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New IRS 83(b) Election Regulations Ease Paper Filing Requirements with Income Tax Return

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Taxpayers No Longer have to File Section 83(b) Election with Income Tax Return Under New Final Regulations Issued Under Internal Revenue Code Section 83

A common mistake in employee compensation transactions is the failure of the employee to file the Internal Revenue Code Section 83(b) election with his or her Form 1040. Newly issued final regulations under Internal Revenue Code Section 83 (the Final Regulations) eliminate this Form 1040 requirement to submit a paper copy of the 83(b) election with the employee's income tax return.

This means it will be easier for employees who have made an 83(b) election to file their income tax returns electronically. The Final Regulations are effective for property transferred on or after January 1, 2016. For property transferred on or after January 1, 2015, but before January 1, 2016, employees may rely on the Proposed Regulations, which provide the same rules for eliminating the need to submit a copy of any 83(b) elections with the employee's income tax return.

Important Note: the requirement that an employee file the 83(b) election with the IRS no later than 30 days after the property is transferred remains unchanged. There are still no exceptions to this timing requirement and no ability to make the election at a later time. For this reason, whenever an employee receives property subject to a substantial risk of forfeiture (typically in the form of an equity grant subject to vesting), it is critical to consider and to understand the benefits and potential risks of making the 83(b) election and to understand the timeline for making the election.

General Background: What is an 83(b) Election and Why Does it Matter

Generally, Code Section 83(a) provides that an employee who receives certain equity, such as restricted stock subject to vesting, will recognize income with respect to the equity *in the year in which it vests*. The amount included in taxable income for *each year in which the equity vests* is the excess of the fair market value of equity at vesting over the amount (if any) paid for the property.

Rather than paying taxes on the value of the equity *at vesting*, an

employee can file an 83(b) election with the IRS electing to be taxed *on the date of grant* rather than on the *date the equity vests*. In simple terms, an 83(b) election accelerates an employee's ordinary income tax. So why would anyone accelerate ordinary income tax? Depending on various factors, filing an 83(b) election can dramatically reduce the aggregate tax to be paid by an employee, as illustrated below.

Example of Impact:

For illustrative purposes, assume you receive 100,000 shares of restricted stock subject to vesting, worth \$.10 per share at the time of grant, \$2.00 per share at the time of vesting, and \$5.00 per share when sold more than one year later. We'll also assume that you are subject to the maximum ordinary income tax rate and long-term capital gains rate. For purposes of simplicity, we are not addressing state, local and other employment tax considerations in this example.

Example 1 – 83(b) Election Made Within 30 Days of Grant: You make an 83(b) election within 30 days of grant when your shares are worth \$10,000 ($\$100,000 \times .10$). You will pay federal income tax of \$3,960 (i.e., $\$10,000 \times 39.6\%$). Because you filed a Section 83(b) election, you will not have to pay tax when the stock actually vests, but you will pay capital gains tax on the later sale. On the later sale which occurs more than one year after the date of grant you recognize a taxable gain of \$4.90 per share (not \$5.00, because you get credit for the \$.10 per share you already took into income), and pay additional tax of \$98,000 (i.e., $\$49,000 \times 20\%$). In total, your tax liability from the date of grant to final exit is \$101,960.

Example 2 – No 83(b) Election: You pay no tax in the year the shares are granted but instead recognize income of \$200,000 when the shares vest and thus have federal ordinary income tax of \$79,200 (i.e. $\$200,000 \times 39.6\%$). On the later sale which occurs more than one year after the date of vesting you recognize a taxable gain of \$3.00 per share (not \$5.00, because you get credit for the \$2.00 per share you already took into income), and pay additional tax of \$60,000 (i.e., $\$300,000 \times 20\%$). In total, your tax liability from date of grant to final exit is \$139,200.

In this example, the failure to file a Section 83(b) election, resulted in the payment of an **additional** \$37,240 in taxes.

This is just one example, but it shows that making an 83(b) election can have a significant financial impact on employees in the long run. For executives receiving large equity grants as part of their compensation package, the financial impact of failing to file a Section (83)(b) election may be multiplied tenfold.

A number of factors go into deciding whether to make an 83(b) election, including whether a person has cash available to pay taxes upfront and whether a person believes the value of the stock will increase over time (if the stock declines in value a person may end up paying more by making an 83(b) election). There is no universal answer as to whether a person should make an 83(b) election. The moral of the story is that any person who receives an equity grant with a substantial risk of forfeiture (i.e.,

restricted stock subject to vesting) should discuss with his/her individual tax and legal advisors the factors that may influence the decision to make an 83(b) election soon after the grant is made and should always keep in mind that the filing must be made (if at all) within 30 days after the grant date without exception.

For More Information

For additional information on the final regulations issued under IRS Code Section 83 or any related matter, please contact Bret Busacker at BFBusacker@hollandhart.com or any member of the employee benefits and compensation practice at Holland & Hart LLP.

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