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ERISA AND EMPLOYEE BENEFITS ATTORNEYS

One Embarcadero Center, 12th Floor
San Francisco, California 94111-3617
Tel: (415) 788-3111
Fax: (415) 421-2017
Email: info@truckerhuss.com

633 West 5th Street, 26th Floor
Los Angeles, California 90071-2053
Tel: (213) 537-1016
Fax: (213) 537-1020

www.truckerhuss.com

# New Section 83(i) of the Internal Revenue Code — Qualified Equity Grant Programs Permit Employees to Elect to Defer Income Taxes on Stock Options or RSUs

J. MARC FOSSE AND
ANGEL L. GARRETT

New section 83(i) of the Internal Revenue Code (the "Code") permits eligible private corporations[1] to adopt qualified equity grant plans for issuing stock options or restricted stock units (RSUs) to eligible employees to obtain "qualified stock" (as defined below) in exchange for the performance of services. Qualified equity grants provide employees with two distinct tax preferences. First, when an employee vests in a qualified equity grant, the employee can elect to defer for up to five years the income taxes that otherwise would be due on the date the stock vests or is transferred to the employee. The amount that would normally be taxed under Code section 83(a) at the time of transfer of vested employer stock is the fair market value of the stock, less any amount paid for the stock. Second, when an employee makes a Code section 83(i) deferral election, the "deferral stock" begins its holding period for long-term capital gain tax treatment on the date the qualified stock is transferred to the employee, even though the employee will not pay taxes on the value of the qualified stock for up to five years. The long-term capital gain holding period and the deferral period can run concurrently. The term "deferral stock" means stock that is taxed pursuant to the tax deferral provisions of Code section 83(i).

In this alert, we explain why qualified equity grants can be a helpful tax strategy for employees and an excellent recruiting, retention and incentive program for employers. We then review the statutory requirements for establishing a qualified equity grant program for eligible employees of an eligible corporation.

## Traditional Code Section 83 Treatment

To understand the benefits of a Code section 83(i) election, it is important to first understand what a Code section 83(b) election is and why only a limited number of taxpayers can use that election to obtain a tax advantage. Code section 83(a) states that if a taxpayer receives transferred property in exchange for the performance of services, the value of that property is included in taxable wages of the taxpayer when the property is either transferable or vests — i.e., is no longer subject to a substantial risk of forfeiture. A substantial risk of forfeiture exists when the taxpayer must continue providing substantial services to the employer for a specific period of time to avoid a forfeiture of the transferred property. Property is generally transferable when it can be sold (or assigned, pledged, hypothecated, etc.) by the employee to a third party. The effect of Code section 83(a) is that an employee will not be treated as the owner of employer stock until it vests. This means that all the stock appreciation between the date of an equity grant and the date of vesting will be treated as wages taxable at the individual marginal tax rates. Because individual tax rates are significantly higher (the top rate is 37%) than long-term capital gain rates (the top rate is 20%), an employee will generally pay more taxes when the stock appreciation is taxed at ordinary income rates.

Under Code Section 83(b), a taxpayer can make an election within 30 days of the date the unvested employer stock is transferred to him or her to pay tax on the fair market value of that stock (less any amount paid for it) at ordinary income tax rates. The fair market value of the stock is determined on the date it is transferred to the employee. Once an 83(b) election is made, it is irrevocable, and the employee must pay the applicable income taxes. Any subsequent appreciation of the employer stock during the vesting period will be taxed at capital gains rates when the stock is sold by the employee. The holding period for long-term capital gains treatment also begins on the date the stock is transferred, if an 83(b) election is made.

