

Part III - Administrative, Procedural, and Miscellaneous

Application of Employment Taxes to Statutory Options

Notice 2001-14

I. Purpose and Overview

This notice is intended to clarify the application of FICA, FUTA and income tax withholding to statutory stock options. With respect to incentive stock options (ISOs) described in section 422(b) and options granted under an employee stock purchase plan (ESPP) described in section 423(b) (collectively, “statutory options”), the notice

- provides that, in the case of any statutory option exercised before January 1, 2003, the Service will not assess FICA tax or FUTA tax upon the exercise of the option and will not treat the disposition of stock acquired by an employee pursuant to the exercise of the option as subject to income tax withholding;
- concludes that Rev. Rul. 71-52 is obsolete and that the holding of Rev. Rul. 71-52 does not apply to the exercise of statutory options or to the disposition of stock acquired pursuant to the exercise of statutory options; and
- announces the intent to issue further administrative guidance to clarify current law with respect to FICA tax and FUTA tax on statutory options and to address the issue of whether the disposition of stock acquired by an employee pursuant to the exercise of a statutory option will be subject to income tax withholding. This notice invites public comment on this anticipated guidance.

II. Background

A. Income Tax Withholding and Reporting on Options

Income tax withholding is imposed under section 3402(a) of the Internal Revenue Code of 1986 (Code), which requires employers paying wages to deduct and withhold income tax on those wages. For income tax withholding purposes, section 3401(a) provides that the term “wages,” with certain exceptions, means all remuneration for

services performed by an employee for his employer, including the cash value of all remuneration (including benefits) paid in any medium other than cash.

The legislative history of sections 3401 through 3404 indicates that a purpose of income tax withholding is to enable individuals to pay income tax in the year in which the income is earned. H.R. Conf. Rep. No. 510, 78th Cong., 1st Sess., at 1 (1943); H.R. Rep. No. 401, 78th Cong., 1st Sess., at 1 (1943); S. Rep. No. 221, 78th Cong., 1st Sess., at 1 (1943). Income tax withholding generally is imposed upon remuneration paid by an employer only to the extent that an employee has income.

Under section 421, no compensation income results when a statutory option is exercised. Section 421(a) provides that, if a share of stock is transferred to an individual in a transfer that meets the requirements of section 422(a) or 423(a), no income results at the time of the transfer. Instead, compensation income is deferred until the sale or other disposition of the stock acquired pursuant to the exercise of a statutory option.

Employers making wage payments to an employee (of former employee) that are subject to income tax withholding generally must report such wage payments on Form W-2, as provided in section 31.6051-1(a)(1) of the Employment Tax Regulations. Under certain circumstances, a payment made by an employer to an employee (or former employee) must be reported on Form W-2 even if the payment is not subject to income tax withholding. Specifically, section 1.6041-2(a)(1) of the Income Tax Regulations generally requires reporting if the total amount of the payment and any other payments of remuneration (including wages, if any) made to the employee (or former employee)

that are required to be reported on Form W-2 aggregate at least \$600 in a calendar year.

B. FICA and FUTA Tax

Under sections 3111 and 3301, Federal Insurance Contributions Act (FICA) tax and Federal Unemployment Tax Act (FUTA) tax, respectively, are imposed on the employer in an amount equal to a percentage of the wages paid by that employer. Under section 3101, FICA tax also is imposed on the employee. Under sections 3121(a) and 3306(b), the term “wages” for FICA tax purposes and FUTA tax purposes, respectively, means, with certain exceptions, all remuneration for employment, including the cash value of all remuneration (including benefits) paid in any medium other than cash. Neither the Code nor the relevant regulations contain any provision excluding the value of stock transferred pursuant to the exercise of a statutory option from wages for FICA tax and FUTA tax purposes.

