

Guidance on the Application of Section 83(i)

Notice 2018-97

I. PURPOSE

This notice provides initial guidance on the application of section 83(i) of the Internal Revenue Code (Code), as enacted by section 13603 of the Tax Cuts and Jobs Act, Pub. Law 115-97, 131 Stat. 2054, 2155 (2017) (Act). Section 83 generally provides for the federal income tax treatment of property transferred in connection with the performance of services. Section 13603 of the Act amended section 83 by adding section 83(i) to allow certain employees to defer recognition of income attributable to the receipt or vesting of qualified stock.

Stakeholders have indicated that they would benefit from initial guidance on certain aspects of section 83(i), in particular on (1) the application of the requirement in section 83(i)(2)(C)(i)(II) that grants be made to not less than 80% of all employees who provide services to the corporation in the United States, (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. In response, this notice addresses these three issues. The Department of the Treasury (Treasury Department) and the Internal Revenue Service (IRS) anticipate that further guidance on section 83(i) will be issued in the form of proposed regulations, which are expected to incorporate the guidance provided in this notice.

II. BACKGROUND

Section 83(i) allows certain employees to elect to defer inclusion in income of the amount that would otherwise be included under section 83(a) upon the transfer of stock pursuant to the exercise of a stock option or the settlement of a restricted stock unit (RSU). Inclusion of that income may be deferred for up to 5 years as the result of a section 83(i) election, subject to certain limitations described in this Background section.

A. Effect of a Section 83(i) Election

Section 83(i)(1)(A) provides that if qualified stock is transferred to a qualified employee who makes an election under section 83(i) with respect to such stock, the amount determined under section 83(a) with respect to such stock will be included in income in the taxable year determined under section 83(i)(1)(B). Accordingly, such income shall be included in the taxable year of the employee which includes the earliest of:

- (i) the first date such qualified stock becomes transferable (including, solely for purposes of this clause, transferable to the employer);
- (ii) the date the employee first becomes an excluded employee;
- (iii) the first date on which any stock of the issuing corporation becomes readily tradable on an established securities market;
- (iv) the date that is 5 years after the first date the rights of the employee in such stock are transferable or not subject to a substantial risk of forfeiture, whichever occurs earlier; or
- (v) the date on which the employee revokes the election (at such time and in such manner as the Secretary of the Treasury (Secretary) provides).

B. Definition of “Qualified Employee”

Section 83(i)(3)(A) defines a “qualified employee” as any individual who is not an “excluded employee” and who agrees to meet such requirements as are determined by the Secretary to be necessary to ensure that the withholding requirements of the corporation under chapter 24 (Collection of Income Tax at Source on Wages) with respect to the qualified stock are met.

An “excluded employee” is defined under section 83(i)(3)(B) as, with respect to any corporation, any individual:

- (i) who is a 1 percent owner at any time during the calendar year or who was a 1 percent owner at any time during the 10 preceding calendar years;
- (ii) who is or has been at any prior time (I) the chief executive officer (or an individual acting in such capacity) or (II) the chief financial officer (or an individual acting in such capacity);
- (iii) who bears a relationship described in section 318(a)(1) to any individual described in subclause (I) or (II) of clause (ii); or
- (iv) who is one of the 4 highest compensated officers of the corporation for the taxable year, or was one of the 4 highest compensated officers of such corporation for any of the 10 preceding taxable years, determined on the basis of the shareholder disclosure rules for compensation under the Securities Exchange Act of 1934 (as if such rules applied to such corporation).

C. Definition of “Qualified Stock”

Section 83(i)(2)(A) defines “qualified stock” as any stock in a corporation that is the employer of a qualified employee, if such stock is received (i) in connection with the exercise of a stock option or in settlement of an RSU, and (ii) such stock option or RSU was granted in connection with the performance of services as an employee and during a calendar year that the employer corporation was an eligible corporation. Section 83(i)(5) provides that, for purposes of this subsection, all persons treated as a single employer under section 414(b) shall be treated as one corporation. Section 83(i)(2)(B) provides that qualified stock does not include any stock if the employee may sell the stock to, or otherwise receive cash in lieu of stock from, the corporation at the time that the employee’s rights to the stock first become transferable or not subject to a substantial risk of forfeiture.

