Section 83(b) Election — Traps for the Unwary

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A Section 83(b) election is a powerful tax-planning tool available to founders, employees, consultants, and other service providers who receive equity subject to vesting. When used correctly, it can convert future appreciation into long-term capital gain, accelerate the QSBS holding period, and eliminate wage income that would otherwise arise when restricted stock vests. When used without understanding its risks, an 83(b) election can create unexpected tax liabilities that cannot be undone.

This article explains how an 83(b) election works, when it is appropriate, and—most importantly—why it can be a trap for the unwary, drawing on IRS guidance and the nuanced consequences emphasized in cases.

Section 83 governs the taxation of "property" transferred in connection with the performance of services. Stock, units in a limited liability company, or certain tangible assets (not covered here) generally qualify as "property" for this purpose. Under Section 83(a), a service provider is taxed when the property becomes substantially vested, meaning when it is no longer subject to a substantial risk of forfeiture and is transferable.

At that time, the service provider includes in income the fair market value at vesting minus any amount paid by the service provider. This amount is treated as ordinary compensation income. For startups whose valuations rise quickly, this default rule can result in significant income taxation at vesting—without any liquidity to pay the tax.

Section 83(b) allows a service provider to elect to include the value of restricted property in income immediately upon transfer, even if the property is unvested. If the election is made, the taxable event shifts from vesting to grant, and all subsequent appreciation is expected to be treated as capital gain rather than ordinary income. Further, that appreciation is not taxed until the service provider ultimately disposes of the property. This outcome is especially valuable where the fair market value at grant is low or nominal.

By contrast, if no 83(b) election is made, the service provider is treated as receiving the property incrementally upon vesting, and each vesting event produces ordinary income equal to the then-current fair market value. Each tranche acquires its own basis and its own holding period. In a rapidly growing business, this can generate taxable wage income at times when the service provider may have little or no liquidity to pay those taxes.

The choice between ordinary income treatment at vesting and capital gains treatment at sale can have a material economic impact. Ordinary income is generally taxed at significantly higher marginal rates and often triggers payroll withholding obligations for the service recipient; capital gains are generally taxed at lower preferential rates, and are recognized upon a sale event, providing liquidity to satisfy the resulting tax liability.

A valid Section 83(b) election can also be especially powerful where the underlying property is intended to be qualified small business stock (QSBS) under Section 1202. When restricted stock is granted to a service provider without an 83(b) election, the stock is treated as acquired only when it vests, and therefore the Section 1202 holding period begins on each vesting date, not at grant. An 83(b) election reverses this result. If the taxpayer makes a valid election, the restricted stock is treated as acquired at grant, notwithstanding the vesting conditions, and the Section 1202 holding period begins immediately. For founders and early employees who expect significant growth or an eventual exit, this acceleration of the QSBS holding period may be the single most valuable consequence of making an 83(b) election.

Although the potential benefits of a Section 83(b) election can be substantial, the risks are equally significant and often misunderstood. The most serious trap arises when the property subject to the election is later forfeited. If a taxpayer makes an 83(b) election, pays tax on the value at grant, and subsequently loses the property—for example, by leaving the company before vesting—Section 83(b)(1) expressly prohibits any deduction for the amount previously included in income by the service provider. The taxpayer may claim only a capital loss for the amount actually paid for the property, not for any income recognized as a result of the election.

Compounding this risk is the irrevocable nature of a Section 83(b) election. Once made, an 83(b) election is generally irrevocable. The Internal Revenue Service (IRS) will not allow a taxpayer to withdraw the election simply because circumstances change, or the election later appears disadvantageous. In fact, the Service has emphasized that revocation is permitted only in very limited and narrowly defined situations. First, if the request is submitted within 30 days after the election was originally filed, the IRS will typically consent to the revocation regardless of the underlying reason. Outside that 30-day window, however, the taxpayer must meet a far higher standard: the request must be made within 60 days of discovering a "mistake of fact" relating to the underlying transaction. The "mistake of fact" exception is interpreted very narrowly. Under IRS Revenue Procedure 2006-31, a mistake of fact is an unconscious ignorance of a fact that is material to the transaction. Neither a mistake as to the value (or decline in the value) of the property for which the election was made, nor the failure of anyone to perform an act that was contemplated at the time of transfer of the property, constitutes a mistake of fact for this purpose.

Further exacerbating the potential traps for the unwary is that an 83(b) election must be filed no later than 30 days after the property is transferred to the service provider. To be effective, the service provider must also deliver a copy of the election to the service recipient (and, where the transferee of the property is someone other than the service provider, to the transferee as well) and retain a copy for recordkeeping purposes. The written election must clearly indicate that it is an election under Section 83(b) and must include:

1. The taxpayer's name, address, and taxpayer identification number;
2. The date of transfer and the tax year for which the election is made;
3. A description of the property and the nature of the restrictions to which it is subject;
4. The fair market value of the property at the time of transfer (determined without regard to lapse restrictions) and the amount, if any, paid for the property; and
5. A statement that copies of the election have been furnished to the service recipient and, if applicable, the transferee of the property.

A Section 83(b) election can be enormously advantageous, but only when made under the right circumstances and with a clear understanding of the risks. In broad terms, an election is most appropriate where the value of the property at the time of transfer is low relative to the amount paid, the service provider has a high degree of confidence that the vesting conditions will be satisfied, and there is a meaningful likelihood that the property will increase in value before vesting occurs. In these situations, the election allows the service provider to recognize a minimal amount of ordinary income at grant, begin the capital gains and (where applicable) QSBS holding periods immediately, and convert future appreciation into capital gain taxed only upon a future disposition.

Conversely, an 83(b) election is often ill-advised when the property already has significant value at the time of transfer, when vesting is uncertain, or when the property is not expected to appreciate materially. Under those circumstances, the election accelerates ordinary income without providing any realistic opportunity to benefit from capital gains treatment, and it exposes the taxpayer to the harsh forfeiture rules under Section 83(b)(1) should the property be lost before vesting. The irrevocable nature of the election means that a poor decision cannot be undone once circumstances change.

Service providers and companies should carefully evaluate valuation, vesting risk, expected growth, and QSBS eligibility before making the election. With thoughtful analysis and proper documentation, the election can serve as an important tool in early-stage equity compensation planning; without such diligence, it can quickly become a trap for the unwary.

For more information, please contact attorney Taimoor Choudhry.

See also Section 83(b) Elections – Navigating Fertile Ground for Bad Results for additional guidance on this type of election.