COMMENTS Concerning FSA 199926034:
FICA Liability for ESPPs

The following comments are the individual views of the members of the Section of Taxation who prepared them and do not represent the position of the American Bar Association or the Section of Taxation.

These comments were prepared by individual members of the Executive Compensation Subcommittee of the Employee Benefits Committee of the Section of Taxation. Principal responsibility was exercised by Wayne R. Luepker. The Comments were reviewed by Dan Morgan of the Employment Tax Section and by Diane J. Fuchs, Chair of the Committee on Employee Benefits. They were also reviewed by Ronald Rizzo of the Section’s Committee on Government Submissions and by Stuart M. Lewis, Council Director for the Committee on Employee Benefits.

Although many of the members of the Section of Taxation who participated in preparing these Comments have clients who would be affected by the federal tax principles addressed by these Comments or have advised clients on the application of such principles, no such member (or the firm or organization to which such member belongs) has been engaged by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of these Comments.

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Contact Person: Wayne R. Luepker
(312) 701-7197
wluepker@mayerbrown.com

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cc: Diane J. Fuchs
    Seth H. Tievsky
    Thomas R. Hoecker
    Kyle N. Brown
    Taina E. Edlund
    Pamela Baker
EXECUTIVE SUMMARY

1. **Summary of the recommendations.**

   We recommend that the Internal Revenue Service reconsider the position expressed in Field Service Advice Memorandum 199926034, which concludes that, on the exercise date of an option granted under an employee stock purchase plan that satisfies the requirements of Code § 423 (an "ESPP"), the excess of the then fair market value of ESPP stock over the option price is FICA wages, and that an employer is not excused from withholding and payment of FICA taxes resulting therefrom for periods after the Sun Microsystems decision of 1995.

   We also recommend that the Internal Revenue Service announce that Revenue Ruling 71-52 will continue to apply to ISO and ESPP options, and that a moratorium shall be imposed on the assessment and collection of employment taxes with respect to both types of options until a higher level of review of this issue is completed.

2. **Summary of the issue which the recommendation addresses.**

   The recommendation reviews prior guidance indicating that employment taxes are not applicable to ESPP options, and identifies the inconsistent nature of the FSA and retroactive application thereof.

3. **Please explain how the proposed policy position will address the issue.**

   The recommendation contemplates that a higher level of review should apply to the issue of the FICA tax liability of ESPP options. This higher level of review should also clarify, based upon existing precedent, all employment tax consequences of ESPP and ISO options.

4. **Summary of any minority views or opposition which have been identified.**

   No known minority views or opposition.
The purpose of this comment is to address certain issues arising from Field Service Advice Memorandum 199926034 (April 7, 1999, released July 2, 1999) (the "FSA"). The FSA addresses the application of the "FICA taxes" imposed by §§ 3101 and 3111 of the Internal Revenue Code (the "Code") to the exercise of options granted under an employee stock purchase plan that satisfies the requirements of Code § 423 (an "ESPP"), and having an exercise price less than the fair market value of the stock on the date of exercise. The FSA concludes that (i) on the exercise date of the ESPP option, the excess of the then fair market value of ESPP stock over the option price is FICA wages, (ii) the exercise of an ESPP option constitutes a payment of wages, and (iii) the employer is not excused from withholding and payment of FICA taxes for periods after the decision in Sun Microsystems, Inc. v. Commissioner, T.C.M. 1995-69, acq. AOD CC-1997-010 (November 4, 1997). By way of background, we are providing a summary of the pertinent guidance applicable to the issues raised by the FSA.

1. Income Tax Treatment of Options.

(a) NSOs.

Generally, under Code § 83, the grant to an employee of an option that does not satisfy the requirements of Code §§ 422 or 423 (a non-statutory stock option or "NSO") will not result in the recognition of income by the employee, provided that, at the time of grant, the option does not have a readily ascertainable fair market value. Generally, under Code § 83 and Treas. Reg. § 1.83-7, upon exercise of the NSO for stock that is nonforfeitable, the employee will recognize ordinary income equal to the excess of the then fair market value of the stock over the exercise price, and the employer will be entitled to a corresponding deduction.

(b) ISOs.

