January 2019

IRS Clarifies Tax Law Provision that Could Benefit Private Company Employees

The guidance provides clarity around which equity recipients at private companies qualify for tax relief and how the rule change could impact the prevalence of different equity vehicles.

There's a lot that has been reported in the media about the Tax Cuts & Jobs Act that was passed late in 2017 — the largest overhaul of our tax code in over 30 years. But what hasn't been covered extensively is Section 83(i), which allows for tax deferral of private company equity awards. This is partially because the impact was limited to private businesses, but also because there was a lot of ambiguity surrounding the specifics of how all the moving parts worked.

On Dec. 7, 2018, the request for clarity was finally answered in the form of Notice 2018-97 — the Department of the Treasury and the Internal Revenue Service's guidance on Section 83(i). While there still may be more questions, and undoubtedly more guidance will be needed in the future, this notice makes it easier for businesses and individuals to assess how the change might affect them.

First, let's review what Section 83(i) calls for. The provision allows certain employees to defer the taxation of their stock option exercises or vesting of restricted stock (RSUs) in the case where the employee cannot achieve liquidity to cover the tax withholding amounts. However, open questions remained after the tax law passed, such as:

- The provision requires 80% of a company's workforce in the United States to be eligible for stock awards. How is the workforce determined (i.e., do you count part-time employees, contact employees, etc.)? Also, is it 80% receiving stock options *and* RSUs or 80% receiving stock options *or* RSUs?
- How is withholding done and when does it occur?
- Are companies required to allow the employee deferral just because the company meets all the criteria?

What the Guidance Says

First and foremost, this tax deferral opportunity is applicable to stock options exercised and RSUs awards settled after Dec. 31, 2017. The guidance says settlement of equity awards is the taxable event trigger in RSUs and not vesting. While in the past, this exercise/settlement would require the employee to cover their tax withholding obligation without being able to sell or swap shares to do so, now the employee can elect to defer the taxation of

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the exercise/settlement for up to five years with an 83(i) election. The deferral begins when the rights of the employee in the stock are transferable or no longer subject to a substantial risk of forfeiture. The deferral lasts until the earliest of the following:

- The date the stock becomes readily tradable on an established securities market
- The date the stock becomes transferable
- The date the employee is no longer a "qualified employee" under 83(i)
- The date the employee themselves revokes the deferral election
- Five years from the beginning of the deferral

The guidance also answers one of the biggest lingering questions from this provision: There is no tax benefit to the employee in the timing of their revocation of the election. In other words, the taxable income and subsequent taxation amounts are based on what would have been recognized at the time of the exercise or settlement and not whatever the amount is at the time of revocation, IPO, etc.

Company Eligibility

Part of Section 83(i) specifies that the grant of stock-based compensation that is allowed to be deferred must be granted by an "eligible corporation," which is defined as:

- A company that doesn't have any stock that is readily tradable on an established securities market (and has never had such readily tradable stock), and
- Has a written plan which, during the year of grant, at least 80% of its U.S.-based qualified employees were granted stock options or RSUs in more than a de minimus amount with the same rights and privileges.

Here, a very important distinction is that 80% of its U.S. employees must receive grants of stock options or RSUs awards and not a mixture of both. A mixture of award vehicles where 50% of the U.S. qualified employees receive stock options and 40% of the U.S. qualified employees receive RSUs does not allow for the deferral because the company is not considered an eligible corporation.

If a company is an eligible corporation, they are required to inform their U.S. qualified employees of their right to deferral prior to the vesting of the stock that is covered by the deferral. When an employee elects their deferral, the company is required to report the income on the employee's Form W-2, both in the year of deferral and in the year that election either lapses or is revoked.

In the instance that a company is inadvertently an eligible corporation but does not want to offer the election to their employees, there is no official "opt out" option, but there is a practical workaround available. Since an eligible corporation must establish a share deferral escrow arrangement with the employee base in order to satisfy withholding tax obligations at the end of the deferral period, the practical workaround is to fail to establish such an escrow arrangement. This would then keep employees from electing a deferral under 83(i).

Regardless of what a company chooses to do, the fines for not informing employees of their right to deferral are $100 per notice missed up to a maximum penalty of $50,000 per year.

Employee Eligibility

The definition of the eligible employee group is anyone that is not an “excluded employee,” which is defined as:

- A 1% owner of the company at any time during the year of grant or during the preceding ten calendar years,
- The current or a former CEO or CFO of the company,
- A family member of the current or former CEO or CFO of the company, or
- One of the four highest compensated officers of the company (as determined under the SEC’s executive compensation disclosure rules) for the year of grant or any of the preceding ten taxable years.

In calculating the 80% of U.S. qualified employees, the IRS has determined that the employee population is anyone that was employed during the calendar year, regardless of whether they were employed at the beginning or end of the year.

Next Steps

While conceptually beneficial, the drawback to Section 83(i) is that it could be administratively burdensome. Meeting the requirements to be considered an eligible corporation is oftentimes out of the scope of many companies’ compensation structures and will require an overhaul to even set up — not to mention track and execute. However, we do expect to see more guidance in the future on Section 83(i) and will likely see some success stories in private companies providing tax benefits to their employees that receive equity. For companies that were already contemplating moving to RSUs and meet the requirements of Section 81(i), then this latest guidance could help push them over the line since the taxable event that made RSUs so hard to grant will be at the discretion of the participant if they submit an 83(i) election.

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