



GMS Flash Alert

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United States - Guidance on Sec. 83(i) and Deferring Compensation on Qualified Stock

The U.S. Internal Revenue Service (IRS) recently released Notice 2018-97, which provides some initial guidance on a variety of questions involving the application of the Internal Revenue Code section 83(i) rules, including how employers can opt out of section 83(i), how to properly withhold income tax, and the appropriate application of the “80-percent rule.”¹

Section 83(i) provides non-public corporations an opportunity to offer employees up to a five-year deferral of income on qualifying non-statutory stock options and restricted stock units (“RSUs”).

The IRS anticipates incorporating this guidance into proposed regulations.

WHY THIS MATTERS

Section 83(i) provides new deferral opportunities for certain private employer equity arrangements. It allows a qualified employee to elect to defer compensation on the vesting of RSUs and/or the exercise of stock options, for federal income tax purposes, up to five years or when the private entity stock is liquid. If the stock is qualified for a section 83(i) election, an employer has notice requirements and is eventually required to withhold income tax at the highest rate if employees make the section 83(i) election.

There have been many questions regarding the operation of section 83(i) and how to comply with this new election. Notice 2018-97 offers some initial guidance to address some of these questions and provide a framework for employers going forward.

Background

Enacted with the signing of H.R. 1 in December 2017, section 83(i) is a response to the general tax rules under Code section 83 that, upon vesting, tax service providers have income inclusion on the fair market value of property received over the amount paid for such property. (For prior coverage of H.R. 1, see GMS [Flash Alert 2017-187](#), December 19, 2017.) Section 83(b) does allow taxpayers to elect early taxation of restricted shares on grant, but options and RSUs do not qualify for section 83(b) elections. As a result, RSUs and options may provide “dry income” to service recipients when such awards are received or exercised if they are settled in illiquid private company stock prior to an exit event. The potential benefit of qualified equity grants and section 83(i) elections is the deferral of income tax while qualifying for capital gains from the date of vesting/transfer.

Specifically, section 83(i) allows for “qualified employees” to make an election to defer income inclusion as a result of the transfer of “qualified stock” until the earliest of: the stock becoming transferable (including to the employer), the stock becoming traded on a securities market, the employee no longer being a qualified employee, the date the employee revokes the election, or five years from the election being made.

“Qualified employees” are all employees who are not:

- a 1-percent owner of the corporation, or who have been a 1-percent owner of the corporation in the past 10 years;
- an individual who is or has been at any time, the Chief Executive Officer or Chief Financial Officer, or any individual acting in such roles;
- any individual who bears a relationship to such 1-percent owners or officers as described by section 318(a)(1); or
- any individual who is one of the four most highly compensated officers of the corporation (or who has been one such officer in the past 10 years), determined using SEC shareholder disclosure rules.

Section 83(i) defines “qualified stock” as shares granted to a qualified employee, by an eligible corporation, if the stock is received in connection with the exercise of an option or RSU that was granted in connection with the performance of services for the eligible corporation. An eligible corporation is any corporation that is not publicly traded, and has a written plan under which at least 80 percent of qualified employees are granted stock options or RSUs for which they can receive qualified stock. There are additional notice and election requirements contained in the statutory language.²

Transitional relief applies until regulations are promulgated for any good faith, reasonable interpretation of section 83(i).

Notice 2018-97

Notice 2018-97 specifically addresses three aspects of section 83(i): the application of the 80-percent rule, the federal income tax withholding of the deferred income from qualified stock, and the question of whether employers are able to “opt-out” of section 83(i).

Application of the 80-Percent Rule

Several commentators asked whether the requirement that 80 percent of qualified employees receive qualified stock under a written plan is applied cumulatively or if the test is applied on an annual basis. The Notice clarifies that the plain language of the statute indicates that the determination of whether a corporation is an eligible corporation occurs each calendar year, and the 80-percent requirement means taking into account the number of qualified employees granted stock options or RSUs, as well as the number of total employees as of such calendar year. Further, the Notice provides that the 80-percent requirement is not applied cumulatively and that such interpretation is not considered a reasonable, good faith interpretation such that transitional relief is available.

Application of Withholding Rules to Income on Deferred Stock

The Notice clarifies that though the federal income tax withholding rules were amended with respect to qualified stock, the FICA and FUTA rules were not.³ Thus, FICA and FUTA withholding and deposits are unchanged by a section 83(i) election and continue to apply to such shares as those sections would have previously.

The federal income tax withholding rules, however, have been amended with respect to deferral stock. The Notice clarifies that deferral stock is included in wages at the end of the deferral period as determined under section 83(i), in an amount determined under section 83 generally. The rate of tax withholding with respect to deferral stock is not to be less than the maximum tax rate in effect for the year of inclusion, and that deferral stock is to be treated under the non-cash fringe benefit withholding rules as provided in IRS Announcement 85-113.⁴

Since section 3401(i) provides specific dates that deferral stock is treated as wages (as determined under section 83(i)), certain aspects of Announcement 85-113 do not apply to deferral stock. First, an employer cannot pick a date to have the income tax apply. Second, an employer cannot treat benefits provided in the last two months as applying in the subsequent calendar year.

KPMG NOTE

When the qualified stock is treated as paid under section 83(i), the employer makes a reasonable estimate of the value in order to make a timely deposit of federal income tax withholding based on that estimate. Best practice may include determining this value when relevant withholding must occur at the highest tax rate. Withholding cannot be decreased or increased based on the employee's Form W-4. By January 31 of the following year, the employer must determine the actual value of the stock on the date includible in the employee's income based on the original vest or exercise date and report such amount on the employee's Form W-2. If income tax is paid from the employee's own funds, the employer can recover amounts from the employee by April 1 of the year following the date the stock is treated as paid.

Withholding and Escrow Arrangements

Finally, the Notice provides that, when making the election under section 83(i), the qualified employee must agree to an escrow arrangement that provides the following:

- The deferral shares must be deposited in escrow before the end of the calendar year in which the transfer is made, and must remain in escrow until such time as the withholding may be collected on such shares.
- The employer has the ability to, at any time between the date of income inclusion and March 31st of the subsequent calendar year, remove a portion of such shares from escrow to satisfy withholding obligations. The number of shares removed will be enough such that the fair market value of the shares (as determined using the rules under section 409A) will satisfy withholding obligations.
- Any shares remaining in escrow must be delivered to the employee as soon as reasonably practicable after the withholding obligation has been met.

The Notice provides that future guidance may provide for alternative or substitute arrangements for satisfying the federal income tax withholding requirements.

Ability of Employers to “Opt Out”

The Notice provides that to the extent a corporation would otherwise meet the various definitions and requirements so that a section 83(i) election may be made, but the corporation does not wish to allow employees to make a section 83(i) election, it is possible for the employer to do so. The corporation need merely not create an escrow arrangement such as described within the Notice. If there is no escrow arrangement provided, then employees are unable to make a section 83(i) election.

FOOTNOTES:

- 1 See [Notice 2018-97](#), on the IRS website.
- 2 For more detailed analysis of the statutory requirements of section 83(i), please see our [Global Reward Services Alert](#) on the section 83(i) election.
- 3 FICA is a U.S. federal payroll tax tied to Social Security and Medicare. It stands for *Federal Insurance Contributions Act*. FUTA is a tax for unemployment imposed on employers. It stands for *Federal Unemployment Tax Act*.
- 4 *Announcement 85-113*, 1985-31 I.R.B. 31.

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