

**NEWS ALERT****TAX GROUP****IRS Issues Initial Guidance on Deferral Option for Qualified Equity Grants**

By Marc T. Finer | January 3, 2019

On December 22, 2017, President Trump signed the Tax Cuts and Jobs Act (“TCJA”) into law. One of the lesser publicized changes enacted by the TCJA was the introduction of new Internal Revenue Code (“Code”) Section 83(i), which permits certain employees of privately-held companies to defer the payment of income tax on the exercise of stock options or settlement of restricted stock units (“RSUs”) for up to five years beyond the year in which the income would otherwise be recognized under current federal tax law. Code Section 83(i) was created to promote employee stock ownership at startup and early-stage private companies and address an income tax issue that many of these employees face. They become subject to income tax upon receipt of the equity award but have no source of liquidity to pay the resulting tax liability because the equity is not publicly tradable.

Under new Code Section 83(i), if stock is received (i) in connection with the exercise of a stock option or in settlement of a RSU and (ii) the stock option or RSU was granted in connection with the performance of services as an employee of an “eligible corporation” (referred to as “qualified stock”), the employee may make an election within 30 days of receipt of the qualified stock to defer the income tax until the earliest of: (1) the first date the stock becomes transferable, (2) the date the employee becomes an “excluded employee,” (3) the first date on which the stock of the issuing corporation becomes publicly tradable on an established securities market, (4) the five-year anniversary of the date the stock becomes vested (i.e., either transferable or not subject to substantial risk of forfeiture), or (5) the date on which the employee revokes the election.

An “excluded employee” is any individual who (1) currently is or has ever been the corporation’s CEO or CFO (including certain family members of the individual), (2) is currently or was a 1% owner of the corporation during the previous 10 years, or (3) is one of the four highest paid officers of the corporation during the current year or previous 10 years.

An “eligible corporation” is a privately held corporation that has a written plan under which at least 80% of its non-excluded/non-part-time US-based employees are granted stock options or RSUs with the same rights and privileges to receive qualified stock.

On December 7, 2018, the IRS released [Notice 2018-97](#) (the “Notice”) which provides initial guidance on certain aspects of Code Section 83(i).

## 80% Requirement

The Notice makes it clear that the determination of whether a corporation satisfies the 80% requirement is made on a calendar year basis. Therefore, to satisfy this requirement, the corporation must have granted stock options to at least 80% of its eligible employees or RSUs to at least 80% of its eligible employees in the calendar year. For example, a start-up corporation that hires 10 employees in calendar year 2018 and grants RSUs to each employee during the year will satisfy the 80% requirement. However, if in the year 2019, the corporation grants RSUs to only two newly hired additional employees, the corporation will not meet the 80% requirement in the year 2019 because the corporation will have made grants to only 20% of its employees in the year 2019 in the absence of additional grants to the original 10 employees. This result obtains despite the fact that 100% of the employees have been granted RSUs and causes the year 2019 RSU grants to be ineligible for the Code Section 83(i) deferral election. For purposes of the 80% requirement, the corporation must take into account the total number of individuals employed at any time during the year (ignoring excluded and part-time employees).

## Income Tax Withholding Requirements

The Notice makes it clear that the qualified stock is considered wages (i.e., ordinary income) that is treated as paid on the earliest of the five dates listed above. In connection with the payment, the corporation is required to withhold income tax at the maximum income tax rate in effect for the relevant year without regard to withholding allowances claimed on the employee's Form W-4. Since the wages are paid in stock, the corporation is also required to determine the actual value of the qualified stock and report the amount and withholding on Form W-2 and Form 941. If the employer pays the income tax withholding with its own funds, the employer is permitted to recover the withholding from the employee until April 1 of the following year. The escrow requirement described below is used to satisfy the employee's withholding requirement. FICA and FUTA taxes are not affected by Code Section 83(i) and therefore are due and payable at the time the option is exercised or the RSU is settled.

## Escrow Requirement

The Notice prohibits employees from making a deferral election unless the corporate employer deposits the qualified stock into an escrow account. The stock must remain in the escrow until the employer uses the stock to satisfy the employee's income tax withholding obligation or recovers the income tax withholding obligation from the employee. The corporation may deliver to the employee any remaining qualified stock held in escrow after the corporation's income tax withholding obligation has been met.

Corporations that wish to preclude employees from making the Code Section 83(i) deferral election may do so by failing to establish the required escrow arrangement or otherwise not creating the conditions that would permit the employees to make the election. In addition, the terms of a stock option or RSU may provide that no election under Code Section 83(i) will be available with respect to stock received on exercise of the stock option or settlement of the RSU.

Code Section 83(i) applies to qualified stock received pursuant to stock options exercised or RSUs settled after December 31, 2017. The Notice states that the guidance included in the Notice will be incorporated into future regulations that will apply to any taxable year ending on or after December 7, 2018.

## Additional Insights

By making the Section 83(i) deferral election, the employee is essentially betting that the employer's stock will increase in value after the election is made. If the stock is sold at a fair market value in excess of its fair market value at the time the deferral election is made, the gain above the initial fair market value will be treated as capital gain rather than ordinary income. In contrast, if the employer's stock decreases in value, the income

tax that is eventually owed on the receipt of the stock remains locked in based on the fair market value of the stock at the time the stock option is exercised or RSU is settled and the election is made. The amount of this tax liability is owed even if the stock remains illiquid at the expiration of the deferral period and does not change even if the stock decreases in value. This may create a situation in which the tax liability is actually greater than the value of the stock when the employee is required to include the stock value in income and the tax liability becomes due.

To illustrate the benefits and risks of making a Code Section 83(i) deferral election, consider a qualified employee who exercises an option for a \$10 exercise price in the year 2018 and receives vested, nontransferable qualified stock worth \$100. Under general federal income tax rules, the employee would be taxed on the \$90 spread in the year 2018 at ordinary income rates even if the stock is illiquid. Assuming Code Section 83(i) applies, the employee could defer the payment of federal income tax on the \$90 spread until the year 2023 (five years after the deferral election year) if none of the other tax triggering events has already occurred. If the stock becomes transferable in the year 2025 and the employee sells the stock for \$150, the employee will pay tax at capital gains rates on \$50 in the year 2025 since the \$90 ordinary income component was locked in at the time of option exercise and the associated tax liability was paid in the year 2023. On the other hand, even if the stock decreases in value to \$60 in the year 2023, the employee still owes ordinary income tax on \$90.

Code Section 83(i) has the potential to promote broad based employee ownership of start-up or early-stage private companies and provide valuable upside compensation to large groups of non-executive employees. For the right company that relies on stock options and RSUs to attract and compensate its employees, the Code Section 83(i) deferral election may serve as an important device for incentivizing and recruiting employees. However, it is too early to tell whether it will garner widespread use due to its stringent requirements. Furthermore, state tax implications of Code Section 83(i) will depend on state conformity with federal tax law and may make federal/state tax compliance more difficult. Because of the tax uncertainty that results from making the deferral election, companies should exercise caution about encouraging employees to file a deferral election or guaranteeing a liquidity event within five years from the date of the deferral election.

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*This Client Alert is intended to give general information on Code Section 83(i) and Notice 2018-97 and is not intended to be a comprehensive summary of the federal tax rules applicable to the deferral election. If you have any questions regarding Code Section 83(i) or the Notice, how they might affect your business or personal tax situation and/or any potential tax planning opportunities, please contact Marc T. Finer, Tax Partner, at 860-240-6096 or [mfiner@murthalaw.com](mailto:mfiner@murthalaw.com).*

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