Tax Issues Related to Startup Secondary Sales

by Marshall Mort, Hans Andersson, and Shawn Lampron, Fenwick & West, LLP, with Practical Law Employee Benefits and Executive Compensation

Maintained

A Practice Note addressing the tax treatment of startup secondary sales of equity securities, including specific factors that can create tax risk or affect the tax consequences of the sales.

Why Private Companies Delay Their IPOs
Why Secondary Sales
Tax Treatment of Secondary Sale Proceeds
Purchases at a Premium
Classification of Repurchases
Exercise of Options and Sales of Underlying Shares in Secondary Sales
Section 409A Valuations
Loss of Qualified Small Business Stock Status
Constructive Sales (with Loans)
Section 280G
Section 83(i) Election
Alternatives to Section 83(i) Elections
Two-Tier Liquidity-Based RSUs
Extensions to Post-Termination Exercise Windows for Options

With the rise of so many **unicorn** companies, large valuations and financings are becoming more familiar to investors. In response, venture-backed **startup** companies are staying private for a longer period of time. Traditionally, holders of equity in private companies had to wait for a liquidity event, that is, either an acquisition or an **initial public offering** (IPO), to see any cash from their equity. "Secondary sales" enable employees to exchange their illiquid equity for cash before a liquidity event occurs. For more information on secondary sales and late-stage startup liquidity, see Practice Note, Late-Stage Startup Liquidity: Overview.

There are significant tax issues related to secondary sales that all parties must consider with their tax advisors before conducting, facilitating, or participating in a secondary sales program. This Note addresses the tax treatment of secondary sales, including specific factors that can create tax risk or affect the tax consequences. While beyond the scope of this Note, the company should also consider the accounting implications of any secondary sales program.

Why Private Companies Delay Their IPOs

Private companies delay their IPOs for many reasons, including:

- A desire to achieve certain corporate goals before the offering.
- A desire to continue to operate autonomously.

 © 2019 Thomson Reuters. No claim to original U.S. Government Works.

- A desire to delay:
    - public disclosures and challenges from activist shareholders; and
    - the costs associated with being a **reporting company**.
- The need to recruit and hire senior management with sufficient experience to position the company for an IPO and lead a public company.
- The then-prevailing capital market conditions.

Why Secondary Sales

There is often a tension between a company's desire to stay private and its employees' desire for near-term liquidity. Startup companies often face pressure from their employees to push toward a liquidity event when the employees can cash in some of their equity. Companies increasingly are offering their employees the opportunity to sell some of their equity incentives for cash before a liquidity event occurs through secondary sales to either:

- The issuing company.
- Inside or existing stockholders.
- New investors.

In addition to providing liquidity to their employees, secondary sales may create an opportunity for the company to:

- Transfer shares into the hands of friendlier parties (for example, from former employees to an investor represented on the board).
- Encourage retention (by mandating that only current employees may participate in the secondary sale).
- Add as investors more sophisticated and well-known funds whose reputations will lend support to the company.

If the company permits or arranges secondary sales by employees, it must carefully consider:

- How the proceeds from that transaction should be treated for the employees' tax purposes.
- The tax consequences for the employer.
- Whether the secondary sales constitute a tender offer for securities law purposes (see Practice Note, Private Tender Offers: Selected Considerations).

 © 2019 Thomson Reuters. No claim to original U.S. Government Works.

The resolution of these issues turns on the context and unique factual setting in which the secondary sale occurs.

Tax Treatment of Secondary Sale Proceeds

The primary tax question that secondary sales raise is the appropriate tax treatment of the gains realized from the secondary sale transaction. If the excess of the fair market value of the shares at the time of the secondary sale over the original purchase price is treated as capital gain, the gain will be short-term or long-term, depending on how long the seller has held the shares. The proceeds from a sale of shares that are held for more than one year and treated as capital gains generally are taxed at the rate for long-term capital gains (up to 20%), which is almost always the optimal tax treatment sought by both companies and employees, whereas the proceeds from a sale of shares held for one year or less are treated as capital gains but taxed at the short-term capital gains rate, which is typically the marginal tax rate (up to 37%). For more information on tax treatment of capital gains, see Practice Note, US Equity Offerings in the US: Tax Consequences for Investors: Taxation of Capital Gains.

However, if the purchasing company is the buyer and pays a premium price for the shares or if the facts suggest that all or a portion of the price paid is really disguised compensation, then:

- The tax consequences may be less favorable to the employee.
- The company may have withholding obligations.

