The Section 83(b) Election Is Alive and Well And Sometimes Indispensable

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The authors believe that, although in certain situations the Section 83(b) election may be harmful, tax advisors should continue to consider making Section 83(b) elections, which, in many cases, will postpone or eliminate substantial amounts of tax.

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Right—Jeffrey S. Bortnick

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In an article in the July 1988 edition of this magazine, "The Demise of the Section 83(b) Election," [1] it was suggested that the Tax Reform Act of 1986 has virtually nullified the Section 83(b) election. The authors of the July TAXES article observe what they see as the demise of Section 83(b) and further suggest, since in their view the election is not only useless but also sometimes an expensive trap for the unwary, that Congress consider repealing Section 83(b).

As discussed below, however, the Section 83(b) election is not dead; rather, it has continued viability after the Tax Reform Act of 1986 and may be an extremely valuable tool in tax planning. Although the July TAXES article is correct in concluding that in certain situations the Section 83(b) election may be harmful, tax advisors should continue to consider making Section 83(b) elections and the Section 83(b) election should not be repealed. In many cases, the election will postpone or eliminate substantial amounts of tax. In fact, in some instances *not* making the Section 83(b) election may be a trap for the unwary.

This article briefly summarizes the Section 83(b) election, explains why the election remains viable and provides some examples of planning

[1] Lassila and Wiggens, "The Demise of the Section 83(b) Election," 66 TAXES—*The Tax Magazine* 512 (1988).

and many taxpayers still prefer receiving capital gain income to ordinary income.[7]

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The major potential benefit of the Section 83(b) election is the deferral of the payment of tax until the property is sold. This benefit may be very significant. In fact, if the stock is never sold until after the death of the employee, the income tax on the appreciation may be avoided forever because of the stepped-up basis at death.[8]

In the July TAXES article, the so-called "proof" that the Section 83(b) election should not be made assumed that "the employee will sell the stock at the time his receipt of stock is no longer subject to substantial risk of forefeiture."[9] By making this assumption, the major benefit of the Section 83(b) election was assumed away without any explanation. Although an employee who has made the Section 83(b) election may be able to sell his stock as soon as there is no substantial risk of forfeiture, there is no reason to assume that the employee will do so. In fact, if there has been substantial appreciation in the value of the stock, so that a substantial tax on capital gains will be incurred on sale of the stock, purely from a tax point of view, the employee should defer sale of the stock as long as possible. Indeed, if tax planning were the only issue, the best tax strategy would be to keep the stock until death, and never pay the tax on the appreciation.

There are a number of situations in which an employee may not be able to sell the stock, even though the restrictions have 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 where the stock can be sold, an employee may hesitate to do so for business reasons. Since restricted stock is often issued to key employees where both the employer and employee want the employee to have an equity interest in the company, if the employee is still working for the employer at the time the restrictions lapse, it is possible that neither the employee nor the employer will want the employee to sell his stock as soon as he is allowed to do so.

An obvious reason to sell the stock when the restrictions lapse is the need or desire for the cash proceeds of sale. But even the need or desire for cash 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 proceeds of sale and believes that his return on investment on his now vested employer shares is as good as or better than the return on investment he could achieve by investing the net proceeds (after the tax on capital gains) from his sale of the stock, he is likely to keep his shares, deferring the tax and keeping an equity interest in his 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 he had received from his employer, in order to defer the income tax on the gain.[10]

The July TAXES article attempts to use present-value analysis to demonstrate that Section 83(b) is no longer viable. What the authors in fact prove is merely that if circumstances exist in which (1) the stock is issued at a discount (that is, there is a spread when the stock is issued), (2) the employee will sell at the moment the restrictions lapse, and (3) the tax consequences of ordinary income and capital gains are the same, then the Section 83(b) election should not be made. But restricted stock is not always issued at a discount, the employee will not necessarily sell at the moment the restrictions lapse and the tax effect of ordinary income and capital gains, even after 1986, is not always the same.

Present-value analysis is not needed to prove that the ability for the employee to choose when to be taxed on the stock appreciation (by choosing when the stock is sold) is valuable. Quantifying

[7] Although a discussion of the reasons some taxpayers may prefer capital gain income is beyond the scope of this article, the following possible advantages should be considered: (a) many tax advisors believe that in the future there will again be a differential between the highest rate applicable to long-term capital gains as compared to the highest rate on ordinary income; (b) since capital losses are generally limited under Section 1211(b) to capital gains plus $3,000, capital gains may be desirable in order to make use of capital losses; and (c) if a taxpayer is subject to the investment interest expense limitations of Section 163(d), the capital gains produced by the sale of his stock will most likely be investment income, whereas ordinary income under Section 83(a) will almost certainly not be.

