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The differential between the ordinary income and capital gain rates, along with other complications of the Code, increases the potential benefits of immediate recognition compared with waiting for restrictions to lapse. If the employee pays current FMV in anticipation of substantial appreciation, there will be no current income and later capital gain. Even if a small current tax is incurred by the employee, it may be worthwhile for the employer to pay a cash bonus to cover the taxes as an incentive for the employee to make the election, which in turn will entitle the employer to a current deduction.

Whether to make a Section 83(b) election has been the subject of substantial controversy and disagreement among tax advisers.¹ Because RRA '93 restored a substantial differential between ordinary tax rates and long-term capital gain tax rates (of up to 11.6%, or up to 25.6% for small business stock that qualifies under Section 1202), and because there have been many proposals to increase this differential, substantial tax savings may be achieved through the use of the Section 83(b) election. Recently, it was reported that the vast majority of taxpayers elect immediate recognition of income on stock transfers.² Nevertheless, while the Section 83(b) election is often useful, it is not always appropriate.

Framework of the 83(b) Election

Under Section 83(a), when restricted stock (or other property) is received in connection with the performance of services, the excess of the FMV of the property over what was paid for the property is taxed to the person providing the services as ordinary income in the first year that the property is not subject to a substantial risk of forfeiture (that is, when the stock becomes "vested") or when the property is sold in an arm's-length transaction, whichever is earlier.³ The spread is taxed as ordinary income and constitutes wages if the recipient is an employee. Thus, in the absence of a Section 83(b) election, the employee pays no tax on the receipt of restricted stock.⁴ Instead, tax is paid on the difference between the FMV when the re-

striction lapses and the cost to the employee (usually referred to as the spread or bargain element).

If a proper and timely Section 83(b) election is made, however, the timing of taxation is reversed. Pursuant to a Section 83(b) election, the employee is taxed on the spread⁵ as ordinary income when the restricted stock is received; there is no tax when the restriction lapses.⁶ When the employee thereafter sells the stock, or otherwise disposes of it in a taxable transaction, the gain is generally long-term capital gain (assuming the stock has been held for more than one year after the transfer to the employee).

To be effective, the Section 83(b) election must be made by the employee no later than 30 days after the stock is received.⁷ This is a short and *not* extendable deadline that, together with other formalities provided in the Regulations, should be strictly complied with.⁸ Although a Section 83(b) election may in rare circumstances be revoked, rescinded, or corrected,⁹ a practitioner should not rely on this possibility as a planning tool.

If the election is made, the excess (if any) of the value of the restricted stock received (determined without regard to a restriction that will lapse) over the price paid for the stock will be additional compensation to the employee in the year of receipt. The employee's basis in the property for determining gain or loss is equal to the employee's cost (if any) plus the amount taxable as compensation under Section 83(b) (that is, the employee's basis

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is the FMV of the stock on the date of the transfer).

The key benefits of the Section 83(b) election (discussed in more detail below) are that any appreciation in value after the stock is received (1) is not taxed until the employee sells or disposes of the stock, and (2) is taxed at that time as capital gain. If, after a Section 83(b) election has been made, the stock is forfeited because of the failure to satisfy the restriction (for example, employment terminates before the stock vests), the employee cannot obtain any deduction for the amount included in income as the result of a Section 83(b) election. The amount paid for the forfeited property less the amount realized on such forfeiture, however, generally would be a capital loss (subject to the limitations on such deductions).¹⁰

Employer's deduction. The employer generally receives a deduction under Section 83(h) for the ordinary income

included by the employee, in the same year the employee is taxed thereon.¹¹ In 1995, the IRS repealed the controversial (and some would say incorrect) Regulation that required an employer to withhold in order to be entitled to a deduction under Section 83 for property transferred to an employee for services rendered. The revised Regulation allows the employer to deduct the amount taxable to the employee whether or not the employer withholds taxes on such compensation (but withholding is still generally required for other reasons).¹² Where the employee has made a Section 83(b) election, that deduction will be allowed to the employer in the year the employee receives the stock, in an amount equal to the spread at the time of receipt.¹³ Where the employee does not make the Section 83(b) election, the employer's deduction will generally be in the year or years that the restriction lapses, in an amount equal to the spread at the time of the lapse.¹⁴

Potential Benefits

If it is assumed that the restricted stock (or other property received) will appreciate in value over time, there are three primary potential benefits to an employee from a Section 83(b) election.

