

IRS POSTPONES PROPOSED TAX WITHHOLDING RULES FOR STATUTORY OPTIONS

In February of this year we informed our clients that the Internal Revenue Service (the "IRS") had 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. The proposed regulations, which were scheduled to become effective January 1, 2003, would have required 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.

On June 26, 2002, the IRS issued Notice 2002-47 (2002-28 I.R.B. 1) which indefinitely delays the implementation of the proposed regulations. Until such time as further guidance is issued, the IRS will not assess FICA or FUTA taxes, or apply federal income tax withholding obligations, upon either the exercise of Statutory Options or the disposition of stock acquired pursuant to the exercise of Statutory Options. The Notice does not, however, relieve employees of their obligation to include any compensation in income upon a disposition of stock acquired pursuant to the exercise of Statutory Options, nor does the Notice relieve employers of any reporting obligations relating to a disqualifying disposition of stock acquired pursuant to the exercise of Statutory Options.

The delay in implementing the proposed regulations will provide Congress with additional time to consider legislation on this matter. Legislation has already been introduced in both the House (H.R. 2695) and the Senate (S. 1383) that would permanently exempt Statutory Options 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 appears to be present in Congress at this time.

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If you have any questions regarding the IRS Notice, please call Frank A. Daniele at (212) 728-8216 or Peter J. Allman at (212) 728-8101.

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