[8] IRC Sec. 1014.

[9] Supra note 1 at 513.

[10] This is known as a short sale against the box.

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 [Section 83(b)] election." This regulation has been upheld by the Ninth Circuit in *Alves v. Commissioner*.[13] In *Alves*, the taxpayer argued that making the Section 83(b) election was unnecessary where the stock was purchased at fair market value. Although making the election had no tax cost to the employee, the Tax Court and Ninth Circuit both determined that the election was necessary in order to avoid taxation when the restrictions thereafter lapsed. The Ninth Circuit in *Alves* suggested that the failure to make the Section 83(b) election in that case may be a potential trap for the unwary. Although the consequences of not making a Section 83(b) election in such a case (where the employee pays fair market value for the restricted shares) may not be as drastic under current law as in the *Alves* case (since the tax rate on long-term capital gain and ordinary income is currently the same), as indicated in the above example, the negative tax consequences can still be drastic.

Additional Tax Planning Opportunities Through a Section 83(b) Election

Even if an employee pays less than fair market value 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 cases, the benefits of a Section 83(b) election will outweigh any disadvantages. A Section 83(b) election is often advisable when the restricted stock is expected to appreciate substantially during the period of the restriction and the employee expects to continue to hold the stock after the restrictions lapse.

> ***Example (2).*** Assume the same facts as in Example (1), except the fair market value of the stock in Year 1 is $12 per share and the employee purchases the restricted stock for $10 per share. On making the Section 83(b) election, the employee will be taxed on additional compensation income equal to $2 per share ($12 value less $10 purchase price). The tax on the $2 (at 28 percent) is 56 cents per share. The employer corporation will receive a deduction for the amount the employee includes in income because of the Section 83(b) election ($2 per share). If the corporation is in the 34 percent tax bracket, the tax savings to the corporation is 68 cents per share (34 percent of $2).
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> As in Example (1), if the stock is worth $110 in Year 5, when the restrictions lapse, if no Section 83(b) election had been made, the tax in Year 5 would be $28 per share ($110 per share value less $10 cost) whether or not the stock is sold in Year 5. As in Example (1), if a Section 83(b) election is made, there is *no* tax to the employee (other than the 56 cents per share in Year 1) until the stock is sold. Without the need for great computational skill, it is apparent that the deferral of payment of the $28 tax for even a relatively short period of time would more than make up for the use of 56 cents from the date of receipt of the stock until the restrictions lapse. If the stock is never sold prior to the employee's death, there is no income tax on the appreciation. If the stock is sold at a gain prior to 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.

As indicated from the above example, if a large appreciation is expected and the stock will be held beyond the lapse of the restriction, a Section 83(b) election is often advisable.

Furthermore, as indicated in Example (2), since after the Tax Reform Act of 1986 the highest marginal corporation tax rate exceeds the highest individual tax rate, the tax savings to the corporation in Year 1 from the Section 83(b) election (68 cents per share in the above example) should exceed the cost in Year 1 to the employee in making the election (56 cents per share in the above example). Therefore, a Section 83(b) election will generally *reduce* the combined taxes paid by the employee and the corporate employer in the year of the election. This fact is important in overall tax planning for the corporation and its employees. In fact, as indicated below, corporations may wish to encourage employees to make Section 83(b) elections by providing their employees additional cash

(Footnote 12 continued.)
the latter type of stock may raise an additional audit risk. However, 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.

[13] 84-2 USTC ¶ 9546, 734 F. 2d 478 (CA-9), aff'g CCH Dec. 39,501, 79 TC 864 (1982).

Summary and Conclusion

The Section 83(b) election is still viable and is a valuable tool in tax planning. When restricted property is purchased at fair market value in connection with the performance of services, the election should almost always 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 time the property is sold (together with the gain being considered capital gain instead of ordinary income) will make the Section 83(b) election advisable in many cases. Contrary to the implications of the July TAXES article, the Tax Reform Act of 1986 has not virtually nullified the Section 83(b) election. In fact, because the individual rates have been decreased, the tax on making a Section 83(b) election has generally been reduced. Furthemore, the issuance of restricted stock to employees making the Section 83(b) election may be a useful tool in tax planning for corporations, particularly where the corporation pays the tax generated by the election, if any. Tax 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, and employers should consider encouraging their employees to make a Section 83(b) election (and perhaps paying for the tax) when issuing restricted stock to their employees. ●