IRS Issues Initial Guidance on Deferral of Private Company Equity Awards

On December 7, 2018, the Department of the Treasury and the Internal Revenue Service issued Notice 2018-97, their initial guidance on Section 83(i) of the Internal Revenue Code, the provision allowing for the deferral of income from the exercise of stock options or the vesting of restricted stock unit ("RSU") awards granted by certain private companies. Section 83(i) was added by the Tax Cuts and Jobs Act of 2017 (the "Tax Act").

This guidance addresses three key questions that have arisen concerning the operation of Section 83(i):

- The application of the requirement that awards must be granted to not less than 80% of all employees who provide services to the company in the United States;
- The application of federal income tax withholding to the deferred income arising in connection with a stock option exercise or RSU award settlement; and
- The ability of a company to opt out of permitting employees to elect the deferred tax treatment even if all the requirements of the provision are otherwise met.

This Thoughtful Pay Alert summarizes the requirements of Section 83(i) and the recent guidance, and offers our initial observations on its potential impact on private companies.

Background

The Tax Act added Section 83(i) to the Internal Revenue Code to enable eligible employees of private companies who exercise certain stock options or vest in certain RSU awards to postpone income taxation from such transaction for up to five years. This tax deferral treatment applies to stock options that are exercised and RSU awards that are settled after December 31, 2017.

Section 83(i) is intended to address an issue that has plagued many technology and life sciences companies that have yet to develop a public market for their stock, which precludes their employees from selling shares following a stock option exercise or the vesting of an RSU award to pay the taxes (and exercise price costs, potentially) associated with such event. By allowing employees to defer the payment of the income taxes that otherwise must be withheld at the time of exercise or vesting, the provisions relieves much of the pressure that they otherwise face in the absence of liquidity for their shares. This problem has only gotten more acute in recent years as many private companies have delayed their initial public offering, either because they have raised sufficient capital to fund their ongoing operations or to avoid the regulatory burdens of public company status.

Nonetheless, compliance with Section 83(i) is not easy and many aspects remain unclear even under the new IRS guidance. The provision contains numerous technical requirements that must be satisfied in order to take advantage of its deferral opportunities. Further, until now, the precise application of various aspects of the provision have been unclear, thereby forcing companies to proceed cautiously in the absence of specific guidance as to their operation. The recent guidance is a welcome first step to helping companies understand the intended scope and operation of the provision.

Section 83(i) – Technical Requirements

Section 83(i) allows the employees of private companies who, beginning in 2018, acquire stock in their company either through the exercise of a stock option or the settlement of an RSU award to elect to defer paying income taxes on such transaction for a period of up to five years from the date the rights of the employee in the stock are transferable or no longer subject to a substantial risk of forfeiture (essentially, when the stock is vested), or until the earliest to occur of the following events:

- The date the stock becomes transferable (including to the company);
- The date the employee is no longer a "qualified employee" eligible for the deferral;
- The date the stock becomes readily tradable on an established securities market (such as in an IPO); or
- The date the employee revokes the deferral election.

The amount of income that must be recognized by an employee at the end of the deferral period is the income that would have otherwise been recognized at the time the stock option was exercised or the RSU award vested.

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Although this sounds straightforward, the prescriptive definitions that govern the provision limit its scope – and, potentially, its utility.

Qualified Employee

The group of employees who are eligible to take advantage of the deferral election provided by Section 83(i) is defined as any employee who is not an "excluded employee." For these purposes, an excluded employee is defined as:

- a 1% owner of the company at any time during the year of grant or during the preceding 10 calendar years;
- the current or a former CEO or CFO of the company;
- a family member of such a CEO or CFO; and
- one of the four highest compensated officers of the company (as determined under the SEC's executive compensation disclosure rules) for the year of grant or any of the preceding 10 taxable years.

Qualified Stock

The stock that is eligible to be subject to a deferral election includes stock received upon the exercise of a stock option or the settlement of an RSU award that was granted to a qualified employee by an "eligible corporation" in connection with the performance of services as an employee. If the employee may sell such stock to, or otherwise receive cash in lieu of stock from, the company at the time of exercise or settlement, then such stock is not considered to be "qualified stock," (Presumably, this would include a "net exercise" or vesting transaction where a portion of the shares that would otherwise be received are withheld to satisfy the tax liability associated with the transaction).

Eligible Corporation

The stock option or RSU award for qualified stock must be granted by a company that doesn't have any stock that is readily tradable on an established securities market (and has never had such readily tradable stock) and has a written plan under which, during the year of grant, at least 80% of its U.S. qualified employees were granted stock options or RSU awards in more than a de minimis amount with the same rights and privileges. For this purpose, the determination of rights and privileges with respect to the shares of stock is to be made using the same rules that apply to employee stock purchase plans under Section 423 of the Internal Revenue Code.

Notice and Reporting Requirements

Where the requirements for a deferral election exist, a company must notify its qualified employees of the tax deferral opportunity on or prior to the vesting date for an eligible stock option or RSU award. Companies that fail to provide the required notice are subject to a monetary penalty of $100 per notice up to a maximum penalty of $50,000 per year. Further, where an employee makes a deferral election, the company must report on the employee's Form W-2 the income amount covered by the election for both the year of deferral and the year the employee actually recognizes income.

