Executive Insights

A Quick Guide to 83(b)

Section 83 of the IRS tax code governs the timing and amount of compensation income that is taxable to a taxpayer. This is an important section of code, as executives have many decisions to make regarding their equity compensation. One of the choices is an 83(b) election, which gives executives the option to pay taxes on the total fair market value of restricted stock at the time of granting with the hope of paying fewer taxes in the future. Below, we will explore some of the factors to consider in determining whether an 83(b) election makes sense for your executive equity compensation.

Why Make the Election?

The 83(b) election makes the grant date the relevant date, rather than the vesting date. It recognizes the taxable income as of the grant date, based on the fair market value of the stock on that date. By making the 83(b) election, you may avoid federal earned income tax consequences at the time the stock vests.

When you subsequently sell the equity, any appreciation in the value of the stock over the price from the time you made the election are taxed as a capital gain, rather than ordinary income. Your holding period starts from the date you received the equity. Any sell after one year will receive long-term capital gain treatment. In the event the price granted is equal to the full fair market value of the equity, you will not likely have any federal income tax liability as a result of the purchase.

The 83(b) election can also be beneficial if, at the time of vesting, the stock is illiquid or you are prevented from trading, yet you owe taxes on the vested award.

	83(b) Elected	No 83(b) Election
Current Stock Price	$10.00	$10.00
Shares Granted	10,000	10,000
Assumed Annual Return of Stock	10.0%	10.0%
Years Until Grant Vest	4	4
Value at Grant	$100,000	$100,000
Assumed Value at Vest	$146,410	$146,410
Current Earned Income Tax Rate	45.4%	45.4%
Capital Gains Tax Rate	29.8%	29.8%
Ordinary Income Tax	$45,350	$66,397
Capital Gains Tax	$13,830	
Total Tax Paid	**$59,180**	**$66,397**
Net Procceds	**$87,230**	**$80,013**
Difference	**$7,217**	

Note: This chart is for example purposes only.

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From a pure tax perspective, an 83(b) election makes sense if the stock appreciates, but taxes are not the only factor to consider.

A Few Cons to Making the Election

Here are a few reasons this election may not be right for you. First, if the equity does not vest or is forfeited, you cannot recapture or deduct any of the taxes paid as a result of making the election. The capital loss is limited to any amount you paid for the equity award out-of-pocket. When making the 83(b) election, one must be confident that the stock will grow and that they are unlikely to forfeit the award due to performance criteria associated with the award.

It is also unlikely that you will be able to make changes to an 83(b) election. In the unlikely event that a revocation is accepted by the IRS; the *entire* election is revoked. For example, if you made a mistake in the number of shares granted or the value was mistakenly overvalued in the election, you cannot lower the value without IRS permission.

Alternative Strategy

Another scenario to consider is taking the equivalent amount of taxes that would paid on the 83(b) election and investing that amount in company stock as illustrated below.

	83(b) Elected	No 83(b) Election Purchase shares with funds equal to 83(b) taxes
Funds you would have used to pay the 83(b) tax		*$45,350*
Assumed Annual Return of Stock		10.0%
Years Until Grant Vest		4
Assumed Value at Vest Date		$66,397
Current Earned Income Tax Rate		45.4%
Capital Gains Tax Rate		29.8%
Ordinary Income Tax		
Capital Gains Tax		$6,272
Total Tax Paid		**$6,272**
Net Procceds - Sub Total		**$14,775**
Net Procceds	**$87,230**	**$94,788**
Difference		**$7,558**

Earned Income tax rate is assumed maximum federal, state, and medicare tax rates.

Note: This chart is for example purposes only.

What Do The Numbers Tell Us?

The analysis shows that if you are working for a publicly-traded company, an 83(b) election most often does not make sense. You are likely better off utilizing the alternative strategy above, taking the amount of taxes you would have paid and purchasing the stock outright. You could be left with more money in your pocket, and you might not face the risk of paying taxes on an award that may be forfeited or holding stock that might decrease in value.

Executives of non-publicly traded companies, especially startups with founder's stock that have little to no real value, should probably consider using the 83(b) election. The risks are minimized, and there is no ability to purchase the stock on the open market.

It is important to note that the IRS requires 83(b) election documents to be submitted to them within 30 days of issuing restricted shares. In addition to notifying the IRS of the election, the recipient of the equity must also submit a copy of the completed election form to their employer and include a copy with their annual tax return.

As with any financial decision, be sure to consult a professional to ensure that you are making the right choice for your individual situation. It is especially important to confirm with your CPA if there are specific state tax requirements. Reach out to the SignatureEXEC team with questions.

Disclosures