

# Equity compensation



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For many individuals, equity compensation is a significant portion of their wealth. Many companies compensate employees, directors, and other individuals using equity or equity-based arrangements.<sup>1</sup> Equity compensation includes stock (sometimes unrestricted but more often restricted), incentive stock options (ISOs), nonqualified stock options (NSOs), and restricted stock units (RSUs). The income taxation of these forms of equity compensation at each stage of their life cycle—grant, vesting, exercise (in the case of ISOs and NSOs), and sale—generally differs. Because the rules that apply to these forms of equity compensation vary, wealth transfer planning opportunities generally differ too.

With equity compensation, terminology sometimes creates confusion. For example, restricted stock isn't the same as restricted securities, which are securities acquired in an unregistered, private sale from the issuing company or a company insider.<sup>2</sup> Similarly, restricted stock, which is sometimes called a restricted stock award (RSA), isn't the same as an RSU. There also are times when terms are used imprecisely. For example, a person might talk about owning "exercised ISOs" or "exercised NSOs." Upon exercising an ISO or an NSO, an individual will own stock (sometimes restricted but usually unrestricted). Accordingly, it's more accurate to speak in terms of the individual owning "shares acquired by exercising ISOs" or "shares acquired by exercising NSOs," because there are differences in how those shares are taxed (at least for a time). Being clear and precise can go a long way in helping to demystify the tax rules and planning strategies around equity compensation.

## Vesting

When a company grants equity compensation to an individual, the individual's ownership often is subject to certain pre-defined conditions. Their ownership vests if the conditions are met. The existence of these conditions can affect the taxation of what the individual receives.

These conditions fall into three categories:

- Time-based vesting
- Performance-based vesting
- Market-based vesting

Time-based vesting (sometimes called service-based vesting) is common. The shares vest over time so long as an individual continues to perform services for the company. Thus, they generally incentivize an individual's continuing employment or work for the company. For example, a company might grant an executive shares that vest ratably annually over three years. So long as the executive is continuing to perform services for the company, one-third of those shares would vest one year after the grant, one-third of those shares would vest two years after the grant, and one-third of those shares would vest three years after the grant. Alternatively, a company might grant an executive shares that vest 20% one year after the grant and ratably monthly over following four years. In some cases, vesting accelerates upon the individual's death, disability, or termination of employment by the company without cause.

With performance-based vesting, the shares vest if certain performance targets are met. The target might include the company achieving a specified sales goal, the company closing a specified round of financing, the company undergoing a change of control, or the company having an initial public offering. Once the performance target is met, the shares (or a specified portion of the shares) vest.

With market-based vesting, the shares vest if the company achieves a milestone tied to the company's share price, an internal rate of return, a rate of return relative to a market index of peer companies, the company's market capitalization, or a similar metric. For example, when the company's share price is \$100, the company might grant an executive shares that vest upon the company's share price exceeding \$110.

Vesting may be based on a single event or two events. Single-trigger acceleration involves a partial or full vesting upon the occurrence of a single event (such as the sale of the company). Double-trigger acceleration involves a partial or full vesting upon the occurrence of two events (such as the sale of the company *and* the termination of employment by the company without cause within 12 months after the sale).

<sup>1</sup> Some words about what we cover and don't cover in this whitepaper. We focus on equity compensation. Accordingly, we explore the tax effects of a grant of equity or equity-based compensation in connection with the performance of services, and we ignore the tax effects of an equity grant in an exclusively non-compensatory context (e.g., the contribution of money or property to a corporation by an investor in exchange for stocks or warrants). We also focus on arrangements in which a company grants equity or equity-based compensation to the individual performing the services, and we ignore those uncommon arrangements in which a company grants equity to a third party in connection with services that someone else is performing.

<sup>2</sup> 17 CFR § 230.144(a)(3). In legal parlance, an insider is an affiliate of the issuing company.

## Unrestricted stock

Unrestricted stock is vested, transferrable shares of the company's stock. Companies are more likely to grant restricted stock but may grant unrestricted stock in some circumstances. For example, a company might grant unrestricted stock to a founder in recognition of work the founder did before the company's formation.

(The company might simultaneously grant restricted stock to the founder as an incentive for performing future services for the company.)

### Grant of unrestricted stock

The grant of unrestricted stock is a taxable event. An individual who receives unrestricted stock generally must include the stock's fair market value in income.<sup>3</sup> If, however, the individual pays something for the stock, the amount includable in income is the stock's fair market value less the amount the individual paid for the stock.<sup>4</sup> The includable amount is ordinary income.<sup>5</sup> The individual's basis in the stock is the stock's fair market value.<sup>6</sup> More specifically, the individual's basis is the sum of the amount paid to acquire the stock and the amount includable in income.<sup>7</sup>

### Sale or exchange of unrestricted stock

The sale or exchange of unrestricted stock is a taxable event. The individual recognizes capital gain to the extent that the amount realized exceeds the individual's basis in the stock.<sup>8</sup> If the individual has held the stock for more than one year after the stock was granted, the gain is long-term capital gain.<sup>9</sup> Otherwise, it's short-term capital gain.<sup>10</sup> If those shares qualify as Qualified Small Business (QSB) stock and the individual has held them for more

than six months, then the gain potentially can be deferred by investing the gain in other shares that qualify as QSB stock.<sup>11</sup> If those shares qualify as QSB stock and the individual has held them for more than five years, then the gain potentially is excludable from income.<sup>12</sup>

## Restricted stock

Restricted stock is nonvested or temporarily non-transferrable shares of the company's stock. For example, a company might grant a founder shares that vest ratably annually over three years, or it might grant an executive shares that vest upon the company closing a pre-defined round of financing. In either case, the shares would be restricted stock. Restricted stock includes stock that's subject to transfer restrictions under Section 16 of the Securities Exchange Act of 1934, which effectively limits transfers by certain insiders of public companies.<sup>13</sup>

### Grant of restricted stock

The grant of restricted stock is not a taxable event. An individual who receives restricted stock doesn't include anything in income.<sup>14</sup> The individual, however, might consider making an 83(b) election and causing the grant to be a taxable event.

### 83(b) election

An 83(b) election causes the grant to be a taxable event. In some cases, this can result in more favorable overall tax treatment. An 83(b) election must be made within 30 days after a grant of restricted stock. We discuss the procedure for making an 83(b) election in more detail below.

<sup>3</sup> Treas. Reg. § 1.61-2(d)(4). See also IRC § 83(a).

<sup>4</sup> Id.

<sup>5</sup> IRC § 64.

<sup>6</sup> Treas. Reg. § 1.61-2(d)(2)(i).