LTCG on appreciation. One potential benefit is that the appreciation will be taxed as capital gain (generally long-term capital gain) instead of ordinary income. Currently, the top individual tax rate is 39.6% and the long-term capital gains rate is 28%—a fairly significant differential, although not as significant as before TRA '86. This differential may be increased in the near future under proposals to lower the capital gains tax rate and to index basis.¹⁵

Tax deferral. Another potential benefit of the Section 83(b) election is the deferral of the payment of tax on the appreciation until the property is sold rather than when the restriction lapses.

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¹ See, e.g., Lassila and Wiggins, "The Demise of the Section 83(b) Election," 66 Taxes 512 (1988); Cohen and Bortnick, "The Section 83(b) Election is Alive and Well and Sometimes Indispensable," 66 Taxes 684 (1988); Jones, "If It Ain't Broke ... Another Viewpoint on Section 83(b)," 66 Taxes 791 (1988); and Lassila and Wiggins, "The Section 83(b) Election Decision: A Reply," 66 Taxes 798 (1988).

² Treasury Tax Legislative Counsel Glen A. Kohl observed that "the vast majority of taxpayers elect for section 83(b) treatment on stock transfers rather than section 83(a)," in commenting that IRS and Treasury officials were studying ways to reduce paperwork by allowing companies to designate transactions as Section 83(b) transfers, unless the other party to the transaction chooses Section 83(a) treatment within 30 days. See 95 TNT 222-6.

³ See Section 83 and the Regulations for definitions of "substantial risk of forfeiture" and other terms of art set forth therein. In general, Section 83 does not apply to stock options.

⁴ Section 83 also may apply to recipients who are not employees (i.e., independent contractors) and to property that is not stock. Also, Section 83 is not limited to individuals and therefore a corporation that renders services to another entity and receives restricted stock therefor may make a Section 83(b) election. Further, the restricted stock does not have to be that of the employer but rather could be stock in a related (or unrelated) corporation. Transfers of such stock may raise other tax issues and are beyond the scope of this article. For convenience, all the examples in this article assume that the

recipient is an employee and that the property is restricted stock of the employer.

⁵ If a Section 83(b) election is made, the value of the stock has to be determined as of the date of transfer to the employee. This may raise valuation issues if the stock is not publicly traded.

⁶ In general, Social Security taxes (FICA and Medicare) also would be imposed on the spread. Under Proposed Regulations issued in January 1996, nonqualified deferred compensation that is subject to a substantial risk of forfeiture is not taken into account for Social Security tax purposes until the restriction lapses. Prop. Regs. 31.3121(v)(2)-1(a)(2)(iii), -1(b)(4)(iii). If a Section 83(b) election is made, the transfer of restricted property should be taken into account for Social Security tax purposes at the time of the transfer (i.e., a Section 83(b) election should cause the same timing for both income and Social Security taxes). See Goodman and Edmond, "Proposed Regs on Application of FICA Taxes to Nonqualified Deferred Compensation," 96 TNT 104-86.

⁷ The Treasury is apparently considering a reversal of the default rule, i.e., allowing an employer to designate Section 83(b) treatment, subject to a deferral election made by the employee within 30 days. See note 2, *supra*.

⁸ See Reg. 1.83-2. A Section 83(b) election is filed with the IRS service center where the employee's income tax returns are filed, and a copy of the election must be attached to the employee's return. See also IRS Publication 525.

⁹ See, e.g., Reg. 1.83-2(f) (revocable with consent of IRS); Ltr. Rul. 9104039 (rescission of Section 83(b) election in same year in which made voided the election); and Ltr. Rul.

9240018 (correction of number of shares to which election applied was not a revocation).

¹⁰ See Reg. 1.83-2(a).

¹¹ The deduction from the corporate side is complicated by several potential limitations—the Section 461 economic performance requirements, the Section 162(m) \$1 million limitation for publicly traded corporations), and the Section 280G golden parachute limitation.

In general, under Reg. 1.461-4(d)(2), a taxpayer is not allowed to deduct payments for services to be rendered until the services are performed. That is, economic performance occurs as the services are performed and an up-front payment for the services is not deductible when paid but rather as the services are performed.

The interplay between Section 461 and a Section 83(b) election is not clear. In its economic performance guidance, the IRS specifically reserved Reg. 1.461-4(d)(2)(iii)(B) for the interplay of the economic performance requirement and the transfer of property to an employee for services rendered. It appears, based on the Preamble to the Section 461 Regulations, that the IRS will allow a deduction to an employer under the general Section 83 rules but has some concerns about having the Section 83 deduction timing rules trump the Section 461 economic performance rules where the service provider is an independent contractor rather than an employee.

