Qualified Equity Grants: Tax Deferral for Illiquid Employer Stock

VORRIS J. BLANKENSHIP

Employees may now elect to defer tax on the bargain element in "qualified stock" that is received on the exercise of employee stock options or on the settlement of restricted stock units.

Stock received on the exercise of a nonstatutory stock option may create liquidity problems for a recipient employee. The employee must generally pay tax on the bargain element in the stock when the stock is received or later when it vests.[1] However, the employee may not have the cash to pay the tax, particularly if the stock received is not a source of liquid funds because it is not then readily tradable or transferable. This problem is most frequently associated with startup corporations that have not yet gone public.

Fortunately, Congress has provided a potential solution.[2] For stock vesting after 2017, a "qualified employee" may elect to defer tax on the bargain element in "qualified stock" issued pursuant to an equity grant awarded by an "eligible corporation." Such equity grants consist of either stock options or restricted stock units (RSUs).[3] If qualified stock is received under such a grant, an employee may be able to defer payment of tax on the bargain element for as long five years from the date of receipt or vesting. However, the deferral will end earlier upon one of the following events:

1. The stock becomes transferrable (even if only transferrable to the employer corporation).
2. Any stock of the issuing corporation becomes readily tradable on an established securities market.
3. The recipient becomes an excluded employee (i.e., becomes one of certain key employees or 1% owners).

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4. The recipient revokes his or her election (e.g., to report the income in a loss year or a low-tax-bracket year).[4]

When the deferral period ends, the bargain element in the stock becomes subject to tax as compensation,[5] with any remaining appreciation in the stock taxed on subsequent disposition. The bargain element is the fair market value of the stock when the employee received it, or when it later vests, less the option price paid for the stock.[6] Thus, if the stock declines in value during the deferral period, the employee must still pay tax at ordinary income tax rates on the full amount of the bargain element. The employee must pay the tax even if the bargain element has been entirely lost due to the decline in value.[7]

When the deferral period ends, the bargain element also becomes subject to income tax withholding at the maximum individual tax rate.[8] If the stockholder is no longer employed (e.g., retired), the stockholder may have to provide the funds to pay the withholding.[9] On the other hand, Social Security taxes on the bargain element are required to be paid earlier when the stock is received or later vests.[10]

The nature of the restricted stock units (RSUs), mentioned above, may warrant further explanation. An RSU is an arrangement giving an employee the right to receive employer stock, or its value in money, at a specified future time. The employee's right may be subject to a condition, such as continued employment or the satisfaction of performance goals. The transfer of stock or the payment of money to the employee is referred to as a "settlement" of the RSU.[11] However, RSUs granted under a qualified equity grant plan may be settled only with stock, not cash.[12]

If the employer corporation is a member of a controlled group of corporations, the employer corporation and other members of the controlled group are considered one corporation for purposes of applying the qualified equity grant provisions.[13] Such a group may be:

1. A parent-subsidiary group.
2. A brother-sister group.
3. A combination of the preceding two groups.[14]

In this article, "vested" stock means stock that is transferable or is not subject to a substantial risk of forfeiture.[15]

If the stock declines in value during the deferral period, the employee must still pay tax at ordinary income tax rates on the full amount of the bargain element.

Only an Eligible Corporation May Issue Qualified Equity Grants

Only an "eligible" corporation may award qualified equity grants. For this purpose, a corporation is not eligible during a calendar year if it had any stock traded on an established securities market during any preceding calendar year.[16] In addition, for the year of eligibility, the corporation must have a written plan that provides grants of stock options or RSUs to at least 80% of the corporation's employees (excluding key, part-time, and foreign employees).[17] The corporation may grant stock options to all the covered employees or RSUs to all the covered employees, but may not grant a mixture of the two.[18]

All employees covered by the plan must have the same rights and privileges to receive qualified stock.[19] For this purpose, an employer must establish the rights and privileges under rules similar to those applicable to employee stock purchase plan options (ESPP options).[20] For example, the method of payment for stock and the purchase price of stock must be the same for all covered employees.[21] Further, events accelerating exercise or payment must be the same.[22] Nevertheless, under an exception applicable only to qualified equity grants, the amount of stock issued to covered employees need not be equal or proportional in amount, provided the amount issuable to each covered employee is more than de minimis.[23]

For stock options or RSUs granted before 2018 that are exercised or settled after 2017, it is not necessary that the covered employees have the same rights and privileges.[24] This provision is apparently a recognition that, before 2018, corporate employers did not know future legislation would authorize qualified equity grant plans. Thus, they did not have an opportunity in those years to carefully structure a complying plan.

