JOURNAL of PENSION BENEFITS

ISSUES IN ADMINISTRATION, DESIGN, FUNDING, AND COMPLIANCE

Volume 25 • Number 4 • Summer 2018

Ay, Ay, Ay, How Do You Comply with Section 83(i)—To Obtain Tax Deferrals on Qualified Equity Grants

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BY SCOTT E. GALBREATH

An analysis of the requirements of Code Section 83(i), enacted under the Tax Cuts and Jobs Act of 2017.

The Tax Cuts and Jobs Act of 2017 (the Act) added a new section to the Internal Revenue Code (Code)—Section 83(i) (83(i)). Section 83(i) allows employees who receive equity compensation from corporations whose stock is not readily tradeable on an established securities market (private corporation) the ability to defer the income tax on such equity compensation for up to five years.

This is an attempt to partly remedy the inequities of the income tax consequences of equity compensation between employees of private corporations, where there is no market to sell some of the stock to pay the income tax, and those of corporations whose stock is readily traded on an established securities market (public corporations). However, 83(i) is fraught with so many qualifications and limitations that its usefulness is a bit suspect. The number of employers that will provide such opportunities will likely be small due to the qualifications and onerous burden of compliance and administration. Still, under the right circumstances, 83(i) could be a useful technique for providing a broad base of employees the opportunity to share in the growth of the value of their employer corporation and to defer the income tax on receipt of the stock until a year when paying the tax is more feasible for the employee.

This article will examine the taxation of equity compensation without the 83(i) deferral election (which, in part, led to the enactment of 83(i)), the complex rules to qualify for deferral under 83(i), the issues presented by such rules, and where guidance is needed from the authorities.

Section 83 Taxation of Property Exchanged for Services

In order to understand the tax advantages provided by 83(i), it is important to understand how compensatory stock options are taxed. Options exchanged for services are taxed differently depending on whether they qualify as statutory options, also known as incentive stock options (ISOs), or non-statutory options (NSOs).

Code Section 83 generally provides that when an employee is compensated with property in exchange for services, the employee will be subject to income tax on the fair market value of the property in the year that the employee's right to the property is either transferrable or vested (not subject to a substantial risk of forfeiture). Thus, if a public corporation transferred 10,000 shares of stock to an employee as compensation on a day when the stock's value on the New York Stock Exchange was $1/share, the employee would have an additional $10,000 of compensation, which must be included in income. Additionally, such compensation would be considered wages for income tax withholding and employment tax purposes.

The employer corporation issuing the option generally is only allowed a deduction for the compensation when the employee includes the compensation in income.

Incentive Stock Options

ISOs have special tax advantages under Code Section 422, which delays the time the option or stock would ordinarily be taxed under Code Section 83. ISOs must satisfy certain requirements, including that: they may only be issued to employees; they must be exercised within 10 years of grant or expire and generally not more than three months after termination of employment; no more than $100,000 worth of stock (determined based on the fair market value (FMV) on the grant date) may first become exercisable by any employee in any one year; and they may not be granted to an employee who already owns more than 10 percent of the total voting power of the company unless the exercise price is at least 110 percent of the fair market value of the stock on the date of grant and the option expires after five years.

Unlike with NSOs under Section 83, an employee doesn't recognize income on the grant or exercise of an ISO. An employee is taxed only when the stock is sold. The gain recognized on the sale is long-term capital gain for a qualified disposition of the stock and ordinary income on any other disposition. A disposition is qualified if the stock was held for at least two years from the date of grant of the option and one year from the date of exercise. A cost of this favorable treatment for the employee is that the employer is not allowed a deduction for any compensatory element of the option. Despite these tax advantages of ISOs, their exercise can give rise to taxation under the Alternative Minimum Tax.

Non-Statutory Options

NSOs are options that do not meet the statutory requirements of the Code to be an ISO. This can be because they are not designed to be ISOs or because they are intended to be ISOs but do not satisfy Code Section 422 operationally. Regardless of the reason, NSOs do not qualify for the favorable tax treatment afforded to ISOs.

