To Elect or Not to Elect?

By Robert W. Wood • Wood LLP

Very few sections of the tax code make it into common speech, or even into the talk of the boardroom or corporate bullpen. Code Sec. 1031 qualifies since tax-free swaps of real estate have been commonplace for decades. That section is even used as a verb. But Code Sec. 83 is increasingly recognized too.

Many business people know that Code Sec. 83 governs the income tax treatment of property (including stock) transferred in connection with the performance of services. This provision applies to employees. It also applies to the increasingly large class of people in our on-demand economy known, for the time being at least, as independent contractors.

Many of them may know that when you get value, it is taxed, unless there are restrictions that prevent it from being taxed. On that point, Code Sec. 83(b) allows the recipient to make an election for *current* taxation, notwithstanding the imposition of restrictions. But the details matter.

Say an employee or independent contractor receives a stock bonus subject to a three-year vesting condition. The worker could elect current taxation of the stock bonus, even though the restrictions remain in place for another three years. Why?

Playing the Odds

The Code Sec. 83(b) election is desirable where the worker thinks he or she will ultimately satisfy the conditions (in this example, the three-year vesting). Of course, there is a gamble too. The election makes sense if the worker thinks the tax play is better electing to recognize the income now.

Paying tax sooner sounds counterintuitive. A nearly universal rule of tax planning is to delay our tax obligations into the future wherever possible. We do not want to accelerate income and we do not want to accelerate paying taxes.

We want to accelerate deductions and *defer* income. The Code Sec. 83(b) election, however, accomplishes two goals. Property transferred in connection with the performance of services is ordinary income. For employees, it would also be wages subject to employment taxes.

Thus, it might on first blush seem unreasonable to make a Code Sec. 83(b) election. Yet there are often two distinct advantages of doing so. By making an election, one can cap the ordinary income (and wage) portion of the gain you expect to realize.

Vesting and Valuation Lottery

If you feel you are going to meet the vesting criteria that would result in your being taxed later and that the value of the property you are receiving will likely go up, electing earlier taxation *via* a Code Sec. 83(b) election will result in the later appreciation being taxed as a capital gain. You pay ordinary income (and potentially wage) taxes now in order to get that flexibility and rate advantage later.

Moreover, you even can alter the *timing* of future gain recognition. If you do not make a Code Sec. 83(b) election, you would simply allow Code Sec. 83 to tax you when the restrictions lapse. You will be taxed (as ordinary income and wages, as applicable) when the restrictions lapse.

In contrast, if you elect under Code Sec. 83(b) to be taxed now, there will be no tax event when the restrictions lapse. The only remaining tax event will be when you ultimately sell the property. How does this play out?

Suppose that you meet the three-year restrictions hurdle and hold onto your shares. Assume that you and sell them in year six. What is the tax result? If you have filed a Code Sec. 83(b) election, you are taxed on the value of the shares in year one when you received them (notwithstanding the restrictions).

Then, you have no tax event in year three when the restrictions lapse. Finally, you have capital gain in year six when you sell the shares. All this may seem straightforward and it often can be.

Nonetheless, the facts may play out differently than you expect. Indeed, the Code Sec. 83(b) election may mean that you pay some tax that you would never pay.

Looking Back

Suppose that you *expect* to meet the restrictions threshold and want to lock up capital gain rates for the future. Therefore, you make a Code Sec. 83(b) election to be taxed on the grant of the shares in year one. Unfortunately, you unexpectedly leave the company or are fired in year two.

If you make the election but end up not meeting the three-year vesting requirement, you forfeit the property. Moreover, you get no tax deduction for the forfeiture. [*See* Code Sec. 83(b)(1).] That seems harsh. It is a reminder that Code Sec. 83(b) elections are not risk free, except perhaps when they involve zero income.

There may be some consolation in the fact that you do get a deduction for out-of-pocket losses you incur by reason of the forfeiture. Thus, you get a deduction if the amount you paid for the property is not fully restored on the forfeiture.