The grant of an option that satisfies the requirements of Code § 422 (an incentive stock option or "ISO") will not result in taxable income to the employee. Pursuant to Code § 421(a), the exercise of an ISO will not result in taxable income to the optionee, provided that the optionee was an employee of the employer or certain related companies during the period beginning on the date of the grant of the option and ending on the date three months prior to the date of exercise (subject to exceptions for death or disability).

If the employee does not sell or otherwise dispose of the stock within two years from the date of the grant of the ISO or within one year after the transfer of such stock, then, upon disposition of such shares, any amount realized in excess of the exercise price will be taxed to the employee as capital gain, and the employer will not be entitled to a deduction for Federal income tax purposes.
Under Code § 421(b), if ISO stock is disposed of prior to satisfaction of the foregoing holding period requirements (a "disqualifying disposition"), then, at the time of the disposition of the shares, the employee will generally recognize ordinary income, and a corresponding deduction will be allowed to the employer in an amount equal to the lesser of: (i) the excess of the fair market value of the shares on the date of exercise over the exercise price, and (ii) the excess, if any, of the amount realized upon disposition of the shares over the exercise price. If the amount realized exceeds the fair market value of the shares on the date of exercise, the additional amount will be capital gain. If the amount realized is less than the exercise price, the employee will recognize no income, and will recognize a capital loss equal to the excess of the exercise price over the amount realized upon the disposition of the shares.

(c) ESPPs.

The grant of an ESPP option will not result in taxable income to the employee. Pursuant to Code § 421(a), the exercise of an ESPP option will not result in taxable income to the optionee, provided that the optionee was an employee of the employer or certain related companies during the period beginning on the date of the grant of the option and ending on the date three months prior to the date of exercise (subject to exceptions for death and disability).

If the employee does not sell or otherwise dispose of the stock within two years from the date of the grant of the ESPP option or within one year after the transfer of such stock, then, upon disposition of the ESPP shares (a "qualifying disposition"), the employee will recognize ordinary income equal to the lesser of: (i) the excess of the fair market value of the shares at the time of such disposition over the option price, or (ii) the excess of the fair market value of the shares at the time the option was granted over the option price. Code § 423(c). Any remaining gain is capital gain. The employer is not entitled to any deduction upon the qualifying disposition of stock acquired pursuant to an option granted under an ESPP.

Under Code § 421(b), if ESPP stock is disposed of prior to satisfaction of the foregoing holding period requirements (a "disqualifying disposition"), then, at the time of disposition of the shares, the employee will recognize ordinary income equal to the excess of the fair market value of the stock on the date of exercise over the option exercise price. Any remaining gain or loss shall be a capital gain or loss. The employer will also have a deduction (which may be less than the ordinary income recognized by the employee), provided that the disqualifying disposition is timely reported.

Although the tax treatment of ISOs and the tax treatment of ESPP options are both governed by Code § 421, the treatment differs in one respect. Under § 423(c), if a share of stock is purchased pursuant to an ESPP option for a price between 85% and 100% of its fair market value as of the date the option is granted, a qualifying disposition will result in recognition of ordinary income up to the amount of the discount from fair market value at the time the option is granted. The exercise price of an ISO cannot be less than 100% of the fair market value of the
stock at the time the option is granted, and so there is no corresponding provision addressing such discount.

2. Employment Tax Obligation.

(a) General.

Under § 3402 of the Code (relating to income tax collected at the source on wages), an employer is required to withhold income taxes on "wages" (as defined in Code § 3401) paid to an employee. Code § 3101 imposes a tax on the income of an individual received with respect to employment for Old-Age, Survivors, and Disability Insurance and for Hospital Insurance (together referred to as the "FICA" tax). Under Code § 3102, an employer is required to withhold FICA taxes on "wages" (as defined in Code § 3121) paid to an employee and, under Code § 3111, the employer is required to pay a corresponding additional FICA tax. Under Code § 3301, which reflects the Federal Unemployment Tax Act, an employer is required to pay taxes on "wages" (as defined in Code § 3306) paid to an employee ("FUTA taxes").

The term "wages" for all these purposes generally means all remuneration from employment, including the cash value of all remuneration (including benefits) paid in any medium other than cash. Although the Code lists a number of specific exceptions under each of these definitions, NSOs, ISOs, or ESPPs are not expressly listed. Moreover, there is no indication under the respective Code sections that NSOs, ISOs, or ESPPs should be treated any differently for purposes of FICA and FUTA withholding than for purposes of income tax withholding.