Instead, Code Section 83 governs the taxation of NSOs as transfers of property in connection with the performance of services. Taxation of the NSO depends on whether the option has "a readily ascertainable fair market value." On the grant to an employee of an NSO having "a readily ascertainable fair market value," the employee has gross income on the date of grant equal to the excess of the option's fair market value over the amount, if any, paid for it. The employee will not recognize income when the option is exercised, and the employee will have basis in the option equal to its fair market value on the date of grant (sum of income recognized on receipt of the option and any amount paid for the option). By contrast, Section 83 does not create a taxable event upon the grant of NSOs without "a readily ascertainable fair market value," which includes most options of private corporations. Instead, Section 83(a) applies to the stock transferred on exercise of the option. This means that the employee will have income on exercise of the option equal to the excess of the stock's fair market value over the exercise price. However, if stock is received subject to a substantial risk of forfeiture and is nontransferable, recognition and measurement of income is delayed until the forfeiture risk lapses or the property becomes transferable, whichever is earlier, unless the employee makes a Code Section 83(b) election to recognize the income at exercise. Thus, absent an election under Code Section 83(b) to recognize the income at exercise, an option to purchase restricted stock won't give rise to taxable income until the restrictions on transferability or forfeiture lapse.

Therefore, the grant to an employee of an NSO that has no readily ascertainable fair market value will not give rise to taxable compensation to the employee on the grant date. However, upon exercise of such option, the employee will have ordinary income of the fair market value of the stock over the exercise price paid for the stock (assuming the stock is not restricted). Such ordinary income will be considered supplemental wages for purposes of income tax and employment tax withholding. This causes the employee to have phantom income because the employee has taxable income, but no additional cash to pay the additional taxes or withholding. Therefore, the taxes and withholding would have to come from other wages, thereby reducing the employee's net cash pay.

For example, assume that a privately-held company grants an NSO to an employee in 2018 to purchase 1,000 shares of stock at the fair market value on the date of grant of $1.50/share. The employee has no additional income on the grant in 2018. If the employee exercises the option in 2019 and purchases the stock for $1,500 when the stock is worth $2.00/share, the employee will have $500 in taxable income, the difference between the fair market value of the shares of $2,000 and the amount paid for the shares, $1,500. This $500 of income is wages subject to income tax and employment tax withholding and is phantom income because the employee has not received any additional cash from which the taxes could be paid. Therefore, in addition to the exercise price the employee has the cost of paying taxes on $500 to acquire the stock.

If a public company issues NSOs to its employees, the tax consequences are the same except, in that case, the employee has an open market in which to sell some of the stock upon receipt from exercising the option in order to pay the taxes.

Restricted Stock Units

A Restricted Stock Unit (RSU) is a grant of a right to receive stock (or the cash value of such stock) in the future upon some occurrence such as reaching a performance goal, staying with the employer for a number of years, or the occurrence of a triggering event such as a change in control. RSUs are taxed when they are settled (*i.e.*, paid). If they are settled in stock, the employee will have income equal to the fair market value of the stock on the date of settlement. As with options, this amount is wages for tax and withholding purposes. Again, this creates phantom income, as the employee has only received stock and no additional cash to pay the taxes. If the employer is a public corporation, the employee can sell some of the stock on the public market once received, to have cash to pay the additional taxes. However, an employee of a private corporation has no such option.

Like an NSO, if the underlying stock received from settling the RSU is itself not transferrable or vested upon receipt, tax is deferred until the earlier of when the stock vests or becomes transferrable unless the employee makes a Code Section 83(b) election to recognize income earlier. Again, the employer does not get an income tax deduction until the employee has income.