The following sections address certain nuances that a company contemplating secondary sales should consider when structuring its secondary sales program to ensure optimal tax treatment while furthering its other goals.

Purchases at a Premium

The stock price in a secondary sale often is set well above the prevailing **Section 409A** appraised fair market value (see Section 409A Valuations and Treas. Reg. § 1.409A-1(b)(5)(iv)(B)) at either:

- The latest preferred stock price.
- A discount off that preferred stock price, which may account for the differences in rights, preferences, and privileges between the preferred stock sold to venture capital investors and the common stock typically sold in the secondary sale.

Where the company repurchases shares from employees at a premium, the gains to the employees, that is, the excess of the premium price paid over the fair market value of the shares (reflected by the Section 409A valuation), is generally considered compensation and therefore taxed not as capital gains but as ordinary income to the employee and subject to employment-related withholding obligations by the company.

Compensation can include economic benefits provided to employees. For example, a premium paid by an employer when buying property from an employee, similar to an employer providing property at a discount to an employee, would generally be viewed as compensation. (See Tech. Adv. Mem. 83-37-012 (I.R.S. May 25, 1983); see also *Azar Nut Co. v. Comm'r*, 94 T.C. 455, 460 (1990) (suggesting that if an employer purchasing a house from an employee had paid a "premium or additional amount in excess of the fair market value," the premium would constitute compensation), *aff'd*, 931 F.2d 314 (5th Cir. 1991).)

 © 2019 Thomson Reuters. No claim to original U.S. Government Works.

Where the buyer is a third-party investor, the compensation analysis becomes more nuanced. In other areas of tax law, the IRS has held that payments from a company's existing stockholders could be viewed as payments from the company for compensation and tax deduction purposes. (See Treas. Reg. § 1.83-6(d)(1) (observing that if an employee receives property from a stockholder for services the employee performed for the employer, the property is treated as having been contributed to the employer by the stockholder and then transferred from the employer to the employee).)

Additionally, if a premium paid by an investor is deemed compensatory, the employer is generally still responsible for the tax withholding and the investor may also be responsible if the investor has control over the source of funds conferred and withholding is not otherwise made (see, for example, *In re Telecard Commc'ns Int'l Inc.*, 2001 WL 1750774 (Bankr. S.D. Fla. Nov. 7, 2001) (holding that a corporation that used the bank account of its subsidiary for payroll purposes was responsible for payment of payroll taxes on its employees' wages as it retained control over the bank account and payment of wages); *Kittlaus v. United States*, 41 F.3d 327 (7th Cir. 1994) (holding that the management agent was responsible for withholding taxes where the agent exercised complete and exclusive control over payment of wages); Priv. Ltr. Rul. 88-25-134 (noting that a trust fund was the employer for tax withholding purposes because the trust had complete control over timing and amount of payments)).

Whether a secondary sale to an investor at a premium is treated as compensation for an employee would likely turn on the unique facts and circumstances of the transaction, including:

- The types of participants eligible to participate in the secondary sale transaction.
- The identity of the buyer.
- The purpose of the secondary sale.

Eligible Participants

If the premium price is a benefit offered only to employees or a limited group of employees, the IRS may view the payment as disguised compensation.

For example, if only employees or a subset of employees, such as key employees (like the founders), employees with the longest tenure, or employees with senior titles, are eligible to sell shares to an investor at a premium (while nonemployee stockholders are ineligible for that bargain), then the premium may be treated as compensatory.

In contrast, there are indicia that the premium is not compensatory where the sellers:

- Include many nonemployees (such as former employees, consultants, advisors, and early investors).
- Negotiate their own sales price without company involvement.
- Have held their shares for a long period of time before the sale.

Even if nonemployee stockholders may participate in the sale, the premium in a secondary sale may still be deemed compensatory if either:

 © 2019 Thomson Reuters. No claim to original U.S. Government Works.

- There are few nonemployee participants.
- The nonemployee participants sell only a few shares.

Identity of Buyer

In the case of premiums paid by third-party investors, the IRS considers whether the investor is a new or an existing investor. Any investor payment to company employees could be recharacterized by the IRS as a contribution of capital from the existing stockholder to the employer and then a subsequent payment of compensation by the employer to the employee. (See, for example, Rev. Rul. 84-68 (disallowing a parent company from deducting a cash bonus made to a subsidiary's employees, indicating that the deduction belonged to the subsidiary instead); *Columbian Rope Co. v. Comm'r*, 42 T.C. 800 (1964); *Anderson v. Comm'r*, 67 T.C. 522 (1976), *aff'd per curiam*, 583 F.2d 953 (7th Cir. 1978); Priv. Ltr. Rul. 97-35-042.)

