Chapter 14

Vesting and the Section 83b Election

Special rules apply when your client receives shares that are not considered vested for tax purposes.

Upon completion of this chapter you will understand:

- The general rules for vesting
- Determining whether shares are vested
- Application of the rules to restrictions under the securities laws
- The consequences when shares are not vested
- The effect of section 83b election
- Avoiding the *Alves* trap
- The steps in making the section 83b election
- Various problems in making the section 83b election
- The tax treatment of restricted stock units

14.1 General Rules

The tax treatment described in the previous chapter applies when there are no restrictions on stock, or when the restrictions do not prevent the shares from being *vested* at the time your client receives them. Generally, shares are considered vested when your client no longer has to provide additional services to the company to avoid losing some or all of the value of the stock.

> **Example:** Your client receives a stock grant in 2006, but under the terms of the grant she has to give the shares back to the company if her employment terminates before the second anniversary of the grant date. This means the shares are not vested until the two years have elapsed.

If stock is not vested when your client receives it, the tax treatment depends on whether your client makes the *section 83b election* as described later in this chapter. The "normal" treatment, when your client does not make this election, is to treat your client as if she did not receive the shares until the vesting date. In the example above, if your client did not make the section 83b election, she would not report income in the year she received the shares. Two years later, when the stock vests, she would report compensation income based on the value of the stock on the vesting date.

An alternate treatment applies if your client files the section 83b election within 30 days after the transfer. In this case your client is treated as the owner when she receives the shares, even though she has not yet earned the right to keep them. She reports nothing at all on the vesting date. She is not permitted to claim a deduction if she forfeits the shares. Here is a summary of the alternatives:

Receiving Stock that Is Not Vested

Action	Result
Taxpayer does nothing	Taxpayer is treated as receiving stock when it becomes vested
Taxpayer makes section 83b election	Taxpayer is treated as receiving stock at time of transfer; no loss deduction for forfeiture

Transfer. When we refer to the time a *transfer* occurs, we mean the time the company acts to transfer ownership. Often this means the shares go into an escrow or similar arrangement until vesting. This transfer triggers the start of the 30-day period to make the section 83b election even though it does not place the shares directly in the hands of your client.

14.2 Determining Whether Shares Are Vested

Generally, stock is considered vested when *either* of the following conditions is true:

- Your client can transfer the shares to another person (including a partnership, trust or other entity) that takes them free and clear of any restriction, or

- The stock is not subject to a substantial risk of forfeiture.

The definition of *substantial risk of forfeiture* is somewhat technical, but generally it means your client will lose some or all the value of her holdings if she does not remain employed long enough. For example, if she exercised an option to buy stock at $2 per share, a rule allowing the company to repurchase it at the same price could create a substantial risk of forfeiture, because the stock could have a higher value when the company invoked that privilege.

Here are some things that do *not* give create a substantial risk of forfeiture:

- *Decline in value.* The risk that shares will decline in value is not a substantial risk of forfeiture.

- *Forced sale at fair market value.* A condition requiring your client to sell shares back to the company at termination of employment does not create a substantial risk of forfeiture if the company is required to pay fair market value for the shares.

- *Termination for cause.* A forfeiture that occurs only if your client is terminated for cause or for committing a crime does not create a substantial risk of forfeiture.

The first item above sometimes causes heartburn. Your client may hold stock that is vested for tax purposes—and therefore taxable—even though the shares cannot be sold and your client can do nothing while their value declines.

14.3 Restrictions Relating to Securities Laws

Chapter 6 describes various ways the securities laws may prevent your client from selling stock. Sales may be limited or forbidden during a lockup period, a blackout period, or a period in which Rule 144 applies. By themselves, these restrictions do not prevent shares from being vested because they do not create a substantial risk of forfeiture.

The tax law includes a special rule saying shares are not vested during the period they are subject to the short-swing rules of Section 16 of the Securities Exchange Act of 1934. This rule is rarely invoked, however. The regulations under Section 16 provide special exemptions for stock acquired directly from the company. In addition, these regulations provide that stock acquired by exercising a stock option is considered to have been acquired when the option was granted. As a result, stock received as equity compensation is rarely subject to the short-swing rules.

14.4 Consequences When Shares Are Not Vested

As indicated earlier, if shares are not vested at the time of the transfer, and your client does not make the section 83b election, your client is not treated as the owner of those shares until they vest. This rule has several consequences, some good and some bad.

To begin with, your client does not have to pay tax on income he may forfeit later. The tax rules for shares that are not vested provide a level of comfort that your client will not have an adverse tax result stemming from a forfeiture.

Second, the rule delays the reporting of income until the shares vest. Often this means there will be no tax liability until a later year. Other things being equal, tax deferral is an advantage, although this benefit can backfire if your client is in a higher tax bracket in the year the stock vests.