Example. You paid $100 for the restricted property, filed a Code Sec. 83(b) election and reported $1,000 of income. You then forfeit the property receiving no cash back. Here, you get to deduct $100, but only as a capital loss. [Reg. § 1.83-2(a); *see also* LTR 8025127 (Mar. 28, 1980).] If on forfeiture you got back the $100 you paid, you receive no tax deduction.

Zero-Income Elections

Can you have your cake and eat it too? Sometimes you can. Consider the "zero-income" election. This too may seem counterintuitive. Some recipients of options and restricted stock may fail to make elections if they are paying what they consider to be the fair market value of the stock.

If you pay fair market value, how could it be a compensatory payment? By definition, a payment at full fair market value might logically mean that there is no discount that could be linked to services. This has long been one of the alluring traps set by Code Sec. 83.

Suppose that you are offered stock in your employer. Let's say, as is probably true in most cases, that you would not otherwise have been offered but for your employment. Also, suppose that you pay for the stock what is meant to be fair market value, say a dollar a share. Let's assume you work for a privately held company.

You might well assume that you bought the shares for fair market value, so Code Sec. 83 is not implicated. However, the IRS's view is that your shares were *still* transferred in connection with the performance of services even if you paid fair market value for the shares. The point will be obvious if the shares are subject to restrictions, such as resale restrictions (which will typically occur in a private company context).

If you make a Code Sec. 83(b) election, you should indicate that you have paid fair market value for the shares. Therefore, you are electing to include the compensatory amount—which happens to be zero—in your income then. Clearly, such a zero-income Code Sec. 83(b) election is appropriate.

Choose Wisely

In fact, an ugly situation arises if you *could* make an election but you fail to make it. Consider the seminal case of *L.J. Alves* [CA-9, 84-2 USTC ¶9546, 734 F2d 478]. The Tax Court and Ninth Circuit Court of Appeals recognized that Mr. Alves paid what was indisputably fair market value for the shares. Thus, it might seem logical that he could simply report the sale many years later as a capital gain.

Nevertheless, the Tax Court and Ninth Circuit both held that Mr. Alves was stuck with ordinary income. The IRS and courts viewed the shares Mr. Alves received as transferred in connection with the performance of services. Even though there was no "bargain element," Mr. Alves was offered the stock because of his employment.

After all, he would not have been offered the shares were it not for his position with the company. The fact that Mr. Alves failed to make a Code Sec. 83(b) election meant that his shares were *still* ordinary income property when he sold them many years later. This fact pattern remains a danger today. It is a big reason to stress the timing and mechanics of Code Sec. 83(b) elections.

Election Mechanics

A Code Sec. 83(b) election must be filed within 30 days of the transfer. A copy must be attached to the employee's tax return for the year of the transfer. The election causes any difference between the value at the time of receipt and the ultimate sales price when the employee disposes of the stock to be capital

Table 1. Transfer of Property Subject to Substantial Restrictions		
	Without Code Sec. 83(b) Election	**With Code Sec. 83(b) Election**
Taxable on initial transfer?	No	Yes (as ordinary income)
Taxable when restrictions lapse?	Yes (as ordinary income)	No (the lapsing of restrictions becomes a nonevent)
Taxable on sale or disposition of property?	Yes (only on appreciation between time restrictions lapse and time of disposition, as a capital gain)	Yes (only on appreciation between initial transfer and time of disposition, as a capital gain)

gain. The election affects both an important timing difference and a tax-rate differential, as illustrated in Table 1.

Options Too

In evaluating restricted stock, consider stock options too. There are incentive stock options (ISOs) and nonqualified stock options (NSOs). ISOs are taxed more favorably. There is generally no tax at the time ISOs are granted and no "regular" tax at the time ISOs are exercised.