NOTES

1 Section 83(a).

2 Tax Cuts and Jobs Act, Pub. L. No. 115-97, section 13603.

3 Note that neither stock options without readily ascertainable fair market value nor RSUs are subject to tax under Section 83. Reg. 1.83-7(b)(2); Section 83(i)(7). However, they might be subject to the deferred compensation rules of Section 409A, if no specific exemption applies.

4 Section 83(i)(1)(B).

5 Section 83(i)(1)(A).

6 Section 83(a).

7 Section 83(i)(6)(B)(ii)(I).

8 Sections 3401(i) and 3402(t)(1).

9 Sections 3402(t)(2) and 3501(b); Ann. 85-113, 1985-31 IRB 31.

10 Section 3121(a)(5), (v)(2), and (v)(3); Reg. 31.3121(v)(2)-1.

11 Conference Committee Report of the Tax Cuts and Jobs Act (HR 1), Pub. .L. No. 115-466—Part 1, Business Tax Reform, I.3 and I.4.

12 Section 83(i)(2)(B).

13 Sections 83(i)(5), 414(b), and 1563.

14 Section 1563(a).

15 Section 83(a).

16 Section 83(i)(2)(C)(i)(I); Even more important, the deferral election cannot be made if any of the corporation's stock has been traded on an established securities market at any previous time. Section 83(i)(4)(B)(ii); Conference Committee Report of the Tax Cuts and Jobs Act (HR 1), Pub. L. No. 115-466—Part 1, Business Tax Reform, I.3, footnote 1070.

17 Section 83(i)(2)(C)(i)(II) and (C)(iii).

18 Section 83(i)(2)(C)(ii)(III).

19 Section 83(i)(2)(C)(i)(II).

20 Section 83(i)(2)(C)(ii)(I).

21 Reg. 1.423-2(f)(1).

22 GCM 37380.

23 Section 83(i)(2)(C)(ii)(II).

24 Section 83(i)(2)(C).

Nevertheless, a qualified equity grant plan must still cover at least 80% of employees for a pre-2018 year (even though the employees might have different rights and privileges). Thus, a previous statutory or nonstatutory stock option plan in existence during a pre-2018 year could qualify if it had 80% coverage. It is not clear whether different plans might be aggregated for purposes of satisfying the 80% requirement. Fortunately, however, Congress has provided that a corporation may make a reasonable good faith interpretation of the 80% requirement, at any time before the IRS issues regulations or other guidance.[25]

Only a Qualified Employee May Receive Qualified Stock

Most employees will be qualified employees eligible to elect tax deferral on qualified stock if they agree in their deferral election to comply with certain conditions. Those conditions are designed to guarantee that income tax withholding requirements will be satisfied when deferred amounts become taxable.[26] Nevertheless, an employee will not be a qualified employee if he or she:

1. Is or was a 1% owner at any time during the current or preceding ten calendar years.[27]
2. Is or has ever been the chief executive officer (CEO) of the corporation.[28]
3. Is or has ever been the chief financial officer (CFO) of the corporation.[29]
4. Is the spouse, child, grandchild, or parent of the corporate officers described in (2) or (3), above.[30]
5. Is or was one of the four highest-compensated officers of the corporation during the current or preceding ten calendar years.[31]

Stock Issued Must Satisfy the Requirements for Qualified Stock

Stock is qualified stock only if it is received by a qualified employee upon the exercise of an option or the settlement of an RSU. The option or RSU must have been granted in connection with the performance of services as an employee in a calendar year the employer was an eligible corporation.[32] However, stock will not be qualified if the employee has the right to elect a cash payment instead or the right to sell the stock to anyone (including his or her employer) at the later of the time the stock is received or vests.[33]

