

**Par. 2.** In § 1.1502–80, paragraph (d) is revised to read as follows:

**§ 1.1502–80 Applicability of other provisions of law.**

(d) *Non-applicability of section 357(c)–(1) In general.* Section 357(c) does not apply to cause the transferor to recognize gain in any transaction to which § 1.1502–13 applies, if such transaction occurs in a consolidated return year beginning on or after [the date these regulations are published as final regulations in the **Federal Register**]. Notwithstanding the foregoing, for purposes of determining the transferor's basis in property under section 358(a) received in a transfer described in section 351, section 358(d)(2) shall operate to exclude liabilities described in section 357(c)(3)(A), other than those also described in section 357(c)(3)(B), from the computation of the amount of liabilities assumed that is treated as money received under section 358(d)(1), if such transfer occurs in a consolidated return year beginning on or after [the date these regulations are published as final regulations in the **Federal Register**]. This paragraph (d)(1) does not apply to a transaction if the transferor or transferee becomes a nonmember as part of the same plan or arrangement. The transferor (or transferee) is treated as becoming a nonmember once it is no longer a member of a consolidated group that includes the transferee (or transferor). For purposes of this paragraph (d)(1), any reference to a transferor or transferee includes, as the context may require, a reference to a successor or predecessor. For rules regarding the application of section 357(c) to transactions occurring in consolidated return years beginning on or after January 1, 1995, but before [the date these regulations are published as final regulations in the **Federal Register**], see § 1.1502–80(d) in effect prior to the date these regulations are published as final regulations in the **Federal Register** (see 26 CFR part 1 revised April 1, 2001).

(2) *Examples.* The principles of paragraph (d)(1) of this section are illustrated by the following examples:

*Example 1.* P, S, and T are members of a consolidated group. P owns all of the stock of S and T with bases of \$30 and \$20, respectively. S has assets with a total fair market value equal to \$100 and an aggregate basis of \$30 and liabilities of \$40. S merges into T in a transaction described in section 368(a)(1)(A) (and in section 368(a)(1)(D)). Section 357(c) does not apply to cause S to recognize gain in the merger. P's basis in T's stock increases to \$50 (\$30 plus \$20), and T succeeds to S's \$30 basis in the assets transferred and the \$40 of liabilities.

*Example 2.* P owns all the stock of S1. S1 has assets with a total fair market value equal to \$100 and an aggregate basis of \$30. S1 has \$40 of liabilities, \$5 of which are described in section 357(c)(3)(A), but not section 357(c)(3)(B), and \$35 of which are not described in section 357(c)(3)(A). S1 transfers its assets to a newly formed subsidiary, S2, in exchange for stock of S2 and S2's assumption of the liabilities of \$40 in a transaction to which section 351 applies. Section 357(c) does not apply to cause S1 to recognize gain in connection with the transfer. For purposes of determining S1's basis in the S2 stock it received in the exchange, section 358(d)(2) operates to exclude \$5 of the liabilities from the computation of the amount of liabilities assumed that are treated as money received under section 358(d)(1). S1's basis in the S2 stock received in the exchange is a \$5 excess loss account (reflecting its \$30 basis in the assets transferred reduced by \$35, the amount of liabilities assumed that are not described in section 357(c)(3)(A)).

\* \* \* \* \*

**Robert E. Wenzel,**

*Deputy Commissioner of Internal Revenue.*

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**DEPARTMENT OF THE TREASURY**

**Internal Revenue Service**

**26 CFR Parts 1 and 31**

**[REG–142686–01]**

**RIN 1545–BA26**

**Application of the Federal Insurance Contributions Act, Federal Unemployment Tax Act, and Collection of Income Tax at Source to Statutory Stock Options**

**AGENCY:** Internal Revenue Service (IRS), Treasury.

**ACTION:** Notice of proposed rulemaking and notice of public hearing.

**SUMMARY:** This document contains proposed regulations relating to incentive stock options and options granted under employee stock purchase plans. These proposed regulations would provide guidance concerning the application of the Federal Insurance Contributions Act (FICA), Federal Unemployment Tax Act (FUTA), and Collection of Income Tax at Source to these options. These proposed regulations would affect employers that grant these options and employees who exercise these options. This document also provides notice of a public hearing on these proposed regulations.

