Section 83(b) Elections – Navigating Fertile Ground for Bad Results

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This article addresses what service providers that acquire equity in a company should know about Section 83(b) elections to avoid adverse tax consequences.

Companies sometimes allow their service providers to acquire equity as a means of retaining the service providers and incentivizing the service providers to help grow the companies' equity values for the benefit of all of the companies' equity holders. Often, a service provider who receives employer equity has to earn, by satisfying some tenure or performance requirement (often referred to as "vesting"), the right to ultimately sell the equity for more than he or she paid for it. Typically in that case, if the service provider's service terminates, any portion of the equity that has not yet vested at the time of the termination is subject to repurchase by the employer for the amount paid by the service provider for the equity (or, if less, the equity's then fair market value). The service provider either gets to keep the vested portion of the equity or, if he or she has to sell the equity back to the employer, receives the then fair market value of the vested portion from the employer in the sale.

A service provider who receives property (typically, employer equity) in connection with his or her performance of services and in which he or she has to vest based on some tenure or performance requirement (and which is not transferable free of the vesting restriction) generally has two choices under Section 83 of the Code[1] in determining the tax consequences of his or her receipt of the property.[2] On the one hand, the service provider can make an election under Section 83(b) (a "Section 83(b) election") with respect to the property. If the service provider makes a valid Section 83(b) election, he or she is deemed to have acquired the property upon receiving it (notwithstanding that the property then remains subject to vesting) and has ordinary compensation income upon receiving the property equal to any amount by which the then value of the property exceeds the amount paid by the service provider for the property.[3] The service provider has no further income upon vesting in the property. For purposes of reporting the amount and character of any gain the service provider may have upon subsequently selling the property, the service provider's holding period has begun, and his or her initial basis in the property is the property's fair market value, upon his or her receipt of it.[4]

On the other hand, if the service provider does not make a valid Section 83(b) election with respect to the property, he or she is deemed to receive the property under Section 83(a) only as he or she vests in the property. In that case, whenever the service provider vests in any portion of the property, he or she has ordinary compensation income in the amount by which the then value of that portion of the property exceeds the amount he or she paid for that portion. Each time the service provider vests in any portion of the property, his or her holding period for that portion begins, and his or her initial basis in that portion becomes the then value of that portion.[5]

Basically, then, the Section 83 rules require the service provider to choose between his or her receipt of the property (notwithstanding the property's being subject to vesting), on the one

hand, and his or her vesting in the property, on the other hand, as the compensatory transfer event. The consequences of the transfer are driven by the value of the property at the time of that event, and the service provider's holding period for, and initial basis in, the property are determined based on the time of the event and the value of the property at the time of the event.[6] An election may be warranted, therefore, if (i) the value of the property upon its receipt by the service provider does not significantly exceed the amount paid by the service provider for the property, (ii) the service provider is reasonably confident that he or she will vest, and (iii) there is a reasonable chance that the property will significantly appreciate in value between the time the service provider receives it and the time that he or she will vest in it. On the other hand, an election may not be warranted if (a) the value of the property upon its receipt by the service provider significantly exceeds the amount paid by the service provider for the property, (b) the service provider is not confident that he or she will vest, and/or (c) the property is not likely to appreciate in value after the service provider receives it.[7]

The Section 83 rules include some fertile ground for inadvertently bad results. That vesting rather than receipt is the default compensatory transfer event makes the rules a trap for the unwary in common situations where their applicability isn't obvious and adverse consequences can result only from not making the election. The rules by their terms apply to property transferred "in connection with" the performance of services, which means that they can apply even if the service provider has paid fair market value for the property.[8] Thus, if an employee pays fair market value for stock of his or her employer subject to vesting, he or she has no compensation income upon receiving the stock (regardless of whether or not he or she makes the election) but has to make the election to begin his or her holding period upon receiving the stock and avoid reporting any post-receipt appreciation as compensation income upon vesting in the stock. Further, the rules can apply if the service provider receives property subject to vesting in exchange for other property in a transaction that otherwise would have been tax-free to the service provider under Section 351 or Section 354. There as well, the service provider can receive the property tax-free in any event, but has to report any post-receipt appreciation in the value of the property as compensation income upon vesting if he or she fails to make the election.[9]