Timing of the Election and the Limitations Imposed

An employee must make the election to defer tax on qualified stock by filing the election with the IRS within 30 days after the stock is no longer subject to a substantial risk of forfeiture or is transferrable, if earlier.[34] An employee may not make the election if:

1. The employee previously elected to include the bargain element in gross income before the stock vested.
2. Any stock of the corporation is or was readily tradable on an established securities market at any time before the deferral election.
3. The corporation purchased any of its outstanding stock in the calendar year preceding the year the employee's stock vested (except as explained in the second following paragraph).[35]

Under item 1, above, an employee has previously made an election to include the bargain element in gross income if, upon receipt of unvested stock, the employee elected to report as compensation income an amount equal to the excess of the then fair market value of the stock over the amount paid for it. An employee would normally make this election if he or she wished to avoid reporting as compensation income any later pre-vesting increase in the value of the stock.[36]

Item 3 above will not prevent a deferral election in the current year if the corporation purchased *all* the outstanding deferral stock in the preceding calendar year. Nor will item 3 prevent a current-year election if at least 25% of the value of the stock purchased in the prior year was deferral stock, and allocation of the purchases among the holders of deferral stock was reasonable. Deferral stock is defined as qualified stock for which a deferral election was made but, for purposes of item 3, above, excludes stock purchased from a shareholder that had a shorter elapsed deferral period than any stock retained by the shareholder (i.e., a first-in, first-out requirement).[37]

A corporation with a qualified equity grant plan may continue to award more favorable equity grants to employees who do not participate in the plan.

Qualified Stock That Is Not Part of the Equity Grant Plan

An employee electing to defer gain on qualified stock need not be one of the 80% of employees under an equity grant plan necessary to qualify the employer as an "eligible corporation." Nor does the employee's option or RSU need to be granted pursuant to the equity grant plan. It is enough that the employee is a qualified employee,[38] and the employer was an eligible corporation in the calendar year the employer granted the option or RSU.[39] Thus, an option or RSU granted to a qualified employee who is not covered by the equity grant plan is allowed to have different rights and privileges than options or RSUs under the equity grant plan.[40]

Example 1. Corporation A established a written qualified equity grant plan covering 80% of its full-time employees. In 2018, corporation A awarded nonstatutory stock options with the same rights and privileges to each covered employee. Later that year, Corporation A also awarded nonstatutory stock options to employee B, who was not among the 80% of

employees covered by the qualified equity grant plan. None of the options has a readily determinable fair market value at the date of grant. Also assume the options were exempt from the requirements of Section 409A. (See Example 2, below, for an illustration of a Section 409A exemption.)

The option price payable by Employee B upon exercise of his option is lower than the option price payable by employees covered by the qualified equity grant plan. In 2020, Employee B exercised his option and agreed to certain requirements related to tax withholding. Employee B had no right to elect a cash payment or sell the vested stock to anyone at the time he received the stock. Neither Employee B nor his relatives have ever been a 1% owner or an actual or acting officer of Corporation A. No stock of Corporation A has ever been tradable on an established securities market.

Employee B may elect to defer tax on the bargain element attributable to the stock he received. He was a "qualified employee" receiving "qualified stock" issued pursuant to the exercise of a qualified equity grant awarded by an "eligible corporation." He was a "qualified employee" because he satisfied the following three requirements:

1. He has never been a 1% owner or a highly paid officer of Corporation A.
2. Neither he nor his relatives have ever been the actual or acting CEO or CFO of Corporation A.
3. He agreed to certain requirements related to tax withholding.

Corporation A satisfied the definition of an "eligible corporation" for 2018, the year the option was awarded to Employee B, because it satisfied the following three requirements:

1. In that year, Corporation A had a written equity grant plan covering 80% of its full-time employees.
2. The corporation granted the covered employees stock options with the same rights and privileges to receive stock.
3. No stock of Corporation A has ever been readily tradable on an established securities market.

The stock received by Employee B was "qualified stock" because it satisfied the following three requirements.

1. Corporation A was an eligible corporation for the year 2018, when it granted the option to Employee B.
2. The corporation granted the option for the performance of services.
3. Employee B had no right to elect a cash payment or sell the vested stock to anyone at the time he received the stock.

