

THE AMERICAN JOBS CREATION ACT OF 2004 – TAX TREATMENT OF STATUTORY STOCK OPTION TRANSACTIONS

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For many years, the tax treatment of statutory stock options was rife with uncertainty. In 2001, the IRS proposed rules that would have required employers to withhold FICA and FUTA taxes on the "spread" (that is the difference between the amount paid for the shares and the fair market value of the shares on the date such shares were acquired) resulting from the exercise of incentive stock options ("ISO") and in employee stock purchase plan ("ESPP") transactions (ISOs and ESPPs are collectively referred to herein as "statutory stock options"). The proposed regulations, scheduled to take effect January 1, 2003, would have required employers to withhold cash from other compensation or forced employees to pay cash to their employers to fund the required tax payments.

Many employers complained that the proposed regulations imposed significant administrative burdens. One year later, due to intense pressure from the corporate community, the IRS succumbed and announced that it would defer indefinitely the application of the proposed rules. IRS Notice 2002-47 states that the postponement is necessary to provide employers adequate time to make the changes and for the IRS to consider the many comments it received on the proposed regulations. Under Notice 2002-47, the IRS would not assess FICA or FUTA taxes, or impose federal income tax withholding, on the exercise of any statutory stock option or the disposition of any stock acquired by exercising a statutory stock option.

The American Jobs Creation Act of 2004

On October 22, 2004, President Bush signed into law the American Jobs Creation Act of 2004 {the "JOBS Act"}. The JOBS Act makes a wide variety of federal tax law changes, including changes to the tax treatment of certain statutory stock option transactions. Specifically, the JOBS Act makes clear that:

- No FICA or FUTA taxes would be assessed on the purchase of shares under an ISO or ESPP or on the disposition of such shares,
- Employers do not have an obligation to withhold federal income taxes arising in connection with the disposition of shares acquired under an ESPP, and
- Employers do not have an obligation to withhold federal income taxes arising in connection with the disqualifying disposition of shares acquired upon the exercise of an ISO.

The JOBS Act, however, does not change the reporting requirements associated with statutory stock options. Employers should also continue to draft into their ISO award agreements a provision requiring employees to notify the employer

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in writing of any disqualifying disposition of ISO shares. Furthermore, employers should continue to issue the statements required by Section 6039 of the Internal Revenue Code to each employee or former employee who exercises an ISO or acquires shares under an ESPP by not later than January 31 of the year following the year in which legal title to the shares is transferred. Employees who receive compensation income as the result of the exercise of statutory stock options or any disposition of such stock should be aware that they may have to make estimated tax payments with respect to that compensation.