

IRS Issues Guidance on the Deferral of Income from Private Corporation Stock Options and Restricted Stock Units

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On December 22, 2017, the Tax Cuts and Jobs Act (the “Act”) was signed into law. The Act added a new Section 83(i) to the Internal Revenue Code of 1986, as amended (the “Code”), pursuant to which certain employees of eligible private corporations could elect to defer income from stock options and restricted stock units for up to five years. The IRS recently provided initial guidance regarding Section 83(i) of the Code in Notice 2018-97 (the “Notice”) with respect to (i) the requirement that an eligible corporation must grant equity awards to at least 80% of its US employees, (ii) the mechanics regarding the withholding of federal income taxes on income from the deferral stock (including an escrow requirement) and (iii) confirmation that an eligible corporation may opt out of Section 83(i) of the Code. The Notice indicated that the Treasury Department and the IRS expect to issue regulations which will incorporate the guidance set forth in the Notice.

Background

Section 83(i) of the Code allows certain employees of eligible corporations to defer income from stock options or restricted stock units and this provision became effective for options exercised or restricted stock units which were settled after December 31, 2017.

Section 83(i)(3)(B) of the Code provides that certain employees of eligible corporations are not be permitted to make a Section 83(i) election, including: (i) 1% owners or individuals who were 1% owners at any time during the 10 preceding calendar years (or persons related to such owners); (ii) an employee who is or has been at any prior time, the chief executive officer or the chief financial officer of the company (or persons related to such employees); or (iii) one of the four highest compensated officers in a taxable year (or individuals who fell into such a classification in any of the 10 preceding taxable years).

Deferrals are permissible only with respect to stock issued by an eligible corporation. Section 83(i) of the Code provides that in order to qualify as an eligible corporation, (i) no stock of the corporation (or any predecessor or member of its control group (as defined under Section 414(b) of the Code)) was publicly-traded in any preceding calendar year, and (ii) the corporation must issue restricted stock units or stock options (which are more than de minimis) with the same rights and privileges in a relevant calendar year under a written plan to at least 80% of its full-time eligible employees providing services in the US

If an eligible employee makes a Section 83(i) election, recognition of the income will be deferred until the tax year that includes the earliest to occur of the following: (i) the first date the qualified stock becomes transferable, including, solely for this purpose, transferable to the employer, (ii) the date the employee first becomes an “excluded employee”, (iii) the first date on which any stock of the employer becomes readily tradable on an established securities market, (iv) the date five years after the first date the employee’s right to the stock becomes substantially vested or (v) the date on which the employee revokes his or her inclusion deferral.

Requirement of Awards Granted to 80% of All US Employees

As described above, Section 83(i)(2)(C)(i)(II) of the Code provides that in order for a private corporation to qualify as an “eligible corporation” for purposes of Section 83(i) of the Code, it must grant awards to not less than 80% of its eligible US employees. Practitioners had questioned whether this requirement would be applied based on awards granted only during the applicable calendar year or whether it could be applied on a cumulative basis, so that employees who were granted awards in prior calendar years would also be included in this coverage test. The Notice clarified that this determination is based solely on awards granted in the current calendar year, as application of the test on a cumulative basis is contrary to the language of Section 83(i) of the Code and is not a reasonable interpretation of the coverage requirement.

For purposes of this determination, the corporation must take into account the (i) total number of individuals employed at any time during the calendar year, and (ii) the total number of employees who received equity grants during the calendar year (excluding part-time employees for both (i) and (ii)). Individuals employed during the calendar year will be included in the calculation regardless of whether such individuals were employed at the beginning of the year or at the end of the year.

Federal Income Tax Withholding

Income from Deferral Stock is Subject to Income Tax Withholding. The Notice reiterated the provisions in the Act which indicate that the income from a Section 83(i) election is subject to federal income tax withholding at the maximum marginal income tax rate (which is 37% for 2019), without regard to withholding exemptions or other allowances claimed by the employee on his or her Form W-4, on the earliest date on which it is included in income pursuant to Section 83(i)(1)(B) of the Code. The corporation must make a reasonable estimate of the amount of income and determine the amount of withholding based on such estimate. No later than January 31 of the following year, the corporation must calculate the actual value of the stock on the applicable income inclusion date and report that amount on the employee’s Form W-2. To the extent that the corporation pays the withholding amounts using its own funds, it can recover the amount of such withholding it paid from the employee until April 1 of the year following the calendar year in which such income was recognized.

Escrow Requirement. Pursuant to authority provided to the IRS pursuant to Section 83(i)(3)(a)(ii) of the Code, the Notice also imposes an escrow requirement with respect to the stock subject to a Section 83(i) election . The Notice requires that:

1. The deferral stock must (a) be deposited in an escrow no later than the end of the calendar year in which the Section 83(i) election is made, and (b) remain in escrow until removed by the corporation (as described in point 2. below) or the corporation has recovered from the employee an amount equal to the requisite federal income tax withholding.
2. Between the date of the income inclusion pursuant to Section 83(i) of the Code and March 31 of the following year, the corporation may remove from escrow and retain a number of shares of deferral stock

with a fair market value equal to the amount of the income tax withholding obligation that the employee has not otherwise satisfied.

3. The remaining shares must be delivered from the escrow to the employee as soon as reasonably practicable after the corporation's income tax withholding obligations have been satisfied.

Employment Taxes Not Affected. The Notice also reiterated that a Section 83(i) election only affects the income tax associated with the deferred income and that FICA and FUTA taxation with respect to the deferral stock is not deferred.

To the extent that a corporation intends to grant awards intended to allow employees to make Section 83(i) elections, the escrow provisions in the Notice create another level of complexity that will need to be described to the employees when implementing the program in addition to the general mechanics of how the deferral elections operate.

Ability for an Eligible Corporation to Opt Out

Prior to the release of the Notice, some private corporations which did not wish to allow employees to make deferrals pursuant to Section 83(i) of the Code were concerned that their equity award practices would unintentionally satisfy the requirements Section 83(i) of the Code and create the opportunity for employees to make such deferrals.

As described above, a corporation could elect to not establish the escrow arrangement described in the Notice (which prevents an eligible corporation from inadvertently granting equity awards which would allow employees to make Section 83(i) elections). In addition, the Notice indicates that a corporation may also include specific language in the terms of the stock option or restricted stock unit award which indicates that no Section 83(i) election is permitted with respect to the grant.

Practical Considerations

While the Notice provides some clarity regarding certain provisions of Section 83(i) of the Code, the confirmation that the 80% coverage test applies only to grants which are made in a particular calendar year will make it more difficult for private companies to qualify as eligible corporations for purposes of Section 83(i) of the Code. Additionally, the escrow requirement imposes an additional burden on potentially eligible, private companies and it remains to be seen whether private companies will choose to try and comply with the requirements of Section 83(i) versus opting-out. For those private corporations that wish to opt-out, the Notice allows such companies to now update the requisite plan documents and award agreements to explicitly opt-out.

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