

## [Updates](#)



The recent tax reform bill, commonly referred to as the Tax Cuts and Jobs Act of 2017 (the Act), was signed into law on December 22, 2017.

The Act includes a new income tax deferral regime for certain employee stock options and restricted stock units (RSUs) granted by eligible private corporations under broad-based programs that are exercised or settled after December 31, 2017. Effective January 1, 2018, affected employers that fail to notify eligible employees regarding their right to defer income could incur penalties.

This update summarizes the key highlights of the new deferral opportunity for employees and notice obligations for employers, as well as additional guidance needed, and offers practical advice. It remains to be seen how the new regime will make an impact on the equity granting practices of private companies in future years. Due to the

various restrictions and limitations described in this update, it may be difficult for many private corporations to fully benefit from the relief. This new deferral opportunity is not available for equity awards granted by limited liability companies taxed as partnerships for federal tax purposes.

## Setting the Stage: Existing Tax Rules for Employee Stock Options and RSUs

**Stock Options.** Private companies commonly grant two types of equity-based awards to employees: nonqualified stock options and incentive stock options (ISOs). Both types of stock options typically represent the right to purchase a fixed number of shares within a fixed period of time at a fixed price, generally following the satisfaction of conditions, such as continued employment for a certain period and/or the attainment of certain performance goals. Many private companies grant ISOs to employees to provide an opportunity for a potential tax benefit.

**Restricted Stock Units.** Some private companies also grant RSUs. An RSU is an arrangement under which an employee has the right to receive an amount (typically in shares of employer stock but sometimes in cash) at a specified time in the future determined by reference to the value of one or more shares of employer stock. An employee's right to receive the future amount may be subject to one or more conditions, such as continued employment for a certain period, the attainment of certain performance goals or the occurrence of a liquidity event. The payment to the employee of the amount due is referred to as settlement of the RSU.

**Existing Tax Treatment.** None of these types of equity-based awards is generally taxed at grant or vesting (unless the RSU is also settled at vesting), but each otherwise involves different tax treatment.

- **Nonqualified Stock Options.** If an employee exercises a nonqualified stock option, the employee generally recognizes ordinary income equal to the difference between the fair market value of the shares underlying the option on the date of exercise and the aggregate option exercise price paid (the "option spread"). Employers must collect and deposit tax withholdings for income and employment taxes at the time of exercise, and report the income on Form W-2.
- **Incentive Stock Options.** If an employee exercises an ISO, the employee will not recognize any income for regular income tax purposes solely as a result of the exercise (although the employee generally will recognize income for alternative minimum tax purposes at that time as if the option were a nonqualified stock option), and the employer is not required to collect tax withholding for income or employment taxes at the time of exercise of an ISO, or upon a later disposition (including a disqualifying disposition as described below) of the stock acquired upon exercise of an ISO.
  - **Dispositions.** If the applicable holding period requirements are met with respect to the stock purchased on exercise of an ISO (two years after grant and one year after exercise) and the employee later disposes of the stock, the employee's gain generally is treated as capital gain and not as ordinary income. However, if a disposition occurs before the end of the required holding periods (a "disqualifying disposition"), the employee recognizes ordinary income in the taxable year in which the disqualifying disposition occurs. The amount of ordinary income is reported on a Form W-2 and generally equals the option spread on the date of exercise.
- **Restricted Stock Units.** An employee generally will recognize ordinary income at the time of settlement of an RSU in an amount equal to the then fair market value of any shares, cash or property the employee receives. Such income will be subject to withholding of income and employment taxes (employment taxes generally are due at vesting if earlier than settlement) and will be reported on Form W-2.