(b) NSOs.

Generally, income realized in connection with NSOs granted to employees is treated as "wages" subject to FICA and FUTA taxes and income tax withholding at the time of exercise of the option. See, e.g., Rev. Rul. 78-185, 1978-1 C.B. 304. However, the determination of "wages" has, in the past, been covered by different rules when the tax treatment of the option has been subject to Code § 421.

(c) Rev. Rul. 71-52.

(i) ISOs and ESPPs.

The tax treatment of an option that satisfied the requirements of Code § 422 and which, generally, was granted on or before May 20, 1976 (a "qualified stock option" or "QSO") was to be determined in accordance with Code § 421. Rev. Rul. 71-52, 1971-1 C.B. 278, held that if an employer sells its stock to an employee pursuant to a QSO, then, for purposes of FICA and FUTA taxes, and collection of income tax at the source on wages, the acquisition of the stock does not result in the payment of "wages" by the employer, and a disqualifying disposition of
such stock does not result in the payment of "wages" by the employer or the receipt of "wages" by the employee. The revenue ruling does not set forth a specific rationale for its conclusions.

Prop. Treas. Reg. § 1.422A-1(b), by reference to the regulations under § 83 (including, specifically, Treas. Reg. § 1.83-6(a)(2), as in effect on the date the proposed regulations were issued), required employers to withhold income tax on a disqualifying disposition of ISO stock as a condition of obtaining a deduction. In Notice 87-49, 1987-2 C.B. 355, the Service stated:

[The position stated in the proposed ISO regulations] conflicts with the rule articulated in Revenue Ruling 71-52, 1971-1 C.B. 278, in which the Service ruled that the disqualifying disposition of stock acquired by the exercise of a qualified stock option described in section 422(b) of the Code did not result in the receipt of wages for Federal employment tax purposes.

Notice 87-49 announced that the deduction on a disqualifying disposition of ISO stock would not depend on whether taxes were withheld. The Notice also stated that:

The Internal Revenue Service is reconsidering Rev. Rul. 71-52. Until the results of such reconsideration are announced, the principles of that revenue ruling will apply to a disqualifying disposition of stock acquired by the exercise of an ISO. Pursuant to section 7805(b) of the Code, any determination that the gross income resulting from such a disqualifying disposition is wages for Federal employment tax purposes will be given prospective effect only.

(ii) Sun Microsystems.

The amount of "wages" paid by an employer is taken into account in determining the research credit available under Code § 41. Code § 41(b)(2)(D)(i) provides that, for purposes of § 41, the term "wages" has the definition used in § 3401(a). (As noted above, this is the definition used for purposes of determining the amounts subject to income tax withholding.) In Sun Microsystems, the court considered whether, for purposes of Code § 41, the term "wages" included the income realized from the disqualifying disposition of stock purchased through the exercise of ISOs. The Service sought to have such amounts excluded from wages for purposes of determining the research credit, and in support of this position cited Rev. Rul. 71-52 and Notice 87-49. The court, holding against the Service, stated that:

[The Service's] position as expounded in Rev. Rul. 71-52 . . ., and Notice 87-49 . . . is totally unpersuasive. In the first place, each of these pronouncements was issued for the specific purposes of administrative convenience not related to the issue before us herein. In the second place, and more importantly, revenue rulings, to say nothing of lesser pronouncements such as notices, represent "merely the opinion of a lawyer in the agency and must be accepted as such," and are "not binding on the * * * courts." . . . Accordingly, "a ruling or other interpretation by the Commissioner is only as persuasive as her reasoning and the precedents upon which she relies." . . .[The Service's]
interpretation of section 3401 is in conflict with the statute and the regulations thereunder. . . . We hold that the ISO spread income constitutes "wages" under section 3401(a) and that, therefore, the ISO spread constitutes "wages" for the purposes of section 41. [Citations omitted.]

(iii) Field Service Advice Memorandum.