While an 83(b) election can provide tax advantages, at private companies this election is helpful for only a limited number of employees — namely, the employees who have the funds to pay taxes out of pocket on stock that is not readily tradable on an established market. Consider the following example: Assume a vice president–level employee at a privately owned corporation is granted a restricted stock award for 10,000 shares of stock with a fair market value per share of $1 on the date of grant, which will vest if the employee continues working for the corporation for four years. In addition, the employer stock is not transferable and there is no readily available market for the stock. To make an 83(b) election, the employee would need to have the funds immediately available to write the employer a check to cover the employer's income and employment tax withholding obligation on the $10,000 value of the award. If the employee does make the 83(b) election, the employee would pay taxes on $10,000 of ordinary income for the year of grant and then pay taxes on any increase in value at capital gains rates when the employee sells the stock in the future. If an 83(b) election is not filed, and the fair market value of the shares grows to $5 per share during the vesting period, then the employee would owe taxes (and the employer would be required to withhold income and employment taxes) on the $50,000 value of the shares on the date of vesting. At first glance, it may appear great that the employee has stock valued at $50,000, but the rub is that these are shares in a private corporation with no market to sell the shares. Unless this employee has really skyrocketed up the corporate ladder, he or she probably does not have the funds readily available to pay the taxes due on $50,000 of non-transferable and non-marketable employer stock. The employer also is up the creek without a paddle because the employer has income and employment tax withholding obligations that cannot be satisfied by selling a portion of the vested shares. This is one reason why many startups issue stock options, instead of restricted stock or RSUs: Employees can wait to exercise the stock option until the employer's stock can be sold on a securities exchange, or in a corporate transaction, when the employee can sell shares to cover the related income and employment taxes.

## Code Section 83(i) Elections to the Rescue?

To illustrate the potential value of qualified equity grants and making an 83(i) election, let us analyze the tax consequences of the example above if the startup vice president had been granted qualifying RSUs for 10,000 shares of employer stock which vest after four years. In year four, the vested 10,000 shares are still worth $50,000. If the vice president makes an 83(i) election within 30 days of the date the RSUs vest, then the $50,000 value of the employer stock transferred to the employee (assuming the transfer date is the same date as the vesting date) would be deferred for up to five years. By making a timely 83(i) election, the startup vice president does not have to pay any money out of pocket at the time of vesting. Five years is a long time in startup land for a liquidity event (sale, IPO, merger, etc.) to occur and put cash in the employee's pocket to pay the taxes. Also, if during the five-year period the value of the stock increased to $20 per share (or $200,000), the employee would only pay ordinary income taxes on the deferred amount of $50,000 and would pay long-term capital gains rates on the remaining $150,000 in value.

There are still some potential downside issues to consider when making an 83(i) election, which are very similar to the issues a person must consider when making an 83(b) election. First, even if the value of the deferral stock decreases in value during the deferral period, the amount of income taxes due on the deferral stock at the end of the deferral period will still be based on the value when the 83(i) election was made. In the example above, if the vice president makes an 83(i) election when the value of the qualified stock is $50,000, and during the deferral period the value of those shares decreases to $30,000, the employee will still owe income taxes on $50,000 at the end of the deferral period. The employee might be able take a loss deduction in the year the shares are sold, but the employee will still include the $50,000 in income when the deferral period ends. Second, Code section 83(i) only defers income taxes, it does not defer employment taxes. When an employee makes the deferral election, the employee will still be responsible for paying (and the employer will be responsible for withholding) Social Security and Medicare taxes.

## Who Can Make Qualified Equity Grants?

An "eligible corporation" is (1) a privately held company (i.e., no stock is traded on an established securities market), (2) that has a written plan that provides stock options or RSUs, to acquire "qualified stock," (3) to at least 80% of its employees in the United States, (4) with the same rights and privileges under the plan as required under Code section 423(b)(5) for qualified employee stock purchase plans. However, employees will not be treated as having disparate rights and privileges under a qualified equity grant plan solely because: (a) the number of shares of qualified stock granted to all employees is not the same, as long as the amount granted to any eligible employees is not de minimis, or (b) the rights and privileges with respect to the exercise of an option are not the same as the rights and privileges for the settlement of a RSU. Unlike a tax-qualified employee stock purchase plan or incentive stock options, an eligible corporation cannot choose whether to provide qualified stock grants to its parent or subsidiary employees. An eligible corporation includes all parent and subsidiaries that would be treated as a single employer for purposes of Code section 414(b). Based on this definition, qualified equity grants must be provided to 80% of all employees who provide services in the United States or its possessions for any member of the corporation's controlled group of companies for federal corporate tax purposes.

