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# Avoiding Gain on the Receipt or Vesting of Startup Company Stock

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By: Roger Royse

The 2017 Tax Cuts and Jobs Act added section 83(i) to the Internal Revenue Code to allow employees to defer for up to five years the income taxes that would be due on the grant or vesting of stock received on exercise of an option. We described the new law a year ago [here](#) and note this is a huge potential benefit to optionees who are discouraged to exercise nonstatutory options (NSO) because of the tax hit.

We now have a year of experience with 83(i) and the IRS has issued guidance on the new rules. As you may recall, the 83(i) election allows a “qualified employee” to elect, within 30 days of vesting, to defer the taxable income that would otherwise result from the grant or vesting of qualified stock to the earliest of (i) the date the stock becomes transferable (ii) the date the employee becomes an “excluded employee” (ii) the date the stock is listed or (iv) 5 years after vesting or transferability. Qualified stock is generally stock received on exercise of a stock option or in settlement of an RSU. An excluded employee is, generally, regarding the employer corporation, a 1% owner, the CEO or CFO, a related party or a highly compensated individual (as defined).[\[1\]](#)

In Notice 2018-97, the IRS issued guidance in three areas: (1) the requirement that grants be made to not less than 80% of all employees who provide services to the corporation in the United States[\[2\]](#), (2) the application of federal income tax withholding to the deferred income related to the qualified stock, and (3) the ability of an employer to opt out of permitting employees to elect the deferred tax treatment even if the requirements under section 83(i) are otherwise met. An “eligible corporation” is any corporation that has no stock tradable on an established securities market, has a written plan under which not less than 80% of all employees who provide services to the corporation in the United States are granted stock options, or are granted RSUs, with the same rights and privileges to receive qualified stock.

## The 80% requirement

Some commentators asked how the 80% is determined. Is it a cumulative number, for example, or annual? The Notice states that the determination is not cumulative, but made on a calendar year basis, and whether the corporation has satisfied the 80% requirement is based solely on the stock options or the RSUs granted in that calendar year to employees who provide services to the corporation in the United States (or any possession of the United States). Unfortunately, this interpretation renders the 83(i) exclusion useless for a lot of optionees.

## Withholding

Taxpayers had questions about how withholding would apply when the 5 year deferral period

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ends. Section 3403(t) treats 83(i) stock like a noncash fringe benefit. The Notice concludes that deferral stock constitutes wages under section 3401(i) and is treated as received on the earliest date described in section 83(i)(1)(B) in an amount equal to the amount included in income. The company can make a reasonable estimate of value for this purpose. As a practical matter, this will require a large cash payment for taxes at some future date, even though the underlying stock may be illiquid. The Notice requires that deferral stock be held in escrow to satisfy withholding requirements. This could place a burden on cash strapped startups with illiquid stock.

## Employer Opt Out

A corporation might not want to make the section 83(i) election available to its employees, especially given the withholding requirement and compliance issues. The law allows a corporation to preclude its employees from making section 83(i) elections by declining to establish an escrow arrangement as described above. There, to properly set expectations with employees, a stock option should provide that no election under section 83(i) will be available regarding stock received upon exercising the stock option (or settlement of the RSU). Failing to have that clause in the option plan may be a “gotcha’ down the road).

A year later, we have seen few (if any) employers actually take Congress up on its 83(i) program. While the statute is directionally right, the escrow requirement, the possibility of a big tax bill before liquidity and the 80% annual requirement has made this intended benefit to the startup community illusory and another compliance hassle in the worst case.

[\[1\]](#) IRC section 83(i)(3)(B).

[\[2\]](#) IRC section 83(i)(2)(C)(i)(II)