In 1981, the Supreme Court in Rowan Companies, Inc. v. U.S., 452 U.S. 247, held essentially that the definition of “wages” for FICA tax and income tax withholding purposes was the same. As part of the Social Security Amendments of 1983, Pub. L. No. 98-21, 97 Stat. 65, Congress reversed this holding. Sections 3121(a) and 3306(b)¹ were amended to provide that “[n]othing in the regulations prescribed for purposes of chapter 24 (relating to income tax withholding) which provides an exclusion from ‘wages’ as used in such chapter shall be construed to require a similar exclusion from ‘wages’ in the regulations prescribed for purposes of this chapter.” This sentence makes clear that the definition of wages for income tax withholding purposes is not always the

same as the definition of wages for FICA tax and FUTA tax purposes, and that an item of income can be wages for FICA tax purposes even if it is not wages for income tax withholding purposes.

The legislative history of the 1983 provision explains that Congress intended to reverse the holding in Rowan, and the Senate Report states: “Since the [social] security system has objectives which are significantly different from the objective underlying the income tax withholding rules, the committee believes that amounts exempt from income tax withholding should not be exempt from FICA unless Congress provides an explicit FICA tax exclusion.” S. Rep. No. 23, 98th Cong., 1st Sess., at 42 (1983).

C. Administrative Guidance

Revenue Ruling 71-52 (1971-1 C.B. 278) addressed the FICA tax, FUTA tax and income tax withholding consequences applicable to the exercise of qualified stock options under former section 422². The ruling holds that a taxpayer does not make a payment of wages for FICA tax, FUTA tax and income tax withholding purposes at the time of the exercise of a qualified stock option under former section 422, and that income realized by employees and former employees from a disqualifying disposition of

¹Sections 3121(a) and 3306(b) were amended by section 327(b)(1) and (c)(4), respectively, of the Social Security Amendments of 1983.

²Section 603 of the Tax Reform Act of 1976, Pub. L. No. 94-355, 90 Stat. 1520, amended former section 422 to provide, generally, that qualified stock options could not be granted after May 20, 1976. Current section 422 (Incentive Stock Options) was added to the Internal Revenue Code of 1954, as section 422A, by section 251(a) of the Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, 95 Stat. 172. Subsequently, section 11801(c)(9)(A)(i) of the Omnibus Budget Reconciliation Act of 1990, Pub. L. No. 101-508, 104 Stat. 1388, repealed former section 422 (Qualified Stock Options) and re-designated former Code section 422A as section 422 of the Internal Revenue Code of 1986.

stock acquired by the exercise of a qualified stock option is also not wages for FICA tax, FUTA tax and income tax withholding purposes.

Rev. Rul. 71-52 was published before the 1983 statutory changes to sections 3121(a) and 3306(b) described above. In addition, in 1971, the Old-Age, Survivors, and Disability Insurance (OASDI) contribution and benefit base was only \$4,800, as compared to the current OASDI wage base of \$80,400. Further, in 1971, the \$4,800 limit applied to the Hospital Insurance (HI) portion of the FICA tax as well as to the OASDI portion; by contrast, under current law, there is no limit on the amount of wages for purposes of the HI portion. Accordingly, in 1971, since most optionees had other wages that equaled or exceeded the FICA wage base, inclusion of option-related income in FICA wages would have had no effect on the FICA tax liability or Social Security benefits of most optionees (and no appreciable effect on FICA receipts). Given the increased wage base for purposes of the OASDI portion of the FICA tax and removal of the limit on the wage base for purposes of the HI portion, that is no longer the case.

Notice 87-49 (1987-2 C.B. 355) addresses potential inconsistencies among, and coordination of, the proposed regulations under section 83, former section 422A (current section 422), and Rev. Rul. 71-52. Notice 87-49 provides that Rev. Rul. 71-52 is being reconsidered, but until the results of such reconsideration are announced, the principles of Rev. Rul. 71-52 will apply to the disposition of stock acquired by an individual pursuant to the exercise of an ISO, which does not meet the requirements of former section 422A(a) (current section 422(a)).

