IRS Issues Initial Code Section 83(i) Guidance — Mostly Good News

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DECEMBER 10, 2018

The IRS has provided initial guidance in Notice 2018-97 (the "Notice") about certain statutory requirements for private corporations granting options and restricted stock units (RSUs) which they intend to treat as qualified equity grants under section 83(i) of the Internal Revenue Code (the "Code"). If an option or RSU is treated as a qualified equity grant, then an eligible employee can make an 83(i) election to defer the taxation of vested stock transferred to the employee (i.e., "deferral stock") until a later date or specified event, and to start the holding period for favorable long-term capital gains when the stock is sold. For an in-depth discussion of the requirements for granting qualified equity grants, making an 83(i) election, and the resulting tax consequences, please see our previous alert: ***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*** (January 2018).

Private corporations have been hesitant to grant section 83(i) qualifying equity grants for various reasons, including certain ambiguities in section 83(i); a potential disconnect between former employee tax deferrals and the corporations' statutory tax withholding obligations; and the administrative complexity of maintaining a qualified equity grant program. Because of the significant requirements under section 83(i), other private corporations have been concerned that they could inadvertently grant qualified equity grants and face penalties for not providing employees an 83(i) notice. The Notice answers some of these questions and provides a workable solution for tax withholding from former employees, but it adds to the administrative complexity of 83(i) programs.

With respect to the issues addressed in the Notice, the Department of Treasury ("Treasury") and the IRS intend to incorporate the guidance into future regulations and intend that the incorporated guidance ***will be effective for taxable years ending on or after December 7, 2018***.

How to Calculate 80% of a Corporation's US Workforce

To be an "eligible corporation" that can grant qualified equity grants, the corporation must grant either options or RSUs to at least 80% of the employer's US workforce. Employers have had questions about how to measure whether an employer has made equity grants to 80% of its entire US workforce. Notice 2018-97 provides some answers. First, the Notice clarifies that only stock options or RSUs granted during a "single calendar year" count toward meeting the 80% minimum. Treasury determined that based on the plain language of Code section 83(i), using a multi-year cumulative approach to meet the 80% test is not a good faith interpretation of Code section 83(i). For employers with taxable years that end on or after December 7, 2018, the Notice does not provide grandfathering or other relief for employers that have issued 83(i) notices or accepted 83(i) elections from employees in situations where the employer had measured the 80% requirement using multi-year cumulative equity grants. If an employer has relied on cumulative grants over more than one year, then the employer should seek advice from legal counsel regarding potential remedial action that can be taken.

Second, the Notice clarifies that the 80% test cannot be satisfied based on a single-date snapshot of the employer's US workforce. Instead, an employer's total workforce is measured based on the number of US employees *at any time* during the calendar year whether the employee is an employee at the beginning or the end of the calendar year. By applying an "at any time" standard, the Notice makes clear that an employer desiring to make qualified equity grants will need to constantly monitor, during the applicable calendar year, the number of eligible employees in the corporation's US workforce. The Notice also states that the employer would need to ascertain "the total number of employees receiving grants during the year." Based on this guidance, an employer will need to monitor the number of workers granted awards throughout the entire applicable calendar year and verify at the end of the calendar year that grants were made to 80% of the highest number of eligible employees, counted at any time during the calendar year. This portion of Treasury's interpretation of section 83(i) seems to unnecessarily add to the administrative complexities that have, so far, been one factor affecting corporations' willingness to make qualified equity grants. Private corporations must already align many moving parts when making equity grants, such as Code section 409A stock valuation timing and costs, venture capital requirements, board and stockholder meetings, and retaining and incentivizing a highly mobile and growing employee population. The ability to make grants of qualified equity grants based on a snapshot of the employee population only at the time of grant would make 83(i) programs more attractive to private corporations.

Mandatory Deferral Stock Escrow Arrangements

A significant concern about implementation of an 83(i) program is how employers will meet their tax withholding obligations up to five years down the road when the holder of the deferral stock may be a former employee. The Notice sets out the applicable law relating to employers income tax withholding obligations, and emphasizes that employers are on the hook to pay the required income tax withholding even if the employer cannot obtain the funds from an employee or former employee. The employer must pay the tax withholding and then seek to collect the funds from the holder of the deferral stock. The employer could then be in the position of a debt collector with these former employees to obtain reimbursement for the tax withholding already deposited with the IRS from the employer's bank account.

The Notice seeks to solve this problem by requiring mandatory escrow of deferral shares by the employer until the date the deferred tax withholding obligation is triggered. Code section 83(i) requires that an employee agree to cooperate with the employer to effectuate the necessary tax withholding. However, the Secretary of the Treasury did not feel that agreement was a sufficient mechanism for employers to meet their tax withholding obligation. Instead, the Secretary of the

Treasury used his authority over the administration of tax collections to require that a valid 83(i) election must include an agreement by the employee to escrow all the deferral shares with the employer until the deferred tax date. If the employer cannot obtain a cash payment from the holder of the deferral shares for the income tax withholding, the employer can remove sufficient deferral shares from escrow to pay the required tax withholding obligations.

This new escrow arrangement does not change the timing of FICA tax withholding, which is still due at the time the stock is transferred to an employee even though an 83(i) election is made.

Electing Out of 83(i) Compliance

The Notice also answered the question about whether an employer can inadvertently issue deferral shares subject to an 83(i) election. The answer is no. Because escrow of deferral stock is now mandatory, the Notice states that employers can prevent awards from being qualified equity grants by not entering into an escrow arrangement with the grantee. In this way, the employer has control over whether an 83(i) election can be made.

For employees that already made an 83(i) election without an escrow arrangement, the Notice does not provide guidance about how this escrow requirement affects prior 83(i) elections made with no escrow arrangement. The statutory transition rule should apply in these situations, and constitutes a good faith interpretation of section 83(i).

Fixed Employer Tax Withholding

Code section 83(i) states that tax withholding on deferral shares must be made at the highest marginal income tax rate — currently 37%. The Notice provides that income tax withholding will be applied at the required flat rate regardless of employees' Form W-4 allowances or any agreement between the employee and employer to withhold more or less. This mandatory flat-rate withholding seems like it would be computed similar to a payment of supplemental wages in excess of $1,000,000. It is fairly common for an employee and employer to enter into an agreement to withhold more taxes than is statutorily required when stock options are exercised. While Treasury representatives have informally stated that there is no statutory authority for an employer to withhold additional income taxes, they have also indicated that there is no particular reason for the IRS to take action against employers for sending extra money to the US Treasury.

Conclusion

The Notice provides a workable solution to withholding income taxes on deferral shares from former employees. It also verifies that an employer cannot inadvertently grant qualified equity grants, which would subject the employer to the section 83(i) notice requirements and penalties for failure to provide the notice. These items of the guidance will enable employers to feel more comfortable regarding how section 83(i) works. However, the new guidance seems to increase the administrative complexity of section 83(i) programs by interpreting the section to require employers to track their employee population at all times during the year and to provide equity grants to 80% of the highest level of employees calculated at any time during the applicable calendar year.

The Department of Treasury has requested comments regarding the guidance in the Notice. Comments must be submitted by February 5, 2019.

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