If the IRS takes the position that the Section 461 rules trump the Section 83 rules (which is probably unlikely), the effect of a Section 83(b) election would need to be re-evaluated.

A Section 83(b) election is not taken into account under the golden parachute rules. Prop. Reg. 1.280G-1, Q&A-12.

es. This benefit may be very significant. If there is substantial appreciation in the value of the stock, so that a substantial tax on capital gains would be incurred on sale of the stock, the employee should—purely from a tax point of view—defer sale of the stock as long as possible. Indeed, if tax planning were the only issue, the best tax strategy for the employee would be to keep the stock until death and never pay the income tax on the appreciation. If the stock is not sold until after the death of the employee and a Section 83(b) election had been made, the income tax on the appreciation may be avoided forever because of the stepped-up basis at death.¹⁶

Impact of dividends. Another potential benefit is the treatment of any dividend income received on the stock prior to when the restriction lapses as investment income instead of wage income. This may, among other things, decrease Social Security taxes, eliminate taxation of the dividend income in the state or locality where the services are performed, and increase the deduction for investment interest expense.

Practical Limitations on Sale

An employee may not be able to sell

the stock even though the restriction has lapsed. If the stock is not publicly traded, it may not be salable at all or it may be salable only at a very reduced price. Even if the stock can be sold, an employee may hesitate to do so for business reasons. Restricted stock is often issued to key employees because both the employer and employee want the employee to have an equity interest in the company. Thus, if the employee is still working for the employer when the restriction lapses, it is possible that neither the employee nor the employer will want the employee to sell the stock as soon as it becomes feasible to do so.

If a proper and timely Section 83(b) election is made, the timing of taxation is reversed.

An obvious reason to sell the stock as soon as the restriction lapses is the need or desire for the cash proceeds. If a Section 83(b) election is not made, the employee may need cash to pay the ordinary income tax at the time of vesting or the employer would be required to withhold income tax and So-

cial Security taxes.¹⁷ If the Section 83(b) election is made, there may be no need for cash when the restriction lapses because the spread would not be required to be included in income merely because of the lapse.

Even the need or desire for cash, however, does not necessarily justify selling the stock and paying the tax on the gain. It may be possible to borrow the needed or desired funds, pledging the unrestricted stock as security. Whether such a loan is desirable is a function of the anticipated interest costs as compared with the anticipated dividends on and appreciation of the now-vested shares. If the employee does not need the sale proceeds and believes that the return on the investment in the now-vested employer shares is as good as or better than the return on investments that could be made with the net proceeds (after the tax on capital gains, assuming the employee made a Section 83(b) election) from the sale of the stock, the employee is likely to keep the shares, deferring the tax and maintaining an equity interest in the employer. Even if it is anticipated that the value of the stock will decline, it may be possible for the employee to sell short shares of the same stock, while retaining the shares

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¹² Final Reg. 1.83-6 (TD 8599, 7/18/95). Under these Regulations, the employer will be able to claim a deduction if it provides a timely W-2 (or 1099 in the case of independent contractors). The Preamble to TD 8599 cautions, however, that although withholding is no longer required to obtain a deduction under Section 83, withholding still would be required under the general income tax withholding rules. "Therefore, although the withholding requirement is eliminated as a prerequisite for claiming a deduction, these regulations do not relieve the service recipient from any applicable withholding requirements of subtitle C or from the statutorily prescribed penalties or additions to tax for noncompliance with those requirements. Thus, for example, if an employer transferred to an employee property to which section 83 applies and failed to withhold income tax on the payment, the employer would be liable for the tax under section 3403. However, under section 3402(d), any tax liability assessed against the employer would be offset by any tax paid by the employee. In addition, nothing in these regulations relieves the service recipient from penalties or additions to tax for noncompliance with the requirements of section 6041 or 6041A (relating to information reporting) to the extent they otherwise apply."

Therefore, it would still behoove most employers to incorporate some type of withholding mechanism in order to satisfy withholding and information reporting requirements (e.g., grant restricted stock for a price equal to the anticipated withholding requirement) or gross-up the grant of property for the anticipated withholding tax (which would in turn require grossing up for the additional amount paid).

¹³ Where the employer's and the employee's tax years are different, the employee's tax year controls. For example, if the restricted stock is issued on 9/15/96 to a calendar-year employee who makes a Section 83(b) election, and the employer's fiscal year ends September 30, the employer would receive the deduction for its year ending 9/30/97, not its year ending 9/30/96. See Reg. 1.83-6(a)(1).