The Initial IRS Guidance

Notice 2018-97 addresses three specific issues: the 80% requirement, the federal income tax withholding requirement on the deferred income, and a company's ability to opt out of Section 83(i).

The 80% Requirement

As described above, a company is not an "eligible corporation" that may grant stock options and RSU awards that are eligible for a deferral election unless, in any calendar year, it grants stock options or RSU awards with the same rights and privileges to at least 80% of its qualified employees in the United States. Questions have arisen as to whether, for purposes of the 80% requirement, stock options or RSU awards granted in a prior year may be counted toward the cumulative total of options or awards considered granted in a given calendar year.

The IRS guidance takes a narrow reading of the statutory language, providing that the determination of whether a company is an eligible corporation must be made on a calendar year basis, and, therefore, whether a company has satisfied the 80% requirement is based solely on stock options and RSU awards granted in that calendar year to employees who provide services to the company in the U.S. Further, in calculating whether the 80% requirement has been satisfied, a company must take into consideration the total number of individuals employed at any time during the year in question as well as the total number of employees receiving awards during the year, regardless of whether the employees were employed at the beginning or end of the calendar year.

Observations: Although Section 83(i) is intended to promote broad-based employee ownership while solving the liquidity issue that confronts employees receiving equity in a private company, the 80% requirement sets a high threshold where companies do not have a regular practice of granting regular equity awards (such

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as "refresh" grants) to their workforce. For example, a company may have granted equity awards to fully 100% of its employees, but if those awards are scattered across several years, it will not satisfy the 80% requirement. In addition, it's not entirely clear when awards will be considered to have the same rights and privileges. While Section 83(i) indicates that the awards can be for different numbers of shares, it is unclear whether all of the other terms and conditions, such as vesting, must be the same.

Withholding Tax Requirements

Section 83(i) contemplates not only the deferral of the income taxes arising from the exercise of a stock option or settlement of an RSU award but also the income tax withholding obligation associated with the transaction. Such withholding must be made, however, for the taxable year in which the deferral period ends.

The IRS guidance sets forth how the income tax withholding requirements are to be satisfied when the deferral ends. Specificaly, the IRS guidance specifies that companies must establish an escrow arrangement to hold the shares subject to the tax deferral until such time as the deferral ends to ensure that a company's statutory withholding obligations are met. Thus, the guidance provides that to be a "qualified employee," an individual making a Section 83(i) election with respect to qualified stock must agree in the election that all shares to be deferred will be held in an escrow arrangement that satisfies certain conditions.

Observations: Given the potential for deferrals as long as five years, it's not surprising that the IRS would want to establish a clear procedure for how the withholding of income taxes is to be accomplished once a deferral ends. The likelihood that the employee may be difficult to locate at that time or not be in a position to meet the associated withholding obligation (particularly if the stock remains illiquid) are two potential scenarios that explain the use of an escrow arrangement of the deferred shares. While this at least puts the company in the position of being able to sell or retire the shares needed to satisfy the applicable withholding requirement, it creates an additional administrative burden which will need to be evaluated to determine whether to offer employees the opportunity for income tax deferral under Section 83(i).

Opting Out of Section 83(i)

Section 83(i) has been drafted in such a way that a company may find itself unintentionally satisfying the conditions that would be necessary for employees to make deferral elections, inadvertently putting itself at risk for monetary penalties if it fails to comply with the provision's employee notice, escrow, and communication requirements. Questions have arisen as to whether there are specific ways that companies may disqualify themselves from Section 83(i) coverage.

The IRS guidance provides that a company may preclude its employees from making Section 83(i) elections by declining to establish the share deferral escrow arrangement that is required to satisfy withholding tax obligations. They may also avoid Section 83(i) coverage by deliberate non-compliance with any of the other technical requirements of the provision that would give rise to employees having the ability to make deferral elections.

Observations: Most small private companies are likely to find the employee notice and communication requirements of Section 83(i), along with the ongoing monitoring necessary to ensure that income is properly recognized in a future year to be distinct drawbacks of the provision. In addition, some private companies may also have already established mechanisms to provide key employees with ongoing liquidity opportunities prior to a potential IPO. Thus, having a clearly acceptable way to avoid unintentional compliance with the provision should provide some comfort to companies that they will not fall within the ambit of Section 83(i) until they are prepared to embark on a program of deferral elections for their employees. The IRS has also made clear that if a company does not intend to create conditions that will allow its employees to make Section 83(i) deferral elections, the terms of its stock option or RSU awards may provide that no election under Section 83(i) will be available with respect to the shares received upon the exercise of the stock option or settlement of the RSU award.

Need Assistance?

Compensia has significant experience in helping companies understand and address ISS' corporate governance and executive compensation policies. If you have any questions on the topics covered in this Thoughtful Pay Alert or would like assistance is assessing how the policies are likely to affect your executive compensation program, please feel free to contact Jason Borrevik at 408.876.4035 or Mark A. Borges at 415.462.2995.■

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