

**SECTION 83(b) ELECTIONS:  
the WHAT, the WHEN, and the WHY (or WHY NOT)**

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**I. SECTION 83(b) ELECTIONS: THE BASICS.**

A. What is the Section 83(b) Election?

A stock award is received by an employee, subject to a vesting schedule. The employee will not be taxed on the value of the stock as compensation (ordinary) income until the stock becomes vested. The employee's income at that time will be based on the value of the stock when it vests. The compensation element remains "open" until the stock vests. The employee's holding period (for Rule 144 and for long term capital gain purposes) for the stock will begin only after the vesting date(s).

A Section 83(b) election permits the employee to elect to pay tax (as ordinary compensation income) on the value of the stock when it is received (disregarding the vesting or forfeiture risk). The compensation element is "closed" as a result of the election. All future "upside" in the stock is then capital gain (either long or short term). The employee's holding period for purposes of Rule 144 and achieving long term capital gain begins upon his receipt of the shares if he makes the Section 83(b) election. When the shares vest, there is no tax consequence.

The employer's tax deduction for the stock award must be taken at the same time and in the same amount as the employee's ordinary income tax inclusion. Therefore, if an 83(b) election is made, the employer's tax deduction is accelerated also. No future deduction can be claimed by the employer based on future appreciation in the stock.

B. When must the Section 83(b) Election be made?

The election must be filed no later than 30 days after receipt of the restricted stock. There are no extensions of this deadline. Once filed, the election is irrevocable. It is the

responsibility of the employee to file the election, and it is in the employee's discretion whether to make the election. The election is filed with the IRS center where the employee's federal tax return filings are made.

C. Why would an employee make a Section 83(b) Election?

Bullish optimism.

The employee believes that there is a huge appreciation potential for future upside in the shares. He would like to convert that appreciation from ordinary income to capital gain. The cost? He must pay ordinary income tax now, but perhaps on a very low or nominal value. The election may be a "no brainer" if this is "founder's stock," i.e., exercisable for \$ .00125 per share!

D. Should an employee make a Section 83(b) Election -- or Why Not?

In a down market, the employee has the worst of all possible worlds. He has paid his option exercise price on shares that he could not liquidate in order to capture their value. If he later disposes of the shares at a loss, it will be a capital loss (short or long term depending on his holding period). Long term capital losses can only be used to offset long term gains, and the balance can only be used at the rate of \$3,000 per year to offset ordinary income.

Many employees mistakenly assume that because they paid ordinary income tax on the value of the stock when they make the Section 83(b) election, that any subsequent forfeiture (i.e., if they terminate employment before vesting) should be available to them as an ordinary deduction from income. No ordinary loss is recognized! Only a short or long term capital loss would be triggered upon disposition of the shares. This is not a mistake that is readily forgotten (that @#%\* \$3,000 deduction per year shows up on your return *ad infinitum*!)

E. Federal Income Tax Withholding.

If a Section 83(b) election is filed, the employer has a corresponding obligation to withhold federal income tax or obtain from the employee funds to pay the required withholding tax.

F. FICA and FUTA Tax: No "Section 83(b) election" concept for FICA taxes.

The Section 83(b) elections does not accelerate the time for reporting wages for purposes of employment taxes (FICA and FUTA). *IRS General Counsel Memorandum 38069* (August 28, 1979). This means that although the Section 83(b) election triggers federal income taxes (and withholding obligations), the FICA wages are not reportable until the restricted stock vests. As the shares vest, the then current value of the shares would be includable in the employee's FICA wages. The GCM states: "Section 83 is an income tax provision and neither its statutory language nor its legislative history contain any indication of an intent to modify the provisions of FICA and FUTA."

## II. USE OF SECTION 83(B) ELECTIONS IN AWARDS OF RESTRICTED STOCK.

As described above, the most common use of the Section 83(b) election is with awards of restricted stock. Often, founders' shares will be issued subject to vesting restrictions, and Section 83(b) elections are made because of the nominal value of the shares in a start-up enterprise.

In more mature pre-IPO companies and public companies, restricted stock awards are out of favor. (Referred to as "awards for continued breathing.") There is no cost to the employee for the shares, and all the employee must do to become vested is keep his or her job. Therefore, very few companies utilize restricted stock.

## III. "EARLY EXERCISE" STOCK OPTIONS.

### A. What are they?

- 99% of issuers today favor the use of stock options as their long term incentive for employees. As an additional "wrinkle," it is very common now for technology companies to issue stock options that can be exercised immediately for unvested shares. These are referred to as "early exercise" stock options. The employee may elect to pay the stock option exercise price immediately, and receive restricted shares (subject to the same vesting schedule as the options). The restricted shares are subject to a repurchase right. If the employee terminates employment before the vesting period, the shares are repurchased at the original option exercise price (i.e., they are forfeited).