The award of stock options in 2018 to Employee B, who was not covered by the qualified equity grant plan, has no bearing on the independent determination of Corporation A's status as an eligible corporation for 2018. It is also irrelevant that Employee B's option price was not the same as the option price payable by employees covered by the qualified equity grant plan, because only covered employees are required to have the same rights and privileges.

Thus, it is apparent that a corporation with a qualified equity grant plan may continue to award more favorable equity grants to employees who do not participate in the plan. Those favored employees may even be able to defer tax on qualified stock they receive, if they are not 1% owners, officers, or relatives who are disqualified.

A qualified employee may also make a deferral election for qualified stock received on exercise of a *statutory* stock option, if the employer was an eligible corporation in the calendar year it granted the option. Statutory options may be either incentive stock options (ISOs) or options under employee stock purchase plans (ESPPs).[41] However, if an employee makes a valid deferral election with respect to qualified stock that is received under a statutory stock option, the option exercised will no longer be considered a statutory stock option. Instead, the qualified equity grant rules will apply.[42] (Example 4, below, illustrates a deferral election with respect to statutory stock.)

Applicability of Section 409A Unchanged by a Deferral Election for Qualified Stock

Independently of the qualified equity grant provisions, the Code imposes taxes, penalties, and interest on nonqualified deferred compensation plans that do not satisfy the deferral and distribution requirements of Section 409A.[43] Fortunately, statutory stock options are exempt from the requirements of 409A.[44]

Nonstatutory stock options may also be exempt if certain conditions are satisfied.[45] RSUs are exempt if they are settled by transferring unvested stock.[46] In any event, if a qualified equity grant is exempt from the requirements of Section 409A, an election to defer tax on the re-

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25 Tax Cuts and Jobs Act, Pub. L. No. 115-97, section 13603(g).

26 Section 83(i)(3)(A)(ii).

27 Section 83(i)(3)(B)(i). Sections 416(i)(1)(B)(i)(I) and (ii) define a 1% owner as any person who owns more than 1% of the outstanding stock of the corporation, or stock possessing more than 1% of the total combined voting power of the stock of the corporation. The ownership attribution rules of Section 318 apply (as modified by Section 416(i)(1)(B)(iii)).

28 Section 83(i)(3)(B)(ii)(I).

29 Section 83(i)(3)(B)(ii)(II).

30 Sections 83(i)(3)(B)(iii) and 318(a)(1).

31 The four highest compensated officers are determined as if the disclosure rules for compensation under the Securities Exchange Act of 1934 applied to the corporation. Section 83(i)(3)(B)(iv).

32 Section 83(i)(2)(A).

33 Sections 83(i)(1)(B)(i) and (2)(B).

34 Section 83(i)(4)(A). Transferability and the existence of a substantial risk of forfeiture are determined under the rules of Section 83(c)(3) and the regulations thereunder. Conference Committee Report of the Tax Cuts and Jobs Act (HR 1), Pub. L. No. 115-466—Part 1, Business Tax Reform, I.3.

35 Section 83(i)(4)(B).

36 Section 83(b); Regs. 1.83-2(a) and 1.83-7(a); Rev. Proc. 2012-29, 2012-2 CB 49.

37 Section 83(i)(4)(C).

38 Section 83(i)(3).

39 Section 83(i)(2)(C).

40 Section 83(i)(2)(C)(ii).

41 Sections 421, 422, and 423; Conference Committee Report of the Tax Cuts and Jobs Act (HR 1), Pub. L. No. 115-466, Part 1—Business Tax Reform, I.3.

42 Sections 422(b), and 423(b)(5) and (d).

43 Section 409A(a)(1). See Blankenship, "Retirement Planning for Unfunded Deferred Pay Under Section 409A," 81 Prac. Tax Strategies 14 (July 2008).

44 Reg. 1.409A-1(b)(5)(ii).

45 Reg. 1.409A-1(b)(5)(i).

46 Reg. 1.409A-1(b)(6)(ii).

ceipt of qualified stock will not subject the arrangement to the section.[47]

Example 2. Assume the facts are the same as in Example 1, so that stock received by Employee B upon exercise of his nonstatutory option is qualified stock. In addition, assume all grants of options by Corporation A specify the number of shares the employee can purchase. Further, under each grant, the option exercise price equals the fair market value of the stock on the date of grant. Stock received on exercise is fully vested common stock without liquidation preferences or restrictions on sales. Finally, the options do not include any special deferral features other than the usual income deferral for the receipt of stock options without a readily ascertainable fair market value.

