

Answers to Some Questions About 83(b) Elections (Including the Most Difficult One)

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In what passes for “news” regarding 83(b) elections, the IRS recently issued final regulations that eliminate the need to attach a copy of an 83(b) election to the service provider’s federal income tax return for the year of the election. The change is intended to encourage the electronic filing of tax returns, which isn’t available if one needs to attach non-standard forms and statements like 83(b) elections.

To be clear, taxpayers still need to submit a paper copy of the 83(b) election to the IRS within the applicable 30-day deadline. The final regulations apply to property transferred on or after January 1, 2016, but taxpayers were already permitted to rely on identical, previously proposed regulations for transfers on or after January 1, 2015.

While we are on the topic, we should seize the opportunity to answer some of the most commonly asked questions about

83(b) elections. Although the rules are written more generally to apply both to employees and independent contractors, to any kind of restricted property, and whether the property is transferred to the service provider or a third party, let’s focus on the typical situation where you are an employee receiving unvested stock of your employer as compensation for services.

What does an 83(b) election do?

As background, when property is transferred in connection with the performance of services, Section 83 governs the *timing* and *amount* of compensation income taxable to the service provider. The general rule is that the *vesting date* governs both timing and amount of taxable income.

That is, you recognize taxable income in the year in which the stock is substantially vested, in the amount of the difference



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between the stock's fair market value on the vesting date and any amount you paid for the property.

The function of an 83(b) election is to make the *grant date* the relevant date, rather than the *vesting date*. That is, you have taxable income as of the grant date, based on the fair market value of the property on that date.

In either scenario, upon the "compensation event" (i.e., the vesting date or grant date, depending on whether the 83(b) election is made), the income is taxable at ordinary rates and your holding period in the property begins. Any further appreciation or depreciation of the stock is capital gain or loss.

Why would I want to file an 83(b) election if doing so will accelerate my income?

Normally you want to defer rather than accelerate income. But the difference between the tax rates for ordinary compensation income (39.6% max.) and long-term capital gains (20% max.) may change your calculus. If you expect the property to both increase in

value and eventually vest, the 83(b) election allows you to start your holding period (long-term capital gains treatment requires you hold the property for more than a year) and apply the lower capital gains tax rate to any further appreciation. Without an 83(b) election the taxable income is deferred, but any appreciation between the grant date and vesting date is taxed as ordinary income instead of, potentially, long-term capital gains.

Why would I *not* want to file an 83(b) election?

An 83(b) election comes with risks. If you forfeit the property, or if the property decreases in value (or becomes worthless) prior to vesting, you will have unnecessarily paid some taxes (an odious, despicable thought in our business).

You may think there's a consolation prize in those scenarios. Because the property's value on the grant date becomes your tax basis, you should logically get a capital loss if you later forfeit the property or dispose of it for a lesser amount. Unfortunately, under one of the most ludicrously unfair rules in the tax law, if you make an 83(b)

election and later forfeit the property, your capital loss is limited to any amount you actually paid for the property out of pocket. In the event of a forfeiture, you get no tax loss for the amount previously included in your income by reason of the 83(b) election.

So, how do I decide whether to file an 83(b) election?

As you can see, making an 83(b) election is a calculated risk that the possibility of a lower tax rate on future gains outweighs the certainty of ordinary rates. As Dirty Harry would say, "Do you feel lucky, punk?"

In practice the choice is easier for some service providers than others. For instance, if you receive early-stage company stock with nominal value, an 83(b) election has nothing but upside. At the other end of the spectrum, if the company is highly mature with a steady value, you will typically be happy to defer income and avoid the risk of forfeiting the stock prior to vesting.

Can I file an 83(b) election if I receive stock options subject to a vesting schedule?

No, with a very narrow exception. An 83(b) election cannot be made on compensatory stock options unless the options have a “readily ascertainable fair market value,” which functionally means the options are publicly traded. But even this exception is narrower than it appears, since a company’s options that are

same, resulting in an immediate compensation event regardless of whether an 83(b) election is filed.

The complexity lies in determining whether the property is “vested” within the meaning of Section 83. For tax purposes, property is vested if it is either (1) no longer subject to a “substantial risk of forfeiture,” or (2) transferable to any third party free and clear of any

This question arises most in the context of preferred financing rounds, where founders holding fully vested common stock agree, as a condition of the financing, to subject those shares to vesting restrictions. It can also arise in the M&A context, where shareholder/employees exchange their existing shares for unvested shares of the buyer in a taxable or tax-free transaction.

