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Why Founders and Employees of Emerging Businesses Need to Understand 83(b) Elections

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Entrepreneurs founding startup companies are often unaware of a potentially significant tax liability that can rear its ugly head with respect to stock issued to founders and employees. Emerging business founders often acquire their stock through a restricted stock purchase arrangement providing for time-based vesting. However, this common structure may set the stage for an unwelcome and unexpected tax bill down the road. An 83(b) election can, in the right circumstances, provide a relatively simple and effective way to avoid the tax.

An emerging business will commonly issue equity to its founders and early employees in the form of restricted stock subject to a vesting schedule that incentivizes those individuals to remain with the company during its critical early years. Unless and until it vests, restricted stock is normally subject to forfeiture to the company if the founder or employee leaves the business. For example, under an ordinary four-year graded vesting schedule, one-quarter of the stock would vest and therefore cease to be subject to the risk of forfeiture after the first year, and the remaining restricted stock would vest pro rata on a monthly, quarterly, or annual basis over the next three years.

The potential tax problem arises because the IRS does not consider restricted stock to be actually received by the founder or employee until it is no longer subject to a substantial risk of forfeiture. The stock's holder is therefore deemed for tax purposes to acquire the stock in installments over time as it vests, rather than all at once when originally issued. As restricted stock vests according to the agreed vesting schedule, the founder or employee would be subject to taxation based on the value of the stock at the time of vesting, and this taxation will be based on the recipient's ordinary income tax rate and the value of the stock on the vesting date. If the emerging business is successful and performs well, resulting in the company's value increasing year-over-year, the holder of the restricted stock may become subject to an increasing tax liability as his or her equity vests. And there is no corresponding tax relief in the event that the value of the business subsequently declines. In addition, the holding period for determining the future capital gain or loss treatment upon the disposition of the stock will not start to run until the shares vest.

For an example of how the tax would apply in the real world, assume that a startup company founder were to acquire 100,000 shares of restricted stock valued at $0.01 per share at the time of issuance, subject to a four-year graded vesting schedule. One year later, the company has substantially increased in value so that the founder's restricted stock is then worth $5.00 per share.

Under the vesting schedule, one quarter of the founder's stock would vest, and those 25,000 newly-vested shares would have a total fair market value of $125,000. The founder would have to include that $125,000 of value as ordinary taxable income for the year in which the shares vest. One can easily imagine a similar scenario leading to an unexpected and painful tax burden.

An 83(b) election can provide a solution. 83(b) refers to a section of the Internal Revenue Code that allows a person acquiring restricted stock to choose to be taxed upfront based on the value of that stock at the time of issuance, notwithstanding that the shares are unvested. The holder of the stock making such an election is taxed on the difference between the fair market value of the equity at the time of issuance and the price, if any, the holder paid for the equity. In the case of a founding employees, the purchase price and value of the restricted stock is typically a very low or nominal amount because the startup has little value at the time of original issuance. If the purchase price for the stock equals the stock's fair market value, then no taxable income would result from the transaction. In addition, since the value of the shares will have been included in the holder's ordinary income, the holding period for capital gain or loss purposes will begin to run as of the date of issuance.

A person acquiring restricted stock can make an 83(b) election by filing a relatively simple form with the IRS within thirty days after issuance of the equity. However, anyone considering making an 83(b) election with regard to the acquisition of equity should consult his or her tax advisor before doing so. The election is irrevocable once made, and may not make sense for every situation. In most cases, however, the ability to make an 83(b) election can offer an emerging business founder a welcome relief from a possible future tax headache.

For more information on the matters discussed in this *Locke Lord QuickStudy,* please contact the authors:

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