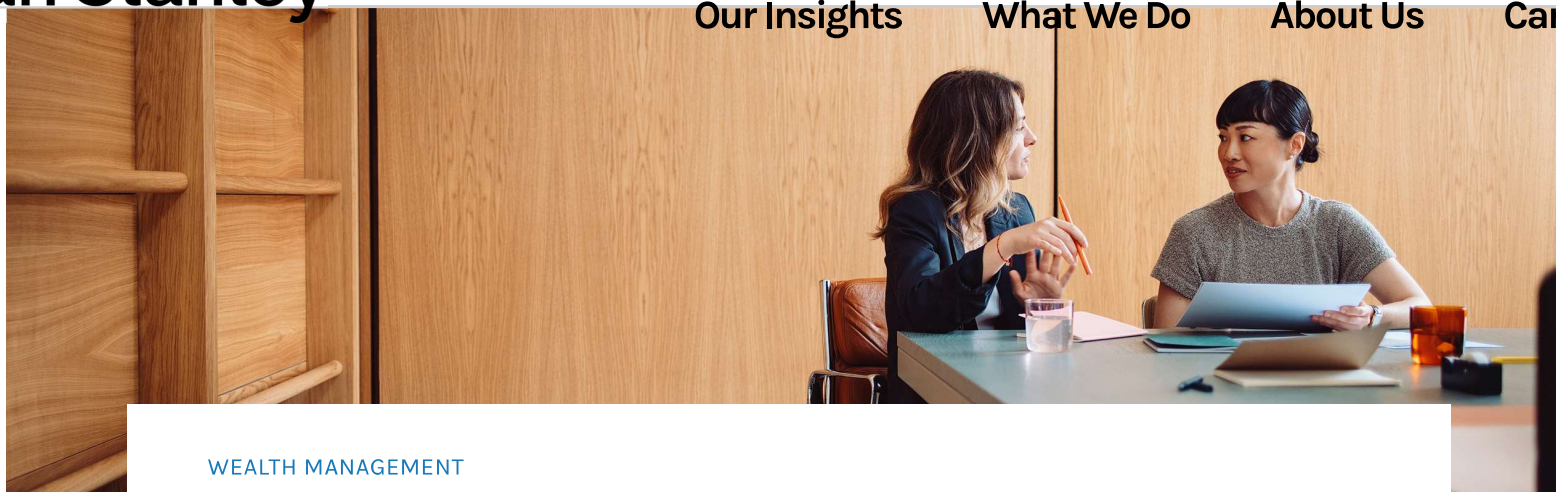




WEALTH MANAGEMENT

How to Manage Taxes on Equity Compensation

Explore how company founders should consider the potential tax benefits and risks of an 83(b) election for certain equity awards.

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Key Takeaways

- Company founders who receive equity compensation may want to consider an 83(b) election, which allows them to pay federal taxes on certain equity awards when they are granted, rather than after vesting.

- The election must be made within 30 days of the grant (or exercise, in the case of early-exercised options), and it applies to both private and public company stock.
- However, there are risks to this approach if the stock's value declines or if you forfeit the award.

Navigating the complexities of equity compensation can be challenging – especially for company **founders** who may receive significant amounts of stock. One critical decision you may face is whether to file an 83(b) election for certain equity grants. Taking advantage of this important Internal Revenue Code provision can yield significant federal tax savings by allowing you to pay federal taxes on the value of your equity awards when they're granted, which may be significantly lower than what it will be later. However, the election also comes with risks you'll want to consider.

Here are simple answers to questions you may have about 83(b) elections.

What is an 83(b) election?

An 83(b) election is a provision under the Internal Revenue Code that allows you to choose to be taxed on the value of certain equity awards, such as restricted stock, at the time of grant (i.e., when the company officially awards you the equity compensation), rather than at the time of vesting (when you gain full ownership rights to the shares). You may also file an 83(b) election if you early-exercise stock options and receive restricted stock that remains subject to vesting; in this scenario, you choose to be taxed on the value of the shares as of the date of exercise.

Why consider an 83(b) election?

The main advantage of an 83(b) election is to potentially lower your overall federal tax liability by locking in the current value of the equity award at grant (or exercise, in the case of early-exercised options). If you believe your company's stock will appreciate significantly in the future, paying federal taxes on the current value, which can be nominal, can potentially result in substantial tax savings.

Additionally, once the stock has potentially increased in value after vesting, any gain on the sale of the stock is taxed at the more favorable federal long-term capital gains rate (if held for more than a year), rather than as ordinary income.

How can an 83(b) election affect my tax bill?

The potential tax impact of an 83(b) election can vary in different circumstances, but consider one hypothetical example: A founder, Sarah, is granted 10,000 non-qualified stock options (NQSOs) with an exercise price of \$1.00 each.

- **Scenario A:** Sarah does *not* file an 83(b) election. Four years later, her business has grown substantially. She exercises the vested options, paying \$10,000, and sells all of her shares at a fair market value of \$11.00 each, resulting in a gain of \$100,000 (i.e., \$110,000 in sale proceeds, minus her \$10,000 exercise price), which is treated as ordinary income. Assuming Sarah's

- **Scenario B:** Alternatively, Sarah early-exercises all of her options at grant and receives restricted stock, paying \$10,000 for the shares,³ and files an 83(b) election within 30 days of exercising. In this example, the shares' fair market value at early exercise is \$1.00, which is the same as the exercise price; thus, the taxable "spread" is zero, so Sarah initially pays no upfront federal taxes. After four years, she sells the shares at the higher fair market value of \$11.00 each, resulting in a gain of \$100,000, which is treated as a capital gain. In this case, assuming a 23.8% federal tax rate on the capital gains, the sale results in a potential \$23,800 tax liability.^{2,3}

In this example, making the 83(b) election leads to a potential \$15,550 in tax savings.

What are the risks of an 83(b) election?

While the potential tax benefits are appealing, there are risks associated with an 83(b) election:

Cash Flow Impact

You'll want to consider whether you have the cash on hand to cover the exercise cost and potential federal taxes versus how those dollars might otherwise be used.

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Forfeiture Risk

If you leave the company before the award fully vests, you generally lose the right to receive the unvested shares and cannot recover the exercise cost and federal taxes paid. This is a critical consideration if there is uncertainty about your future with the company or the company's prospects.

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Stock Devaluation

Maximizing the Potential Benefits

An 83(b) election can allow company founders and executives to lock in a potentially lower tax basis on equity awards. This can lead to significant tax savings, particularly in combination with other strategies, such as using [Qualified Small Business Stock exemptions](#). However, navigating the complexities of this election, including understanding the risks, timing and potential financial implications, requires careful attention and expertise.

Connect with your Morgan Stanley Financial Advisor to explore the considerations and strategies appropriate for your specific needs to maximize the potential benefits of an 83(b) election.

You should also work closely with your attorneys and tax advisors to help ensure that your plans for your equity compensation are structured appropriately and aligned with your long-term financial goals.

To learn more, ask your Morgan Stanley Financial Advisor or Morgan Stanley representative for a copy of the Morgan Stanley Private Wealth Management report, “IRC Section 83(b) and 83(i) Elections.”

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Footnotes

¹This calculation assumes Sarah has reached the Social Security wage base limit through her other income

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