III. Reconsideration of Rev. Rul. 71-52 and Interim Guidance

A. Reconsideration of Rev. Rul. 71-52

Treasury and the Service have concluded that the holding and principles of Rev. Rul. 71-52 do not apply to the exercise of ISOs or options granted under an ESPP, or to the disposition of stock acquired pursuant to such statutory options, and have therefore determined that Rev. Rul. 71-52 is obsolete. Accordingly, the provisions of Notice 87-49 described above no longer apply.

B. Interim Guidance

In view of the lack of clear administrative guidance regarding the application of FICA, FUTA, and income tax withholding to statutory options, the Service, with respect to statutory options exercised before January 1, 2003, will not treat the disposition of stock acquired by an employee pursuant to the exercise of a statutory option as subject to income tax withholding and will not assess FICA tax or FUTA tax upon the exercise of a statutory option.

This Part III.B applies to an exercise of a statutory option and the disposition of stock acquired by an individual pursuant to the exercise of a statutory option, if the exercise occurs on or after publication of this notice and before January 1, 2003. However, employers may, at their option, choose to apply this Part III.B with respect to any exercise of statutory options, or dispositions of stock acquired by individuals pursuant to any exercise of statutory options, that occurred before the publication of this notice. Thus, with respect to exercises of statutory options covered by this Part III.B, the Service will not require payment of FICA tax or FUTA tax, will not assert penalties or interest, and will honor otherwise allowable adjustments and claims for refund of any FICA tax or FUTA tax paid. Furthermore, with respect to dispositions of stock acquired

pursuant to the exercise of statutory options covered by this Part III.B, the Service will not require income tax withholding and will not assert penalties or interest. This Part III.B does not relieve individual taxpayers of the obligation to include any compensation in income upon a disposition of stock acquired pursuant to the exercise of a statutory option, and does not relieve employers of any of their reporting obligations.

IV. Request for Comments on Anticipated Administrative Guidance

A. Anticipated Guidance

Treasury and the Service anticipate issuing administrative guidance that will clarify current law with respect to FICA tax, FUTA tax, and income tax withholding on statutory options. It is anticipated that the administrative guidance would reflect the view that the statute defines “wages” for FICA tax and FUTA tax purposes broadly, without any statutory exclusion for exercises of statutory options. With respect to the disposition of stock acquired pursuant to such an exercise, however, it is the view of Treasury and the Service that there may be authority for future administrative guidance to treat amounts realized upon such disposition of stock as not being subject to income tax withholding.

Comments are requested regarding the anticipated administrative guidance. In particular, comments are requested on whether it is appropriate, in light of the issues of administrative feasibility associated with a requirement of income tax withholding upon disposition of stock acquired pursuant to the exercise of a statutory option (when the optionee may no longer be employed by the grantor), to treat amounts realized upon the disposition as not being subject to income tax withholding. All comments will be available for public inspection and copying.

B. Prospective Effective Date

It is anticipated that the administrative guidance described in this Part IV will be effective only prospectively. However, it is anticipated that employers will be permitted to apply the guidance to exercises of statutory options that occurred on an earlier date and to a disposition of stock acquired pursuant to such exercises.

V. Effect on Other Documents

This notice constitutes the result of the reconsideration of Rev. Rul. 71-52, referred to in Notice 87-49. This notice concludes that the holding and principles of Rev. Rul. 71-52 do not apply to the exercise of ISOs described in section 422(b) or options granted under an ESPP described in section 423(b), or to the disposition of stock acquired pursuant to the exercise of such statutory options and, thus, Rev. Rul. 71-52 is determined to be obsolete. Notice 87-49 is modified to the extent it is inconsistent with this notice.

VI. Submission of Comments

Comments must be submitted by May 7, 2001. Comments should reference Notice 2001-14, and be addressed to:

Associate Chief Counsel

(Tax Exempt and Government Entities)

CC:TEGE

ATTN: Employment Taxes and Statutory Options

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VII. Drafting Information

The principal author of this notice is Stephen Tackney of the Office of Associate Chief Counsel (Tax Exempt and Government Entities). For further information regarding this notice contact Stephen Tackney at (202) 622-6040 (not a toll-free call).