Section 83(b) Election – Better Safe Than Sorry

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I. Introduction

Founders, executives and other employees of fast growing companies – if you received or are about to receive restricted stock in connection with the performances of services, you should consider making a timely § 83(b)[1] election in the US, even if you are not currently taxed in the US.

Generally, if stock is transferred in connection with the performances of services, the person performing such services may elect, for US federal income tax purposes, to include in gross income the fair market value of the property (less the amount paid for the stock, if any) at the time of transfer as compensation for services. If this election is made, the rules in the US that generally would require recognition of income when vesting occurs, would not apply. As a result, subsequent appreciation in the value of the stock between the time of its grant and the time when it vests is not taxable as compensation to the person who performed the services.

This treatment could turn out to be extremely beneficial to many non-US founders, executives and other employees of fast growing companies that, in connection with the performance of services, received amounts of stock that have little or no value when granted (but may significantly appreciate in value), and that at a later point in time are taxed in the US (*e.g.*, because they move to the US). However, failure to make a valid § 83(b) election could result in a significant tax hit to such persons after they become subject to US tax and their stock vests.

A valid § 83(b) election must be made not later than 30 days after the date of the transfer of the stock, and is to be made in a manner set forth in the regulations. There are no exceptions to this timely filing rule. Therefore, as further discussed below, careful consideration should be given to situations where non-US persons received restricted stock in connection with the performances of services, but failed to timely make a § 83(b) election, and become, or are about to become, US persons.

II. General Rules For Property Transferred In Connection With The Performances Of Services

For US federal income tax purposes, as a general rule, if property,[2] such as stock, is transferred in connection with the performance of services, the employee who performed the services has gross income in an amount equal to the excess of the fair market value of the stock over the amount paid for the stock by the employee (which may be zero).[3] However, under this rule, both the income event and the measurement of the fair market value of the stock are to take place only when the stock is first transferable or not subject to a substantial risk of forfeiture.[4]

A common substantial risk of forfeiture is one that conditions full ownership of the stock upon the future performance (or refraining from performance) of services (such as a vesting restriction, which occurs during the employment period).[5] The person performing services must earn full rights to the stock by performance of future services. Due to the real possibility that the condition might not be fulfilled, the presence of such restriction will normally postpone taxation until the restriction lapses and the stock will be treated as restricted stock. Once vesting occurs (*i.e.*, when the restriction lapses), the employee is treated, for US federal income tax purposes, as the owner of the stock, an event that could be taxable to the employee. If the stock is forfeited before it is free and clear of those restrictions, there will be no income event to the employee.

Moreover, the holding period[6] for the restricted stock transferred in connection with the performance of services begins when the employee's rights in the stock become substantially vested, *i.e.*, when the stock is either transferable or not subject to a substantial risk of forfeiture, whichever occurs first.[7] As further discussed below, if a § 83(b) election is made, the holding period will begin to run from the date of the transfer.

III. Section 83(b) Election

A. Overview Of US Federal Income Tax Consequences

Although stock transferred in connection with the performance of services that is subject to forfeiture and transferability restrictions is normally taxed to the employee only when those restrictions lapse, § 83(b) allows the employee to elect to accelerate the taxable event to the time of the transfer itself. If the employee makes this election, the compensation element in the transaction is closed at the time of transfer and, thereafter, the employee is treated as the owner of the stock for US federal income tax purposes.

Why would the employee elect to include an amount of compensation in income in a taxable year earlier than the year otherwise required by the general rule under § 83(a)? Often such treatment is desirable where at the time of the grant the stock has no or small fair market value and is expected to appreciate significantly. When vesting occurs (*i.e.*, when the restriction lapses), if stock has appreciated in value, absent a § 83(b) election, each vesting would be a taxable event to the employee.