When you exercise an ISO, you acquire the shares. Thereafter, when you sell your shares, you pay tax, hopefully as a long-term capital gain. However, you need to know a special rule about selling shares you acquired *via* exercising an ISO. The usual capital gain holding period is one year.

Nonetheless, to get capital gain treatment for shares acquired *via* ISOs, you must hold the shares for more than a year. Moreover, you must sell the shares at least two years after your ISOs were granted. This latter two-year rule catches many people by surprise.

Although you pay no regular tax when an ISO is exercised, the alternative minimum tax (AMT) can take its own tax bite when you exercise ISOs.

> **Example.** Alice receives ISOs to buy 100 shares at the current market price of $10 per share. Two years later, when shares are worth $20, Alice exercises, paying $10. The $10 spread is subject to AMT. How much AMT Alice pays will depend on her other income and deductions, but it could be a flat 28-percent AMT rate on the $10 (28% x $10 = $2.80).

Note that one does not generate cash when exercising ISOs. That means if the exercise triggers the AMT, you will have to use other funds to pay the AMT.

Nonqualified Options (NSOs)

NSOs are more prevalent than ISOs. They are not taxed as favorably as ISOs, but there is no AMT trap. Further, NSOs offer some planning possibilities that ISOs do not.

With NSOs, there is no tax at the time the option is granted. When you exercise the option, however, you have ordinary income (and, if you are an employee, employment taxes). An ISO, in contrast, produces no regular tax, but does trigger the AMT. With an NSO, the *exercise* triggers income.

When you exercise the NSO, you are taxed on the difference between what you pay and the value of the stock you buy.

> **Example.** John receives an option to buy stock at $5 per share when the stock is trading at $5. Two years later, John exercises when the stock is trading at $10 per share. John pays $5 when John exercises, but the value at that time is $10, so he has $5 of compensation income. Then, if John holds the stock for more than a year and sells it, any sales price above $10 (John's new basis) should be long-term capital gain.

Exercising options takes money and generates tax. Many people exercise NSOs to buy shares but then sell the shares the same day. Some plans permit a cashless exercise, cutting down on the seemingly meaningless round-trip flow of funds.

But there is no *requirement* that you exercise and immediately sell the acquired shares. You might exercise and hold the shares. Moreover, you only must hold the stock for more than a year to get long-term capital gain treatment.

Restricted Stock and Options

The restricted property rules and the rules governing stock options often work in tandem. Sometimes one must deal with both sets of rules and that creates confusion. For example, you may be awarded stock options (either ISOs or NSOs) that are restricted and that do not vest until a stated term elapses. The IRS generally waits to impose tax in such a case.

If you must wait two years to see if your options vest, there should be no tax until that vesting date. Then, the stock option rules take over. When the options vest, you would pay tax under either the ISO or NSO rules. It is even possible to make Code Sec. 83(b) elections for compensatory stock options.

The idea of any Code Sec. 83(b) election is to trigger a tax event on the election. Hopefully the taxable event is small or even nonexistent—a tax on zero income. The bigger idea is to start the clock running on future appreciation, which should be taxed as a capital gain.

The Dreaded AMT

One reason to prefer restricted stock is AMT. When you receive an ISO, you do not have income. Likewise, when you exercise an ISO, you still do not have income (at least for regular tax purposes).

You do have income for AMT purposes. The benefit of an ISO is that, since you do not have regular income tax on exercise, you would pay capital gain tax much later, only when you dispose of the shares. The real rub for ISOs is therefore the AMT.

Many taxpayers have been hit where it hurts by this problem. The problem was particularly noteworthy in the aftermath the first dot.com era. In the soaring values, many ISOs were exercised and shares were increasing enormously in value, only to plunge thereafter. More than a few taxpayers had large AMT liabilities.

In many cases, the shares became worthless or dropped precipitously in value. Could this happen again? The tax problem could, and it ties directly into the mix of planning that Code Sec. 83 requires.