D. Definition of “Eligible Corporation”

Section 83(i)(2)(C)(i) defines an “eligible corporation” as any corporation that, with respect to any calendar year, (i) has none of its (or any predecessor’s) stock readily tradable on an established securities market during any preceding calendar year, and (ii) has a written plan under which, in such calendar year, not less than 80% of all employees who provide services to the corporation in the United States (or any possession of the United States) are granted stock options, or are granted RSUs, with the same rights and privileges to receive qualified stock. As provided in section 83(i)(2)(C)(iii), for purposes of section 83(i)(2)(C)(i)(II), the term “employee” does not include any excluded employee or any employee described in section 4980E(d)(4) (certain part-time employees).

Section 83(i)(2)(C)(ii)(I) provides that the determination of rights and privileges shall be made in a manner similar to the determination under section 423(b)(5). However, in accordance with section 83(i)(2)(C)(ii)(II), employees shall not fail to be treated as having the same rights and privileges to receive qualified stock solely because the number of shares available to all employees is not equal in amount, so long as the number of shares available to each employee is more than a de minimis amount. In addition, section 83(i)(2)(C)(ii)(III) provides that rights and privileges with respect to the exercise of an option shall not be treated as the same as rights and privileges with respect to the settlement of an RSU. Finally, in the case of any calendar year beginning before January 1, 2018, section 83(i)(2)(C)(iv) provides that neither stock options nor RSUs are required to have been granted with the same rights and privileges for the stock received to be treated as qualified stock.

E. Manner of Making Election

Section 83(i)(4)(A) provides that an election with respect to qualified stock shall be made no later than 30 days after the first date the rights of the employee in such stock are transferable or are not subject to a substantial risk of forfeiture, whichever occurs earlier, and shall be made in a manner similar to the manner in which an election is made under section 83(b). Section 83(i)(4)(C) provides that the term “deferral stock” is used to refer to stock with respect to which a section 83(i) election has been made.

Section 83(i)(4)(B) provides that no election may be made under section 83(i) if the qualified employee has made an election under section 83(b) with respect to such qualified stock, or if any stock of the corporation which issued the qualified stock is readily tradable on an established securities market at any time before the election is

made. In addition, no election may be made under section 83(i) with respect to any qualified stock if the corporation that issued the stock purchased any of its outstanding stock in the calendar year preceding the calendar year which includes the first date the rights of the employee are transferable or are not subject to a substantial risk of forfeiture, unless (i) not less than 25% of the total dollar amount of the stock so purchased is deferral stock, and (ii) the determination of which individuals from whom deferral stock is purchased is made on a reasonable basis.

F. Notice Requirement

Section 83(i)(6) provides that any corporation which transfers qualified stock to a qualified employee shall, at the time an amount attributable to such stock would first be includible in the gross income of such employee (or a reasonable time before), certify to the employee that such stock is qualified stock, and notify the employee that the employee may be eligible under section 83(i) to defer income on such stock. Section 83(i)(6) provides that the corporation must also notify the employee that if the employee makes such an election:

- (i) the amount of income recognized at the end of the deferral period will be based on the value of the stock at the time at which the rights of the employee first become transferable or not subject to a risk of forfeiture, notwithstanding whether the value of the stock has declined during the deferral period;
- (ii) the amount of such income recognized at the end of the deferral period will be subject to withholding under section 3401(i) at the rate determined under section 3402(t); and

(iii) the responsibilities of the employee, as determined by the Secretary under section 83(i)(3)(A)(ii), with respect to such withholding.

Section 6652 was amended by the Act to include a new subsection (p) which imposes a \$100 penalty for each failure to provide a notice as required by section 83(i)(6) (up to a maximum of \$50,000 per calendar year), unless it is shown that such failure is due to reasonable cause and not to willful neglect. The penalty applies to failures after December 31, 2017.

G. Transition Rule

Section 13603(g) of the Act provides that until the Secretary (or the Secretary's delegate) issues regulations or other guidance for purposes of implementing the 80% requirement of section 83(i)(2)(C)(i)(II) or the notice requirements of section 83(i)(6), a corporation shall be treated as in compliance with those requirements if the corporation complies with a reasonable good faith interpretation of such requirements.

