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Section 83(B) Election Should Be Effective for FICA Taxation of Restricted Shares

By Francesco Ferrante, Thompson Hine LLP

In anticipation of the 2013 tax rate increase, many taxpayers who received restricted shares in 2012 made Section 83(b) elections to lock in the pre-change lower tax rates. A question revisited was whether the Section 83(b) election is effective for FICA taxes. This question is important with respect to limiting the potential tax in the situation where the share value increases, but is further complicated by the issue of whether (1) the employee is subject to the 2012 1.45 percent Medicare tax or the post-2012 2.35 percent Medicare tax and (2) the new 3.8 percent Medicare tax on unearned investment income could also apply so as to duplicate the tax paid.

Before reading further, taxpayers should rest assured that the IRS has informally acknowledged that the Section 83(b) election is equally effective for FICA tax purposes.

The reason for the possible different result for federal income tax and FICA purposes is that the statutory taxation date differs in each case. For Section 83 purposes, the property is subject to income taxes when included in income and a Section 83(b) election treats the benefit as included in income. In contrast, the FICA tax liability applies to the wages paid and the regulations treat wages as paid when actually or constructively paid and when there is no substantial limitation or restriction. There is no provision that the Section 83(b) election is effective for FICA purposes.

A 1979 General Counsel Memorandum (GCM 38069) stated that the IRS was reviewing whether a Section 83(b) election should be effective for FICA tax purposes. In that GCM, the shares were held in trust without a risk of forfeiture. Nonetheless, the IRS suspended the issuance of a proposed revenue ruling that would have treated the shares held in trust as subject to FICA taxation. The GCM focused on the

fact that the shares had not been actually or constructively received, and would not have been for five years. (See also: Rev. Rul. 79-305; GCM 37947 (1979).) The following is from GCM 38069:

The Legislation and Regulations Division (L&R) is currently considering whether the regulations should be amended to provide that "wages" are paid for employment tax purposes even though not actually or constructively received if the employee elects to include such amount in gross income pursuant to an election under Section 83(b). In O.M. 18925, ***, I-572-76 (March 13, 1978), the Interpretative Division requested that L&R undertake this study and recommended that it consider modifying the income tax withholding provisions to provide that for purposes of income tax withholding, "wages" will be considered paid at the time of a Section 83(b) election. The Interpretative Division recommended consideration of this modification because the legislative purpose behind income tax withholding would not be satisfied if withholding of income tax on "wages" occurred in a year subsequent to the year such "wages" were included in the employee's gross income. O.M. 18925 did not, however, suggest that the regulations be amended to include a special provision governing the payment of "wages" in the case of a Section 83(b) election for FICA and FUTA purposes because Section 83 is an income tax provision, and neither its statutory language nor its legislative history contain any indication of an intent to modify the provisions of FICA and FUTA. In a memorandum attached to O.M. 18925, the Director, Individual Tax Division, Office of the Assistant Commissioner (Technical), agreed to suspend

publication of the proposed revenue ruling underlying O.M. 18925 pending L&R's consideration of that issue, but requested that the regulations be amended to provide that "wages" are paid for FICA and FUTA purposes as well as income tax withholding at the time of a Section 83(b) election.

More recent publications have also pointed to the different taxation dates for Section 83 and FICA purposes. A March 14, 2003 LMSB Field Directive states the following:

While I.R.C. Sec. 83 and the Regulations thereunder generally point to exercise date as the trigger for inclusion of income from exercise of nonqualified stock options, the FICA and income tax withholding provisions do not impose a withholding obligation on the employer until wages are actually or constructively paid.

In the context of income tax withholding, the IRS has been more lenient and acknowledges that the income tax withholding rules should be more in line with the income recognition rules. (See: Rev. Rul. 2007-48, 2007-2 C.B. 129.) However, even as recently as 2007, the following statement was made in Rev. Rul. 2007-48:

FICA and FUTA. When an employer contributes to a nonexempt employees' trust on behalf of a highly compensated employee, the FICA and FUTA taxation of such contributions depends on whether the employee's interest in the contribution is vested at the time of contribution. If the contribution is vested at the time of contribution, then the amount of the contribution is subject to FICA and FUTA taxes at the time of contribution. The employer is liable for the payment of FICA and FUTA taxes on such amounts. If the contribution is not vested at the time of contribution, then the amount of the contribution and the earnings thereon are subject to FICA and FUTA taxation at the time of vesting. With respect to contributions and earnings thereon that become vested after the date of contribution, the nonexempt employees' trust is considered the employer under § 3401(d)(1) with respect to such amounts as they become vested.

This issue also surfaced last year at conferences. As reported in *Corporate Executive* (September-October 2012 issue), this issue was raised at the National Association of Stock Plan Professionals Annual Conference in October and commented on by Stephen Tackney (Deputy Division Counsel/Deputy Associate Chief Counsel (Tax Exempt and Government Entities Division), Office of Chief Counsel – IRS), who acknowledged that most companies treat a Section 83(b) election as effective for both income and FICA taxes and the IRS is not challenging this position. A follow-up phone call made during December with the IRS group responsible for FICA taxes provided the same response.

If the Section 83(b) election is not effective for FICA taxes, an illustration easily highlights the costly effect that could result. Assume that 1000 shares with an aggregate value of \$5,000 are issued in 2012 subject to a substantial risk of forfeiture. The employee makes a timely Section 83(b) election to include the \$5,000 in income in 2012. Also assume that the aggregate value of the shares increases to \$20,000 by 2015, when the risk of forfeiture lapses. On the day immediately after the risk of forfeiture lapses, the employee sells the shares for cash.

If the Section 83(b) election is not taken into account for FICA tax purposes, the employee is subject to the 2.35 percent Medicare tax on the \$20,000 share value when the risk of forfeiture expires and is also subject to the new 3.8 percent Medicare tax on unearned income on the \$15,000 in share appreciation value when the shares are sold. The latter result from the fact that the new 3.8 percent tax is based on the amount included in gross income applying the tax basis of the shares for income tax purposes.

The true result (and the one followed by everyone) is that the 1.45 percent Medicare tax applies in 2012 on the \$5,000 and the new expanded 3.8 percent Medicare tax on unearned income applies to the \$15,000 in gain from the 2015 stock sale. The current 20 percent capital gain rate would also apply to the taxable appreciation on the stock sale.

FOR MORE INFORMATION

For more information, please contact:



Francesco A. Ferrante

Thompson Hine LLP

Phone: 937.443.6740

Mobile: 937.470.0598

Francesco.Ferrante@ThompsonHine.com

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