¹⁴ The impact, if any, on financial statements of Section 83 or a Section 83(b) election is beyond the scope of this article.

¹⁵ Although planning based on any proposed changes to tax law is highly speculative, most practitioners expect an increase in the differential between ordinary and capital gains rates to be more likely than any decrease in such differential. The possibility of a future increase in the differential should be taken into account when determining whether a Section 83(b) election should be

made. Since any tax law change is speculative, all examples and calculations in this article are performed based on current (not proposed) law.

Some taxpayers may prefer capital gain income for reasons other than preferential tax rates. A discussion of such reasons is beyond the scope of this article, but the following possible advantages should be considered: (1) since capital losses for taxpayers other than corporations are generally limited under Section 1211(b) to capital gains plus \$3,000, capital gains may be desirable in order to use up capital losses, and (2) if a taxpayer is subject to the investment interest expense limitations of Section 163(d), a Section 83(b) election may produce capital gains on the sale of stock that may be investment income, while the ordinary income recognized under Section 83(a) would not be.

¹⁶ Section 1014. If the stock is not sold until after the death of the employee and a Section 83(b) election was not made, the estate (or beneficiary) would not receive a stepped-up basis and would have income in respect of a decedent under Section 691, taxed at ordinary income tax rates (but would be entitled to a deduction for estate tax paid on the restricted stock).

¹⁷ See note 12, *supra*.

received from the employer, in order to defer the income tax on the gain.¹⁸

The ability of the employee to choose when to be taxed on the stock appreciation (by choosing when the stock is sold) is valuable. Quantifying the value of the potential deferral of tax can be done with a present-value analysis if a year of sale is assumed (and other assumptions, including the expected dividend rate and the anticipated appreciation in the stock, are made). As noted above, if the employee makes a Section 83(b) election and holds the stock until death, the tax on the appreciation is eliminated completely. If the stock is sold prior to death, the tax on the appreciation is deferred until the sale (and is capital gain instead of ordinary income). As indicated in the example¹⁹ below, a Section 83(b) election can sometimes be made at no cost to the employee and result in enormous tax benefits.

EXAMPLE 1: In year 1, a closely held corporation sells stock to a key employee, Allison, at its FMV of \$10 per share, subject to a substantial risk of forfeiture that will lapse in five years. Both the employer and Allison expect the stock's value to skyrocket if Allison continues working for the employer for the five-year period. If Allison quits before the five years are up, she must sell the stock back to the corporation at her \$10-per-share cost. In year 5, when the restriction lapses, the FMV of the stock is \$110 per share.

Under Section 83(a), Allison's addi-

tional taxable compensation in year 5 would be \$100 per share (the \$110 FMV less the \$10 cost). At a 39.6% tax rate, the tax would be \$39.60 per share (more if state and local taxes are included). In order to pay the tax, Allison may be forced to sell some of her shares (even though both the employer and Allison would prefer that she keep her shares).

If Allison made a Section 83(b) election, however, there would be no tax in year 1 due to the election since she paid FMV for the stock—\$10 per share. In year 5, when the restriction lapses, there is no tax due. The tax is deferred until the stock is sold (when cash should be available to pay the tax). If the stock were sold on the date it vests, the gain would be long-term capital gain. At a long-term capital gains tax rate of 28%, the tax would be \$28 per share instead of \$39.60 per share, a savings of \$11.60 per share. If the stock were sold after year 5, the employee would have received the benefit of the additional deferral of the tax until the stock is sold, as well as the benefit of the then long-term capital rate differential. If the stock were not sold prior to Allison's death, the gain would never be taxed.

Clearly, in Example 1 a Section 83(b) election should be made. Understandably, Allison would be upset if she had to pay a tax on the appreciation in the stock in year 5 at ordinary rates and prior to her sale of the stock, when a Section 83(b) election would

have allowed her to defer the tax until the stock were sold and converted into capital gain from ordinary income to capital gain income, at no tax cost to her.

When to Make the Election

As indicated in Example 1, a Section 83(b) election almost always should be made when restricted property is purchased at FMV in connection with the performance of services. The purchase of restricted stock at FMV sometimes occurs at the start-up of a corporation (where all stockholders agree to perform services for a period of time) or in certain closely held corporations (not publicly held and rarely traded) that offer shares only to key employees (and such shares are restricted). It is unlikely that the situation will occur with respect to publicly held and freely traded stock, since the employee could obtain such stock at FMV without restrictions by purchasing it in the open market.

