DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

OFFICE OF
CHIEF COUNSEL

April 7, 1999

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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR DISTRICT COUNSEL

FROM: Chief, Branch 2
CC:EBEO

SUBJECT: Request for Field Service Advice

This Field Service Advice responds to your memorandum dated November 25, 1998. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

LEGEND:

A =

ISSUES:

I. Whether the excess of the fair market value of ESPP stock on the exercise date over the option price is wages under the FICA.

II. If this amount is wages under the FICA, whether the exercise of an ESPP option constitutes a payment of wages.

III. Whether A is excused from its obligations under the FICA based upon the notice principles of Central Illinois and General Elevator.

CONCLUSIONS:

I. The amount in which the fair market value of ESPP stock on the exercise date exceeds the option price is wages under the FICA.

II. The exercise of an ESPP option constitutes a payment of wages.

III. A is not excused from its obligations under the FICA based upon the principles of Central Illinois and General Elevator.

FACTS:

The periods at issue are through . A maintains an Employee Stock Purchase Plan ("ESPP") meeting the requirements under section 423 of the Code. A's ESSP established sequential offerings each lasting months (an " "), the first day of which being the " ." Each generally consists of four six-month " ," the last day of which being the " ." The " " (option price) of a share is generally 85% of the lesser of the fair market value of a share of A common stock on the , or the . Upon exercise, the ESPP stock is nonforfeitable.

A's eligible employees may participate in the ESPP by providing A with a subscription agreement authorizing payroll deductions from percent of the participant's compensation. These payroll deductions do not reduce a participant's taxable wages.

With respect to "disqualifying dispositions" of ESPP stock, A treats as ordinary income, in the year of disposition, the amount equal to the excess of the fair market value of the shares on the over the . This amount is reported in box 1 of the employee's Form W-2 as gross wages. With respect to "qualifying dispositions," A treats as ordinary income, in the year of disposition, the lesser of (a) the 15% discount calculated on the or (b) any excess of the fair market value of the shares on the disposition date over the purchase price. These amounts are also reported on the employee's W-2 as gross wages. Employment taxes are not paid or withheld with respect to the income reported on the employee's Form W-2.

LAW AND ANALYSIS

Section 421(a) provides that if the requirements under section 423(a) are met, no income shall result at the time of such transfer of such share upon the employee's exercise of the option with respect to such share.

Section 423(a) provides, in part, that section 421(a) shall apply with respect to the transfer of a share of stock to an individual pursuant to his exercise of an option granted under an employee stock purchase plan if no disposition of such share is made by the individual within 2 years after the date of the granting of the option nor within 1 year after the transfer of such share to the individual.

Section 83(e)(1) provides that section 83 does not apply to a transaction to which section 421 applies. But if the requirements under section 423(a) are not met, then section 421(a) does not apply and the income taxation of the transaction is governed by section 83. Section 83(a) generally provides that the excess of the fair market value of property transferred in connection with performance of services over the amount paid for the property is included in gross income at the first time the rights of the person having the beneficial interest in such property are transferable or are not subject to a substantial risk of forfeiture.

Section 421(b) provides that if there is a failure to meet the holding period requirement of section 423(a)(1), any increase in the income of such individual or deduction from the income of his employer corporation for the taxable year in which such exercise occurred attributable to such disposition, shall be treated as an increase in income or a deduction from income in the taxable year of such individual or of such employer corporation in which such disposition occurred. Thus, section 421(b) provides a necessary accommodation to section 83, which would otherwise require that the income resulting from the disqualifying disposition be included in the year in which the option was exercised.

Sections 3121(a), 3306(b), and 3401(a) of the Code define the term "wages," with certain exceptions, as all remuneration for services performed as an employee.

Sections 31.3121(a)-1(e), 31.3306(b)-1(e), and 31.3401(a)-1(a)(4) of the Employment Tax Regulations provide that remuneration may be paid in cash or something other than cash and generally the medium in which the remuneration is paid is not material. Section 31.3121(a)-1(e) further provides the remuneration paid in other than cash shall be computed on the basis of the fair value of such items at the time of payment.