Compounding the potential for bad results is the requirement that, to be valid with respect to any property received by a service provider, a Section 83(b) election has to be filed by the date that is 30 days after the service provider's receipt of the property. The service provider has to deliver a copy of the election to the person for whom he or she performed the services (and, if the person who performed the services and the transferee of the property are not the same person, the transferee of the property) and keep a copy of the election until the expiration of the statute of limitations for the year of the election. Among other things, the election has to (i) identify the service provider, the date of the transfer of the property, and the tax year for which election is made, (ii) describe the property and the nature of the restrictions to which the property is subject, (iii) specify the fair market value of the property and the amount paid by the service property for the property, and (iv) state that copies of the election have been furnished to the person for whom the services were performed and, if applicable, any transferee of the property.

For more information on the Section 83(b) Election, please contact Attorney Chip Wry.

See also Section 83(b) Election — Traps for the Unwary for additional guidance on this type of election.

[1] References in this article to "the Code" are to the Internal Revenue Code of 1986, as amended, and to "Sections" are to Sections of the Code.

[2] In the terminology of the rules, for as long as the equity remains subject to repurchase from the service provider for less than the equity's fair market value, the equity remains subject to a

"substantial risk of forfeiture" in the hands of the service provider.

[3] Under the rules, fair market value is determined without regard to any restrictions other than restrictions which by their terms will never lapse. Thus, value is generally determined without regard to the applicable vesting restrictions.

[4] Thus, the service provider's holding period for his or her subsequent reporting of gain as long-term capital gain, or exclusion of gain under the "qualified small business stock" rules of Sections 1045 and 1202 of the Code if the company is a C corporation and the stock is qualified small business stock, has begun upon his or her receipt of the property. One point to note, though, is that if the service provider reported ordinary compensation income upon receiving the property by making a Section 83(b) election, that income cannot be reversed by a loss if the service provider subsequently has to sell the property back to the employer at the unvested repurchase price.

[5] Any dividends or distributions the service provider receives with respect to the property before vesting are treated as compensation.

[6] The employer's compensation deduction and, if the service provider is an employee, withholding obligation are determined based on the amount and timing of the service provider's compensation income.

[7] It should also be noted that the Section 83(b) rules do not necessarily apply to all equity awards. For example, property is not subject to vesting for purposes of the rules if it's subject to repurchase for less than fair market value only upon the termination of the service provider for "cause" (although what constitutes "cause" under the rules may not be so clear). Also, there's generally no need to file an election for a stock option granted by a private company, although an election may be warranted (even if just for alternative minimum tax purposes if the option is an "incentive stock option" or "ISO") upon the exercise of the option for shares subject to vesting. At least under current authorities, elections may not be necessary to avoid compensation income upon vesting in certain "profits interests" issued by entities classified as partnerships (although, out of caution, many practitioners advise that elections be made for interests intended to be profits interests subject to vesting due to uncertainties that can exist in determining whether the interests really are profits interests as the term is defined by the Internal Revenue Service).

[8] *Alves v. Commissioner*, 54 AFTR 2d 84-5281, 734 F.2d 478 (9th Cir. 1984).

[9] The rules can allow for some odd possibilities. Suppose, for example, that two individuals form an S corporation, each contributing property to the corporation for 50% of the common voting stock of the corporation, and with the shares of stock each receives having a value equal to the value of the property he or she contributes. Under Section 351 of the Code, each could contribute his or her property for stock without recognizing gain or loss. What, though, if the two individuals sign a stockholders' agreement allowing for the buy-out of the shares of either of them who stops working for the corporation before the expiration of some period of time at a price less than the then value of the shares? Have the individuals been deemed to own their shares before vesting in them, and if not, how is the income of the S corporation reported until then?