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Code Section 83(i) … Initial Questions Answered … Stil Need More Guidance

By release of Notice 2018-97, the IRS provided initial guidance on the application of new Section 83(i) of the Internal Revenue Code, as enacted by the Tax Cuts and Jobs Act (2017). Additional guidance is expected in the future in the form of proposed regulations.

Section 83(i) allows rank-and-file employees of privately held corporations to elect to defer the income inclusion on the receipt of stock pursuant to the exercise of a stock option or settlement of a restricted stock unit (RSU). This arrangement may be attractive to cash-strapped, startup companies that rely on employee ownership to recruit top talent. When taxes are due at exercise or settlement, however, employees may not have the cash and lack a ready market to sell shares to pay the tax. While the company may retain some shares to meet the collections part of its tax withholding obligation, the startup may also be constrained in its ability to remit cash to the taxing authorities to satisfy the payment part of this obligation. Thus, by deferring income inclusion from certain stock awards for up to five years, Section 83(i) is intended to assist cash-strapped startups compete for talent and provide business ownership to rank-and-file employees.

Contrary to its noble intentions, however, Section 83(i) encountered negative reactions in the business community due to its compliance requirements. Namely: (i) the requirement for a company to make grants to 80% of its full-time rank-and-file employees, while excluding the top executives from the deferral opportunity (CEO, CFO, one-percent owners, and the four highest paid officers); (ii) the requirement to withhold taxes at the end of the deferral period at the maximum income tax rate (37%) instead of the flat supplemental withholding rate (21%); and (iii) a number of ambiguities around implementation. Notice 2018-97 clarifies some – but not all – of the uncertainties.

Are employers allowed to prohibit employees from making deferral elections?

The IRS clarified that an employer may simply designate the stock as not eligible for a Section 83(i) election. It was previously unclear if an employer can reject an employee's deferral election on qualified stock, so employers were advised to take actions that would disqualify the stock, such as making grants to the top executives or including put or call rights.

What is the test period for the 80% requirement?

To be eligible, a privately held corporation must have a written plan under which, in such calendar year, not less than 80% of all U.S. full-time employees are *granted* stock options or RSUs with the same rights and privileges to receive qualified stock.

The IRS clarified that the 80% test is determined on a *grant* basis and not on an *outstanding awards*

basis. In calculating whether the 80% standard is satisfied, the corporation must compare the total number of individuals employed at any time during the year and the total number of employees receiving grants during the year (excluding part-timers and the top executives in each case). The determination is not based on the number of employees who have outstanding awards during the year from previous grants.

This initial guidance did not further clarify the "same rights and privileges" clause within the 80% requirement beyond the statutory language.

Is the 37% tax withholding rate mandatory?

The IRS clarified that the maximum withholding rate in effect under Section 1 (37% in 2018) is the only rate that is applied at the end of the deferral period.

Previously, the only time it became mandatory to withhold at the maximum income tax rate was when an employee's supplemental wages exceeded $1 million during the year. However, Section 83(i) now imposes this mandatory withholding rate on the deferred stock of rank-and-file employees. This requirement is counter-productive to assisting employees and employers that were unable to fund the withholding at the flat supplemental wage rate of 21% at the time of exercise or settlement, and will likely result in excessive withholding in relation to the tax ultimately owed.

What are the withholding procedures under Section 83(i)?

Notice 2018-97 addresses the income tax withholding procedures on Section 83(i) deferred stock by reference to existing guidance on noncash fringe benefits. To ensure the withholding requirements are met, an employee must agree to have the stock deposited into escrow throughout the deferral period. At the time of income inclusion, the employer may remove from escrow and retain the number of shares of deferral stock with a fair market value equal to the income tax withholding obligation that has not been recovered from the employee by other means and distribute the remainder to the employee. Notably, this escrow requirement does not resolve the potential issue of a cash-strapped employer having to remit cash to the tax authorities. Further, the number of shares the employer retains to accommodate the potentially excessive tax withholding at a 37% mandatory rate reduces the number of shares provided to the employees.

The Notice does not address the uncertainty around the timing of the withholding obligation prior to the Section 83(i) election. In general, employers must collect and remit tax withholding within a few days of the exercise or settlement. However, it is uncertain if the income tax withholding will be due at that time pending the 30 day window for employees to make an 83(i) election.