Gains realized upon the disposition of stock purchased pursuant to employer-granted stock options can include a component which is compensatory in nature, and a component which is proprietary in nature. The amount which is compensatory is equal to the fair market value of the stock on the exercise date less the amount paid for the stock pursuant to the option (hereinafter, referred to as "the compensatory amount"). Of course, upon disposition of the stock, any amount of the sale price exceeding the fair market value of the stock on the exercise date is proprietary in nature and will receive capital gain treatment. At issue in this case is the FICA tax treatment of the compensatory amount. The following discusses whether the compensatory amount is "wages" for employment tax purposes, and whether the compensatory amount is subject FICA tax upon the exercise of an ESPP option.

Issue I. Whether the excess of the fair market value of ESPP stock on the exercise date over the option price is wages under the FICA.

For nonstatutory stock options, the income and employment tax treatments of the compensatory amount are well-established. In Commissioner v. Smith, 324 U.S. 177 (1945), and Commissioner v. LoBue, 351 U.S. 243 (1956), the Court held that the difference between the fair market value of the stock and the amount paid pursuant to an employer-granted stock option is compensatory and includible in income when the option is exercised. The income tax treatment under section 83 of employer-granted stock options is in substance a codification of Smith and LoBue. Section 1.83-7 of the regulations provides that in the case of an option that does not have a readily ascertainable fair market value at the time of grant, the rules under section 83(a) shall apply at the time the option is exercised. Thus, with respect to a nonstatutory stock options, the compensatory amount is includible in income when the option is exercised.

In Revenue Ruling 78-185, 1978-1 C.B. 304, the Service addressed the employment tax treatment of the compensatory amount in the context of nonstatutory employer-granted stock options. The ruling holds that the compensatory amount is wages for FICA, FUTA, and income tax withholding purposes when the option is exercised. See also Rev. Rul. 67-257, 1967-2 C.B. 359 (the compensatory amount is includible in the employee's gross income on the exercise date, and, as such, is wages subject to income tax withholding on that date);[1] Rev. Rul. 79-305, 1979-2 C.B. 350 (the value of stock transferred in trust for

[1]Although the ruling was issued before section 83, it remains valid because it is consistent with the provisions of section 83.

an employee's benefit is wages for employment tax purposes at the time the risk of forfeiture lapsed).

The Service has not issued guidance addressing the employment tax treatment of ESPP options. However, the Service issued Revenue Ruling 71-52, 1971 C.B. 278, which addressed the income and employment tax treatment of qualified stock options. The ruling holds that a taxpayer does not make a payment of "wages," for purposes of the FICA, the FUTA, or the Collection of Income Tax at Source on Wages, at the time of the exercise of options granted to its employees participating in its qualified stock option plan under section 422.[2] The ruling also holds that the disposition of shares of stock purchased by eligible employees under a plan does not result in the receipt of additional "wages" by them or in the payment of "wages" by the employer for income tax withholding purposes.

Rev. Rul. 71-52's holding with respect to income tax withholding was at issue in Notice 87-49, 1987-2 C.B. 278. The Service issued Notice 87-49 to reconcile inconsistencies among the proposed regulations under section 422A, section 83, and Rev. Rul. 71-52. The proposed regulations under section 422A, involving incentive stock option (ISO) plans, provide that the income tax effects of a disqualifying disposition of stock are determined by reference to section 83 and the regulations thereunder.[3] Section 1.83-6(a)(2) of the regulations, prior to revision, provided that a deduction is allowable only if the employer withholds upon the amount includible in income in accordance with section 3402.[4] The Notice provides that to the extent the proposed regulations and the regulations under section 83 require withholding as a condition to deductibility, which is inconsistent with Rev. Rul. 71-52, the proposed regulations will not become final. The Notice added that Rev. Rul. 71-52 is being reconsidered, but in the meantime, the Notice will apply to incentive stock options. Notice 87-49 does not discuss whether the compensatory amount is wages for employment tax purposes; rather, it discusses only whether the deduction provided under section 421(b) is conditioned upon withholding income

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[2]See infra note 3.

