



Application of Employment Taxes to Employee Stock Purchase Plans, Incentive Stock Options

Issue

The Internal Revenue Service (“IRS”) contends that the transfer of stock to an individual pursuant to the exercise of an incentive stock option (“ISO”) or an option under an Employee Stock Purchase Plan (“ESPP”) (collectively a “statutory stock option”) constitutes the receipt of “wages” to which employment taxes under the Internal Revenue Code apply.

Background

Historically, the vast majority of employers maintaining statutory stock option programs have taken the position that these programs are not subject to employment taxes. This position has come under increasing attack in recent years by the IRS. A number of employers had been challenged on audit, and at least one case had proceeded to litigation. An IRS Field Service Advice, published in 1999, outlined the IRS National Office position on the issue, which was uncompromising (FSA 199926034).

Notice 2001-14, 2001-6 I.R.B. 516 (January 2001), conceded that the imposition of employment taxes on statutory stock option programs was not sufficiently clear, as a result of previous IRS guidance on the issue (and consequently, litigation underway contending the contrary position was dropped). However, the Notice indicated that the IRS expected to issue guidance imposing FICA and FUTA taxes upon exercises occurring after 2002. On November 13, 2001, the IRS followed through on its warning, issuing proposed regulations (Prop. Reg. Sec. 31.3121(a)-1(k)). On June 25, 2002, the IRS extended “indefinitely” the administrative moratorium on employment taxes for statutory stock options until new guidance is issued (Notice 2002-47)

Rep. Amo Houghton (R-NY) and Sen. Pat Roberts (R-KS) have introduced companion bills (H.R. 286 and S. 206) earlier this year to exempt the exercise of statutory stock options from FICA and FUTA taxes and federal income tax withholding. In addition, chairmen of the House Ways and Means and the Senate Finance Committee have announced their intention to revive last year’s pension protection legislation during the 108th Congress.

Published December 8, 2004

Visit the Silicon Valley Tax Directors Group Web site at www.svtdg.org



Application of Employment Taxes to Employee Stock Purchase Plans, Incentive Stock Options

Policy Considerations

The imposition of employment taxes on statutory stock options would be contrary to the long-held understanding of taxpayers that such taxes do not apply under the Internal Revenue Code. Statutory stock option programs do not involve the payment of wages and it is only such "wages" to which employment taxes legally apply. Imposition of employment taxes on ESPPs and ISOs would make these programs more costly for both employers and employees, and would impose a disincentive to their use.

Recommendation

The Silicon Valley Tax Directors Group ("SVTDG") recommends that legislation be enacted in the 108th Congress, which permanently exempts the exercise of statutory stock options from employment taxes.