The M&A Tax Report

JANUARY 2019 VOLUME 27, NUMBER 6

The Monthly Review of Taxes, Trends & Techniques

New Code Sec. 83(i): Buy Now! Pay Later!

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Code Sec. 83(i) is one of many novelties baked into the Tax Cuts and Jobs Act of 2017. When it applies, the new provision allows employees of private companies to defer, for up to five years, income they would otherwise have to report when exercising stock options or settling restricted stock units. In this article, we will concentrate on Code Sec. 83(i) as it relates to employee stock options.

Code Sec. 83(i) was enacted as part of the TCJA, but it was initially introduced—with bipartisan support—as the Empowering Employees Through Stock Ownership Act. Senator Mark Warner (D-Va.), one of the bill's sponsors, made the case for *broad-based* employee stock ownership, particularly in the startup context:

> When employee ownership is spread across a growing business, it has a huge impact on workplace culture, productivity, and wealth creation. It also is a key tool for startups, allowing cash-poor innovators to recruit top talent. Extending employee stock programs to a broader universe of workers will strengthen business growth and create new economic opportunities, especially for rank-and-file workers.

Co-sponsor Senator Dean Heller (R-Nev.) sounded an almost utopian note, although he was careful to keep the focus on his constituents:

> Employee ownership fuels entrepreneurship and provides economic growth across the Silver State. As the footprint of the startup community in Nevada continues to expand, I believe it's important to give employees the flexibility to pay their taxes on their stock options. This legislation will allow for companies, like startups and other small businesses, to offer competitive

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compensation packages to attract and retain key talent. When workers feel valued and appreciated, the sky's the limit for both the employee and employer.

Given Code Sec. 83(i)'s transformative ambitions, perhaps it's no surprise that the new provision has more than *doubled* the length of Code Sec. 83. Most of its 1,600 words are devoted to limiting the election to rank-and-file employees.

Most commentators on Code Sec. 83(i) have focused on the rules restricting access to the election, and the administrative burdens it imposes on employers. They tend to doubt that companies will want to get involved with the new provision.

Issues relating to implementation certainly deserve attention. But let's take a step back. Even assuming that employers embrace Code Sec. 83(i), what will the election actually accomplish for rank-and-file employees—particularly those who work for high-risk startups?

It is something less than clear that providing startup employees with "flexibility to pay their taxes on their stock options" will have much effect on whether and when they exercise. Even if the deferral election succeeds in changing employee behavior, will it result in *better* investment decisions?

Evaluating Their Options

Advocates of broad-based employee stock ownership recognize that the existing regime has failed to deliver. Members of the Tesla-driving set, flush from making a killing at their *last* startup, revel in their options. Rank-and-file employees, on the other hand, seem to have trouble getting into the party spirit—and it's not just because they've been priced out of Burning Man.

Rank-and-file employees of startup companies are notoriously reluctant to exercise their options unless a liquidity event is imminent. They often let their options expire unexercised, even when they're "in the money" based on the company's latest valuation. Stock ownership may be empowering, but real-life employees do not exactly rush to purchase startup shares.

If you're sure that "the sky's the limit" if employees purchase employer stock, it's natural to point the finger at the tax system. After all, an employee who exercises a non-qualified option and receives vested shares is immediately taxable on the spread—*i.e.*, the excess of the value of the shares over the exercise price. Even holders of incentive stock options face immediate tax on the spread for AMT purposes.

The boosters have a point. Immediate inclusion of the spread can be a powerful deterrent to exercise if: (1) the option shares are significantly appreciated; and (2) rank-and-file employees will have to dig into savings to pay the resulting tax. A logical response would be to change the rules for rank-and-file employees who cannot sell their option shares at the value they are required to report them for tax purposes.

The direct approach would be to change the rules governing the *timing* and the *amount* of tax triggered by the exercise of an option to purchase non-transferable shares. One might consider a solution similar to current

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THE M&A TAX REPORT (ISSN 1085-3693) is published monthly by Wolters Kluwer, 2700 Lake Cook Road, Riverwoods, Illinois 60015. Subscription inquiries should be directed to 2700 Lake Cook Road, Riverwoods, IL 60015.
Telephone: (800) 449-8114. Fax: (773) 866-3895. Email: cust_serv@cch.com.

