TO 83(b) OR NOT TO 83(b)

To 83(b) or not to 83(b), that is the question…that many early employees face whenever they are granted company stock. First, what is an 83(b) election?

83(b) refers to the section of the Internal Revenue Code that lets an employee choose to pay the taxes on stock grants up front, before the shares have vested. At the time of the election, stock grants should be “substantially nonvested.”

If an employee chooses the 83(b) election, she will include in gross income, the excess of the fair market value of the share of stock at the time of transfer over the amount paid for the shares.

Example 1: Options granted and exercisable at current value

An employee is granted an option to purchase 100,000 shares of a private (non-publicly traded) company. The stock options vest annually, 25,000 shares per year, over a four-year period. The option allows the employee to purchase the stock at $1.00/share, which is also the most recent valuation of the company.

The employee is optimistic about the long-term prospects of the company, including a potential initial public offering (IPO) or acquisition at a substantially higher valuation. The employee chooses to exercise the unvested shares of stock and make an 83(b) election. (Note that if the employee does not remain eligible for vesting on the vesting date, the stock is subject to repurchase by the company at the lower of prevailing market value or purchase price.)

The employee exercises the grant and pays the company $100,000 (100,000 shares x $1.00/share). The employee includes in gross income, the excess of fair market value OVER the amount paid. Since the exercise price and the fair market value of the stock are identical, the amount included is $0.00: 100,000 shares x $1.00 market value - $100,000 purchase amount).

The employee has now established a cost basis ($1.00/share) and a holding period start date for the unvested shares for the purpose of achieving long-term capital gains treatment.

If the stock appreciates significantly in the future, the value of making an 83(b) election and establishing long-term capital gains treatment can be significant.

In 2019, the highest marginal Federal income tax rate is 37%, while the highest marginal Federal capital gains tax rate is 20%.

Imagine that 5 years after the grant, the stock value rises from $1.00 to $10.00 per share. The benefit of the 83(b) election is that the lower tax rate applies:

Tax payable with 83(B) election:
100,000 shares x ($10.00 current value - $1.00 cost) x **20% capital gains tax** = $180,000

Tax payable without 83(B) election
100,000 shares x ($10.00 current value - $1.00 cost) x **37% income tax** = $333,000

Therefore, the 83(b) election allows the employee to pay significantly lower taxes on the sale.

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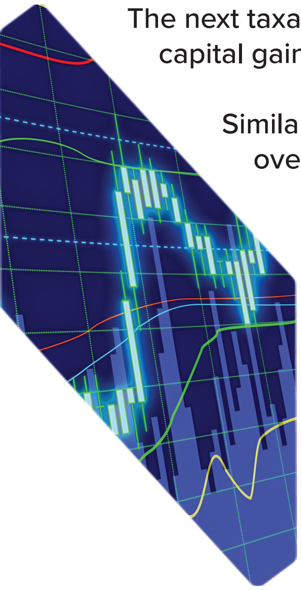
Example 2: Restricted Stock Grants

An employee is granted 100,000 shares of restricted stock, which also vest annually, 25,000 shares per year, over a four-year period. But in this case, the shares have a cost of $0.00 and a valuation of $1.00 at the time of grant. At the time of grant, if the employee makes the 83(b) election, he would include $100,000 in gross income: 100,000 shares x ($1.00 market value - $0.00 cost).



The next taxable event occurs when the employee chooses to sell the vested shares of stock, incurring long-term capital gains.

Similar to example 1, the tax savings can be significant. Let's assume the stock appreciates $2.00/year over the four-year vesting schedule.

Without an 83(b) election, the taxable income events for an RSU would occur when the stock vests. The employee would pay taxes on the stock price multiplied by the number of vested shares.