As indicated above, the FSA addresses the application of FICA taxes to the exercise of an option granted under an ESPP, and having a price less than the fair market value of the stock on the date of exercise. The FSA concludes that (i) at the time of exercise of the option, the excess of the then fair market value of ESPP stock over the option price is FICA wages, (ii) the exercise of an ESPP option constitutes a payment of wages, and (iii) the employer is not excused from withholding and payment of FICA taxes for periods after the Sun Microsystems decision.

The basis of the first conclusion of the FSA is largely contained in the following paragraph from the FSA:

The court [in Sun Microsystems] made three points which are instructive in determining the correct employment tax treatment of ESPP options. First, the court's analogy to [Apple Computer, Inc. v. Commissioner, 98 T.C. 232 (1992)] is significant because Apple Computer involved the employment tax treatment of nonstatutory stock options. As stated, the compensatory amount with respect to nonstatutory stock options is subject to employment taxes on exercise. Rev. Rul. 78-185; Rev. Rul. 67-257. Second, the court completely discredited Rev. Rul. 71-52; therefore even assuming for the sake of argument that this ruling applies to ESPPs, the [court] opinion nullifies any [effect] the ruling had. Third, the court found ISOs and ESPPs to be indistinguishable with respect to whether the compensatory amount is wages. Therefore, given the court's holding that the compensatory amount with respect to ISOs is wages, it follows that the compensatory amount with respect to ESPP options is wages for employment tax purposes.

The FSA, in discussing its second conclusion, notes that, upon the exercise of an ESPP option, the discount below the fair market value of the stock at the time of exercise is not then includible in income by reason of Code § 421. The FSA states that this raises the issue of whether the discount on the ESPP stock should be subject to FICA wages. The FSA reviews the legislative history of the Social Security Amendments Act of 1983, and the rule that, under some circumstances, FICA taxes are due with respect to income that is not recognized for income tax purposes until a later date, and concludes that "in determining the correct FICA tax treatment, the income tax withholding treatment is irrelevant." The FSA reasons that, because employment taxes are due in connection with the exercise of an NSO, and the income tax treatment of an ESPP option is irrelevant in determining FICA tax treatment, the employment tax treatment applicable to NSOs should also apply to ESPP options.

The final conclusion of the FSA is that the first and second conclusions should be retroactively applied to the date of the Sun Microsystems decision. The basis for this conclusion
is that a taxpayer's reliance on Rev. Rul. 71-52 and Notice 87-49 would have been unreasonable after that date, because the ruling and the notice were discredited in Sun Microsystems, and because Notice 87-49 addresses only whether the compensatory amount of an ISO is deductible by an employer, but does not address the FICA tax obligation. It also states that:

In Sun Microsystems, the Service stipulated that the compensatory amount in the context of ESPP options is wages; therefore, despite the loss in Sun Microsystems, the Service's position with respect to ESPPs was clear. Assuming for the sake of argument that the Service's position prior to Sun Microsystems was ambiguous based upon Rev. Rul. 71-52, as a result of Sun Microsystems, [the taxpayer] was put on notice regarding its duty to withhold FICA tax.

3. Discussion of FSA Position.

(a) General.

Although a field service advice memorandum is not binding on examination or appeals, and may not be cited as precedent, we are concerned that the FSA reflects the current thinking of the Service on the subject. As stated in Tax Analysts v. IRS, 1996 U.S. Dist. Lexis 3529 (D.D.C. 1996), aff'd, 326 U.S. App. D.C. 53, 117 F.3d 607 (1997),

FSAs deal with "significant" tax issues, and one of their purposes is the "promotion of uniformity" in IRS assertions of positions on tax law[.] IRS Answers to Tax Analyst's Interrogatories Nos. 2, 9 . . . . FSAs are advisory; they are not binding on either the taxpayers to whom they pertain or the IRS. Whether they are followed is determined on a case-by-case basis by IRS field personnel. As one would expect, however, FSAs are "highly regarded," and the advice they contain is "generally taken."

The conclusions reached by the FSA represent a substantial shift from the law as currently understood by many employers and their advisors. We believe that the conclusions are not consistent with prior guidance or authority. Further, although the conclusions of the FSA are limited to the application of FICA tax on the exercise of discounted options granted under ESPPs, we are concerned that the Service may take an analogous approach to FUTA taxes, and may also take an analogous approach to FICA and FUTA taxes to the exercise of ISOs. We believe that such application would also be inappropriate. Therefore, we request that the Service reconsider the position expressed in the FSA, and that a higher level of review be given to the issue of whether FICA and FUTA withholding should apply to ISOs and ESPP options. In the interim, we request that the Service announce that the holdings of Rev. Rul. 71-52 continue to apply to ISOs and ESPP options, and impose a moratorium on the assessment and collection of employment taxes with respect to both types of options.