Code Sec. 83(a), which not only defers tax until the employee's shares vest, but also calculates the amount due based on the spread on the vesting date. The new rule would be keyed to the date on which the option shares become *transferable*.

Since the point is to help the rank-and-file, this could be made subject to volume limitations (like ISOs) or some form of means testing such as those in new Code Sec. 83(i). The revised rule would also make sure that employees are not left exposed to the AMT, as they are when they exercise "tax-free" ISOs.

Kicking the Tax Can Down the Road

But Code Sec. 83(i) does nothing of the sort. An employee who exercises an option and receives vested but non-transferable shares still recognizes income based on the spread on the date of *exercise*. [*See* Code Sec. 83(i)(1)(A).] All that changes is that the employee can elect to defer *reporting* this income for up to five years [Code Sec. 83(i)(1)(B)(iv)].

If the stock becomes transferable during that period, the income must be reported immediately [Code Sec. 83(i)(1)(B)(i)]. Immediate inclusion is also required if *any* stock of the employer becomes tradable on an established securities market [Code Sec. 83(i)(1)(B)(iii)], or if the employee becomes the CEO, CFO, or a one-percent owner of the company [Code Sec. 83(i)(1)(B)(ii)].

Absent a significant change in tax rates during the deferral period, Code Sec. 83(i) essentially requires the U.S. Treasury to make an interest-free loan to the employee to pay the tax incurred upon exercise. Congress has provided the employee with what amounts to a streamlined alternative to (say) taking out a second mortgage on his house. The fact that this mechanism is built into the Code should not obscure the fact that an electing employee is *going into debt* to pay the tax triggered by his purchase of a volatile investment asset.

If the startup is a success—and Senators Warner and Heller seem almost certain that it will be—the newly empowered employee should have no problem paying off the loan. This assumes, of course, that the transfer restrictions lapse *before* the deferral period expires. But the real question is, what happens if the promising new company goes belly up during the deferral period?

Even in the best of times, the great majority of new enterprises fail. Most do so without getting the kind of valuation that threatens employees with mammoth tax bills if they exercise their options. But startups with sky-high valuations can and do go bust.

In the first 10 months of 2018, for example, 12 companies, backed by *$1.4 billion* in venture-capital funding, closed their doors. [*See Startup Graveyard 2018*, The Daily Pitch: VC, PE and M&A (Oct. 24, 2018).] Employees who exercised options as these companies' valuations climbed higher and higher saddled themselves with some serious tax liabilities.

The lucky ones immediately sold some of their new shares to pay the IRS. In most private companies, however, transfer restrictions make that impossible. Employees who managed to acquire their shares on a fully net basis—*i.e.*, net of both the exercise price *and* withholding tax—would have been glad they did. But this is an unlikely scenario, because startups are rarely willing to burn up precious cash to pay their employees' taxes.

So, is this the part where Code Sec. 83(i) comes to the rescue? Nope. An employee who elected to defer $600,000 in income back when the sky was the limit will *still* have to report $600,000 three years later, when the company is a pile of smoking rubble. Even if the employee has found a new job, this unfunded tax liability is likely to be a disaster.

Baiting a Trap?

Perhaps it is unfair to blame Code Sec. 83(i) for the employee's difficulties. After all, Code Sec. 83(i) does not purport to eliminate the risk that a startup will fail. It provides for deferral—not forgiveness—of taxes on the exercise of employee options. Proponents of Code Sec. 83(i) might contend that it just gives employees a choice about *when* to pay their taxes. It's 100 percent up to them whether to exercise in the first place.

As the Senatorial quotations above make clear, however, Code Sec. 83(i) is intended to *encourage* rank-and-file employees to acquire employer stock. What is remarkable is that Congress did nothing to reduce the tax risks that have historically deterred many employees from exercising options. Congress just allowed employees to postpone the date on which the tax piper must be paid.

Suppose that our rank-and-file employee would have decided, without Code Sec. 83(i), that it was too risky for him to exercise and incur a $100,000 tax liability. Does exercising the option make any more sense just because Code Sec. 83(i) lets him *defer* payment of the tax? The siren call of "EZ CREDIT!!!" has sunk tens of millions of consumers. Is Congress really doing rank-and-file employees a favor by persuading them to buy now and pay later?

