



Securities Industry Association

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HAND DELIVERED

CC:IT:RU (REG-142686-01)
Courier's Desk
Internal Revenue Service
1111 Constitution Avenue NW
Washington, DC

Dear Sir or Madam:

I am writing on behalf of the Securities Industry Association ("SIA") regarding Notice 2001-72, Notice 2001-73, and the proposed regulations that were published in the Federal Register on November 14, 2001 (collectively, the "Proposed Guidance").¹ The Proposed Guidance would provide new rules governing the application of the Federal Insurance Contributions Act ("FICA"), Federal Unemployment Tax Act ("FUTA"), and collection of income tax at source, for incentive stock option plans ("ISOs") and employee stock purchase plans ("ESPPs") (sometimes collectively referred to as "statutory stock

SIA is the securities industry trade association, representing the business interests of more than 700 securities firms in North America. SIA's member companies administer and provide other third-party services to statutory stock option programs, and, in many instances, also sponsor statutory stock option programs in their own right for their employees.

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66 Fed. Reg. 57,023 [REG-142686-01].

SIA respectfully requests that final regulations provide that FICA and FUTA taxes (also referred to herein as “employment taxes”) do not apply upon the exercise or disposition of ISOs or ESPPs. We believe that conclusion is supported as a matter of law and policy and, as discussed more fully below, there are a number of complex legal, policy and administrative issues that have not been adequately considered to date in the formulation of the Proposed Guidance. At a minimum, we recommend reinstating Revenue Ruling 71-52² and making it applicable to all statutory stock option plans until all of these issues are fully considered and resolved, and it becomes clear that rules can be implemented by employers, the Internal Revenue Service (the “Service” or “IRS”), and the Social Security Administration.³

I. EMPLOYMENT TAXES SHOULD NOT APPLY UPON EXERCISE OR DISPOSITION OF A STATUTORY STOCK OPTION.

ISOs and ESPPs should not be subject to employment taxes at the time of exercise because there is no income recognized upon such exercise, and the Internal Revenue Code (the “Code”) specifically provides that recognition of income is a prerequisite to imposition of employment taxes. The legal and policy reasons that support the Service’s longstanding position not to impose employment taxes on statutory stock option plans have been explored thoroughly in other comment letters, and there has been no change in the law that warrants a reopening of those issues at this time.

² 1971-1 C.B. 278.

³ SIA does agree with the conclusion in the Proposed Guidance that income tax withholding does not apply upon a disposition of a statutory stock option.

The language of the Code is clear.⁴ Section 3101(a)⁵ (relating to Old-Age, Survivors, and Disability Insurance ("OASDI")) provides, "[T]here is hereby imposed on **the income** of every individual a tax equal to the following percentages of wages (as defined in section 3121(a)) received by him with respect to employment" (emphasis added). Similarly, section 3101(b) (relating to Hospital Insurance) provides, "[T]here is hereby imposed on **the income** of every individual a tax equal to the following percentages of wages (as defined in section 3121(a)) received by him with respect to employment" (emphasis added). Thus, under both provisions, employment taxes are imposed on income, and such taxes are equal to a percentage of wages. Because there is no income recognized upon the exercise of an ISO or ESPP under any provision of the Code, there can be no imposition of employment taxes upon exercise, even if such exercise could be considered "remuneration for wages." Stated differently, if an amount is not "income," **it is irrelevant whether it is considered "wages" because the tax is imposed on income.**

Even if the plain language of the Code was not clear, there is case law supporting the view that amounts which are excluded from income are not "wages" for FICA purposes. In *Anderson v. United States*,⁶ the Court of Federal Claims, in an opinion affirmed by the Federal Circuit Court of Appeals, concluded that housing allowances that were excluded from income also were not "wages" for FICA purposes. *Anderson* has been followed by a number of Circuit Court of Appeals.⁷

Moreover, the Proposed Guidance undermines nearly 30 years of IRS ruling positions and administrative practice on which employers and employees have relied in structuring stock arrangements for a broad cross-section of the workforce. Absent a clear rationale for changing such ruling positions and administrative practice, the Treasury Department and

⁴ It is a well-established canon of statutory interpretation to follow and give effect to the plain meaning of a statute. See, e.g., *City of Chicago v. Environmental Defense Fund*, 511 U.S. 328 (1994); *Estate of Cowart v. Nicklos Drilling Co.*, 505 U.S. 469 (1992); *United States v. Providence Journal Co.*, 485 U.S. 693 (1988).

⁵ Unless otherwise indicated, all section references are to the Code.

⁶ 16 Cl. Ct. 530 (Cl. Ct. 1989), *aff'd*, 929 F.2d 648 (Fed. Cir. 1991).