Under the above facts, the options granted to Employee B and to the employees covered under the equity grant plan satisfy the requirements for exemption from 409A. In each case:

- The employer established the number of shares subject to the option on the grant date.[48]
- The exercise price was not less than the fair market value of the stock on the date of grant of the option.[49]
- The option did not include any deferral feature other than income deferral until exercise or disposition of the option.[50]
- The common stock received on exercise had no distribution preferences and was not subject to any mandatory repurchase obligation.[51]
- The stock received was taxable under Section 83 as property transferred for services (in the absence of a deferral election).[52]

Consequently, the exemption from 409A will continue to apply. Neither the election to defer tax on receipt of the qualified stock nor the mere availability of the election will cause 409A to apply.[53]

On the other hand, if a nonstatutory stock option is *not* exempt from the requirements of 409A, failure to comply with those requirements will usually trigger taxes, penalties, and interest.[54] Unfortunately, stock options that are not exempt from 409A will normally fail to comply with its requirements. Specifically, a nonstatutory stock option is by its nature generally exercisable, and thus payable, at a time chosen by the holder of the right. Such a feature is generally incompatible with the 409A requirement that deferred compensation be payable only upon objectively determined dates or events.[55] Unfortunately, a deferral election for qualified stock will not prevent imposition of 409A.[56]

A similar applicability of 409A to a *statutory* stock option is less clear. That is, if an employee makes a deferral election with respect to qualified stock that is received on exercise of a statutory stock option, it is uncertain whether the stock will continue to be exempt from 409A. If the employee makes the election, the statutory stock option becomes a nonstatutory stock option.[57] This transformation from statutory stock option to nonstatutory stock option appears to be retroactive. For example, the election retroactively imposes Social Security taxes on the prior receipt of the qualified stock even though Social Security taxes would not have applied if the stock had remained stock received on exercise of a statutory stock option.[58]

Unfortunately, the actual terms of the previously exempt statutory stock option may not satisfy retroactive application of the stricter exemption requirements applicable to nonstatutory stock options.[59] For example, an ESPP option is exempt from 409A even though the option price is less than the fair market value of the stock on the date of grant.[60] However, a nonstatutory stock option is *not* exempt from 409A if the option price is less than the fair market value at date of grant.[61]

Nevertheless, it is possible to argue that the original exemption for the statutory stock option should carry forward to the transformed nonstatutory option. The Code provides that the exemption from 409A will not be lost "solely because of" the deferral election.[62] Thus, it can be argued that the transformation from statutory stock option to nonstatutory stock option will not forfeit the previous exemption because the transformation was caused "solely" by the deferral election. In any event, this issue is one that cries out for clarification by the IRS.

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47 Section 409A(d)(7).

48 Reg. 1.409A-1(b)(5)(i)(A)*(1)*.

49 *Id*.

50 Reg. 1.409A-1(b)(5)(i)(A)*(3)*.

51 Reg. 1.409A-1(b)(5)(iii).

52 Reg. 1.409A-1(b)(5)(i)(A)*(2)*.

53 Section 409A(d)(7).

54 Section 409A(a)(1).

55 Section 409A(a)(2). See, e.g., CCA 201521013. Nevertheless, it may be feasible (although not necessarily desirable) to structure a nonstatutory stock option so that it complies with 409A, by making the option exercisable only during a single designated tax year. Reg. 1.409A-3(i)(1)(i).

56 An exemption from 409A for a nonstatutory stock option will not be lost *solely* because the employee makes a deferral election with respect to qualified stock. Section 409A(d)(7). The necessary implication is that the exemption is not available if the requirements for the exemption are otherwise not satisfied, even if the employee attempts to make a deferral election.