<sup>7</sup> Id.

<sup>8</sup> IRC § 1001(a).

<sup>9</sup> IRC § 1222(3).

<sup>10</sup> Id.

<sup>11</sup> IRC § 1045. For a discussion of qualified small business stock, see Todd D. Mayo, *Qualified Small Business Stock* (a publication of the UBS Advanced Planning Group).

<sup>12</sup> IRC § 1202(a).

<sup>13</sup> IRC § 83(c)(3). For a discussion of Section 16 of the Securities Exchange Act of 1934, see Ann Bjerke and Laura M. Chooljian, *Estate Planning and Securities Law Implications* (a publication of the UBS Advanced Planning Group).

<sup>14</sup> IRC § 83(a). The stock must be subject to a substantial risk of forfeiture. Essentially, there must be a real risk that the vesting condition won't be met. A substantial risk of forfeiture exists only if the individual's rights in the stock are conditioned (directly or indirectly) upon the future performance (or refraining from performance) of substantial services or upon the occurrence of a condition related to a purpose of the transfer if the possibility of forfeiture is substantial. Treas. Reg. § 1.83-3(c)(1).

An individual who receives restricted stock and makes an 83(b) election generally must include the stock's fair market value in income.<sup>15</sup> If, however, the individual pays something for the stock, the amount includable in income is the stock's fair market value less the amount the individual paid for the stock.<sup>16</sup> The includable amount is ordinary income.<sup>17</sup> The individual's basis in the stock is the stock's fair market value.<sup>18</sup> More specifically, the individual's basis is the sum of the amount paid to acquire the stock and the amount includable in income.<sup>19</sup>

An 83(b) election is potentially advantageous when the restricted stock has a low fair market value (so there's little or no ordinary income includable in income) and the individual has a high degree of confidence that the vesting conditions will be met and the stock will appreciate substantially. By making the election, the individual is incurring an immediate income tax liability in the hope of more favorable tax treatment in the future. Any post-election gain would be taxable as capital gain and, if the shares are held for more than one year after the election, the gain would be long-term capital gain.<sup>20</sup> An 83(b) election also might be advantageous for state income tax purposes, potentially limiting the amount that's taxable by a state in which a nonresident is working or by a state after an individual who was a resident when the stock was granted becomes a nonresident.

An 83(b) election, however, isn't without risk. Once the individual makes the election, they must include the stock's value in income and will owe any resulting income tax regardless of what happens after the election. For example, they will owe the tax even if the stock's value declines substantially after they make the election. They also can't take a loss for the income taxes paid if the vesting conditions aren't met and they thus forfeit the

stock.<sup>21</sup> If, however, the individual makes an 83(b) election and subsequently forfeits the stock because the vesting conditions aren't met, the individual may claim a loss to the extent that the amount paid for the stock exceeds the amount (if any) they received upon the forfeiture of the stock.<sup>22</sup> A sale or exchange that's in substance a forfeiture is treated as a forfeiture for these purposes.<sup>23</sup>

### **Sale or exchange of restricted stock**

The sale or exchange of restricted stock is a taxable event. The tax consequences depend on whether an 83(b) election was made.

#### *83(b) election wasn't made*

If an 83(b) election wasn't made with respect to the stock, the sale or exchange of restricted stock is a taxable event, and the individual generally must include the stock's fair market value in income.<sup>24</sup> If, however, the individual pays something for the stock, the amount includable in income is the stock's fair market value less the amount the individual paid for the stock.<sup>25</sup> The includable amount is ordinary income.<sup>26</sup>

#### *83(b) election was made*

If an 83(b) election was made with respect to the stock, the sale or exchange of restricted stock is a taxable event, and the individual recognizes capital gain to the extent that the amount realized exceeds the individual's basis in the stock.<sup>27</sup> If the individual has held the stock for more than one year after making the 83(b) election, the gain is long-term capital gain.<sup>28</sup> Otherwise, it's short-term capital gain.<sup>29</sup> If those shares qualify as QSB stock and the individual has held them for more than six months after their grant, then the gain potentially can be deferred by investing the gain in other shares that qualify as QSB stock.<sup>30</sup> If those shares qualify as QSB stock and

<sup>15</sup> IRC § 83(b)(1). See Treas. Reg. § 1.83-2(a).

<sup>16</sup> Id.

<sup>17</sup> IRC § 64.

<sup>18</sup> Treas. Reg. § 1.83-2(a).

<sup>19</sup> Id.

<sup>20</sup> IRC §§ 1221(a) and 1222(3). The individual's basis includes the amount includable in income by reason of making an 83(b) election. Treas. Reg. § 1.83-2(a).

<sup>21</sup> IRC § 83(b)(1) (flush language).

<sup>22</sup> Treas. Reg. § 1.83-2(a).

<sup>23</sup> Id.

<sup>24</sup> Treas. Reg. § 1.83-1(b)(1). The regulations provide that this rule applies to an arm's length transaction, which they distinguish from a part-gift, part-sale transaction.

<sup>25</sup> Id.

<sup>26</sup> IRC § 64.

<sup>27</sup> IRC § 1001(a). See also Treas. Reg. § 1.83-2(a).

<sup>28</sup> IRC § 1222(3).

<sup>29</sup> Id.

<sup>30</sup> IRC § 1045.

the individual has held them for more than five years after their grant, then the gain potentially is excludible from income.<sup>31</sup>

### **Vesting of restricted stock**

The vesting of restricted stock is a taxable event, unless an 83(b) election was made with respect to that stock.

#### *83(b) election wasn't made*

If an 83(b) election wasn't made with respect to the stock, the vesting of restricted stock is a taxable event. Upon vesting of restricted stock, the individual who received the stock and didn't make an 83(b) election with respect to the stock generally must include the stock's fair market value in income.<sup>32</sup> If, however, the individual pays something for the stock, the amount includable in income is the stock's fair market value less the amount the individual paid for the stock.<sup>33</sup> The includable amount is ordinary income.<sup>34</sup>

#### *83(b) election was made*

If an 83(b) election was made with respect to the stock, the vesting of restricted stock is not a taxable event. Upon the vesting of restricted stock, the individual who received the stock and made an 83(b) election with respect to the stock doesn't include anything in income.<sup>35</sup>

### **Sale or exchange of formerly restricted stock**

After restricted stock vests, the stock generally ceases to be restricted stock and becomes unrestricted stock. (It potentially would continue to be restricted stock to the extent that it's subject to transfer restrictions that eventually lapse.) The sale or exchange of unrestricted stock is a taxable event. The individual recognizes capital gain to the extent that the amount realized exceeds the individual's basis in the stock.<sup>36</sup> If the individual has held the stock for more than one year after the stock was granted (if an 83(b) election was made) or vested

