

FEBRUARY 14, 2018

Elective Tax Deferral for Non-Publicly Traded Company Equity Grants

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Speed Read

As noted in [our alert on December 21, 2017](#), the Tax Cuts and Jobs Act provides an opportunity to defer taxation of certain equity awards under the new Section 83(i) of the Internal Revenue Code of 1986, as amended. Until the IRS issues guidance on Section 83(i), compliance by companies under Section 83(i) will be based upon a reasonable good faith standard. This alert provides a suggested framework for companies to approach Section 83(i).

The Tax Cuts and Jobs Act provides an opportunity to defer taxation of certain equity awards under the new Section 83(i) of the Internal Revenue Code of 1986, as amended. Under current law, employees who are granted non-qualified stock options or restricted stock units (RSUs) from their employer generally are subject to income tax with respect to such awards when the option is exercised or the RSU is settled. Effective after December 31, 2017, if certain conditions are satisfied, full-time employees of certain non-publicly traded companies (private companies) will be permitted to elect to defer the recognition of income for up to five years upon vesting of stock options or the settlement of RSUs.

The new Section 83(i) was likely intended to help ease the financial burden for employees who are interested in equity ownership but do not have the funds to cover the taxes due with respect to private company stock options and RSUs. However, the new section assumes that a liquidity event will happen within five years from the deferral election and that the value of the underlying equity will not decrease in value. To the extent such assumptions are wrong, Section 83(i) may put employees in a more precarious cash situation.

Further, while the idea of a deferral election is appealing to many, it may be difficult for companies to determine and continually track qualification under Section 83(i), noting that companies have an obligation to determine eligibility and notify employees if awards are eligible for a Section 83(i) election (or else pay penalties as further described below). Unfortunately, the wording of Section 83(i) leaves many other important questions unanswered as well, including how companies should practically collect funds from employees (including former employees) to cover withholding obligations at the end of the deferral period and how favorable employee changes such as increased salaries and promotions could trigger an immediate end to the deferral period and unexpected tax consequences for employees. Some companies may intentionally choose to take steps toward disqualification from Section 83(i) eligibility rather than address these issues. In addition, the limitations included in this section will likely result in a limited application of the deferral election. Until the IRS issues guidance on Section 83(i), compliance will be based upon a reasonable good faith standard. Below is a suggested framework for companies to approach Section 83(i):

Is The Company Eligible To Make Grants For Which An 83(i) Election May Be Made?

Only an “eligible corporation” can grant awards eligible for a deferral election. An eligible corporation must meet the following requirements:

- *Must Be a Private Company (i.e., no stock of such company is or ever has been readily tradeable on an established securities market).*
- *Company Must Make Equity Awards Pursuant to a Written Plan.*
- *Company Must Meet Annual Equity Grant Threshold Requirements.* In order for a stock option or an RSU to qualify for a deferral election, the award must be (or have been) granted in a calendar year in which at least 80% of the employees of the company who provide services in the United States are granted the same type of award, i.e., either stock options¹ or RSUs, as the case may be (but cannot combine both award types toward the 80% threshold) with the same rights and privileges.² The 80% threshold is determined on an annual basis so companies need to calculate the percentage for each calendar year (including past years if there are still options or RSUs outstanding granted for such years) to determine which year or years (if any) the company was an “eligible corporation.”³

If a company does not meet the requirements of an “eligible corporation” in a particular year, the stock options and/or RSUs granted in such year are not eligible for the deferral election even if the company meets the “eligible corporation” requirements in earlier or later calendar years.

Assuming The Company Is An Eligible Corporation, Does The Company's Stock Qualify Under Section 83(i)?

The deferral election is only available for awards that are granted by an employer to a full-time employee in connection with the performance of services by such employee. Moreover, the deferral election is only available with respect to stock that qualifies under Section 83(i).