⁷ See *Gerbec v. United States*, 164 F.3d 1015 (6th Cir. 1999); *Dotson v. United States*, 87 F.3d 682 (5th Cir. 1996); *Redfield v. Insurance Co. of North America*, 940 F.2d 542 (9th Cir. 1991).

Service merely are imposing their own policy preferences in a settled area of the law, without any direction or indication from Congress to do so. To the contrary, Congress has been aware of the long-standing position of the Service on this issue, and has had ample opportunity to require the Service to change its position. If anything, recent Congressional activity reaffirms Congress' long-standing ratification of the Service's historic position, and confirms that the Proposed Guidance oversteps its bounds in increasing payroll taxes. For example, on April 11, 2002, the House of Representatives voted to prevent the Service from applying employment taxes to statutory stock options.⁸

**II. APPLYING PAYROLL TAXES IS INCONSISTENT WITH THE POLICIES
UNDERLYING THE CREATION OF STATUTORY STOCK OPTIONS.**

ISOs and ESPPs have tremendous benefits for workers and American business. Employee ownership benefits employees, the firms for whom they work, and the economy as a whole by aligning the interests of employees and employers. Congress created ISOs and ESPPs to encourage companies to offer a stake in the enterprise to a broad group of employees, including rank-and-file employees. By imposing FICA and FUTA taxation on amounts that are not considered income and have never been subject to employment taxes in the past, the Treasury Department and the Service will be imposing new taxes on these programs, and creating additional complications and burdens for employers who sponsor such programs, thereby greatly discouraging their use.

Significantly, because the OASDI portion of FICA taxes is paid only with respect to individuals who earn less than the Social Security wage base (\$84,900 in 2002), the Treasury Department and the Service will be imposing an extremely regressive tax on those least able to afford it. Thus, the end result of the Proposed Guidance may be to ensure that stock option programs again become the exclusive prerogative of company executives – the exact opposite result that Congress intended when it enacted the ISO and ESPP provisions.

Statutes should be interpreted in light of the policies underlying them. In this regard, one of the more ironic aspects of the Proposed Guidance is that the imposition of employment taxes often may require employees to take “disqualifying dispositions” to cover those

⁸ H.R. 3762, 107th Cong. § 301 (2002).

taxes, thereby forcing employees to engage in the very types of transactions that Congress wished to discourage. Another counterintuitive result of the Proposed Guidance is that employees could pay employment taxes with respect to statutory stock options from which they never realize any amount (e.g., when the price of the stock declines following exercise). As discussed more fully below in section III, we appreciate the efforts of the Treasury Department and the Service in attempting to provide proposed rules of administrative convenience, but we respectfully submit that those proposed rules would not prevent employees from having to take disqualifying dispositions to satisfy employment tax obligations or pay employment taxes when no amount is realized on the option.

In addition, employer-employee relations could be damaged due to employee resentment of the very large withholding imposed by employers on employee earnings in order to satisfy the employer's withholding obligations on statutory stock options. Again, this runs counter to one of chief purposes of stock option programs – namely, to align the interests of employers and employees. Moreover, in light of recent economic difficulties, now certainly is not the time to be creating issues that could have a dampening effect on employee morale and increasing tax burdens.

**III. THE PROPOSED GUIDANCE IS NOT ADMINISTRABLE IN MANY INSTANCES,
AND THE PROPOSED RULES OF ADMINISTRATIVE CONVENIENCE DO NOT
SOLVE THE PROBLEMS OF ADMINISTRABILITY.**

If employment taxes were imposed upon statutory stock options, it often would not be administratively feasible to collect such taxes. Regardless of the conclusions reached on the law and policy, the Proposed Guidance should not be implemented until it is clear that the requirements could be administered by employers, employees, former employees, the Service, and the Social Security Administration. In many cases, employers would be unable to collect the necessary amount of employment tax because there would be an insufficient amount to withhold. In the case of current employees, this would occur because the amount required to be withheld could exceed regular compensation. In the case of former employees, this would occur because employers would not have access to amounts to withhold. In other instances, it is unclear that employers would have the ability or a legal right to collect the necessary withholding (e.g., former employees).

As part of the Proposed Guidance, the Treasury Department and Service have issued proposed “rules of administrative convenience” (the “Rules”) that attempt to alleviate some of the difficulty of administering the Proposed Guidance.⁹ Although we appreciate the

⁹ See IRS Notice 2001-73, 2001-49 I.R.B. 549.

Treasury Department and Service's efforts and intentions in issuing the Rules, for the reasons discussed below, we respectfully submit that the Rules will not solve the administrative difficulties created by the Proposed Guidance.

