

Part III - Administrative, Procedural, and Miscellaneous

Notice of Proposed Rules Regarding Income Tax Withholding and Reporting Obligations Upon the Sale or Disposition of Stock Acquired Pursuant to the Exercise of a Statutory Stock Option

Notice 2001-72

I Overview and Purpose

This notice provides proposed rules regarding an employer's income tax withholding and reporting obligations upon sale or disposition of stock acquired by an individual pursuant to the exercise of a statutory stock option, i.e. an incentive stock option (ISO) under section 422 or an option granted under an employee stock purchase plan (ESPP) under section 423. This notice is being published at the time of publication of related proposed regulations clarifying the application of employment taxes to statutory stock options. This notice solicits comments regarding the proposed rules. Treasury and the Service anticipate issuing a notice with final rules when the final regulations addressing the application of FICA tax, FUTA tax, and income tax withholding with respect to statutory stock options are issued.

II Comments Received Pursuant to Notice 2001-14

On February 6, 2001, Treasury and the Service issued Notice 2001-14 (2001-6 I.R.B. 416). Notice 2001-14 addresses the application of employment taxes to statutory stock options. Notice 2001-14 announced the intent to issue administrative guidance

that would clarify, among other issues, the application of income tax withholding on statutory stock options, and requested comments regarding the anticipated administrative guidance.

In response to Notice 2001-14, commentators stated that determining the occurrence of a disqualifying disposition (i.e., a disposition of stock acquired pursuant to the exercise of a statutory stock option that results in loss of the special income tax treatment provided in section 421) to fulfill the income tax withholding deposit requirements on a timely basis would be burdensome, especially as to former employees.

Commentators also stated that fulfilling the income tax withholding obligations would be difficult as to certain employees, because those employees would not have sufficient other cash compensation from which to fund the withholding. Specifically, the commentators referred to former employees who are no longer receiving other cash compensation, as well as employees with disqualifying dispositions resulting in large income tax withholding obligations whose current other cash compensation would not be sufficient to fund these amounts.

Commentators also pointed out that the current reporting requirements mandate that the amounts be reported to the employees, so that the compensation will not escape Federal income tax. They also noted that employers have an incentive to report these amounts under section 1.83-6(a)(2) of the Income Tax Regulations.

III Proposed Rule - Income Tax Withholding

In response to these comments, Treasury and the IRS propose the following rule:

An employer would have no income tax withholding obligation when an

employee sells or disposes of stock acquired by the employee pursuant to the exercise of an ISO under section 422 or an option granted under an ESPP under section 423.

Example of proposed rule

(a) Individual X is granted an option under a plan that satisfies the requirements of section 423(b). The option allows X to acquire 50 shares of the stock of X's employer, Y, at an exercise price equal to 85% of the fair market value of the stock at the time the option is granted. The fair market value of the Y stock at the time the option is granted is \$100 per share. X exercises the option later when the fair market value of the Y stock is \$120 per share. Thus, at the time of exercise, X acquires 50 shares of Y stock having a fair market value of \$120 per share for \$85 per share. X pays cash to acquire the shares of Y stock. Four months later, X sells the shares of Y stock for \$160 a share.

(b) In this example, when X sells the shares of Y stock, X recognizes ordinary income under section 421(b) equal to the excess of the fair market value of the Y stock at the time of exercise (\$120 per share) over the amount paid for the stock (\$85 per share) which equals \$35 per share, for a total of \$1,750. Under the proposed rule, this \$1,750 is remuneration that would not be subject to income tax withholding. X also has capital gain of \$40 per share equal to the appreciation in value of the stock from the time of exercise to the time of sale. The capital gain of \$40 per share is not remuneration and is not subject to income tax withholding.

IV Proposed Rules - Reporting

Treasury and the Service propose the following rules:

Section 1.6041-2(a)(1) requires that, under certain circumstances, a payment made by an employer to an employee be reported on Form W-2 even if the payment is not subject to income tax withholding. Specifically, section 1.6041-2(a)(1) generally requires reporting if the total amount of the payment and other payments of remuneration, if any, made to the employee that are required to be reported on Form W-2, aggregate at least \$600 in a calendar year. An employer must make reasonable efforts to ascertain whether it must provide a Form W-2 to an employee who has received remuneration not subject to income tax withholding upon a sale or disposition of stock acquired pursuant to the exercise of an ISO or option granted under an ESPP. An employer has not made reasonable efforts in any case in which it claims a deduction under section 83 for payment of the remuneration to an employee but fails to provide a Form W-2 reporting that remuneration to the employee, if the total amount of that payment, along with any other payments of remuneration made to the employee that are required to be reported on Form W-2, aggregate at least \$600 in that calendar year. The employer is not required to provide a Form W-2 if the employer has made reasonable efforts and cannot determine whether a payment of remuneration has been made.

V Former Employees

For purposes of this notice, the term “employee” includes any former employee.

VI Request for Comments

Comments are requested regarding the proposed rules regarding income tax withholding and reporting obligations upon the sale or disposition of stock acquired pursuant to the exercise of a statutory stock option. All comments will be available for public inspection and copying. Comments must be submitted by February 14, 2002.

Comments should reference Notice 2001-72, and be addressed to:

Associate Chief Counsel
(Tax Exempt and Government Entities)
CC:TEGE
ATTN: Statutory Stock Options and Income Tax Withholding
Room 5214
Internal Revenue Service
1111 Constitution Ave., NW
Washington, DC 20224

VII Effective Date

The proposed rules set forth in this notice are not effective until a subsequent notice is issued with final rules. Treasury and the Service anticipate issuing such a notice to accompany the issuance of final regulations addressing the application of FICA tax, FUTA tax, and income tax withholding to statutory stock options.

VIII Drafting Information

The principal author of this notice is Stephen Tackney of the Office of the Associate Chief Counsel (Tax Exempt and Government Entities). However, other personnel from Treasury and the Service participated in its development. For further information regarding this notice contact Stephen Tackney at (202) 622-6040 (not a toll-free call).