An auditor may treat a premium paid by an existing investor as compensatory because:

- The stockholder (more so if the stockholder is a significant investor or is represented on the board of directors) may want to offer employees value and interim liquidity as an incentive and retention feature.
- The IRS could recharacterize the payment by the stockholder as a contribution of capital to the company and a subsequent wage payment.

By contrast, there is generally less skepticism regarding the payment price set by an outside or new investor.

The analysis of motive may turn on how much of the employer company the buyer owns and how much confidential information that investor receives from the company. For example, if the investor's interest is 5% or less, this could bolster a claim that the buyer's purchase of shares was not meant to compensate employees. In addition, the existence of multiple buyers, including some who are not then-existing investors, may prove relevant in showing that the price paid is not meant to confer compensation.

Purpose of the Secondary Sale

In certain situations, the investors' motivations are clearly not compensatory. For example, the purpose of the secondary sale may be to:

- Have shares delivered to a new or friendly investor without causing additional dilution.
- Offer the investor a control premium (or other singular stockholder rights, such as information or co-sale rights for major investors).
- Gain a strategic investor that is and has been important to corporate growth or established objectives.
- Address a distressed situation where the company is in need of investment and recapitalization is required as a condition to that investment.

 © 2019 Thomson Reuters. No claim to original U.S. Government Works.

- Satisfy an investor that will only invest if it can purchase a certain percentage of the company or a certain dollar amount. If the company will not authorize new shares to meet the investor's request, the sale of shares by existing stockholders to fill out the round would support an argument that any premium is not compensatory.

Penalties for Failing to Withhold

Employers must generally:

- Withhold income tax and the employee's share of social security and Medicare taxes (FICA taxes) from employees' wages (26 U.S.C. §§ 3402 and 3102). These amounts are considered to be held in trust for the US (26 U.S.C. § 7501).

- Pay their own share of FICA taxes and federal unemployment tax.

Employers can in certain cases face civil and/or criminal sanctions from the IRS for failing to withhold taxes on compensatory payments, including potential negligence penalties (26 U.S.C. §§ 6662, 6672, 7203, and 7204). Wages for income tax and FICA withholding purposes generally include any remuneration to an employee unless exempted (26 U.S.C. §§ 3121 and 3401). Companies considering secondary sales must therefore carefully evaluate whether or not the sales will be deemed compensatory and will therefore be treated as wages subject to ordinary income tax and withholding.

For more information on employers' employment tax withholding obligations, including penalties for failing to withhold, see Practice Note, Payroll (FICA) Taxes.

Classification of Repurchases

To the extent that a repurchase is not treated as compensation, the parties should analyze whether the amounts paid are subject to taxation as a dividend. Specifically, amounts paid to an employee in a company buyback may need to be treated by the employee and reported by the company as dividend income subject to ordinary income taxation (assuming the company has earnings and profits) unless either:

- The sale is a substantially disproportionate redemption of stock.

- The employee sells all of its equity interests in the company.

(26 U.S.C. § 302(b)(2).)

A repurchase of stock from an employee will generally be treated as a sale of the stock and qualify for capital gain treatment if the sale is a substantially disproportionate redemption of stock, meaning that both:

- The employee owns immediately after the redemption less than 50% of the total combined voting power of all classes of stock entitled to vote.

- The employee's share of the company's voting stock immediately after the redemption is less than 80% of the employee's share of the voting stock before the redemption.

 © 2019 Thomson Reuters. No claim to original U.S. Government Works.

A liquidation of an employee's entire ownership interest, for example, generally would qualify for exchange treatment, resulting in capital gain or loss. Companies may require that any former employees who want to participate in a secondary sale sell all of their shares so that they are no longer on the company's capitalization table following the transaction. However, where the employer facilitates the secondary transaction (for example, by introducing the parties to each other), the employer often imposes limits on how much employees may sell (for example, only 20% of their owned and vested shares rather than their entire equity stake in the employer), which ensures that the employee's interests will continue to remain aligned with those of other stockholders. Current employees are therefore rarely allowed to cash out their equity incentives entirely.