The Payment Period Rule. The "payment period rule" does not address the fact that certain employees will not (and should not) have disposed of their stock prior to the expiration of the "payment period," and thus liquidity difficulties still will exist. Under ISOs and ESPPs, the key tax benefits are met only if employees do not dispose of their stock within 2 years of the grant date nor within 1 year of the exercise date.¹⁰ Because the payment period rule would require all employment taxes to be paid by the end of the taxable year in which the option is exercised (except in cases where the "special accounting rule" is applicable), employees who have insufficient cash to pay employment taxes on their ISOs or ESPPs still would be forced to enter into a disqualifying disposition to satisfy their employment tax obligations in some instances (e.g., when the exercise date is less than one year from the end of the "payment period" year). Significantly, lower-income employees would be the most likely to fall into this category, as they would be least likely to have the cash to pay employment taxes and thereby would be forced to enter into a disqualifying disposition.

The Special Accounting Rule. In addition, the "special accounting rule" does not solve the payment period rule problem, but instead only provides some relief for individuals who exercise a statutory stock option in the last quarter of the year and who thus would receive limited relief from the ability to "spread" the employment taxes over the entire taxable year under the payment period rule. Instead, as under the payment period rule, employees who have insufficient cash to pay employment taxes on their ISOs or ESPPs still would be forced to enter into a disqualifying disposition to satisfy their employment tax obligations in some instances.

The Pre-Funding Method. The "pre-funding method" is unworkable for a variety of reasons. As an initial matter, employees will not want to pre-fund employment taxes that they may never have to pay (e.g., because they ultimately decide not to exercise the stock option). In addition, the pre-funding method does not work as a practical matter because the employer and employee never know in advance what the exercise price will be, and

¹⁰ See section 422(a)(1); section 423(a)(1).

would not know the amount of employment taxes to pre-fund and withhold. Related to this is a question of how one would procedurally handle overpayments of employment tax amounts under the pre-funding method – no guidance on this is provided in the Rules.

While these issues alone are enough to make the pre-funding method unworkable, there are a number of other problems with it. For example, the pre-funding method provides no protection to employees if their employer does not deposit the pre-funded amounts (i.e., the employee remains jointly liable for the tax). The pre-funding method also is unfair to employees because they should not be forced to lose the time value of money by pre-funding taxes for amounts that are not even considered income. At the same time, the pre-funding method would likely result in less substantial participation in the plan, e.g., because a portion of an employee's contribution to the plan would be used to pay taxes rather than purchase shares.

In addition, it is unclear whether employers would be allowed to require employees to pre-fund taxes. For example, in some instances, state law may prohibit employers from pre-funding such taxes. In other instances, employers be prohibited by collective bargaining agreement provisions or other legal or contractual impediments.

The Employer Advance Method. The “employer advance method” also is unworkable as a practical matter. Once the employer advances the employment tax amount, the employer has no way to guarantee that the employee will return the employer advance.¹¹ The simplest example of this is a situation where the employee terminates prior to re-paying the employer advance, and has an insufficient amount of compensation outstanding to offset the employer advance. Clearly, this scenario alone would prevent most employers from utilizing the employer advance method. In addition, employers might be concerned about the characterization of such an employer advance in other contexts (e.g., would it be considered a loan for various purposes?).

IV. THE NEGATIVE RAMIFICATIONS OF THE PROPOSED GUIDANCE AND THE POTENTIAL FOR A SERIOUS DRAIN ON GOVERNMENT FINANCES AND RESOURCES HAVE NOT BEEN FULLY CONSIDERED.

¹¹ Possible solutions to this problem such as requiring employees to sign a note or other evidence of indebtedness present their own problems. First, from an employee relations perspective, many employers and employees would be uncomfortable with such an arrangement. Even if a note is signed, the employer is not guaranteed to receive repayment and the procedures for collecting on the note would likely be costly and time-consuming.

If the Proposed Guidance is finalized in its current form, the results for statutory stock option programs and the workers who benefit from them could be catastrophic. At a minimum, increasing employment taxes and compliance burdens associated with statutory stock option programs are likely to cause some employers to terminate such programs or not establish new plans. For those employers that decide to try to continue offering statutory stock option plans, the ongoing uncertainty with respect to how and whether employment taxes must be paid will lead to complex and costly administrative problems for the plan sponsors and the government.

It is almost certain that the Proposed Guidance will be challenged in court as inconsistent with the Code and related case law. As discussed in section II above, there are strong and compelling arguments that statutory stock options are not subject to employment taxes, notwithstanding regulations or other guidance promulgated by the Treasury Department and the Service to the contrary. The uncertainty surrounding the litigation of this controversy would result in further unnecessary damage to stock option programs and tax administration in general.