**DATES:** Written or electronic comments and outlines of topics to be discussed at

the public hearing scheduled for March 7, 2002, must be received by February 14, 2002.

**ADDRESSES:** Send submissions to: CC:ITA:RU (REG–142686–01), Room 5226, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered Monday through Friday between the hours of 8 a.m. and 5 p.m. to: CC:ITA:RU (REG 142686–01), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW., Washington, DC. Alternatively, taxpayers may submit comments electronically via the Internet by selecting the "Tax Regs" option on the IRS Home Page, or by submitting comments directly to the IRS Internet site at [http://www.irs.gov/tax\\_regs/reglist.html](http://www.irs.gov/tax_regs/reglist.html). The public hearing will be held in the Auditorium of the Internal Revenue Building, 1111 Constitution Avenue, NW., Washington, DC.

**FOR FURTHER INFORMATION CONTACT:**

Concerning the proposed regulations, Stephen Tackney of the Office of Division Counsel/Associate Chief Counsel (Tax Exempt and Government Entities), (202) 622–6040; concerning submissions of comments, the hearing, and/or to be placed on the building access list to attend the hearing, Treena Garrett, (202) 622–7180 (not toll-free numbers).

**SUPPLEMENTARY INFORMATION:**

**Background**

This document contains proposed amendments to the Employment Tax Regulations (26 CFR part 31) under sections 3121(a), 3306(b), and 3401(a) of the Internal Revenue Code of 1986 (Code), and to the Income Tax Regulations (26 CFR part 1) under section 424 of the Code. These regulations would clarify current law regarding FICA tax, FUTA tax, and income tax withholding consequences upon the exercise of statutory stock options, *i.e.*, incentive stock options described in section 422(b) and options granted under an employee stock purchase plan described in section 423(b). FICA tax consequences are determined by sections 3101 through 3128, FUTA tax consequences by sections 3301 through 3311, and income tax withholding consequences by sections 3401 through 3406.

**A. Statutory Stock Options**

Section 422(b) sets forth the requirements for treatment of options as incentive stock options. If certain conditions are met, special tax treatment is provided in section 421(a) for the transfer of stock to an individual

pursuant to the exercise of an incentive stock option. These conditions include a requirement that the individual not dispose of the stock within two years from the date of the grant of the option, and a requirement that the individual not dispose of the stock within one year after the transfer of the stock to the individual.

Section 423(b) sets forth the requirements for establishment of an employee stock purchase plan. If certain conditions are met, special tax treatment is provided under section 421(a) for the transfer of stock to an individual pursuant to the exercise of an option granted under an employee stock purchase plan. These conditions include a requirement that the individual not dispose of the stock within two years from the date of the grant of the option, and a requirement that the individual not dispose of the stock within one year after the transfer of the stock to the individual.

Section 421(a) provides that at the time stock is transferred to an individual pursuant to the exercise of an option, if the conditions of section 422(a) or 423(a) are met, then no income to the individual results upon the exercise. Section 421(b) provides that at the time stock is transferred to an individual pursuant to the exercise of an option, if the stock is sold or disposed of by the individual and the holding period requirements of section 422(a)(1) or 423(a)(1) are not met, then any income to the individual which results for the taxable year, in which the option was exercised, attributable to the sale or disposition of the stock is income to the individual in the taxable year, of the individual, in which the sale or disposition occurred.

Section 423(c) provides guidance when the option price of a share of stock acquired by an individual pursuant to the exercise of an option granted under an employee stock purchase plan is less than 100 percent of the fair market value of the share at the time the option was granted. Section 423(c) provides that in the event of either the disposition of the share of stock by the individual which meets the holding period requirements of section 423(a) or in the event of the individual's death while owning the share of stock, that any resulting compensation is attributable to the individual in the taxable year in which the disposition or death occurred. The compensation attributable to the individual is the amount equal to the lesser of (1) the excess of the fair market value of the share at the time of the disposition or death over the amount paid for the share under the option or (2) the excess of the fair market value of

the share at the time the option was granted over the option price.