III. GUIDANCE

A. Application of the 80% Requirement

As described above, section 83(i)(2)(C) defines an "eligible corporation," in relevant part, as, with respect to any calendar year, any corporation that has a written plan under which, in such calendar year, not less than 80% of all employees who provide services to the corporation in the United States (or any possession of the United States) are granted stock options, or are granted RSUs, with the same rights and privileges to receive qualified stock. Stakeholders have asked whether the 80% requirement of section 83(i)(2)(C)(i)(II) with respect to a calendar year is applied on a cumulative basis that takes into account stock options or RSUs granted in prior calendar

years.

The determination of whether a corporation qualifies as an eligible corporation is made “with respect to any calendar year.” Furthermore, to meet the 80% requirement, the corporation must have granted “in such calendar year” stock options to 80% of its employees or RSUs to 80% of its employees. Therefore, the determination that the corporation is an eligible corporation must be 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). In calculating whether the 80% requirement is satisfied, the corporation must take into account the total number of individuals employed at any time during the year in question as well as the total number of employees receiving grants during the year (in each case, without regard to excluded employees or part-time employees described in section 4980E(d)(4)), regardless of whether the employees were employed by the corporation at the beginning of the calendar year or the end of the calendar year.

The Treasury Department and the IRS have determined that interpreting the 80% requirement of section 83(i)(2)(C)(i)(II) with respect to a calendar year on a cumulative basis that takes into account stock options or RSUs granted in prior calendar years is contrary to the language of the statute and is not a reasonable good faith interpretation of the 80% requirement. Accordingly, the transition rule in section 13603(g) of the Act does not apply to such an interpretation.

B. Employment Taxes (including Income Tax Withholding)

1. General

Employment taxes under Subtitle C of the Code include Federal Insurance Contributions Act (FICA) taxes, Federal Unemployment Tax Act (FUTA) tax, and federal income tax withholding. The Act made no amendments to FICA and FUTA taxation with respect to deferral stock. Thus, the FICA and FUTA taxation of deferral stock is unaffected by the Act. See H.R. Rep. No. 115-466, at 501 (2017).¹

The Act did amend the income tax withholding provisions in the Code with respect to deferral stock. Specifically, section 13603(b) of the Act amended the income tax withholding provisions, as described below, to conform the income tax withholding provisions in section 3401 and section 3402 to the income taxation of deferral stock. The remainder of the discussion of employment taxes concerns only federal income tax withholding.

Section 3402(a) provides that, except as otherwise provided in section 3402, every employer making payment of wages shall deduct and withhold upon such wages a tax determined in accordance with tables or computational procedures prescribed by the Secretary. The term “wages” is defined in section 3401(a) for income tax withholding purposes as including all remuneration for services performed by an employee for his or her employer including the cash value of all remuneration (including benefits) paid in any medium other than cash, with certain specific exceptions. Section 3401(i), as added by section 13603(b)(1) of the Act, provides that for purposes of section 3401(a), qualified stock (as defined in section 83(i)) with respect to which an election is made under section 83(i) is treated as wages (1) received on the earliest date described in section 83(i)(1)(B), and (2) in an amount equal to the amount included

¹ See H.R. Rep. No. 115-466, pages 496-497 for a discussion of FICA and FUTA taxation.

in income under section 83 for the taxable year which includes such date. Thus, under section 3401(i), the amount of the deferral stock included in gross income is treated as wages subject to federal income tax withholding on the earliest date described in section 83(i)(1)(B), which sets forth the end date of the applicable deferral period.

Section 3402(t), which was added by section 13603(b)(2) of the Act, provides that, in the case of any qualified stock with respect to which an election is made under section 83(i), (1) the rate of tax under section 3402(a) must not be less than the maximum rate in effect under section 1 (37% in 2018), and (2) such stock is treated for purposes of section 3501(b) in the same manner as a noncash fringe benefit.