An 83(b) election may in rare circumstances be revoked, rescinded, or corrected, but this possibility should not be relied on as a planning tool.

In any event, in just about any situation in which an employee may buy stock at FMV, it seems advisable to make the Section 83(b) election.²⁰ As stated in Reg. 1.83-2(a), "[t]he fact that the transferee has paid full value for the property transferred, realizing no bargain element in the transaction, does not preclude the use of the election...."

This Regulation has been upheld by the Ninth Circuit in *Alves*, 734 F.2d 478 (CA-9, 1984), *aff'g* 79 TC 864 (1982). There, the taxpayer argued that the Section 83(b) election was unnecessary where the stock was purchased at FMV. Although making the election had no tax cost to the employee, the Tax Court and the Ninth Circuit both determined that the election was necessary in order to avoid taxation when the restrictions thereafter lapsed. The Ninth Circuit suggested that the failure

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¹⁸ This is known as a "short sale against the box." See Kleinbard and Nijenhuis, "Short Sales and Short Sale Principles in Contemporary Applications," 53 *NYU Inst. on Fed. Tax'n*, ch. 17 (1995). Recent proposals would eliminate this technique; see, e.g., section 9512 of the proposed Revenue Reconciliation Bill of 1996, which would have added Section 1259 to the Code (see also the Treasury's *General Explanation of the Administration's Revenue Proposals*, 3/19/96, page 72).

¹⁹ The examples in this article assume that the employee making the Section 83(b) election has a marginal tax rate of 39.6% and that the employer is a corporation with a 35% marginal tax rate. Calculations in the examples consider federal income tax only, ignoring state or local income taxes, payroll taxes, and the effect of phase-outs or disallowances based on AGI, all of which could increase the effective marginal tax rates of the employee or the employer.

²⁰ The principal situation in which a Section 83(b) election may not be advisable is where the taxpayer believes that the purchase price is FMV but suspects that the valuation may be subject to widely different interpretations. Stock that is publicly traded or has had consistent earnings in a stable market may be valued by experts in a fairly narrow range. Conversely, stock that is closely held and rarely traded and has great fluctuations in earnings or other factors that make valuation difficult may be valued by different experts at highly disparate prices. Making a Section 83(b) election for the latter type of stock may raise an additional audit risk. Even if a Section 83(b) election is not made, valuation may be an issue in the year the restrictions lapse. Furthermore, for the reasons discussed in this article, a Section 83(b) election may be advisable even if there is a risk of some taxation in the year the restricted stock is issued.

to make the Section 83(b) election in that situation may be a potential trap.

Additional Planning Opportunities

Even if an employee pays less than FMV for restricted stock, so that the bargain element will be taxed in the year of purchase if a Section 83(b) election is made, an election should be carefully considered—in many instances, the benefits will outweigh any disadvantages. From an employee's viewpoint, the decision to make the Section 83(b) election is complicated by many variables, some of which are extremely speculative at the time the election must be made.

If the employee has made an 83(b) election, the employer can take a deduction for the spread in the year the employee receives the stock.

The main disadvantages of the election are ordinary income for the bargain element on receipt of the stock and capital loss treatment on its later sale at a loss, or disallowance of some or all of a loss on forfeiture of the stock. Thus, an employee who has to pay a large tax on making the election (without cash to pay it), or who thinks it likely that the stock will be forfeited or decline in value, is unlikely to make the election at least without an incentive from his employer for doing so.

EXAMPLE 2: The facts are the same as in Example 1, except that the FMV of the stock in year 1 is \$12 per share. Since Allison purchases the restricted stock for \$10 per share, there is a \$2-per-share bargain element. On making the Section 83(b) election, Allison will have additional compensation income of \$2 per share, the tax on which (at 39.6%) is \$0.79 per share. The employer will deduct the amount the employee includes in income because of the Section 83(b) election (\$2 per share). If the corporation is in the 35% tax bracket, the tax savings to the corporation is \$0.70 per share (35% of \$2).

If Allison quits her job in year 3 and

is forced to forfeit the stock to the employer for \$10 per share, she would *not* be able to take a \$2 per share ordinary deduction or capital loss even though that amount was included in her income in year 1 because of the Section 83(b) election. If, alternatively, Allison sells the stock (not pursuant to forfeiture) in year 3 or later for \$10 per share, she would have a \$2 per share long-term capital loss. The capital loss may or may not be usable to Allison in year 3, depending on her other capital gains or losses; the value of that loss, if allowable, would depend as well on her tax rate in that year 3. In hindsight, under either of these fact patterns Allison should not have made the Section 83(b) election. If she had not made the election, she would not have had to pay tax on the bargain element in year 1.

