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Start Ups and Emerging Companies – 101: IRC 83(b)

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Stock issuances are generally taxed when the stock is issued to the stockholder (i.e. at grant). If the consideration exchanged for the stock has a value that is less than the value of the stock being issued, the stockholder is imputed income for the difference. The value of the stock is measured by valuing the company as a whole and multiplying that value (the value of the entire company) by the percentage of the company represented by the stock subject to the issuance. In essence, if the stockholder paid less than the value of the stock, the stockholder receives stock as a gift from the company, which is income to the stockholder under the tax law.

For example, if the company is worth $100,000, and the founder pays $1,000 for 50% of the company, the founder will have a $49,000 taxable gain to report to the IRS. This is because he only paid $1,000 for $50,000 worth of stock.

Because of these tax implications, the founder will want to incorporate early when the value of the company is low. If incorporation is delayed until after the company has recognizable tangible value, the founder will either pay more for the shares, or will pay a hefty income tax obligation if the founder does not pay market value for the shares. This can be avoided if the stock is purchased when the company has little or no value, but has a significant upside in the future.

For example, had the founder in the above example incorporated the company when the business was only worth $2,000, he would have had no taxable gain on the purchase of the shares, because he paid $1,000 for $1,000 worth of stock. His tax obligations will arise if and when he sells the shares for a profit in the future. Any future gain in value would be considered by the IRS to be capital gain when he sells the stock.

This is where IRC 83(b) comes into play. IRC 83(b) generally provides for different (and most often less favorable) taxation for Restricted Stock. If the stock is Restricted Stock, the stock is taxed not at grant (as explained above), but rather, as of the date the stock vests (i.e. becomes free of the restrictions). This can be problematic.

Example

? X purchases 20% of XYZ Co for $100

? Later, when X's shares "vest", the stock is worth $2M.

? X will have $2M in ordinary income to report when the stock "vests"

In the above example, X will have to pay ordinary income tax on $2M of income when the stock "vests", **even though he did not sell the stock** at that time.

GOTCHA: What if you don't have the money to pay the tax, OR you are able to muster up the tax payment and pay tax on $2M, and the stock value drops before you sell it?

GOTCHA: What if you are forced to sell your stock prematurely to pay the tax, OR worse yet, you need to sell the stock to pay the tax and can't find a buyer (or are unable to sell the stock due to a lock up on the stock)?

Conversely, had the stock not been Restricted Stock, the tax (if any) would have been payable upon the grant, and there would be no tax obligation **until he sold the stock**. Moreover, the tax that would ultimately be paid on the sale of the stock would be capital gain, which is beneficial if capital gain is taxed at a lower tax rate than ordinary income.

Fortunately, IRC 83(b) permits the taxpayer to make an election to pay tax on Restricted Stock at the time of grant (as if it were unrestricted) in order to avoid the hardship that may occur if an IRC 83(b) election were not made. The election must be made within 30 days of the grant, and may not be revoked once it is made. With an IRC 83(b) election in place, any appreciation on the stock is taxed as capital gain (instead of ordinary income) and is paid when the stock is sold (when funds are then available to pay the tax), which is favorable in most situations.

Bottom line, if you are purchasing Restricted Stock, it is critical that the stockholder consider the implications of IRC 83(b) and make a decision whether or not to make an IRC 83(b) election within 30 days of the grant. As a rule of thumb, an election is generally a good idea if the stock value is increasing, and forfeiture of the stock under the restriction is unlikely. Conversely, it is a bad idea to make an IRC 83(b) election if the stock is not increasing in value, because by making an IRC 83(b) election, you would have accelerated your tax obligation without a material benefit. Likewise, if the stock is ultimately forfeited, you would have paid tax on the stock under the IRC 83(b) election that you would have not ultimately received.

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