The primary effect of the § 83(b) election is to shift the tax focus in a transfer of restricted stock from the lapse of the restrictions to the transfer itself. The lapse of restrictions, which normally triggers the taxable event under § 83(a), is no longer a taxable event if a § 83(b) election is made. Rather, compensation income arises in the year of the transfer. Thereafter, the general rule under § 83(a) (discussed above) does not apply to the stock, even when the restrictions lapse. At issue is the compensation income that normally arises between the transfer and the lapse of the restrictions due to appreciation in the value of the stock. The § 83(b) election permits the employee to avoid taxation on that appreciation when the restrictions lapse and to pay tax on that appreciation only if and when the employee disposes of the stock. Moreover, if the § 83(b) election is made, when the stock is disposed of, the tax character of that appreciation changes from compensation income under § 83(a) to capital gain.[8]

In addition, because the § 83(b) election closes the compensation element in the transaction, once the election is made the employee is treated, for US federal income tax purposes, as the owner of the stock. Thus, the employee's holding period in the stock begins to run "just after the date such property is transferred."[9] And if the stock is treated as being held for more than a year, the employee could be eligible for the reduced capital gains rate.

The election under § 83(b) carries with it certain risks to the employee. One of the risks that the employee assumes in making the election is that the election, once made, is irrevocable, unless the revocation request is filed on or before the due date for making the § 83(b) election[10] or the Internal Revenue Service (the "IRS") consents to the revocation.[11] The regulations provide that the employee may revoke the election if there was a mistake of fact "as to the underlying transaction" and if the request for revocation comes within 60 days of the date on which the mistake of fact becomes known to the employee.[12] A mistake as to the value of the stock, a decline in value of the stock, or the failure to perform an act contemplated at the time of the transfer does not qualify as a mistake of fact.[13]

Another risk in the election arises since the election is made while the stock is still subject to a substantial risk of forfeiture. If the stock is later forfeited, no deduction will be allowed for the amount included in income as a result of the § 83(b) election in respect of such forfeiture.[14] However, the employee is allowed a capital loss deduction if the amount paid for the stock is not fully restored upon forfeiture.[15]

Essentially, the employee is given a choice to wait until the forfeiture or non-transferability restrictions lapse for the income event, or to incur an accelerated income event, recognizing the possibility of forfeiture, but seeking the substantial tax benefits arising from the election. The cost extracted for those significant benefits is that no deduction is allowed for the amount included in income, if the stock is forfeited.

B. Time And Manner Of Election

A valid § 83(b) election must be made not later than 30 days after the date of the transfer of the stock, and in a manner set forth in the Treasury regulations.[16] There are no exceptions to this timely filing rule. The last possible day for filing is calculated by counting every day (including Saturdays, Sundays and holidays) starting with the next day after the date on which the stock is purchased. For example, if the stock is purchased on May 16, the last possible day for filing is June 15. The official postmark date of mailing is deemed to be the date of filing.

The election must be in writing and must generally be filed within the above time limits at the IRS office at which the employee regularly files their tax returns.[17] A written statement (discussed immediately below) must also be attached to the employee's income tax return for the year of the transfer.[18] The employee must send a copy of the election to the employer, and in any situation in which the transferee of the stock is not the employee, a copy of the statement must be forwarded to the transferee.[19]

The written statement must indicate that it is being made under § 83(b) and must be signed by the employee. In addition, the statement must include the following information:

(1) The taxpayer's name and address, and a taxpayer identification number (further discussed immediately below);
(2) A description of the property which is the subject of the election;
(3) The date of the transfer and the calendar year involved;
(4) The nature of the restrictions attached to the stock;
(5) The fair market value of the stock (at the time of the transfer);
(6) The amount paid (if any) for the stock; and
(7) A statement that copies of the election have been filed with the employer and, if necessary, with the transferee of the stock.[20]

The IRS has provided sample language that may be used, but is not required to be used, for making a § 83(b) election.[21] *See* Revenue Procedure 2012-29,[22] effective June 25, 2012. A § 83(b) election must contain all the information required by the regulations, but need not use the exact format or language of the sample election.

