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IRC Section 83(b) and 83(i) Elections

Equity Awards/Executive Compensation

A significant issue facing many executives is whether the executive should change the timing of income recognition with respect to certain equity compensation awards by making an election under section 83(b) of the Internal Revenue Code (IRC). For instance, executives typically must wait until stock options become vested to exercise, and they are subject to U.S. federal ordinary income tax upon exercise on the spread value (that is, the difference between the strike price and the fair market value on the date of exercise). Some stock plans permit options to be exercised *before* vesting, with the option settled in restricted stock. An executive can then make an election under IRC section 83(b) and recognize income on the value of the restricted stock less the amount paid to exercise the option (i.e., typically the spread value of the option). Similarly, when the initial grant is in the form of restricted stock, the value of restricted stock is not taxable as U.S federal ordinary income until the restrictions lapse and the restricted stock vests; however, the executive may elect to recognize U.S. federal ordinary income on the date of grant (rather than the vesting date) under the same section. A so-called “83(b) election” has significant U.S. federal tax ramifications that executives with certain equity compensation awards, such as options or restricted stock, should carefully consider.

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The 83(b) Election

Subject to the terms of the documents governing the applicable equity award, an employee may be able to exercise an unvested option early and make an 83(b) election with respect to the resulting shares of restricted stock. An election under IRC section 83(b) will typically result in the recognition of ordinary income equal to the spread value (that is, the difference between the option's strike price and the fair market value on the date of exercise) in the year of exercise. The amount recognized as ordinary income will be subject to U.S. federal ordinary and payroll taxes and applicable tax withholding. Likewise, an employee holding unvested restricted stock may elect to recognize the excess of the fair market value ("FMV") of the restricted stock in the year of grant over the amount paid (if any) rather than waiting for the restricted stock to vest. However, in both cases, the election must be made fairly quickly: within 30 days of exercise (stock options settled in restricted stock) or grant (for restricted stock).

Section 83 generally provides for the U.S. federal tax treatment of property transferred in connection with the performance of services. Section 83(i) allows certain employees to elect to defer the recognition of income on certain illiquid company stock that would otherwise be included under IRC section 83(a) upon, for example, the exercise of a stock option or settlement of a stock-settled restricted stock unit. Income subject to such an election generally may be deferred for up to 5 years from exercise/vest (as applicable), subject to certain limitations and restrictions

Benefits

An 83(b) election can have several advantages to an employee. First, presuming that the stock of their employer is increasing in value and will continue to do so, an 83(b) election may reduce the amount of taxable ordinary income the employee would otherwise recognize. In addition, the employee will generally begin the holding period for determining whether the capital gain or loss is long-term at the time of grant or exercise, as applicable, rather than at a later date. Consequently, if the stock is held for the required holding period, all future appreciation will be subject to U.S. federal long term capital gains rates rather than U.S. federal ordinary income tax rates.

The effect of the election, as illustrated by the examples below, is different depending on the type of compensation the employee holds: non-qualified stock options ("NQSOs"), Incentive Stock Options ("ISOs") or restricted stock. It should be noted that for NQSOs and ISOs, a transfer of property under IRC section 83 does not occur until the option is exercised. The grant of Restricted Stock Units ("RSUs") is not subject to section 83 and the 83(b) election is, therefore, not applicable to RSUs.

Drawbacks

There are several limitations and risks associated with an 83(b) election:

1. It may be possible for an employer to prohibit a section 83(b) election as a condition of an equity award. In addition, the early exercise of an ISO followed by an 83(b) election poses an increased risk of a "disqualifying disposition", such that the ISO will lose preferential tax treatment.
2. The employee must have sufficient liquidity to pay the strike price and applicable taxes, as illustrated in the examples below.
3. Despite the payment of applicable taxes, if the employee is terminated or leaves the company before the award vests, the employee may forfeit the unvested restricted stock. Moreover, the applicable taxes paid at exercise or grant (if any) are not refunded to the employee if they forfeit the unvested restricted stock. The exercise price for an option may also not be refunded.
4. Likewise, if the stock is sold at a loss, the applicable taxes paid at exercise or grant (if

any) with respect to the 83(b) election are not refunded. The exercise price for an option may also not be refunded.

5. If a public market never becomes available for the stock, or a liquidity event for the company never occurs, then the employee may receive nothing for his or her investment unless the shares can be sold privately.

