

New US Tax Law Provides Tax Deferral Opportunity for Certain Private Company Equity Grants

Article By:

Mary B. "Handy" Hevener

Zaitun Poonja

The adoption of Internal Revenue Code Section 83(i) under recent US tax reform will allow certain private company employees to defer federal income tax on eligible stock options and restricted stock units for up to five years following their respective exercise or settlement. While additional clarification from the Internal Revenue Service is still needed, and there are a number of technical requirements under Section 83(i) that must be satisfied, Section 83(i) could be useful for bridging the gap between when an employee is subject to income tax and when the employee's shares can be liquidated.

The Tax Cuts and Jobs Act of 2017 (PL 115-97) added new Section 83(i) to the US Internal Revenue Code, which allows eligible employees of private companies the opportunity to defer US federal income taxation on eligible stock options and restricted stock units (RSUs) for up to five years following exercise of the stock options or settlement of the RSUs. The deferral treatment applies to a stock option that is exercised and RSUs that are settled after December 31, 2017.

Under current tax law, a nonqualified stock option is generally taxed upon exercise of the stock option and RSUs are generally taxed upon settlement of the RSUs. Stock of a private company cannot be readily sold by employees to cover taxes. Accordingly, Section 83(i) could be useful for bridging the gap between when an employee is subject to income tax and when the employee's shares can be liquidated. However, given the technical requirements of the new rule and some of the clarifications needed from the Internal Revenue Service (IRS), it is unclear how widely Section 83(i) will be used. On the other hand, it appears that companies cannot opt out of Section 83(i), in which case companies will have to determine whether their stock options or RSUs might be granted to enough employees to meet the 80% eligibility test described below, and then ensure that they do not inadvertently fail to comply with the requirements of Section 83(i), which could result in penalties to the company.

What Is the Tax Deferral Period?

Section 83(i) allows certain eligible employees the opportunity to defer federal income taxation attributable to "qualified stock" until the *earliest* of

-
- five years after an employee's right in the stock is transferable or not subject to a substantial risk of forfeiture (generally, meaning five years after exercise of a stock option (for a vested option) or the settlement date of RSUs);
 - the qualified stock becoming transferable (including becoming transferable to the employer corporation);
 - the employee becoming an "excluded employee";
 - the stock becoming readily tradable on an established securities market; or
 - the employee revoking the election.

At the end of the deferral period, the amount of income that must be recognized (and subject to withholding) is based on the value of the stock at the time of exercise of the stock option or the settlement of the RSUs, even if the stock has declined in value during the deferral period. It may be difficult for the company to collect the withholding taxes from the employee (or former employee) at the end of the deferral period, even though the employee (or former employee) would have been required to agree to pay the withholding. It is also not clear how the company's withholding and reporting obligations would apply for year-end exercises or settlements where the election could be made in a subsequent year. The deferral does not apply to FICA or FUTA taxes.

Who Is Eligible to Make a Section 83(i) Election?

There are a number of eligibility requirements with respect to Section 83(i) elections, including that the employee must be a full-time employee^[1] who is not an "excluded employee" and who has received "qualified stock" granted by an "eligible corporation" as compensation for services.

An excluded employee is an individual who

- is or has been the company's CEO or CFO,
- is or was during the last 10 years (a) a 1% owner or (b) one of the four highest paid officers of the company, or
- is a family member of the CEO or CFO.

What Is Qualified Stock?

"Qualified stock" generally means stock in an eligible corporation that is received by an eligible employee in connection with either the exercise of a stock option (including an incentive stock option or an employee stock purchase plan (ESPP) option)^[2] or the settlement of RSUs. Stock will not be treated as qualified stock if the employee may sell it to the corporation or otherwise receive cash from the corporation in lieu of such stock at the time the stock becomes transferable or not subject to a substantial risk of forfeiture. This would likely preclude net settlement of employment taxes.

What Is an Eligible Corporation?

An "eligible corporation" means, with respect to any calendar year, a company that (a) has never had its stock traded on an established securities market and (b) has a written plan under which at least 80% of full-time US employees (other than excluded employees) are granted stock options or RSUs, with the same rights and privileges to receive qualified stock.^[3] It appears that the 80% rule applies separately to RSUs; therefore, if 80% of eligible employees receive stock options, they can make a Section 83(i) election for stock options but not for RSUs, unless 80% of the eligible employees also get RSUs.

An eligible corporation is not required to give each employee the same number of shares of qualified stock, as long as the number of shares available to each employee is more than a de minimis amount.

Additionally, no election is permitted if the corporation purchased any of its outstanding stock in the prior calendar year unless (a) at least 25% of the total dollar amount of the stock purchased is stock under which there is an active Section 83(i) deferral election (deferral stock), and the determination of which individuals from whom deferral stock is purchased is made on a reasonable basis, or (b) the stock repurchased by the corporation includes all outstanding deferral stock.

When Must an Election Be Made?

A Section 83(i) election must be made within 30 days after the date the stock is transferable or no longer subject to a substantial risk of forfeiture, and cannot be made if the employee made an election under Internal Revenue Code Section 83(b).

If an employee makes a Section 83(i) election with respect to an incentive stock option (ISO) or an ESPP option, the stock option will be treated as a nonqualified stock option and will no longer be eligible for the preferential tax treatment applicable to ISOs or ESPP options, as applicable. In that case, FICA and FUTA taxes will be due upon exercise of the stock option and income tax withholding on the income recognized under the Section 83(i) timing rules.

What Are a Corporation's Notice and Reporting Obligations?

Section 83(i) imposes a notice requirement that a corporation must satisfy at the time that (or a reasonable time before) an amount attributable to such stock would first be includible in income absent the Section 83(i) election. The notice must

- certify that the stock is qualified stock,
- notify the employee that the employee may be eligible to make an election under Section 83(i), and
- inform the employee of the tax consequences of the deferral.

The corporation also has a reporting obligation on Form W-2 for both the year of deferral (applicable to the reporting of FICA-taxable income and FICA tax withholding) and the year income is recognized by the employee (applicable to the reporting of "Box 1" taxable income and of income tax withholding).

The failure to provide the notice to employees results in a penalty of \$100 per failure, subject to a maximum penalty of \$50,000 per year for failure to provide the required notices.

Additional guidance from the IRS is needed to clarify the meaning of a number of terms used in the election and the impact on withholding obligations.

[1] Nonemployees are not eligible to make Section 83(i) elections.

[2] Section 83(i) applies to ESPP options, although private companies rarely implement such plans.

[3] It appears that the rules apply to qualifying awards made prior to 2018 that are exercised or settled after 2017.

National Law Review, Volume VIII, Number 66

Source URL: <https://natlawreview.com/article/new-us-tax-law-provides-tax-deferral-opportunity-certain-private-company-equity>