

Section 83(b) Election for Restricted Stock and Stock Options

Topic: Using a tax election to reduce the tax burden on restricted stock and stock options

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Date: November 12, 2004

Executive Summary: With the increase in restricted stock, executives should be aware of the tax election allowed under Section 83(b) of the IRS Code. This election is most useful if the value of the stock is low at the grant and has potential to rise significantly in the future. This most often occurs in start up companies or companies contemplating an IPO. The election allows the executive to take into the income the lower grant value and then is given capital gain treatment when it is sold.

Among the various ways to compensate employees are restricted stock and/or stock options. Each is designed to provide deferred compensation tied to the fortunes of the company. In the proper situation, making a Section 83(b) election can be very beneficial for the employee.

Restricted Stock

Typically the company gives the employee restricted stock which vests if the employee remains with the company for at least a period of years (often 2 or more). Under Section 83 of the Internal Revenue Code, if the stock has not vested, the employee has no income to recognize at the time of grant. However, when the stock vests, the employee has compensation income equal to the fair market value of the stock (less any cost he might have paid at the outset) at the date of vesting. This income is taxed at ordinary tax rates.

For example, an employee is given 5000 shares of restricted stock in a startup company. The stock will only vest if the employee remains with the company for 2 years. At the time of issuance the stock is worth \$1 per share. Shortly thereafter the company goes public. The stock is selling for \$30 per share at the vesting date two years later. Under the normal rules of Section 83, the employee has no compensation at the time he receives the shares, but he has compensation income of \$150,000 at the two year vesting date taxable at ordinary tax rates.

On the other hand, under Section 83(b), the employee has the opportunity to treat the unvested stock as vested at the date of issuance. The value of the stock is taxable income at that time. In this case, the employee would report income of \$5,000 (5000 shares @ \$1 per share) when it is issued. In two years when the stock vests, there is no taxable income. Moreover, when the employee sells the stock after it vests, the gain is taxable at the lower long term capital gains rates (subject to potential AMT). Thus by making the 83(b) election he pays tax on \$5000 in year 1 at ordinary income tax rates and is taxed on \$145,000 at long term capital gains rates when the stock is sold any time after it vests.

Stock Options

An 83(b) election can also be used for certain stock options. Typically non-qualified stock options are issued at the current stock price, will vest within 2 years and are exercisable for up to 10 years. In this case there is no tax liability upon the grant of the option, but upon subsequent exercise the gain is compensation taxed at ordinary income tax rates. If these options are on publicly traded securities, an executive may make an 83(b) election. Such an election will allow her to take into income at date of grant the excess of the fair market value of the options over any cost and

treat it as compensation. Much like the restricted stock rules, any subsequent appreciation from the grant date to the exercise date would be taxed at capital gains rates.

For example, an executive is granted 5000 non-qualified options at a strike price of \$30 at a time when the stock is trading at \$30. The option vests in two years and is exercisable for the next 8 years. The fair market value of the options at date of grant is \$3 per share or \$15,000. Assume the stock appreciates to \$80 per share by the time the options are exercised in year 7. Under general option rules the executive would have no income at date of grant and in year 7 would report \$250,000 as compensation income (5000 x \$50 gain). On the other hand, if she made an 83(b) election, she would treat the grant value of \$15,000 as compensation in year 1, but more importantly the subsequent gain upon exercise in year 7 or \$235,000 (5000 x \$47 gain) would be long term capital gain.

Drawbacks of the Election

There are several drawbacks to the 83(b) election. The election must be filed with the IRS and the employer within 30 days after receiving the stock or option grant. If one leaves before the stock or option vests, one cannot claim a deduction for the income already reported, but the loss would be a capital loss subject to any such limitations. In addition, if the election is made and the stock drops in value before the stock is sold one would have paid more tax than necessary up front and would only have a capital loss to partially offset it. Therefore if the stock is volatile, it may not be suitable for such an election.

When to use the Election

The 83(b) election makes sense to use if the amount of income taxable at the date of grant is small and the potential growth in value of the stock is large (such as start up companies). It should also be considered if there is reasonable growth potential in the stock and the likelihood of forfeiture is very small. Conversely, avoid the election if forfeiture is likely, a large tax liability results from the grant, the stock is volatile, or there are only modest prospects for growth.

The information contained herein is of a general nature and should not be relied upon without first consulting a financial advisor. If you would like further information please email info@vantagefinancial.com.

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