Mechanics of the Election

For the purposes of comparing the effect of an 83(b) election, we provide an overly-simplified example of a hypothetical executive with the following equity participation in their company:

NON-QUALIFIED STOCK OPTIONS:

- 15,000 shares @ $.50 strike price ("SP")/10,000 vested
- 2,500 shares @ $1.00 SP/ none vested

INCENTIVE STOCK OPTIONS:

- 15,000 shares @ $.50 SP/ 10,000 vested
- 2,500 shares @ $1.00 SP/ none vested

RESTRICTED STOCK:

- First tranche: 15,000 shares granted when stock was $.50/per share/ 10,000 vested
- Second tranche: 2,500 shares granted when stock was $1.00/per share/ none vested

The FMV of the stock at the time of option exercise is $1.00/share, and the FMV of the first tranche of restricted stock at the time of vesting is $.50/per share. The executive is in the 37% U.S. federal ordinary income tax bracket. Compare the effect on each item of equity participation of (1) a standard exercise or grant (as applicable) and no 83(b) election with (2) an early exercise or grant (as applicable) and 83(b) election. **Note that the following only considers U.S. Federal Income Tax and not state or local taxes, if any.**

NON-QUALIFIED STOCK OPTIONS: If the executive exercises all of his or her vested NQSOs, s/he would pay $5,000 for the strike price (10,000 shares x $.50/share). The executive would also pay ordinary income tax on the “spread” of this tranche. The “spread” is the difference between the strike price and the FMV on the date of exercise. Thus, the employee must pay an additional $1,850 in ordinary income tax upon exercise ($5,000 x 37%), in addition to payroll taxes.

Note: As non-qualified stock options are compensation, the company must withhold applicable taxes on the spread. The employee will have to pay both the strike price and the applicable withholding tax at the time of exercise.

The executive also early exercises the 2,500 NQSOs with a strike price equal to $1.00 which are not yet vested, making an 83(b) election at the time of exercise with respect to the restricted stock paid in settlement of the NQSOs. The executive pays the strike price of $2,500. As the spread value equals $0 (i.e., the strike price and the FMV are the same), the executive owes no income tax on the exercise or 83(b) election. Any future appreciation would be capital gain (long term if the stock is held more than one year from exercise).

INCENTIVE STOCK OPTIONS: If the executive exercises all of his or her vested ISOs, the executive would pay $5,000 to exercise his or her vested tranche. There is no ordinary income subject to tax, but the employee may owe Alternative Minimum Tax (“AMT”) on the spread (generally equal to 26% or 28% of $5,000); basis is $1.00/share for AMT purposes and $0.50/share for regular tax purposes.

If the employee early exercised the unvested ISO’s granted at $1.00/share, the executive would pay $2,500 to exercise that tranche, but no ordinary income tax or AMT tax because the spread value equals $0; basis is $1.00/share. See the special note regarding ISO’s and early exercise, below.

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RESTRICTED STOCK: The employee recognized $5,000 worth of stock as ordinary income on the first tranche (10,000 shares) at the time it vested and paid applicable taxes. The employee would recognize $2,500 of ordinary income at the time of grant on the second tranche (2,500 shares) as well if s/he made an 83(b) election within 30 days of the restricted stock award grant date: the 83(b) election is an election to pay applicable taxes on the value on the grant date ($1.00/share) rather than when the restricted stock vests. Notice the value at time of grant of the first tranche of restricted stock is irrelevant here. The employee pays applicable taxes on the value of the first tranche upon vesting. In contrast, in the case of the second tranche with the 83(b) election, the employee pays applicable taxes on the value upon the grant date. Total income taxes: $1,850 on the first tranche and $925 on the second tranche, or $2,775 in total. Again, any future appreciation would be capital gain (long term if the stock is held more than one year from grant in the case of an 83(b) election, or from the vesting date if no 83(b) election is made).