Limitations Surrounding Company Redemptions and Repurchases. Company stock does not qualify under Section 83(i) if a company purchased any of its own stock in the year preceding the calendar year in which the applicable award first becomes transferable or vested, unless (1) all of the company's stock that is subject to outstanding deferral elections is purchased by the company in such calendar year, or (2) (a) 25% or more of the total dollar value of the repurchased stock is “deferral stock” (as described below) and (b) the decision from whom to repurchase such deferral stock was made on a reasonable basis. “Deferral stock” means stock which is subject to an outstanding deferral election, provided that if the company purchases deferral stock from an individual who has more than one outstanding deferral election, the company must purchase the shares that are subject to the oldest effective deferral election held by such employee or else such purchase does not count toward the 25% threshold.

Notes

- A typical employee liquidity program would likely disqualify the stock of a company from Section 83(i) eligibility in the following year. Also, a repurchase of shares after an employee is terminated (for example, an employee who early exercised a stock option and held restricted stock) may similarly affect Section 83(i) eligibility.
- Companies with stock subject to outstanding deferral elections that repurchase their stock must report the total dollar amount of the repurchased stock and such other information as required by the IRS on the company's tax return.

Assuming The Company's Stock Qualifies Under Section 83(i), Which Compensatory Equity Awards Qualify?

The election is only available for stock options and RSUs.

The election is not available for the following types of equity awards:

- restricted stock
- any award for which the employee has made a Section 83(b) election

- any award of the stock that can be or is converted into cash (such as cash-settled stock appreciation rights)
- any award with respect to stock that is subject to a put right back to the company
- any award permitting the employee to sell such stock back to the company when the award is exercised or settled (including, possibly, to cover taxes, i.e., net exercise/settlement).

Which Employees Are Eligible To Make A Deferral Election With Respect To Their Qualifying Equity Award?

The deferral election is only available for full-time employees.⁴ The deferral election is not available for part-time employees, non-employee directors, consultants, advisors, or anyone that is or becomes an “excluded employee.” “Excluded employees” include:

- individuals who are (or were, at any time in the preceding 10 calendar years) one percent owners of the company;
- the current or former CEO or CFO of the company (or any of their family members); or
- individuals who are (or were, at any time in the preceding 10 tax years) among the top four highest compensated officers of the company.

What Does The Company Need To Do Once It Determines That Employees Hold Awards That Are Eligible For An 83(i) Election?

Companies are affirmatively required to certify that their stock is eligible for a deferral election and provide notice of that fact to their eligible employees. If a company meets all of the requirements for 83(i) eligibility, the company must inform its eligible employees – a company cannot voluntarily opt out of Section 83(i). However, if a company does not meet the requirements of Section 83(i), there does not appear to be a similar requirement to notify employees about disqualification.

Any company that offers qualified stock to a qualified employee must provide such notice at, or a reasonable period prior to, the time that the income attributable to the stock would otherwise first become includible in income. The required notice must:

- certify that the stock is eligible for deferral;
- inform the employee that the deferred amount is based on the value of the stock at the time the award first becomes transferable or vested (less the exercise price, if applicable);
- inform the employee that the deferred amount will be subject to withholding by the Company at the end of the deferral period; and
- contain an agreement and acknowledgment from the employee to cover tax withholding at the end of the deferral period.

Notes

- Companies need to provide notice every year after reassessing qualification for the past calendar year. It is unclear how and whether a company needs to assess qualification for partial calendar years or current calendar years.
- Companies should exercise caution about encouraging employees to file a deferral election or guaranteeing a liquidity event within five years from the deferral election.

Are There Penalties For Failure To Provide Notice Of The Ability To Make An 83(i) Election?

Yes, the penalty for failure to provide the required notice is \$100 per each missed notice, not to exceed \$50,000 per calendar year, unless such failure is due to reasonable cause and not willful neglect. The notice obligation is effective as of December 31, 2017.

What Do Companies Need To Think About If An Employee Files An 83(i) Election?