Section 83(i) Qualified Equity Grant Plans

Many private corporations, especially Silicon Valley tech start-ups, like to attract talented employees by offering employees equity in the venture either through NSOs or RSUs. However, as explained above, Code Section 83 creates phantom income when the stock is received, if it is vested. This means that the employees have to pay the tax from other income and the withholding of income and employment taxes must come from other wages. This can create significant cash flow hardships for the employee.

The Act added 83(i) to offer private corporations the ability to structure NSO or RSU arrangements in a way that will give employees up to five years to pay the resulting income tax due from the exercise of an NSO or settlement of an RSU, which may alleviate the economic hardship that can result from the phantom income explained above. Code Section 83(i) provides that certain "qualified employees" receiving "qualified stock" from a "qualified equity grant" can elect to defer the inclusion in income and resulting income tax that normally occurs upon the receipt of stock resulting from the exercise of NSOs or settling of RSUs. In addition, if the election is made, the capital gain holding period begins to run on the date the stock is received by the employee, even though the employee's income tax is deferred. It is important to note that the 83(i) election does not defer employment taxes (Social Security and Medicare).

Qualified Stock

Qualified stock is stock in the employer received in connection with the exercise of a stock option (an ISO or an NSO) or settling of an RSU granted to a "qualified employee" in exchange for services by the employee during a calendar year when the employer is an "eligible corporation." [Code § 83(i)(2)(A)] However, stock will not be qualified if the employee can sell the stock to the company or receive cash in lieu of stock upon the stock becoming vested or transferrable. [Code § 83(i)(2)(B)] An employer is an eligible corporation for a calendar year if none of its stock is tradeable on an established securities market and during that calendar year the corporation makes grants under a written plan:

1. That provides for the granting of options or RSUs to acquire qualified stock;
2. Under which grants are made to at least 80 percent of the employer's non-excluded U.S. employees in the calendar year (80% Test) [Code § 83(i)(2)(C)]; and
3. Under which all grantees have the same rights and privileges to acquire qualified stock. [Code § 83(i)(2)(C)(ii)]

For purposes of the 80% Test, neither part-time employees who customarily work less than 30 hours per week nor excluded employees as defined below are counted. [Code § 83(i)(2)(C)(iii)] Also, the controlled group rules of Code Section 414(b) apply, making all employees of a controlled group of corporations count as being employed by one employer. [Code § 83(i)(5)] The company must grant 80 percent of the non-excluded U.S. employees options, RSUs, or a combination of both. [Code §§ 83(i)(2)(C)(i)(II) and (III)] However, the company could not grant 40 percent of its non-excluded U.S. employees only stock options and 40 percent of its non-excluded U.S. employees only RSUs, because RSUs and options are considered to have different rights and privileges. [Code § 83(i)(2)(C)(ii)(III)] Grantees will not be considered to have different rights and privileges to acquire the qualified stock because the number of shares each grantee can acquire is not equal, provided all grantees have the right to acquire more than a *de minimis* amount of stock. [Code § 83(i)(2)(C)(ii)(II)] Under a transition rule, for grants made before 2018, the 80% Test is applied without regard to whether grantees have the same rights and privileges to acquire stock. [Code § 83(i)(2)(C)(iv)]

Qualified Employees

Only qualified employees may make the Section 83(i) election. A qualified employee is any employee in the United States who normally works more than 30 hours per week and is not an excluded employee. Excluded employees are:

1. A one percent or more owner of the employer during the calendar year of the election or in one of the 10 preceding calendar years;
2. One who has ever been or acted in the capacity of CEO or CFO;
3. A spouse, child, grandchild, or parent of an individual listed in any of the above; or
4. One who is among the four highest paid officers of the corporation for the current taxable year and 10 preceding taxable years. [Code § 83(i)(3)(10)]

Thus, a qualified employee's promotion to CEO, CFO, or one of the four highest paid officers before the end of the deferral period will eliminate the ability to make an 83(i) election (and if the election has already been made, result in immediate taxation). Similarly, the employee acquiring more than one percent of the employer's stock from other sources (or from the exercise of other NSOs or settlement of other RSUs during the deferral period) or the employer going public will also eliminate the employee's ability to make an 83(i) election (and if the election has already been made, result in immediate taxation). It is important to note that excluded employees can still participate in the plan and be granted stock options or RSUs; they just don't qualify to make the 83(i) election and get the income tax deferral.

