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Electing Deferral Under Code Sec. 83(i)

By Donald P. Board • Wood LLP

Code Sec. 83(i), which was enacted as part of the Tax Cuts and Jobs Act of 2017 (TCJA), is intended to secure the blessings of stock ownership for rank-and-file employees of early-stage companies. When it applies, the new provision lets employees elect to defer reporting income realized in connection with the exercise of compensatory stock options and the settlement of restricted stock units (RSUs). Absent such an election, an employee must report compensation in the year of exercise or settlement equal to the excess of the fair market value of the relevant shares over the amount, if any, that the employee paid to obtain them (the "spread").

The employer must withhold and pay over the applicable tax on the spread, in cash, even when it is paid to the employee in the form of corporate shares. Established companies can front the cash for their employees' withholding and rely on getting repaid over time through payroll deductions. In a start-up context, however, cash is a precious commodity, so it's generally up to employees to provide the funds that the employer must send to the Treasury.

Rank-and-file employees are rarely enthusiastic about digging into their savings to pay tax on a receipt of employer shares. In the case of options, employees also need to pay the exercise price. Given the uncertain prospects of early-stage companies, there is a good chance that employees who exercise options are just throwing their money away. High fliers may relish a good gamble, but it's not the kind of thing most rank-and-file employees feel like taking a chance on.

As a result, regular employees are notorious for refusing to exercise their options until a liquidity event is pounding on the door. Given their brief holding periods, the rank and file usually end up with ordinary income. In the case of RSUs, employees do not control the settlement schedule, so they have a better shot at capital gain. But the fact

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that RSUs *force* employees to pay tax on speculative and illiquid start-up shares is one of the reasons that many employees do not like RSUs.

Code Sec. 83(i) tries to turn this around with a flood of cheap credit. If rank-and-file employees do not want to pay current tax for the privilege of gambling on start-up shares, why not have the Treasury simply *lend* them the money? The new election under Code Sec. 83(i), which permits employees to defer reporting the spread for income tax purposes for up to five years, does essentially that.

A "solution" that works by letting unsophisticated employees simply push off the day of tax reckoning is bogus at best. [*See generally* Donald P. Board, *New Code Sec. 83(i): Buy Now! Pay Later!*, THE M&A TAX REPORT (January 2019).] However, Congress has required corporations to meet strict requirements before their employees can elect deferral under Code Sec. 83(i).

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The requirements are so strict that many observers doubt that employers will take the steps necessary to make the election available. If they're right, Code Sec. 83(i) may do only limited damage to rank-and-file employees. In this article, we will review the mechanics of the new provision, including the rules restricting access to the dubious election. We will also look at Notice 2018-97 [2018-52 IRB 1062 (December 7, 2018)], which has given employers an inconspicuous means to opt out of the new regime.

Qualifying to Elect

Code Sec. 83(i) does not apply unless the employer is an "eligible corporation" that has adopted a written plan for the issuance of options or RSUs to "eligible employees" to receive "qualified stock" in connection with their performance of services. Under Code Sec. 83(i)(2): (1) the stock of the employer (or any predecessor) must never have been readily tradable on an established securities market; and (2) the employer's written plan must have granted, in the relevant calendar year, options or RSUs to at least 80 percent of its employees providing services in the U.S. or any possession.

This 80-percent-participation requirement applies separately to options and RSUs. The employer must issue either options to at least 80 percent of its U.S. employees, or RSUs to at least 80 percent of its U.S. employees. It cannot issue options to 50 percent of its U.S. employees and RSUs to another 30 percent.

The point of the 80-percent requirement is to promote *broad-based* employee stock ownership. The employer's equity grants must reach rank-and-file employees, not just employees within the golden circle. However, Code Sec. 83(i) lets the employer decide how the options or RSUs will be allocated *among* participants. The only constraint is that each of them must receive a right to obtain more than a *de minimis* number of shares.

Qualified Employees

Only a "qualified employee" can elect deferral under Code Sec. 83(i). This means a conventional employee, not an independent contractor. The employee must agree to any steps prescribed to ensure that withholding

requirements will be met when the deferral period expires. [Code Sec. 83(i)(3)(A).]

A participant must not be an "excluded employee." This rules out any employee is who a one-percent owner, within the meaning of Code Sec. 416(i)(1)(B)(ii), during the current or 10 preceding calendar years. [Code Sec. 83(i)(3)(B)(i).]

