

Part III - Administrative, Procedural, and Miscellaneous

Notice of Proposed Rules of Administrative Convenience Regarding Application of the Federal Insurance Contributions Act and Federal Unemployment Tax Act to Statutory Stock Options

Notice 2001-73

I Overview and Purpose

This notice provides proposed rules of administrative convenience relating to the application of the Federal Insurance Contributions Act (FICA) and Federal Unemployment Tax Act (FUTA) to statutory stock options, i.e., incentive stock options under section 422 (ISOs) and options granted pursuant to an employee stock purchase plan under section 423 (ESPP options). The rules are proposed under the authority to be granted to the Commissioner under the regulations that are currently being proposed (as § 31.3121(a)-1(k) and § 31.3306(b)-1(l)) addressing the application of FICA tax, FUTA tax, and income tax withholding with respect to statutory stock options. This notice solicits comments regarding the proposed rules of administrative convenience. 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.

On February 6, 2001, Treasury and the Service issued Notice 2001-14 (2001-6 I.R.B. 561). The notice states that Treasury and the Service anticipate issuing

guidance clarifying the application of employment taxes to statutory stock options, and requests comments regarding the guidance. Proposed regulations are now being issued that generally provide that, at the time of the exercise of a statutory stock option, the individual who was granted the statutory stock option receives wages for FICA and FUTA purposes when the stock is transferred to the individual pursuant to the exercise.

To address the concerns raised by certain comments to Notice 2001-14, the proposed regulations would grant the Service authority to prescribe rules of administrative convenience to assist employers and employees in meeting the employment tax obligations that arise upon the exercise of a statutory stock option. To notify taxpayers of the potential rules, this notice describes the proposed rules of administrative convenience.

II Proposed Rules of Administrative Convenience

Treasury and the Service propose the following rules of administrative convenience:

A Payment Periods

Under the proposed rules, an employer would be permitted to treat FICA and FUTA wages resulting from the exercise of a statutory stock option as paid on a pay period, quarterly, semi-annual, annual, or other basis. An employer also could choose to treat FICA and FUTA wages resulting from the exercise of a statutory stock option as paid over more than one period. The deemed payment or payments could not commence before the exercise occurred and all payments would be required to be treated as paid on or before December 31 of the year of the exercise (except as provided under Section B below). The employer could change

the method used at any time. A formal election would not be required, and the employer would not need to notify the Service of the use of any method or change in method used.

Examples

(i) Employer A sponsors an employee stock purchase plan under section 423 that permits the purchase of stock on a quarterly basis (January 1, April 1, July 1, and October 1). Employer A elects to treat the wages resulting from the exercises of ESPP options (i.e., the stock purchases) as paid ratably over the calendar quarter in which the exercises occur, with an automatic acceleration upon the employee's termination of employment.

(ii) Employer B sponsors an incentive stock option plan under section 422. Employer B elects to treat all wages resulting from the exercises of incentive stock options in a calendar year as paid on December 31 of that year.

(iii) Employer C sponsors an incentive stock option plan under section 422 that permits employees to exercise stock options during employment and within the 90-day period following a termination of employment. Employer C chooses to treat the FICA and FUTA wages resulting from an exercise in a calendar year as paid on December 31 of the calendar year, except that if the employee terminates employment before December 31, Employer C treats the wages as paid on the later of the date of termination of employment or the date of exercise of the statutory stock option.

B Special Accounting Rule

Under the proposed rules, the employer would be permitted to choose to treat the wages resulting from the exercise of a statutory stock option occurring in the last month of the calendar year (December), or any shorter period ending on December 31, as paid in the first calendar quarter of the next following calendar year. However, an employer who treats any or all wages resulting from the exercise of a statutory stock

option during the first 11 months of the calendar year as paid, in whole or in part, during the month of December would not then be permitted to treat those wages as paid in the first calendar quarter of the following calendar year. Rather, only the wages resulting from an actual exercise of a statutory stock option during the month of December could be treated as paid in the next following calendar quarter. Employers that choose to use the special accounting rule would not need to make a formal election, and employers would not need to notify the Service of the use of the rule or any change in the use of the rule.

Examples

(i) Employer A sponsors an employee stock purchase plan under which ESPP options are exercised on a semi-annual basis (June 30 and December 31). Employer A chooses to treat the FICA and FUTA wages resulting from each December 31 exercise as paid on the earlier of March 31 of the subsequent year or the employee's termination of employment.

(ii) Employer B sponsors an incentive stock option plan. Employer B chooses to treat the FICA and FUTA wages resulting from an exercise that occurs during the final seven days of December of any calendar year as paid on the earlier of January 31 of the subsequent year or the employee's termination of employment.

The special accounting rule would only apply for purposes of determining the date on which the FICA and FUTA wages result from the exercise of a statutory stock option. Therefore, the choice would apply for purposes of both the employer portion of FICA tax and the employee portion of FICA tax. If the employer used the special accounting rule, the employee would be required to use the special accounting rule and to use it for the same period as the employer. In addition, the employee would

be required to use the special accounting rule and the same period for all purposes. For example, the special accounting rule would apply in determining the calendar year in which the wages were paid for purposes of the credit or refund under section 6413(c) relating to FICA tax and wage payments from multiple employers in the same calendar year.

An employer's choice to use the special accounting rule would be required to apply to all participants in the relevant employee stock purchase plan or incentive stock option plan. An employer that chose to use the special accounting rule would be required to notify the affected employees that the special accounting rule had been used and of the period for which it had been used. The employer would be required to provide the notice directly to each employee at or near the time the employer provided the employee with the Form W-2 for the calendar year in which the exercise occurred; the notice could not be provided earlier than with the employee's last paycheck of that calendar year.