Qualifying Dividend

Even if the repurchase is essentially equivalent to a dividend, the payment received for the shares may be a "qualifying" dividend eligible for long-term capital-gains treatment if:

- The shares are held for 61 days during the 121-day period beginning 60 days before the ex-dividend date.
- The company is domestic or meets certain requirements.
- The shareholder is not a corporation.

Although long-term capital gains rates apply to dividends that are "qualifying" dividends, an employee cannot use any of its tax basis in the company stock to reduce the amount of dividend income.

Companies should be cautious of redeeming a portion of recently exercised option shares. If such a redemption is essentially equivalent to a dividend, the redemption may not meet the holding period needed for qualifying dividend treatment.

For more discussion of the US tax consequences of stock redemptions, see Practice Note, Taxation of Stock Redemptions and Partial Liquidations.

Exercise of Options and Sales of Underlying Shares in Secondary Sales

This section addresses the tax consequences to the employee and employer if an employee seller must exercise his or her stock options and immediately sell the shares purchased on exercise to complete a secondary sale.

Non-Qualified Stock Options

If an employee seller must exercise a non-qualified stock option to complete a secondary sale, the normal tax treatment for non-qualified options will apply to the exercise, that is:

- The seller will recognize taxable compensation income equal to the excess of the fair market value of the shares underlying the option on the date of exercise over the exercise price (the "spread").
- The employer:

 © 2019 Thomson Reuters. No claim to original U.S. Government Works.

- will be entitled to a corresponding income tax deduction on the amount recognized as ordinary income by the employee; and
- must withhold income and employment taxes on the spread.

When the employee sells the shares acquired on exercise, the employee has a capital gain or loss on the difference between the sale price and the fair market value of the shares on the date of exercise (in other words, the sum of the exercise price paid plus the ordinary income recognized on exercise). Under circumstances where an immediate sale is not required, an employee who holds the shares acquired on exercise of a non-qualified stock option for more than one year following exercise will have a long-term gain or loss.

Incentive Stock Options

Incentive stock options (ISOs) generally receive favorable tax treatment (no taxes owed at the time of exercise and long-term capital-gains taxation on the sale of shares) if the shares are held for both:

- At least **two years** from the **date of grant**.
- At least **one year** from the **date of exercise**.

An earlier sale of the shares is called a **disqualifying disposition**, which causes the spread on the later of exercise or vesting to be taxed as ordinary income on sale (but, unlike non-qualified stock options, the income realized in a disqualifying disposition is not subject to withholding or employment taxes and not taxed at exercise for regular tax purposes but is includible for **alternative minimum tax** (AMT) tax purposes).

If a seller must exercise an ISO and immediately sell the shares to complete a secondary sale, the sale will constitute a disqualifying disposition and:

- The seller will recognize taxable compensation income on exercise equal to the spread value.
- The employer will be entitled to a corresponding income tax deduction, assuming the spread is reported as income to the taxpayer on a Form W-2 or Form 1099.

The amount realized on the sale of the shares in a disqualifying disposition is generally equal to:

- The fair market value of the shares on the date of exercise or later vesting (assuming in this case that the ISO shares are sold at a profit) less the exercise price paid.
- Capital gain as to the excess of this spread.

Employee sellers may be incentivized to sequence the sales of their shares to maximize tax opportunities. For example, an employee may prefer to sell stock held in a long-term capital-gains position in the hope of continuing to hold any remaining shares to meet long-term capital-gains holding periods. Similarly, instead of exercising and immediately selling shares under an ISO, an

 © 2019 Thomson Reuters. No claim to original U.S. Government Works.

employee may prefer to sell other shares eligible for long-term capital gains and use the proceeds to exercise remaining ISOs with the intention of continuing to hold the resulting shares.

Related to this sequencing, there may be adverse tax consequences when an employee experiences a disqualifying disposition and then later purchases new substantially identical stock. If the disqualifying disposition proceeds were greater than the exercise price paid but less than the fair market value of the shares on exercise, the ordinary income recognized in the disqualifying disposition is normally limited to the actual gain realized. For example, if an optionee pays a $100 exercise price when shares are worth $200 and then sells at $150, the ordinary income on the disqualifying disposition would be limited to $50 (rather than the $100 spread at exercise). This relief does not apply if the holder engages in a "wash sale," that is, sells a losing security to claim a capital loss only to purchase the same or a substantially similar security within 30 days of the sale (including from the exercise of new options). In this scenario, the ordinary income on the prior disqualifying disposition would not be capped and would be for the full $100 spread at exercise. (See Treas. Reg. § 1.422-1(b)(3), Example 3.)