Certain top managers are also excluded. The statute does not lock out the entire C-suite, but it bars any employee who is, or has *ever* been, the chief executive officer or the chief financial officer of the corporation, or has acted in such capacity. [Code Sec. 83(i)(2)(B)(ii).] The prohibition also extends to members of the CEO's or CFO's families described in Code Sec. 318(a)(1)—*i.e.*, spouses, children, grandchildren, and parents. [Code Sec. 83(i)(2)(B)(iii).] As usual, siblings get a pass.

Finally, Code Sec. 83(i)(2)(B)(iv) excludes any employee who is (or was) one of the four most highly compensated officers during the taxable (not calendar) year in question, or any of the 10 preceding taxable years. Of course, identifying the four most highly compensated employees can be tricky. Here, the Code borrows the tests used to identify HCEs for reporting purposes under the Securities Exchange Act. [*Id*.]

Qualified Stock

An employee can make a deferral election only with respect to a transfer of "qualified stock." [Code Sec. 83(i)(1)(A).] This means stock received by a qualified employee upon the exercise of an option or the settlement of an RSU. However, the option or RSU must have been granted while the corporation was an eligible corporation. [Code Sec. 83(i)(2)(A).]

Under Code Sec. 83(i)(2)(B), "qualified stock" does *not* include stock:

> if the employee may sell such stock to, or otherwise receive cash in lieu of stock from, the corporation at the time that the rights of the employee in such stock first become transferable or not subject to a substantial risk of forfeiture.

Code Sec. 83(i) permits employees to elect deferral so that they do not have to use their savings to pay the income tax that would otherwise be due on the spread. Employees who can sell some of their new shares back to the issuer (or can take cash in lieu of shares in the first place) do not face this liquidity problem. Hence, they do not need a deferral election.

Electing Deferral

A qualified employee who wishes to defer reporting the spread on an option or an RSU must make an election as described in Code Sec. 83(i)(1)(A). The election must be made within 30 days after the first date the employee's rights in the underlying qualified stock are transferable or are not subject to a substantial risk of forfeiture. [Code Sec. 83(i)(4)(A).]

There is an obvious timing parallel to the election under Code Sec. 83(b). The statute provides no details, but it requires that the new election be made "in a manner similar to the manner in which an election is made under subsection (b)." [*Id*.] The IRS has never bothered to create a standard form for Code Sec. 83(b) elections, so it will presumably leave it to the tax bar to figure out what needs to be filed under Code Sec. 83(i).

There are several limitations on the deferral election. First, no election can be made if any stock of the issuer is or was tradable on an established securities exchange at any time before the election is made. Second, the election is barred if the corporation has purchased any of its stock in the calendar year before the date the employee's rights to the stock became transferable or substantially vested. This is subject to an exception permitting the election if: (1) at least 25 percent of the total dollar amount was paid to repurchase "deferral stock" (*i.e.*, stock for which there has already been a deferral election); and (2) the selection of the individuals from whom the deferral stock is purchased is made on a reasonable basis. [Code Sec. 83(i)(4).]

A recent history of share repurchases suggests that the issuing corporation is not strapped for cash. Congress may have concluded that, in such circumstances, it is reasonable to expect the corporation to pay the tax currently and collect it from the employee over time. That would undercut the rationale for allowing the employee to elect deferral under Code Sec. 83(i).

The limitation is not very strict. Share repurchases in the previous calendar year are no

problem if at least 25 percent of the payments went to holders of deferral stock. Congress appears to have been concerned primarily with ensuring that corporations will give the rank and file a decent share of the repurchase bounty.

Requiring the corporation to have a "reasonable basis" for selecting *which* holders will be permitted to sell their deferral stock prevents managers from discriminating among participants. If the corporation repurchases all of its outstanding deferral stock, that is not an issue. In that case, both the reasonable-basis and the 25-percent requirements are waived. [*See* Code Sec. 83(i)(4)(iv).]

Inclusion of Deferred Amount

Even if a qualified employee makes a valid election under Code Sec. 83(i), the *amount* of the employee's compensation income is fixed on the date that the employee's rights in the underlying shares became transferrable or substantially vested. All that changes is the taxable year in which the employee must report that amount as gross income. If the actual value of the deferral stock plummets in the interim, the employee must still report and pay tax on the stock's former value.

The *timing* of the employee's inclusion is determined under Code Sec. 83(i)(1)(B). The maximum deferral period is five years. But there are several events that can accelerate reporting of the deferred amount.

First, the employee must include the compensation as soon as the deferral stock becomes transferable—including transferable *to the employer*. [Code Sec. 83(i)(1)(B)(i).] This is a departure from the rules under Code Sec. 83(b), which do not treat property as transferable unless it can be transferred, free of a substantial risk of forfeiture, to a person *other* than the transferor of the property. [*See* Reg. §1.83-3(d).]