[3]Former Code section 422 provided rules for Qualified Stock Options. The Omnibus Budget Reconciliation Act of 1990 (Pub. L. No. 101-508) repealed former section 422 as of November 5, 1990, and redesignated former Code section 422A, which provided rules for Incentive Stock Options, as section 422.

[4]Section 1.83-6(a)(2), as amended by T.D. 8599, 1995-2 C.B. 12, applicable to years beginning on or after January 1, 1995, provides that the service provider is deemed to have included the amount as compensation if the service recipient satisfies all the requirements of section 6041 (Forms 1099 and W-2 reporting).

tax from the compensatory amount. Therefore, Notice 87-49 is not an affirmation of Rev. Rul. 71-52's holding regarding the FICA taxation of the compensatory amount.

In Sun Microsystems, Inc. v. Commissioner, T.C.M. 1995-69 (Tannenwald, J.), acq., AOD CC-1997-010 (November 4, 1997), the court considered whether the term "wages," for purposes of the research credit provided under section 41, included the income realized from the disqualifying disposition of stock purchased through the petitioner's qualified ISO plan. Section 41(b)(2)(D)(i) provides that the term "wages" has the same meaning given such term under section 3401(a). As an initial matter, the court agreed with the petitioner that in determining whether the compensatory amount in a disqualifying disposition is "wages" under section 3401(a), the analysis in Apple Computer, Inc. v. Commissioner, 98 T.C. 232 (1992), acq. 1992-2 C.B. 1, which involved the same issue in the context of nonqualified stock options, was equally applicable in the context of incentive stock options under section 422.

The Service's sole argument in Sun Microsystems was that based upon Rev. Rul. 71-52 and Notice 87-49, the compensatory amount realized upon the disqualifying disposition of ISO stock is not wages. The Service conceded that the compensatory amount with respect to stock purchased under an ESPP, or under a nonqualified plan, was "wages" under section 3401(a); but argued that based upon Rev. Rul. 71-52, the compensatory amount with respect to ISOs was not wages. The court commented that it was unable to understand the Service's distinction between ISOs and ESPPs. The court explained that a ruling or notice is only as persuasive as the reasoning and precedents upon which it relies; and because these pronouncements were issued only for administrative convenience, without any basis in law, they are "totally unpersuasive." Because there is no statutory provision excluding the compensatory amount from the definition of wages, the court concluded that the compensatory amount in a disqualifying disposition of ISO stock is wages for purposes of income tax withholding.

The court made three points which are instructive in determining the correct employment tax treatment of ESPP options. First, the court's analogy to Apple Computer 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 upon 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 opinion nullifies any affect 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.

In conclusion, it is our position that the compensatory amount is subject to FICA tax. We base our conclusion on section 31.3121(a)-1(e), which provides that wages may be paid in the form of property; and Sun Microsystems, which held that the compensatory amount with respect to statutory stock options is wages for employment tax purposes. In addition, based upon Sun Microsystems, which applied the Apple Computer court's reasoning, it is our position that in determining whether the compensatory amount in the context of statutory stock options is subject to FICA tax, it is appropriate to apply the reasoning used by the authorities addressing nonstatutory stock options; for example, LoBue, in which the Court held that the compensatory amount was compensation for services; and Rev. Rulings 78-185, and 67-257, which conclude that the compensatory amount is wages subject to FICA.

Issue II. If the compensatory amount is wages under the FICA, whether the exercise of an ESPP option constitutes a payment of wages.