C Employee Pre-Funding of the Employee Portion of FICA Tax

Under current law, an employer and an employee may contractually arrange for the employee to pre-fund the amount of the employee portion of FICA tax that will arise upon the exercise of a statutory stock option.

Example

(i) Employer A sponsors an employee stock purchase plan under section 423 under which ESPP options are exercised on a quarterly basis (March 31, June 30, September 30, December 31). Employees fund the ESPP option exercise through payroll deductions. The payroll deductions include an additional amount equal to one percent of the payroll deduction

deducted each payroll period and the one percent amount is used to fund the employee portion of FICA tax due at the time of the exercise. Any shortfall in funds to pay the employee portion of FICA tax is settled through withholding from the employee's current compensation at the time of the exercise, or such other method as may be available. Any excess over the amount necessary to pay the employee portion of FICA tax is returned to the employee.

Withholding to pre-fund the payment of the employee portion of FICA tax does not affect the taxation of, or the timing of taxation of, compensation. Therefore, the withheld amounts are included as gross income for income tax purposes, as well as wages paid to the employee for FICA tax, FUTA tax, and Federal income tax withholding purposes, as appropriate. In addition, for purposes of sections 3101 and 3102(a), this separate contractual arrangement does not satisfy either the employer's collection obligation or the employee's FICA tax liability until the funds are remitted to the Service. If the employer withholds funds from the employee and does not deposit the funds with the Service in satisfaction of the employee portion of FICA tax, the employee and the employer each remain liable for the tax, and any right of the employee to the pre-funded amounts held by the employer is not enforceable under the Internal Revenue Code.

D Employer Advance of Employee Portion of FICA Tax

Under current law, an employer may arrange to advance the funds necessary to pay the employee portion of FICA tax and obtain reimbursement of those funds from the employee.

Examples

(i) Employer A sponsors an employee stock purchase plan under section 423 that permits the exercise of ESPP options on a quarterly basis (March 31, June 30, September 30, and December 31). Employees fund the ESPP option exercise price through payroll deductions. When an option is exercised, Employer A advances the funds to pay the employee portion of FICA tax arising from the exercise, and is repaid the advance from the employee's payroll deductions over the following quarter. Any repayment due to Employer A is accelerated upon the employee's termination of employment or termination of participation in the employee stock purchase plan.

(ii) Employer B sponsors an incentive stock option plan under section 422. When an incentive stock option granted under the plan is exercised, Employer B advances the funds to satisfy the employee portion of FICA tax arising from the exercise of the incentive stock option. Employer B is repaid the advance from the employee's future payroll. Any repayment due to Employer B is accelerated upon the employee's termination of employment.

E Consistency Rule

For purposes of the rules of administrative convenience outlined in Sections A and B, the employer would be required to apply the chosen rule consistently to all employees eligible to participate under the relevant employee stock purchase plan under section 423 or incentive stock option plan under section 422. In addition, the requirements of section 423(b)(5) are applicable to an employee stock purchase plan under section 423. Section 423(b)(5) provides, with certain exceptions, that the terms of an employee stock purchase plan under section 423 must provide the same rights and privileges to all employees granted options under the plan.

Employers could impose conditions under which a chosen method would or would not apply to employees, provided that those conditions and the resulting method were applied consistently to all employees. For

example, the employer could accelerate the deemed wage payment if an employee terminated employment, provided that the acceleration rule applied to all employees who terminated employment. All of the examples provided in Sections A through E above would meet the consistency requirement of this notice as well as the requirements of section 423(b)(5).

III Effective Date

The proposed rules 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.

IV Request for Comments

Comments are requested regarding the proposed rules of administrative convenience described in this notice. All comments will be available for public inspection and copying. Comments must be submitted by February 14, 2002.

Comments should reference Notice 2001-73, and be addressed to:

Associate Chief Counsel
(Tax Exempt and Government Entities)
CC:TEGE
ATTN: Employment Taxes, Statutory Stock Options and Proposed
Rules of Administrative Convenience
Room 5214
Internal Revenue Service
1111 Constitution Ave., NW
Washington, DC 20224

V Paperwork Reduction Act

Before final rules of administrative convenience are published, the collection of

information contained in the proposed rules of administrative convenience described in this notice will be submitted to the Office of Management and Budget for review in accordance with the Paperwork Reduction Act (44 U.S.C. 3507(c)).

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless the collection of information displays a valid OMB control number.

The collection of information in the proposed rules of administrative convenience is in section B, requiring employers who choose the special accounting rule to notify employees of the application of the rule. This information is required to inform employees that for purposes of FICA and FUTA, certain wage payments made in the December of a calendar year will be deemed paid during some specified period in the first quarter of the following calendar year. This information will be used to explain the wage reporting on the Forms W-2 that the employee receives. The collection of information is required if the employer chooses to use the special accounting rule. The likely respondents are business or other for-profit institutions.

The estimated total annual reporting and/or recordkeeping burden is 17,010 hours.

The estimated annual burden per respondent/recordkeeper varies from 1 to 10 hours, depending on individual circumstances, with an estimated average of 3 hours.

The estimated number of respondents and/or recordkeepers is 5,670.

The estimated annual frequency of responses (used for reporting requirements only) is once per calendar year.

Books or records relating to a collection of information must be retained as long as their contents may become material in the administration of any internal revenue law.

Generally tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.

VI Drafting Information

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