#### *B. FICA, FUTA, and Income Tax Withholding*

##### **1. FICA**

FICA tax is generally imposed on each employer and employee. Under section 3111, FICA tax is imposed on the employer in an amount equal to a percentage of the wages paid by that employer. Under section 3101, FICA tax is also imposed on the employee in an amount equal to a percentage of the wages received by the employee with respect to employment.

FICA tax is composed of a tax for Old-Age, Survivors, and Disability Insurance (OASDI) and a tax for Hospital Insurance (HI). The OASDI portion of FICA tax is imposed separately on the employer and on the employee in an amount equal to 6.2 percent of wages. Under section 3121(a)(1), the wages subject to the OASDI portion of FICA tax are limited to the contribution and benefit base for OASDI for that year (\$80,400 for calendar year 2001). The HI portion of FICA tax is separately imposed on the employer and the employee in an amount equal to 1.45 percent of wages. There is no dollar limit on the wages subject to the HI portion of FICA tax.

Under section 3102, the employer is required to collect the employee portion of FICA tax by deducting the amount of the tax from wages, as and when paid, and is liable for payment of the tax required to be collected. Under § 31.3102-1(a) of the Employment Tax Regulations, the employer is required to collect the employee portion of FICA tax, notwithstanding that the wages are paid in something other than money, and to pay over the tax in money.

##### **2. FUTA**

FUTA tax is generally imposed under section 3301 on each employer in an amount equal to a percentage of wages paid by the employer with respect to employment. FUTA tax is imposed on the employer in an amount equal to 6.2 percent of wages. Under section 3306(b), wages of an employee subject to the FUTA tax are limited to \$7,000 per calendar year.

##### **3. Income Tax Withholding**

Income tax withholding is imposed under section 3402(a), which requires employers paying wages to deduct and withhold income tax on those wages. The amount deducted and withheld is determined in accordance with tables or computational procedures prescribed by the Secretary of the Treasury.

#### ***C. Wages***

##### **1. FICA**

For FICA purposes, section 3121(a) provides that the term *wages*, with certain exceptions, means all remuneration for employment, including the cash value of all remuneration (including benefits) paid in any medium other than cash. Similarly, under § 31.3121(a)-1(b), the term *wages* means all remuneration for employment unless specifically excepted under section 3121(a) or § 31.3121(a)-1(j). Neither the Code nor the regulations contain an exclusion from wages for the value of stock transferred pursuant to the exercise of an option.

Under § 31.3121(a)-1(e), in general, the medium in which the remuneration is paid is immaterial. It may be paid in cash or in kind. The amount of non-cash remuneration is based on the fair market value of the non-cash remuneration at the time of payment.

Under § 31.3121(a)-1(a), in general, wages are received by an employee at the time that they are paid by the employer to the employee. Wages are generally paid by an employer at the time that they are actually or constructively paid.

Under § 31.3121(a)-1(i), remuneration for employment, unless specifically excepted under section 3121(a) or § 31.3121(a)-1(j), constitutes wages even though at the time paid the relationship of employer and employee no longer exists between the person in whose employ the services were performed and the individual who performed them.

##### **2. FUTA**

For FUTA purposes, section 3306(b) provides that the term *wages*, with certain exceptions, means all remuneration for employment, including the cash value of all remuneration (including benefits) paid in any medium other than cash. Similarly, under § 31.3306(b)-1(b), the term *wages* means all remuneration for employment unless specifically excepted under section 3306(b) or § 31.3306(b)-1(j). Neither the Code nor the regulations contain an exclusion from wages for the value of stock transferred pursuant to the exercise of an option.

Under § 31.3306(b)-1(e), in general, the medium in which the remuneration is paid is immaterial. It may be paid in cash or in kind. The amount of non-cash remuneration is based on the fair market value of the non-cash remuneration at the time of payment.