A taxpayer identification number ("TIN") is an identification number used by the IRS in the administration of tax laws. A TIN may include a Social Security Number ("SSN"), issued by the Social Security Administration, or an Individual Taxpayer Identification Number ("ITIN"), issued by the IRS.[23]

Foreign taxpayers often do not have an SSN[24] and therefore should consider obtaining an ITIN before making the § 83(b) election. An ITIN is a tax processing number only available for certain nonresident and resident aliens, their spouses, and dependents who cannot obtain an SSN. It is a nine-digit number, beginning with the number "9," formatted like an SSN (NNN-NN-NNNN). ITINs are issued regardless of immigration status because both resident and nonresident aliens may have a US filing or reporting requirement under the Code. ITINs are for US federal tax reporting only, and are not intended to serve any other purpose. The IRS issues ITINs to help individuals comply with the US tax laws, and to provide a means to efficiently process and account for tax returns and payments. IRS Form W-7, IRS Application for Individual Taxpayer Identification Number is used to obtain an ITIN. Form W-7 requires documentation substantiating foreign/alien status and true identity for each individual. Taxpayers that qualify for an ITIN should receive a letter from the IRS assigning their ITIN usually within six weeks after submitting the application.[25]

It is not entirely clear whether an otherwise complete § 83(b) election that is missing a TIN will be respected by the IRS. Nevertheless, taxpayers without an ITIN that need to promptly make a § 83(b) election (*e.g.*, because the 30-day period is about to expire) should also submit an ITIN application and state in the election that such application was made and is pending.

C. If You Become A US Taxpayer But Did Not Properly File A § 83(b) Election …

The United States has a worldwide taxation system that generally subjects only "United States persons" to tax on their worldwide income. The term "United States person" is defined to include, among others, any citizen or resident of the United States.[26] Therefore, there generally should not be any US tax consequences to a non-US person receiving restricted stock in connection with the performance of services rendered outside the US, including when the restrictions attached to such shares lapse (*e.g.*, when the shares vest). This rule apparently leads many non-US persons to refrain from filing a § 83(b) election with respect to stock received in connection with the performances of services outside the US. And if any such non-US person never becomes a US person, not filing the election generally should not result in any adverse US tax consequences.

However, any person while a resident of the United States, regardless of such person's nationality, will generally be treated as a US person and will be subject to US federal income tax on their worldwide income, regardless of its source.[27] As a result, in the absence of a valid § 83(b) election, the lapse of the restrictions attached to the stock, or a block of stock, received in connection with the performances of services (*e.g.*, upon vesting) would be a taxable event to the employee. Specifically, this means that when a non-US person becomes a US person (which is likely to occur when the person moves to the US), on each vesting date that person will have ordinary income on the spread between his original nominal purchase price and the fair market value of the stock, at the time of the vesting. This could mean substantial tax over time.

Unfortunately, as discussed above, there are generally no exceptions to the timing for filing a valid § 83(b) election – the election must be made not later than 30 days after the date of the transfer of the stock. No relief is available for taxpayers that did not file the election within the 30-day period, even though they were not US persons when receiving the shares and only became US persons at a later point in time. Unfortunately, we've seen this occur to founders and executives of fast growing companies that started operating outside the US and then moved into the US.

To avoid this issue, founders, executives and other employees receiving restricted stock subject to vesting should be advised to promptly file a § 83(b) election in the US, in the manner discussed above and within the 30-day period, even if they don't know if and when they will eventually move to the US.[28] This may also require applying to receive an ITIN, as discussed above.

Careful consideration should be given to situations where non-US persons received restricted stock in connection with the performances of services, failed to timely make a § 83(b) election, and become, or are about to become, US persons. Such persons are strongly advised to consult with their own tax advisors with respect to the particular US federal income tax consequences that would apply to them.

