated or the recipient acquires the power to transfer the shares free of the forfeiture condition.

Golden Election

A service provider who expects — or at least hopes — that the restricted shares will appreciate in the interim has 30 days to elect under section 83(b) to report the current value of shares as income in the year of the grant. An 83(b) election also starts the service provider's capital gain holding period, which can translate into tax savings if the fabled corporate "liquidity event" ever materializes. In many start-up situations, making the election is standard operating procedure, especially if it costs little or nothing.

When an enterprise is just starting up, founders often take the position that the FMV of their newly issued shares is whatever they paid for them, which is generally par value. If that is the case, the election decision is easy. If the founders elect, the amount of income they report is zero, because the FMV of their shares on grant does not exceed the amount they paid for them. Then, later, when the forfeiture conditions actually lapse, there is no income event.

If one of these founders didn't make an 83(b) election on grant, the lapsing of the condition will trigger income equal to the increase in the value of the shares. Tax is due even if the founder does not dispose of the stock. What's more, it is ordinary income, and might even be wages.

Making an 83(b) election has capital gain consequences, too. An election changes the timing as noted above, and it changes the character of the income. If a founder fails to elect, the entire appreciation up to the point when the restrictions lapse is ordinary. The founder can still report capital gain when he sells the shares, but only on the amount of appreciation since the date of lapse. An election, on the other hand, morphs the entire appreciation since the date of grant into capital gain. And this gain is triggered only when the founder actually sells the shares.

Thus, electing to include a value of zero in income seems to have little downside, and only upside. Both the capital gain character and the time of income recognition are improved by an election, and any ordinary income or wage taint is purged. So if a founder or other service provider thinks there is any possibility that the IRS could consider the shares to have been issued in connection with the performance of services, that election is awfully important.[1]

Whether by accident or design, however, founders sometimes fail to make 83(b) elections for their new stock. If the new company turns out to be a success, the tax stakes can be high. If litigation ensues, the founders, their companies, and sometimes even the IRS may argue that there was no need to make the omitted election in the first place.

A typical focus of controversy is whether the risk of forfeiture was "substantial" within the meaning of reg. section 1.83-3(c)(1). To illustrate some of the surprising nuances taxpayers, the IRS, and the courts may need to address, we consider two cases. In an interesting twist, in both cases it was the IRS, not the taxpayer, that contended that the founders' risk of forfeiture was less than substantial.

QinetiQ U.S. Holdings

Founders of a new enterprise usually have a lot on their plates. Even if they have hired a lawyer to get their corporate documentation in place, accidents do happen. After all, an 83(b) election doesn't look like much — it's usually a single page and it doesn't even have its own IRS form. But the 30-day deadline is strictly enforced, so a lapse in attention (by the founders) or diligence (by their lawyer) during the new company's busy first month can have serious consequences down the road.

The founders in *QinetiQ U.S. Holdings*[2] learned this the hard way. In 2002 Thomas Hume and Julian Chin each paid $450 for 4,500 shares of their recently organized corporation, Dominion Technology Resources Inc. (DTRI). Hume was issued 50.25 percent of the voting shares; Chin got the remaining 49.75 percent. Hume became DTRI's sole director and CEO, and Chin was appointed chief operating officer and executive vice president.

The two founders entered into a shareholders' agreement with DTRI on largely equal terms. Neither founder was permitted to sell his shares without the other's consent, which is the norm in a closely held corporation. Much less conventionally, the agreement subjected both founders to a *20-year* vesting schedule, with their shares vesting at a rate of 5 percent per year of continued employment.

If a founder voluntarily left DTRI, the shareholders' agreement gave the company the option to repurchase his vested shares at a reasonable formula price. Unvested shares, on the other hand, would be forfeited. On paper, at least, each founder's ownership of his shares was conditioned on his provision of substantial future services.

The standard advice would have been for Hume and Chin to make 83(b) elections, but this simple step was somehow overlooked. Still, the two founders managed to do pretty well with DTRI. In 2008 just six years later, they sold their $900 start-up to QinetiQ U.S. Holdings Inc. for $123 million — more than 137,000 times their initial investment.