The key question is whether a

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publicly traded by investors have dramatically different terms than those issued under the company’s equity compensation plans (regarding length, strike price, application of SEC regulations, etc.). Translating the price of the former into a price for the latter is likely too complex to satisfy the “readily ascertainable” value standard.

Do I need to file an 83(b) election if the stock is fully vested when granted to me?

Strictly speaking, no. Where property is fully vested when granted, this means the grant date and vesting date are the

forfeiture conditions (more on this later). We often equate a “substantial risk of forfeiture” with a requirement for future services, but it can be any compensation-related condition, such as a requirement that the individual or company reach certain performance targets. So think carefully about all conditions before concluding that the stock is fully vested, and if in doubt, consider filing a “protective” 83(b) election.

Should I file an 83(b) election if vesting restrictions are imposed on fully vested stock that I own?

holder of fully-vested property is receiving any “new” property that is subject to the vesting restrictions. If vesting restrictions are simply being applied to the founder’s current shares, no 83(b) election is required. What often happens, however, is the founders receive “new” shares of some sort, albeit in a tax-free way. For instance, as part of the financing, the company may reincorporate in Delaware or the company may recapitalize to increase or decrease the number of common shares. If the founder exchanges his existing vested shares for new unvested shares, an 83(b)

election is required to avoid any further appreciation from being taxed as compensation income upon vesting. The election would not trigger any additional income – the founder has “paid for” the new shares by exchanging the existing shares of equivalent value.

How do I file an 83(b) election?

Mail your 83(b) election to the IRS service center where you would mail a paper copy of your income tax return if you were not including a payment. You can find the appropriate address on the IRS website. You must also provide a copy of the 83(b) election to your employer and any person or entity to whom you transfer unvested property, such as an estate-planning vehicle.

What is the deadline for filing an 83(b) election?

An 83(b) election must be postmarked within 30 calendar days after you receive the restricted property. There are no exceptions, unless you are serving in the Armed Forces (or in support of the Armed Forces) in a combat zone, or the IRS determines that you are affected

by a presidentially declared disaster or terrorist or military action.

The 30th day is calculated by counting every day (including Saturdays, Sundays and holidays) starting with the day after the date on which you receive the property. For example, if you receive restricted stock on April 19, your 83(b) election must be postmarked no later than May 19. If the 30th day falls on a weekend or holiday, then the deadline is the next business day.

What if an 83(b) election contains a mistake? Can I file an amended election?

Once the 30-day deadline has passed, there is no process for amending an 83(b) election other than securing the IRS’ permission to revoke the election entirely. In terms of what impact a mistake may have on the election, there is no official guidance, but our attitude is to keep in mind the underlying purpose of the election; i.e., to commit the service provider to immediate taxation vs. waiting until vesting. So minor mistakes about your personal information, general description of the property, or vesting schedule will

likely be disregarded. On the other hand, if you are issued 100,000 shares and list only 50,000 shares on the election, the IRS would be dubious if you claimed you really meant to make the election on 100,000 shares when their value skyrockets.

What can I do if I missed the deadline for filing an 83(b) election?

The most common question is also the most difficult. The 30-day deadline is hard and fast, and the IRS claims it lacks the authority to grant extensions.

First, let’s rule out having the company simply cancel and re-issue your stock in the same terms. The IRS will see through that sham in a second. Instead, the company could replace the stock with options or new stock with materially different terms.

If those solutions won’t suffice, there is another potential solution that we’ve employed in emergency situations. It’s ugly and must be customized to the specific facts, but it aims to accelerate the “compensation event” and reach the same tax result as if you had timely filed your 83(b) election. Recall your

stock is “vested” (and thus taxable in the absence of a timely 83(b) election) when there is no longer a substantial risk of forfeiture or the stock is transferable to a third-party free of the forfeiture risk. Understandably, the company

will not want to waive the vesting schedule and/or other forfeiture conditions. But it may consider making the stock *transferable* under certain limited circumstances. Once the stock is transferable, the compensation event is triggered, ordinary

income tax is due, and any further appreciation may be long-term capital gains. How to make transferability palatable to all parties is where the ugliness and customization come in.

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