83(i) Election. The qualified employee must make the 83(i) election within 30 days of the date the employee's right to the qualified stock becomes vested or transferrable, whichever occurs first. The Code states that the election is to be made in the same manner that an election to be taxed in the year of transfer under Code Section 83(b) is made. [Code § 83(i)(4)(A)] Code Section 83(b) allows a taxpayer to elect to be taxed on the fair market value of non-vested property exchanged for services in the year of transfer as if it were fully vested, allowing future appreciation of the property to be tax deferred. A Code Section 83(b) election is made by filing a statement with the IRS that contains specific information about the property transferred and providing a copy to the employer. [Treas. Reg. § 1.83-2(c)] The IRS will have to issue more guidance on exactly what information should be contained in the 83(i) election.

However, no 83(i) election can be made by a qualified employee with respect to the qualified stock if: (1) the employee has filed an election under Code Section 83(b) with respect to the grant; (2) any stock of the employer is readily tradeable on an established securities market before the date of the election; or (3) the employer corporation redeemed any of its stock in the calendar year before the qualified stock of the employee becomes taxable (absent the 83(i) election) unless at least 25 percent of the value of all such redeemed stock was stock for which an 83(i) election had been made and the determination of which qualified stock was redeemed was made on a reasonable basis. [Code § 83(i)(4)(B)] This 25 percent redemption rule will be deemed met if the corporation redeems all stock for which an 83(i) election has been made. If an employee has made two or more 83(i) elections, the stock must be redeemed in order of the 83(i) elections beginning with the earliest election (*i.e.*, the election that has been in place the longest) if the company desires to count the redemption toward the 25 percent test, described above. Further guidance on this point would be helpful.

Effect of Election. If the 83(i) election is made, then the income that would have been taxed under Code Section 83 will not be taxed until five years after the date income would otherwise be taxable. [Code § 83(i)(1)(B)(iv)] However, other events can make the income from the stock taxable if occurring earlier. The stock will be taxable upon any of the following events if they occur prior to the end of the five-year deferral period:

1. The stock becomes transferrable (including to the employer);
2. The employee becomes an excluded employee;
3. The stock becomes readily tradeable on an established securities market; or
4. The employee revokes the 83(i) election.

[Code § 83(i)(1)(B)]

The ability to revoke the 83(i) election creates an interesting planning opportunity by allowing the employee to choose the year to pay the tax before the end of the five-year deferral period. If the employee receives extra cash from a bonus or other activity during the deferral period, he or she could revoke the election and pay the tax on the stock when he or she is better able to afford it. Likewise, if the employee is in a low tax year due to reduced income or incurring a loss, the employee could revoke the election and pay the tax in a year when his or her marginal tax rate is lower than normal, thus saving money.

Presumably an election would be revoked in a similar fashion as the election is made, by filing a statement of revocation with the IRS and delivering a copy to the employer. However, guidance is needed.

Employer Notice. Upon the transfer of the qualified stock to the qualified employee, the employer must provide a notice to the employee. [Code § 83(i)(6)] The notice must: (1) certify that the stock is qualified stock; (2) notify the employee that he or she may be eligible to elect to defer taxation of the income on such stock; (3) state that if an election is made, then (a) the income recognized after deferral will be based on the value of the stock when the employee's right to the stock vests or becomes transferrable even if the value diminishes and (b) when the income is so recognized, there will be corresponding income tax withholding obligations at the rate required by Code Section 3402(t); and (4) set forth the employee's obligations to ensure satisfaction of the corporation's withholding obligations (both for income tax at the end of the deferral period and Social Security and Medicare Taxes upon exercise of the option or settlement of the RSU) regarding the stock. [Code § 83(i)(6)(B)]

The fact that the 83(i) election only defers income tax means that the NSO and RSU transactions still give rise to phantom income for Social Security and Medicare tax purposes. For employees who earn over the Social Security Taxable Wage Base ($128,400 in 2018), only the 1.45 percent unlimited Medicare tax would have to be paid from other wages. However, for those earning under the Social Security Taxable Wage

Base, an additional 6.2 percent, for a total of 7.65 percent for any additional income up to the Social Security Taxable Wage Base, must be withheld from other wages. Of course, the employer also has a matching employer FICA contribution.