(if an 83(b) election wasn't made), the gain is long-term capital gain.<sup>37</sup> Otherwise, it's short-term capital gain.<sup>38</sup>

If those shares qualify as QSB stock and the individual has held them for more than six months after the stock was granted (if an 83(b) election was made) or vested (if an 83(b) election wasn't made), then the gain potentially can be deferred by investing the gain in other shares that qualify as QSB stock.<sup>39</sup> If those shares qualify as QSB stock and the individual has held them for more than five years after the stock was granted (if an 83(b) election was made) or vested (if an 83(b) election wasn't made), then the gain potentially is excludible from income.<sup>40</sup>

### **Wealth transfer planning**

Wealth transfer planning with restricted stock is limited. For gift tax purposes, a gift of restricted stock isn't complete until the stock vests.<sup>41</sup> Thus, gifting restricted stock won't shift any post-gift appreciation out of the transferor's estate for estate tax purposes; it will only shift appreciation that occurs after vesting, potentially after much of the appreciation has occurred. For income tax purposes, an individual who transfers restricted stock to another person continues to be taxable on any income realized upon its vesting, unless an 83(b) election was made with respect to the stock.<sup>42</sup> Thus, gifting restricted stock to the transferor's child won't shift the income liability to the child. The transferor would include the stock's fair market value in income when the stock vests. Likewise, gifting restricted stock to a nongrantor trust—a trust that's generally treated as a separate taxpayer for income tax purposes<sup>43</sup>—won't shift the income liability to the trust. Again, the transferor would include the stock's fair market value in income when the stock vests.

### **Transfer upon death**

If an individual dies while owning restricted stock, there are estate and income tax implications.

<sup>31</sup> IRC § 1202(a).

<sup>32</sup> IRC § 83(a).

<sup>33</sup> Id.

<sup>34</sup> IRC § 64.

<sup>35</sup> IRC § 83(b)(1) (flush language).

<sup>36</sup> IRC § 1001(a).

<sup>37</sup> IRC § 1222(3).

<sup>38</sup> Id.

<sup>39</sup> IRC § 1045.

<sup>40</sup> IRC § 1202(a).

<sup>41</sup> See Rev. Rul. 98-21.

<sup>42</sup> Treas. Reg. § 1.83-1(c). To the extent that, in a part-gift, part-sale transaction, the transferor receives money or other property in exchange for the transfer of restricted stock, the transferor would realize income to the extent of the money and other property received.

<sup>43</sup> See IRC §§ 641, 651, 652, 661, and 662.

### *Estate taxes*

If an individual dies while owning restricted stock, the fair market value of the stock is includable in the individual's estate for estate tax purposes.<sup>44</sup>

### *Income taxes if 83(b) election wasn't made*

If an 83(b) election wasn't made with respect to the stock, the person who inherits the stock essentially inherits the built-in income tax liability.<sup>45</sup> The stock doesn't get a stepped-up basis.<sup>46</sup> Upon the vesting, sale, or exchange of the stock, the person who inherits the stock must include the stock's fair market value (less any amount paid for the stock) in income.<sup>47</sup> The includable amount is ordinary income.<sup>48</sup> The person who inherits the stock may have an income tax deduction for the estate taxes attributable to the stock.<sup>49</sup>

### *Income taxes if 83(b) election was made*

If an 83(b) election was made with respect to the stock, the person who inherits the stock doesn't inherit an income tax liability. To the extent the stock is includable in the decedent's estate, the stock gets a stepped-up basis.<sup>50</sup> The vesting of the stock (whether on or after the decedent's death) isn't a taxable event. The sale or exchange of the stock (either before or after vesting) is a taxable event. The person who inherits the stock would have long-term capital gain to the extent the stock's fair market value exceeds the person's basis in the stock.<sup>51</sup>

## ISOs

ISOs enjoy preferential income tax treatment. They are stock options that meet certain requirements. These requirements include:

- the individual who receives the options must be an employee of the company granting the options,
- the options must be nontransferable,
- the strike price can't be less than the stock's fair market value when the option is granted (or, in the case of an employee who owns 10% or more of the company's shares, 110% of the stock's fair market value), and

- the options can't be exercisable more than ten years after being granted (or, in the case of an employee who owns 10% or more of the company's shares, five years after being granted).<sup>52</sup>

In addition, there's a limit on the amount of options that can qualify as ISOs. To the extent that an individual can acquire more than \$100,000 of shares (based on the shares' fair market value when the options are granted) by exercising the options when they first become exercisable during the calendar year, the options aren't ISOs but instead are NSOs. We discuss this limitation in more detail below.

### **Granting ISOs**

The grant of ISOs is not a taxable event. The individual who receives the ISOs doesn't include anything in income.<sup>53</sup> If the ISOs are exercisable before they vest (i.e., they allow early exercise), the individual might consider exercising the ISOs immediately or shortly after they're granted. We discuss early exercise below.

### **Vesting of ISOs**

The vesting of ISOs is not a taxable event. An individual who received ISOs doesn't include anything in income when the ISOs vest.

### **Exercising ISOs**

The exercise of ISOs is not a taxable event for regular income tax purposes but is a taxable event for alternative minimum tax (AMT) purposes. For regular income tax purposes, the individual who exercises the ISOs doesn't include anything in income.<sup>54</sup> For AMT purposes, the individual who exercises the ISOs generally includes the spread between the strike price (i.e., exercise price) and the shares' fair market value in income.<sup>55</sup> If, however, the individual exercises ISOs and, in the same calendar year, sells the shares acquired by exercising those ISOs,

<sup>44</sup> See, e.g., IRC §§ 2033 and 2038.

<sup>45</sup> In this whitepaper, we use the term "inherit" in the colloquial sense—meaning to receive of property by reason of an individual's death—rather than its strict legal sense.

<sup>46</sup> IRC § 1014(c).

<sup>47</sup> Treas. Reg. § 1.83-1(d).

<sup>48</sup> IRC § 64.

<sup>49</sup> IRC § 691(c).

<sup>50</sup> IRC § 1014(a). More precisely, the stock's basis generally will be the stock's fair market value on the date of the decedent's death.

<sup>51</sup> IRC §§ 1221(a) and 1223(9).

<sup>52</sup> IRC §§ 422(b) and 422(c)(5). For these purposes, the stock's fair market value is determined without regard to any restriction that may lapse. IRC § 422(c)(7).