57 Sections 422(b), and 423(b)(5) and (d).

58 Sections 3121(a)(5), (v)(2), and (v)(3); Reg. 31.3121(v)(2)-1; Conference Committee Report of the Tax Cuts and Jobs Act (HR 1), Pub. L. No. 115-466—Part 1, Business Tax Reform, I.3. Although Social Security taxes do not apply to statutory stock, the deferral election automatically converts the statutory stock to nonstatutory stock. Sections 422(b), and 423(b)(5) and (d).

59 If the transformation to a nonstatutory stock option is considered a "modification" of the option, the exemption for statutory options is generally lost. Reg. 1.409A-1(b)(5)(ii).

60 Reg. 1.409A-1(b)(5)(ii).

61 Reg. 1.409A-1(b)(5)(i)(A)*(1)*. Similarly, a Section 409A exemption for a nonstatutory stock option is unavailable if stock received under the option is *not* subject to taxation as property received under Section 83. Reg. 1.409A-1(b)(5)(i)(A)*(2)*. Unfortunately, a statutory stock option is generally not subject to Section 83, and absent the available exemption, would rarely satisfy the requirements of 409A. Reg. 1.421-2(a)(1)(i). Arguably though, this condition is automatically satisfied because the deferral election transforms the statutory stock option to a nonstatutory option that is generally subject to Section 83. Although the election then bypasses Section 83 by deferring the gain, the Code provides that the exemption from 409A cannot be lost "solely" due to the election. Section 409A(d)(7). In any event, it is clear that Congress intended to make qualified stock received under a statutory stock option eligible for a deferral election. It is highly unlikely that Congress would then effectively nullify that intent by making receipt of the stock almost automatically subject to the taxes, penalties, and interest imposed by 409A. Conference Committee Report of the Tax Cuts and Jobs Act (HR 1), Pub. .L. No. 115-466—Part 1, Business Tax Reform, I.3.

Unfortunately, RSUs are normally subject to the requirements of Section 409A.[63] Nevertheless, they can usually be structured to satisfy those requirements, often by making the transfer of stock subject to a substantial risk of forfeiture.[64] For example, assume an eligible corporation grants an RSU to a qualified employee. Under the terms of the RSU, shares of qualified stock are to be delivered to the employee on a specific date in a future year, contingent on his or her continued employment until that date. The receipt of the stock on that date will be a short-term payment that satisfies the requirements of 409A because the stock will be transferred immediately on vesting.[65]

Even if the RSU is not subject to forfeiture, it can satisfy the payment requirements of 409A by limiting the transfer of the qualified stock to specific dates, events, or tax years. Assume an eligible corporation grants a qualified employee an RSU on 10/1/2018, with qualified stock to be transferred to the employee during his or her tax year 2022, or earlier on the employee's death or disability. Assume the RSU is not subject to a substantial risk of forfeiture, and the employee receives the vested stock on 10/1/2022. In that event, the RSU satisfies the time-of-payment requirements of 409A and thus will not trigger penalties and interest. Payment during the tax year 2022 or the possible earlier payment on death or disability are each permissible payment dates or events under 409A.[66]

When the Deferral Election for Qualified Stock Is Beneficial

Absent a 409A problem, an employee would normally want to make a deferral election (if available) for qualified stock received on settlement of an RSU or on exercise of a *nonstatutory* stock option. In most cases, the deferred tax can eventually be paid with the sales proceeds from deferral stock that becomes tradable or transferrable within the five-year overall limit on deferral. If the deferral stock does not become tradable or transferrable, the employee will still normally have five years to solve his or her liquidity problem, while enjoying the benefits of tax deferral. Of course, unusual circumstances in a tax year, such as an offsetting loss or low marginal tax brackets may make it desirable to forgo or revoke the election.

A nonstatutory stock option is *not* exempt from 409A if the option price is less than the fair market value at date of grant.