Third, the rule changes the valuation date. Instead of reporting income based on the value of the shares when he receives them, your client will report income based on the value on the vesting date. The result could be more income or less, depending on how the stock performs during the vesting period. We cannot say in advance whether this aspect of the rules will turn out to be an advantage for your client, but it is worth noting that it eliminates the risk of a capital loss whipsaw caused by the requirement to hold shares until they vest.

> **Example:** Your client received shares with a value of \$50,000 but their value on the vesting date was \$30,000. If your client had to report income based on the value at the time he received the shares, he would have \$50,000 of compensation income. He would also have a \$20,000 capital loss upon sale of the shares, but the loss would be subject to the \$3,000 capital loss limitation. Under the actual rule, your client reports \$30,000 of income based on the value of the stock on the vesting date, avoiding the capital loss whipsaw.

Fourth, the rule changes the start of the holding period of the shares for purposes of determining whether gain or loss from a sale of the shares is short-term or long-term. Your client is not considered the owner during the vesting period, so the shares will not produce long-term capital gain or loss until they have been held more than a year *after* the vesting date.

And fifth, the rule changes the tax treatment of dividends paid on the shares during the vesting period. For tax purposes, these payments are considered compensation income, not dividends, because your client is not considered the owner of the shares prior to vesting. That means these dividends are not eligible for the favorable rates that apply to qualified dividend income.

14.5 Effect of Section 83b Election

When your client receives shares that are not vested, he has the opportunity to make an election that changes the tax consequences described in the previous section. *Within 30 days after the transfer*, he can make the section 83b election. If he does, he will be treated as if the shares were vested at the time he received them. In other words, he is treated as the owner of the shares during the vesting period:

- Your client reports income at the time of the transfer, even though he has not yet earned the right to retain the shares.
- Your client does not defer income to a later year.
- The amount of income reported is based on the value of the stock on the date of the transfer, not the vesting date.
- Your client's holding period for the shares, used to determine whether subsequent gains or losses are short-term or long-term, begins on the date of the transfer, so it includes the vesting period.
- Dividends paid during the vesting period are eligible for the favorable rates that apply to qualified dividend income.

Consequences at vesting date. If your client makes the section 83b election, he has no tax consequences whatever on the vesting date. Vesting may be economically important to your client as it secures his right to keep the shares, but it has no tax significance in this situation.

Consequences of forfeiture. The section 83b election causes the shares to be treated as vested for tax purposes, but does not eliminate the risk that your client will in fact forfeit the shares. It seems logical that in this situation your client would get a deduction to offset the income reported because of the section 83b election, but the tax law says otherwise: "If such property is subsequently forfeited, no deduction shall be allowed in respect of such forfeiture." Your client gets no ordinary deduction, and also no capital loss deduction. He gets no tax benefit whatever to offset the income reported with the section 83b election.

14.6 The Alves *Trap*

The previous sections make it clear that there are tradeoffs in making the section 83b election. Your client can come out ahead making the election if she does not forfeit the shares and they go up in value during the vesting period. On the other hand, the election can be a big mistake if your client forfeits the shares or they decline in value.

There is one situation, however, where the election can produce advantages with no downside. If your client pays full value for the shares that will vest later, she can make the election without paying any tax. There is nothing to lose by making the election because the taxable amount is zero for someone who pays full value. If your client fails to make the election, however, she will have compensation income on the vesting date to the extent the shares rose in value during the vesting period.

It may seem illogical that your client should be required to make the section 83b election in this situation, but a court ruling in the *Alves* case makes the election necessary. The court said a taxpayer who fails to make the election has to pay tax as of the vesting date even if he paid the full value when acquiring the shares.

> This issue is most likely to come up in connection with an *early exercise stock option plan*, where participants can exercise options before the stock is vested. See Chapters 18 and 30 for discussion.

14.7 Making the Section 83b Election

The most important thing to keep in mind about making the section 83b election is that *it must be made within 30 days after the transfer.* For practical purposes this deadline is absolute; if your client misses the deadline you should not expect the IRS to grant an extension unless the extenuating circumstances are extraordinarily compelling. The 30-day period is a simple count of calendar days including holidays and weekends.

Preparing the election. Most employers that offer compensation for which the section 83b election is appropriate provide a suitable form for this purpose. If no form is provided, you or your client can make up a section 83b election. The Internal Revenue Service provided a suggested format for the election in Rev. Proc. 2012-29, which is easily found by Internet search.

Filing the election. The regulations say the election should be sent to the IRS office where your client files his tax return. It is highly recommended to send the election by certified mail, retaining a stamped receipt with a legible date. If there is ever any question, the stamped receipt should stand up as adequate evidence that the election was timely filed. Some tax practitioners seek additional evidence by using the return receipt option for certified mail, so they will receive a postcard confirming that the IRS actually received the election.

> Some tax professionals go even one step further, enclosing an extra copy of the election, a stamped, self-addressed envelope, and a cover letter asking the IRS to stamp one copy of the election as "received," indicating the date, and return it to the taxpayer in the enclosed envelope. The IRS usually complies with this request but there is no reason for panic if they fail to do so.

As indicated earlier, your client must provide a copy of the election to the company. In addition, he must attach a copy of the election to his tax return for that year.