<sup>53</sup> Treas. Reg. § 1.83-3(a)(2). For purposes of IRC § 83(a), the option isn't property, so there isn't any amount to include in income upon its receipt.

<sup>54</sup> IRC § 421(a)(1).

<sup>55</sup> IRC § 56(b)(3).

the spread isn't included in income for AMT purposes.<sup>56</sup> The sale would be subject to the regular income tax (and any gain wouldn't qualify as long-term capital gain).<sup>57</sup>

An individual who incurs AMT will have an AMT credit carryforward.<sup>58</sup> The credit will offset the individual's regular income tax in future years. The individual, however, can use the credit only to the extent that, in a future year, their regular income tax exceeds their tentative minimum tax.<sup>59</sup> Accordingly, an individual might not be able to take advantage of this credit until they sell the shares acquired by exercising the ISOs. When the individual sells the shares acquired by exercising the ISOs, they potentially would have gain for regular income tax purposes but not AMT purposes, in which case their regular income tax potentially would exceed their tentative minimum tax. This may create conditions under which they could use the AMT credit carryforward (to the extent it wasn't previously used).

#### *Early exercise*

Although uncommon, ISOs may be exercisable before they vest.<sup>60</sup> For example, ISOs might be immediately exercisable upon grant, even though they are subject to a time-based vesting. If the ISOs allow early exercise, the individual who received the ISOs might consider exercising the ISOs. By doing so, they potentially can minimize the amount subject to AMT, and they can start the holding period on the shares acquired by exercising the ISOs. Of course, the cost of exercising the ISOs and the risk of forfeiting the shares acquired by exercising the ISOs may outweigh those potential benefits.

#### *Exercising ISOs while avoiding the AMT*

Since it's usually advantageous to avoid being subject to the AMT, an individual may look to exercise just enough ISOs to stay out of the AMT. An example may be helpful. Let's assume that an individual has 30,000 ISOs, the strike price is \$2 per share, and the fair market value currently is \$11 per share. Let's also assume that the individual can incur \$100,000 of tax preference items without becoming subject to the AMT. Based on these assumptions, the individual can exercise 11,111 ISOs without incurring any AMT. The spread on each share would be \$9 (i.e., the \$11 fair market value less the \$2 strike price), so the individual

would incur \$99,999 of tax preference items (i.e., 11,111 multiplied by \$9). That's not enough to cause the individual to be subject to the AMT, so the individual doesn't incur any income tax on the exercise of the ISOs.

The individual would pay \$22,222 to exercise those options (i.e., 11,111 multiplied by \$2). To finance the exercise, the individual could use existing funds. Alternatively, the individual might borrow money (e.g., using an existing line of credit or establishing a securities-backed loan) or sell some shares and use the proceeds. If the individual sells some of the shares to finance the exercise of the options, the individual will own fewer shares when all is said and done. For this purpose, the individual generally wouldn't want to use any shares that the individual just acquired by exercising the ISOs. When selling shares acquired by exercising ISOs, the individual must include in ordinary income an amount equal to what the spread was when the individual exercised the ISOs (i.e., the stock's fair market value on the date of exercise minus the strike price), unless the individual has held the shares for at least two years after the grant of the ISOs and one year after the exercise of the ISOs.

Some practical observations: First, the individual's accountant should be able to estimate the amount of tax preference items that the individual can incur without becoming subject to the AMT. Second, the basic math is the same, but the calculation of the number of ISOs that an individual can exercise tax-free is slightly more involved if the individual has received multiple grants of ISOs having different strike prices and expiration dates. Third, an individual may have a large number of expiring ISOs, so the AMT may be unavoidable if the individual doesn't want to forgo the financial benefit that may come from exercising the options and owning the shares. Fourth, if the individual incurs AMT by reason of exercising ISOs, the individual will have a tax credit that the individual potentially can use to reduce the individual's regular income tax in future years. Fifth, if an individual incurs AMT as the result of exercising ISOs and the value of the shares acquired by exercising those options subsequently declines, the individual could land in a situation in which the AMT paid exceeds any profit that the individual

<sup>56</sup> Id.

<sup>57</sup> Id.

<sup>58</sup> IRC § 53(b).

<sup>59</sup> IRC § 53(c).

<sup>60</sup> The limitation on the number of options that can qualify as ISOs is a key reason why early exercise is uncommon. We discuss this limitation below.

realizes from the shares. Additionally, the individual might have limited or no opportunity to use the credit for the AMT paid or any AMT losses that the individual realizes upon the sale of the shares.

### **Selling the shares acquired by exercising ISOs**

Although the grant and exercise of ISOs may be nontaxable, the sale of the shares acquired by exercising ISOs is taxable. The individual selling the shares is taxed on the gain, which will equal the sale price minus the individual's basis in the shares sold.<sup>61</sup> The individual's basis in the shares acquired by exercising ISOs is the strike price of those shares.<sup>62</sup> The gain is treated as capital gain, so long as the individual has held those shares for at least two years after the grant of the ISOs and one year after the exercise of the ISOs.<sup>63</sup> If the individual doesn't hold the shares for both the one- and two-year time periods, some (and potentially all) of the gain is treated as ordinary income.<sup>64</sup> If those shares qualify as QSB stock and the individual holds them for more than five years after the exercise of the ISOs, then the gain potentially is excludible from income.<sup>65</sup>

### **Wealth transfer planning**

Wealth planning opportunities with ISOs are limited. In contrast, wealth planning opportunities with shares acquired by exercising ISOs abound if they've been held for more than two years after the grant of the ISOs and more than one year after the exercise of the ISOs.

#### *Planning with ISOs*

ISOs are generally nontransferable, so wealth transfer planning opportunities are limited.<sup>66</sup> Nonetheless, an individual's estate plan should take account of any ISOs that the individual owns. During life, an individual potentially can transfer ISOs into a revocable trust, so that the ISOs will avoid probate.<sup>67</sup> The Internal Revenue Service (IRS) privately ruled that such a transfer doesn't cause the ISOs to lose their preferential status,<sup>68</sup> but the ruling isn't

something on which people (other than the taxpayer who requested it) can rely, and plan documents governing ISOs often don't allow for such a transfer. In their will, an individual can direct how ISOs must be transferred upon death.<sup>69</sup>

#### *Planning with shares acquired by exercising ISOs*

After exercising ISOs, an individual can engage in wealth transfer planning with the shares acquired by exercising the options. When gifting or otherwise transferring shares acquired by exercising ISOs, an individual generally should use only shares that the individual has held for more than two years after the grant of the ISOs and more than one year after the exercise of the ISOs. A gift or other transfer of shares that haven't been held for both the one- and two-year time periods generally is a taxable event for income tax purposes, and the individual generally must include in ordinary income an amount equal to what the spread was when the individual exercised the ISOs (i.e., the stock's fair market value on the date of exercise minus the strike price).<sup>70</sup>