A Section 83(b) election is often advisable (even though there is some downside risk) when the restricted stock is expected to appreciate substantially during the period of the restriction or the employee expects to continue to hold the stock after the restriction lapses.

EXAMPLE 3: The facts are the same as in Example 2, except that a different employee, Jenna, purchases the restricted stock for \$10 per share and is confident that she will not forfeit the stock (i.e., she will remain employed for at least five years), the stock's value will skyrocket over time, and she will not sell the stock even after it vests. On making the Section 83(b) election, Jenna will have additional compensation income from the same \$2-per-share bargain element, resulting in tax (at 39.6%) of the same \$0.79 per share. Also, the employer will deduct the same \$2 per share the employee includes in income because of the Section 83(b) election.

As in Example 1, the stock is worth \$110 in year 5 (Jenna's assumption regarding the future value of the stock is correct). If no Section 83(b) election were made, the tax in year 5 (when the restriction lapses) would be \$39.60 per share (39.6% of [\$110 FMV - \$10 cost]) whether or not the stock is sold in year 5. As in Example 1, if a Section 83(b) election were made, there is *no* tax to the employee (other than the

\$0.79 per share in year 1) until the stock is sold. The deferral of payment of the \$39.60 tax for even a relatively short period of time would more than make up for the use of \$0.79 from the date of receipt of the stock until the restriction lapses. If the stock is not sold prior to her death, there is no income tax on the appreciation. If the stock is sold at a gain prior to her death, the sales price less \$12 per share (\$10 cost of stock plus \$2 taxed as compensation in year 1) would be taxed as a long-term capital gain (assuming she holds the stock for more than one year). Even without considering the benefit of the ability to defer the tax, the long-term capital gain differential can result in significant tax savings. If Jenna sold the stock on the date it vests, her tax in year 5 on the gain would be \$27.44 per share (28% of [\$110 - \$12]). Jenna's tax from the shares would total \$28.23 per share (\$27.44 per share in year 5 plus \$0.79 per share in year 1), \$11.37 per share less than the tax without the Section 83(b) election. The tax would be even less (\$14.51 per share) if the stock were shares of a small business under Section 1202 (discussed further, below).²¹

Thus, as indicated in Example 3, if substantial appreciation is expected a Section 83(b) election is often advisable, especially if the stock will be held beyond the lapse of the restriction.

An 'IRS Pays Mostly All' Plan

Because the employer is entitled to a deduction for the amount included in the employee's income and the highest marginal rates for the employer and the employee do not differ that significantly, there is in some circumstances the opportunity to transfer shares of stock to employees at little tax cost.²²

EXAMPLE 4: The employer's shares have an FMV of \$10 per share in year 1. The employer wants to transfer restricted stock to Scott, a key employee, in the

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²¹ The \$14.51-per-share tax is 14% of (\$110 - \$12) per share in year 5, plus \$0.79 per share in year 1. This is \$25.09 per share less than the \$39.60-per-share tax liability that arises if the Section 83(b) election were not made.

most tax-effective way. The employer can give the shares to Scott as a bonus (at no cost to itself) and pay him a bonus sufficient to cover his tax on the stock and cash received. The cash bonus would be \$6.56 per share ($\$10/[1 - 39.6\%] - \10). Scott's income would be \$16.56 per share (stock worth \$10 plus cash of \$6.56). At 39.6%, the federal tax on \$16.56 is \$6.56, leaving Scott with the stock at no tax cost.²³ In order for the employer to be able to take a deduction in year 1, Scott is required to file a Section 83(b) election. The employer gets a deduction of \$16.56 per share (assuming the compensation to Scott is considered reasonable and satisfies the Section 162(m) limitations), which in its 35% bracket saves the employer \$5.80 per share, for a cost to the employer of \$0.76 per share (\$6.56 less \$5.80).

Thus, the employee has no cost and the employer has little cost (other than dilution in ownership of its stock). The IRS pays mostly all.

