GUNDERSON DETTMER

Executive Compensation Update: Tax Bill Impact on Compensation

Insights
January 10, 2018

This Alert briefly describes certain important recent compensation developments affecting public and private companies under the Tax Cuts and Jobs Act.

Federal Tax Law Changes

The Tax Cuts and Jobs Act (Act) impacts executive and employee compensation in a number of ways relevant to our clients. This Alert briefly summarizes several compensation-related provisions of the Act, which became effective on January 1, 2018.

New Income Deferral Election for Certain Private Company Equity Awards

The Act creates a new income deferral election available under Section 83 of the Internal Revenue Code (Code) in connection with certain private company equity awards. This deferral provision, which has been the subject of lengthy lobbying by the venture capital community, offers rank and file employees relief from immediate taxation upon acquisition of illiquid stock. Its inclusion in the Act is intended to facilitate broad-based stock ownership by employees in private companies where the cash necessary to pay applicable withholding taxes triggered by equity compensation awards is not readily available to either the employee (due to the illiquid nature of the stock) or the employer (due to its status as a start-up).

New Section 83(i) imposes a number of conditions and requirements to qualify for its deferral benefit. These conditions and requirements, which are briefly summarized below, raise questions as to whether the new deferral election will be available for the majority of currently outstanding private company equity compensation awards and the extent to which companies will need to change their equity compensation programs going forward to enable employees to utilize the election.

Please note that the new Section 83(i) election is only available in connection with qualifying exercises of stock options and settlements of restricted stock units (RSUs). While it is not available in connection with issuances of restricted stock, service providers continue to be able to utilize a Section 83(b) election in connection with acquiring unvested shares of employer restricted stock.

Deferral Election. By filing a new “Section 83(i) election” eligible employees of certain private companies will be able to defer income recognition upon exercise of qualified stock options and settlement of qualified RSUs for up to five years after the date the employee’s right to the stock is no longer subject to a substantial risk of forfeiture (becomes substantially vested) or until the earliest of the date on which:

- The stock becomes transferable (including to the company),
- The stock becomes publicly traded,
- The employee is no longer eligible for the deferral (including upon his or her promotion to an executive officer position within the company), or
- The employee revokes the election.

The election must be filed within 30 days after exercise or settlement of the award. Once the deferral period ends, the employee will recognize income based on the value of the stock *on the exercise or settlement date*, without regard to changes in the stock value after that date. The employer’s tax deduction will track the timing and amount of the employee’s income inclusion event. Note though that this deferral election applies only to *income tax* and not to *payroll taxes*.

Conditions, Requirements and Impact. The statute imposes a number of conditions in connection with this new deferral election, including:

- Only “qualified employees” may use the deferral election; it is not available to executive officers (generally determined in the same manner used to determine public company “named executive officers”), former executive officers, 1% stockholders of the company, and certain family members of such officers and stockholders, with a 10-year look-back applicable in determining such disqualifying status.

- It can be used only with “qualified stock” issued upon exercise of a stock option or RSU granted by an eligible corporation
  - Qualified stock does not include any stock that the employee can sell to, or otherwise receive cash in lieu of stock from, the company when the award vests.
  - Stock subject to a put right in favor of the employee would seem not to be qualified stock.
- To maintain its status as “qualified stock,” the company will be subject to restrictions in its ability to repurchase its outstanding stock.
  - There are quantitative limits on how much of its stock a company may repurchase annually.
  - It does not appear that a typical unvested share repurchase right will be a problem under this requirement.
  - However, other existing provisions of equity awards, such as the ability for the company to withhold shares to satisfy tax withholding obligations, may conflict with it.
- At least 80% of the company’s U.S. employees must be granted options or RSUs under a written plan for the applicable year, which awards must have equal rights and privileges.
  - This 80% requirement does not apply to options and RSUs granted prior to 2018.
  - It is unclear whether differences in vesting acceleration (e.g., triggered upon a change in control or on involuntary employment termination) or other material terms of equity awards will violate this “equal rights and privileges” rule.
  - The size of awards granted to employees is not affected by this requirement.
- Filing the deferral election with respect to an “incentive stock option” will disqualify it as an ISO, resulting in its being taxed as a nonqualified stock option when income is required to be recognized.

Notice Requirements. Companies are required to provide prescribed notices to employees related to the availability of the Section 83(i) deferral election. *Such notice is required to be provided prior to the vesting date for a stock option or RSU, and this notice requirement became effective as of January 1, 2018*. Companies will, however, need some time to determine whether or not the Section 83(i) deferral election is available for their employees and how to describe the availability of the new deferral election. Additional reporting requirements apply in connection with employees who file the Section 83(i) elections.

