Tax Deferral for Private Company Equity Awards

By William E. Sigler

The Tax Cuts and Jobs Act (the "Act") has received considerable attention due to the lowering of the corporate tax rate to 21% and new tax deduction for pass-through entities. What has not been as frequently discussed is newly added Section 83(i) and the impact that it may have on private employers offering equity-based compensation to employees. Section 83(i) permits qualifying employees to defer federal income tax associated with certain equity awards for as long as 5 years.

Federal Income Taxation of Equity Awards Prior to Section 83(i)

Prior to the passage of the Act, nonstatutory stock options or nonqualified stock options ("NQSOs") granted at fair market value were generally taxable when the option was both vested and exercised. Similarly, restricted stock or restricted stock units ("RSUs") that were either exempt from or in compliance with Section 409A of the Internal Revenue Code (the "Code") were generally not taxable until the applicable restrictions lapsed and fully vested stock was delivered to the employee.

Eligibility for Section 83(i) Deferral of Taxation of Equity Awards

For NQSOs exercised and RSUs settled after December 31, 2017, Section 83(i) permits the deferral of federal income tax for as long as 5 years by a "qualified employee" if the equity award was granted in connection with the performance of services and was granted by an "eligible corporation."

An employee is eligible to be a "qualified employee" if: (i) they are not an "excluded employee," and (ii) they make a timely 83(i) election. "Excluded employees" generally include: the CFO or CEO, the top 4 compensated officers, and people who are 1% owners or were 1% owners during the preceding 10 tax years.

An employer is generally an "eligible corporation" if: (i) its stock was not publicly traded during any prior calendar year, and (ii) it has adopted a written equity award plan pursuant to which not less than 80% of its U.S. employees are granted NQSOs or RSUs with the same rights and privileges.

Duration of Federal Income Deferral Pursuant to Section 83(i)

Section 83(i) permits the deferral of federal income tax for as long as 5 years. This 5 year period will be shortened upon the first to occur of the following events:

- The date the “eligible employee” becomes an “excluded employee;
- The date the employee revokes the 83(i) election;
- The date on which the employer’s stock becomes publicly traded; or
- The date on which the stock becomes transferable (including to the employer).

Example

Assume a vice president–level employee at a privately owned corporation is granted a restricted stock award for 10,000 shares of stock with a fair market value per share of $1 on the date of grant, which will vest if the employee continues working for the corporation for four years. In addition, the employer stock is not transferable and there is no readily available market for the stock. Under Code Section 83(b), a taxpayer can make an election within 30 days of the date the unvested employer stock is transferred to him or her to pay tax on the fair market value of that stock (less any amount paid for it) at ordinary income tax rates. The fair market value of the stock is determined on the date it is transferred to the employee. Once an 83(b) election is made, it is irrevocable, and the employee must pay the applicable income taxes. Any subsequent appreciation of the employer stock during the vesting period will be taxed at capital gains rates when the stock is sold by the employee. The holding period for long-term capital gains treatment also begins on the date the stock is transferred, if an 83(b) election is made.

To make an 83(b) election, the employee would need to have the funds immediately available to write the employer a check to cover the employer’s income and employment tax withholding obligation on the $10,000 value of the award. If the employee does make the 83(b) election, the employee would pay taxes on $10,000 of ordinary income for the year of grant and then pay taxes on any increase in value at capital gains rates when the employee sells the stock in the future. If an 83(b) election is not filed, and the fair market value of the shares grows to $5 per share during the vesting period, then the employee would owe taxes (and the employer would be required to withhold income and employment taxes) on the $50,000 value of the shares on the date of vesting.

Unfortunately, the employee will most likely not have the funds readily available to pay the taxes due on $50,000 of non-transferable and non-marketable employer stock. Moreover, the employer will have a problem because the employer has income and employment tax withholding obligations that cannot be satisfied by selling a portion of the vested shares. This is one reason why many startups issue stock options, instead of restricted stock or RSUs, i.e., employees can wait to exercise the stock option until the employer’s stock can be sold on a securities exchange, or in a corporate transaction, when the employee can sell shares to cover the related income and employment taxes.

To illustrate the potential value of qualified equity grants and making an 83(i) election, consider the tax consequences of the example above if the startup vice president had been granted qualifying RSUs for 10,000 shares of employer stock which vest after four years. In year four, the vested 10,000 shares are still worth $50,000. If the vice president makes an 83(i) election within 30 days of the date the RSUs vest, then the $50,000 value of the employer stock transferred to the employee (assuming the transfer date is the same date as the vesting date) would be deferred for up to five years. By making a timely 83(i) election, the startup vice president does not have to pay any money out of pocket at the time of vesting. Five years is a long time in startup land for a liquidity event (sale, IPO, merger, etc.) to occur and put cash in the employee’s pocket to pay the taxes. Also, if during the five-year period the value of the stock increased to $20 per share (or $200,000), the employee would only pay ordinary income taxes on the deferred amount of $50,000 and would pay long-term capital gains rates on the remaining $150,000 in value.

Take-away

Private employers utilizing equity-based compensation for employees should review their equity-based compensation plans and their compensation objectives to determine if federal income tax deferrals permissible pursuant to Section 83(i) are desirable. This may be especially relevant to employers with employees who have expressed concerns with respect to equity-based compensation because of liquidity issues associated with the exercise of NQSOs or the settlement of RSUs because there does not exist a market for the stock.