(b) Rev. Rul. 71-52 Holdings Should Apply to ISOs and ESPPs.
Rev. Rul. 71-52 has been widely interpreted by employers and their tax advisors as being applicable to ISOs and ESPP options. For the reasons discussed below, we believe that this interpretation is reasonable and consistent with existing guidance.

Rev. Rul. 71-52 holds that neither the exercise of a QSO nor a disqualifying disposition of QSO stock is subject to employment taxes. Rev. Rul. 71-52, by its terms, applies only to QSOs, and the ruling does not set forth a rationale for its holdings. Thus, the extent to which the holdings of the ruling should be extended to other types of options is not apparent from the ruling itself.


The [Economic Recovery Tax] Act provides for "incentive stock options," which are taxed in a manner similar to the tax treatment previously applied to restricted and qualified stock options. [The Explanation adds, in a footnote to this sentence:] In general, to the extent that provisions of prior law have been included in the incentive stock option provisions, interpretations of prior law are to apply to incentive stock options.

The FSA bases its conclusions, in part, on a determination that, for employment tax purposes, ISOs and ESPPs are indistinguishable. We agree that there is a sound basis for concluding that ISOs and ESPP options should be subject to the same employment tax treatment, because they are both subject to Code § 421(a). We also believe that QSOs, ISOs and ESPP options generally should not be treated differently from each other for employment tax purposes, and we believe that the holdings of Rev. Rul. 71-52 are applicable to ISOs and ESPP options as well.

Application of Rev. Rul. 71-52 to ISOs and ESPP options is consistent with Notice 87-49, which provides that the position stated in the proposed ISO regulations conflicted with the rule articulated in Rev. Rul. 71-52 (even though Rev. Rul. 71-52 did not expressly apply to ISOs). It is also consistent with a long line of private letter rulings, many of which explicitly rely on Rev. Rul. 71-52 as the basis of their holdings. See PLRs 8540042, 8525084, 8351020, 8225050, 8142160, 7930187, 6912030450A; but see 9243026. Although private letter rulings do not constitute precedent, we believe that they are pertinent, because they are evidence of the Service's administrative practices. Niles v. United States, 710 F.2d. 1391, 1394 n.4 (9th Cir. 1983).

(c) Sun Microsystems Does Not Discredit Rev. Rul. 71-52.

We do not believe that the Sun Microsystems decision should be viewed as reversing or discrediting Rev. Rul. 71-52.
The Sun Microsystems decision is a Tax Court Memorandum decision. Tax Court Memorandum opinions are not "binding precedents" on the Tax Court. Nico v. Comm., 67 T.C. 647, 654 (1977). We believe that it is inappropriate to treat a decision that is not binding precedent on the Tax Court as, in itself, reversing the holdings of a revenue ruling.

We also believe that the holding of Sun Microsystems should not be treated as reversing Rev. Rul. 71-52 because the holding in that case is not inconsistent with the holdings of Rev. Rul. 71-52. Both Rev. Rul. 71-52 and Sun Microsystems deal with the question of whether income recognized on a disqualifying disposition of stock acquired through the exercise of an option is includible in "wages" for purposes of Code § 3401. In Sun Microsystems, the court was required to determine the meaning of the term "wages" for purposes of Code § 41. Under § 41, "wages" is defined by reference to § 3401, which provides rules for income tax collected at the source on wages. The definition of "wages" for purposes of § 41 does not cross-reference the definition of the term "wages" for purposes of FICA and FUTA taxes. The court in Sun Microsystems did not need to address, and did not address, whether the amount of income recognized on a disqualifying disposition constituted "wages" for purposes of FICA or FUTA taxes. The definition of "wages" under § 3401 (income tax), § 3121 (FICA), and § 3306 (FUTA), though similar, are different in several respects, and we do not believe that they need be interpreted in the same way. Therefore, we do not believe that the meaning of "wages" under Code § 3401, as set forth in Sun Microsystems, should control the interpretation of the "wages" definition under §§ 3121 and 3306. We do not agree with the statement in the FSA that "in determining the correct FICA tax treatment, the income tax treatment is irrelevant." However, we agree that the income tax treatment does not always govern the FICA tax treatment, and that the court's determination in Sun Microsystems with respect to the income tax rules should not affect the validity of the conclusions of Rev. Rul. 71-52 with respect to the FICA or FUTA tax obligations.

