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## Filing Requirements

William B. Sherman and Kevin M. Hall of Holland & Knight write that proposed regulations eliminating the requirement that taxpayers include a copy of an Internal Revenue Code Section 83(b) election with their returns would provide a planning opportunity for certain nonresidents who expect to become U.S. tax residents.

### Proposed Section 83(b) Regulations May Benefit Nonresidents

BY WILLIAM B. SHERMAN AND KEVIN M. HALL

**T**he Internal Revenue Service in July 2015 issued proposed regulations (REG-135524-14) that would eliminate the requirement that taxpayers include a copy of an Internal Revenue Code Section 83(b) election with their returns.<sup>1</sup> Although the stated purpose of the proposed regulations is to facilitate electronic return filing, this simple procedural change would remove an obstacle to nonresidents who plan to become U.S. tax residents and who therefore may benefit from making a Section 83(b) election.

The proposed change would apply to property transferred on or after Jan. 1, 2016, but taxpayers may rely on the proposed regulations for property transferred on or after Jan. 1, 2015.

#### Taxation of Equity Compensation, in General

Any person who receives property in exchange for the performance of services generally must include the fair market value of the property as ordinary income. An employee who receives equity-based compensation therefore is subject to tax at ordinary U.S. federal income tax rates, which currently reach 39.6 percent.

<sup>1</sup> Prop. Treas. Reg. Section 1.83(b)-(c).

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The compensatory transfer of property, however, generally isn't included in income if the property is subject to a "substantial risk of forfeiture" within the meaning of Section 83(a). As a result, equity-based compensation—including restricted stock and certain interests in partnerships—generally isn't included in income until the property is substantially vested. Once such property becomes substantially vested, the fair market value of the property at the time of vesting is included in the service provider's income as ordinary income.

Although this rule allows tax on equity-based compensation to be deferred until the service provider's right to the property is fixed, deferral comes at a price: The full fair market value of the property at the time of vesting is taxed at ordinary income rates.

#### Benefits of a Section 83(b) Election

An employee or other service provider who receives non-vested equity compensation may make a Section 83(b) election. If this election is made, the property is included in the service provider's income as ordinary income based on the fair market value of the property on the date that the election is made.

In certain circumstances, a Section 83(b) election may result in substantial tax savings to U.S. citizens and U.S. tax residents because the service provider has no additional income when the property vests and the risk of forfeiture lapses. Moreover, any gain from future appreciation may be eligible to be taxed at the preferential rates applicable to long-term capital gains.

A Section 83(b) election doesn't come without risk: If the service provider doesn't satisfy the applicable vesting requirements and the property is forfeited, no deduction is allowed for the amount previously included

### Section 83(b) Election Basics

Making a timely tax code Section 83(b) election requires foresight both by the individual and his or her U.S. tax adviser. Taxpayers who receive non-vested equity compensation in return for services and wish to treat it as vested must meet three procedural requirements:

- The election must be made by filing a statement with the IRS Service Center where the taxpayer files his or her individual tax return within 30 days of the date that the stock or other property was transferred.
- The service provider must attach a copy of the election to his or her income tax return.
- A copy of the election must be provided to the service recipient.

in income. Even if the property vests, if the property decreases in value after the Section 83(b) election is made, the service provider will have accelerated the inclusion of ordinary income and may be limited to recognizing a capital loss upon the disposition of the property.

The benefits of a Section 83(b) election may be even greater for nonresidents. The IRS has privately ruled that Section 83(a) applied to an individual who wasn't a U.S. tax resident at the time of receiving restricted stock but was a U.S. tax resident when the stock vested.<sup>2</sup> A nonresident who performs substantially all of the services in exchange for restricted stock outside of the U.S. but who is a U.S. tax resident when the stock vests therefore may be required to include the entire fair market value of the stock on the date of vesting as ordinary income.

If the individual had made a timely Section 83(b) election when the restricted stock was first received (and while the individual was a nonresident), the value of the stock likely would have escaped U.S. tax entirely because any income resulting from the election would have been foreign source income earned by a nonresident.

An additional benefit is that nonresidents aren't subject to the potential adverse consequences confronting U.S. tax residents who make the election. The disallowance of a deduction upon the forfeiture of the property won't harm a nonresident who didn't have a corresponding income inclusion. And the capital loss available if the property declines in value may exceed the loss had the nonresident not made a Section 83(b) election.

### Requirements for a Section 83(b) Election

Under the current regulations, taxpayers must satisfy three procedural requirements to make a Section 83(b) election:

- the election must be made by filing a statement with the IRS Service Center where the service provider files his or her individual tax return within 30 days of the date that the stock (or other property subject to Section 83(a)) was transferred to the service provider<sup>3</sup>;

- the service provider must attach a copy of the election to his or her income tax return; and

- a copy of the election must be provided to the service recipient.

A nonresident who expects to become a U.S. tax resident in the future may not be required to file a return. Failure to do so could, however, invalidate a Section 83(b) election.<sup>4</sup> By eliminating the return filing requirement, the proposed regulations would facilitate Section 83(b) elections by nonresidents.

The IRS could take the position that a nonresident performing services outside of the U.S. isn't eligible to make a Section 83(b) election.<sup>5</sup> Such a position would, however, appear to contradict the general principle that the U.S. tax rules (including available elections) apply to determine the historical tax attributes of assets when they first enter the U.S. tax system.<sup>6</sup>

Because of the procedural requirements necessary to make a timely Section 83(b) election—in particular the 30-day deadline—making the election requires foresight both by the individual and his or her U.S. tax adviser. Nonresidents receiving equity compensation who are contemplating becoming U.S. tax residents should carefully consider the benefits of making a Section 83(b) election and, if the election is made, ensure that all steps are taken to safeguard the validity of the election.

<sup>3</sup> For nonresidents, the election presumably should be filed with the IRS Service Center in Austin, Texas, where all nonresident individuals file their tax returns. The election must include the service provider's taxpayer identification number. A nonresident who doesn't have a taxpayer identification number should consider applying for one, perhaps including an explanation of the circumstances with the election statement indicating that an application for the number has been filed.

<sup>4</sup> Notably, the IRS has privately ruled that failing to file a return attaching the Section 83(b) election statement didn't invalidate the election. See PLR 201438006.

<sup>5</sup> For example, the IRS could take the position that the election isn't relevant at the time that it is made and therefore has no effect. To our knowledge, the IRS has never provided guidance explicitly providing that a nonresident can make a Section 83(b) election. However, the discussion in PLR 8711107 appears to indicate that nonresidents can make an effective Section 83(b) election.

<sup>6</sup> See e.g., AM 2007-006 (ruling that a foreign corporation can make a Section 338(g) election—resulting in a stepped-up tax basis of the foreign target's assets—for a foreign target corporation that has no prior connection to the U.S. tax system); Rev. Rul. 84-139, 1984-2 C.B. 168 (ruling that foreign real property inherited by a U.S. resident from a nonresident of the U.S. received a stepped-up tax basis under Section 1014 even though the value of such property wasn't includible in the nonresident's gross estate for U.S. estate tax purposes).

<sup>2</sup> PLR 8711107.