Because the compensatory amount is not gross income upon exercise of the ESPP option under section 421, and therefore is not then subject to income tax withholding, an issue arises as to the relationship between the income tax withholding requirements and the FICA tax requirements. The legislative history of the Social Security Amendments of 1983, P.L. No. 98-21, § 321, 1983-2 C.B. 322, which amended section 3121(a), discusses the relationship between the FICA and income tax withholding. The Senate Report states,

> The social security program aims to replace the income of beneficiaries when that income is reduced on account of retirement and disability. Thus, the amount of "wages" is the measure used both to define income which should be replaced and to compute FICA tax liability. Since the social security system has objectives which are significantly different from the objectives underlying the income tax withholding rules, your committee believes that amounts exempt from income tax withholding should not be exempt from FICA unless Congress provides an explicit FICA tax exclusion.

S. Rep. No. 98-23, 98th Cong. 1st Sess. 42, reprinted in 1983 U.S.C.C.A.N. 143, 299.[5] The legislative history to section 3121(a) supports the position that the

[5]The change to section 3121(a) came in response to Rowan Companies, Inc. v. United States, 425 U.S. 247 (1981), in which the Court invalidated FICA regulations

compensatory amount receives bifurcated treatment with respect to FICA tax and income tax withholding.

Thus, in determining the correct FICA tax treatment, the income tax withholding treatment is irrelevant. Instead, the principles that have developed regarding the employment tax treatment of property received in connection with the performance of services, and more specifically, the employment tax treatment with respect to stock options received in connection with the performance of services, control in determining when the compensatory amount is subject to FICA tax. As discussed above, Rev. Rulings, 78-185, 67-257, and 79-305 hold that a payment of wages is made when the option is exercised. These rulings in substance apply the principles of section 83(a), which provides that the compensatory amount is gross income when the property is transferrable or not subject to a substantial risk of forfeiture.

The separation of the FICA and income tax withholding requirements finds support in other sections of the Code involving deferred compensation. For example, under section 3121(v)(2), with respect to nonqualified deferred compensation plans, an amount is subject to FICA taxation as of the later of the date when the services giving rise to the wages are performed, or when there is no substantial risk of forfeiture of the rights to the wages. Consequently, an employee who defers income under a nonqualified deferred compensation arrangement may be subject to FICA taxes on that income prior to when that income is includible in gross income. This section is another example of Congress's recognition that the requirements with respect to income tax withholding are distinct from the FICA tax requirements.

In conclusion, the deferred income tax treatment provided with respect to ESPP stock options under sections 421 and 423 is irrelevant in determining when the compensatory amount is subject to FICA tax. There are no FICA provisions that exclude the compensatory amount or defer recognition of the compensatory amount until the disposition of the ESPP stock. Therefore, the principles that have developed through case law and Service pronouncements regarding the income and employment taxation of the compensatory amount in the nonstatutory option context are controlling in determining the correct FICA taxation of ESPP options. Service pronouncements, applying in substance the section 83 principles, have concluded that the compensatory amount is subject to FICA tax when the option is

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which held that the value of employer-provided meals were includible in FICA wages notwithstanding that these amounts may be excluded from wages for purposes of income tax withholding.

exercised. Accordingly, we conclude that the exercise of an ESPP constitutes a payment of wages under the FICA.

Issue III. Whether A is excused from its obligations under the FICA based upon Central Illinois and General Elevator.

Advice has also been requested on whether Central Illinois Public Service Co. v. United States, 435 U.S. 21 (1978), and General Elevator Corp. v. United States, 20 Cl. Ct. 345 (1990), provide A with a defense against the Service's assertion that it had a duty to withhold and pay FICA tax upon the exercise of ESPP options.

Central Illinois considered whether an employer was required to withhold income tax from reimbursements for lunch expenses paid to employees who were on nonovernight company travel. The Court held that withholding was not required, based primarily on the existence of repealed section 31.3401(a)-1(b)(2) of the regulations, which excluded from wages amounts "paid specifically ... for traveling or other bona fide ordinary and necessary expense incurred ... in the business of the employer." In deciding the issue, the Court noted that whether the reimbursements were even income had not been established at the time when there was a putative obligation to withhold. The Court stated that "[b]ecause the employer is in a secondary position as to liability for any tax of the employee, it is a matter of obvious concern that ... the employer's obligation to withhold be precise and not speculative." 435 U.S. at 31.