Those employers that decide to try to continue sponsoring statutory stock option plans would have to withhold and pay employment taxes on amounts not considered income, and do their best to overcome the administrative difficulties detailed above. In the meantime, various refund claim forms would be filed by employers and processed by the Service. In the event that employers prevail in litigation and it is determined that employment taxes cannot be imposed on amounts that are not income, the Service will have to refund with interest any taxes that were inappropriately paid. Employers then will have the additional burden of distributing these refunded amounts to employees (and likely, former employees who, in many instances, will be difficult to locate).

While these potential tax system burdens should be considered carefully in determining the prudence of finalizing the Proposed Guidance, it also is critical to evaluate whether the ramifications of the Proposed Guidance on the Social Security system have been examined fully. In particular, there is a serious potential for a substantial and unanticipated drain on the Social Security system's administrative and financial resources that could result from sizeable claims for increases in wage history for past years. Specifically, if the courts determine that the exercise of a statutory stock option is not wages for employment tax purposes, workers who have participated in those programs would need to have their wage histories adjusted for purposes of determining the Social Security benefits they are entitled to receive. Conversely, even if the Proposed Guidance were upheld in court (or before the challenge is considered), it also should be carefully considered whether a final

government pronouncement that the exercise of a statutory stock option results in “wages” allows workers to go back and claim adjustments to wage history for all years prior to such pronouncement, even though payroll taxes were not required to be paid on such amounts. For example, workers could argue that their wage history should be adjusted to reflect all statutory stock options exercised over the past thirty or more years. This could cause an enormous burden for the Social Security Administration and the Social Security system.

In any event, correcting wage histories is a very difficult process for all parties. It might require the filing of Forms W-2c for all affected individuals (possibly numbering into the millions) which then would have to be processed by the Service and the Social Security Administration. It is our understanding that a similar flood of refund claims occurred after the United States Supreme Court held in *Rowan Cos., Inc. v. United States*¹² that meals and lodging provided to an employee for the convenience of the employer, which were excludable from income, were not subject to FICA taxes, and that the Social Security Administration was unable to correct the wage histories of employees who received refunds. In any event, it is clear that such a massive undertaking would put a substantial strain on government resources, not to mention creating difficulties and hardship for employers across the country and confusion for potential Social Security recipients.

V. EVEN IF SOME OR ALL OF THESE ISSUES WERE ADDRESSED, FOR THOSE WHO DO FIND IT POSSIBLE TO COMPLY WITH THE PROPOSED GUIDANCE, A SUBSTANTIAL TRANSITION PERIOD WOULD BE NEEDED.

Employers will require a substantial transition period to adjust to the Proposed Guidance – to the extent they are able to administer it at all. For employees who participate in the statutory stock option programs, the imposition of employment taxes would be an alarming and unwelcome change, and it would be necessary for employers to educate employees regarding the changes. Employers and employees would need to be given time to decide whether they wish to continue participating in such programs in light of the changes in tax treatment.

At the same time, employers would need to coordinate with payroll service providers, stock program administrators, and other third parties to ensure that procedures are in place to

¹² 452 U.S. 247 (1981).

attempt to comply with the Proposed Guidance. In some cases, plans and related computer systems may need to be modified. In addition, costly new systems and procedures to monitor compliance with the Proposed Guidance would have to be put in place. As discussed above, such compliance would be extremely complex, and it would take a lengthy period of time to develop, test, and implement these new systems and procedures. Unfortunately, due to the complexities involved with implementing the Proposed Guidance, even best practices will lead to a number of unavoidable errors necessitating the development of corrective procedures and the issuance of corrected returns and refunds in some instances. Establishing systems and procedures to deal with these issues could take substantially longer than the time currently allowed under the Proposed Guidance. These problems are compounded by the fact that many plans operate for longer than one year. Thus, it would be necessary for these plans to make changes in the middle of a plan period. For plans that allow employees to exercise their statutory stock options at any time (as many plans do), implementation of the Proposed Guidance would be even more difficult.

VI. CONCLUSION.

For the reasons discussed above and consistent with thirty years of IRS rulings and administrative practice, we respectfully submit that (1) the position in the Proposed Guidance that income tax withholding does not apply upon a disposition of a statutory stock option should be finalized, and (2) final regulations should provide that employment taxes do not apply upon the exercise or disposition of statutory stock options. If that position is not adopted, we recommend that the Proposed Guidance should be delayed for further study and that, in the interim, Revenue Ruling 71-52 be reinstated for all statutory stock options as above.

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We appreciate your consideration of our views. If you have any questions or would like to discuss these comments further, please let us know.

Sincerely,