The individual can give shares acquired by exercising ISOs outright or in trust. For example, the individual could contribute those shares to an irrevocable trust for the benefit of children and future generations or an irrevocable trust for the benefit of the individual's spouse and other persons (commonly called a spousal lifetime access trust (SLAT)).<sup>71</sup> For purposes of reporting the gift, the individual would use the shares' fair market value on the date of the gift (i.e., the date contributed to the trust). Thus, it can be advantageous to make the gift when the shares' value is expected to appreciate. Any future appreciation in the shares' value generally would avoid gift and estate taxes. Similarly, the individual could contribute the shares to a grantor retained annuity trust (GRAT) or sell them to an irrevocable trust that is a grantor trust for federal tax purposes.<sup>72</sup> Those strategies would potentially enable an individual to shift some of the future

<sup>61</sup> IRC § 1001(a).

<sup>62</sup> IRC § 1011.

<sup>63</sup> Treas. Reg. § 1.424-1(c)(4) Ex. 2.

<sup>64</sup> Treas. Reg. § 1.424-1(c)(4) Ex. 9.

<sup>65</sup> IRC § 1202(a).

<sup>66</sup> IRC § 422(b)(5). Despite the apparent prohibition against transfer, ISOs might be transferrable but convert into NSOs upon a transfer. See Treas. Reg. § 1.421-1(b)(2) and Rev. Rul. 2002-22. If so, an individual who is willing to forgo the tax advantages of ISOs potentially can engage in wealth transfer planning with those options.

<sup>67</sup> Treas. Reg. § 1.421-1(b)(2).

<sup>68</sup> PLR 9309027 (December 4, 1992).

<sup>69</sup> IRC § 422(b)(5).

<sup>70</sup> IRC § 83(a) and Treas. Reg. § 1.421-2(b)(1)(i).

<sup>71</sup> For a discussion of SLATs, see Catherine McDermott, *Spousal Lifetime Access Trusts* (a publication of the UBS Advanced Planning Group).

<sup>72</sup> For a discussion of GRATs, see Jennifer Lan, *Grantor Retained Annuity Trusts* (a publication of the UBS Advanced Planning Group). For a discussion of sales to grantor trusts, see Casey Verst, *Using Irrevocable Grantor Trusts to Transfer Wealth* (a publication of the UBS Advanced Planning Group).



appreciation to children or other persons. If the shares qualify as QSB stock, the individual might also consider strategies for multiplying (or stacking) the amount of gain excludible from income.

### **Transfer upon death**

In their will, the individual can direct how ISOs must be transferred upon their death.<sup>73</sup> ISOs usually don't lapse when the individual who owns them dies, and they usually must be exercised within 12 months after death.

#### *Estate taxes*

The fair market value of those options generally are includable in the individual's estate for estate tax purposes.<sup>74</sup>

#### *Income taxes*

When exercising inherited ISOs, a person doesn't include anything in income for regular income tax purposes but generally must include the spread between the strike price (i.e., exercise price) and the shares' fair market value in income for AMT purposes.<sup>75</sup> If, however, the person exercises inherited ISOs and, in the same calendar year, sells the shares acquired by exercising those ISOs, the spread isn't included in income for AMT purposes.<sup>76</sup> The sale would be subject to the regular income tax (and any gain wouldn't qualify as long-term capital gain).<sup>77</sup>

### **Limitation on ISOs**

There's a limit on the amount of options that can qualify as ISOs. To the extent that, when options first become exercisable during the calendar year, the aggregate value of the shares that could be acquired by exercising those options exceeds \$100,000, the options are NSOs, not ISOs.<sup>78</sup> For this purpose, a share's value is its fair market value when the option was granted, not its fair market value later (e.g., when the option becomes exercisable).<sup>79</sup>

An example might help to illustrate this limitation. Let's assume a company grants an executive (who's an employee) 60,000 options that vest ratably annually over four years and are exercisable only after they vest. Let's

also assume that the options qualify as ISOs (except to the extent the \$100,000 limitation applies), the fair market value of a share is \$10 when the options are granted, and the executive doesn't have or receive any other options. When the first tranche of 15,000 options vests, there will be 10,000 ISOs and 5,000 NSOs. There's 10,000 ISOs, because the aggregate value of the shares that could be acquired by exercising those options is \$100,000 (i.e., 10,000 multiplied by \$10 per share). The shares' fair market value upon vesting doesn't matter for purposes of this calculation. When the second tranche of 15,000 options vests (i.e., when they first become exercisable, which will be on the second anniversary of the grant), there again will be 10,000 ISOs and 5,000 NSOs. The calculation is the same. Thus, in total, the executive will have received 40,000 ISOs and 20,000 NSO.

This limitation is one reason why early exercise of options is uncommon. Fewer options can qualify as ISOs. Let's assume a company grants an executive (who's an employee) 60,000 options that vest ratably annually over four years and those options are immediately exercisable. Let's also assume that the options qualify as ISOs (except to the extent the \$100,000 limitation applies), the fair market value of a share is \$10 when the options are granted, and the executive doesn't have or receive any other options. Since all of the options are exercisable immediately, the executive will have 10,000 ISOs and 50,000 NSOs. There's 10,000 ISOs, because the aggregate value of the shares that could be acquired by exercising those options is \$100,000 (i.e., 10,000 multiplied by \$10 per share).

### **NSOs**

NSOs are stock options that don't qualify as ISOs. Accordingly, companies can grant NSOs to employees, directors, and independent contractors. A company's NSOs often are governed by the same terms as its ISOs, even though certain terms may not be required for tax purposes.

<sup>73</sup> IRC § 422(b)(5).

<sup>74</sup> See, e.g., IRC § 2033. If, however, the ISOs lapse upon the individual's death, there wouldn't be anything includable in the individual's estate for estate tax purposes.

<sup>75</sup> Treas. Reg. § 1.421-2(c)(1).

<sup>76</sup> Id.

<sup>77</sup> Id.

<sup>78</sup> IRC § 422(d).

<sup>79</sup> Id.

### Granting NSOs

A grant of NSOs generally is not a taxable event. The individual who receives the NSOs generally doesn't include anything in income.<sup>80</sup> If the NSOs are exercisable before they vest (i.e., they allow early exercise), the individual might consider exercising the NSOs immediately or shortly after they're granted. We discuss early exercise below.