Section 3501(b) provides that the taxes imposed by Subtitle C with respect to noncash fringe benefits must be collected (or paid) by the employer at the time and in the manner prescribed by the Secretary by regulations. Questions and Answers 5 and 6 of § 31.3501(a)-1T provide that the employer is liable for the payment of the tax with respect to a noncash fringe benefit regardless of whether the benefit is paid by another entity.

Noncash fringe benefits that fall within section 3501(b) generally are subject to the provisions of Announcement 85-113, 1985-31 I.R.B. 31, which provides guidelines for withholding, paying, and reporting employment tax on taxable noncash fringe benefits. Announcement 85-113 provides generally that taxpayers may rely on the guidelines in the announcement until the issuance of regulations that supersede the temporary and proposed regulations under section 3501(b). No regulations have been issued under section 3501(b) that supersede the announcement. Thus, Announcement 85-113 generally is applicable to current payments of noncash fringe benefits, and until

further regulatory guidance is issued, it applies to deferral stock, except as limited by the specific rules of section 3401(i) and the terms of the announcement itself, as discussed further below.

Section 2 of Announcement 85-113 sets out the general income tax and accounting rule, which provides, in relevant part, that employers must withhold the applicable income tax on the date the benefits are paid and must deposit the withheld taxes under the regular rules for tax deposits. The employer may make a reasonable estimate of the value of the fringe benefit on the date the fringe benefit is paid for purposes of meeting the timely deposit requirements. The actual value of the fringe benefit must be determined by January 31 of the following year and reported on Form W-2, Wage and Tax Statement, and Form 941, Employer's Quarterly Federal Tax Return (or Form 944, Employer's Annual Federal Tax Return, if applicable instead of Form 941).

Announcement 85-113 states that if the employer underestimates the value of the fringe benefit and as a result deposits less than the amount required to be deposited (that is, the amount the employer would be required to deposit if the employer had correctly withheld the applicable taxes), the employer may be subject to the failure to deposit penalty under section 6656. Under Announcement 85-113, if the employer overestimates the value and deposits more than the amount required, the employer may claim a refund or elect to have the overpayment applied to the employer's next Form 941 (or other employment tax return).

Generally, under § 31.6205-1(d)(2), if an employer collects less than the correct amount of income tax required to be withheld from wages during a calendar year, the

employer must collect the amount of the undercollection on or before the last day of the year by deducting the amount from remuneration of the employee. Under § 31.6205-1(d)(2),² if such a deduction is not made, the obligation of the employee to the employer with respect to the undercollection is a matter for settlement between the employee and the employer within the calendar year. However, in the case of noncash fringe benefits, Announcement 85-113 permits the employer to recover the undercollection of income tax withholding from the employee after the end of the calendar year during which the wage payment is made, as long as the recovery occurs prior to April 1 of the year following the year in which the benefits are paid. This rule in Announcement 85-113 applies to the amount included in wages under section 3401(i). Thus, with regard to any income tax withholding that the employer deposits for deferral stock included in wages under section 3401(i) that has not been collected from the employee, the employer may recover the income tax from the employee prior to April 1 of the year following the year in which the inclusion in wages under section 3401(i) occurs.

Section 3401(i) provides the specific date on which deferral stock must be treated as wages for income tax withholding purposes and the special rules for timing of inclusion in income under Announcement 85-113 available with respect to certain noncash fringe benefits do not apply.³ The withholding rates described in section 2 of

² The reference in Announcement 85-113 is to the section of the regulations (§ 31.6205-1(c)(4)) setting forth the same principle in the section 6205 regulations before amendments to the regulations after 1985. See T.D. 9405, 72 FR 37376 (July 1, 2008).

³ Announcement 85-113 provides two rules applicable to the date of payment of some noncash fringe benefits that do not apply to deferral stock. The first rule allows payors of certain noncash fringe benefits to treat the benefits as paid on any day(s) during the year so long as they treat benefits provided in a calendar year as paid not later than December 31 of the calendar year. The second rule allows employers to treat certain benefits paid during the last two months of the year (or any shorter period) as paid during the subsequent calendar year. However, Announcement 85-113 provides that neither of these two rules applies when the fringe benefit is the transfer of personal property (either tangible or intangible) of a kind normally held for investment or the transfer

