

New Tax Act Provides Tax Deferral Opportunity for Private Company Equity Compensation Awards

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On December 22, 2017, President Trump signed the **Tax Cuts and Jobs Act** (the “TCJA”) into law. The TCJA adds a new Section 83(i)¹ to the Internal Revenue Code of 1986, which allows eligible employees of private companies to defer U.S. federal income taxes on eligible compensatory stock options and restricted stock units (RSUs) for up to five years after exercise of the stock options or settlement of the RSUs. The new Section 83(i) tax deferral treatment applies to stock options that are exercised and RSUs that are settled after December 31, 2017. Currently outstanding stock options and RSUs that satisfy the various requirements described below are presumably eligible for this new tax treatment.

Section 83(i) is intended to promote broad-based employee stock ownership at startup or early-stage private companies.² Most such companies do not have a public market for their stock and, as a result, their shares cannot be readily sold (unlike public company stock) by employees to cover the taxes that would arise on option exercise or RSU settlement under prior law. Section 83(i) addresses this issue by offering employees of such companies the opportunity to defer taxation on exercise or settlement of their equity awards, thereby bridging the potential disconnect between when employees incur taxes on the awards and when they can liquidate their shares. This potential disconnect has grown more prevalent in recent years as many tech companies have deferred their initial public offerings, frustrating the ability of employees to receive the benefit of equity awards without paying taxes out of pocket.

It is unclear how many companies and employees will actually be able to take advantage of Section 83(i). Section 83(i) imposes numerous restrictive requirements and limitations in order to defer income tax treatment on company stock. For example, at least 80% of a company’s employees who are eligible for Section 83(i) deferral elections must be granted equity awards in the year of the respective award grant for Section 83(i)’s beneficial tax treatment to apply. In addition, Section 83(i) is not available for companies that have engaged in certain share repurchases as described below. Other requirements of Section 83(i) include additional monitoring and reporting burdens on companies.

Furthermore, the exact intent and application of a number of provisions in Section 83(i) are not clear from the statutory language and will need to be interpreted and clarified by the Treasury Department through regulations or other guidance.

Section 83(i) Tax Deferral for Private Company Equity Compensation Awards

Duration of Tax Deferral Under Section 83(i)

Section 83(i) allows private company employees who receive company stock on exercise of a stock option or settlement of an RSU³ after December 31, 2017 to elect to defer the income tax event for up to

¹ All “Section” references herein are to the Internal Revenue Code of 1986, as amended unless otherwise described.

² The provision, which was proposed by Representative Kevin Brady (R-TX), is very similar to a bipartisan bill (the Empowering Employees through Stock Ownership Act) that was introduced in both houses of Congress in 2016 and again in 2017 and was supported by NASDAQ Private Markets.

³ A Section 83(i) tax deferral on exercise of a stock option or settlement of an RSU does not apply to restricted stock, which is eligible instead for potentially preferential tax treatment under Section 83(b).

(cont.)

five years after the date the employee's right to the stock is no longer subject to a substantial risk of forfeiture (i.e., the stock is "substantially vested"),⁴ or until the earliest of the following events to occur within those five years:

- the stock becomes transferable (including to the company)⁵;
- the stock becomes publicly traded on an established securities market (e.g., in an initial public offering);
- the employee is no longer eligible for the deferral, as described below; or
- the employee revokes the deferral election.

The amount of income that must be recognized at the end of the deferral period is based on the value of the stock on the *original* exercise or settlement date, even if the value declines (or increases) during the deferral period.⁶ The company's tax deduction will be in the same amount, but will also be delayed until the year of the employee's income inclusion date. The Section 83(i) tax deferral treatment applies to income tax only and does not affect payroll taxes.

Eligibility Requirements: Qualified Employees, Qualified Stock and Eligible Corporations

Section 83(i) tax deferral is subject to various eligibility requirements applied on a controlled group basis, as determined under Section 414(b). In order to make a Section 83(i) election, a private company employee must be a "qualified employee" who has received "qualified stock" granted as compensation for services by an "eligible corporation."

It seems that, effectively, the only way for a company to opt out of Section 83(i) tax deferral in order to avoid a delayed tax deduction and/or Section 83(i)'s numerous requirements is to design its equity compensation program so as not to meet Section 83(i)'s eligibility requirements.