Shortly before the sale closed, DTRI declared all its outstanding shares fully vested. By now, Hume and Chin understood that they had fumbled the 83(b) election. The two founders reported the FMV of their unvested shares ($118 million) as compensation on their individual returns for 2008 — a year when the top rate for ordinary income was more than double the rate for long-term capital gains.

[1]For a cautionary tale, see *Alves v. Commissioner*, 734 F.2d 478 (9th Cir. 1984).

[2]*QinetiQ U.S. Holdings Inc. v. Commissioner*, T.C. Memo. 2015-123, *aff'd*, 845 F.3d 555 (4th Cir. 2017), *cert. denied*, 138 S. Ct. 299 (2017).

Corporate Deduction

For DTRI, on the other hand, the last-minute vesting of the bulk of the founders' shares would have looked like a tax bonanza. Indeed, it opened the door for the company to deduct $118 million of compensation expense. The prospect of a $41 million federal tax benefit would have figured prominently in the negotiations with QinetiQ, so there is a good chance that Hume and Chin recovered a portion of their tax hit in the form of an increased purchase price for their shares. The founders would still have been better off if they had made a timely 83(b) election, but a $20 million bump to the purchase price would have provided some consolation.

The *QinetiQ* case arose when the IRS challenged DTRI's massive compensation deduction. The IRS argued that, notwithstanding the terms of the shareholders' agreement, Hume's and Chin's risk of forfeiture had been merely illusory. In the IRS's view, the founders' shares had vested, for purposes of section 83, upon issuance back in 2002. So even though the founders' shares had vested for state-law purposes shortly before the sale, DTRI could not claim a tax deduction in 2008.[3]

Substantiality Under the Regulations

Reg. section 1.83-3(c)(1) states that property is not transferred subject to a substantial risk of forfeiture "if at the time of transfer the facts and circumstances demonstrate that the forfeiture condition is unlikely to be enforced." Reg. section 1.83-3(c)(3) provides guidance on how to evaluate the likelihood of enforcement when the recipient of restricted shares is an employee who owns a significant amount of the company's stock. The regulation lists five common-sense factors that should be taken into account:

- the employee's relationship to other stockholders and the extent of their control of the corporation;
- the employee's position and the extent to which he is subordinate to other employees;
- the employee's relationship to the corporation's directors and officers;
- the person or persons who must approve the employee's discharge; and
- the employer's prior actions in enforcing the forfeiture condition.

These factors posed an obvious problem in Hume's case. Not only was he DTRI's CEO and sole director, but he also owned an outright majority of the company's voting stock. With his control of the corporation, Hume presumably had to power to cause DTRI to waive the forfeiture condition on his shares.

QinetiQ could see the writing on the wall. In the midst of the Tax Court proceeding, it conceded that Hume's risk of forfeiture had not been substantial within the meaning of reg. section 1.81-3(c)(3). But QinetiQ continued to press the case for Chin and his half of DTRI's $118 million deduction.

Chin's ownership of 49.75 percent of the voting stock was certainly a significant stake in DTRI. Yet as a legal matter, neither his stock ownership nor his position as chief operating officer and executive vice president gave him the power to block enforcement of the forfeiture condition if he left the company. The regulations, however, look beyond legal rights. They require a court to consider the employee's more intangible relationships and the corporation's prior actions regarding enforcement.

The government pointed to the fact that QinetiQ had failed to produce any history of DTRI enforcing a forfeiture condition against a holder of the company's Class A stock, which is what the founders held. The only forfeitures involved departed employees holding small amounts of DTRI's Class B shares. The Tax Court treated this as evidence that Chin's risk of forfeiture had not been substantial.

It appears, however, that Hume and Chin were the only employees who owned Class A stock. The fact that there was no history of DTRI enforcing the forfeiture condition against the two employees who held Class A shares would be significant if one of them had quit. But, as long as they were both working, the lack of a history of enforcement would not mean anything — except,

[3]The IRS also contended that section 83 was inapplicable because the shares had been issued to the founders for investment purposes, and not in connection with the performance of services. This seems implausible because there was little chance that a third party not involved in running the business would have been permitted to invest on the same terms. *See Alves*, 734 F.2d 478; *cf.* reg. section 1.83-3(f). The Fourth Circuit did not address the IRS's argument.

perhaps, that the risk of forfeiture was substantial enough to deter the founders from leaving the company.