### Vesting of NSOs

The vesting of NSOs is not a taxable event. The individual who received the NSOs doesn't include anything in income.

### Exercising NSOs

The exercise of NSOs generally is a taxable event. An individual who exercises the NSOs includes the spread between the strike price and shares' fair market value in income. The includable amount is ordinary income.<sup>81</sup>

An example may again be helpful. Let's assume that an individual has 50,000 vested NSOs, the strike price is \$3 per share, and the fair market value currently is \$13 per share. Let's also assume that any shares that the individual acquires by exercising the NSOs are fully vested and transferable. If the individual exercises 10,000 NSOs, the spread on each share would be \$10 (i.e., the \$13 fair market value less the \$3 strike price), so the individual would incur \$100,000 of ordinary income (i.e., 10,000 multiplied by \$10). The individual would have to pay \$30,000 to exercise those options (i.e., 10,000 multiplied by \$3) and the tax on the \$100,000 of ordinary income.

To the extent an individual must include an amount in income upon the exercise of NSOs, the individual might consider making an 83(i) election. This election, which is available only to certain qualifying employees in limited circumstances, potentially allows the individual to defer the income. The election must be made within 30 days after the exercise. We discuss the 83(i) election below.

### Early exercise

NSOs sometimes are exercisable before they vest. For example, they might be immediately exercisable upon grant, even though they are subject to a time-based vesting. If the NSOs allow early exercise, the individual who received the NSOs might consider exercising the NSOs and immediately making an 83(b) election. Although not without risk, this may provide more favorable tax results. With early exercise, an individual's post-grant gain generally would be taxable as capital gain and little (if any) would be taxable as ordinary income.

When an individual exercises the NSOs, the individual must include the spread between the strike price and shares' fair market value in income.<sup>82</sup> When exercising NSOs early, there's usually little or no spread, so the individual typically has little or nothing to include in income. The strike price usually is the shares' fair market value on the grant date. Thus, there usually isn't any spread if the individual exercises the NSOs immediately upon their grant. There may be some spread if the individual exercises the NSOs after the grant date and the shares appreciated in value between the grant date and the exercise date. Again, the individual must include the spread in income. To the extent there is any amount includable in income, it's ordinary income.<sup>83</sup> In short, there may be little or no tax cost from an early exercise.

After an early exercise of NSOs, the individual would own restricted stock. The shares acquired by exercising the NSOs early would be subject to the vesting conditions to which the NSOs were subject. Within 30 days after exercising the NSOs, the individual should make an 83(b) election. (We discuss the procedure for making an 83(b) election below.) The individual typically won't have anything to include in income by reason of making the election, and the election may help to ensure any post-election gain is taxable as capital gain. By exercising the NSOs, the individual starts the holding period for long-term capital gain treatment for the shares acquired by the exercise. If the shares are held for more than one year after the exercise, the gain is long-term capital gain.<sup>84</sup>

<sup>80</sup> See Treas. Reg. § 1.83-3(a)(2). See also Notice 2004-28. For purposes of IRC § 83(a), an NSO generally isn't property, so there generally isn't any amount to include in income upon its receipt. An NSO, however, is property if it has a readily ascertainable fair market value. Treas. Reg. § 1.83-7(a). That usually only happens if the NSO is publicly traded (or, more precisely, is actively traded on an established market) but can happen if the NSO is transferrable, immediately exercisable, and exhibits certain characteristics making its value readily ascertainable. Treas. Reg. § 1.83-7(b). An NSO often isn't publicly traded, even though a share acquired by exercising the NSO may be publicly traded. When an NSO has a readily ascertainable fair market value (and thus is property for purposes of IRC § 83(a)), and the individual who receives it generally must include its value in income.

<sup>81</sup> IRC § 64.

<sup>82</sup> IRC § 83(b). See Treas. Reg. § 1.83-2(a).

<sup>83</sup> IRC § 64.

<sup>84</sup> IRC §§ 1221(a) and 1222(3). The individual's basis includes the amount includable in income by reason of making an 83(b) election. Treas. Reg. § 1.83-2(a).

The early exercise of NSOs involves some costs and risks. When exercising the NSOs, an individual must pay the strike price. The individual effectively is making an investment in the company. The individual may lose some or all of the investment if the shares' value declines, the individual forfeits shares (because the vesting conditions weren't met), or the company fails. If, however, the individual makes an 83(b) election and subsequently forfeits the stock because the vesting conditions aren't met, the individual may claim a loss to the extent that the amount paid for the stock exceeds the amount (if any) they received upon the forfeiture of the stock.<sup>85</sup>

#### *Exercising NSOs to exercise ISOs while avoiding the AMT*

Individuals often receive grants of both ISOs and NSOs. For those individuals, exercising NSOs may increase the number of ISOs that the individual can exercise while avoiding the AMT. When an individual incurs ordinary income by reason of exercising NSOs, the individual increases the amount of AMT preference items that the individual can incur without becoming subject to the AMT. Thus, by exercising the NSOs, the individual increases their capacity to exercise ISOs without incurring any AMT. Of course, exercising those options requires money. The individual could use existing funds, borrow money (e.g., drawing on a line of credit or using a securities-backed loan), or sell shares and use the proceeds.

#### **Selling the shares acquired by exercising NSOs**

The sale of the shares acquired by exercising NSOs is a taxable event. The individual selling those shares is taxed on the gain, which is the sale price minus the individual's basis in the shares sold.<sup>86</sup> The individual's basis generally is the stock's fair market value when the NSOs were exercised.<sup>87</sup> More specifically, it's the sum of the amount paid for the shares and the amount includable in income by reason of making an 83(b) election.<sup>88</sup> The gain is treated as capital gain.<sup>89</sup> If the individual has held the shares for more than one year after exercising the NSOs, the gain will be long-term capital gain.<sup>90</sup> If the individual sells the shares shortly after exercising, there may be minimal gain. If the shares qualify as QSB stock and the individual holds them for more than five years after the

exercise of the NSOs, then the gain potentially is excludable from income.<sup>91</sup>

#### **Wealth transfer planning**

The transferability of NSOs determines whether an individual can use them in wealth transfer planning. Some NSOs are transferable; others are not. Some NSOs are transferable only to certain persons, such as family members or trusts for their benefit. The plan documents governing the NSOs dictate the degree to which the NSOs are transferable. Even if the plan documents generally prohibit the transfer of NSOs, companies sometimes are receptive to amending the documents to eliminate the prohibition or otherwise allowing the transfers.

