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**IRS Issues Proposed Regulations
on the Taxation of Employee Stock
Purchase Plans and Incentive Stock Options**

Overview

On January 18, 2001, the Internal Revenue Service (“IRS”) issued Notice 2001-14 which suspended the collection of employment taxes (i.e., FICA and FUTA) on employee stock purchase plans (“ESPPs”) and incentive stock options (“ISOs”) until at least January 1, 2003, subject to clarification of the law, and opened the issue up for public comment. Subsequently, a new bill¹ (“the Houghton Bill”) was introduced into Congress that would exempt ESPPs and ISOs from employment taxes at exercise and income tax withholding at exercise or at a disqualifying disposition. As of the date of this letter, the bill has not yet been passed.

Now, however, the comment period is over and the IRS has released its proposed regulations.² In summary, the regulations provide for the imposition of FICA and FUTA taxes on gains from the exercise of options granted under tax-qualified employee stock purchase plans and from incentive stock options. The IRS also released two notices, the first of which proposes that no income tax withholding will be required on ESPP and ISO transactions and further discusses the reporting obligations. The second notice addresses ways to ease the administrative burden of collecting the related employment taxes.

Proposed Regulations

The proposed regulations with respect to the taxation of both options granted under an ESPP and ISOs are as follows:

- FICA and FUTA taxes will be imposed at the time individuals exercise their options
 - The amount subject to taxation is equal to the “gain” at exercise, or the excess of the fair market value of the stock over the price paid for it
- No income tax withholding shall be required at the time of exercise since no income tax is due at this time

¹ Introduced as H.R. 2695 by Amo Houghton (New York) in the House of Representatives, and as S.1383 by Hillary Rodham Clinton (New York) with co-sponsorship by Senator Pat Roberts (Kansas) in the Senate. See our letter of October 1, 2001.

² http://www.fwcook.com/alert_letters/100101_BillIntroducedIntoCongressExempting.pdf
REG-142686-01

- Rules of administrative convenience intended to assist employers and employees in meeting their employment tax obligations are permitted (see description of Notice 2001-73 below)
 - Adoption of these rules will not be deemed to be a modification to the terms of outstanding options that would change their tax treatment
- The above proposed regulations will become effective for option exercises on or after January 1, 2003 (although companies may voluntarily apply the law sooner if the regulations are finalized as proposed)

Income Tax Withholding and Reporting (IRS Notice 2001-72)

Notice 2001-72 describes the proposed rules with respect to income tax withholding and reporting obligations in connection with the exercise of ISOs or options granted under an ESPP. The proposed rules are as follows:

- No income tax withholding will be required upon a disqualifying or other disposition of stock acquired through the exercise of an ISO or an option granted under an ESPP
- Although option gains from ISO and ESPP stock transactions are not subject to income tax withholding (as discussed above), income resulting from disqualifying dispositions must be reported on an employee's Form W-2
 - Companies must make reasonable efforts to determine if an employee has received such income; e.g., if a company claims a deduction but does not provide a W-2 (presuming W-2 income for the year is at least \$600), the company will be deemed to have not made reasonable efforts.

Administrative Convenience (IRS Notice 2001-73)

Notice 2001-73 details the proposed rules of administrative convenience regarding the application of FICA and FUTA to ISOs or options granted under an ESPP. The proposed rules outlined in this notice are as follows:

- Income received from option exercises may be deemed to have been paid on a specific date or dates (i.e., on a particular pay date, or on a quarterly, semi-annual, annual or other basis) rather than on the actual payment date
- If companies treat income received from option exercises as occurring over more than one period, the payments may not be deemed to commence before the exercise occurs or after December 31st of the year of exercise
 - “Special Accounting Rule” - Income resulting from exercises in December may be treated as occurring in the first quarter of the following calendar year

-- Companies must apply the rule to all participants and must notify the employee of this treatment

- Companies may select and change the method used at any time without having to notify the IRS
- Companies may allow employees to pre-fund the FICA tax or may advance the funds necessary to pay the FICA tax arising from option exercise

Comments Requested

Comments as well as requests to speak at a March 7 hearing on the proposed regulations and both notices must be received by February 14, 2001. Arguments, however, will only be accepted if based on the existing tax code.

Discussion of Proposed Rules

As we pointed out in our prior alert letter¹, favorable tax treatment for ESPPs and ISOs has encouraged many companies to offer these types of programs, thereby building valuable stock ownership among their employees. Although the IRS has made efforts to ease the administrative burden of imposing these tax liabilities in their proposal, the burden is still significant enough to discourage companies from continuing their existing plans or implementing new plans. The additional tax burden on employees may also discourage participation in ESPPs because the tax would have to be withheld from their other compensation (i.e., salary) and rank-and-file employees may not be willing to relinquish that compensation. Ultimately, these plans were created to encourage employee ownership, and the new regulations undermine this goal.

Support Houghton's Bill

The IRS has taken this position because there is no statutory basis for excluding the gain from FICA and FUTA. Therefore, the only solution is for companies to support the Houghton bill. Companies should contact their local Congressmen (especially if they are on the House Ways and Means Committee) and reference the bill number in their letters -- 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.