Qualified Employee

An employee is a "qualified employee" if he or she is a full-time employee who:

- is not and has never been the company's CEO or CFO (or a related person⁷);

(cont.)

⁴ Under Section 83, a substantial risk of forfeiture is determined as a matter of facts and circumstances, and exists only if rights in property that are transferred are conditioned on the future performance (or refraining from performance) of substantial services by the transferee, or on the occurrence of a condition related to a purpose of the transfer if the likelihood of forfeiture is substantial. For example, if an employee has the right to exercise a stock option prior to vesting and receive restricted stock (a right that some startup companies provide their employees), the right would be substantially vested at the stock option grant date, rather than the vesting date of the restricted stock, if the facts and circumstances show that the restrictions on the stock are not regularly enforced or are not based on future employee performance (or non-performance), or vice versa.

⁵ Many private companies prohibit transfer of stock received on exercise of stock options or settlement of RSUs, but also customarily provide rights to transfer stock for estate planning purposes or to family members. It remains to be clarified whether such customary rights could possibly trigger this transferability provision, which would foreclose the deferral opportunity to holders of many, if not most, currently outstanding awards.

⁶ Example: An employee receives an RSU that has a value of \$100 on the settlement date, and elects a Section 83(i) deferral that lasts five years, at the end of which the stock is worth \$300. Seven years after the settlement date, the employee sells the shares for \$400, realizing \$100 of ordinary income at the time the deferral period ends and \$300 of long-term capital gains at the time of sale. However, if the employee were to have sold the shares for \$70 seven years after the settlement date, he or she would have realized \$100 of ordinary income at the time the deferral period ends and a capital loss of \$30 at the time of sale.

⁷ A related person is any director, executive officer, director nominee or 5% shareholder of the company, in addition to such person's immediate family members, including stepparents, stepchildren, parents- and children-in-law and any persons living in the same household (other than a tenant or employee).

- has not been one of the company's 4 highest compensated executive officers⁸ in any of the 10 preceding taxable years; and
- has not been a 1% owner of the company at any time in the 10 preceding calendar years.⁹

An employee who holds stock options or RSUs equal to more than 1% of a company would be considered to own more than 1% of the company, and consequently would not be a qualified employee.

Qualified Stock

The stock received must be “qualified stock”—namely stock in a private company received by an employee on exercise of a stock option or settlement of an RSU that was granted by the private company as compensation for services.

Section 83(i) also explicitly states that “qualified stock” does not include any stock that the employee can sell to, or otherwise receive cash in lieu of stock from, the company when the employee's stock options or RSUs vest. This would likely preclude net settlement for employment taxes on vesting of deferred RSUs.

The statutory language for Section 83(i) does not provide clear guidance on whether company stock that later becomes subject to put or call rights would still be qualified stock under Section 83(i) or would be considered as having become transferable, cutting short the tax deferral period. Customary call rights on an employee's stock on termination of employment would likely not disqualify the stock for Section 83(i) tax treatment, given that the exercise of a call right is at the company's discretion and the stock is not transferrable by the employee. However, if the employee has the right to put the stock, the stock could be considered to become transferable and disqualified under Section 83(i) at the time that the put right arises.¹⁰

Eligible Corporation

A private company is an “eligible corporation” under Section 83(i) if:

- the company has never had its stock readily tradeable on an established securities market (i.e., it cannot be a successor entity to a previously public company); and
- the company has a written plan under which, in the applicable calendar year, at least 80% of the company's U.S. qualified employees received either stock options or RSUs (but not a combination of stock options and RSUs), with the same rights and privileges to receive qualified stock.

⁸ A company's highest compensated officers are determined by referring to each officer's total compensation (the sum of all elements of compensation that would be reportable in the Total column of the Summary Compensation Table pursuant to Item 402(c) of Regulation S-K) for the last completed fiscal year, minus any amount that would be reportable in the Change in Pension Value and Nonqualified Deferred Compensation Earnings column of the Summary Compensation Table, had the private company disclosed executive compensation under the proxy disclosure rules applicable to U.S. public companies.