A deferral election for qualified stock received on exercise of a *statutory* stock option (an ISO or ESPP option) is somewhat more problematic. Such stock (hereafter statutory stock) generally provides more favorable tax benefits than deferral stock. Unlike deferral stock, the appreciation in statutory stock that occurs between the date of grant of the option and the date of exercise can be converted from ordinary income to long-term capital gain if certain special holding period requirements are satisfied.[67] In addition, recognition of gain on statutory stock can be deferred indefinitely until the stock is sold;[68] whereas deferral of the bargain element for qualified stock can be terminated by an event such as a public offering or expiration of the five-year deferral limit.[69] Finally, Social Security taxes do not apply to the receipt of statutory stock,[70] but they do apply to deferral stock upon receipt, or on vesting if later.[71]

Even if statutory stock is disqualified for favorable tax treatment because of failure to satisfy the applicable holding period requirements, treatment of the statutory stock is still marginally better than for deferral stock. It is true the bargain element is taxed as ordinary income both on the disposition of deferral stock and on a disqualifying disposition of statutory stock.[72] Nevertheless, for ISOs (although not for ESPP options), the ordinary income is limited to the gain on disposition of the stock,[73] while the ordinary income on deferral stock is recognized in full even if it is greater than the gain on disposition.[74] Further, as noted above, Social Security taxes are payable on receipt or vesting of deferral stock, but not on statutory stock.

Example 3. On 6/30/2018, Corporation A granted Employee C an incentive stock option (ISO) for 2,000 shares of stock. The option price was $30,000 (equal to the fair market value on the date of grant). The employee exercised the ISO in its entirety on 2/28/2020, while still employed by Corporation A. She received vested stock the same day with a fair market value of $45,000. The employee sold all the stock for $40,000 on 1/31/2021 (11 months after exercise of the ISO).

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62 Section 409A(d)(7).

63 Reg. 1.409A-1(b)(6).

64 Section 409A(a)(1)(A)(i).

65 Reg. 1.409A-1(b)(4).

66 Section 409A(a)(2)(A); Reg. 1.409A-3(i)(1)(i). More than one permissible payment dates and events may apply to the same deferred compensation. Reg. 1.409A-2(b)(6), (b)(9), Examples 15 and 24; Reg. 1.409A-3(j)(2); H. Rep't No. 108-755, 108th Cong. (2004); Staff of the Joint Committee on Taxation, General Explanation of Tax Legislation Enacted in the 108th Congress (JCS 5-105) ("Treatment of nonqualified deferred compensation plans").

67 Section 421(a).

68 However, if a statutory option is exercised without satisfying the continuing employment requirement of Section 422(a)(2) or 423(a)(2), the stock received is immediately taxable as if it were nonstatutory stock, and withholding of income tax is required. Section 3401(a); Reg. 1.422-1(c); Temp. Reg. 35.3405-1T, Q&A-18 and Q&A-21. Nevertheless, the stock continues to qualify as statutory stock that is exempt from Social Security taxes, provided a deferral election is not made under Section 83(i). However, a Section 83(i) deferral election would automatically convert the statutory stock to nonstatutory stock for all purposes, including liability for Social Security taxes. Sections 422(b), and 423(b)(5) and (d).

69 Section 83(i)(1)(B).

70 Sections 3121(a)(22), 3231(e)(12), and 3306(b)(19).

71 Sections 3121(a)(5), (v)(2), and (v)(3); Reg. 31.3121(v)(2)-1; Conference Committee Report of the Tax Cuts and Jobs Act (HR 1), Pub. L. No. 115-466—Part 1, Business Tax Reform, I.3.

72 Sections 83(i), 421(b).

73 Section 422(c)(2); Reg. 1.422-1(b)(2)(i).

74 Section 83(i)(6)(B)(ii)(I). Any excess of the compensation income over the gain on sale of the stock is capital loss.

Employee C's sale of the stock less than 12 months after receiving it was a disqualifying disposition under the ISO rules. Thus, she would ordinarily be required to recognize ordinary compensation income of $15,000 as of the date of sale of the stock (an amount equal to the excess of the $45,000 fair market value of the stock on date of receipt over the $30,000 option price). However, in this case, her ordinary compensation income is limited to $10,000 (the excess of the $40,000 sales proceeds over the $30,000 option price).

By comparison, the following example shows the unfavorable consequences of an election to defer tax on the bargain element attributable to the stock in Example 3, above, under the rules applicable to "qualified stock."