## Who Is Eligible to Receive Qualified Equity Grants and Make an 83(i) Election?

A "qualified employee" is eligible to receive a qualified equity grant and can make an election under Code section 83(i) to convert qualified stock into deferral stock. The term "qualified employee" is defined as an employee who is not an "excluded employee." An excluded employee is an employee who:

- Has been a one-percent owner at any time during the calendar year or during the ten preceding calendar years;
- Has been at any time the chief executive officer or chief financial officer, or an individual acting in either capacity;

- Is a spouse, child, grandchild or parent of any individual listed in the two categories above; or
- Is one of the four highest compensated officers of the company for the taxable year or for any of the ten preceding taxable years.

Based on this definition, a qualified equity grant may not be awarded to an independent contractor. Also, other than the exclusions above, Code section 83(i) does not provide for any classes of employees that can be excluded from participating in the plan (such as the classes under Code section 423 for a tax-qualified employee stock purchase plan). Instead, if at least 80% of eligible employees are not granted an award under the plan, then the employer will also not be treated as an eligible corporation. It appears that employers have full flexibility to define which employees will be excluded from the plan, as long as no more than 20% of the eligible employees of the US corporation are excluded.

## What Is Qualified Stock?

Under the Code section 83(i), "qualified stock" is stock of an eligible corporation that is received in connection with the exercise of a stock option or in settlement of an RSU. The option or RSU must have been granted by the employer in connection with the employee's performance of services during the calendar year in which the corporation was an "eligible corporation." Moreover, the stock is not considered "qualified stock" if the employee can sell the stock to the company or receive cash in lieu of stock when the employee's right to such stock becomes transferable or not subject to a substantial risk of forfeiture (i.e., vested).

## How to Make an 83(i) Election

If a stock option or RSU meets all the conditions to be a qualified equity grant, an eligible employee must proactively choose to defer the tax associated with the qualified stock within 30 days of the first date the employee's rights to the qualified stock are transferable or are vested, whichever comes first. Moreover, this election is to be made in the manner similar to that under Code section 83(b), which requires the taxpayer to send an election to the IRS and provide a copy to the employer. Based on this requirement, it appears that the information in an 83(i) election would be similar to the information that must be provided in a valid 83(b) election. Until the IRS provides additional guidance, an 83(i) election should be accepted by the IRS as long as the employee made a reasonable good faith effort to provide an election similar to an 83(b) election. However, the IRS has been very strict about complying with the 30-day requirement for 83(b) elections and we would recommend that employees do not test the IRS on this 30-day deadline for 83(i) elections. Furthermore, unlike an 83(b) election, an 83(i) election is revocable at any time after it is made.

An employee may not make an election under section 83(i) if he or she has made a section 83(b) election with respect to the qualified stock. This deferral election is also not available if the company has repurchased any of its outstanding stock in the year before the date the employee's rights to the qualified stock are transferable or vested, unless at least 25% of the total dollar amount is "deferral stock" (i.e. stock that was elected to be deferred under section 83(i)), and the determination of which individuals from whom such stock is purchased is made on a reasonable basis. However, these two conditions — the 25% requirement and determination of whom the stock is purchased from – shall be treated as met if the employer purchases all outstanding deferral stock. Employers are also required to report on their tax returns the total dollar amount of their outstanding stock purchased during the calendar year.

## What Is the Effect of Making an 83(i) Election?

If an eligible employee has a stock option or RSU to acquire qualified stock, the employee can make an 83(i) election to convert the qualified stock into "deferral stock" within 30 days of the date when the stock option or RSU vests. If an employee elects to acquire deferral stock, the deferral stock is taxed as follows:

1. The fair market value of the deferral stock on the date the deferral stock is transferred to the employee (less any amount the employee paid for the deferral stock) will not be taxed until the first to occur of the following events:

- The first date the deferral stock becomes transferable (including to the employer),
- The date the qualified employee first becomes an "excluded employee,"
- The first date the corporation's stock becomes readily tradable on an established securities market,
- Five years after the first date the employee's qualified equity grant vests or becomes transferable, whichever is earlier, or
- The date the employee revokes his or her election with respect to his or her deferral stock.

2. The deferral stock will be treated as a capital asset and the holding period for long-term capital gain begins on the date the qualified stock is converted to deferral stock. If the deferral stock is held for at least 12 months, then the fair market value of the deferral stock on the date of the sale, minus the fair market value of the qualified stock on the date it vested or was transferred to the employee, whichever is later, will be taxed at the favorable rates for long-term capital gains.