14.8 Problems in Making the Section 83b Election

Problems of one kind or another are not uncommon in dealing with the section 83b election. Here are the ones you are most likely to encounter.

Missing the 30-day deadline. As noted earlier, relief is unlikely to be available if your client misses the 30-day deadline. We can imagine circumstances that might be compelling enough to persuade the IRS to grant an extension, but unless your client was physically unable to file the election or cause someone to file it for him, it is virtually certain he will simply have to live with the consequences of failing to make the election.

Failing to obtain documentation. Your client may file the election without using certified mail, lose the receipt, or otherwise fail to obtain documentation that he filed the election. As long as he actually filed the election with the IRS, there will rarely be a problem. It is highly desirable to have documentation of the election, but failing to obtain such documentation does not invalidate the election if the IRS actually received it.

Failing to attach a copy. The regulation requires your client to attach a copy of the election to his tax return for the year he received the property. Inevitably, some people forget to do this. Although this is a requirement of the regulation, it seems unlikely that the IRS would take the position the election is invalidated in this situation. The primary thrust of the rules regarding this election is to have the election permanently in place (or permanently forgone) as of the end of the 30-day period.

Incorrect or missing information. The consequences of missing or incorrect information on a section 83b election may depend on the specific circumstances. If the error is clearly clerical in nature, it should not invalidate the election. Where the situation indicates the taxpayer could obtain an improper advantage by supplying some of the information after the 30-day period has expired, the IRS may be inclined to challenge the filing.

Unwanted election. Some people make the election and realize afterward that it was a bad idea. They may have simply assumed the election was something they were supposed to do, and found out later that it is a choice that can be good or bad depending on circumstances. The IRS generally grants a request to revoke the election if the request is made is made within the time limit for making the election. By contrast, if your client does not make this request within 30 days of receiving the stock, it is highly *unlikely* the IRS will provide relief. The regulation says relief is available only if the taxpayer can show he was under a mistake of fact as to the underlying transaction. The most common reasons for wishing to undo a section 83b election—a misunderstanding of the tax consequences or a mistaken assessment of the prospects for continued employment or subsequent change in the value of the stock—will not qualify as a mistake of fact for this purpose. The requirement is so strict that we are aware of only one case in which a taxpayer obtained relief after the 30-day period elapsed.

14.9 Restricted Stock Units

Restricted stock units are similar to restricted stock grants in their overall consequences. The difference is based on when the shares are transferred. In the case of restricted stock grants, the company transfers shares at the time of the grant, subject to a possible forfeiture in the future. The shares may be held in escrow, preventing your client from gaining direct access to them, but your client is in many respects the owner of the shares even before they vest. For example, your client can benefit from dividends paid on shares held in escrow, although the dividend will be treated as compensation income (not qualified dividend income) before the shares are vested, unless your client filed the section 83b election.

In the case of restricted stock *units*, the company does not transfer shares at the time of the award. Instead, the company waits to see if your client continues working for the company long enough to receive the shares, and transfers the shares at that time. Many companies pay an additional amount to make up for dividends paid during the vesting period, but this is not a general requirement for a plan providing restricted stock units. If a company pays dividends without a makeup provision, an RSU will provide a smaller economic benefit than restricted stock.

Also, because there is no transfer of shares at the time the company grants the restricted stock unit, your client cannot file a section 83b election to convert future appreciation of the shares to capital gain. As a result, the tax consequences of restricted stock units are fairly simple:

- Your client has nothing to report at the time the restricted stock unit is awarded, and cannot file a section 83b election.

- When the company transfers the stock, the shares are vested, and your client is treated the same as if the company made an unrestricted stock grant at that time. The amount of compensation income is equal to the value of the shares at the time of the transfer, and your client's basis for the shares is equal to the amount of compensation income reported.

Chapter Summary

1. Unless your client files the section 83b election, he is treated as receiving stock on the vesting date.
2. Shares are vested when your client can transfer them free of restrictions, or when the stock is not subject to a substantial risk of forfeiture. A risk that the shares will decline in value is not a risk of forfeiture.
3. Except for the short-swing rule under Section 16 of the Exchange Act, rules under the securities laws that restrict sales of stock do not prevent shares from being vested for tax purposes.
4. If shares are not vested and your client does not make the section 83b election, your client is treated as if he received the shares on the vesting date. Dividends received prior to vesting are treated as compensation income.
5. If your client files the section 83b election, she is treated as receiving the shares on the date of the original transfer. Dividends may qualify for favorable tax rates, even prior to vesting. Your client receives no deduction in the event of a forfeiture.
6. If your client pays full value for shares that are not vested, the section 83b election has no cost and may provide a tax benefit if the share value increases during the vesting period.
7. The section 83b election must be made within 30 days after the stock is transferred.
8. Some possible problems in making the election are not significant, but someone who misses the 30-day deadline should not expect relief.

9. The section 83b election is not available for restricted stock units because the stock is not transferred until it is vested.