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Bill Introduced into Congress Exempting Employee Stock Purchase Plans and Incentive Stock Options from Employment Taxes and Income Tax Withholding

Overview

On January 18, 2001, the Internal Revenue Service issued Notice 2001-14, which may potentially lead to employment taxes (i.e., FICA[1] and FUTA[2] taxes) and income tax withholding being imposed on stock acquired through employee stock purchase plans ("ESPPs") and incentive stock options ("ISOs") beginning in January 2003. This Notice comes after almost thirty years of exemption from these tax liabilities, and threatens to diminish or possibly eliminate the use of such plans by companies seeking to build broad-based employee ownership.

In response to this, on August 1, 2001, the Chairman of the House Ways and Means Oversight Subcommittee, Amo Houghton (New York), introduced a bill into Congress that would pre-empt the IRS' position by changing the tax law. The bill was introduced in the Senate by Hillary Rodham Clinton (New York) and co-sponsored by Senator Pat Roberts (Kansas) on August 3, 2001.

Background

In 1971, the IRS issued Revenue Ruling 71-52 which exempted qualified stock options (predecessor to ISOs) from employment taxes. If the stock was sold prior to the minimum holding period (i.e., a "disqualifying disposition"), Revenue Ruling 71-52 also provided that the company was not required to withhold income taxes. In 1984, it appeared that the IRS would reverse this ruling with respect to ISOs in its proposed regulations, but later extended the same favorable treatment in IRS Notice 87-49, subject to a review of Revenue Ruling 71-52. Since these options were similar in many respects to ESPPs, companies assumed that ESPPs should also be treated in this manner.

Despite this long-standing guidance from the IRS, which most companies followed for ESPPs, random audits resulted in the assessment of employment tax deficiencies against many companies from ESPP transactions. Furthermore, in early 1999, the IRS issued Chief Counsel Field Service Advice[3], reinforcing the position that ESPPs were subject to FICA and FUTA taxes upon the exercise of stock options.

Finally, the IRS issued its Notice 2001-14 (as discussed above), which renders Revenue Ruling 71-52 obsolete, and provides that employment taxes and income tax withholding in disqualifying dispositions on ESPP and ISO stock will not be imposed until at least January 1, 2003, subject to clarification of the law. Companies that were subjected to these liabilities previously can seek refunds of any employment taxes paid on such amounts. The comment period for this notice is currently over, and it is unclear when the administrative guidance will be finalized.

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[1] Federal Insurance Contributions Act taxes
[2] Federal Unemployment Tax Act taxes
[3] No. 199926034, April 7, 1999.

What is the Proposal?

Representative Houghton's bill seeks to uphold the IRS' original guidance for ISOs and to formally extend the treatment to ESPPs. It proposes that stock acquired through ESPPs and ISOs should not be subject to employment taxes. It also eliminates Federal tax withholding requirements on income that results from a disqualifying disposition of ESPP or ISO stock.

Why is the Bill Necessary?

Congress originally created these stock benefits to encourage broad-based employee stock ownership, an action that we believe has contributed to long-term growth in the United States economy. Favorable tax treatment, along with the Financial Accounting Standards Board's position that ESPPs do not result in an accounting compensation expense, have encouraged companies to offer these beneficial programs. The National Center for Employee Ownership estimates that approximately 4,000 companies offered such plans last year, with approximately 16 million participants.

Although the discount from fair market value under an ESPP is considered compensation, if the stock is held, employees do not actually receive any cash. Therefore, any taxes due would need to be withheld from normal wages. Imposing this extra tax burden on the rank-and-file employees reduces the attractiveness of these plans and undermines the original purpose for which they were created. Furthermore, if these employment taxes were paid and the stock price subsequently went down, employees would have paid taxes on paper profits that were never realized.

For companies, keeping track of these payment liabilities presents a significant administrative burden. When an employee disposes of stock, the employer is not in a position to know how much stock has been sold and at what price. In addition, participants may not even be current employees when their shares are sold. These compliance and tracking issues are real burdens that some companies may not want or even be able to deal with, thereby leading to the cancellation of existing plans and discouraging companies from putting new plans in place. As a result, an important opportunity for rank-and-file employees to accumulate equity positions in their companies would be eliminated.

What Should Companies Do?

It is important that companies write their local Congressmen in support of the bill, especially if their local representative is on the House Ways and Means Committee. Letters advocating the bill should reference its number, which is S.1383 in the Senate and H.R. 2695 in the House of Representatives.

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Specific questions concerning this topic should be addressed to corporate counsel. General questions may be addressed to Michael Chavira or Beverly Aisenbrey in our New York office at (212) 986-6330. Copies of this letter and other published material are available on our website at www.fwcook.com.