

Publications

IRS Issues Guidance on Deferrals of Private Company Equity Under Section 83(i)

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On December 7, 2018, the Internal Revenue Service (“IRS”) issued Notice 2018-97 (the “Notice”), addressing certain open issues under the new section 83(i) of the Internal Revenue Code (the “Code”), which was added to the Code last year by the Tax Cuts and Jobs Act. (For more information on the Tax Cuts and Jobs Act, please refer to our January 12, 2018 article at <https://www.groom.com/resources/tax-reform-series-iii-executive-compensation-provisions/>.) The Notice addresses several practical concerns commentators have raised regarding the operation of Code section 83(i), and provides helpful solutions.

Background

Generally, if an employer transfers employer stock to an employee as compensation, the employee must recognize income in the tax year in which the employee’s right to the stock is transferable or is not subject to a substantial risk of forfeiture (i.e., “vested”). While employees of publicly held corporations can sell shares to generate cash to pay income taxes due at vesting or exercise, the options for employees of private companies are more limited. In addition, compensation (including restricted stock unit (RSU) awards) paid under a nonqualified deferred compensation plan is subject to the requirements of Code section 409A, unless an exemption applies.

Under new Code section 83(i), private companies may now offer rank and file employees the opportunity to defer income tax on compensatory stock options or RSUs for up to five years, provided certain requirements are met. Importantly, such “83(i) deferrals” are exempt from Code section 409A.

These special deferral provisions only apply to “qualified stock,” which requires stock to be: (i) received in connection with the exercise of options or settlement of RSUs; and (ii) provided for an employee’s performance of services during a calendar year in which the corporation was an eligible corporation. A company is generally an “eligible corporation” if it is privately held and has a written plan under which at least 80% of all employees providing services to the company in the U.S. are granted qualified stock (the “80% requirement”). Current or former CEOs and CFOs (including their family members), 1% owners, and certain highly compensated

officers are “excluded employees” ineligible to make 83(i) deferrals.

Withholding at Maximum Rate

Perhaps the most significant guidance in the Notice relates to income tax withholding on qualified stock. The Tax Cuts and Jobs Act added section 3401(i) to the Code, which provides that qualified stock must be treated as “wages” for income tax withholding purposes when it is first includible in income under Code section 83(i). In addition, the Act added Section 3402(t) to the Code, which provides that qualified stock is subject to withholding at the maximum individual income tax rate (37% in 2018) and should be treated as a noncash fringe benefit for income tax withholding purposes.

The Notice clarifies that Announcement 85-113, which generally provides guidance regarding income tax withholding on noncash fringe benefits, applies to qualified stock. Thus, in accordance with Announcement 85-113, when qualified stock is treated as paid under section 3401(i), the employer must make a reasonable estimate of the value of the stock and make deposits of the amount of income tax withholding based on that estimate. Further, by the following January 31, the employer must determine the actual value of the stock as of the date it is includible in the employee’s income, and report that amount and the withholding on Form W-2 and Form 941. Notably, if the employer pays the income tax withholding from its own funds, the employer has until April 1 of the following year to recover the amount from the employee. The Notice clarifies that income tax on qualified stock must be withheld at the maximum income tax rate, without regard to the employee’s Form W-4.

Escrow Solution to Facilitate Withholding

The Notice also provides a mechanism that employers must use to collect employees’ income tax withholding obligation on qualified stock. Specifically, the Notice requires qualified stock to be held in escrow until the employer has recovered the applicable income tax withholding obligation from the employee. The Notice also provides that an employer may recover this tax from the employee by removing from escrow, and retaining, the number of shares of stock with a fair market value equal to the income tax withholding obligation. Under this method, the fair market value must be determined pursuant to the valuation rules for service recipient stock under the Code section 409A regulations.

Importantly, the Notice requires an employee to enter into the required escrow arrangement with the employer in order for the employee to be considered a “qualified employee” eligible to make 83(i) deferrals. The Notice indicates that an employer can thus “opt out” of offering 83(i) deferrals by declining to enter into the escrow arrangement with its employees.

Yearly 80% Requirement

Code section 83(i) requires at least 80% of all employees who provide services to a corporation in the United States must be granted stock options or RSUs in a calendar year “with the same rights and privileges” to receive qualified stock. The Notice clarifies that this 80% requirement is only met if at least 80% of these employees are granted stock options, or at least 80% of these employees are granted RSUs, in the same calendar year. In other words, options or RSUs granted in a prior calendar year cannot count toward the 80% requirement in a subsequent calendar year. The IRS clearly states that taking into account awards granted in a prior year would not be a reasonable good faith interpretation of the 80% requirement. In addition, the Notice indicates that for purposes of the 80% requirement, all employees employed at any time during the year and the total number of employees receiving grants during the year (excluding, in each case, excluded employees and part-time employees) must be included in the calculation, regardless of whether the employees are employed at the beginning or end of the year.

Next Steps

The IRS has indicated that it anticipates incorporating the guidance in the Notice into future regulations, and also indicates that these regulations may include more restrictive mechanisms to ensure income tax withholding compliance. However, the Notice provides that such regulations will apply only prospectively. Please contact any of the attorneys listed here or your regular Groom Law Group attorney for further information.