What To Do Now. Due to the multiple conditions and requirements imposed by this new law, it is not yet clear how popular “Section 83(i) programs” are likely to be among our private company clients. We anticipate that the interpretive questions raised by it will be addressed in due course through Treasury regulations and other Internal Revenue Service (IRS) guidance. In the coming days, we will be distributing materials for clients to use to provide the required notice to employees, to assist in figuring out whether their employees are able to utilize the new deferral election and to determine whether they want to make changes to their existing equity compensation awards to better position their employees to utilize this new income deferral opportunity.

Amendment of Section 162(m)

Section 162(m) of the Code limits the tax deduction that a public company may take for compensation paid to each of its top executives to $1 million per year. The Act makes several fundamental changes to this deduction loss rule that will immediately make nondeductible a significant portion of executive compensation that has previously been deductible and may impact compensation design for top executive officers at public companies. The changes to this law are effective as of January 1, 2018 (with one exception noted below). We anticipate IRS guidance including regulations interpreting the changes and transition issues.

Elimination of Performance-Based Compensation Exception*.* While Section 162(m) limits the amount paid to a top executive during a year that may be deducted by the employer company to $1 million, the law has previously incorporated an important exception that enabled companies to deduct amounts without regard to this cap if the compensation was qualifying “performance-based compensation.” For the more than 20 years it has been in place, this exception has greatly impacted executive compensation design for public companies. It is now being eliminated (including as to stock options, performance-based stock awards, cash incentive bonus programs and commissions), effective as to all arrangements entered into after November 2, 2017 and as to certain arrangements (in particular, arrangements that afford the employer discretion to determine the amount) entered into prior that date.

PRACTICE NOTE: Companies should seek legal advice *before amending* any executive arrangement that was *in place on November 2, 2017*.

Expansion of Deduction Loss Rule Applicability. The Act corrects the inadvertent omission of Chief Financial Officers (CFOs) as officers covered by Section 162(m) due to a technical glitch that occurred when the Security and Exchange Commission's executive compensation disclosure rules changed about ten years ago. In addition to covering compensation of CFOs, amended Section 162(m) will also apply to compensation paid after a covered executive's employment terminates (including amounts paid to a deceased executive's estate). In addition, Section 162(m) is expanded to apply to companies with publicly traded debt and to certain nonpublicly traded companies if they exceed specified thresholds relating to their number of stockholders.

Change to Alternative Mininum Tax (AMT) Thresholds

Although the initial version of the tax reform bill introduced in the House of Representatives would have eliminated AMT as it applies to individuals, the final Act retains AMT but temporarily increases the individual AMT exemption amount by about 29% over the levels imposed under prior law and increases the exemption amount phase out thresholds. This may, for the time it remains in effect, decrease the impact of AMT on employees exercising ISOs.

Employer FMLA Credit

The Act allows employers to claim a general business credit equal to 12.5% of wages paid to qualifying employees on family and medical leave (FMLA), if the employees are paid at least 50% of their normal wages. This credit is increased by 0.25% for each percentage point by which the payment rate exceeds 50% (capped at 25% of wages paid).

Elimination of Deduction of Moving Expenses

Employees will no longer be able to deduct moving cost expenses from their federal income taxes, or exclude from income related reimbursements from employers, beginning in 2018.

Related Services

Executive Compensation

Tax

Featured Insights

CLIENT NEWS

Anduril Announces Acquisition of Klas to Advance Tactical Edge Computing and Communications

FIRM NEWS

Gunderson Dettmer Commemorates 2025 Asian American and Pacific Islander Heritage (AAPI) Month

CLIENT NEWS

Prosus Leads US$7.25M Financing of Zapia

CLIENT NEWS

Brazilian Carbon Capture Company Mombak Announces $30M Financing

CLIENT NEWS

Latin American Fintech Clara Announces $80 Million Financing

CLIENT NEWS

Africa B2B OmniRetail Announces $20M Financing

CLIENT NEWS

Glacier Announces Series A Financing to Expand Robot Recycling Fleet

CLIENT NEWS

Dataminr Announces $100M Investment Led by Fortress Investment Group

CLIENT NEWS

Omnidian Announces $87M Series C for Renewable Energy Performance

INSIGHTS

Splitting the Pie: How Savvy Founders Divide Ownership and Navigate Other Founder Equity Decisions

CLIENT NEWS

Chainguard Announces $356 Million Series D Led by Kleiner Perkins and

© 2025 Gunderson Dettmer; all rights reserved.