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Founder Traps: How Failing to Make an 83(b) Election Can Kill You (Almost)

by Michael J. Gorback

When startup founders get together to form a new company, one of the first steps after actually incorporating the entity is to issue the founders their initial equity in the company. This is commonly referred to as "founders stock." Most initial cap tables target the issuance to founders of around 8 million shares, so that combined with a 2 million share option pool, the initial "fully diluted" capitalization is 10 million shares. That's not a rule, but a common practice for a number of reasons that aren't important for purposes of this article. What's important is understanding that if two founders divide 8 million shares between them, they are each buying 4 million shares up front. Four founders would each be buying 2 million shares, and so on. How do the founders get those shares? They buy them! But for how much? Well, usually not very much. Most new companies incorporate with a "par value" of around $0.00001 per share, and that par value is often used as the purchase price for founder shares based on the premise that the company isn't worth very much, if anything, so shortly after incorporation. A founder buying 4 million shares would therefore pay the company only $40 for the full 4 million shares. Imagine the company going public seven years later with a price of $17 per share. Those 4 million shares would be worth $68 million! Not a bad deal after having paid only $40 for them.

Keep in mind though that most founders also buy their shares subject to vesting (sometimes called "reverse vesting," since the "vesting" here really refers to a right of the company to repurchase the shares if the founder leaves, with that right of repurchase lapsing over time). There are many reasons why founders stock is typically made subject to vesting over several years, but for purposes of this article the important thing is how that vesting schedule can create some potentially devastating tax consequences for founders. The way U.S. tax rules typically work for property that is subject to vesting is as follows: when a chunk of the property vests, we look at its value at that time, then subtract how much was originally paid for that chunk, with the difference equating to ordinary, taxable income. Let's look at how that might play out for a founder that paid $40 for his or her 4 million shares.

Let's say that the shares are set to vest 25% after 1 year, 25% after 2 years, 25% after 3 years, and the final 25% after 4 years. Let's further say that during the first year, the company made significant headway on its product, generated some “buzz,” and maybe even raised a small seed round that valued the company at $5 million post-money, such that when the founder’s first tranche of 1 million shares vests at the end of year 1, those shares are valued at $0.35 per share, or a total of $350,000. Remember what the founder paid for that same 1 million shares on day 1? $0.00001 per share, or $10. Yep, ten bucks. So guess what the IRS does at the end of year 1? The IRS says that the founder has $349,990 of taxable income as a result of nothing more than the founder shares having vested. Then let’s say that the company does even better in year 2, so that when the second tranche of shares vests at the end of year 2, those shares are valued at $1.3M. See what’s coming? Right- subtract another $10 for the initial purchase price and you’ve got $1,299,990 of taxable income. And so on. For a company that might not even be bringing in any revenue yet, let alone turning a profit, let alone distributing its profit to its founders via dividends (which is extremely rare anyway), to be faced with the requirement to pay taxes on seven figures of “income” can be devastating.

But all is not lost. In fact, Section 83(b) of the tax code makes it extremely easy to avoid such a result. What section 83(b) says is that, if within 30 days after receiving property subject to vesting, the property recipient files a one or two page form with the IRS electing to treat the property as fully vested, then the IRS will look only to what the entire property was worth on the date it was purchased, and what the purchaser paid for the property, and apply ordinary income tax only to that difference, if any. Because founders most often pay for their founder shares an amount equal to what they are worth, which is typically tied to the par value, there is usually no difference between the fair value and the purchase price, and therefore no income tax obligation as a result of vesting, no matter how much the shares are worth when they vest years down the road. Note that the purchase price will establish a basis in the shares for purposes of long term capital gains taxes, but those will only apply when the stock is sold, presumably for a nice profit, not simply because the shares vested. Remember that the 30 day deadline to file an 83(b) election is a strict one. Failure to timely file the election can be a killer, so mind your 83(b)!

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