Deferred Compensation and the New Tax Act

By Logan Hinkle and Debra Mackey January 2018

The Tax Cuts and Jobs Act of 2017 (the "TCJA") contains a new provision that potentially offers a substantial benefit to participants in equity incentive plans. Prior to its passage, much of the incentive-compensation related discussion regarding the TCJA centered on certain proposed changes that, if passed, would have substantially curtailed the use of deferred and equity compensation arrangements. In the end, however, these provisions were not included in the final bill.

The TJCA creates a new Section 83(i) of Internal Revenue Code. This provision allows certain employees of eligible companies to delay the taxation of gains realized from certain stock options or restricted stock units ("RSUs") for up to five years.

Prior to the enactment of the TJCA, an employee exercising a non-qualified stock option generally had to recognize ordinary income in the taxable year in which the employee exercised the option. The amount of the income was the difference between what the employee paid for the stock obtained pursuant to the option and the stock's actual fair market value on the date of exercise. Similarly, RSUs generally were taxed on the date of vesting. At that time, an employee holding RSUs normally was required to recognize ordinary income equal to the fair market value of the underlying stock (less any amount that the employee is required to pay for such stock).

An employee making an election pursuant to the new Section 83(i) will defer the taxation of income related to “qualified stock” until the earliest of:

- the date that is five years after the stock vests (five years is the maximum deferral);
- the date the stock becomes transferable;
- the date the stock becomes readily tradable on an established securities market (pursuant to an IPO, for example);
- the date the employee becomes an “excluded employee”; or
- the date the employee revokes the 83(i) election.

If a proper 83(i) election is made, the income that must be recognized by the employee at the end of the deferral period is based upon the fair market value of the stock at the time the election was made, regardless of increases or decreases in value during the holding period.

The new Section 83(i) is effective and generally applies to stock attributable to options exercised or restricted stock units settled after December 31, 2017.

Certain requirements must be met to take advantage of Section 83(i):

1) Only income related to “qualified stock” is eligible for deferral under Section 83(i). Qualified stock is: (i) received through the exercise of an option or settlement of a restricted stock unit and (ii) granted in connection with the performance of services during a calendar year in which the employer was an "eligible corporation." Otherwise qualified stock will be disqualified if the employee may receive cash in lieu of the stock at the time of the stock's vesting or if the corporation has repurchased any of its outstanding stock during the preceding year (subject to certain exceptions).

2) The qualified stock must be issued by an "eligible corporation." An eligible corporation must be privately held. The equity at issue must be offered pursuant to a written plan under which at least 80% of the corporation's U.S. based full-time employees participate. The number of options or RSUs issued to each employee need not be the same (however, de-minimis awards don't count toward the 80% minimum) but all awards must carry the same rights and benefits.

3) "Excluded employees" may not take advantage of Section 83(i). Excluded employees are: (i) 1% owners (at any time during the current or preceding 10 years), (ii) any person that has ever served as the CEO/CFO (including an individual acting in such capacity even if such person carries a different title), (iii) family members of 1% owners or the CEO/CFO, and (iv) the four highest compensated officers (at any time during the current or preceding 10 years).

4) The Section 83(i) election must be made within 30 days after the employee's rights to the qualified stock vest. As with an 83(b) election, the employee must file the 83(i) election with the IRS and provide a copy, containing certain information about the stock subject to the election, with the employer. An employee that has already made an 83(b) election may not make an 83(i) election with respect to the same stock. A Section 83(i) election will also cause an incentive stock option to be treated as a non-qualified stock option.

Section 83(i) imposes notice and reporting requirements upon employers. At the time the stock vests, the employer must notify the employee that the stock is qualified stock and that the employee may be eligible to make an election to defer under Section 83(i). In addition, the employer must inform the employee of the tax consequences of the 83(i) election. The IRS may impose a penalty tax for failure to comply with these requirements.

Income deferred pursuant to 83(i) must be reported on Form W-2, both for the year of deferral and the year in which it is recognized by the employee. Income tax withholding applies in the year in which the deferral ends. The 83(i) election is effective only for income tax purposes. The employer must still pay FICA (both employee and employer shares) and FUTA tax in the year in which the stock vests.

The TJCA makes it clear an 83(i) election alone does not create a deferred compensation arrangement subject to Internal Revenue Code Section 409A.

83(i) has the potential to substantially increase the value of equity compensation. However, because of the 80% participation requirement, the most likely beneficiaries of Section 83(i) appear to be employees of start-up and other early stage companies. In those situations, 83(i) could promote broad-based employee ownership and provide a valuable upside incentive to large groups of non-executive employees. For established companies, it's too early to tell if 83(i) will become a valuable compensation tool.

If you would like more information on Qualified Equity Grants, Section 83(i) or any other portion of the TCJA, please contact:

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If you would like more information on any of these tax matters, please contact:

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- Jim McCarten, Josh Ehrenfeld, Tucker Herndon and/or Maureen Beaver in Nashville at (615) 724-3200;
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- Warren Matthews in Montgomery at (334) 241-7000; and
- Scott Miller in Orlando at (407) 540-6600.