There is a special caution for employees who exercise ISOs and then sell them in a later tax year when the sales price is less than the spread at exercise or later vesting. In this scenario, taxpayers may have recognized AMT in the year of exercise or later vesting and will likely not recoup the value of those taxes paid. The AMT previously recognized will not be refunded, and there will be no gain on sale to offset with AMT credits.

Cancellation of Options

In some resale transactions, a company purchaser cancels options held by employees for cash to either:

- Issue a similar number of shares to an investor.
- Decrease overall dilution of the company's capitalization.

Here, canceling an option for cash is treated as payment of a wage and not an exercise and resale of the shares because no exercise price is paid to the company. Rather, the employee is receiving payment in exchange for a contractual right rather than a property interest. The payment is therefore subject to ordinary income tax, and the company has withholding obligations.

Cashless Exercise

In some secondary sales, purchasers "front" the exercise price of the employees' options and then reduce the transaction proceeds to the seller by the same amount, so that the seller just receives the spread in cash. This **cashless exercise** feature is a common method of exercising stock options, as the option holders are not required to come up with the cash needed to pay the exercise price.

If the company and employee have an understanding that checks tendered for option exercise prices will not be cashed until after the closing of the secondary sale, there is significant risk that the options will not be viewed as having been exercised at all, meaning that the entire proceeds will be treated as a cancellation of the option (and entirely compensatory) rather than as a cashless exercise (see Treas. Reg. § 1.421-1(f) ("A promise to pay the option price does not constitute an exercise of the option unless the optionee is subject to personal liability on such promise. An agreement or undertaking by the employee to make payments under a stock purchase plan does not constitute the exercise of an option to the extent the payments made remain subject to withdrawal by or refund to the employee.")).

 © 2019 Thomson Reuters. No claim to original U.S. Government Works.

In contrast, if the investor fronts the exercise price on behalf of the optionee, and prior to the option exercise, this should not necessarily be viewed as a modification of the ISO, even if it eventually reduces the ultimate proceeds to be paid to the optionee on later sale. This is because the optionee still unconditionally satisfied the exercise price by directing the buyer to pay the exercise price on behalf of the optionee. In this case, the cashless exercise should be treated as a disqualifying disposition.

A further nuance exists when the company or investor commits to a premium purchase price before the exercise of the option. If the company makes this commitment, the optionee would be viewed as not having ever incurred the risk of loss under the shares (and would be viewed as canceling the option on sale, resulting in compensation income as to the entire spread). In contrast, if a new third-party buyer offers this premium price, this should not generally be viewed as undermining the risk of loss on the shares, so the shares should remain eligible for capital gain treatment. (See *United States v. Tuff*, 469 F.3d 1249 (9th Cir. 2006) ("The regulation does not require that the risk of decline in value be transferred to and permanently vested in the employee, but rather considers only whether it has been transferred from the employer.").)

For information on stock options generally, including tax consequences for both the employee and the company, see Practice Notes, Stock Options: Overview and Overview of the Taxation of Equity Compensation Awards: Non-Qualified Stock Options and Incentive Stock Options. For a checklist of ISO requirements, see Incentive Stock Options Checklist.

Section 409A Valuations

For stock options to be exempt from Section 409A, the stock options must be granted with an exercise price that is no less than the fair market value of a share of company stock on the grant date. Determining the fair market value of the company's common stock is not always straightforward in the private company context. Section 409A contains guidelines for determining the fair market value of private company stock, requiring the "reasonable application of a reasonable valuation method" and including some presumptively reasonable safe harbor methods (26 U.S.C. § 409A). The most commonly used safe harbor valuation method is an appraisal by an independent valuation firm (see Treas. Reg. § 1.409A-1(b)(5)(iv)(B)(1)).

A company that permits secondary sales of its stock should expect Section 409A valuations that occur following the secondary sales to take these sales into consideration when determining the fair market value of the company's stock (Treas. Reg. § 1.409A-1(b)(5)(iv)(B)(2)). Factors that should be considered under a reasonable valuation method include:

- The value of tangible and intangible assets of the corporation.
- The present value of anticipated future cash-flows of the corporation.
- The market value of stock or equity interests in similar corporations.
- Recent arm's length transactions involving the sale or transfer of such stock or equity interests.
- Control premiums or discounts for lack of marketability.