For an individual who owns transferable NSOs, the immediate efficacy of wealth transfer strategies depends on how many of the NSOs are vested. Contributing unvested NSOs to an irrevocable trust or otherwise gifting those options would accomplish little from a wealth transfer tax perspective. For gift tax purposes, a gift of unvested NSOs is not complete until the options vest.<sup>92</sup> In contrast, a gift of vested NSOs is a completed gift.<sup>93</sup> The individual could give those options outright to a child or other individual, could contribute those options to a SLAT, GRAT, or other irrevocable trust, or could sell those options to an irrevocable grantor trust. Gifting vested NSOs generally becomes more attractive when the share value is depressed, because the drop in the share value decreases the NSOs' value for gift tax purposes. Of course, it wouldn't make sense to make gifts using vested NSOs if the individual believes that the value of the shares will continue to fall.

After giving NSOs to another individual or a nongrantor trust, the transferor will continue to be liable for the income taxes arising from the NSOs' exercise. Transferring NSOs does not shift the income tax liability. For example, if an individual gives 1,000 NSOs to their child, they will recognize income when their child's exercises the NSOs (assuming that, upon the options' exercise, the child receives shares that are fully vested and fully transferable).

<sup>85</sup> Treas. Reg. § 1.83-2(a). A sale or exchange that's in substance a forfeiture is treated as a forfeiture for these purposes.

<sup>86</sup> IRC § 1001(a).

<sup>87</sup> IRC § 1012(a) and Treas. Reg. § 1.83-2(a).

<sup>88</sup> Id.

<sup>89</sup> IRC § 1221(a).

<sup>90</sup> IRC § 1222(3).

<sup>91</sup> IRC § 1202(a).

<sup>92</sup> Rev. Rul. 98-21.

<sup>93</sup> Id.

After exercising NSOs, the individual can engage in wealth transfer planning with the shares acquired by exercising the options. The individual could contribute the shares to an irrevocable trust, such as a SLAT or a GRAT, or sell those shares to an irrevocable grantor trust. Here again, those strategies can be more attractive when the shares' value are expected to appreciate substantially in the future. If the shares qualify as QSB stock, the individual might also consider strategies for stacking.

### Transfer upon death

In their will, the individual can direct how NSOs must be transferred upon their death. NSOs usually don't lapse when the individual who owns them dies, and they usually must be exercised within 12 months after death.

#### *Estate taxes*

When an individual who owns NSOs dies, the fair market value of those options generally are includable in the individual's estate for estate tax purposes.<sup>94</sup>

#### *Income taxes*

When exercising inherited NSOs, a person includes the spread between the strike price and shares' fair market value in ordinary income.

## RSUs

An RSU is a right to receive a payment in the future. The payment (which is sometimes called a settlement) is made either in stock or in an equivalent amount of cash. An RSU isn't stock. A company doesn't grant stock when it grants an RSU. Instead, it grants stock when the RSU vests if the payment must be in stock (rather than cash).

### Granting RSUs

The grant of RSUs is not a taxable event. An individual who receives the RSUs doesn't include anything in income.<sup>95</sup> An individual can't make an 83(b) election with respect to RSUs they receive.<sup>96</sup>

### Vesting of RSUs

The vesting of RSUs generally is a taxable event. Upon vesting, the individual must include in income:

- the amount of cash received upon the settlement of the RSU, and

- the fair market value of any shares received upon the settlement of the RSU, unless those shares are restricted stock (e.g., they are subject to vesting conditions).<sup>97</sup>

The includable amount is ordinary income.<sup>98</sup> To the extent that the individual receives restricted stock when the RSUs vest, the individual doesn't include their value in income.<sup>99</sup> The individual, however, might consider making an 83(b) election with respect to the restricted stock, thereby requiring the individual to include the stock's fair market value in income and causing any future gains to be capital gains. We discuss the taxation of restricted stock above.

To the extent an individual must include an amount in income upon the vesting of RSUs, the individual might consider making an 83(i) election. This election, which is available only to certain qualifying employees in limited circumstances, potentially allows the individual to defer the income. The election must be made within 30 days after the vesting. We discuss the 83(i) election below.

### Wealth transfer planning

Wealth transfer planning with RSUs is limited. RSUs are non-transferable, so it isn't possible to gift them. In addition, the individual who received them must include in income the amount of cash and the fair market value of unrestricted stock received when the RSUs vest.

### Transfer upon death

RSUs usually vest upon the death of the individual to whom they were granted. Some plans allow an individual to designate a beneficiary of their RSUs. If the plan allows beneficiary designations and the deceased individual had designated a beneficiary who survives them, the RSUs would pass to the beneficiary upon the deceased individual's death. Otherwise, the RSUs typically pass to the deceased individual's estate upon their death. The beneficiary or estate thus would receive the stock or cash upon the settlement of the RSUs.

#### *Estate taxes*

If the RSUs vest upon the death of the individual to whom they were granted, their fair market value is includable in the individual's estate for estate tax purposes.<sup>100</sup> The RSUs' fair market value generally is the amount of cash and the fair market value of any shares paid upon their settlement.

<sup>94</sup> See, e.g., IRC § 2033. If, however, the NSOs lapse upon the individual's death, there wouldn't be anything includable in the individual's estate for estate tax purposes.

<sup>95</sup> Treas. Reg. § 1.451-1(a).

<sup>96</sup> IRC § 83(i)(7).

<sup>97</sup> Treas. Reg. § 1.451-1(a).

<sup>98</sup> IRC § 64.

<sup>99</sup> IRC § 83(a).

<sup>100</sup> IRC § 2033.

### Income taxes

If the RSUs vest upon the death of the individual to whom they were granted, the person who inherits the RSUs generally must include in income the amount of cash received upon the settlement of the RSU and the fair market value of any shares received upon the settlement of the RSU.<sup>101</sup> The includable amount is ordinary income.<sup>102</sup> The person who inherits the RSUs may have an income tax deduction for the estate taxes attributable to the RSUs.<sup>103</sup>

### 83(b) election

When an individual receives restricted property—such as restricted stock either as a grant on its own or by exercising stock options—it sometimes may be advantageous to make an 83(b) election. By making the election, the individual generally must include the property's fair market value in income upon its receipt, and any post-election gain usually is capital gain. The election thus may be appealing if the property's fair market value upon its receipt is minimal, the value is expected to increase substantially, and the vesting conditions are expected to be met.

