

## **§83 REVISITED: BASIC CONSIDERATIONS & AN EXAMPLE**

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Timing and character of income are powerful decision drivers in the tax world, and perhaps nowhere is this better illustrated than in the context of restricted stock, Section 83 and the election thereunder. Section 83 governs the tax treatment of transfers of property in connection with the performance of services. As a starting point, Section 83 tells us that a service provider (employee) will recognize gross income equal to the amount that the fair market value of the property transferred exceeds the amount, if any, paid for the property. The timing of the income inclusion is delayed until the property is transferable or no longer subject to a substantial risk of forfeiture. The income is compensation income and therefore ordinary in character. From this default, Section 83(b) gives the employee the ability to make an election to accelerate the ordinary income event to the time of grant, as opposed to waiting until the property vests, that is to say, waiting until the property is transferable or no longer subject to a substantial risk of forfeiture. Although the income inclusion is accelerated under the election, any future appreciation in the restricted property, usually stock, will be taxed at traditionally favorable capital gains rates.

The decision to make (or not to make) the election under Section 83 affects both employers and the employed. The basic economic drivers for the employer are derived from the corresponding deduction for compensation expense that is generated when the employee includes an amount in income. Although the timing of the deduction in this case is often in the hands of the employee, some employers mandate that the employee make, or not make as the case may be, the election. Employers that expect dramatic growth in stock values would generally be well advised to require (at the employee's expense) that the employee not make the election. This is true because the employer derives more benefit from a large deduction several years out than from a small deduction now. In essence, the time value of money associated with a small deduction taken at grant will not outweigh the advantages of a large future deduction taken when the stock vests. As would be expected then, in the instance where modest stock growth is forecast, the present value of the deduction is generally more valuable to the employer than the future deduction.

For the employee, the inherent advantage of making the election under Section 83(b) is that appreciation of the stock will be taxed as capital gain and not ordinary income on subsequent disposition. It is the current spread in these tax rates that flies in the face of deferral. Also beneficial to the employee is that the election accelerates the capital gain holding period to the date of the grant, rather than the vesting date, ensuring that the capital gain will be further preferenced as long-term capital gain. However, depending on what the employee paid for the stock at grant, depreciation in the stock occurring between the date of grant and the vesting date could result in the inclusion of a larger amount in ordinary income than would have been realized in the absence of the election.

The balance of the employee's decision is, on a basic level, most often driven by the spread between the fair market value of the stock and the amount paid, if any, at grant. In the easy case, perhaps an IPO with stock that has little or no value at the time of grant, the employee is generally well advised to make the election. Although the tax is accelerated, the resulting



Section 83 is but one example of how the Internal Revenue Code drives decisions made by taxpayers, and the example above is but one reminder of the many possible scenarios that taxpayers must contemplate when trying to drive those decisions where they want to go.

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