If secondary sales of common stock take place at a premium over the fair market value of the company's stock as determined by reference to the then-current independent Section 409A valuation, the company may find that this places upward pressure on subsequent Section 409A valuations, thereby limiting the potential upside for future option recipients and reducing options' effectiveness as equity incentives.

 © 2019 Thomson Reuters. No claim to original U.S. Government Works.

There are circumstances under which an independent appraiser may exclude a secondary sale from its valuation. An isolated sale or a sale under unusual circumstances, for example, may be treated by the appraiser as a one-off transaction that has no meaningful effect on the fair market value of the shares as no single person is offering to buy all of the company's common stock at the premium price. The price therefore may not apply to shares other than those that were actually bought. Some appraisers weigh the impact of recent secondary sale transactions based on factors, such as:

- The percentage of each holder's shares that can be sold. For example, if only 20% of each holder's shares can be sold, then 80% of the appraisal will be weighted based on standard appraisal factors.
- The frequency of the secondary sales. For example, if a company engages in multiple secondary sales in a series of years (for example, three to five in a 36-month time frame), this may impact the discount for lack of marketability that may otherwise apply.
- Whether nonemployees sold in the secondary sale. For example, the prices of sales by persons who never were service providers are more indicative of the fair market value of the stock (as opposed to a compensatory premium).

In contrast, those companies that administer frequent (such as quarterly or annually) secondary sales see greater effects on their Section 409A valuations. A company may be able to minimize the effect of secondary sales on subsequent independent valuations for purposes of Section 409A by limiting:

- The number of shares subject to secondary sales.
- The company's direct involvement in the secondary sales by avoiding direct repurchases.
- Secondary sales to specifically approved persons in limited contexts and for limited purposes unrelated to the fair market value of the underlying shares (for example, the purchase of shares from a departing founder to acquire his or her ownership in the company).

Anytime a company conducts or facilitates secondary sales, it should discuss the specifics with its independent appraisal firm and make sure that the appraiser:

- Factors any secondary sales into the appraisal process.
- Explicitly recites the secondary sales in the report.

A secondary transaction generally is given some weight in the appraisal process but not significant weight. Often, companies should expect that one-time secondaries involving less than 5% of the fully diluted capitalization table should not be given notable weight. In contrast, if companies orchestrate frequent or assured secondary markets, this would likely diminish the extent of any discount applied to the appraised value for the lack of marketability of the relevant shares.

Loss of Qualified Small Business Stock Status

Under the tax code, sale of "qualified small business stock" (QSBS) is subject to favorable tax treatment, with a portion (or all) of the gain realized on the sale excludable for federal tax purposes, including the 3.8% net investment income tax. However,

 © 2019 Thomson Reuters. No claim to original U.S. Government Works.

to qualify as QSBS under Internal Revenue Code (Code) Section 1202 (26 U.S.C. § 1202), the stock must have been obtained directly from the issuer. This means that stock that would otherwise qualify as QSBS loses this favorable status after it has been purchased through a secondary sale. This loss of favorable tax treatment may make stock purchased in a secondary sale worth less to the purchaser than it was to the original holder. For more information on the tax treatment of QSBS, see Practice Note, Qualified Small Business Stock: Tax Benefits.

Constructive Sales (with Loans)

If the company imposes transfer restrictions that allow pledging but not transfer of shares, employees and potential secondary buyers may enter into a loan structure. Here, the buyer could offer a loan to the employee in exchange for a pledge for the shares, where the loan would be repaid from proceeds in a liquidity event. A loan structure like this carries some tax risk of being deemed a "constructive sale" in which the tax effects would be the same as if a real sale had occurred when the loan was made. (26 U.S.C. § 1259(a).)

A unique variation of this constructive sale construct exists where an investor purchases a call option on private company shares from an employee, which may be exercised by that investor within a certain period of time with the payment of an additional purchase price. The entry into these call right agreements should not create a constructive sale of the stock as long as the underlying stock is not a "marketable security" and the call option expires within a year. (26 U.S.C. § 1259(c)(2) (carving out agreements from constructive sale rules that settle within a year after the contract is executed if the underlying property is not a marketable security).) Code Section 1259(c)(2) then references the definition of "marketable security" in Code Section 453(f), which provides that "any security for which, as of the date of the disposition, there was a market on an established securities market or otherwise" is a marketable security. While legislative history behind this section suggests that the term "otherwise" in this statute should not be so broadly construed to include regular secondary activities, this remains a somewhat unsettled area of law.