The deferral election is expected to be similar to a Section 83(b) election and, based on the current language in Section 83(i), must be made by the eligible employee no later than 30 days after the date the stock option or RSU is first substantially vested or transferable. It is unclear whether the 30-day window for stock options starts at the time of vesting, as the statutory language indicates, or should instead be 30 days from the time of exercise. Until the IRS issues further guidance, it does not seem like Section 83(i) will be of much use for stock options since the election must be made in connection with vesting and not exercise. It is also unclear how the deferral election affects any taxes withheld by the company at the time the stock option or RSU is first vested or transferable, to the extent such act occurs prior to the employee submitting a deferral election.

The ultimate preparation and filing of the deferral election is the employee's responsibility, and the employee should notify the company once he or she has filed a deferral election. This notification is important so that the company can keep track of the withholding obligation related to such award and so the company is aware that it cannot take a tax deduction for such award until the end of the deferral period.

What Value Is Deferred?

The value deferred is the value of the stock at the time the award is vested (less the exercise price, if applicable). Such amount will be included as taxable income in the year the deferral period ends even if the stock value subsequently declines over the deferral period.

Social Security and Medicare taxes are not deferred by a Section 83(i) election, so the employee and company will need to appropriately report and withhold such taxes at the time of exercise of the stock option or settlement of RSUs.

Any appreciation in value of the deferral stock from the time the Section 83(i) election is made through the time such shares are sold should be taxed at capital gains rates.

When Should The Company Report And Include The Deferred Amount As Taxable Income?

The deferred amount is included in taxable income in the first taxable year in which one of the following events occurs:

- Five years after the employee's right to the stock option or RSU is first substantially vested or transferable.
- The date the qualified stock becomes transferable (i.e., the date the employee has the ability to sell the stock to any person, including back to the employer).
- The date the employee revokes the deferral election (the parameters of a revocation will be addressed by the IRS in future guidance).
- The date the company goes public.
 - **Note:** Given that the shares will likely be subject to a lock-up for a period of time after a company goes public, it is unclear how Section 83(i) is meant to help in this instance since the shares will still essentially be illiquid at the time of taxation.
- The date the employee becomes an excluded employee (as described above).
 - **Note:** It may be difficult for companies to keep track of when an employee becomes an "excluded employee," since a promotion, significant pay raise, or other unexpected mid-year changes could unintentionally trigger earlier income inclusion.

Other Considerations:

Administrative tracking. Companies need to set up procedures (or hire an accounting or consulting firm) to determine annual qualification and subsequent tracking of eligible grants and employees. Companies also need to take necessary measures to track deferral elections, including those held by former employees, to ensure the company's withholding obligation is met at the end of the deferral period (which may arise sooner

than anticipated if, for example, the eligible employee becomes an excluded employee prior to the end of the deferral period).

Companies should strategize how to restructure equity programs in order to qualify for Section 83(i). If a company does not qualify for Section 83(i) elections, it may want to consider engaging in steps to proactively qualify under Section 83(i) for future awards in order to make a deferral election available for employees. Taking such steps could be useful if the company anticipates that a liquidity event will occur within five years.

Companies should consider whether qualifying for deferral elections is worthwhile. If a company does not think its employees will be interested in Section 83(i) elections or otherwise finds the reporting and tracking obligations too burdensome, it may consider engaging in steps to disqualify its stock from Section 83(i) (through an annual repurchase program, granting at below the 80% threshold, etc.). Intentional disqualification would also eliminate the risk for any penalties related to failure to provide notice.

As described above, Section 83(i) is quite complicated and may not be as helpful as originally expected. We are happy to assist our clients with this new law.

¹ The same analysis applies to options granted under employee stock purchase plans (although few private companies offer such plans).

² The same rights and privileges standard is a little unclear noting that companies are not required to provide employees with the same ratio or number of options or RSUs, so long as each employee is eligible to receive more than a de minimis amount of company stock. Additionally, the standard is waived for any awards granted prior to January 1, 2018.

³ Companies should be careful when calculating the threshold. It appears that the threshold would account for stock options or RSUs granted to excluded employees (as described in this alert) even if such employees are not eligible for the deferral election.

⁴ It is unclear whether full-time employee status is required only on the date of grant, the date of the 83(i) election, or at all times.

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