The Sun Microsystems decision holds that the income recognized on a disqualifying disposition of ISO stock is "wages." The court, in rejecting Rev. Rul. 71-52 as a basis for exclusion of wages in determining the tax credit, states that the ruling "was issued for specific purposes of administrative convenience not related to the issue before us herein." Such language suggests that, in the court's view, the Service could, as a matter of administrative convenience, not require payment of employment taxes on those wages. Although considerations of administrative convenience were not relevant to the decision in Sun Microsystems, we believe that such considerations would have been important in the Service's decision to issue Rev. Rul. 71-52. We believe that the court in Sun Microsystems could conclude that income from a disqualifying disposition is "wages" for purposes of Code § 3401, and that the Service could nonetheless conclude, for reasons of administrative convenience, that such amounts are not subject to employment taxes. Thus, we believe that the holding in Sun Microsystems, which addresses the treatment of a disqualifying disposition of ISO stock, does not necessarily discredit the holding in Rev. Rul. 71-52.

Rev. Rul. 71-52 dealt with the application of FICA and FUTA taxes, as well as income tax withholding, on both the exercise of a QSO and the disqualifying disposition of QSO stock.
The Sun Microsystems decision addresses only the income tax treatment of a disqualifying disposition and, as discussed above, we believe that the holding in Sun Microsystems is distinguishable from the holding of the ruling on that issue. Accordingly, we believe that it is inappropriate to treat the Sun Microsystems decision as being inconsistent with any of the holdings of the revenue ruling.

(d) Establishment of Withholding Obligation Through FSA Is Inappropriate.

We believe that it is inappropriate for the Service to modify its position in Rev. Rul. 71-52 ruling though the use of a field service advice memorandum. If any such modification is made, it should be done only after a higher level of review has been completed. The more formal review is appropriate because of the policy issues discussed below. A more formal review is also consistent with procedure specified in Notice 87-49, which indicates that no change will be made with respect to an employer's income tax withholding obligation on a disqualifying dispositions of ISO stock until the application of Rev. Rul. 71-52 has been reconsidered. The Notice indicates that imposition of a withholding obligation will be prospective. The FSA distinguishes the subject of Notice 87-49 from the subject of the FSA by stating:

Notice 87-49 cannot reasonably be relied upon because it does not address whether FICA tax is owed upon the exercise of an employer-granted stock option; but rather addresses only whether the compensatory amount is deductible by the employer.

Of course, Notice 87-49 addresses the interaction of deductibility and withholding of income taxes. We believe that from both a technical and policy perspective, the income tax withholding issues are closely related to the FICA and FUTA tax issues, and it would be inappropriate for the Service to address them on a piecemeal basis.

The FSA concludes that Rev. Rul. 71-52 was revoked at the time of the Sun Microsystems decision, and that case itself put employers on notice of this revocation. As discussed above, we do not view the Sun Microsystems decision as reversing or discrediting Rev. Rul. 71-52, and we do not believe that such a case constitutes adequate notice of the revocation of a revenue ruling, especially when the acquiescence by the Service was not issued for more than 2-½ years after the decision, in an announcement that makes no mention of FICA taxes.

The need for adequate notice is particularly important in connection with employment taxes. In Central Illinois Public Service Co. v. United States, 435 U.S. 21, 31-32 (1978), the Court stated:

Because employer is in a secondary position as to liability for any tax of the employee, it is a matter of obvious concern that, absent further specific congressional action, the employer's obligation to withhold be precise and not speculative. [Citations omitted.]
The court in American Airlines v. United States, 98-1 U.S.T.C. para. 50,323, citing the
foregoing language from Central Illinois Public Service, stated:

A duty to withhold income taxes on payments made to its employees should not be
imposed retroactively on an employer unless there was adequate notice (from relevant
statutes, regulations, and IRS pronouncements) to the employer at the time of the
payments that such a withholding obligation existed. [Citations omitted.]