Unlike cash compensation, the distribution of employer stock as compensation can result in significant benefit to the employee at little cost to the corporation because there is generally no cost to a corporation in issuing its

own stock (other than dilution of the percentage ownership of the other outstanding shares). If the employer does not want to "bonus out" the entire employee tax liability from the Section 83(b) election, the employer might pay the employee a small bonus as an incentive to make the election (so that the employer will be able to get the tax deduction currently).

Variations on the IRS pays mostly all plan could apply to unrestricted stock issued as compensation and to restricted stock for which no Section 83(b) election is made. In each instance, the employer could give the employee a bonus to reimburse the employee for some or all of the tax on the stock received and the tax on the bonus. The employer would not reimburse the employee nor would it obtain the deduction until the year the substantial risk of forfeiture lapses.

Other Contexts

Special planning is necessary where the employer is a qualifying small business under Section 1202, an S corporation, or where cross-border issues are involved. The impact of state and local taxes and the alternative minimum tax also have to be considered.

Small business stock. A Section 83(b) election may be beneficial for restricted stock in a company that qualifies under Section 1202, which was enacted as part of RRA '93 as an incentive for stock ownership in small businesses.²⁴ If the stock qualifies, the shareholder excludes 50% of his gain on the disposition of his stock in the company. This means the qualifying gain would be subject to a maximum federal tax rate (under current law) of 14% instead of the normal long-term capital gain rate of 28%. This is significantly less than the 39.6% maximum ordinary tax rate on the appreciation if a Section 83(b) election were not made, a spread of 25.6% (39.6% - 14%).

One of the requirements to qualify for this 50% exclusion is that the shareholder must hold the stock for at least five years. If the Section 83(b) election were not made, the issuance and the holding period for Section 1202 purposes would not commence until the restriction lapsed.²⁵ By making the Section 83(b) election, however, the employee triggers the beginning of this holding period as of the grant of the restricted stock.²⁶ Thus, another benefit of a Section 83(b) election is the earlier commencement of the holding period for Section 1202 purposes.

S corporations. Making a Section 83(b) election causes the stock with respect to which the election is made to be treated as outstanding stock for S corporation purposes.²⁷ Therefore, practitioners should consider the effect of the election on the one-class-of-stock rule and the 75-shareholder limitation.²⁸ Because the stock would be considered outstanding, the restricted stock for which a holder may make a Section 83(b) election should confer rights to distribution and liquidation proceeds that are identical to such rights for the other outstanding stock and there should be no more than 75 shareholders overall, including those to whom the restricted stock is issued.

Cross-border elections. Section 83(b) election planning is not limited to restricted stock of domestic (U.S.) companies or the performance of services in the U.S. Any cross-border Section 83(b) elections or other compensation

NOTES

²² When the highest corporate tax rate exceeds the highest individual tax rate, as it did briefly after TRA '86, there could be an overall tax savings in some circumstances.

²³ Practitioners are cautioned to use real and not assumed rates. An employee may be in a different marginal bracket. Furthermore, the additional income may reduce the deduction for medical expenses and other miscellaneous itemized deductions and may increase the phase-out of certain itemized deductions under Section 68. The employer may be in the 39.6% bracket (for example, an S corporation or a partnership, through its shareholders or partners) or in a zero bracket (in a loss year or a loss carryover year). State and local taxes also will affect the computations. While the computations must be done, they seem to work out favorably in many instances.

²⁴ See DeLap and Brandt, "RRA '93 Cut in Capital Gains Tax Encourages Investment in Small Businesses," 80 JTAX 266 (May 1994).

²⁵ H. Rep't No. 103-213, 103d Cong., 1st Sess. 12 (Statement of the Managers, 8/4/93).

²⁶ Reg. 1.83-4(a).

²⁷ Regs. 1.1361-1(b)(3) and -1(l)(3).

²⁸ Increased from 35 by the Small Business Job Protection Act of 1996. See generally Cummings and Starr, "The Impact of the

New S Corporation Revisions," 85 JTAX 197 (October 1996).

²⁹ Section 865(a).

³⁰ See, e.g., Ltr. Rul. 9037008.