This difference is justified by the rationale for the deferral election. If the point is to refrain from taxing employees who cannot raise cash by selling their shares, there is no reason to defer tax on employees who can sell to their *employers*. Note that, from this perspective, options with a "net exercise" feature should be treated as transferrable to the employer.

Second, the employee's income is accelerated if *any* stock of the corporation becomes readily tradable on an established securities market. [Code Sec. 83(i)(1)(B)(iii).] The fact that some *other* class of stock of the employer is publicly traded will not solve the employee's liquidity problem, so this rule can produce a harsh result. Congress presumably took this hard line to pressure issuing corporations to make sure that their deferral stock will be publicly tradable as well.

Third, deferral ends if the participant becomes an excluded employee. [Code Sec. 83(i)(1)(B)(ii).] The idea seems to be that an individual who becomes the CEO or CFO of the issuing corporation is unlikely to suffer from a liquidity problem. That is generally sensible, but the assumption may be mistaken if, say, the employee agrees to serve as the CEO or CFO at a modest salary after the corporation has gotten into financial difficulties.

Finally, employees must report their deferred income if they *revoke* their elections with respect to the shares in question. [Code Sec. 83(i)(1)(B)(v).] Hard to argue with that.

Administrative Burden on Employer

Rank-and-file employees are unlikely to consult professional advisors regarding the application of Code Sec. 83(i) to an equity grant. Code Sec. 83(i)(6) responds by shifting the burden of informing employees about their rights to the issuer. If qualified stock is transferred to a qualified employee, the corporation must, at the time an amount attributable to the stock would first be includible in the gross income of the employee (or a reasonable time before): (1) certify to the employee that the stock is qualified stock; and (2) notify the employee that he may be eligible under Code Sec. 83(i) to defer income on that stock.

The corporation must also notify the employee that, if he elects deferral:

- The amount of income recognized when deferral ends will be based on the value of the stock when the employee's rights to the shares first became transferable or were no longer subject to a substantial risk of forfeiture, notwithstanding that the value of the stock may have declined during the deferral period;

- The amount of income recognized at the end of the deferral period will be subject to income-tax withholding pursuant to Code Sec. 3401(i) at the rate determined under Code Sec. 3401(t); and
- The employee will be subject any duties regarding withholding that are imposed by the Secretary of the Treasury pursuant to Code Sec. 83(i)(3)(A)(iii).

If a corporation fails to provide the required notices, it faces a fine of $100 per omitted notice, up to $50,000 per year. The penalty is waived if the omission was due to reasonable cause and not to willful neglect. [Code Sec. 6652(p).]

Notice 2018-97

There are, as yet, no regulations under Code Sec. 83(i). However, the Treasury has provided some interim guidance in Notice 2018-97.

Eighty-Percent Requirement

The Notice clarifies that the 80-percent-participation requirement under Code Sec. 83(i)(2)(c)(i)(II) means 80 percent of all persons who were U.S. employees (other than excluded employees) *at any time* during the calendar year. Suppose that a U.S. employee is hired on July 1, 2019, hates the job, and quits on August 15 without receiving any options or RSUs. This ex-employee may seem irrelevant, but he must still be included in the denominator of the fraction used to determine whether the 80-percent requirement was met in 2019.

A number of employers asked whether the 80-percent requirement with respect to a calendar year can be applied on a "cumulative" basis. This would mean treating employees as participating under the employer's plan in the *current* year if they were granted stock options or RSUs under the plan in *prior* calendar years. The IRS rejected this interpretation because it is simply inconsistent with the language of Code Sec. 83(i)(2)(c)(i)(II).

This means that Code Sec. 83(i) options and RSUs will qualify for the election only if they were awarded in installments that include at least 80 percent of employees per year. This can have awkward consequences. Suppose, for example, that a corporation issues qualified options to 90 percent of its U.S. employees in December 2019.

In January 2020, the corporation hires Jones. If the corporation issues options to Jones, they will not qualify for a future deferral election unless the 80-percent requirement is satisfied in the year of grant. To give Jones qualifying options, it will have to issue *additional* options to its employees in 2020, even though they just received a pile of options in December 2019.

This may be tricky to manage. As noted above, *de minimis* grants are disregarded, so the employer cannot use token awards to make it to 80 percent in 2020. Perhaps Congress was hoping that employers would start making significant grants of options and RSUs to just about every employee, every year.

Income Tax Withholding

Following a successful deferral election, an employee holds deferral stock. Code Sec. 83(i) postpones only the income tax. FICA and FUTA taxes must be paid on their usual schedule, based on the employee's receipt of qualified stock.

