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To Be or Not To Be ... Subject to the New Section 83(i) Deferral Process - IRS Issues New Guidance

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The Internal Revenue Service issued guidance on a tax law change that permits the deferral of income tax on equity awards in private companies. Section 83(i) of the Internal Revenue Code was included in the 2017 Tax Cuts and Jobs Act (TCJA), and it established an entirely new mechanism allowing qualified employees of privately-held corporations to defer paying income tax, for up to five years, on the value of qualified stock options and restricted stock units (RSUs) granted to them by their employers.

We previously discussed Section 83(i) here. Few companies have adopted the provisions of Section 83(i) because of the need for clarification on how Section 83(i) should be implemented. Notice 2018-97 provides guidance to taxpayers on (1) the application of the requirement in Section 83(i)(2)(C)(i)(II) that grants be made to not less than 80% of the employer's employees, (2) the application of federal income tax withholding to the deferred income related to qualified stock, and (3) the manner in which an employer may opt out of permitting employees to elect the deferred tax treatment even if the requirements under Section 83(i) are otherwise met.

In welcome guidance, the Internal Revenue Service clarified that companies will be able to opt out of Section 83(i) by not allowing employees to make the deferral election. The terms of stock options or restricted stock units issued to employees may be drafted to preclude them from making the deferral election, or companies may otherwise create conditions that would preclude employees from making the election. For example, if a company declines to establish an escrow arrangement required under the notice, the agency said that this would make Section 83(i) elections impossible. This relieves concerns that companies might inadvertently create a situation where the employees would be permitted to make Section 83(i) elections regardless of the company's willingness to satisfy the burdens of the process, and particularly the fear that the company would be subject to monetary penalties for failure to provide the required notice.

For companies that do want to allow their employees the option to make the deferral under Section 83(i), the notice gave further details on the law's requirement that grants of RSUs or stock options must be made to not less than 80 percent of a corporation's employees in the U.S. per calendar year. It also clarified how employers must withhold taxes from the deferred income. The IRS did not allow companies to take into account stock

options or restricted stock units granted in prior calendar years for purposes of the 80 percent requirement, saying it would be contrary to the language of the statute. Notice 2018-97 also created a requirement that in order for employees to be qualified to make the Section 83(i) election, employers must deposit deferral stock into an escrow arrangement before the end of the calendar year in which the election is made. When the income is realized, the employer would remove a number of shares equal to the tax withholding from escrow and distribute the rest to the employee, the notice said.

The IRS said it expects to issue proposed regulations providing further guidance on the deferral program that incorporate the requirements set forth in the notice.

Given the technical requirements to utilize the deferral election under Section 83(i), we expect that only companies in very specialized situations will consider using these provisions. Thankfully, the IRS has provided helpful guidance both to the employers that will open the arrangement to their employees, as well as employers that choose not to be subject to Section 83(i) obligations or penalties. Notice 2018-97, is posted on IRS.gov. For additional questions about the Notice 2018-97 and its impact on employee equity incentives, contact a member of Holland & Hart's Benefits Law Group.

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