³¹ In general, if an employee is granted ISOs, the employee does not have income for regular income tax purposes either on the grant of the ISOs or on the exercise of the ISOs. Section 56(b), however, sets forth various items that are adjustments applicable to individuals in determining their AMTI. Section 56(b)(3), which sets forth an adjustment for ISOs, states that Section 421 does not apply to the transfer of stock acquired pursuant to the exercise of an ISO (as defined in Section 422). Because Section 421 does not apply to the exercise of ISOs, Section 83 is not precluded from applying to the exercise of ISOs for AMT purposes (see Section 83(e)(1)). Therefore, conceivably and theoretically, an individual should be able to make a Section 83(b) election for AMT purposes when he exercises the ISOs even though the election would have no regular income tax consequences. See, e.g., Stone and Chaze, "The Alternative Minimum Tax Separate System, How Far Does It Go?," 68 Tax Notes 201 (7/10/95). The IRS has not "blessed" this technique. Computations should be done in order to determine potential tax savings and discussions with the IRS may be advisable.

techniques are fairly complex, however, and need to be planned and structured to take into account any foreign tax consequences in addition to the U.S. tax consequences. Some of the considerations involved are illustrated below.

EXAMPLE 5: Restricted stock with a five-year vesting period is awarded to an employee. In the past, the employee always has worked in the U.S. for the employer, but now will work in the U.S. for 2½ years during the vesting period and abroad for the remaining 2½ years. If the employee makes a Section 83(b) election on receipt of the restricted stock, any future appreciation would be capital gain income and would be U.S.-source or foreign-source income depending on the employee's tax home at the time of sale.²⁹ Whether this is beneficial to the employee depends on factors such as the employee's foreign tax credit position, the U.S. tax status of the employee, and conceivably the employee's Section 911 position. If the employee did not make the Section 83(b) election, the employee would have ordinary income on the lapse of the restriction that would be half U.S.-source and half foreign-source.³⁰

If, conversely, the employee had worked abroad and will work in the U.S. for a portion of the restrictions period, it may be beneficial to make the Section 83(b) election prior to moving to the U.S. so that the compensation portion is limited and any future appreciation may be foreign-source capital gain income (depending on the employee's tax home) and may thereby escape U.S. taxation entirely.

From the employer's perspective, a foreign corporation, as well as a domestic corporation, can award restricted stock, and its employees can also take advantage of the Section 83(b) election technique. (Of course, an employer that does not do business in the U.S. would not receive the benefit of a deduction for U.S. tax purposes.)

State and local tax effects. State and local Section 83(b) election considerations are similar to cross-border Section 83(b) election considerations. That is, in making the election the employee seeks to minimize taxation in one jurisdiction when the employee

(1) may be subject to taxation in two jurisdictions, (2) moves from one jurisdiction to another jurisdiction, or (3) is not a resident in the jurisdiction where he works. The viability of this concept and the potential tax savings depend on the specific jurisdictions involved and their tax rates.

EXAMPLE 6: Lauren works in New York but is a resident of Connecticut. If Lauren receives restricted stock from her employer and does not make a Section 83(b) election, the appreciation in the stock will be subject to tax in New York as compensation when the restriction lapses. A Section 83(b) election not only would defer the tax on the appreciation until sale of the stock but also would convert the appreciation to capital gain, which would not be subject to New York tax for a non-New York resident.

As with cross-border Section 83(b) election considerations, the state and local Section 83(b) election technique is fairly complex and needs to be planned and structured accordingly.

AMT Section 83(b) election. Another area where a Section 83(b) election may be useful is for alternative minimum tax purposes. For example, where an employee exercises incentive stock options (ISOs) but the stock purchased on the exercise of the ISOs is subject to restrictions, the ISO AMT adjustment would not be includable in alternative minimum taxable income (AMTI) until the restrictions lapse. If the employee makes an AMT Section 83(b) election, however, the ISO AMT adjustment would be includable in AMTI at the time the ISOs are exercised. This would be beneficial where the employee is not subject to AMT in the year the ISOs are exercised but would be subject to AMT in the year the restrictions lapse. Further, if the employee includes the income for AMT purposes, the employer should be entitled to a deduction for its AMT purposes for the same year in which the employee includes the ISO AMT adjustment in AMTI.³¹

Conclusion

There continue to be several significant benefits to a Section 83(b) election. Leg-

islative changes and other developments have increased the benefits of the election but have also increased the complexity and the number of variables to consider in deciding whether to make the election, both from the employee's and the employer's perspectives.

When restricted property is purchased at FMV in connection with the performance of services, the election almost always should be made. In other circumstances, the possible deferral of tax on the appreciation in value of the property from the time the restriction lapses until the property is sold (together with the gain being capital instead of ordinary income) will make the Section 83(b) election advisable in many cases. Because there are significant benefits to a Section 83(b) election, advisors should continue to consider making a Section 83(b) election for their clients who receive restricted property in connection with the performance of services. A Section 83(b) election, however, is not always appropriate and careful analysis is required in each case. ■