New “Qualified Equity Grants” Allow Income Deferral Opportunity for Rank-and-File Employees

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The Tax Cuts and Jobs Act, which was signed into law on December 22, 2017, creates a new type of deferred compensation known as “qualified equity grants.” The new arrangements allow rank-and-file employees of eligible privately owned corporations to defer income recognition on certain equity awards received in connection with the performance of services. Qualified equity grants provide eligible employers with an opportunity to incentivize a broad portion of their workforce, beyond management or highly compensated key employees, by allowing all employees to share in the company’s growth and success in a tax-advantaged manner. Like other types of deferred compensation arrangements, qualified equity grants may be particularly attractive to owners of closely held businesses as a means of increasing employee compensation without a significant current cash outlay.

Under Internal Revenue Code Section 83(i), which was added by the Tax Cuts and Jobs Act, eligible employees of certain privately owned corporations may elect to defer income recognition upon receipt of certain employer stock, referred to as “qualified stock,” in connection with the exercise of a stock option or the settlement of a restricted stock unit (RSU). Upon a timely Section 83(i) election, the employee’s income recognition may be deferred for up to five years after his or her rights in the qualified stock become transferrable or are no longer subject to a substantial risk of forfeiture, whichever occurs first. Income inclusion may be triggered prior to the conclusion of the five-year deferral period, however, upon the occurrence of certain events, including, for example, the corporation’s stock becoming readily tradeable on an established securities market or the recipient employee becoming an “excluded employee” who is no longer eligible to make a Section 83(i) election.

At the conclusion of the deferral period, whether it be five or fewer years, the fair market value of the qualified stock received upon the exercise of the option or the settlement of the RSU, less any amount the employee paid for the stock, is taxable to the employee as ordinary income. The amount includable in income is calculated based on the fair market value of the stock at the time the employee’s rights in the stock first become transferrable or are not subject to a substantial risk of forfeiture (i.e., the fair market value at the commencement of the deferral period), even if the value of the stock declines during the deferral period. Absent a Section 83(i) election, such amount would be taxable to the employee sooner, generally when his or her rights in such stock first became transferrable or were not subject to a substantial risk of forfeiture. In either case, the employer generally receives a corresponding federal income tax deduction in the tax year in which the employee recognizes income in connection with the receipt of stock.

An eligible employee must make a Section 83(i) election no later than 30 days after his or her rights in the qualified stock become transferrable or are no longer subject to a substantial risk of forfeiture, whichever occurs first. The election is to be made “in a manner similar to” a Section 83(b) election, which generally requires a written election statement to be filed with the Internal Revenue Service and the employer.

The new qualified equity grant arrangements may be established by eligible privately owned corporations and must be implemented in accordance with a written plan under which stock options or RSUs, but not both, may be granted in a given calendar year. In any year in which awards are granted under the plan, they must be granted to at least 80 percent of the sponsoring corporation’s employees (including employees of entities in such corporation’s controlled group) who regularly work at least thirty hours per week in the United States or its possessions and who are not “excluded employees,” as defined below. While each employee must have the same rights and privileges to receive qualified stock under the options or RSUs granted under the plan, the awards to each eligible employee need not be identical if all such employees receive more than a de minimis number of shares.

Employees of the corporation sponsoring the plan who are not “excluded employees” are generally eligible to make a Section 83(i) election with regard to qualified stock, even if, for example, they work fewer than 30 hours and, thus, are not taken into account for purposes of satisfying the 80 percent coverage test. Excluded employees, who are not eligible to make a Section 83(i) election and are not taken into account for purposes of meeting the 80 percent coverage test, include: (i) individuals who are, or were in the preceding ten calendar years, “one-percent owners” of the company; (ii) the chief executive and chief financial officers of the company, anyone who has ever held such positions, and certain relatives of any such current or former officers; and (iii) the company’s four highest compensated officers or anyone who has been such an officer in the preceding ten taxable years.

Section 83(i) is effective for stock issued in connection with options exercised or RSUs settled after December 31, 2017.

It remains to be seen whether the new qualified equity grants will be widely utilized in view of the requirement that such arrangements must benefit a significant percentage of an employer’s workforce. There remain, however, a variety of nonqualified deferred compensation arrangements, including equity and non-equity based plans, which can be designed to meet an employer’s particular business and financial objectives.

Nonqualified deferred compensation arrangements can be customized, for example, to benefit one or more select individuals, including employees and consultants. They can be structured so that participants acquire an actual ownership interest in a business or, without becoming actual owners, receive an amount determined in whole or in part by reference to the value of the business’ stock (or other applicable ownership unit). The awards under a deferred compensation arrangement can be granted in a variety of forms. For example, an award can correspond to a stated number of shares of company stock, to a specified percentage of the outstanding shares of company stock, or to a percentage of the transaction value of a company. Participants can receive payment for their awards at various predetermined times or

upon the occurrence of certain events, which, depending upon how the arrangement is structured, can include:

- The participant's retirement, completion of a certain number of years of service, or attainment of a certain age.
- The sale of the business, an initial public offering, or at such time as the founders cash-out all or a portion of their ownership interests in the company.
- The attainment of predetermined individual or organizational performance goals.
- A specified date or in accordance with a fixed schedule.

Ultimately, nonqualified deferred compensation arrangements can be customized to meet a business' particular compensation needs, whether they are to attract or retain top talent, give select individuals an interest in the success of the business, or encourage all employees to work to their highest potential.

To learn more about the range of possible deferred compensation arrangements, or if you have questions regarding their potential use within your business to attract, retain and motivate key employees or your broader workforce, please contact the author of this Alert, **Lisa J. Clapp**, or the Chair of our Employee Benefits and Executive Compensation Practice Group, **Thomas C. Senter.**