

Stock Options and the 83b Election

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The job looks great, the commute is tolerable and you've negotiated a decent salary and some stock options. But where do you stand on being allowed an 83b election?

Section 83(b) of the Internal Revenue Code allows taxpayers to elect to pay the tax upon the exercise of stock options in which they are not yet vested. This is an exception to the principle is that you aren't liable for the tax until you get the goods.

The risk with an 83b election is that the exercise cost and any tax paid is lost if you forfeit the stock or if the stock becomes valueless. (You can claim the exercise cost as a capital loss.) The money at risk equals the exercise price times the number of shares. Since this is a relatively small sum when the exercise price is pennies per share, an 83b election is an important consideration with a start-up company.

The primary reason that you might decide to lay out a small amount of money for stock that you will not own for another year or two is to avoid having to come up with serious money to pay the tax at the time of a later exercise. There may be a reduction in the cumulative tax liability but the primary benefit is delay. Delaying the tax also means that you will have less money on the table should the stock price move south and an early exercise might make it possible to sell the stock sooner while still paying the lower, long term tax rates.

The tax liability when an option is exercised is based on the difference between the exercise price and the fair market value of the stock. The exercise price is be the same whether the option is exercised now or a couple of years from now. Right now, your new company is only an idea shared by a dozen people and the exercise price, low though it might seem, could exceed the fair market value. Thus any gain on exercise when the stock value is low will be small and the tax of this gain will be small. I assumed no incremental tax for the 83b election scenarios in the accompanying table.

In a couple of years when your options vest, your company might be negotiating a \$20/share IPO. Although the fair market value is not yet \$20/share, it is certainly worth more than the exercise price and, if you exercise now, your gain on exercise will be dollars per share. This gain is taxed as ordinary income (non qualified options) or according to the AMT rules (incentive stock options.) There is also FICA tax to pay when non qualified options are exercised.

If you exercise the options when the stock's fair market value is \$10/share, your costs will be \$30,000 - \$50,000 whereas you only had to put up a thousand dollars under the 83b election, early exercise scenario.

If you hold the stock for at least two years from the date of grant and at least one year from the date of exercise, your gain when the stock is sold will qualify for long term capital gain rates. The gain on sale is measured from your tax paid investment. If you exercised when the fair market value was low, the gain will be large because you have only a small investment. If you exercised when the fair market value was \$10/share, there is a smaller gain on sale.

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Cumulative costs and after tax gains are similar for all scenarios, over a broad range of base income. The primary benefit from exercising when the fair market value is low is that you can delay paying the tax until you sell the stock. The incentive for early exercise is somewhat larger with non qualified options.

Base Taxable Income	\$40,000 (Single)			\$250,000 (MFJ)			
	Type	83b	NQual	ISO	83b	NQual	ISO
FMV @ Exercise	10¢/share	\$10/share	\$10/share	10¢/share	\$10/share	\$10/share	
Exercise							
Exercise Cost	\$ 1,000	\$ 1,000	\$ 1,000	\$ 1,000	\$ 1,000	\$ 1,000	
Federal & CA Tax		37,426	28,319		45,535	29,369	
FICA		3,000			1,436		
SubTotal, costs	1,000	41,426	29,319	1,000	47,971	30,369	
Sell @ \$20/share							
Federal & CA Tax	55,433	\$27,574	56,763	54,507	\$27,745	\$55,661	
AMT <AMT credit>	7,216		<25,081>	2,242		<21,919>	
SubTotal, costs	62,649	\$27,574	31,682	56,749	\$27,745	\$33,742	
Sale Proceeds	200,000	200,000	200,000	\$200,000	\$200,000	\$200,000	
Net Gain, after-tax	\$ 136,351	\$ 131,000	\$ 138,999	\$ 142,251	\$ 124,284	\$ 135,889	

Caveats. These scenarios assume 1999 tax rules. They are simplified; state tax was the only itemized deduction for example, and they have not been optimized. The AMT could probably be reduced and AMT credit recovery could probably be improved by selling and/or paying state tax over two tax years. Speak to a tax professional if you feel that you would benefit from a personalized forecast.

To make the election, you send a simple statement to the IRS indicating that you are making the election under Section 83(b) within thirty days of exercising the options. You will attach a copy of this statement to your federal and California income tax returns. The election is not valid unless it is made within thirty days of exercise and the election is nearly impossible to revoke.

IRS Regulation 1.83-2(e) says that your statement needs to include the following:

- Your name, address, Social Security number and signature;
- A description of the options being exercised;
- The date(s) on which the options were exercised and the tax year(s) for which the election is being made;
- The nature of the restriction or restrictions to which the stock is subject;
- The fair market value at the time of exercise;
- The exercise cost; and
- A statement that a copy of the election has been furnished to your employer.

You cannot make the election without the cooperation of your employer since they must be willing to lift their restriction prohibiting you from exercising the options before they vest. One approach is to enter into a contract whereby you get to exercise the options immediately in exchange for an agreement to sell the stock back to your employer at the exercise price if you leave the firm before the original vesting date.

Because you need your employer's cooperation, be sure to resolve whether you will be allowed to exercise unvested options before you accept the assignment. Good luck!