Certain facts distinguish the present case from Central Illinois. In Central Illinois, there was an employment tax regulation that explicitly excluded expenses such as lunch reimbursements from wages. In the present case, A claims it was misled by Rev. Rul. 71-52, and Notice 87-49. A's purported reliance on these pronouncements is unreasonable, however, in light of the Sun Microsystems opinion, which was issued in February of 1995, well before the exercise of options in 1996 and subsequent years under A's ESPP. In addition, 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. Moreover, in Central Illinois, the Court found persuasive that courts had been finding that these types of meal allowances were not even income, and that this exacerbated the lack of notice problem. 431 U.S. at 31. Whereas, with respect to ESPP options, there is no question that the compensatory amount is income, sections 421 and 423 only affect the timing of the income inclusion.

In addition, the applicability of Central Illinois is limited in cases involving the application of FICA tax. In Chicago Milwaukee Corp. v. United States, 35 Fed. Cl. 447 (1996), a FICA tax case, the court held that the principles of Central Illinois apply only to an employer's obligations for which it is in a secondary position of liability, i.e., those obligations for which it has a duty to withhold. Therefore, Central Illinois is inapplicable with respect to the employer's portion of FICA, for which it is primarily liable. 35 Fed. Cl. at 462. Accordingly, the principles of Central Illinois are inapplicable with respect to A's portion of the FICA.

In General Elevator, the taxpayer claimed a refund of employment and income taxes assessed against per diem allowances paid to construction workers who traveled to temporary job sites. The Service had published Rev. Rul. 76-453, 1976-2 C.B. 86, requiring withholding from reimbursements of transportation costs to and from the job site. This modified an earlier Service position. However, the Service suspended the ruling due to a moratorium imposed by Congress on the position advanced by the ruling. In addition, an industry trade association, of which the taxpayer was a member, obtained a letter from a Service agent stating the agent's opinion that the per diem allowances were not subject to withholding. Based upon this letter, the association issued a memorandum advising its members that withholding was not required. Under these facts, the court concluded that the amounts were wages but that there was inadequate notice concerning the duty to withhold. 20 Cl. Ct. at 354.

In the present case, there was no modification of authority sufficient to create ambiguity concerning A's duty to withhold. 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, A was put on notice regarding its duty to withhold FICA tax.