Asking the Wrong Questions?

The Tax Court's treatment of the relationship factors also warrants comment. Chin did not have the legal power to block a forfeiture. According to the Tax Court, however, his relationship with Hume and his vital role at DTRI indicated that his risk of forfeiture was not substantial:

> Hume and Chin had a very close work relationship. They were DTRI's initial investors, and together they built the company from its early stages of incorporation. Along with Hume, Chin voted on all company matters and helped determine the company's overall direction. Since Chin held such a vital role within DTRI as the executive vice president, COO, and a 49.75 percent shareholder in voting stock, it is unlikely that Hume would have taken any actions to terminate his employment.[4]

There is no reason to doubt the Tax Court's findings, but we can question their relevance. First, there is a question of timing. The regulations state that a risk of forfeiture is not substantial "if *at the time of transfer* the facts and circumstances indicate that the condition is unlikely to be enforced."[5] (Emphasis added.) If what mattered was the state of Chin's relationships when he was granted his shares in 2002, developments in his relationship with Hume and DTRI over the following six years would have been beside the point.

We can also question the Tax Court's focus on the probability that Hume would have taken actions to terminate Chin's employment. Under the shareholders' agreement, Chin faced forfeiture if he voluntarily left the company. The fact that Hume was unlikely to fire Chin was irrelevant.

The analytical problem goes deeper than this. It would have been just as misguided for the Tax Court to focus on the fact that Chin was unlikely to quit of his own free will. Other things being equal, the higher the probability that a forfeiture condition will be enforced, the less likely an employee is to resign. The fact that a condition is doing its job should not be treated as evidence that the risk it imposes is insubstantial.

The Tax Court should have asked a different question. How likely was it, under the circumstances, that Hume would have enforced the forfeiture condition if Chin had voluntarily left the company? One can imagine that counterfactual inquiry going either way.

On the one hand, Hume and Chin had worked together closely for years, building DTRI into a success. Hume might have been deeply grateful for Chin's contributions to DTRI. If Chin had told Hume shortly before the closing that he was retiring to start a new life in Tahiti, we can easily imagine Hume waiving the forfeiture condition. It's not always about the money.

Suppose, on the other hand, that Chin, who played a "vital" role at DTRI, had chosen to depart at a critical juncture in the company's history. Hume might have been dumbstruck, then furious, that Chin was leaving him in the lurch. In this scenario, it is easy to imagine Hume insisting that the forfeiture be enforced against his fellow founder.

Timing Matters

This brings us back to the timing issue mentioned earlier. A founder's risk of forfeiture can depend on circumstances, and circumstances often change over time. If a court must evaluate whether a risk of forfeiture is substantial, what is the relevant testing date? Five minutes before the acquisition agreement is signed? Or five months before that, when the founders are working around the clock to find a buyer and negotiate the best possible price?

Reg. section 1.83-3(c)(1) appears to focus on circumstances at the time of the transfer. For founders, this would mean an early date in the company's history, when there is much work ahead. This is precisely the time when founders enter into agreements subjecting their new shares to forfeiture if they do not continue to provide substantial services to the shared venture.

[4] *QinetiQ*, T.C. Memo. 2015-123, at 11.

[5] Reg. section 1.83-3(c)(1).

Was Chin's risk of forfeiture substantial when he acquired his shares in 2002? The two founders had just entered into a shareholders' agreement providing for 20-year vesting of their shares of DTRI. Against that backdrop, how likely is it that Hume would have allowed Chin to drop everything and head off to Tahiti with half the Class A stock?

If we accept the date of transfer as the testing date, it seems clear that Chin initially held his shares subject to a substantial risk of forfeiture. Then the question is whether this transfer-date determination must be revisited in subsequent years. Although the regulation suggests (but doesn't literally state[6]) that the probability of enforcement should be tested only once, most other factors relating to the risk of forfeiture are evaluated on a continuous basis.