Section 280G

Secondary sales involving a sufficient number of shares of a company's capital stock may cause a change in control of the company within the meaning of Code Section 280G, which may result in adverse tax treatment of excess parachute payments (potentially including payments made for the shares purchased in the secondary sales) to "disqualified individuals" (26 U.S.C. § 280G).

For a change in control to occur for purposes of Code Section 280G, a transaction must be either a change in:

- Ownership of a corporation.
- Effective control of a corporation.
- Ownership of a substantial portion of the assets of a corporation.

Under certain circumstances it may be possible for a buyer to trigger the "effective control" prong of Code Section 280G's change in control definition in a secondary sale. In general, a change in effective control of a company is presumed to occur on the date that any one person or more than one person acting as a group acquires or has acquired during the 12-month period ending on the date of the most recent acquisition stock representing at least 20% of the total voting power of the company. The presumption can be rebutted if the acquisition does not cause a transfer of the power to control the company's management and policies but not if the stock acquired possesses more than 50% of the total voting power of the company.

 © 2019 Thomson Reuters. No claim to original U.S. Government Works.

A buyer in a secondary sale may be deemed to be acquiring effective control of the company by virtue of either:

- Quick successive investments in a 12-month period.
- One large investment in excess of 20% of the company's voting power.

Similarly, a buyer in a secondary sale may be deemed to acquire effective control if it acquires over 50% of the voting power over staggered multi-year small investments (see Treas. Reg. § 1.280G-1, Q/A-28(g), Example 1).

This is mainly a risk where the investment in the company is by a strategic investor with plans to acquire the company (either entirely or a majority stake) or in certain private equity investments where the private equity investor acquires substantial voting power, call option privileges, or substantial influence or control over the board of directors.

If multiple buyers are participating in the secondary sale, the buyers may be aggregated for this purpose if they are "acting as a group." Parties do not "act as a group" simply because they co-invest at the same time, but they may be deemed to be acting in concert if they combine forces to gain leverage in the negotiated terms. (See Treas. Reg. § 1.280G-1, Q/A-28(e).)

If the buyer or buyers are deemed to have obtained more than 20% of the company's voting power, the presumption of a change in control may be rebutted by the taxpayers by showing certain facts, including that:

- The founders and management maintained "substantial stock ownership."
- The buyer's interest will fall to below 20% over a relatively short period of time due to dilution from option exercises.
- None of the buyer's shareholders or management hold company management positions, even though they do nominate directors subject to shareholder approval.
- The transaction is consistent with a typical institutional investor financing.
- The buyer would not be viewed as acquiring the company as some of its other portfolio companies compete with the company.
- There are no shareholder agreements or veto rights that allow the buyer to effectively control the management decisions.
- The company's charter and bylaws did not change as part of the transaction.

(See Priv. Ltr. Rul. 2000-34-013.) While the IRS authorities do not offer clear guidance on how to quantify the above guidance (for example, what is "substantial stock ownership"?), it is expected that the guiding principle is whether the investor will gain and retain meaningful control for the reasonably foreseeable future and about important upcoming strategic decisions.

Special care should be taken if the buyer negotiates for a call option alongside the secondary sale. The shares that may be acquired under the call option may count toward the acquisition of 20% voting power unless there are serious conditions precedent (usually from external forces) to the buyers' ability to exercise that call option. (See Field Service Advice Memorandum 1999-15-007.)

 © 2019 Thomson Reuters. No claim to original U.S. Government Works.

For an overview of Code Section 280G, see Practice Note, Sections 280G and 4999: Golden Parachute Payments.

Section 83(i) Election

2017 tax reform (commonly referred to as the **Tax Cuts and Jobs Act**) added Section 83(i) to the Code (26 U.S.C. § 83(i)). This provision allows certain private corporations to offer qualified employees the opportunity to make an election (a Section 83(i) election) to defer the recognition of income on illiquid company stock acquired through the exercise of stock options or settlement of RSUs either:

- For up to five years.
- Until the occurrence of an earlier specified event (including the shares becoming transferable or otherwise subject to liquidation and the company undergoing an IPO).

The company's withholding obligation is similarly deferred.