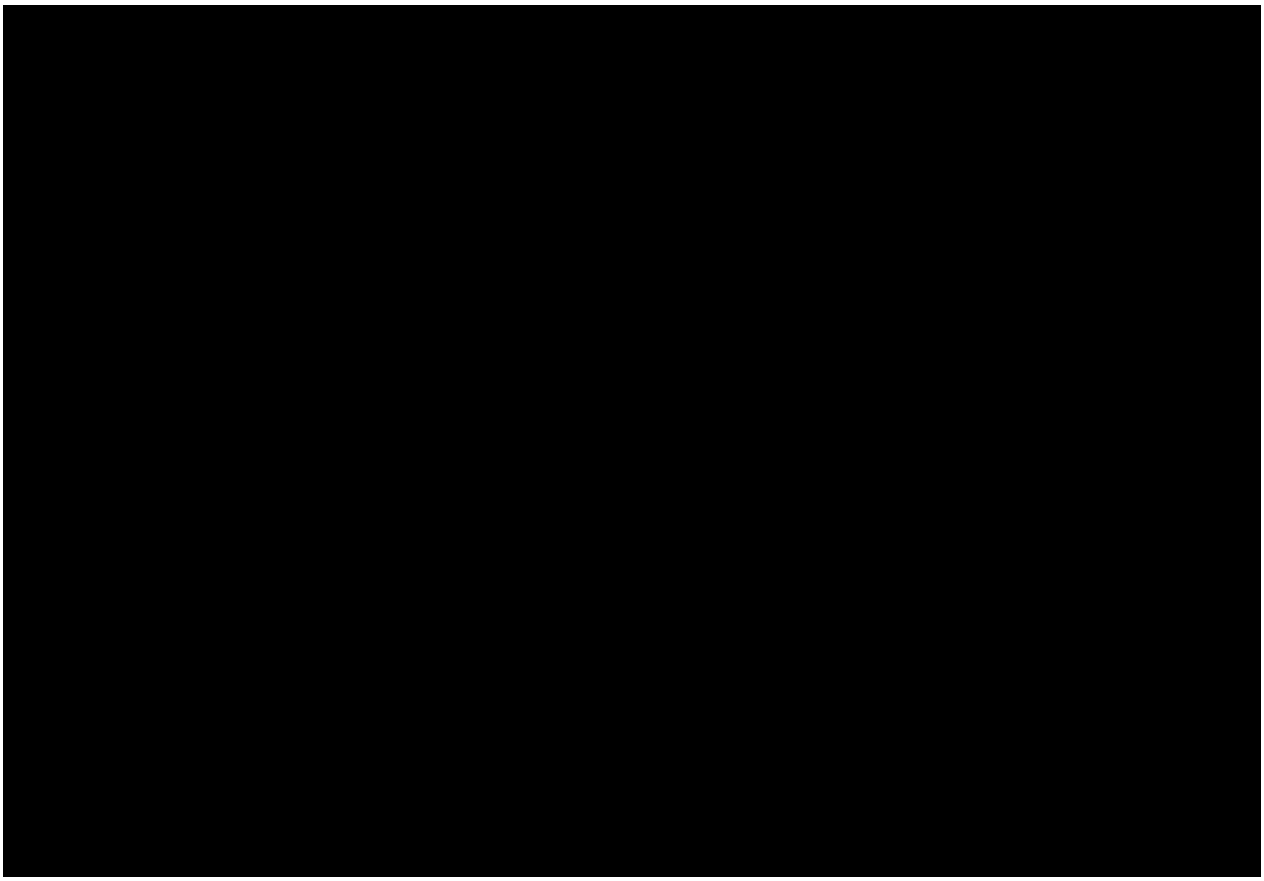
Moreover, the Service's letter rulings involving ESPPs do not reveal an inconsistent position. Indeed, private letter ruling 9243026 affirmatively states that upon the exercise of an option under an ESPP plan, FICA tax is owing on the difference between the option price and the FMV of the stock.[6] Numerous other rulings on section 423 plans explicitly state that no inferences should be drawn regarding the application of FICA tax upon the exercise of an option under an

[6]But see LTR 8540042, which states that no employment tax liability under the FICA attaches with respect to the exercise of an option under an ESPP.

ESPP.[7] Based upon the numerous rulings issued in recent years, it cannot argued that the Service has changed its position with respect to ESPPs.[8]

In conclusion, based upon Sun Microsystems, it was not reasonable for A to rely on Rev. Rul. 71-52. Moreover, the Service's position in Sun Microsystems, as well as the letter rulings issued by the Service, demonstrate that the Service's position on ESPPs has remained consistent.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:



[7]LTRs 8919004, 8920040, 8921027, 9001043, 9028090, 9039036, 9046010, 9407013, 9309035, 9622042, 9650005, 9640014.

[8]Although technical advice memoranda and private letter rulings are not precedential authority (section 6110(k)(3)), they nonetheless provide persuasive "evidence" as to the Service's interpretation of its rulings. See, e.g., Rowan Cos. v. United States, 453 U.S. 247, 261 (1981); Canterbury v. Commissioner, 99 T.C. 223, 247 n. 19 (1992); Estate of Christofani v. Commissioner, 97 T.C. 74, 84 n. 5 (1991).

[redacted]

If you have any further questions or need additional assistance, please contact my office at (202) 622-6040.

Sincerely,

JERRY E. HOLMES
CHIEF, BRANCH 2
ASSOCIATE CHIEF COUNSEL
(EMPLOYEE BENEFITS AND
EXEMPT ORGANIZATIONS)