For example, if the founders and DTRI had legally terminated the shareholders' agreement in 2005, Chin's shares would have vested for purposes of section 83(a) in that year. Chin would have been subject to tax, and DTRI would have been able to claim a deduction, in 2005. In principle, we should reach the same result if, instead, the relationship between Hume and Chin had simply reached the point that Hume would have been unlikely to enforce the forfeiture condition.

In practice, however, this approach could be problematic. It would be one thing to require Chin to report income based on the termination of the shareholders' agreement. But could we reasonably require Chin to determine annually, based on the state of his relationship with Hume, whether the probability that Hume would enforce the forfeiture condition had fallen below some (unspecified) level? Perhaps this is why the regulations suggest a single determination, at the time the shares are transferred to the service provider.

[6]Reg. section 1.83-3(c)(1) states that property is not transferred subject to a substantial risk of forfeiture if, at the time of the transfer, the circumstances demonstrate that the forfeiture condition is unlikely to be enforced. However, the fact that circumstances prevailing at the time of the transfer are sufficient to establish that a risk of forfeiture is not substantial does not logically imply that identical circumstances arising after the transfer would be insufficient to do so.

Austin: Making Founders' Shares Disappear

Let's switch to second pair of founders, Larry Austin and Arthur Kechijian, who had prospered mightily in the distressed debt loan portfolio business. The presence of distressed debt in a tax case usually means that readers should buckle up. The Tax Court's decision in *Austin*, recently affirmed by the Fourth Circuit,[7] features an over-the-top employee stock ownership plan tax shelter, and is no exception.

In 1998 it became possible for tax-exempt ESOPs to hold shares of S corporations.[8] An ESOP can hold all of an S corporation's stock, so it is possible for 100 percent of an S corporation's earnings to escape current tax. The catch is that the owners of the S corporation have to share ownership with the company's employees.

Austin and Kechijian found a way to get around 95 percent of that inconvenience. The two founders had been operating their distressed debt business through a group of C corporations and limited liability companies. The first thing they did was to contribute their various ownership interests to a newly organized S corporation in exchange for 95 percent of its shares. The remaining 5 percent went to a newly established ESOP.

As part of the formation of the S corporation, each founder entered into a restricted stock agreement (RSA) and an employment agreement with the new company. The RSA established a five-year "earn-out" period. If a founder voluntarily terminated his employment during the five years, he would forfeit half his shares.

Here, the founders deliberately skipped making 83(b) elections. This allowed the S corporation and the founders to take the position that the RSA had subjected the founders' shares to a substantial risk of forfeiture, rendering them "substantially nonvested" within the meaning of reg. section 1.83-3(b). Under reg. section 1.1361-1(b)(3), substantially non-vested shares are treated as not outstanding for purposes of subchapter S.

[7]*Austin v. Commissioner*, T.C. Memo. 2017-69, *aff'd sub nom. Estate of Arthur E. Kechijian v. Commissioner*, No. 18-2402 (4th Cir. 2020).

[8]Section 1361(c)(6).

If the two founders were not shareholders for subchapter S purposes, their pro rata share of the company's taxable income was zero.[9] Consequently, the S corporation allocated 100 percent of its income to the ESOP in accordance with section 1366. The ESOP was a tax-exempt trust protected from the unrelated business income tax rules,[10] so the outsized allocation to the ESOP did not trigger any tax.

If the S corporation had declared a state-law dividend, the 95 percent paid to the founders would have been taxed to them as compensation.[11] Not surprisingly, the corporation chose to retain the millions of dollars of untaxed profits it was earning. The founders' artful use of restricted stock had converted the S corporation into something resembling a gigantic 401(k) account, in which they each had a 47.5 percent share.

Spheres of Influence

The five-year earn-out period expired on January 1, 2004, so the legal risk of forfeiture terminated on that date. Austin and Kechijian should have reported the FMV of their newly outstanding shares (about $46 million each) as compensation in 2004, but they apparently failed to do so. The IRS's primary argument, however, was that the shares had never been subject to a substantial risk of forfeiture, so the two founders should have been paying tax on their 95 percent of the S corporation's income during the entire earn-out period.