Under § 31.3301–4, wages are considered paid when actually or constructively paid.

Under § 31.3306(b)–1(i), remuneration for employment paid by an employer to an individual for employment, unless specifically excepted under section 3306(b), constitutes wages even though at the time paid the individual is no longer an employee.

### 3. Income Tax Withholding

For income tax withholding purposes, section 3401(a) provides that the term *wages*, with certain exceptions, means all remuneration for services performed by an employee for his employer, including the cash value of all remuneration (including benefits) paid in any medium other than cash. Similarly, under § 31.3401(a)–1(a), the term *wages* in general means all remuneration for employment for services performed by an employee for his employer unless specifically excepted under section 3401(a) or 3402(e).

Under § 31.3401(a)–1(a)(4), in general, the medium in which the remuneration is paid is immaterial. It may be paid in cash or in kind. The amount of non-cash remuneration is based on the fair market value of the non-cash remuneration at the time of payment.

Under § 31.3402(a)–1(b), the employer is required to collect the tax by deducting and withholding the amount from the employee's wages as and when paid, either actually or constructively.

Under § 31.3401(a)–1(a)(5), remuneration for services, unless specifically excepted by statute, constitutes wages even though at the time paid the relationship of employer and employee no longer exists between the person in whose employ the services were performed and the individual who performed them.

The legislative history of sections 3401 through 3404 indicates that a purpose of income tax withholding is to enable individuals to pay income tax in the year in which the income is earned. H.R. Conf. Rep. No. 78–510 at 1 (1943); H.R. Rep. No. 78–401 at 1 (1943); Rep. No. 78–221 at 1 (1943); and Senate Rep. No. 78–221 at 1 (1943). Therefore, income tax withholding is generally imposed only upon remuneration paid by an employer to the extent that an employee recognizes income. Section 421(a) provides that if a share of stock is transferred to an individual in a transfer which meets the requirements of section 422(a) or 423(a), no income is recognized at the time of the transfer.

As part of the Social Security Amendments of 1983, Public Law 98–21, 97 Stat. 65 (1983), Congress

amended sections 3121(a) and 3306(b)<sup>1</sup> to provide specifically that regulations providing an exclusion from wages for income tax withholding purposes are not to be construed to require a similar exclusion from wages for FICA and FUTA purposes. The legislative history to the Social Security Amendments of 1983 at S. Rep. No. 98–23, 42, 98th Cong., 1st Sess. explains as to FICA and income tax withholding that “[S]ince, [however], the [social] security system has objectives which are significantly different from the objective underlying the income tax withholding rules, the committee believes that amounts exempt from income tax withholding should not be exempt from FICA unless Congress provides an explicit FICA tax exclusion.” The legislative history further explains that Congress intended to reverse the holding in *Rowan Companies v. U.S.*, 452 U.S. 247 (1981), that the definitions of *wages* for FICA and income tax withholding purposes were the same. Thus, wages for income tax withholding purposes are not always the same as wages for FICA and FUTA purposes.

### D. Application of Law to Statutory Stock Options

Revenue Ruling 71–52 (1971–1 C.B. 278) which was published before the statutory changes to sections 3121(a) and 3306(b) mentioned immediately above, addressed the FICA, FUTA, and income tax withholding consequences applicable to the exercise of qualified stock options under former section 422.<sup>2</sup> The ruling holds that a taxpayer does not make a payment of wages for purposes of FICA, FUTA, and income tax withholding at the time of the exercise of a qualified stock option under former section 422.

Notice 87–49 (1987–2 C.B. 355) addressed potential inconsistencies among and coordination of the proposed regulations under former section 422A (current section 422), section 83, and Rev. Rul. 71–52. Notice 87–49 provided

<sup>1</sup> Sections 3121(a) and 3306(b) were amended by section 327(b)(1) and (c)(4), respectively, of the Social Security Amendments of 1983, Public Law 98–21, 97 Stat. 65 (1983).

