

Practical Implications of Section 83(i) Option and RSU Tax Deferral



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ALERTS

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The Tax Cuts and Jobs Act (the Act) was passed in a whirlwind at the end of 2017. Now that a bit of time has passed and the dust has begun to settle, it is a good opportunity to remind everyone of one of the changes introduced under the Act—the new Section 83(i) of the Internal Revenue Code (Section 83(i)). Below we describe the practical implications these rules will have for many private employers beginning in 2018.

Section 83(i) allows eligible employees to elect to defer federal income taxes for up to five years from the exercise of a stock option or the settlement of a restricted stock unit (RSU) that occurs after December 31, 2017, but only if the underlying stock is eligible stock of an eligible corporation.

The Internal Revenue Service (IRS) has yet to issue guidance under Section 83(i), but employers need to take steps now to determine if any of their outstanding options or RSUs are eligible for tax deferral. If so, employers must meet the notification requirement described below.

Eligibility for Section 83(i) Tax Deferral

The Section 83(i) deferral opportunity is subject to a number of restrictive conditions, including the following:

Eligible Stock. Section 83(i) is available only with respect to "qualified stock," which is stock of the employer corporation that:

- is received by the employee in connection with the exercise of an option or settlement of an RSU after December 31, 2017;
- is issued under an option or RSU that was granted by the employer in connection with the award recipient's performance of services as an employee during a calendar year in which the employer was an "eligible corporation" (see below); and
- does not include a put right or right to be cashed out by the employer at the time of option exercise or RSU vesting.

Eligible Corporations. An "eligible corporation" means, for any calendar year, any employer that is a corporation if:

- no stock of the corporation or its predecessors is readily tradeable on an established securities market during any prior calendar year; and
- the corporation offers options or RSUs under a written plan and, in the calendar year in which the applicable option or RSU was granted, at least 80 percent of all employees who provide services

in the U.S. (or any U.S. possession) were granted options or RSUs with the same "rights and privileges" to receive qualified stock.

- Whether options and RSUs have the same rights and privileges is determined without regard to differences due to status as part-time employees or "excluded employees" (see below). Additionally, grants do not need to be for the same number of underlying shares, although they must be for more than a de minimis amount.
- The joint explanatory statement of the conference committee accompanying the final version of the Act specified that the "rights and privileges" requirement is not satisfied in a taxable year by granting a combination of stock options and RSUs, and instead, 80 percent of U.S. employees must either have been granted stock options or RSUs for that year. We expect regulations to clarify this issue further. We currently interpret this to mean that the requirement is applied separately to options and to RSUs, meaning that if, in a particular year, 60 percent of U.S. employees were granted options with the same rights and privileges, and 85 percent of U.S. employees were granted RSUs with the same rights and privileges, the test would be met with respect to the RSUs but not the options. If, in this example, 90 percent of U.S. employees had received options with the same rights and privileges, the test would be met with respect to both RSUs and options.
- For years before January 1, 2018, the "rights and privileges" requirement will not apply (but the remainder of the 80 percent test still applies).

Comment: Whether awards have the same "rights and privileges" is determined in a manner similar to employee stock purchase plans. It likely includes the method of purchasing stock and vesting terms, although the scope of the requirement is unclear.

Comment: All controlled group members are treated as one corporation for Section 83(i) purposes. For readability, we generally refer to the "employer" or the "corporation" to mean all members of a controlled group that includes the employing corporation.

In addition, no election may be made on qualified stock if the employer has repurchased any of its outstanding stock in the prior calendar year, unless either:

- at least 25 percent of the dollar amount of the repurchased stock was stock for which a Section 83(i) deferral election was in effect and the determination of individuals from whom such stock is repurchased is made on a reasonable basis; or
- the stock repurchased includes all outstanding stock for which Section 83(i) deferral elections were in effect.

Eligible Employees. Section 83(i) elections are available only to "qualified employees," which includes U.S. employees of the employer, other than any "excluded employee." An excluded employee is an individual who:

- is or was a one percent owner of the employer at any time during the current or the ten prior calendar years;
- is or has been at any prior time the chief executive officer or chief financial officer of the employer, or an individual acting in either capacity;
- is a family member (spouse, children, grandchildren, and parents) of anyone described in the second bullet above; or
- is or was among the top four highest compensated officers of the employer during the current or any of the ten prior tax years.

Comment: Note that Section 83(i) is limited to employees and is not available to consultants, directors, or other non-employees.

Other Limitations. In addition, no election may be made on qualified stock if:

- at any time before the election, any stock of the employer issuing the options or RSUs is readily tradeable on an established securities market; or
- the employee has made an election under Section 83(b) of the Internal Revenue Code with respect to the qualified stock.

Employer Notice Requirements and Penalties

Employers with outstanding options or RSUs that satisfy the eligibility requirements described above must provide notice of eligibility of the Section 83(i) deferral election generally when (or a reasonable period before) the qualified stock would, but for the application of Section 83(i), be taxable to the

employee. Generally, this is the date on which the employer transfers the stock to the employee. The notice must:

- certify to the employee that the stock is eligible for the Section 83(i) deferral opportunity;
- notify the employee that he or she may be eligible to elect to defer income on the stock under Section 83(i);
- notify the employee that if a Section 83(i) election is made, the amount of income recognized at the end of the deferral period will be based on the value of the stock when the employee's rights in the stock first become transferable or not subject to substantial risk of forfeiture, regardless of any changes to the value of the stock during the deferral period; and
- notify the employee that the deferred income will be subject to wage withholding at the end of the deferral period at the maximum individual income tax rate in effect at such time and the employee's responsibilities with respect to such withholding.