Example 4. Assume the stock in Example 3, above, was also qualified stock received on exercise of a statutory option granted by an eligible corporation (Corporation A) to a qualified employee (Employee C). Assume Employee C elected to defer the bargain element, thereby converting the statutory stock to nonstatutory stock. Then, when Employee C sold the stock, she had to recognize the $15,000 bargain element as ordinary compensation income, even though her overall gain on sale was only $10,000. The excess of the ordinary income over the gain on sale is reportable as capital loss. This is, of course, less favorable than the $10,000 of ordinary income (with no capital loss) on the disqualifying disposition of unconverted statutory stock in Example 3. Furthermore, unlike in Example 3,

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Employee C's deferral election triggers Social Security taxes.

Certainly though, there are situations where a deferral election for statutory stock will be beneficial. For example, a statutory stock option must be exercised (1) within a continuous period of employment that begins with the date of grant of the option, or (2) within three months after termination of such a period of employment. If a statutory stock option is exercised too late to satisfy this rule, the bargain element in the stock is taxed when the stock is received or later vests.[75] In that situation, an election to further defer tax on the bargain element may be beneficial. The drawback, however, is that the deferral election makes the bargain element immediately subject to Social Security taxes.[76]

Example 5. On 6/30/2018, Corporation A granted Employee D an ISO for 2,000 shares of stock. The option price was $30,000 (equal to the fair market value on the grant date). The employee did not exercise the ISO before he retired on 12/31/2019. Instead, he exercised the ISO in its entirety on 9/30/2020 and received vested stock the same day with a fair market value of $45,000. The employee sold all the stock on 11/30/2024 for $50,000.

The vested stock received by Employee D did not qualify for incentive stock treatment because he exercised his ISO on 9/30/2020, nine months after retirement (not within the required three months). Upon receipt of the stock in 2020, the employee recognized ordinary compensation income of $15,000 (stock fair market value of $45,000 less option price of $30,000). Upon subsequent sale of the stock in 2024, the employee recognized capital gain of $5,000, an amount equal to the $50,000 sales price less the $45,000 adjusted basis. The adjusted basis is the sum of the $30,000 option price and the $15,000 compensation income.

By comparison, the following example shows the generally favorable consequences of an election to defer tax on the bargain element attributable to the stock in Example 5, above, under the rules applicable to "qualified stock."

Example 6. Assume the statutory stock in Example 5, above, was also qualified stock received on exercise of a statutory option granted by an eligible corporation (Corporation A) to a qualified employee (Employee D). Assume that when Employee D received the stock on 9/30/2020, he elected to defer the bargain element, thereby converting the statutory stock to nonstatutory stock. Assume also that the deferral did not terminate until 11/30/2024, when Employee D sold the stock for $50,000. He then recognized the $15,000 deferred bargain element taxable as ordinary income. His basis in the stock became $45,000 (the original cost of $30,000 plus the $15,000 of ordinary income recognized). Thus, he also recognized capital gain of $5,000 (the $50,000 sales price less the $45,000 basis).

Note that Employee D was able to defer the tax on the ordinary income attributable to his stock option for more than four years until the date the stock was sold. By comparison, because D did not (or could not) make the deferral election under the facts stated in Example 5, above, he had to recognize the ordinary income on the bargain element as of the earlier date of exercise of the ISO. Nevertheless, in Example 5, the employee was not liable for Social Security taxes; whereas, the deferral election in this Example 6 triggers liability for Social Security taxes.

Conclusion

The new election to defer income tax on settlement of an RSU or on exercise of a nonstatutory stock option offers very real tax-saving opportunities. The election can also solve the problem of trying to find the money to pay income tax on the receipt of illiquid employer stock. Yet, in some situations, its use can have serious drawbacks. For example, the election may be made with respect to statutory stock, but doing so might transform capital gain to ordinary income. The election could also increase an individual's Social Security tax liability. Thus, the tax ramifications of making the election should be very carefully considered.

NOTES

[75] Reg. 1.422-1(c).

[76] Sections 3121(a)(5), (v)(2), and (v)(3); Reg. 31.3121(v)(2)-1; Conference Committee Report of the Tax Cuts and Jobs Act (HR 1), Pub. L. No. 115-466—Part 1, Business Tax Reform, I.3. Although Social Security taxes do not apply to statutory stock, the deferral election automatically converts the statutory stock to nonstatutory stock. Sections 422(b), and 423(b)(5) and (d).