An 83(b) election must be made within 30 days after the transfer of the restricted property to an individual.<sup>104</sup> The election may be made before the transfer.<sup>105</sup> The election is made by a written statement that the individual files with the IRS office where they regularly file their tax returns.<sup>106</sup> The individual must also send a copy of the statement to the company that granted the stock.<sup>107</sup> The statement must include:

- the individual's name, address, and taxpayer identification number;
- a statement that the individual is making an 83(b) election (or, more precisely, an election under Section 83(b) of the Internal Revenue Code);

- a description of restricted property;
- the nature of the restriction or restrictions to which property is subject (e.g., the vesting conditions);
- the date on which the property was transferred to the individual;
- the taxable year for which the election is being made (e.g., the 2023 calendar year);
- the property fair market value at the time of transfer;
- the amount (if any) paid for the property; and
- a statement confirming that a copy of the statement has been sent to the company that granted the property.<sup>108</sup>

The individual must sign the statement.<sup>109</sup> The IRS has published a model statement that individuals can use.<sup>110</sup> An 83(b) election is generally irrevocable.<sup>111</sup>

### 83(i) election

When a company's shares aren't publicly traded, an individual may find it challenging to pay the income taxes that arise upon the exercise of stock options or the vesting of RSUs. An 83(i) election mitigates this problem. By making the election, the individual can temporarily defer the income from the exercise of stock options or the vesting of RSUs.<sup>112</sup>

#### General requirements

To qualify to make an 83(i) election, the employee must be a qualified employee, and the company that grants the stock options or RSUs must be an eligible company.<sup>113</sup> The employee must make the election within 30 days of the exercise or vesting.<sup>114</sup> The employee can't make an 83(i) election if any of the company's stock is or previously was readily tradable on an established securities market<sup>115</sup> or, under certain circumstances, the company has repurchased 25% or more of any of its stock.<sup>116</sup> The

<sup>101</sup> Treas. Reg. §§ 1.451-1(a) and 1.691(a)-1(b).

<sup>102</sup> IRC § 64.

<sup>103</sup> IRC § 691(c).

<sup>104</sup> IRC § 83(b)(2).

<sup>105</sup> Treas. Reg. § 1.83-2(b).

<sup>106</sup> Treas. Reg. § 1.83-2(c). The individual may have an obligation to attach a copy of the statement to their state income tax return. Before 2015, an individual had to attach a copy of the statement to their federal income tax return.

<sup>107</sup> Treas. Reg. § 1.83-2(d).

<sup>108</sup> Treas. Reg. § 1.83-2(e).

<sup>109</sup> *Id.*

<sup>110</sup> Rev. Proc. 2012-29.

<sup>111</sup> IRC § 83(b)(2) and Treas. Reg. § 1.83-2(f).

<sup>112</sup> IRC § 83(i)(1)(A). An 83(i) election may not be available for state income tax purposes.

<sup>113</sup> IRC §§ 83(i)(1)(A) and (2)(C)(i).

<sup>114</sup> IRC § 83(i)(4)(A).

<sup>115</sup> IRC § 83(i)(4)(B)(ii).

<sup>116</sup> IRC § 83(i)(4)(B)(iii).

employee also can't make an 83(i) election if they make an 83(b) election with respect to the shares acquired upon the exercise of stock options or the vesting of RSUs.<sup>117</sup>

### Qualified employees

An individual may make an 83(i) election only if the individual is a qualified employee.<sup>118</sup> A qualified employee is an employee other than:

- a 1% owner,
- any current or former chief executive officer,
- any current or former chief financial officer,
- a spouse, parent, child, or grandchild of a 1% owner, chief executive officer, or chief financial officer,
- any one of the four highest compensated officers during the current calendar year, and
- any one of the four highest compensated officers during any of the preceding 10 calendar years.<sup>119</sup>

A 1% owner is an individual who, during the current calendar year, owns more than 1% of the company's outstanding stock or more than 1% of the total combined voting power of all of the company's stock.<sup>120</sup> A 1% owner also is an individual who, during any of the preceding 10 calendar years, owned more than 1% of the company's outstanding stock or more than 1% of the total combined voting power of all of the company's stock.<sup>121</sup>

### Eligible companies

An 83(i) election is available only if, during any calendar year preceding the grant of the stock option or RSU, none of the company's stock (or any predecessor's stock) was readily tradable on an established securities market.<sup>122</sup> In addition, the election generally is available only if the company grants stock options or RSUs to 80% or more of its employees who perform services in the United States.<sup>123</sup> The rights and privileges to receive stock through any stock options or RSUs granted after 2017 must be the same for all employees.<sup>124</sup> Thus, an 83(i) election generally isn't available if, after 2018, a company makes special grants to a few executives.

<sup>117</sup> IRC § 83(i)(4)(B)(i).

<sup>118</sup> IRC § 83(i)(1)(A).

<sup>119</sup> IRC § 83(i)(3).

<sup>120</sup> IRC § 83(i)(3)(B)(i).

<sup>121</sup> *Id.*

<sup>122</sup> IRC § 83(i)(2)(C)(i)(I).

<sup>123</sup> IRC § 83(i)(2)(C)(i)(II). The statute uses the term "eligible corporation."

<sup>124</sup> IRC §§ 83(i)(2)(C)(i)(II) and (C)(iv).

<sup>125</sup> IRC § 83(i)(4)(A).

<sup>126</sup> Treas. Reg. § 1.83-2(c).

<sup>127</sup> Treas. Reg. § 1.83-2(d).

<sup>128</sup> IRC § 83(i)(1)(B).

### Manner of making an 83(i) election

An 83(i) election is made in a manner similar to that for making an 83(b) election.<sup>125</sup> Thus, the election is made by a written statement that the individual files with the IRS office where they regularly file their tax returns,<sup>126</sup> and the individual must send a copy of the statement to the company that granted the stock.<sup>127</sup> We discuss the 83(b) election in more detail above.

### Period of deferral

An 83(i) election provides only a temporary deferral of income. When an employee makes an 83(i) election, income generally is deferred until:

- the stock becomes transferrable (including to the employer),
- the employee ceases to be a qualified employee,
- the stock becomes readily tradable on an established securities market,
- five years after the exercise of vested options or the vesting of the RSUs, or
- the employee affirmatively revokes the 83(i) election.<sup>128</sup>

For example, an employee who makes an 83(i) election and subsequently becomes the company's chief financial officer must include in income the amounts deferred by making the election. Thus, upon becoming the chief financial officer, the employee's deferral ends, and they must include the deferred amounts in income.

## Conclusion

The wealth and taxes created by equity compensation sometimes can be exceptionally large. Good planning considers the personal, investment, and tax dimensions of equity compensation. Cash flow, taxes, and economic conditions often are important considerations in that planning. For many individuals, however, the most important factors in deciding how to manage equity compensation are the outlook for the stock and their tolerance for having a substantial portion of their wealth tied to the fortunes of one company.

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