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Analysis that matters from Washington National Tax

Fourth Circuit Holds Vesting Schedule and Non-Compete Agreement Did Not Create a Substantial Risk of Forfeiture

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QinetiQ US Holdings v. Commissioner[1] turns on the income tax treatment of stock issued to an executive officer and owner of a company. The Fourth Circuit Court of Appeals upheld the Tax Court's ruling that the stock granted to an employee-owner was not deductible several years later because there was no substantial risk of forfeiture at the time of the grant. The Tax Court's finding of no substantial risk of forfeiture was based on a variety of factors, including that the employee was a 49.75 percent owner, had a close working relationship with the other owner, and played a vital role in the company.

Facts of the Case

During 2002, Dominion Technology Resources, Inc. ("DTRI") was formed and stock was issued to the two owners of the company, Mr. Hume and Mr. Chin. The stock issuance was ostensibly connected to employment, issued via board consent, and subject to a shareholders agreement. The shareholders agreement restricted the sale or transfer of stock. The company had the right to repurchase the stock at full value upon death, disability, or termination with cause. In the event of voluntary termination by the employee, the shareholders agreement provided that shares could be purchased by DTRI at five percent of the value for each year of employment, up to a maximum of 100 percent after 20 years. However, if the employee voluntarily resigned and competed with DTRI or was terminated for cause,

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1 845 F.3d 555 (4th Cir. 2017), *aff'g* T.C. Memo 2015-123 (2016).

then the shares could be purchased at five percent of the value for every year of employment, up to a maximum of 25 percent of the value.

The Fourth Circuit highlighted the differences between the shareholder agreements entered into by Hume and Chin and the stock agreements entered into by DTRI and other employees. Other employees' agreements were more restrictive in transfer provisions and contained different formulas for calculating the value of the stock in the event of a repurchase. None of the other employees received, as did Hume and Chin, voting rights in the stock granted. Additionally, the employees' employment agreements referenced the stock received as compensation; Hume's and Chin's employment agreements did not reference the 2002 stock grant.

From 2002 through 2007, the original stock subject to the shareholders agreement was not reported as compensation and no deduction was taken. However, later stock issued to Hume and Chin was reported as compensation.

In 2008, QinetiQ and DTRI entered into a merger agreement. Hume and Chin executed consent agreements waiving DTRI's rights with respect to transfer restrictions on partially vested stock prior to the close of the transaction. At the time of the transaction, Chin was a 49.75 percent owner of DTRI. The merger closed during October 2008.

For the tax year ending March 31, 2009, QinetiQ withheld payroll taxes for the stock originally granted in 2002 and claimed a compensation deduction for the fair market value of the stock. Hume and Chin reported the income as compensation on their personal income tax returns.

The IRS issued a deficiency notice that QinetiQ had not established it was entitled to a deduction under section 83[2] and its taxable income was thereby increased.

Tax Court Decision

Before trial, QinetiQ agreed with the IRS that the stock transferred to Hume did not qualify as section 83 property. As for Chin, QinetiQ claimed that the deduction was properly taken in 2008, contending that the stock was transferred in connection with the performance of services and subject to a substantial risk of forfeiture. Under section 83, QinetiQ contended, the stock was not included as compensation in Chin's income until 2008, and 2008 was thus the proper year for the deduction.

The Tax Court ruled that the stock was neither property transferred in connection with the performance of service nor property subject to a substantial risk of forfeiture. QinetiQ appealed the Tax Court's decision to the Fourth Circuit.

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[2] Unless otherwise indicated, section references are to the Internal Revenue Code of 1986, as amended (the "Code") or the applicable regulations promulgated pursuant to the Code (the "regulations").

Section 83

Under section 83, property transferred in connection with the performance of services is treated as compensation and taxed at the time of transfer. The taxable amount is the fair market value of the property less any amount paid for the property. There is an exception: If the property is transferred subject to a substantial risk of forfeiture, it is taxed when the substantial risk of forfeiture lapses.[3]

For a substantial risk of forfeiture to have effect, it must be enforceable and likely to be enforced. The regulations provide that if a substantial risk of forfeiture is unlikely to be enforced, it is not a true substantial risk of forfeiture and the property is properly taxed at the time of transfer.[4] A covenant not-to-compete may be a substantial risk of forfeiture, but it is a fact dependent determination taking into account: "[T]he age of the employee, the availability of other employment opportunities, the likelihood of the employee obtaining such other employment, the degree of skill possessed by the employee, the employee's health, and the practice (if any) of the employer to enforce such covenants."[5]

Fourth Circuit Analysis

The court discussed the two requirements for an employer to establish entitlement to a deduction in a year later than the year of transfer:

- The property was transferred in connection with the performance of services, and
- The property was subject to a substantial risk of forfeiture from the time the property was transferred until the tax year for which the deduction is claimed.

If the employer fails to establish either requirement, the employer is not entitled to a deduction for property transferred in an earlier tax year.

The court considered the shareholders agreement for evidence as to whether or not the shares were potentially forfeitable. According to the shareholders agreement, the shares were repurchased by the company at full fair market value in the instance of death, disability, or termination without cause. Because Chin would receive the entirety of the value of the shares in these instances, this repurchase provision did not amount to a substantial risk of forfeiture.

The court then considered the provisions in the shareholders agreement for repurchase for less than fair market value. The shareholders agreement provided that, per Chin's voluntary resignation, the stock would be repurchased at five percent of fair market value for each year of service with the company. Thus, voluntary resignation from DTRI with less than 20 years of service would result in a repurchase at a price less than the fair market value of the stock. The agreement further provided that upon voluntary resignation and joining another firm, or termination for cause, the stock would be repurchased at five percent of fair market value per year of service, up to 25 percent of the value.

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[3] Section 83(a).

[4] Section 1.83-3(c)(1).

[5] Section 1.83-3(c)(2).

The court dismissed the covenant not to compete and the termination for cause provisions, citing section 1.83-3(c)(2) to state that these provisions do not amount to a substantial risk of forfeiture. Focusing on the voluntary resignation provisions, the Fourth Circuit affirmed the Tax Court's decision. The court stated that it was unlikely that these provisions would be enforced against Chin because he worked closely with the owner, was one of the initial investors in the company, and had a vital role in the company as CFO and as possessor of 49.75 percent of the company's stock. Thus, the court declared that the condition did not truly amount to a substantial risk of forfeiture.

While the Tax Court found that QinetiQ had failed to provide either requirement (in connection to the performance of service or substantial risk of forfeiture) for establishing its deduction, the Fourth Circuit only reviewed the issue of substantial risk of forfeiture. Because failing either requirement denies the deduction in a subsequent year, the Fourth Circuit did not address whether the compensation was transferred in connection with the performance of services. QinetiQ Holdings was denied the compensation deduction for these amounts.

KPMG Observation

Although the significant ownership position and close relationship between the two owners were the main drivers of the court's determination, it is worth noting that the company did not take a tax position in the case consistent with its 2002-2007 tax returns. The argument was that the vesting occurred at a rate of five percent per year with a maximum of 25 percent if Chin engaged in competition. If there had been a substantial risk of forfeiture, there still would have been stock compensation inclusion and deduction for 2002-2007. This may not have been relevant to the court's decision, but it is generally helpful to have a consistent tax position.

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