Comment: Deferrals under Section 83(i) can continue following termination of employment. As a result, employers may need to make special arrangements with departing employees that have deferral elections to ensure that wage withholding is satisfied when the deferral period ends.

It is important that employers timely provide the above notice. Each failure to do so may result in a \$100 penalty and up to a maximum \$50,000 penalty per calendar year.

Timing and Method of Election

Upon exercise of a vested option or settlement of an RSU, a qualified employee has 30 days to make an election under Section 83(i) to defer tax on the stock received. For stock received upon the early exercise of an unvested option, subject to further guidance from the IRS, any Section 83(i) election likely must be made within 30 days after vesting (or after the first time the stock is transferable, whichever is earlier), although this is not clear. Section 83(i) elections are made in a similar manner to Section 83(b) elections.

Comment: A qualified employee may make a Section 83(i) election for qualified stock acquired under a statutory option (such as an incentive stock option), but this would cause the statutory option to lose its tax-preferred status under the U.S. tax code and instead to be taxed as a nonstatutory stock option. Generally, upon exercise of an incentive stock option, an employee recognizes no income taxes, but the unrealized value at exercise is included as an adjustment in determining his or her alternative minimum taxes (AMT) for that year. The Act significantly increased the AMT exemption thresholds. Accordingly, the likelihood that incentive stock option exercises would trigger AMT obligations for an employee has been reduced dramatically. Employers may want to consider having employees who are eligible to make a Section 83(i) election with respect to incentive stock options consult their personal tax, accounting, or other adviser to weigh the comparative tax benefits to them of making a Section 83(i) election on shares issued under an incentive stock option versus maintaining the award's statutory option status.

If an employee makes a valid Section 83(i) deferral election on stock received, the amount of federal income tax that otherwise would be due at such time is deferred until the earliest of:

- the first date the qualified stock becomes transferable (including to the employer);
- the date the qualified employee first becomes an "excluded employee;"
- the first date the employer's stock becomes readily tradeable on an established securities market;
- the five-year anniversary of the date the employee's right to the stock becomes transferable or not subject to substantial risk of forfeiture; or
- the date the employee revokes his or her Section 83(i) deferral election on the stock (at the time and in a manner to be determined in future guidance from the IRS).

The Section 83(i) election will not defer FICA or FUTA taxes and also may not defer state taxes in certain states.

Comment: In the event of an initial public offering, an employer's stock appears to become readily tradable, and therefore the tax deferral ceases, on the date of the first public sale and not the date a lock-up or similar restriction on transferring stock ends.

Comment: The amount of federal income recognized on the stock at the end of the deferral period is locked in at the time of exercise of the option or settlement of the RSU, as applicable. This is the case even if the value of the stock decreases during the deferral period. For example, employees who make a Section 83(i) election at option exercise likely cannot decide later to "unwind" their exercise to reduce their tax obligation if the value of the stock has dropped and may end up paying more in taxes

than they would have had they waited to exercise. Employers may want to consider potential employee reactions regarding these particular circumstances.

Comment: If no liquidity event (such as an initial public offering or a sale of the corporation) has occurred with respect to the employer's stock by the time the deferral period ends, then the benefits of the Section 83(i) election generally may consist only of the time value of money in delaying the tax payment by a few years and having some additional time to come up with the cash to pay the tax.

Next Steps

Employers should begin assessing whether they have an obligation to comply with Section 83(i)'s notice requirements to avoid incurring penalties. Under a transition rule, until the IRS issues guidance implementing the employer notice and 80 percent test provisions, employers may comply with those requirements under a reasonable good faith interpretation of the statute.

Employers wishing to enable their employees to take advantage of the Section 83(i) deferral opportunity should evaluate whether they wish to design their equity program to permit employees to make Section 83(i) elections in the future and begin planning early.

Section 83(i) provides a favorable, tax-deferral opportunity for rank-and-file employees. However, it likely will involve considerable administrative burden for employers to track eligibility, comply with the notice requirement, and properly report and withhold on deferred taxable income. Given the administrative complexities associated with Section 83(i), some employers may desire to avoid qualifying for Section 83(i) elections either by plan design or operation of the equity compensation program.

Many aspects of the Section 83(i) tax deferral opportunity currently are unsettled and we anticipate that the IRS will release guidance in the future that clarifies the deferral opportunity and the eligibility requirements. We look forward to guidance from the IRS for further clarity on various aspects of the new Section 83(i). However, no definitive timeline for the release of such guidance has been provided yet.

Please contact the [employee benefits and compensation team](#) at Wilson Sonsini to discuss if Section 83(i) impacts your equity compensation programs or tax reporting obligations, and if needed, to help with appropriate forms of Section 83(i) notice and election to send to employees.