Announcement 85-113 also do not apply to deferral stock because, under section 3402(t)(1), the income tax withholding rate under section 3402(a) “shall not be less than the maximum rate of tax in effect under section 1.” The Treasury Department and the IRS expect that proposed regulations providing further guidance on section 83(i) will provide that the rate of withholding under section 3402(t)(1) on deferral stock is the maximum rate of tax in effect under section 1 and will provide that withholding is applied (1) without reference to any payment of regular wages, (2) without allowance for the number of allowances or other dollar amounts claimed by the employee on Form W-4, Employee’s Withholding Allowance Certificate, (3) without regard to whether the employee has requested additional withholding, and (4) without regard to the withholding method used by the employer. Thus, under the anticipated proposed regulations, only one rate, the maximum rate of tax under section 1, would be used in withholding on deferral stock under section 3402(t), and employers would not be able to increase or decrease the rate at the request of the employee. Under Code section 3402(t) and this notice and unless and until superseding guidance is issued, with respect to wages resulting from deferral stock under section 3402(t), employers must withhold taxes at the maximum rate of income tax under section 1 without regard to whether the employee has requested additional withholding and without regard to any withholding allowances or dollar amounts entered on the employee’s Form W-4.

In summary, 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 under section 83 for the taxable year that

of real property. Because deferral stock is personal property of a kind normally held for investment, neither of these rules may be used with respect to deferral stock.

includes such date. When the wages are treated as paid under section 3401(i), the employer must make a reasonable estimate of the value of the stock and make deposits of the amount of income tax withholding liability based on that estimate. The wages included under section 3401(i) are subject to withholding at the maximum rate of tax in effect under section 1, and withholding is determined without regard to the employee's Form W-4. By January 31 of the following year, the employer must determine the actual value of the deferral stock on the date it is includible in the employee's income and report that amount and the withholding on Form W-2 and Form 941. With respect to income tax withholding for the deferral stock that the employer pays from its own funds, the employer may recover that income tax withholding from the employee until April 1 of the year following the calendar year in which the wages were paid.

An employer that fails to deduct and withhold federal income tax under section 3402 is liable for the payment of the tax whether or not the employer collects it from the employee, unless section 3402(d) applies.⁴ Section 3402(d) provides that if the employer fails to deduct and withhold the correct amount of income tax withholding, and thereafter the income tax against which the tax under section 3402 may be credited is paid, the tax imposed under section 3402(a) shall not be collected from the employer. Section 3402(d) does not relieve the employer from liability for any penalties in respect of the failure to deduct and withhold.

2. Escrow Arrangement

Section 83(i)(3)(A)(ii) provides the Secretary with authority to impose any requirements as the Secretary determines to be necessary to ensure that the

⁴ Section 3403, Section 31.3403-1.

withholding requirements of the corporation under chapter 24 with respect to the qualified stock are met. In order to be a qualified employee, an employee making an election under section 83(i) must agree in the election to these requirements.

Pursuant to the authority provided to the Secretary under section 83(i)(3)(A)(ii), in order to be a qualified employee an employee making a section 83(i) election with respect to qualified stock must agree in the election that all deferral stock will be held in an escrow arrangement, the terms of which are consistent with the following requirements:

- (i) The deferral stock must be deposited into escrow before the end of the calendar year during which the section 83(i) election is made and must remain in escrow until removed in accordance with clause (ii) or the corporation has otherwise recovered from the employee an amount equal to the corresponding income tax withholding obligation under section 3401(i) for the taxable year determined in accordance with section 83(i)(1)(B).
- (ii) At any time between the date of income inclusion under section 83(i)(1)(B) and March 31 of the following calendar year, the corporation may remove from escrow and retain the number of shares of deferral stock with a fair market value equal to the income tax withholding obligation that has not been recovered from the employee by other means. The fair market value of the shares must be determined pursuant to the rules in § 1.409A-1(b)(5)(iv). The fair market value used for purposes of this calculation is the fair market value of the shares at the time the corporation retains shares held in escrow to satisfy the income tax withholding obligation.

- (iii) Any remaining shares held in escrow after the corporation's income tax withholding obligation has been met, whether by retention of shares in accordance with clause (ii) or otherwise, must be delivered to the employee as soon as reasonably practicable thereafter.

