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Tax Reform & Qualified Equity Grants: New Tax Provisions

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Beyond cutting individual tax rates temporarily and slashing corporate taxes to 21 percent permanently, the Tax Cuts and Jobs Act includes new options in the taxation of certain employee equity awards.

The new tax law has a new Code section 83(i) providing for a deferral of up to five years for the taxation of compensation paid to employees of "eligible corporations" in the form of "qualified stock." An "eligible corporation" is one with stock that is not readily tradable on an established securities market and that has a written plan in place to grant stock options or restricted stock units (RSUs) to at least 80% of all full-time, U.S.-based employees in a calendar year.

"Qualified stock" is:

- Delivered by the exercise of options or settlement of RSUs;
- Provided for the performance of services during a calendar year in which the corporation was an eligible corporation.

Stock is not "qualified stock" if the employee is able to transfer the stock back to the corporation for cash when it first becomes transferable or a substantial risk of forfeiture lapses.

Employees must make an affirmative election within 30 days of the date of vesting to defer income taxes on the exercise of an option for qualified stock, or be taxed, similar to an 83(b) election. Once this election is made, income taxes on qualified stock (measured on the vesting date) would be due upon the earliest of the following:

- The date the stock is transferrable, including to the employer;
- The date the employee first becomes an "excluded employee" (i.e., CEO, CFO or a 1% owner or one of the top four highest-paid employees for any of the 10 preceding taxable years, determined on the basis of the Securities and Exchange Commission disclosure rules for compensation, as if such rules applied to such a corporation);
- The first date any stock of the employer becomes readily tradable on an established securities market;
- The date five years after the date the employee's right to the stock is not subject to a substantial risk of forfeiture;
- The date on which the employee revokes a deferral election which can be done at any time.

For employees to be eligible to make an 83(i) election, an eligible corporation would need to grant at least 80% of all full-time, U.S.-based

employees stock options or RSUs that have the same rights and privileges (determined under the rules for Employee Stock Purchase Plans in Code section 423(b)(5)) in a calendar year. To meet this standard, employees may receive different amounts of stock, but each participant must get more than a *de minimis* amount.

Qualified stock that is subject to an 83(b) election is not eligible for elections under Code section 83(i). Additionally, the deferral election is generally not available if the corporation has bought back any outstanding stock in the preceding calendar year, unless at least 25% of the total dollar amount the company bought back is stock to which a Code section 83(i) deferral election is in effect and other requirements are satisfied.

The employer would be subject to reporting requirements for stock with deferred income tax. The employer would also be required to provide notice to employees about their right to defer income tax on the stock as well as the consequences of the deferral with penalties of \$100 per failure to provide this notice but capped at \$50,000 per year. Employees who make the election would pay tax on the share value at vesting.

Finally, qualified stock under 83(i) would not be treated as deferred compensation for purposes of Code section 409A.

It is our impression that the ability to make deferral elections under the new Section 83(i) could be useful in specific situations, such as a private company with a rapidly appreciating stock price and expectations of a liquidity event, but the administrative complexity and broad based grant requirements will limit the usefulness of this election for a majority of companies.

If you would like more information, please feel free to contact one of our [Employee Benefits attorneys](#).