⁹ As determined under the Section 416(i)(1)(B)(ii) rules for top-heavy qualified retirement plans, a 1% owner of a company is any person who, if the employer is a corporation, owns (or is considered as owning within the meaning of Section 318) more than 1% of the outstanding stock of the corporation or stock possessing more than 1% of the total combined voting power of all stock in the corporation, as well as the person's family members, who generally include the person's spouse, children, grandchildren and parents as defined under Section 318(a)(1).

¹⁰ Typically, such put rights for stock are not provided except perhaps to founder employees and senior management in involuntary termination of employment scenarios.

The determination of whether awards have the “same rights and privileges” will be made in a similar manner as under Section 423(b)(5) for employee stock purchase plans (ESPPs)¹¹ and will be determined separately for the exercise of a stock option and the settlement of an RSU.

Qualified employees will not fail to be treated as having the same rights and privileges to receive qualified stock solely because different amounts are granted to different qualified employees, so long as each qualified employee who counts toward the 80% test receives more than a *de minimis* amount, and rights and privileges with respect to the exercise of a stock option and the settlement of an RSU are treated separately.¹² This requirement could be interpreted by omission to mean that qualified employees would not have the same rights and privileges if, for example, the vesting terms or the consequences of a termination of employment or a change in control of the company differ among equity awards made to various qualified employees.¹³

Limitation on Company Share Repurchases

An employee cannot make a Section 83(i) election if his or her company has repurchased any of its outstanding stock in the preceding year, unless at least 25% of the dollar amount of the repurchased stock was previously deferred by employees under Section 83(i) and the determination of which individuals from whom the stock was repurchased was made on a reasonable basis, or the stock repurchased by the company includes all outstanding company stock for which Section 83(i) elections have been made.

The legislative history for the TCJA is silent on why Section 83(i) restricts share repurchases; however, a sponsor of the Empowering Employees through Stock Ownership Act, which is very similar to Section 83(i), described employee stock ownership as “a key tool for startups, allowing cash-poor innovators to recruit top talent.”¹⁴ The drafters of the bill may have thought that companies that have enough cash to repurchase shares should have enough cash to net settle employee stock options and RSUs and therefore should not be the beneficiaries of a tax deferral opportunity for “cash-poor innovators.”

Notice and Reporting Requirements on Private Company Employers

A private company employer must notify an employee of the Section 83(i) deferral election opportunity on or prior to a stock option or RSU’s vesting date. Companies that fail to provide this notice after December 31, 2017 are generally subject to a fine of \$100 per missed notice, subject to a cap of \$50,000 per year.

The Section 83(i) notice must certify to the employee that the stock to be received on exercise of the stock option or settlement of the RSU is qualified stock. It must also notify the employee that the

¹¹ Under Section 423(b), the plan will not fail to provide employees with the same rights and privileges if the amount of stock that may be purchased by any employee on exercise of a stock option is uniformly based on the employees’ total compensation or basic or regular compensation rate, and the plan provides that no employee may purchase more than a maximum amount of stock fixed under the plan.

¹² In the case of any calendar year beginning before January 1, 2018, employees will not fail to be treated as having the same rights and privileges to receive qualified stock, whether or not the rights and privileges with respect to the qualified stock are the same.

¹³ If qualified employees would not have the same rights and privileges if their respective vesting terms differ, an equity compensation program intended to qualify for Section 83(i) deferral may not be able to limit, as is commonly practiced, equity vesting acceleration on termination of employment for good reason to senior executives only. However, such senior executives are not likely to be qualified employees.

¹⁴ Warner, Heller, Paulsen & Crowley Reintroduce Bipartisan Legislation to Encourage Stock Options for Employees of Startups and Privately-Held Firms, MARK. R. WARNER, available at <https://www.warner.senate.gov/public/index.cfm/2017/6/warner-heller-paulsen-crowley-reintroduce-bipartisan-legislation-to-encourage-stock-options-for-employees-of-startups-privately-held-firms> (Jun. 27, 2017).

employee may be eligible to elect to defer income recognition pursuant to Section 83(i), and that the amount of income that must be recognized at the end of the deferral period is based on the value of the stock on the original exercise or settlement date and will be subject to withholding.