The following items should be noted:

1. No tax was due on the options with a spread value equal to $0, but the employee had to pay more in exercise costs for the stock. One could conclude that if s/he has the available liquidity and is bullish, it may be more compelling to "early exercise" the options the moment they are granted. However, keep in mind that there is inherent value in the optionality.
2. After more than one year, the client is holding stock long term for capital gains purposes, but ISO shares **cannot be sold for more than two years from grant and one year from exercise** to maximize long term capital gains (or loss) tax treatment. A sale of stock prior to this required holding period would result in a disqualifying disposition and the difference between the lesser of the strike price and (1) FMV at exercise or (2) the sale price would be taxable as ordinary income, with the remainder of the increase in value, if any, taxed as capital gains.
3. In the example, the employee paid $15,000 to exercise the NQSOs and ISOs plus $1,850 in ordinary income taxes (assuming the AMT does not apply to the ISOs). If the company goes under, the employee may lose part of this investment. If the employee is terminated for cause, he or she may forfeit all unvested equity awards even though he or she paid applicable exercise costs and taxes, depending on what the governing documents, such as the plan, provide. If he or she voluntarily leaves the company, the employee might forfeit the unvested equity awards, but this depends on the terms of the governing documents.

Special Issues Involving ISOs

The tax consequences of a disqualifying disposition of shares acquired by early exercise (i.e., shares that were disposed of in (i) 2 years or less following the option grant or (ii) 1 year or less after exercise) were somewhat unclear until the issuance of Final Regulations in late 2004. While some commentators believed the exercise of the unvested options controlled the AMT consequences and started the holding period of the shares for capital gains (or loss) purposes, the Final Regulations make clear that:

1. The section 83(b) election will trigger the application of the AMT. The amount subject to AMT will generally be equal to the spread, if any, at the time of exercise.
2. In general, an employee who makes a disqualifying disposition of shares acquired via early exercise of an ISO must report compensation equal to the fair market value of the stock on the vesting date (not the date of exercise) less the exercise price. It would also be reported on a Form W-2.

3. Pursuant to corrective amendments to the regulations released by the IRS on October 14, 2004, the holding period for determining capital gains (or loss) treatment with respect to the disqualified shares begins on the date of vesting and not the date of exercise (this was unclear under earlier issuance of final regulations).

83(i) Elections: New Deferral Provision

In addition to the existing tax rules described above for the 83(b) election, the Tax Cuts and Jobs Act of 2017 adds a new section 83(i) to the IRC that allows certain employees of private corporations that broadly grant stock options or RSUs to elect to defer the recognition of income on illiquid stock for up to five years. This is referred to as an “83(i) election”.

Subject to certain restrictions and eligibility requirements, the 83(i) election generally offers employees the opportunity to delay the recognition of income on illiquid company stock resulting from the exercise of stock options, settlement of RSUs, or purchase of shares under an employee stock purchase plan (“ESPP”). The 83(i) election must be made within 30 days of the exercise of the option, settlement of the RSU or purchase of shares under an ESPP. This defers the tax impact to a later tax year. Making the 83(i) election:

- Defers U.S. federal ordinary income (but not employment taxes) equal to the fair market value on date of settlement for RSUs and equal to the spread between the exercise price and fair market value on the date of exercise for options.
- Treats this deferred income as compensation subject to U.S. federal ordinary income tax at the U.S. federal ordinary tax rates at the end of the deferral period. A decrease in the stock’s value after the date of exercise/vesting, as applicable, does not decrease the amount included as compensation income at the end of the deferral period. Any increase in the stock’s value after the date of exercise/vesting, as applicable, is generally treated as capital gain upon sale.
- After the election, any preferential ISO or ESPP federal tax treatment is lost.

In addition, Notice 2018-97 provides guidance to taxpayers regarding (1) application of the requirement in IRC section 83(i)(2)(C)(i)(II) that grants be made to 80% of the employer’s employees, (2) application of income tax withholding to the deferred income related to qualified stock, and (3) the manner in which an employer may opt out of permitting employees to elect the deferred tax treatment even if the requirements under IRC section 83(i) are otherwise met.

There are complex rules as to excluded employees, events that trigger the end of the deferral period and the time frame for making the elections. As with IRC section 83(b), there are potential downsides to making the election. Clients should consult with their financial advisor and tax advisor to ensure they fully understand the implications and have that documented before making the election.

Conclusion

When does the 83(b) election make sense? Generally, there are 2 scenarios when the 83(b) election makes sense: First, when the amount of income reported is small and the potential growth of the stock is great, and secondly, when one expects reasonable growth in the value of the stock and the likelihood of forfeiture is very small. While an 83(b) election can be a valuable strategy, it’s important to remember that the employee must have the liquidity, be willing to accept some risk, pay the exercise price and applicable taxes, not leave the company and the company must create a market for the stock either by going public or being sold.

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