

INTERNAL REVENUE SERVICE

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March 16, 2001

████████████████████
United States Senate
Washington, D.C. 20510

Dear Senator ██████:

I am writing in response to your letter of December 11, 2000 to the Department of Treasury, on behalf of your constituent, ██████. ██████ asked about the application of employment taxes to options granted under an employee stock purchase plan.

I have responded directly to ██████, as requested. Enclosed is a copy of my response.

I hope the information we provided ██████ is helpful. If you need further assistance, please call me at (202) 622-6010 or Stephen Tackney, Identification Number 50-18084, at (202) 622-6040.

Sincerely,

Mary Oppenheimer
Assistant Chief Counsel
(Exempt Organizations/Employment Tax/
Government Entities)

Enclosure

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INTERNAL REVENUE SERVICE

March 16, 2001



Dear Mr. [REDACTED]:

This letter responds to your September 29, 2000 correspondence to [REDACTED]. You expressed concerns about potential administrative guidance from the Department of the Treasury (Treasury) on the application of employment taxes to stock options granted under an employee stock purchase plan described in section 423 of the Internal Revenue Code (Code). You said that the guidance would impose employment taxes upon the exercise of a stock option granted under an employee stock purchase plan (an ESPP option), and reverse 30 years of precedent and business practice. You also said that the application of employment taxes to ESPP options would result in less participation by lower paid employees, and that the tax collected and administrative burden imposed would not be justified given the current budget surplus.

As part of the review of comments requested in the Notice 2001-14 described below, we anticipate revisiting these issues in arriving at any final administrative guidance. We appreciate your input regarding the issues raised by the application of employment taxes to ESPP options, and invite you to provide comments as requested in Notice 2001-14. If you would like to provide comments, please address them to:

Ms. Sarah Hall Ingram
Associate Chief Counsel (Tax Exempt and Government Entities)
CC:TE/GE
ATTN: Employment Taxes and Statutory Options
Room 5214
Internal Revenue Service
1111 Constitution Ave., N.W.
Washington, DC 20224

We need your comments by May 7, 2001. I hope the following general information is helpful.

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Notice 2001-14

On February 5, 2001, the Internal Revenue Service published Notice 2001-14, 6 I.R.B. 516, copy enclosed, which announced that we would not enforce the application of employment taxes (Federal Insurance Contributions Act (FICA) tax, Federal Unemployment Tax Act (FUTA) tax and federal income tax withholding) upon the exercise of an ESPP option that occurs before January 1, 2003, or upon the disposition of stock acquired pursuant to such an exercise. In addition, Notice 2001-14 provides retroactive relief for employers who had been paying employment taxes.

Employee Stock Purchase Plan Options

Notice 2001-14 discusses the background of ESPP options and the application of employment taxes to ESPP options. To summarize, Sections 421 and 423 of the Code provide favorable income tax treatment for ESPP options. If the requirements of section 423(a) are met, no income results when an ESPP option is exercised. [Section 421]. However, if the employee sells or disposes of the stock acquired pursuant to the exercise of the ESPP option in a transaction that does not meet the holding requirements of section 423(a), the special tax treatment under section 421 of the Code is lost and the employee recognizes income in the year of the disposition. This type of disposition is often called a disqualifying disposition.

Employment Taxes and Employee Stock Purchase Plan Options

Sections 421 and 423 of the Code do not address the treatment of transactions involving ESPP options for purposes of the FICA tax, the FUTA tax or federal income tax withholding. Therefore, we refer to the relevant employment tax provisions to determine how these taxes will apply.

FICA tax, FUTA tax and federal income tax withholding are imposed upon an employee's wages. The definition of wages for FICA tax and FUTA tax purposes is not always the same as the definition of wages for federal income tax withholding purposes, and a payment can be wages for FICA tax and FUTA tax purposes even if it is not wages for income tax withholding purposes. [Sections 3121(a) and 3306(b)].

Wages for FICA and FUTA Tax Purposes

For FICA and FUTA tax purposes, wages generally are defined as 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. [Sections 3121(a) and 3306(b)]. Neither the Code nor the relevant regulations contain any provision excluding the excess, if any, of the fair market value of stock transferred pursuant to the exercise of an ESPP option over the amount paid for the stock from

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wages for FICA tax and FUTA tax purposes. In accordance with these statutory provisions, the IRS historically has applied FICA tax and FUTA tax upon the exercise of an ESPP option.

Wages for Federal Income Tax Withholding

Wages for purposes of federal income tax withholding generally also include all remuneration for services performed by an employee for his employer. [Section 3401(a)]. However, because the purpose of federal income tax withholding is to enable an individual to pay federal income tax in the year in which the individual realizes income, federal income tax withholding generally is imposed upon remuneration paid by an employer only if the employee realizes income. As stated above, an employee does not realize income upon the exercise of an ESPP option, and therefore federal income tax withholding does not apply. An employee does realize ordinary income, however, upon the disqualifying disposition of stock acquired pursuant to the exercise of an ESPP option at the time of the disposition. In response to concerns of administrative burden raised by employers, however, Treasury and the IRS are considering administrative guidance that would treat the amounts realized upon these disqualifying dispositions of stock as not being subject to federal income tax withholding.

Anticipated Guidance

Consistent with the discussion above, Notice 2001-14 states that Treasury and the Service anticipate issuing guidance that would reflect the view that the Code defines "wages" for FICA tax and FUTA tax purposes broadly, without any statutory exclusion for the excess, if any, of the fair market value of stock transferred pursuant to the exercise of an ESPP option over the amount paid for the stock. However, Notice 2001-14 also requests comments as to the anticipated guidance, which Treasury and the Service plan to review before any guidance is issued. Any guidance issued would not be effective until the current moratorium granted in Notice 2001-14 expires.

If you have any questions, please contact Stephen Tackney (ID #50-18084) at (202) 622-6040.

Sincerely,

Mary Oppenheimer
Assistant Chief Counsel
(Exempt Organizations/Employment Tax/
Government Entities)

Enclosure