# Executive Compensation Alert:

## New Guidance Regarding 83(b) Elections

JULY 2, 2012

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On June 26, 2012, the Internal Revenue Service (the "**IRS**") released Revenue Procedure 2012-29, which provides language that taxpayers may use when making an election under Section 83(b) of the Internal Revenue Code of 1986, as amended (the "**Code**"). A copy of the Revenue Procedure can be found here: [http://www.irs.gov/pub/irs-drop/rp-12-29.pdf].

**Background: Taxation of Restricted Property Under Section 83 of the Code**

Stated generally, Section 83(a) of the Code provides that if property is transferred to a service provider in connection with the performance of services, that service provider must report as gross income the excess of the property's fair value over the amount paid for such property in the taxable year when the property first (i) becomes transferable, or (ii) is no longer subject to a substantial risk of forfeiture, whichever occurs earlier.

Under Section 83, a substantial risk of forfeiture may be established only through a service condition or a condition related to the purpose of the transfer of the property. Whether a substantial risk of forfeiture exists depends on facts and circumstances. Both the likelihood that the forfeiture event will occur and the likelihood that the forfeiture will be enforced must be considered. The IRS recently proposed regulations to this effect on May 29, 2012, and found here: [http://www.gpo.gov/fdsys/pkg/FR-2012-05-30/pdf/2012-12855.pdf]. A common example of when property is subject to a substantial risk of forfeiture is when the property may be repurchased by the Company at the lower of the fair market value at the repurchase date or the original purchase price upon the service provider's termination of service. The lapse of this substantial risk of forfeiture is often referred to as "**vesting**."

In contrast to the default taxation **at the time of vesting** in Section 83(a), Section 83(b) permits the service provider to elect to include in gross income the excess of the property's fair value over the amount paid for such property **at the time of transfer**. To make this election, the service provider must file an election under Section 83(b) of the Code (an "**83(b) Election**") no later than 30 days after the transfer of the property with the IRS office where such person files his or her tax return. If an 83(b) Election has been properly made, any appreciation in the property's value is not taxable as compensation to the service provider upon vesting.

The following examples illustrate the alternatives set forth above. Taxpayer A purchases 25,000 shares of unvested stock from his employer on April 1, 2012 for $25,000 (the fair value of such stock on such date). The stock vests on April 1, 2014, when the stock is worth $40,000, and A sells the stock on April 1, 2015 for $60,000.

| Event | Amount Subject to Tax without 83(b) Election | Amount Subject to Tax with 83(b) Election |
|---|---|---|
| 2012 (purchase)<br>FMV: $25,000 | $0 taxable income<br>(no taxation upon transfer of unvested property) | $0 taxable income<br>($25,000 fair value - $25,000 paid for property) |
| 2014 (vesting)<br>FMV: $40,000 | $15,000 in ordinary income upon vesting<br>($40,000 fair value - $25,000 paid for property) | $0 taxable income<br>(no taxation upon vesting, since taxation was elected upon transfer instead, pursuant to the 83(b) Election). |
| 2015 (sale)<br>Sale Price: $60,000 | $20,000 in capital gain<br>($60,000 amount realized - $25,000 amount paid - $15,000 included as ordinary income) | $35,000 in capital gain<br>($60,000 amount realized - $25,000 paid for property) |

However, if a service provider has made an 83(b) Election and forfeits the property while it is unvested (i.e. because his or her service is terminated and the Company repurchases the unvested property at cost), no deduction shall be allowed for such forfeiture. The following examples illustrate this concept:

Taxpayer A receives, but does not pay for, 25,000 shares of unvested stock from his employer on April 1, 2012, when the value of such shares is $25,000. The shares vest on April 1, 2014, but the taxpayer's service is terminated in 2013, when the property remains unvested and is forfeited to his employer without payment.

| Event | Amount Subject to Tax without 83(b) Election | Amount Subject to Tax with 83(b) Election |
|---|---|---|
| 2012 (receipt without payment)<br>FMV: $25,000 | $0 taxable income<br>(no taxation upon transfer of unvested property) | $25,000 ordinary income<br>($25,000 fair value - $0 paid for property) |
| 2013 (forfeiture without payment) | $0 taxable income | $0 taxable income, and no deduction for taxes paid for 2012 |

**The IRS Suggested Form 83(b) Election**

An 83(b) Election must include the following: (i) a signature of the service provider making the election, (ii) a statement that the election is made under Section 83(b) of the Code, (iii) the service provider's name, address, and taxpayer identification number, (iv) a description of the property with respect to which the election is being made, (v) the date on which the property was transferred and the taxable year in which the election is made, (vi) the nature of the restrictions to which the property is subject, (vii) the fair market value of the property at the time of transfer, (viii) the amount paid for such property, and (ix) a statement that a copy of the election has been furnished to the person for whom the services were performed.

In Revenue Procedure 2012-29, the IRS provided a sample 83(b) Election, as referenced here: [http://www.irs.gov/pub/irs-drop/rp-12-29.pdf]. However, so long as the election contains all of the required information above, it does not need to use the exact format or language of this sample.

**For more information, you may contact any attorney in the Executive Compensation and Employee Benefits Group at Fenwick & West LLP.**


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