## New Tax Deferral Rules Change Timing of Income Inclusion

**Limited Opportunity to Elect to Defer Timing of Income Inclusion.** The new tax deferral rules generally allow a qualified employee to make an election (a "Section 83(i) election") to defer income inclusion associated

with the exercise of a stock option or the settlement of an RSU in employer stock until the *earliest* of the following events:

- the first date on which the individual's qualified stock becomes transferable, including to the employer corporation (see Additional Guidance Needed below);
- the date on which the individual first becomes an "excluded employee" (as defined below);
- the first date on which any stock of the issuing corporation becomes readily tradeable on an established securities market;
- the date that is five years after the first date on which the rights of the individual in the qualified stock are transferable (see Additional Guidance Needed below) or are not subject to a substantial risk of forfeiture, whichever is earlier (generally, meaning five years from the exercise date (in the case of a vested option) or the settlement date (in the case of an RSU)); and
- the date on which the individual revokes the election (at such time and manner as the Secretary of the Treasury provides).

If an employee makes a Section 83(i) election with respect to the exercise of an ISO, the ISO will be treated as a nonqualified stock option and will no longer be eligible for the preferential treatment applicable to ISOs.

**Amount of Income Inclusion.** If an employee makes a Section 83(i) election, for income tax purposes, the employee will recognize income at the end of the deferral period equal to the value of the qualified stock at the time at which the rights of the employee in such stock first become transferable or not subject to a substantial risk of forfeiture, whichever is earlier. Accordingly, the amount of income recognized generally will equal the option spread on the date a vested option is exercised or the value of the qualified stock on the date an RSU is settled, as applicable. Such amount will be included in income even if the value of the qualified stock at the end of the deferral period is less than the value required to be taken into account at the time of exercise or settlement.

#### Eligibility Requirements

For an employee to be eligible to make a Section 83(i) election, a number of technical requirements must be satisfied. Simply stated, "qualified stock" must be issued to a "qualified employee" by an "eligible corporation."

**Qualified Stock.** A Section 83(i) election may be made only with respect to "qualified stock," which generally means stock received by a qualified employee in connection with the exercise of a stock option, or in settlement of an RSU, granted by an "eligible corporation." Stock generally will not be treated as qualified stock if the employee may sell the stock to, or otherwise receive cash in lieu of stock from, the eligible corporation.

**Qualified Employees; Excluded Employees.** Only qualified employees are eligible to make a Section 83(i) election. In general, a "qualified employee" means any full-time employee of a corporation, other than an "excluded employee."

The term "excluded employee" includes any individual who:

- becomes in the relevant calendar year, or was at any time in the 10 preceding calendar years, a 1% owner of the corporation;
- is or has ever been the corporation's CEO or CFO (or has acted in either capacity);
- is a family member (spouse, children, grandchildren and parents) of the corporation's CEO, CFO or former CEO or CFO; or
- becomes in the relevant calendar year, or was at any time in the 10 preceding calendar years, one of the four most highly paid officers of the corporation.

Non-employee service providers, including independent contractors and non-employee directors, are not eligible to make a Section 83(i) election.

**Eligible Corporation; Broad-Based Plan Requirement.** A corporation will qualify as an "eligible corporation" in a calendar year if:

- none of the corporation's stock (or the stock of any predecessor) is, or has ever been, readily tradeable on an established securities market (i.e., publicly traded); and
- the corporation has a written plan under which, in such calendar year, not less than 80% of all full-time qualified employees providing services in the United States (or any possession of the United States) are granted stock options, or are granted restricted stock units, with the same rights and privileges to receive qualified stock (other than with respect to the number of underlying shares). A special transition rule provides that the same rights and privileges requirement will not be applied for calendar years beginning before January 1, 2018.

In addition, unless an exception applies, a Section 83(i) election is not available with respect to qualified stock if the employer corporation repurchased 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. To qualify for the exception, 25% or more of the total dollar amount of the repurchased stock must be deferral stock (i.e., qualified stock with respect to which a Section 83(i) election has been made) and other requirements must be satisfied.

