Option and Restricted Stock Basics, Part II

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Code Sec. 83(b) Elections

Most tax planning involves a degree of deferral, trying to postpone income tax recognition events and trying to accelerate tax deductions. Therefore, it may sound counter-intuitive to *elect* to include something on your tax return *before* it is required. As we've seen, the restricted property rules generally adopt a wait-and-see approach for restrictions that will eventually lapse.

Nevertheless, you are allowed to *elect* to include the value of restricted property in your income earlier (in effect disregarding the restrictions). The reason this can be a very desirable strategy is that you may wish to include the restricted property in income at a low value, locking in future capital gain treatment.

To elect current taxation, you must file a written Code Sec. 83(b) election with the IRS within 30 days of receiving the restricted property. You must report on the election the value of what you received as compensation. That value might be small or even zero. Then, you must attach another copy of the election to your tax return for that year.

Example. Sallie is offered stock by her employer at $5 per share when the shares are worth $5, but she must remain with the company for two years to be able to sell them. Sallie buys the shares, paying $5 per share. Sallie has already paid fair market value for the shares, so there's no compensatory element here. That means filing a Code Sec. 83(b) election could report *zero* income.

Yet by filing it, Sallie converts what would otherwise be ordinary income into capital gain. When she eventually sells the shares (after the restrictions lapse), she will have insured her gain is long-term capital gain as long as she holds the shares for more than a year. In contrast, if Sallie fails to file a Code Sec. 83(b) election, the stock will be viewed as issued in connection with the performance of services, thus retaining an ordinary income taint.

Note that there is another effect of the Code Sec. 83(b) election. The most obvious impact of the election is in locking in future capital gain treatment. But the election also has the effect of altering the time at which future tax events will occur.

Example. Niles is offered stock in his employer at $2 per share, but must resell the shares back to the company if he leaves its employ within the next seven years. There is no market for the stock, but $2 represents the price the company believes the shares are worth. Niles buys his stock for $2, makes a Code Sec. 83(b) election reporting zero income and holds the shares. Seven years later, the shares are worth $60 per share. Three years after that (a total of 10 years after he bought his stock), he leaves the company and sells his shares for $75 per share. Niles has a $73 gain on each share, all of it taxed as long-term capital gain.

What results if Niles did not make a Code Sec. 83(b) election? Niles bought his stock for $2 as before, but filed no election. As a result, when the resale restrictions on his shares lapse at the end of year 7, Niles has compensation income measured by the difference between the price he paid ($2 per share) and the then fair market value of the stock when the restrictions lapse, $60 per share. That means Niles has $58 of wage income at the end of year 7, even though he hasn't sold his shares, and even though he may not have sufficient cash on hand to pay that tax. When Niles sells the shares three years after that, he has a long-term capital gain of $15 per share.

Double Duty

The restricted property rules and the rules governing stock options often work in tandem. Sometimes you have to deal with both sets of rules. For example, you may be awarded stock options (either ISOs or NSOs) that are restricted and that do not vest until a stated term elapses. The IRS generally waits to impose tax in such a case.

If you must wait two years to see if your options vest, there should be no tax until that vesting date. Then, the stock option rules take over. When the options vest, you would pay tax under either the ISO or NSO rules. It is even possible to make Code Sec. 83(b) elections for compensatory stock options. The idea of any Code Sec. 83(b) election is to trigger a tax event on the election, and to start the clock running on future appreciation which should be taxed as a capital gain.

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