
Tax Act: New Opportunity to Defer Income from Certain Private Company Equity Grants

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The new Section 83(i) of the tax code, enacted as part of the Tax Act, allows certain private company employees to elect to defer, solely for income tax purposes and for a period of up to five years, the income attributable to stock received upon the exercise of compensatory options or the vesting of restricted stock units (RSUs) on or after January 1, 2018. The potential tax deferral afforded by this new election could be a significant benefit for holders of stock options and RSUs of private companies. However, substantial guidance from the IRS is necessary to interpret the Tax Act provisions, and the benefit may ultimately prove to be illusory. And in any event, the election will generally not be available for the founders and other key service providers, as explained below.

Generally. Under the new provision, a “qualified employee” may make an election (a “Section 83(i) election”) with respect to “qualified stock” within the 30-day period following the first date on which the employee’s rights in the qualified stock are transferable or are no longer subject to a substantial risk of forfeiture (i.e., are vested), whichever occurs earlier. The statute provides that a Section 83(i) election will be made in a manner similar to the manner in which an election is made under Section 83(b) of the tax code. If a Section 83(i) election is timely made, the amount that would have been included in income upon exercise or vesting of the award, as applicable, is deferred for income (but not payroll) tax purposes until the first to occur of the following:

- the qualified stock becomes transferable (including, for this purpose, to the employer itself);
- the employee becomes an excluded employee (described below);
- any of the corporation’s stock becomes readily tradeable on an established securities market;
- the fifth anniversary of the employee’s right to the stock becoming substantially vested; or
- the employee revokes the election.

When the deferral period ends, the amount deferred (disregarding any appreciation or depreciation in the value of the stock) will be treated as ordinary compensation income for income tax (but not payroll tax) withholding and reporting.

Eligibility. Not all private company stock is “qualified stock” for purposes of Section 83(i), and not all

employees are eligible to make a Section 83(i) election.

Qualified stock. In order for the stock issued upon exercise of an option or vesting of an RSU to be “qualified stock,” the equity award must have been granted to the employee by the employer-corporation in connection with the performance of services by such person as an employee in a year in which the employer-corporation was an “eligible corporation.” An eligible corporation is any corporation (i) the stock of which (including, the stock of any predecessor corporation) has never been readily tradable on an established securities market and (ii) which has a written plan under which, during the calendar year in which the award was granted, at least 80% of all of the corporation's U.S.-based employees are granted stock options, or are granted RSUs, with the same rights and privileges, as described in Section 83(i), to receive qualified stock (the “80% Test”). Any stock issued upon exercise of an option or vesting of an RSU that may be sold to, or replaced with cash in lieu of stock from, the corporation at the time that the rights of the employee in such stock first become transferable or not subject to a substantial risk of forfeiture will not be treated as qualified stock. As with many issues under Section 83(i), it is not clear what having the same “rights and privileges” means other than that it does not require equal-sized grants to all (although each must receive more than a *de minimis* amount). It could mean, for example, that the vesting conditions must be the same.

Qualified employees. Only employees who are not “excluded employees” are eligible to make a Section 83(i) election. For purposes of Section 83(i), an “excluded employee” is any individual:

- who is a 1% owner of the corporation at any time during the calendar year or who was a 1% owner of the corporation at any time during the ten preceding calendar years (or who is a family member of such a person), taking into account for ownership the individual's and family member's outstanding options and RSUs;
- who is, or has been at any time, the chief executive officer or chief financial officer (or someone acting in either capacity) of the corporation (or who is a family member of any such person); or
- who has been one of the four highest-compensated officers of the corporation for the taxable year or was one of the four highest-compensated officers of the corporation for any of the ten preceding taxable years (determined as if the disclosure rules under the Securities Exchange Act of 1934 applied to the corporation).

A qualified employee must also agree in the Section 83(i) election to meet any requirements necessary to ensure that the corporation's withholding requirements with respect to the qualified stock are met.

Limitations. A Section 83(i) election may not be made if (i) the qualified employee has made an election under Section 83(b) of the tax code with respect to the qualified stock (i.e., it cannot be made for restricted stock that is subject to a Section 83(b) election); (ii) any of the company's stock is readily tradable on an established securities market at any time before the election is made; and (iii) the corporation purchases any of its outstanding stock in the calendar year preceding the calendar year that includes the first date the rights of the employee in the qualified stock are transferable or are not subject to a substantial risk of forfeiture. Repurchases will not disqualify a

qualified employee from making a Section 83(i) election, however, if at least 25% of the total value of the stock repurchased in the preceding calendar year was stock with respect to which an election under Section 83(i) was in effect (“deferral stock”) and the determination of which individuals from whom such stock is purchased is made on a reasonable basis.

Notice and reporting requirements. Any corporation that transfers qualified stock to a qualified employee must, at the time that (or a reasonable period before) any amount attributable to the stock would first be includible in the employee's income, (i) certify to the employee that the stock is qualified stock and (ii) notify the employee that the employee may be eligible to elect to defer income on the stock under Section 83(i) and that, if the employee makes a Section 83(i) election, (1) the amount of income recognized at the end of the deferral period will be based on the value of the stock at the time at which the rights of the employee in the stock first became transferable or not subject to a substantial risk of forfeiture (regardless of any decline in value of the stock during the deferral period), (2) the amount included in income at the end of the deferral period will be treated as ordinary compensation income subject to income tax withholding, and (3) the employee must comply with his or her responsibilities with respect to such withholding. Failure to provide this notice may result in the imposition of a penalty of \$100 for each failure, subject to a maximum penalty of \$50,000 for all failures during any calendar year.

In addition, any corporation that has outstanding stock subject to a Section 83(i) election at the beginning of any calendar year and that purchases any of its outstanding stock during such calendar year must include on its tax return for the taxable year in which (or with which) the calendar year ends, the total amount of its outstanding stock repurchased by the calendar year and any other information that may be required.

Effective date. While the provision generally applies with respect to stock attributable to options exercised or RSUs vested after December 31, 2017, until transition guidance is issued, a corporation will be treated as being in compliance with the 80% Test and the employee notice requirements if the corporation complies with a reasonable good faith interpretation of them.

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