The employee would only do an early exercise (coming "out of pocket" for the exercise price) if he or she intended to file a Section 83(b) election to convert future appreciation in the stock to capital gain, and to begin the holding period for the shares (toward achieving long term capital gain).

- What is the accounting treatment? *Check with your auditors.* (Let me know what they say.) If the option is "settled" in exchange for restricted shares, should a charge to earnings (over the vesting period for the restricted shares) be taken? Or does the early exercise of an option (in exchange for restricted stock) preserve the advantages of APB 25 (no financial accounting charge)?

### B. Pros and Cons.

- Payment of the exercise price (if significant) may not be feasible. Consider permitting exercise with full recourse promissory notes.
  - Check with securities counsel to determine whether payment with promissory note will commence the Rule 144 holding period.

- If non-recourse notes are used, for tax purposes, the employee is considered to still hold an option and no Section 83(b) election could be made.
- If the option is exercised immediately upon its grant date, then there would be no "spread," and no ordinary income reportable arising from the Section 83(b) election. This technique is best used in cases where the optionee will exercise the option immediately upon grant.
- All future appreciation in the stock is converted from ordinary income into long term capital gain.
  - Con: the employer loses the benefit of any corresponding tax deduction (for non-qualified option exercises).
- The benefits of commencing one's holding period immediately are evident, both for long term capital gain purposes and Rule 144 purposes.

B. The \$100,000 Limit on Incentive Stock Options ("ISOS") and other ISO Wrinkles.

- If an ISO grant is immediately exercisable in full (for unvested restricted shares), the entire grant will be subject to the \$100,000 ISO limit (measured by the value of option shares that "first become exercisable" in any year). Therefore, an early exercise feature in ISOs may cause loss of ISO treatment (and non-qualified option status) for a significant part of the grant.

The Section 83(b) election does not apply to ISOs (with respect to the regular tax). This is because for regular tax purposes, there is no income recognized upon exercise of ISOs (unless an early disqualifying disposition occurs). However, the Section 83(b) election does apply to the alternative minimum tax (AMT) that applies to the "spread" in an ISO upon exercise. Therefore, upon an early exercise of an ISO for unvested shares, a Section 83(b) election should be filed for purposes of the AMT, and the election filed with the IRS should be written to specifically refer to the AMT.

Many practitioners also file "protective" Section 83(b) elections to apply if there is an early disqualifying disposition of the ISO shares. However, the IRS position is that no such elections are valid in light of the express provision of the regulations that Section 83 does not apply to ISOs.

#### **IV. MERGERS AND ACQUISITIONS INVOLVING EARLY EXERCISED OPTIONS (OR EARLY "EXERCISABLE" OPTIONS).**

##### **A. Impact on Restricted Shares.**

A merger or acquisition may be a trigger event that causes any outstanding restricted shares to vest. In other cases, the holder of restricted shares will "swap" his restricted stock for new restricted shares in the acquiring company. Which scenario applies will depend on the terms of the restricted stock plan, the restricted stock agreement, and the merger agreement.

##### **B. Impact on Outstanding "Early Exercisable" Options.**

The holders of stock options in the acquired company will often receive substituted options for stock in the acquiring company (with appropriate adjustments in the number of shares and the exercise price). If the holders' options are exercisable early, the newly substituted options may also retain this feature. (Most stock plans would permit the board or committee that administers the plan to exercise some discretion in this regard, which might permit the "early exercise" feature to be omitted from the substituted acquiror firm options.) In many cases, the early exercise technique may no longer be attractive to the holders.

##### **C. The Viability of the Section 83(b) Election Strategy Post-Deal.**

Of course, the continued attractiveness of the early exercise feature depends totally on the performance/market value of the shares if the holder elects to exercise early. If the holder has "founders' share" options with a very low exercise price, it is probably too late for the holder to use this technique, because the ordinary income triggered by the election would be prohibitive. On the other hand, in a declining market, if the current value of the acquiror's shares are depressed, the holders of options may think that an early exercise strategy is viable.

##### **D. Vesting Schedules for Options/Restricted Shares.**

If the acquired company's options/restricted shares are subject to a different vesting schedule, this may be viewed as an inequitable situation. The acquiror may wish to amend the vesting schedules to make them uniform across its workforce post-deal. Be sure and consider whether an acceleration of vesting would trigger an accounting charge to earnings under FAS Interpretation 44.