   It does not appear that a termination of employment with the eligible employer affects the five-year deferral period. If the employee becomes an excluded employee, then the deferral period ends, but Code section 83(i) does not expressly state that a termination of employment will end the deferral period.

   An employer's compensation deduction for options may go down some by making qualified equity grants. Generally, all the appreciation of employer stock on the date of exercise of a nonqualified stock option is treated as ordinary income, which the employer may deduct as a compensation expense. With respect to stock options grants as qualified equity grants, the appreciation of the stock after an 83(i) election will be treated as capital gain, which the employer may not deduct as a compensation expense. The compensation deduction with respect to RSUs that are qualified equity grants should be relatively the same.

## Notice from Employer/Corporation

A corporation that transfers qualified stock to a qualified employee must provide a notice to the employee at the time (or a reasonable period before) the amount would be first included in the employee's gross income under application of Code section 83 (but for the application of subsection 83(i)). The employer notice must:

- Certify that the stock is qualified stock;
- Notify the employee that he or she may choose to defer income on such stock by making an 83(i) election;
- Notify the employee that if an 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 to the qualified stock vest or become transferable, even if the value of the stock decreases during the deferral period;
- Notify the employee of his or her responsibilities with respect to FICA tax withholdings at the time the election is made and notify that the deferred income will be subject to income tax rates in effect at the end of the deferral period.

It is critical that employers provide this notice on a timely basis because failure to do so may result in a penalty of $100 for each failure with a maximum $50,000 penalty for all penalties in a calendar year.

This notice provision will require some guidance from the IRS because it appears that the notice does not need to be provided to an employee until the qualified stock (not the right to the qualified stock) is "transferred" to the employee. However, an 83(i) election must be made when the right to the qualified stock is vested. It appears the 83(i) election must be made when a stock option or RSU vests, but the qualified stock may be transferred to the employee after the date the stock option or RSU vests. For example, if a stock option vests, the qualified stock would not actually be transferred to the employee until the employee exercises the stock option, which could be much later than the date the stock option vests. If the employer provided the notice when the option is exercised, then this notice would be after the deferral election period has expired under Code section 83(i). For that reason, until further IRS guidance is issued, we recommend that employers provide the notice on, or a reasonable time before, the date that an employee's qualifying stock options or RSUs vest or become transferable.

## Conclusion

The new Code section 83(i) sets up a new type of broad-based tax-qualified equity compensation program which privately held corporations may offer to their employees. The new section appears to provide a wider segment of employees with the opportunity to make an election similar to an 83(b) election to limit the amount of the stock's future appreciation that will be subject to ordinary income tax rates. While section 83(i) imposes a number of stringent requirements on qualified equity grant plans, private companies should consider whether this new tax deferral opportunity would make the employer's current equity plan more attractive for purposes of incentivizing and recruiting employees. Whether a plan that offers 83(i) elections will be attractive or not will really depend on what stage the employer is at with respect to the stability of its stock price and the possibility of a liquidity event for the stock.

These grants can only be made under a broad-based equity plan that provides stock options or RSUs to a least 80% of an employer's US employees. An eligible employer interested in offering qualified equity grants should determine whether current participation in its equity plan comes close to 80% and, if not, what the employer would need to change to meet the 80% requirement. However, it does appear that qualified equity grants could be added to an existing equity plan and would not require adoption of an entirely new plan. Also, adoption of a qualified equity grant program does not require shareholder approval, similar to the incentive stock option requirements.

The compensation costs and deductions to the employer should not significantly change by using qualified equity grants, but an employer may want to model that based on past equity compensation. The notice and reporting requirements for qualified equity grants would create an additional administrative burden for employers that should also be considered before implementing one of these programs.

We anticipate that the IRS will issue additional guidance regarding this new section of the Code, and we will provide you with updated information as it becomes available.

Please contact Marc Fosse if you have any questions about setting up a qualified equity grant program.

JANUARY 2018

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[1] The term "corporation" will probably be defined in the same way as it is for incentive stock options under Code section 421, which means that an S corporation or limited liability company that has elected to be taxed as a corporation can be eligible, but no entities that are taxed on a pass-through basis will be eligible to provide qualified equity grants.

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Editor: Shannon Oliver, soliver@truckerhuss.com