Senators Warner and Heller are no doubt imagining a rather different scenario. This time, the rank-and-file employee (whose hobby is securities analysis) has carefully evaluated his employer's future prospects. Based on this appraisal, he is confident that the option is worth exercising *despite* the tax liability he will incur.

But there's a hitch. The employee isn't concerned about the investment risk—this one is definitely a winner. But he's worried that he won't be able to come up with the cash to pay the IRS for the tax incurred on exercise.

The employee explains his situation to friends, family, and mortgage companies. Unfortunately, none of them will help him over the liquidity hump. Stymied by a simple lack of cash, the employee sadly waves farewell to the economic chance of a lifetime.

But then a buddy tells him about this new Code Sec. 83(i). Finally, a government program that does something for the little guy! Cut to a picture of the employee relaxing, tropical drink in hand, on the deck his new boat.

The relative importance of investment risk *versus* liquidity issues in determining whether rank-and-file employees exercise their options is an empirical question. Did the proponents of Code Sec. 83(i) investigate why real employees don't exercise their options? If so, the results of their inquiry do not appear to have been made public. The co-sponsors' invocation of the rhetoric of "empowerment," on the other hand, suggests that the main forces behind the adoption of Code Sec. 83(i) are ideological.

Holding Period

Rank-and-file employees don't like to exercise their options until a liquidity event is in the offing (if then). If an employee holds a non-qualified option, this cautious strategy means that most of the value associated with the option will be taxed as compensation. Even if the option shares generate some capital gain, it is likely to be short term.

The situation is generally no better for rank-and-file holders of ISOs. They, too, tend to delay exercise until a cash payoff is in sight. This means they can't satisfy the one-year holding period imposed by Code Sec. 422(a)(1), so they end up getting taxed as if they had been issued non-qualified options. ISOs are promoted as the golden key to long-term capital gain, but they have a way of not panning out.

One of the main goals of Code Sec. 83(i) is to get employees to stop waiting until the last minute to start their holding periods. Accelerated exercise can certainly produce tax benefits. But encouraging employees to exercise "early" is inconsistent with the point of an option.

A call option is like a crystal ball—it lets a potential investor "wait and see," at least for a while, before deciding to purchase an asset with an uncertain future value. If the investor is going to hold the asset at least until the end of the option period, the rational course (taxes aside) is to exercise only when the option is *about to expire*. In the case of so-called "European" options, it is not even *possible* to exercise until the final day.

Shortening the exercise period makes the option less valuable. Hence, there is something a bit perverse about trying to help employees by persuading them to exercise earlier than they otherwise would. Policies that accelerate exercise can be beneficial from a tax perspective, but they prevent employees from enjoying the full value of their option privilege.

Given this tension, should tax be the tail that wags the employee-stock-ownership dog? Do we really want to devalue the option privilege to accommodate the traditional capital-gains holding period? Or should tax convention yield to other policy considerations?

One could argue that an employee who spends several years working at a startup while agreeing to take part of his compensation in the form of options is *already* taking plenty of risk. Our tax system rewards *financial* investors who put their capital at risk for more than one year with a massively reduced tax rate. Should we do something analogous for startup employees?

One way to help out the rank and file would be to stop treating the exercise of their options as a realization event—essentially the same approach that we take with ISOs. That's a good start, but experience teaches that employees will still delay exercising until the big tuna is almost in the boat. As a consequence, they frequently miss out on the blessings of the long-term capital gains rate.

If we want to change that, is the solution to try to get employees to exercise their options *earlier* than they would otherwise think prudent? Or might we reconsider the holding period? For example, what if we allowed the rank and file to report long-term capital gain based on how long they had held their *options*?

Better yet, why not base the tax treatment on how long they have *worked* for the startup? Holding an option isn't risky. But investing an important slice of your career in a company that will probably go bankrupt certainly is.

Conclusion

Senators Warner and Heller should get credit for at least *thinking* of doing something for the rank and file. Unfortunately, Code Sec. 83(i) does nothing to address the tax hazards of exercising options to purchase vested but non-transferrable shares of risky startups. The new deferral election just lets employees borrow a pile of chips as they walk into the casino.