Under Code Sec. 83, if stock is substantially vested on exercise, the bargain element of the option is generally included in AMT income for the year in which the exercise occurs. Yet as we have seen, Code Sec. 83(b) allows an election to recognize the income early, that is, in the year the substantially nonvested stock is received, notwithstanding the existence of forfeiture restrictions.

Code Sec. 83(b) Elections and AMT

In *A.J. Kadillak* [127 TC 184, Dec. 56,670 (2006), *aff'd*, CA-9, 2008-2 USTC ¶50,462], the Tax Court held that a Code Sec. 83(b) election for nonvested stock acquired pursuant to the exercise of ISOs was valid. Moreover, the Tax Court held that the taxpayer recognized AMT income to the extent the fair market value of the underlying shares on the date the taxpayer exercised the ISOs exceeded the option price.

Mr. Kadillak received ISOs from Ariba Technologies. The options were subject to a restriction on employment termination. On April 5, 2000, Kadillak exercised his ISOs. He received his vested stock; his nonvested stock was placed in escrow, transferred to him out of escrow *seriatim* as the shares vested monthly over the next four years.

He could receive all regular cash dividends on the nonvested shares even though they were held in escrow. In May 2000, Kadillak timely filed a Code Sec. 83(b) election for the exercised ISOs. About a year later, Kadillak's employment with Ariba was terminated and Ariba repurchased the shares.

Although in 2000 Kadillak had elected to realize AMT income of nearly $680,000 on the shares, he wound up reselling the shares to Ariba, forfeiting them at his 2001 cost. He realized no regular capital gain or loss, but solely an AMT capital loss of the same $680,000. Kadillak filed his 2000 and 2001 federal income tax returns assuming that his Code Sec. 83(b) election was valid.

He reported no regular taxable income for the shares in 2000, but an AMT capital gain in 2000 of $3,263,000 on all of the shares (both vested and nonvested). He reported AMT of $932,309 and a total tax liability of $1,099,388. For 2001, Kadillak forfeited his nonvested shares.

At tax return time, he reported no gain or loss on the forfeiture in 2001 (for either regular tax or AMT purposes). In 2002, Kadillak sold his remaining vested shares to a third party. For regular tax purposes, he had a $60,000 capital gain. For AMT purposes, he had an AMT capital loss of over $2.5 million on the sale.

Kadillak later amended his 2000 and 2001 returns, claiming he was not subject to AMT because his Code Sec. 83(b) election was invalid. When the IRS rejected his position, Kadillak went to Tax Court.

Irrevocable Elections

The Tax Court found Kadillak's Code Sec. 83(b) election to be valid. In the Ninth Circuit, Kadillak again argued that his Code Sec. 83(b) election was invalid. Yet beneficial ownership and the fateful Code Sec. 83(b) election were enough, as it turned out.

Indeed, the Ninth Circuit held that the *very purpose* of a Code Sec. 83(b) election was to realize income on assets that otherwise would not be included in income under Code Sec. 83 due to a substantial risk of forfeiture. Sometimes, it isn't a lack of planning or foresight that seems to trip up taxpayers, but bad luck. The Second Circuit Court of Appeals considered an unlucky executive in *O. Gudmundsson* [DC-NY, 2009-2 USTC ¶50,722, 665 FSupp2d 227].

Mr. Gudmundsson was an officer of Aurora Foods and participated in its employee-incentive compensation plan. The Second Circuit rejected the argument that Gudmundsson's risk of losing his job was a substantial risk of forfeiture. The court also rejected Gudmundsson's claim that his exposure to a potential suit under Section 10(b) of the Securities Exchange Act of 1934 evidenced a substantial risk of forfeiture. Code Sec. 83(c)(3) excludes civil suits other than those brought under Section 16(b) of the 1934 Act. Section 16(b) applies to officers, directors and 10-percent shareholders.

Conclusion

Code Sec. 83 is not complex, yet the application of its rules can be tricky. There is no substitute for caution and attention to detail. Being a good guesser also does not hurt.

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