



To 83(b) or Not to 83(b)-That is the Question
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83(b) Elections and Their Consequences

This week the Tax Court came down with its decision in the case of *Kadillak v. Commissioner*, (127 TC No. 13) where a taxpayer lived to regret making a election under §83(b) and then attempted (unsuccessfully) to convince the court that the election wasn't really available to him in the first place, so he shouldn't be stuck with the adverse tax consequences that occurred later when he had to forfeit the shares in question.

The case offers a chance to discuss §83(b) elections and their use, as well as the bad tax results that occur when the future does not work out as the taxpayer had anticipated when the election was made.

Property Given As Compensation—With Strings Attached

Section 83 of the IRC governs the tax result when a service provider is granted property (most often an ownership interest) that is subject to a substantial risk of forfeiture which will eventually lapse. Most often we see this occur, as it did in the *Kadillac* case in question, when the employee remains an employee for a period of time. Quite often there is a gradual release of the property granted—so each year the employee remains employed he/she vests in an additional portion of the property granted.

In general, §83(a) provides that the employee becomes taxable on the property at the earlier of the date the property becomes transferable or no longer is subject to a substantial risk of forfeiture. The amount that is taxable is the difference between the value of the property at that date and the amount the employee paid (if anything) to acquire the property:

(a) General rule

If, in connection with the performance of services, property is transferred to any person other than the person for whom such services are performed, the excess of--

(1) the fair market value of such property (determined without regard to any restriction other than a restriction which by its terms will never lapse) at the first time the rights of the person having the beneficial interest in such property are transferable or are not subject to a substantial risk of forfeiture, whichever occurs earlier, over

(2) the amount (if any) paid for such property, shall be included in the gross income of the person who performed such services in the first taxable year in which the rights of the person having the beneficial interest in such property are transferable or are not subject to a substantial risk of forfeiture, whichever is applicable. The preceding sentence shall not apply if such person sells or otherwise disposes of such property in an arm's length transaction before his rights in such property become transferable or not subject to a substantial risk of forfeiture.

Of course, the timing may prove to be a problem if the asset in question is appreciating in value prior to becoming taxable. Generally, if an employee sees stock compensation as something of value that will keep him/her in place, it's because they believe that value will increase over time. Since the amount taxable will be ordinary income related to the provision of services, the increase in value may substantially raise the tax that is due.

The 83(b) Fix

To address this problem, the Internal Revenue Code provides a solution—the service recipient can, at his/her election, decide to ignore the restrictions. This is known as the “83(b) Election” and is found (not surprisingly) in §83(b). That provides:

(b) Election to include in gross income in year of transfer

(1) In general

Any person who performs services in connection with which property is transferred to any person may elect to include in his gross income for the taxable year in which such property is transferred, the excess of--

(A) the fair market value of such property at the time of transfer (determined without regard to any restriction other than a restriction which by its terms will never lapse), over

(B) the amount (if any) paid for such property.

If such election is made, subsection (a) shall not apply with respect to the transfer of such property, and if such property is subsequently forfeited, no deduction shall be allowed in respect of such forfeiture.

(2) Election

An election under paragraph (1) with respect to any transfer of property shall be made in such manner as the Secretary prescribes and shall be made not later than 30 days after the date of such transfer. Such election may not be revoked except with the consent of the Secretary.

As noted, the election must be made within 30 days of the transfer of the property, and must be made in accordance with Regulation §1.83-2. The contents of the election are as follows:

(e) Content of statement.

The statement shall be signed by the person making the election and shall indicate that it is being made under section 83(b) of the Code, and shall contain the following information:

(1) The name, address and taxpayer identification number of the taxpayer;

(2) A description of each property with respect to which the election is being made;

(3) The date or dates on which the property is transferred and the taxable year (for example, "calendar year 1970" or "fiscal year ending May 31, 1970") for which such election was made;

(4) The nature of the restriction or restrictions to which the property is subject;

- (5) The fair market value at the time of transfer (determined without regard to any lapse restriction, as defined in section 1.83-3(i)) of each property with respect to which the election is being made;
- (6) The amount (if any) paid for such property; and
- (7) With respect to elections made after July 21, 1978, a statement to the effect that copies have been furnished to other persons as provided in paragraph (d) of this section.

The taxpayer must send one copy to the IRS Service Center at which he/she files his/her return, and as well must attach one copy to the tax return for the year in question (Reg. §1.83-2(c)). The taxpayer must also give one copy of the election to the service recipient (Reg. §1.83-2(d)).

Note that when you look at §83(b)(1)'s final clause, you do find one major "gotcha" in the §83(b) election scheme. If the property does end up being forfeited by the service recipient, no deduction is allowed for that forfeiture. So that means the amount would have been included in income (and subject to taxation) even though the individual actually never was able to possess the property—and neither does he/she get a loss on this "disposition" of the property (logically because they never really owned it).

The election can only be revoked with the permission of the IRS, and Reg. §1.83-2(f) makes it clear that it will be granted only in very limited circumstances regarding a mistake of fact—and then only if the request for revoking the election comes within a very narrow time frame after the service recipient becomes aware of the mistake of fact.

These restrictions exist because, obviously, over time it will become clear if it "made sense" to make the §83(b) election or not—and Congress did not want to allow service providers to be able to do after the fact planning. The service provider who wants to chance an §83(b) election has to understand the risk that he/she is taking.

Kadillak Case

With this background, we turn to the case of Anthony Kadillak. Mr. Kadillak was granted incentive stock options by his employer, Ariba Technologies, Inc. ISOs, when exercised, do not create taxable income to the employee for regular tax purposes, but do generate an AMT adjustment that is computed under the standard §83 rules as they apply to options.

Anthony exercised his options at a time when he would not be fully vested in the shares, meaning that if he left employment for any reason prior to full vesting, some of his shares would be surrendered back to the employer. As was noted above, the general rule in that case is that the amount of value would be measured as the shares vested.

Ariba Technologies, Inc. shares had greatly appreciated during the period from when the options were granted in 1998 until Mr. Kadillak exercised them in April 2000—and they

would not fully vest until February 2002. The shares that were exercised were worth \$3,264,000 on the date he exercised them, though his cost was only \$3,002.

Anthony apparently believed that the stock price was going to continue to escalate in the future, so he timely filed an election under §83(b), thus triggering the current inclusion of the spread in his AMT income, but “protecting” him from future increases in value as he vested in the shares.

Forfeiting the Shares

Unfortunately for Anthony, his employment with Ariba was terminated in May of 2001, before a number of the shares had vested. Ariba exercised its option to repurchase the shares for a price of \$642. Anthony then sold all of his vested shares to a third party in 2002.

My Election Wasn't Valid

Anthony would claim, after consultation with a tax attorney, that in reality he was not eligible to make an §83(b) election and thus he should be able to claim a refund on the tax he had “erroneously” paid on his 2000 income tax return. His argument was that, under California law he was not the owner of the shares due to fact they were being held in escrow.

However, the Tax Court did not agree. The Tax Court noted that Anthony, while perhaps not having legal ownership, nevertheless had *beneficial* ownership of the shares in question. He had the rights to all regular dividends and otherwise had all shareholder rights during the period he held the shares.

Anthony next argued that since his employment with Ariba would eventually terminate (if for no other reason than he dies while still working there), that this was an “event certain to occur” that would have made the transfer ineffective under Reg. §1.83-3(a)(3) and (5). However, the court noted that all of the shares could have vested prior to the “certain to occur” event, so Anthony did not have this out either.