The Treasury Department and the IRS have concluded that the escrow arrangement described above adequately ensures the statutory income tax withholding requirements of the corporation will be met and that this approach is less burdensome than alternatives that would require a cash outlay by the corporation or the employee before the due date for the relevant withholding, and thus allow less flexibility with respect to resource allocation. If the corporation and the employee do not agree to deposit the deferral stock into an escrow arrangement consistent with the terms outlined above, the employee is not a "qualified employee" within the meaning of section 83(i)(3). The Treasury Department and the IRS are aware that this has the effect of allowing a corporation to preclude its employees from making section 83(i) elections by declining to establish an escrow arrangement consistent with the terms outlined above.

Future guidance on section 83(i)(3)(A)(ii) may establish alternative or substitute mechanisms to ensure a corporation's income tax withholding requirements are satisfied. Such mechanisms may be more restrictive than the above described escrow arrangement.

C. Designation of Stock as Not Eligible for Section 83(i) Election

As described above, section 83(i) imposes a number of requirements and limitations that must be met for a section 83(i) election to be allowed. Although the election, if allowed, may be made by an employee, the corporation is responsible for

creating the conditions that would allow an employee to make the election.

Stakeholders have indicated that a corporation may wish to compensate its employees with equity-based compensation for which no section 83(i) election may be made. As noted above, a corporation can preclude its employees from making section 83(i) elections by declining to establish an escrow arrangement as described in Section III.B.2 of this notice. As a result, a corporation need not be concerned that it would inadvertently create the requisite conditions for its employees to make section 83(i) elections or be required to comply with the notice requirement of section 83(i)(6). If a corporation does not intend to deposit qualified stock into an escrow arrangement (as described in Section III.B.2 of this notice) or otherwise create the conditions that would allow an employee to make the section 83(i) election, the terms of a stock option or RSU may provide that no election under section 83(i) will be available with respect to stock received upon the exercise of the stock option or settlement of the RSU. This designation would inform employees that no section 83(i) election may be made with respect to stock received upon exercise of the option or settlement of the RSU even if the stock is qualified stock.

IV. EFFECTIVE DATE

Section 83(i) applies to stock attributable to stock options exercised, or RSUs settled, after December 31, 2017. The Treasury Department and the IRS anticipate that the guidance in this notice will be incorporated into future regulations that, with respect to issues addressed in this notice, will apply to any taxable year ending on or after December 7, 2018. Any future guidance, including regulations, addressing the issues covered by this notice, such as the establishment of more restrictive mechanisms to

ensure a corporation's income tax withholding requirements are satisfied, will apply prospectively only.

V. REQUEST FOR COMMENTS

The Treasury Department and the IRS anticipate issuing further guidance on section 83(i). Accordingly, comments are requested on additional issues under section 83(i) that future guidance should address, as well as any clarifications or further guidance that may be helpful on the issues addressed in this notice. Comments specifically are requested on additional or alternative mechanisms that could be established to ensure the collection of the required income tax withholding in accordance with section 83(i)(3)(A)(ii).

Written comments may be submitted through February 5, 2019. Comments should include a reference to Notice 2018-97. Comments may be submitted electronically via the Federal eRulemaking Portal at www.regulations.gov (type IRS-2018-0039 in the search field on the **regulations.gov** homepage to find this notice and submit comments). Alternatively, submissions may be sent to CC:PA:LPD:PR (Notice 2018-97), Room 5203, Internal Revenue Service, P.O. Box 7604, Ben Franklin Station, Washington, DC 20044. Submissions also may be hand delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to CC:PA:LPD:PR (Notice 2018-97), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC 20044. All recommendations for guidance submitted by the public in response to this notice will be available for public inspection and copying in their entirety.

VI. DRAFTING INFORMATION

The principal author of this notice is Michael Hughes of the Office of Associate

Chief Counsel (Tax Exempt and Government Entities), although other Treasury and IRS officials participated in its development. For further information on the provisions of this notice, contact Michael Hughes at (202) 317-5600 (not a toll-free number). For further information regarding issues with respect to income tax withholding, contact A.G. Kelley at (202) 317-4774 (not a toll-free number).