

First Guidance on the Application of Section 83(i) – Tax Deferral for Private Corporation Equity Compensation Awards

December 12, 2018

Section 83(i) of the Internal Revenue Code (section 83(i)) was enacted in December 2017 as part of the [Tax Cuts and Jobs Act](#) (TCJA). It allows eligible employees of private corporations to defer federal income taxes on eligible compensatory stock (qualified stock) received in connection with the exercise of stock options or in settlement of restricted stock units (RSUs) for up to five years after exercise or settlement. Section 83(i) is effective as to stock options that are exercised and RSUs that are settled as of or after December 31, 2017.

On December 7, 2018, the Treasury Department and the Internal Revenue Service (IRS) issued [Notice 2018-97](#) to provide initial guidance on three aspects of Section 83(i):

- how an employer can satisfy the Section 83(i) eligibility requirement that it must grant stock options or RSUs to not less than 80% of U.S. employees (80% requirement);
- the application of federal income tax withholding rules to the deferred income related to qualified stock; and
- how an employer may affirmatively opt out of Section 83(i), even if the requirements of Section 83(i) are otherwise met.

Key takeaways from Notice 2018-97 include the following:

- the measurement period to determine whether the employer satisfied the eligibility requirement that 80% of U.S. employees received grants is measured on a *single* calendar year basis and does not take into account grants made in prior years;
- employers must withhold taxes at the maximum individual rate in effect at the time the stock with respect to which a Section 83(i) election has been made (deferral stock) is treated as received in income and will be treated as a noncash fringe benefit, which will provide employers additional time to collect amounts required to be withheld from employees¹;
- the employee and employer must agree to place deferral stock in escrow to ensure that applicable withholding taxes are deducted; and
- an employer may opt out of Section 83(i) by not establishing an escrow arrangement.

Treasury and the IRS anticipate issuing proposed regulations that are expected to incorporate the guidance contained in Notice 2018-97.

Overview of Section 83(i)

In general, Section 83(i) is intended to promote broad-based employee stock ownership at start-up or early-stage corporations. By offering “qualified employees”² of an eligible corporation the opportunity to

¹ The IRS indicated that these requirements will apply until further guidance is issued.

² A “qualified employee” means a full-time employee who: (i) is not and has never been the corporation’s chief executive officer or chief financial officer; (ii) has not been one of the corporation’s four highest compensated executive officers during the calendar year (*cont.*)

defer taxation on qualified stock received upon exercise of stock options or settlement of RSUs, it provides employers with a means to bridge the potential disconnect between when employees incur taxes on the awards and when they can liquidate their shares.

A deferral period under Section 83(i) will end upon the earliest to occur of:

- five years after the date the employee's right to the qualified stock vests (i.e., is no longer subject to a substantial risk of forfeiture);
- the qualified stock becoming transferrable (including to the corporation);
- the qualified stock becoming publicly traded on an established securities market (e.g., in an initial public offering);
- the employee no longer being eligible for the deferral; or
- the employee revoking his or her deferral election.

For a more detailed explanation of the eligibility requirements and limitations, see our [memorandum](#) from January 8, 2018.

How Does the 80% Requirement Work?

Generally, to satisfy the 80% requirement, the employer must have a written plan under which, *in any calendar year*, not less than 80% of *all of its employees* (with limited exceptions noted below) who provide services to the corporation in the United States (or any possession of the United States), are granted stock options or RSUs (but not a combination thereof), which awards provide for the same rights and privileges to receive qualified stock.

Is the 80% requirement cumulative or based on a calendar year?

Notice 2018-97 provides that only stock options or RSUs granted in a *single* calendar year are considered in determining whether the 80% requirement has been satisfied. This means that an employer will need to determine for each calendar year in which it makes grants, whether it qualifies for Section 83(i) based on whether 80% of all its employees received grants in the given calendar year. Many commentators and practitioners have asked whether the 80% requirement would be cumulative, perhaps because many early-stage and start-up corporations make grants to employees when they are hired and in connection with promotions, rather than on an annual or periodic basis (like many public companies). However, Treasury and the IRS specifically stated that their view is that to permit the 80% requirement to be satisfied on a cumulative basis with any awards granted in prior calendar years would be contrary to, and is not a reasonable good faith interpretation of, the language of the statute.

Which employees are used to calculate the 80% requirement?

The employer must take into account the total number of individuals employed by the employer in the United States *at any time* during the calendar year, regardless of whether the employees were employed at the beginning or the end of the calendar year. Employees excluded from participation in Section 83(i) and part-time employees customarily employed for fewer than 30 hours a week are excluded from the calculation.

(cont.)

or for any of the 10 preceding taxable years (as determined under the shareholder disclosure rules for compensation under the Securities Exchange Act of 1934); and (iii) has not been a 1% owner of the corporation at any time during the calendar year or at any time in the 10 preceding calendar years.

How Does Federal Income Tax Withholding Apply to Deferred Income Related to Qualified Stock?

When is deferral stock treated as income?

Under Section 3401(i) of the Internal Revenue Code and Section 83(i), deferral stock is included in income for purposes of federal income tax withholding on the last date of the deferral period.

How is deferral stock treated for tax withholding purposes?

Section 3402(t) of the Internal Revenue Code provides that, for tax withholding purposes, deferral stock is treated as a noncash fringe benefit. Notice 2018-97 clarifies that the provisions of Announcement 85-113, an IRS announcement that provides guidance for reporting on the withholding of noncash fringe benefits, applies to deferral stock, except as limited by the Section 3401(i).³

What is the consequence of treating deferral stock as a noncash fringe benefit?

By treating deferral stock as a noncash fringe benefit (vs. ordinary wages), an employer who underestimates the amount of income tax to be withheld during any calendar year with respect to deferral stock will have until April 1 of the calendar year following the year in which the amount is included in the employee's wages (instead of December 31 of the year of inclusion) to recover such amounts from the employee.