#### Election Mechanics

A Section 83(i) election must be made:

- no later than 30 days after the first date on which the rights of the employee in the qualified stock are transferable or not subject to a substantial risk of forfeiture, whichever is earlier; and
- in a manner similar to the manner in which Section 83(b) elections must be made.

This generally means the Section 83(i) election must be made within 30 days from the exercise date (in the case of a vested option) or the settlement date (in the case of an RSU). In addition, the employee must agree in the election to meet requirements determined to be necessary to ensure that the federal income tax withholding rules are met with respect to the qualified stock.

#### Employer Notice Requirements

Corporations that issue qualified stock must satisfy certain notice requirements at the time (or a reasonable period before) an amount attributable to such stock would first be includible in an employee's gross income (absent a Section 83(i) election). The notice must, among other things, certify to an employee that the stock is qualified stock, include a statement that the employee is eligible to make a Section 83(i) election, and disclose certain tax risks and consequences associated with making the election.

Failures to provide the notice on a timely basis may result in a penalty of \$100 per failure, subject to a maximum penalty of \$50,000 for all failures during a calendar year. However, until further guidance is issued with respect to the 80% requirement for eligible corporations and the employer notice requirement, a corporation will be treated as complying with the notice requirement if it complies with a reasonable good faith interpretation.

#### Other Considerations

The new tax deferral rules also include special Form W-2 reporting and withholding requirements for employers when employees make a Section 83(i) election.

### Additional Guidance Needed

The Act lacks clarity on several key issues, and this update sets forth our interpretation of the provisions under Section 83(i) based on available guidance. Additional guidance is needed to clarify, among other things, (1) the scope of the term "transferable" in the context of transferability to employer corporations (including whether an exception will apply for customary provisions, such as an employer's right to repurchase an employee's stock after his or her employment relationship is terminated); (2) under what circumstances the provision requiring immediate income inclusion upon an individual's qualified stock becoming "transferable" applies in light of the provision deferring income inclusion for five years after the first date on which the rights of the individual in the qualified stock become "transferable"; and (3) when the holding period for qualified stock begins if a Section 83(i) election is made. Additional guidance would be helpful to confirm that (1) the option exercise date rather than the option vesting date is the relevant date for purposes of Section 83(i) elections; and (2) Section 83(i) elections have no impact on the timing of employment tax obligations.

### Practice Tips

**Private Corporations Should Assess Applicability of Employer Notice Requirements.** Private corporations with outstanding stock options that may be exercised—or RSUs that may be settled—in 2018 or later should begin to assess whether any employees are eligible to make a Section 83(i) election. This assessment generally will require a determination of "eligible corporation" status in each calendar year when outstanding awards were granted and for 2018 and beyond. Each private corporation should implement a process to make this assessment annually going forward.

**Limited Practical Effect for Many Private Company RSUs.** Many private companies that grant RSUs condition the vesting and settlement of RSUs on the occurrence of a liquidity event, such as a change-in-control transaction or an initial public offering, to align the timing of employees' income and employment tax obligations with the opportunity for liquidity. The new tax deferral regime would have limited practical application to these RSUs because any deferral election would have no effect on the timing for the income inclusion.

**Employers Granting ISOs Should Highlight Loss of ISO Status upon Deferral Election.** The special rules for ISOs currently provide preferential tax treatment to ISO holders, including relief from employment tax obligations and deferral of the holder's regular income tax event until the holder disposes of the shares acquired upon exercise. Employers providing notice as required under the new Section 83(i) rules should make it clear that ISO holders are permanently giving up existing preferential tax treatment and will be responsible for employment tax obligations that would not otherwise be due with respect to their options if they make the deferral election.

**Employers Should Consider Highlighting Five-Year Limit for Deferral.** While not technically required under the current notice requirements, employers should consider making it clear in their notice to employees that, if a Section 83(i) election is made, income tax cannot be deferred beyond the five-year deferral period, even if a liquidity event has not occurred by that time.

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