One possible solution to this issue may be to fully accelerate the vesting of the restricted shares before the employee moves to the US. If there are no restrictions attached to the shares the employee is treated as the owner of such shares for US federal income tax purposes and § 83(a) should not apply. In a later point in time, it might be possible to re-impose vesting on the shares.[29] Another alternative solution may be to subject the employee to alternative restrictions such as a lock-up or no sale. However, if the new or alternative restrictions are in substance similar to the original vesting restrictions, there is a greater risk that the transaction would be treated by the IRS as a tax avoidance scheme and be disregarded. Lastly, the unvested shares could be cancelled with the employee instead being issued options. This, however, may not be a popular approach with founders for obvious reasons (*e.g.*, since options carry strike price, do not have voting rights or do not have as favorable tax treatment as shares).

IV. Conclusion

Non-US founders, executives or other employees receiving restricted stock in connection with the performance of services should consider promptly filing a § 83(b) election in the US, in a proper and a timely manner, even if they do not know if and when they will eventually move to the US.

Non-US persons who received restricted stock in connection with the performances of services and failed to properly or timely make a § 83(b) election, and become, or are about to become, US persons should consult with their own tax advisors with respect to the particular US federal income tax consequences that would apply to them.

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Endnotes

1 All section (§) references are to the Internal Revenue Code of 1986, as amended (the "Code"), and the Treasury regulations ("Treas. Reg.") promulgated thereunder.

2 "Property" for this purpose generally includes real and personal property, but does not include either money or an unfunded and unsecured promise to pay money or property in the future. Treas. Reg. § 1.83-3(e). For example, the grant of a stock appreciation right (*i.e.*, an unfunded and unsecured promise to transfer money or property in the future) is not a transfer of "property" for purposes of § 83, but § 83 would apply to the receipt of property upon the exercise of the stock appreciation right.

3 § 83(a).

4 *Id.*

5 *See* Treas. Reg. § 1.83-3(c) (1). A forfeiture condition attached to stock that requires the employer to pay to the employee upon forfeiture the fair market value of the stock is not a substantial risk of forfeiture for purposes of § 83. A condition of this type will, therefore, not delay the taxation of restricted stock beyond the date of the transfer of the stock to the employee. Treas. Reg. § 1.83-3(c) (1). Note also that under § 83(c) (3), "(s)o long as the sale of property at a profit could subject a person to suit under §16(b) of the Securities Exchange Act of 1934, such person's rights in such property are – (A) subject to a substantial risk of forfeiture, and (B) not transferable."

6 The concept of holding period is a fundamental component of the tax treatment of capital gains and losses. The Code distinguishes between short-term and long-term gains and losses. Long-term gains are generally taxed at lower rates than are short-term gains or ordinary income. Under the current law, an asset has a long-term holding period if it has been held, or is deemed to have been held, for more than one year.

7 § 83(f); Treas. Reg. § 1.83-4(a).

8 § 83(b) (1); Treas. Reg. § 1.83-2(a).

9 Treas. Reg. § 1.83-4(a). In addition, due to the employee's status as the owner of the stock (once the compensation portion of the transaction closes), the employee will also be treated as the owner of the income generated by the stock (*e.g.*, dividends) from the time of the § 83(b) election.

10 Rev. Proc. 2006-31, 2006-2 C.B. 32, § 2.08.

11 § 83(b) (2); Treas. Reg. § 1.83-2(f). *See* Rev. Proc. 2006-31, *Id.*, for the procedure to request IRS consent to the revocation of a § 83(b) election.

12 Treas. Reg. § 1.83-2(f).

13 *Id.*

14 § 83(b) (1).

15 Treas. Reg. § 1.83-2(a).

16 Treas. Reg. § 1.83-2(b).

17 Treas. Reg. § 1.83-2(c). If the employee is a resident outside the US, the election should be filed to the following address: Department of the Treasury, Internal Revenue Service Center, Austin, TX 73301-0215, USA.