An example will help illustrate how the deferral works:

> Assume that EC, Inc. (EC) is a private corporation whose 500,000 shares of stock are owned by Eric, and he is planning on selling the corporation or going public in five years. EC has five non-excluded full-time U.S. employees in 2018: Layla, Derek, Ginger, Jack, and Bruce. All employees are qualified employees, and each is granted 10,000 RSUs, representing the right to receive 10,000 shares of stock with a value of $1/share that will vest if the employee is still employed with EC on December 31, 2020, and will be settled in stock that is not transferrable upon that date. On December 31, 2020, the RSUs vest and the employees receive their shares of stock when the value is $2/share. On January 15, 2021, Layla files the 83(i) election to defer the income of $20,000 from 2020 to 2025.
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> In 2025, Layla will have ordinary income of $20,000. Any appreciation in value from 2020 to 2025 will be taxed as long-term capital gain when Layla sells the stock. If the fair market value of EC in 2025 was only $.50/share, Layla would still have ordinary income of $20,000. Note that if only Layla, Derek, and Ginger were granted RSUs in 2018, EC would not be an eligible corporation, because only 60% of the non-excluded full-time U.S. employees were granted RSUs.
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> Now, if EC went public in 2021, and shares opened trading at $10/share, Layla (and the other qualified employees) would pay tax in 2021 on the $20,000 of ordinary income and could sell some of the stock at $10/share to have cash to pay the tax.
>
> Likewise, if, instead of going public, Eric agreed to sell all of his stock in a stock transaction, and drag along the remaining shareholders, for $10/share in 2021, Layla and the other qualified employees would sell their 10,000 shares for $100,000 and have $20,000 in ordinary income and $80,000 of long-term capital gain.

Conclusion

It remains to be seen how popular the new qualified equity grant plans will be with employers. An interesting twist on the new law is that a qualified employee who is granted and exercises an ISO can make a section 83(i) election and convert the ISO to an NSO with the tax deferral, provided all other rules under section 83(i) are met. In this case, the employee does not get the benefit of the tax advantages of an ISO and would recognize income on the exercise subject to the deferral under the 83(i) election. This would be useful for a qualified employee to avoid the Alternative Minimum Tax on the exercise of the ISO.

Another interesting effect is that even if an employer never intended a grant to be a qualified equity grant, it appears that the company would still have an obligation to give the employee an 83(i) notice if the grant meets the definition of a qualified equity grant. Thus, it seems that any plan of the employer providing equity to employees that meets the 80% Test would require the employer to provide qualified employees with the Section 83(i) notice. This adds to the administrative burden of the employer.

Equity compensation is often reserved for key employees and executives of an employer. The 80% Test for the 83(i) election may very well limit its usefulness. Despite the poor tax results of phantom income for employees of private corporations, employers may prefer the ability to grant the NSOs or RSUs to fewer employees rather than maintain a qualified equity grant plan. Additionally, the increased burden of monitoring the operation of the qualified equity grant plan to determine the eligibility for the election and providing the notice to employees receiving stock could deter employers from adopting such plans.

Still, under the right circumstances, a qualified equity grant plan could be advantageous for an employer expecting to go public or to be acquired within a five-year period of time and wanting most employees to benefit from the transaction. Employees who receive qualified stock and make the election will have five years to cash in on the big transaction before having to pay income tax on the value of the stock received. ■