The TCJA amended Code Secs. 3401 and 3402 to integrate deferral stock into the system of income-tax withholding. Under new Code Sec. 3401(i), deferral stock is considered wages subject to employer withholding under Code Sec. 3402. The employee is treated as receiving the wages on the earliest end-of-deferral date specified in Code Sec. 83(i)(1)(B). The amount received is the amount included in income under Code Sec. 83 for the tax year that includes the end-of-deferral date.

New Code Sec. 3402(t) provides that the rate of withholding under Code Sec. 3402(a) must be no less than the maximum rate in effect under Code Sec. 1, currently 37 percent. The stock is treated for purposes of Code Sec. 3501(b) as if it were a noncash fringe benefit. That means that the taxes to be withheld must be collected (or paid) by the employer at the time and in the manner prescribed by in regulations.

The Treasury, however, has not issued regulations on noncash fringe benefits that fall within Code Sec. 3501(b). Announcement 85-113 [1985-31 IRB 31] fills the gap, providing guidelines for withholding, paying, and reporting employment tax on noncash fringes. The general income tax rule is that employers

must withhold the applicable income tax on the date the fringe benefits are provided and must deposit the tax under the regular rules for tax deposits.

An employer may make a reasonable estimate of the value of the fringe benefit (here, the deferral stock) on the date it is paid. The actual value of the fringe benefit must be determined by January 31 of the following year and reported on Form W-2 (*Wage and Tax Statement*) and on Form 941 (*Employer's Quarterly Federal Tax Return*) or, if applicable, Form 944 (*Employer's Annual Federal Tax Return*).

Withholding Escrows

Code Sec. 83(i)(3)(A)(II) authorizes the Treasury to impose any requirements it determines necessary to ensure that an employer's withholding requirements will be satisfied. Any employee who wants to defer income pursuant to Code Sec. 83(i) must agree, as part of the election, to be bound by those requirements. [*Id.*]

Under Notice 2018-97, the employee must agree that all deferral stock will be held in an escrow arrangement, the terms of which are consistent with the following requirements:

- The deferral stock must be deposited into escrow before the end of the calendar year during which the election is made and must remain in escrow until removed as described below, or the corporation has otherwise recovered from the employee an amount equal to the income tax withholding obligation under Code Sec. 3401(i) for the tax year.
- At any time between the date of income inclusion under Code Sec. 83(i)(1)(B) and March 31 of the following calendar year, the corporation may remove from escrow and retain the number of shares of deferral stock with a fair market value equal to the income tax withholding obligation that has not been recovered from the employee by other means.
- The fair market value of the shares must be determined pursuant to Reg. §1.409A-1(b)(5)(iv). This is the value at the time the corporation retains the shares to satisfy its withholding obligation.
- Any remaining shares of deferral stock held in escrow after the corporation's income tax withholding obligation has been met must be delivered to the employee as soon as reasonably practicable thereafter.

Notice 2018-97 imposes what is, in effect, a *net exercise* feature. If the employee does not pony up the cash to fund the withholding when it is due, the employer can treat the employee as transferring a portion of the escrowed shares to the employer. That makes the employer whole from an economic perspective.

However, this does not provide the employer with cash to send to the IRS. This aspect of Notice 2018-97 will not appeal to start-ups, which do not like to burn through their cash by paying their employees' taxes. That's why start-ups do not offer net exercise when they set up their option plans.

Of course, as long as the IRS does not allow withholding to be paid in start-up shares, *somebody* is going to have to inject some cash. Employers can make arrangements for their employees to pay. But, if an employee does not come through, the IRS will still treat the employer as responsible for the withholding.

Opting Out

Many employers do not want to deal with Code Sec. 83(i). Some have even asked the Treasury and the IRS whether there is some way for a corporation to opt out of the deferral provision. Better safe than sorry.

Notice 2018-97 does not provide a formal opt-out button. But it points out that "stakeholders" (*i.e.*, employers) don't really need one. All a corporation has to do is to "decline to establish" a withholding escrow.

If there is no escrow, there can be no deferral election under Code Sec. 83(i). Notice 2018-97 adds that the employer may also want to include a statement in its options or RSUs stating that no deferral election will be available. That will put employees on notice that they cannot use Code Sec. 83(i), even if they receive qualified stock.

Conclusion

Code Sec. 83(i) imposes significant administrative burdens on private companies that grant options or RSUs. The new provision is supposed to promote rank-and-file

stock ownership, but this may not be a high priority for many corporate managers. They have the final say, so we should not expect Code Sec. 83(i)-compliant equity plans to take the start-up world by storm. Sorry, Congress.