18 *Id.*

[19] Treas. Reg. § 1.83-2(d).

[20] Treas. Reg. § 1.83-2(e).

[21] Rev. Proc. 2012-29, 2012-28 I.R.B. 49, available at: http://www.irs.gov/pub/irs-drop/rp-12-29.pdf.

[22] 2012-28 I.R.B. 49.

[23] Other available taxpayer identification numbers may include Employer Identification Number (EIN) and Preparer Taxpayer Identification Number (PTIN). An SSN is issued by the Social Security Administration whereas all other TINs are issued by the IRS.

[24] Form SS-5, Application for a Social Security Card is used to apply for an SSN and requires evidence of identity, age, and US citizenship or lawful alien status.

[25] See IRS, General ITIN Information, available at: http://www.irs.gov/Individuals/General-ITIN-Information.

[26] § 7701(a) (30). On the other hand, under § 871, non-resident alien individuals and other non-US persons are subject to US federal income tax only on their income which is either (i) effectively connected with the conduct of a trade or business within the United States ("effectively connected income" or "ECI"), or (ii) certain other US source income.

[27] An alien individual is considered a US resident if the individual is a lawful permanent resident under US immigration laws, also known as a green card holder. An alien individual is also considered a resident if the individual meets a "substantial presence" test. See § 7701(b) (3). The substantial presence test applies on a calendar year basis. An individual meets the test for a given calendar year if the individual is physically present in the United States for at least 31 days during the year and the sum of the number of days the individual is present during the current year and the two immediately preceding years is at least 183 days (by using 1/3 as a multiplier for the number of days in the preceding year, and 1/6 for days in the second preceding year). *Id.* Thus, for example, an individual meets the substantial presence test if he or she is present in the US for 122 days in the current year and was also present in the US for 122 days in each of the two preceding years, as follows: 122 + 1/3 (122) + 1/6 (122) = 183. However, notwithstanding the above formula, an individual is not treated as meeting the substantial presence test if he or she is physically present in the US on fewer than 183 days during the current year and can establish a closer connection to a foreign country in which he or she has a "tax home" (generally, his or her principal place of business). § 7701(b) (3)(B). In counting the number of days an individual is present in the US for purposes of the substantial presence test, a day must be counted as a full day of presence if the individual is physically present in the US at any time during that day. Certain days on which an individual is physically present in the US are not counted for purposes of the substantial presence test. For example, days on which the individual is a student, trainee, or teacher are excluded from the day count. § 7701(b) (5). Additionally, an individual who is a resident of a country with which the US has an income tax treaty may be able to establish that he or she is a resident of that country, and not the US, under the "tie breaker" residency rules of the treaty. Additionally, an alien individual can make a "first year election" under § 7701(b) (4) to be treated as a US resident for the calendar year if he or she satisfies certain conditions. An individual who is a US income tax resident for the current year but who was not a resident at any time during the preceding year is treated as a resident only for the portion of the current year beginning on the "residency starting date." § 7701(b)(2)(A). For an

individual treated as a resident under the substantial presence test, the "residency starting date" is the first day of the year on which the individual is present in the US. § 7701(b)(2)(A)(iii).

28 Indeed, having non-US persons filing § 83(b) elections could result in a significant administrative burden to the IRS that may have to deal with potentially a very large number of elections.

29 *See* generally, Rev. Rul. 2007-49, 2007-31 I.R.B. 237 (7/30/2007), for the US federal income tax consequences under § 83 when restrictions are imposed on substantially vested stock causing that stock to become substantially nonvested. The ruling generally holds that if the imposition of such restrictions occurs in the absence of an exchange of stock, the substantially nonvested stock is not subject to § 83. However, if the substantially vested stock is exchanged for substantially nonvested stock, the substantially nonvested stock is subject to § 83.