<sup>2</sup> Section 603 of the Tax Reform Act of 1976, Public Law 94–355, 90 Stat. 1520 (1976), amended former section 422 to provide, generally, that qualified stock options could not be granted after May 20, 1976. Current section 422 (Incentive Stock Options) was added to the Internal Revenue Code of 1954 (Code), as section 422A, by section 251(a) of the Economic Recovery Tax Act of 1981, Public Law 97–34, 95 Stat. 172 (1981). Subsequently, section 11801(c)(9)(A)(i) of the Omnibus Budget Reconciliation Act of 1990, Public Law 101–508, 104 Stat. 1388 (1990), repealed former section 422 (Qualified Stock Options) and re-designated former Code section 422A as section 422 of the Internal Revenue Code of 1986.

that Rev. Rul. 71–52 was being reconsidered, but, until the results of such reconsideration were announced, the principles of Rev. Rul. 71–52 apply to the disposition of stock, acquired by an individual pursuant to the exercise of an incentive stock option, which does not meet the requirements of former section 422A(a) (current section 422(a)).

Notice 2001–14 (2001–6 I.R.B. 416) addresses the FICA, FUTA, and income tax withholding consequences applicable to the exercise of statutory stock options. Notice 2001–14 provides that in the case of any statutory stock option exercised before January 1, 2003, the IRS will not assess FICA or FUTA tax upon the exercise of the option and will not treat the disposition of stock acquired by an employee pursuant to the exercise of the option as subject to income tax withholding. Notice 2001–14 also provides that Revenue Ruling 71–52 is obsolete and that the holding of Revenue Ruling 71–52 does not apply to the exercise of a statutory stock option or to the disposition of stock acquired pursuant to the exercise of a statutory stock option. Consistent with that conclusion, Notice 2001–14 also provides that the provisions of Notice 87–49 described above no longer apply.

It has long been recognized that the transfer of stock to an employee pursuant to the exercise of a nonstatutory stock option granted in connection with employment constitutes a payment of compensation to the extent that the fair market value of the stock received by the employee pursuant to the exercise of the nonstatutory option exceeds the option exercise price. *Commissioner v. LoBue*, 351 U.S. 243 (1956); *Commissioner v. Smith*, 324 U.S. 177 (1945). The exclusion from gross income for income tax purposes that is provided by section 421(a)(1) for the transfer of stock upon the exercise of a statutory stock option, does not alter the compensatory character of such stock transfers or serve to distinguish statutory stock options from nonstatutory stock options for purposes of sections 3121(a) and 3306(b).

### Comments Received Pursuant to Notice 2001–14

Notice 2001–14 announced the intent to issue further administrative guidance clarifying current law with respect to the application of employment taxes to statutory stock options and solicited public comments on the anticipated guidance. In response to the request for comments, the IRS received a number of comments addressing a variety of topics pertaining to the application of FICA, FUTA, and income tax withholding to

transactions involving statutory stock options. Because the proposed regulations address only the application of the FICA, FUTA, and income tax withholding at the time of exercise of a statutory stock option, only comments relating to these types of transactions are addressed.

The IRS also received comments regarding an employer's income tax withholding and reporting obligations upon the sale or disposition of stock acquired by an individual pursuant to the exercise of a statutory stock option. The IRS intends to publish two notices, discussed more fully below, at the time of publication of these proposed regulations. One notice includes proposed rules addressing an employer's income tax withholding and reporting obligations upon the sale or disposition of stock acquired by an individual pursuant to the exercise of a statutory stock option. That notice discusses the comments received in response to Notice 2001-14 relating to those types of transactions.

Most commentators who addressed the application of FICA and FUTA tax at the time of exercise of a statutory stock option argued that there was no statutory basis for such application. As discussed more fully previously, the applicable Code provisions do not provide an exception from FICA or FUTA tax for wages paid to an employee arising from the exercise of a statutory stock option.

Several comments were received requesting that the IRS's acquiescence on decision in *Sun Microsystems v. Commissioner*, T.C.M. 1995-69, *acq.* 1997-2 C.B. 1, not be affected by the proposed regulations. The proposed regulations address only the application of FICA and FUTA to statutory stock options and do not address the section 41 issues raised in the *Sun Microsystems* decision.