If the employee makes a Section 83(i) election on receipt of qualified stock, the employer must report on the employee's Form W-2 the income amount covered by the Section 83(i) election for the year of deferral and the year the employee recognizes income, and the aggregate income amount deferred pursuant to Section 83(i) elections as determined as of the close of the calendar year.

Any employer with outstanding deferral stock as of the beginning of any calendar year that purchases any of its outstanding stock during that year must also report the total dollar amount of its outstanding stock purchased during that year on its own tax return for the applicable tax year.

Coordination of Section 83(i) with Section 83(b), ISOs, ESPP and Section 409A Provisions

An employee who receives qualified stock on exercise of a stock option or settlement of an RSU can elect, within 30 days after exercise or settlement, to make a Section 83(i) election to defer the tax event in a manner similar to that in which an election is made under Section 83(b).¹⁵

No election may be made under Section 83(i) if the employee has already made an election under Section 83(b) with respect to the qualified stock. If a Section 83(i) election is made to defer income recognition for a stock option granted as an incentive stock option (ISO), the stock option will no longer be eligible for the favorable tax treatment available to an ISO.

Similarly, a stock option for which a Section 83(i) election is made will not be considered as granted pursuant to an ESPP.

Furthermore, an arrangement under which an employee may receive qualified stock will not be treated as a nonqualified deferred compensation plan under Section 409A solely because of the employee's election, or ability to make an election, to defer income recognition under Section 83(i).

Practical Impact

New Section 83(i) of the TCJA appears to promote broad-based employee stock ownership at startup or early-stage companies by allowing employees of private companies to defer income recognition from exercise of stock options or settlement of RSUs received as compensation.

That said, it is unclear how many private companies and their employees will be able to take advantage of this new tax deferral opportunity. The requirements and limitations of Section 83(i) are numerous and complex, necessitating private companies to monitor the eligibility of both themselves and their employees, restrict their stock repurchases and become subject to additional tax reporting requirements. In making grants of stock options and RSUs to employees, companies will also still need to consider existing U.S. federal and state "blue sky" securities requirements and exemptions, which may be more difficult to comply with if equity grants need to be made to at least 80% of company employees. Depending on the size and personal financial status of the employee population and the amount of equity compensation grants, some companies may find that the challenges involved in meeting the tax and securities requirements are not worth their while.

However, it appears that companies cannot opt out of Section 83(i)—if a private company's equity compensation program happens to meet the eligibility requirements of Section 83(i), its employees will be

¹⁵ As under Section 83(b), Section 83(i) requires that employees notify the Internal Revenue Service and their employers of their election.

entitled to make Section 83(i) elections, and the company must comply with the notice and reporting requirements to avoid incurring penalties.

In light of the many burdens imposed by Section 83(i), private companies may want to modify their equity compensation programs to avail themselves of other ways to make the tax treatment of equity compensation more favorable to their employees. For example, instead of granting RSUs, which would be eligible for capital gains tax treatment only from the settlement date under Section 83(i), companies may choose to grant restricted stock, which may be more tax-efficient for employees because restricted stock would be eligible for capital gains treatment from the grant date (when the fair market value of a startup or early-stage company's stock is usually lower than at the vesting date), if the employee makes an election under Section 83(b). In addition, companies that have historically granted nonqualified stock options instead of ISOs due to the applicability of the alternative minimum tax (AMT) to ISOs may now find it preferable to grant ISOs instead, especially given that the TCJA has increased the AMT exemption and phase-out amounts as part of its general tax reform program.¹⁶

For more analysis on the effect of the TCJA on compensation and employee benefits in particular, as well as on tax issues in general, please visit the [Davis Polk Tax Reform and Transition blog](#) and also refer to [Davis Polk's Client Memoranda on the Tax Cuts and Jobs Act](#).

If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your regular Davis Polk contact.

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¹⁶ For single or head of household filers, the AMT exemption and phase-out amounts will increase from \$54,300, phasing out at \$120,700, for the 2017 tax year to \$70,300, phasing out at \$500,000, for the 2018 tax year. For married taxpayers filing jointly, the AMT exemption and phase-out amounts will increase from \$84,500, phasing out at \$160,900, for the 2017 tax year to \$109,400, phasing out at \$1,000,000, for the 2018 tax year.