The concern arises because the employer's role with respect to employment taxes
includes the collection of taxes on the income of its employees. If there is uncertainty about the
employer's obligations, and the employer resolves the uncertainty by withholding on the amounts
in question, the employer is likely to have employee relations problems, and is likely to also have
competitive concerns if other employers do not withhold on comparable types of compensation.
If there is uncertainty about of the employer's obligations, and the employer resolves the
uncertainty by not withholding on the amounts in question, the employer may not only become
liable for interest and penalties, but also may be required to pay from its own assets amounts that
would otherwise have been due from the employee. Further, Code § 6672 provides that, under
certain circumstances, the individual responsible for collecting the employment taxes may be
personally liable for payment of that tax to the Treasury. We believe that the informal manner
apparently being used to address these issues, and the uncertainty resulting from this approach, is
inconsistent with the sound administration of the tax laws.

We believe that the considerations that initially led to the issuance of Rev. Rul. 71-52 are
also present today. While the amount of compensation currently escaping FICA and FUTA
taxes under ISOs and ESPP options may be greater now than the amount that would have
escaped such taxes when Rev. Rul. 71-52 was issued, and although concerns about Social
Security solvency may be greater today than in 1971, we do not believe that either consideration
justifies the use of informal procedures to modify the employment tax rules. We believe that if
Rev. Rul. 71-52 is to be revoked, it should be done by an announcement by the Service expressly
providing for the revocation. We believe that a higher level of review should be given to the
issue of whether FICA and FUTA taxes are applicable to ISOs and ESPP options, and that the
Service should consider holding public hearings on the matter.

(e) Policy Reasons Also Support Exemption from FICA and FUTA for ISOs and ESPP
Options.

There are strong policy considerations for exemption of ISO and ESPP options from
FICA and FUTA taxes. The Code provides favorable tax treatment for ISOs and ESPP options,
and previously provided favorable treatment for QSOs. One of the main benefits provided for
these options, all of which are subject to § 421, is that taxable income is not recognized by the
employee at the time of exercise. This treatment limits the out-of-pocket cost associated with the
exercise, making it less financially burdensome for the employee to retain rather than sell the
stock after exercise. The reduction of the financial burden is particularly important for
employees who are not among an employer's most highly paid. Because of the coverage
requirements applicable to ESPPs, and the $100,000 limit applicable to ISOs, such employees make up a significant portion of the recipients of these types of options.

For shares acquired pursuant to the exercise of an option of the type covered by § 421 (including ISOs, ESPP options and, previously, QSOs), the Code provides incentives for employees to retain the shares by providing meaningful tax benefits for shares retained for a specified holding period after exercise. Similarly, many employers want their employees to hold shares of the employer's stock, in order to align the interests of the employees with those of the employer's other shareholders. Such employers frequently use ISOs, ESPPs, or both to encourage employees to retain employer stock. Despite the tax benefits provided when such shares are retained after exercise, and other incentives that are sometimes provided by an employer to encourage such retention, employers often find that successfully encouraging such share retention is a difficult challenge. The imposition of employment taxes at the time an ISO or ESPP option is exercised would create another significant obstacle to achieving such retention, and would be contrary to the policy of encouraging retention of employer stock by employees.

(f) Application of FICA Taxes to ISOs and ESPP Options Should Not Be Retroactive.

The perspective expressed by the FSA appears to be that, since the Sun Microsystems decision, taxpayers have been on notice that the exercise of discount ESPP options results in payment of FICA wages. As discussed above, we believe that this conclusion is not appropriate, and that it does not follow from the decision. Contrary to the suggestion in the FSA, we do not agree that a stipulation by the Service in a Tax Court memorandum decision should be treated as sufficient notice to taxpayers of a change in the Service's position on this matter. When the Service was contemplating a revision to the principles of Rev. Rul. 71-52 in connection with ISOs, it provided, in Notice 87-49, that such application would be prospective. We believe that the Service should continue to follow this approach with respect to any change in the employment tax treatment for ISOs or ESPP options.

Very truly yours,

Wayne R. Luepker
Chair