US tax reform

Qualified equity grants by private companies under newly added Section 83(i)

Overview

On December 22, 2017 the US tax reform legislation (formally referred to as "An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018") (the "Act"), passed following successful reconciliation of the House and Senate versions of the bill. This document provides a summary of the changes to treatment of qualified equity grants by certain private companies under newly created Section 83(i) of the Internal Revenue Code.

Section 83(i) qualified equity grants

Under existing tax rules, nonstatutory stock options (i.e., options that are not incentive stock options or options granted under an employee stock purchase plan) granted at fair market value are generally not taxable until the exercise of the option if the service recipient receives fully vested stock. Additionally, restricted stock units (RSUs) that are exempt from, or comply with, the nonqualified deferred compensation rules under Section 409A are generally not taxable until delivery of fully vested stock.

Under the Act, and in addition to the existing tax rules described in the preceding paragraph, a "qualified employee" may elect to defer the income attributable to a stock option or RSU received in connection with the performance of services for up to five years if the corporation's stock is an "eligible corporation." Instead of including income at exercise of a stock option (assuming fully vested stock is received) or at delivery of fully vested stock as required under current law, if the qualified employee makes a timely "inclusion deferral election," then the employee will be subject to income tax at the earlier of the following dates:

- The date the qualified stock is transferrable;
- The date the employee becomes an "excluded employee";
- The date on which any stock of the employer becomes publicly traded;
- Five years after the employee's right to the stock is substantially vested; or
- The date the employee revokes the election.

A "qualified employee" is generally an individual who is not an excluded employee and who agrees, in the inclusion deferral election, to meet the requirements necessary to ensure the income tax withholding requirements with respect to the qualified stock are met. An "excluded employee" includes the following:

- An individual who becomes a 1 percent owner during the taxable year;
- A 1 percent owner of the corporation at any time during the 10 preceding calendar years;
- The current or former chief executive officer or chief financial officer of the corporation (or an individual acting in either capacity);
- A family member of an individual described above;
- One of the four highest-compensated officers of the corporation during the taxable year; or
- The four highest-compensated officers of the corporation for any of the 10 preceding taxable years.

A corporation is an "eligible corporation" with respect to a calendar year if no stock of the employer corporation (or any predecessor) is readily tradable on an established securities market during any preceding calendar year. Additionally, the corporation must have a written plan under which, in the calendar year, not less than 80 percent of all employees who provide services to the corporation in the United States (or any US possession) are granted stock options or RSUs with the same rights and privileges to receive qualified stock (the "80-percent requirement"). This test must be met with respect to options only or RSUs only, not a combination of the two. Note that the amount granted to each employee need not be identical under the plan.

Under the Act, corporations that are members of the same controlled group are treated as one corporation.

An inclusion deferral election must be made no later than 30 days after the first date the employee's right to the stock is substantially vested or is transferable, whichever is earlier. An election is generally made in the same manner as a Section 83(b) election. An inclusion deferral election may be made on a statutory stock option (i.e., incentive stock options or options granted under an employee stock purchase plan). If an election is made with respect to a statutory stock option, then the option is not subject to the statutory stock option rules.

With respect to the employer's deduction, if an employee makes an inclusion deferral election, the employer's deduction is also deferred until the employer's taxable year in which or with which ends the taxable year of the employee for which the amount is included in the employee's income. Also, the inclusion deferral election affects only the deferral of income tax and does not affect the timing of FICA (Federal Insurance Contributions Act) and FUTA (Federal Unemployment Tax Act).

The Act includes certain employee notice requirements. Specifically, a corporation that transfers qualified stock to a qualified employee must provide notice to the employee at, or a reasonable period of time prior to, the point qualified stock becomes substantially vested certifying that the stock is qualified stock. Additionally, the employee must be notified:

- That the employee may (if eligible) elect to defer income inclusion with respect to the stock;
- If the employee makes an inclusion deferral election, the income inclusion amount at the end of the deferral period will be based on the value of the stock at the time the employee's right to the stock first becomes substantially vested, notwithstanding whether the value of the stock has declined during the deferral period (including whether the value of the stock has declined below the employee's tax liability with respect to such stock); and
- That the amount of income to be included at the end of the deferral period will be subject to withholding.

Failure to provide the notice may result in the imposition of a penalty of $100 for each failure, subject to a maximum penalty of $50,000 for all failures during any calendar year.

The provision is generally applicable to options exercised, or restricted stock units granted, in 2018 and later taxable years.

The Act includes a transition rule providing that until regulations or other guidance related to implementing the 80-percent and employer notice requirements is issued, a corporation will be treated as complying with those requirements if it complies with a reasonable good-faith interpretation of the requirements.

Additionally, the provisions related to coordination with Sections 83 and 409A are intended to be limited to the specific issues raised by coordination with Section 83(i).

Deloitte's view

Following the passing of the Act, the most important steps for employers to take immediately include:

- Private corporations with broad-based compensatory stock option or RSU programs should evaluate whether resulting shares are qualified stock for which notification requirement applies:
    - If so, confirm that payroll systems and brokerage accounts properly handle differences in income tax and FICA tax timing, and that proper notice is provided to recipients.
    - If not, determine what is necessary to fall within the qualified stock definition to confirm deferral opportunity for employees.

You can read more about Deloitte Tax LLP's insights on US tax reform and the impact on mobility and rewards programs and also view upcoming events here.