Practically speaking, any such shortfall in withholding would likely be a consequence of an employee either no longer working for the employer at the time such withholding is required or the employee not receiving enough cash compensation in the given year to satisfy the required Section 83(i)-related withholding requirements.

What is the rate of withholding for deferral stock?

Under Section 3402(t)(1), the rate of withholding for deferral stock will be the maximum individual tax rate (i.e., the maximum rate of tax under Section 1 of the Internal Revenue Code). As described in Notice 2018-97, Treasury and the IRS anticipate that withholding for deferral stock will be applied:

- without reference to payment of regular wages;
- without allowance for the number of allowances or other amounts claimed by the employee on Form W-4;
- without regard to any additional employee requests for withholding; and
- without regard to the withholding method used by the employer.

Until further guidance is provided, employers must withhold on deferral stock at the maximum individual rate of income tax without regard to any adjustments.

Are there penalties for failure to withhold on deferral stock?

An employer who fails to deduct and withhold the correct income tax amount with respect to deferral stock will be liable for the payment of any penalties in respect of such failure.

³ Section 3401(i) provides for treatment of deferral stock under Section 83(i) that differs from the treatment of noncash fringe benefits under Announcement 85-113, specifically with respect to the date on which deferral stock must be treated as income and the withholding rates for deferral stock.

Does Notice 2018-97 deal with FICA and FUTA taxes?

No, given that the TCJA did not amend Federal Insurance Contributions Act (FICA) taxes or the Federal Unemployment Tax Act (FUTA) tax with respect to deferral stock, Notice 2018-97 does not make any changes with respect to those taxes. Practically speaking, this means FICA and FUTA taxes will still be owed for RSUs at the time they vest, regardless of whether a Section 83(i) election is made.

How will Treasury and the IRS ensure that all applicable withholding is met?

In order to ensure that the statutory income tax withholding obligations of the corporation and the employee are met, Notice 2018-97 provides that an employee who makes an election under Section 83(i) must agree with his or her employer that the deferral stock will be held in an escrow arrangement, consistent with the following requirements:

- the deferral stock must be deposited into the escrow arrangement before the end of the calendar year in which the Section 83(i) election is made, and it must remain in escrow until it is removed as described below *or* until the corporation has otherwise recovered the appropriate income tax withholding obligation from the employee;
- at any time in between the income inclusion date and March 31 of the following calendar year, the employer may remove from escrow and retain the number of shares of deferral stock with a fair market value equal to the amount of income tax withholding not otherwise recovered from the employee⁴; and
- after the income tax withholding obligations of the corporation have been met, the employee is entitled to delivery of any remaining shares as soon as reasonably practical.

Can a corporation opt out of Section 83(i)?

Yes, a corporation may preclude its employees from making a Section 83(i) election by declining to establish an escrow arrangement as described above. If the intent of the corporation is not to deposit qualified stock into an escrow arrangement or otherwise create the conditions that would allow qualified employees to defer their income under Section 83(i), the corporation may inform the employees that no Section 83(i) election may be made under the terms of any stock option or RSU that would otherwise be eligible for the election.

What topics has the IRS requested comment on?

Notice 2018-97 requests comment on the following:

- additional issues under Section 83(i) that future guidance should address;
- clarification of issues discussed in Notice 2018-97; and
- additional or alternative mechanisms to the escrow arrangement that could be established to ensure the collection of income tax withholding.

Comments may be submitted through February 5, 2019.

⁴ Fair market value is determined pursuant to Treas. Reg. § 1.409A-1(b)(5)(iv) and is determined at the time the corporation retains the shares held in escrow to satisfy the income tax withholding obligation.

Implications

All in all, Notice 2018-97 makes it even more difficult for private corporations to, and therefore even more unlikely that they will, implement a Section 83(i) program and, at the same time, makes it easier for such corporations to affirmatively opt out of Section 83(i) altogether.

In this vein, Notice 2018-97's proposed structure gives rise to financial risk for private corporations that might otherwise enable their qualified employees to make Section 83(i) elections, given that they will remain liable for withholding tax at the value of deferral stock when the election is made and will only really be protected via an escrow of such shares. If the value of the shares were to drop precipitously in value, the corporation would still be required to pay the withholding based on the higher value and would have shares worth much less. As a practical matter, the corporation would then need to decide whether to chase employees (or former employees) to collect the amounts the corporation was required to pay the IRS, likely leaving it responsible for the payment of the taxes in cash.

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.

Jeffrey P. Crandall	212 450 4880	jeffrey.crandall@davispolk.com
Edmond T. FitzGerald	212 450 4644	edmond.fitzgerald@davispolk.com
Kyoko Takahashi Lin	212 450 4706	kyoko.lin@davispolk.com
Jean M. McLoughlin	212 450 4416	jean.mcloughlin@davispolk.com
Veronica M. Wissel	212 450 4794	veronica.wissel@davispolk.com
Ron M. Aizen	212 450 4568	ron.aizen@davispolk.com
Ann Becchina	212 450 4788	ann.becchina@davispolk.com
Stephen I. Brecher	212 450 3563	stephen.brecher@davispolk.com
Gregory D. Hughes	650 752 2045	gregory.hughes@davispolk.com
David Mollo-Christensen	212 450 3295	david.mollo@davispolk.com

© 2018 Davis Polk & Wardwell LLP | 450 Lexington Avenue | New York, NY 10017

This communication, which we believe may be of interest to our clients and friends of the firm, is for general information only. It is not a full analysis of the matters presented and should not be relied upon as legal advice. This may be considered attorney advertising in some jurisdictions. Please refer to the firm's [privacy policy](#) for further details.