# Corporate Insights: Starting a Start-Up? Here's One More Thing You Need to Know: The 83(b) Election

BY JULIE K. O'NEILL • JUNE 28, 2023

Many people are forming start-up entities, especially in the Boston and Worcester areas, and for some, it becomes a great success story. For others, it does not. As an attorney who assists many start-ups and investors, I see some sticky situations. One thing some founders forget about is the very important 83(b) election.

What is an 83(b) election? An 83(b) election is made under a provision of the Internal Revenue Code (IRC) that gives start-up founders the option to pay taxes on the total fair market value of restricted stock at the time the stock is issued, rather than when the restrictions lapse. This means the founder can limit the associated tax liability substantially by one single filing.

By example, let's say David sets up a company for a new business he is starting named *David's Widget Company*. The company issues 900,000 shares of common stock to David for an aggregate purchase price of $9. Before the company has any worth, he decides to bring on a key employee, Lucy. David offers Lucy 10% of the authorized shares, but as an incentive for her dedication to the company for at least four years, the shares will reverse vest. That means that if she quits or her employment with the company is otherwise terminated, some of those shares will be forfeited. For example, if she leaves before one year is up, she will forfeit all the shares; if she leaves during the second year, she will forfeit 75% of the shares; and so forth. If she stays for the full four years, she keeps all the shares. David and Lucy create the paperwork themselves and do not solicit an attorney. Lucy gets her 100,000 reverse vesting shares. She does not pay anything for the shares and does not file an 83(b) election. Indeed, she doesn't know what that even entails.

All sounds good, right? Not quite.

According to the IRC, if a person receives "property" (in this scenario, "property" is stock) in connection with the performance of services, and the property is subject to a substantial risk of forfeiture that lapses over time ("reverse vesting"), then each time a portion of that property vests, the person has to pay taxes (ordinary income) to the extent of the then current value of the portion that vested, minus what the person paid for that portion of the property.

In the scenario above, the company does well and raises a round of capital during the first year. The post-money valuation is $3,500,000, or $1 per share. When Lucy's first vesting date comes around, Lucy now has ordinary income in the amount of $25,000, or $1 times 25,000, which is the value per share times the number of shares that vest on that date. On the next vesting date, the company has done even better, and the valuation is now $10,000,000, or $2.86 per share. On that date, Lucy has $71,500 of ordinary income.

## THE 83(B) ELECTION SOLUTION

How could this tax obligation have been avoided? The IRS allows a person to file an 83(b) election, which means that the person wants to take into account, up front at the time of issuance, any income associated with the issuance of property that is subject to restrictions that lapse with the passage of time. If Lucy had done this, she would have had $1 of income at the time of issuance of the shares, and no income on each vesting date.

The filing is due within 30 days after the property is received. It is a strict deadline and there are no exceptions. If the election is not made within that time frame and the company that issued the stock is successful, the recipient will have adverse tax consequences down the line.