Only "qualifying employees" receiving "qualified stock" of "eligible corporations" may make a Section 83(i) election. For information on how each of these terms is defined, see Section 83(i): Qualified Equity Grants Checklist.

To be an eligible corporation, among other requirements, the company may not have engaged in a self-tender (that is, a purchase of shares by the company) of vested stock within the calendar year preceding the Section 83(i) election unless:

- At least 25% of the total dollar amount of the repurchased stock was subject to prior Section 83(i) elections and the determination of which individuals from whom deferral stock was purchased was made on a reasonable basis.
- If an individual has shares subject to multiple Section 83(i) elections, the individual first tenders the shares subject to the longest standing Section 83(i) election.

Restrictions around self-tenders imposed by the new tax law do not apply to secondary sales to investors. If a company's employees seek to take advantage of the Section 83(i) elections, the company should either:

- Monitor any self-tenders to comply with the 25% rule.
- Arrange for resales to outside investors.

Most private companies have found that Code Section 83(i) does not offer any practical relief because companies often:

- Do not administer their equity programs to comply with the Code Section 83(i) requirements.
- Refuse to accept the delayed withholding obligations, which could show as a significant unfunded liability on financial statements to potential investors.

 © 2019 Thomson Reuters. No claim to original U.S. Government Works.

Alternatives to Section 83(i) Elections

Many companies prefer the following alternatives to Code Section 83(i) that may effectively defer taxation until liquidity:

- Two-tier liquidity-based RSUs.
- Extensions to post-termination exercise windows for stock options.

Two-Tier Liquidity-Based RSUs

Two-tier liquidity-based RSUs accrue vesting based on service but do not vest until a liquidity event first occurs, regardless of whether the holder remains employed on the liquidity date.

For this structure to be viable from a tax perspective, there must be real risk of loss for the RSU holder. Grants under full value awards must be subject to a "substantial risk of forfeiture" (SRF) measured on the grant date, meaning that:

- The liquidity event may not occur.
- The RSU holder may lose everything that has service-vested.

Whether the liquidity event constitutes an SRF is a question of fact. Examples of events that may constitute an SRF could likely include:

- An IPO.
- The attainment of prescribed equity values or earnings.

These two-tier liquidity RSUs should not be granted when an IPO is on the horizon, as the IRS may challenge the IPO as not sufficiently uncertain for the RSUs to qualify as subject to an SRF. Practitioner advice varies on when to stop granting these two-tier RSUs before an expected IPO, but many companies continue to grant these types of awards until the year before the expected IPO effectiveness and then either:

- Switch to alternative equity incentives.
- Require employment through the IPO completion date (which itself is an independent SRF).

(See Treas. Reg. § 1.409A-1(d); Office of Chief Counsel Memorandum 201645012.) Deadlines typically would be set on these liquidity events to heighten the risk that the liquidity event achievement may not occur.

For more information on what constitutes an SRF under Section 409A and other Code sections, see Practice Note, Substantial Risk of Forfeiture Under Code Sections 83, 409A, and 457A.

 © 2019 Thomson Reuters. No claim to original U.S. Government Works.

Extensions to Post-Termination Exercise Windows for Options

Companies generally give participants a limited period of time post-termination to exercise their vested options (often 90 days). Extensions to post-termination exercise windows allow departing employees to continue to hold vested options for a longer period of time (and potentially (and hopefully) bridge to an eventual liquidity event), but the company must consider the tax consequences of any option extensions.

Under Section 409A, the company may amend an option to extend the exercise period without causing a Section 409A issue if the exercise period is extended to a date that is no later than the earlier of:

- The expiration date included in the stock option agreement.
- The tenth anniversary of the grant date.

(Treas. Reg. § 1.409A-1(b)(5)(v)(C).)

If the option is amended after it is granted to extend the post-termination exercise window, the amendment of the option will be deemed a "modification," causing the option, if it was an ISO, to become a non-qualified stock option (Treas. Reg. § 1.424-1(e)(4)(iii)). If the option is underwater at the time of the extension, however, a taxpayer may maintain that:

- The amended option is effectively a new grant of an out of the money option.
- The option retains status as an ISO.

Similarly, if an ISO is granted with a long post-termination exercise window as an original feature, the option will become a non-qualified stock option three months after the holder's termination of employment other than for death or disability (or 12 months following a termination of employment due to disability). (See Treas. Reg. § 1.421-1.)

 © 2019 Thomson Reuters. No claim to original U.S. Government Works.