As in *QinetiQ*, the IRS contended that the risk of forfeiture existed on paper only. The founders, after all, owned 95 percent of the S corporation's voting stock. Although the ESOP would have had to consent to any waiver of the forfeiture condition, its initial board of trustees consisted of Austin, Kechijian, and a subordinate employee.

Reg. section 1.83-3(c)(3) instructs us to consider a stock recipient's relationship to the directors and officers of the corporation and to influential stockholders. If we evaluate the situation at the time of the stock transfers, it seems probable that the founders could have gotten the ESOP to agree to waive their forfeiture conditions. Although Austin and Kechijian later resigned as trustees, they were replaced by employees of the corporation they controlled.

To its credit, the Tax Court framed the issue as whether the founders' shares were subject to a substantial of forfeiture when issued to them. Accordingly, the court concentrated on the situation at the time of the transfer. The court stated that Austin, Kechijian, and the third trustee had credibly testified that they understood their fiduciary obligations and took them seriously. This was accepted as evidence that the trustees were not going to rubber-stamp the founders' decisions, even though two of the trustees were the founders themselves.

The Tax Court also pointed out that the plan participants were entitled to vote to instruct the trustees whether to approve a proposed waiver of the forfeiture provisions. The plan participants voted confidentially, so they were free to vote in their economic self-interests. This counted strongly in favor of substantiality, because the forfeiture of Chin's 47.5 percent interest would have almost doubled the ESOP's ownership of the S corporation.

Warm and Fuzzy?

Contrary to its decision in *QinetiQ*, the Tax Court recognized in *Austin* that the historically warm relationship between the two founders should carry little weight when considering whether a forfeiture condition is likely to be enforced. The inquiry under reg. section 1.83-3(c)(3) must focus on what would have happened if one of the founders had unilaterally decided to leave the company.

The Tax Court observed that the founders had distinct skill sets. Austin performed the front-end work, including the acquisition of the loan portfolios, while Kechijian had back-end and back-office responsibilities, such as servicing the portfolios. Recognizing that the business required both of them to participate, the founders had imposed the earn-out condition.

In the Tax Court's view, the departure of one founder would have left the other with "every

[9] In 2001 Congress shut down this stratagem by enacting section 409(p), which can attribute S corporation income to some non-ESOP shareholders, even though the income was originally allocated to the ESOP. However, this change was made prospectively, and it did not apply to the ESOP in *Austin* until 2005.

[10] Section 512(e)(3).

[11] Reg. section 1.1361 1(a)(1).

incentive" to insist on enforcing the forfeiture condition. The court therefore concluded that Austin and Kechijian had received their shares subject to a substantial risk of forfeiture. Their shares had not vested until January 1, 2004, so the founders were not liable for their 95 percent share of the S corporation's income during the earn-out period.

Conclusions

When *Austin* was before the Fourth Circuit, the IRS was content to let January 1, 2004, serve as the vesting date, and the founders did not seriously contest the point. The court of appeals focused instead on some transactional gymnastics that the founders had undertaken later in 2004 in an effort to counteract the vesting of their shares. Like the Tax Court, the Fourth Circuit concluded that these transactions were devoid of economic substance.

Consequently, the timing puzzle remains unsolved. Is the probability that a forfeiture condition will be not be enforced based on the founders' relationship determined only once, at the outset? Or is it necessary to take the relationship's temperature on an ongoing basis? If everything depends on how things stand at the time of the transfer, the usual result should be that a founder's risk of forfeiture is substantial, assuming that he does not have enough legal control of the corporation to waive the condition.

It would also be good to establish the counterfactual nature of the inquiry. The fact that a forfeiture condition is unlikely to be triggered, because the founder or other service provider will almost certainly remain employed, should be irrelevant. What matters is the probability that the condition would be enforced if the condition were triggered.

Given the sheer number of start-ups and founders, there must be a lot of unfiled 83(b) elections moldering in desk drawers. Most of these slip-ups probably never turn out badly, because the companies and founders have to do well for mistakes of this sort to come to light. But if you are one of the founders or companies caught in the tax crosshairs, the fact you or your company succeeded when many did not is likely to be little consolation. ■