

IRS PROPOSES NEW FICA, FUTA AND INCOME TAX WITHHOLDING RULES FOR ISOs AND ESPPs

Summary

The Internal Revenue Service (the “IRS”) has issued proposed regulations relating to the income and employment tax collection requirements for incentive stock options (“ISOs”) qualified under Section 422 of the Internal Revenue Code (the “Code”), and for options granted under employee stock purchase plans (“ESPPs”) qualified under Section 423 of the Code. If adopted, the regulations will require payment of Social Security taxes (“FICA”) and federal unemployment taxes (“FUTA”) at the time an ISO or ESPP option (collectively referred to as “Statutory Options”) is exercised. As noted under current rules, no income tax withholding will be required with respect to an employee’s (or former employee’s) exercise of a Statutory Option or upon the subsequent sale or other disposition of any shares acquired through the exercise of any such option, even if such sale or other disposition occurs prior to the expiration of the statutory holding period for obtaining favorable capital gains tax treatment on the stock.

If adopted in their present form, the regulations will be effective with respect to Statutory Options exercised on or after January 1, 2003. However, legislation has been introduced in both the House (H.R. 2695) and in the Senate (S. 1383) that would exempt ISOs and ESPPs from employment taxes at the time of exercise and at the time of a subsequent disposition of the stock. The prospects for passage of the bills is unclear, but bipartisan support for the bills appears to be present in Congress.

Background

Statutory Options provide favorable tax treatment to employees. In general, no tax applies at the time a Statutory Option is exercised. If the shares acquired upon the exercise of an ISO are held for at least two years from the date of grant and at least one year from the date of exercise, any appreciation above the exercise price will be taxed at capital gains rates. Similar treatment applies to an ESPP option if the holding requirements are satisfied, except that the difference between the fair market value of the stock at exercise and the exercise price is recaptured at ordinary income tax rates at the time of sale (or, if less, the excess of the fair market value at the time of the sale over the exercise price is recaptured at ordinary income tax rates). If an employee or former employee sells the shares before the above holding periods are met (a “Disqualifying Disposition”), ordinary income will result in the year of the sale in an amount equal to the difference between the fair market value of the shares acquired at exercise and the amount of the exercise price, with any remaining gain taxed at capital gains rates.

For many years the employment tax rules relating to the exercise of Statutory Options have been based on Rev. Rul. 71-52. According to this ruling, an employer does not make a payment of “wages” for purposes of FICA, FUTA and income tax withholding at the time a “qualified stock option” (the predecessor to ISOs and ESPP options) is exercised. Furthermore, any income realized from certain dispositions of stock acquired by the exercise of a qualified stock option is also exempt from FICA, FUTA and income tax withholding.

In Notice 2001-14, the IRS concluded that its prior holding in Rev. Rul. 71-52 did not apply to the exercise of ISOs or options granted under an ESPP, or to the disposition of stock acquired pursuant to such options. As a result, Rev. Rul. 71-52 was declared obsolete. However, in view of the lack of clear administrative guidance regarding the application of FICA, FUTA and income tax withholding to Statutory Options, the IRS announced that, with respect to Statutory Options exercised prior to January 1, 2003, it will not assess FICA or FUTA taxes upon the exercise of a Statutory Option, and will not treat the disposition of any stock acquired by an employee pursuant to the exercise of a Statutory Option as subject to income tax withholding.

The Proposed Regulations and Rules of Administrative Convenience

FICA and FUTA

According to the IRS, the proposed regulations are meant to “clarify current law” regarding the FICA and FUTA tax withholding requirements relating to the transfer of employer stock pursuant to the exercise of a Statutory Option. Under the regulations, at the time an employee exercises a Statutory Option, the employee is treated as having wages for FICA and FUTA purposes equal to the excess of the fair market value of the shares purchased over the price paid for the shares, even though this amount is not included as taxable income at the time of exercise. The position taken in the proposed regulations is based on the broad statutory definition of wages for FICA and FUTA purposes and the absence of any statutory exclusion from this form of treatment.