	Grant Date	Year 1 Vest	Year 2 Vest	Year 3 Vest	Year 4 Vest	4 yr Total
Shares	0	25,000	25,000	25,000	25,000	100,000
Stock Price	$1.00	$3.00	$5.00	$7.00	$9.00	
Taxable Event	$0.00	$75,000	$125,000	$175,000	$225,000	$600,000
Tax (37%)	$0.00	$27,750	$46,250	$64,750	$83,250	$222,000
Net Proceeds	$0.00	$47,250	$78,750	$110,250	$141,750	$378,000
Cumulative Net Proceeds	$0.00	$47,250	$126,000	$236,250	$378,000	
Value of unsold vested stock	$0.00	$0.00	$0.00	$0.00	$0.00	

With an 83(b) election, the income event occurs at the time of the election (grant date) and the employee has the flexibility to sell or continue to hold the stock as it vests without incurring additional taxable income. For the purpose of comparison, the table below assumes that the employee sells the vested stock every year. Again, because the lower long-term capital gain rate applies instead of the higher income tax rate, the employee pays lower total taxes with the 83(b) election.

Value of unsold vested stock	$0.00	$75,000	$250,000	$525,000	$900,000	$0.00
	Grant Date	Year 1 Vest	Year 2 Vest	Year 3 Vest	Year 4 Vest	If sold
Shares	0	25,000	25,000	25,000	25,000	100,000
Stock Price	$1.00	$3.00	$5.00	$7.00	$9.00	
Taxable Event	$100,000	$50,000	$100,000	$150,000	$200,000	$600,000
Tax (37%)	$37,000	$0.00	$0.00	$0.00	$0.00	$37,000
Tax (20%)		$10,000	$20,000	$30,000	$40,000	$100,000
Net Proceeds	-$37,000	$65,000	$105,000	$145,000	$185,000	$463,000
Cumulative Net Proceeds	-$37,000	$28,000	$133,000	$278,000	$463,000	
Value of unsold vested stock	$0.00	$0.00	$0.00	$0.00	$0.00	$0.00

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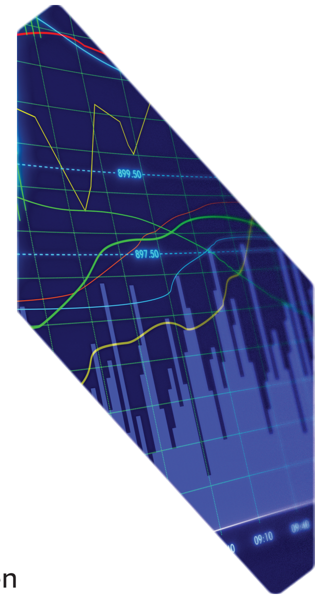
With an 83(b) election, no taxes are incurred on the vesting date, so the employee can decide to hold the shares. If the stock appreciates, the value of that flexibility can become quite significant.

	Grant Date	Year 1 Vest	Year 2 Vest	Year 3 Vest	Year 4 Vest	If sold
Shares	0	25,000	25,000	25,000	25,000	100,000
Stock Price	$1.00	$3.00	$5.00	$7.00	$9.00	
Taxable Event	$100,000	$0.00	$0.00	$0.00	$0.00	$900,000
Tax (37%)	$37,000	$0.00	$0.00	$0.00	$0.00	
Tax (20%)		$0.00	$0.00	$0.00	$0.00	$180,000
Net Proceeds	-$37,000	-$37,000	-$37,000	-$37,000	-$37,000	$763,000
Cumulative Net Proceeds	-$37,000	$28,000	$133,000	$278,000	$463,000	
Value of unsold vested stock	$0.00	$75,000	$250,000	$525,000	$900,000	$0.00



The dual benefits of the lower tax rate and the flexibility to sell more stock at higher prices greatly increase the net proceeds of the option grant.

An 83(b) election is not without risks. By making the 83(b) election, the employee is paying out of pocket up front to purchase the stock and/or pay taxes incurred. If the stock does not significantly appreciate in value or if it falls in value, that upfront expense may not be recouped.

An 83(b) election is best when the difference between the cost and market value is small or when the market value of the stock is expected to rise significantly.

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