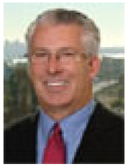
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**Section 83: Property in Exchange for Services**

Planning beyond stock transfers.

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Mention IRC Section 83 and most tax practitioners immediately think of bargain stock transfers.

Fortunately, or unfortunately in certain cases, Section 83 has much broader applications, which can have significant tax impact on both the transferring corporation, as well as the recipient/service provider.

**Background**

IRC Section 83 first appeared in the Code in 1969. The IRS and taxpayers use this Code section to include the value of property (other than cash and most stock options) in the taxable income of service providers (either a W-2 employee or independent contractor).

**Section 83 As a Valuable Tax Planning Tool**

The broad application of Section 83, the ability to control the timing and sometimes the amount and character of the income associated with the property, makes this a valuable tax planning tool for closely-held businesses. The strategy of using property instead of cash can benefit businesses in almost any industry and offers flexibility for cash-strapped companies.

The overall Section 83 strategy is three-fold:

1. Minimize Ordinary Income,
2. Maximize Capital Gain Income, and/or
3. Defer Income without significantly compromising on 1 and 2

In its simplest form, when a service provider receives property as compensation, the service provider must include the difference between: 1) the fair market value (FMV) of the property and 2) the amount paid in taxable income.

Similarly, the transferring business claims a tax deduction for the compensation the service provider received. However, the taxability of such transfers, and measurement of the taxable income, is deferred if the business imposes restrictions on the transferred property.

Besides the ability to shift income from a corporate entity to employees and other service providers, a Section 83(b) election (discussed below) provides flexibility for the timing, amount and character of the income reportable by the service provider.

To show some typical examples, using the most common property transfer — corporate stock — of how Section 83 applies in a corporate context:

**Example 1:**

Let us say start-up tech company, Yo-Yo, issues 1,000 shares to each of its new employees and a few key vendors when investors are paying $1 a share for its stock. There are no restrictions placed on the shares by the employer. The employer will report $1,000 of added compensation on the employee W-2s and vendor 1099s for the value of the stock transferred. The corporation has to withhold taxes on such amounts, which can be problematic. The corporation will deduct the same amount on its tax return as compensation and consulting expenses.

If the Yo-Yo stock increases to $11 a share a year later and a recipient sells the shares, the recipient recognizes a $10,000 long-term capital gain. Yo-Yo has no tax impact or reporting duty associated with the sale.

**Example 2:**

Now assume Yo-Yo requires the employees to stay with the company for at least a year to have full ownership of the shares.

Absent a Section 83(b) election, each recipient will report the full $11,000 value as ordinary income when the restrictions lapse after one year. Bad news for the recipients, but Yo-Yo gets a full $11,000 tax deduction for each transfer.

**Example 3:**

After receiving $11,000 of stock, and being drilled with ordinary income tax rates, half the recipients sell their shares a month later for $12,000 and the rest hold their shares, expecting a Google-esque payday in the future. Unfortunately, the stock tanks the following year and settles back to $1 a share. The remaining recipients sell their shares for one dollar a share after 12 months.

The sellers at $12,000 will report a short-term capital gain of $1,000 and Yo-Yo has no tax impact. The other half who sold their shares at $1 a share will report a long-term capital loss of $10,000 ($1,000 sales price, less $11,000 basis).

***Note:*** Ordinary income, followed by capital loss on the same asset does not make for a happy workforce, or effective employee benefit program.

**IRC Section 83(b) Election**

IRC Section 83(b) is a powerful provision. It allows the service provider who receives property that is not "vested" — either because of lack of transferability or because the property is subject to "substantial risk of forfeiture" at receipt — to "buy" the property by recognizing some taxable income. Treas. Reg. Section 1.83-3(b) and (c) provide more guidance on these definitions. The election by the recipient also speeds up the deduction by the company.

In the examples above, a Section 83(b) election would have limited the ordinary income amount (and corporate deduction) to $1,000.

A Section 83(b) election effectively allows the property recipient to elect within 30 days of the restricted transfer from the company to report the difference between: 1) FMV and 2) any consideration paid by the recipient before the restrictions lapse. In return for reporting the taxable income early, the recipient potentially minimizes ordinary income and starts the clock running for long-term capital gains treatment on any future appreciation in the property. There are potential downsides to such an election, including potential loss limits if the property decreases in value or the transferee has to return the property under the terms of the original transfer (*see* Treas. Reg. Section 1.83-2(a)). The service provider files their election with the IRS, as well as with the transferring corporation.

While company stock is the most commonly used property for purposes of Section 83 transactions, there are many opportunities to use other types of company assets to compensate service providers. Even though such transfers are common, many companies fail to notify service providers about the tax exposure until year-end, often long after the 30-day election period has expired.

The service provider may not revoke his election under Section 83(b) to recognize income on receiving restricted property without the consent of the Commissioner. The Commissioner will consent to the revocation in limited cases such as if the transferee was under a mistake of fact about the underlying transaction. The transferee must seek the Commissioner's consent within 60 days of the date on which the transferee first knew the mistake of fact. Also, see Revenue Procedure 2006-31 for more information.

**Conclusion**

You need a thorough analysis to ensure that both the company and the property recipient achieve their desired results. There are also some practical issues that the parties must include in the evaluation, such as which party will be the legal and tax owner of the property during the period the restrictions are present. This is important if the property will produce taxable income or losses during the restriction period. Next month we'll look at partnerships, options, vehicles (and other depreciable assets) and real estate.