If the proposed regulations are adopted by the IRS, the change will require that employers and employees each pay a 6.2% tax for the Social Security retirement portion of FICA based on the spread at exercise of a Statutory Option, provided the employee’s annual FICA wages have not already exceeded the Social Security taxable wage base (\$84,900 for 2002). For employees whose regular annual wages exceed the Social Security wage base, the regulations affect the timing and manner of collection of the Social Security retirement tax, but not the overall amount of tax paid by the employer and employee. Employers and employees will also be required to pay a 1.45% tax on the spread for the Medicare portion of the FICA tax, regardless of whether the employee’s wages exceed the Social Security wage base. Thus, the Medicare portion of the tax represents a new tax on both the employer and employee. Since FUTA taxes apply only to employers and only to the first \$7,000 of an employee’s wages, this tax is unlikely to affect the amount of tax paid by the employer.

Rules of administrative convenience issued by the IRS in conjunction with the regulations will permit some leeway in paying FICA and FUTA taxes on the exercise of Statutory Options. Under these rules, an employer is allowed to treat the payment of wages resulting from the exercise of a Statutory Option as occurring on any day in the year, including over a period of

dates. Thus, an employer can treat the wages as paid over one or more periods based on a pay period, quarter, semiannual, annual, or other basis. The deemed payments may not commence before the exercise occurs, and all payments are required to be treated as paid on or before December 31 of the calendar year of exercise (except as provided in the special accounting rule described below). An employer can also change the withholding method used at any time without making a formal election or notifying the IRS, but the employer must apply its chosen method of treatment consistently with respect to all employees.

A special accounting rule will also be permitted whereby employers can treat wages resulting from the exercise of Statutory Options in December as paid in the first quarter of the next calendar year. Only wages resulting from the actual exercise of a Statutory Option during the month of December can be treated as paid in the next calendar quarter so that an employer that treats any wages resulting from the exercise of options during the first eleven months of a calendar year as paid during the month of December may not use the special accounting rule to further treat those wages as paid in the first calendar quarter of the next calendar year. An employer's decision to use the special accounting rule will bind the employee, so that the choice applies for purposes of both the employer and employee portion of the FICA tax. The employer must also provide notice of the special accounting rule to each employee at or near the time the employer provides the employee with Form W-2 for the calendar year in which the exercise occurs.

In order to further alleviate the FICA tax obligations for employees, IRS guidance provides that an employer and an employee may contractually arrange to pre-fund any FICA obligations on Statutory Options through advance payroll deductions. Conditions may also be placed on the exercise of a Statutory Option so that acceleration of the employee's tax obligation occurs on termination of employment. An employer may also advance any funds necessary to pay the employee portion of the FICA tax and obtain reimbursement of those funds from employees, although such an advance will presumably be treated as an employer loan.

Income Tax Withholding

Although subject to FICA and FUTA taxes, the proposed regulations provide that employers have no income tax withholding obligations upon the exercise of a Statutory Option since no income is recognized at that time. In addition, employers have no withholding obligation upon an employee's sale of shares acquired through the exercise of the option, even though such sale may be a Disqualifying Disposition which results in a portion of the amount realized being subject to income tax.

While no income tax withholding is required upon an employee's sale of shares acquired through the exercise of a Statutory Option, reporting on Form W-2 will be required in some circumstances. According to administrative guidance issued by the IRS, an employer will need to make "reasonable efforts" to ascertain whether it must provide Form W-2 to an employee who has engaged in a Disqualifying Disposition. For this purpose, an employer will not be treated as making "reasonable efforts" if: (i) the employer claims a tax deduction for payments made to an employee after a sale of shares but fails to provide the employee with a Form W-2 reporting the payment and (ii) the total amount of that payment along with other remuneration to the employee

that is required to be reported on Form W-2 equals at least \$600 in that calendar year. The employer reporting obligations apply to both active and former employees.

Implications

Although the regulations have been issued in proposed form, the IRS has made clear its intention to subject Statutory Options to FICA and FUTA taxes at the time of exercise unless Congress enacts legislation prohibiting such treatment. If adopted in their present form, the proposed regulations and rules will most likely prove costly to employers, both financially and administratively. The new rule will also impose new tax burdens on employees.

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If you have any questions regarding the new regulations and administrative guidance, please call Frank A. Daniele at (212) 728-8216 or Peter J. Allman at (212) 728-8101.

Willkie Farr & Gallagher is headquartered at 787 Seventh Avenue, New York, New York 10019-6099. Our telephone number is (212) 728-8000 and our facsimile number is (212) 728-8111. Our web site is located at www.willkie.com.

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