Some commentators also expressed concern about the administrative burden of applying FICA and FUTA tax at the time of exercise, especially as to former employees, because there is often no payment of cash compensation to the employee at that time. As a result, some employees may need to sell some shares of the acquired stock to fund the employment tax obligations, resulting in a disqualifying disposition of the shares sold. In addition, some commentators expressed concern that the administrative burdens stemming from the application of FICA and FUTA tax upon the exercise of statutory stock options would make the use of these options less attractive to employers and employees. However, commentators did not cite applicable Code provisions that

provide a statutory basis for excluding this type of compensation from the relevant employment taxes. As discussed below, the proposed regulations would enable the IRS to issue rules of administrative convenience to lessen the administrative burdens that commentators cited.

### Explanation of Provisions

These proposed regulations would clarify current law regarding FICA tax, FUTA tax, and income tax withholding on the transfer of stock pursuant to the exercise of statutory stock options. These proposed regulations would provide that at the time of the exercise of a statutory stock option, the individual who was granted the statutory stock option receives wages for FICA and FUTA purposes. These proposed regulations would also provide that the amount of wages received equals the excess of the fair market value of the stock acquired pursuant to the exercise of the statutory stock option over the amount paid for the stock.

The position taken in these regulations is based upon the broad statutory definition of wages for FICA and FUTA purposes and the absence of any statutory exclusion for this form of remuneration. These regulations follow the Congressional directive that no exception from FICA taxes should be created without a specific exclusion and the section 3121(a) and 3306(b) provisions that no exception from FICA and FUTA taxes should be inferred from the fact that income tax withholding does not apply.

These proposed regulations would also provide that income tax withholding is not required when an individual exercises a statutory stock option because no income is recognized at the time of the exercise by reason of section 421(a)(1).

In response to the concerns about administrative burdens, the proposed regulations authorize the IRS to adopt rules of administrative convenience to assist employers and employees in meeting the employment tax obligations. Specifically, the proposed regulations permit the IRS to adopt rules permitting employers to deem the payment of wages resulting from the exercise of a statutory stock option as occurring at a specific date or dates, including over a period of dates, as well as any other appropriate rules of administrative convenience.

Section 424(h) provides that for purposes of the rules governing incentive stock option plans and employee stock purchase plans, if the

terms of any option to purchase stock are modified, extended, or renewed, such modification, extension, or renewal is considered as the grant of a new option. Section 424(h)(3) generally defines the term *modification* as any change in the terms of the option which gives the employee additional benefits. The proposed regulations clarify that the adoption of any of the rules of administrative convenience that may be prescribed by the IRS pursuant to the proposed regulations, and the application of those rules to outstanding incentive stock options under section 422 or outstanding options under an employee stock purchase plan under section 423, will not constitute a modification for purposes of section 424(h).

These regulations are proposed to apply only upon publication of final regulations in the **Federal Register** and cannot be relied upon prior to publication. These proposed regulations, upon becoming final, would be effective only for the exercise of a statutory stock option that occurs on or after January 1, 2003. If these regulations are finalized as proposed, neither FICA nor FUTA tax will apply to the exercise of a statutory stock option prior to January 1, 2003. Consistent with this proposed position, the IRS will not assert FICA or FUTA tax which is based upon the exercise of a statutory stock option that occurs prior to January 1, 2003.

While neither FICA nor FUTA tax will apply to the exercise of a statutory stock option prior to January 1, 2003 if these regulations are finalized as proposed, an employer will be able to apply the final regulations to the exercise of a statutory stock option that occurs prior to January 1, 2003 if the employer elects to do so.

### Related Administrative Guidance

As noted above, the IRS is concurrently publishing two notices. One of the two notices sets forth proposed rules of administrative convenience under the authority provided to the IRS in the proposed regulations. These proposed rules would permit employers to deem the payment of wages resulting from the exercise of a statutory stock option as occurring at a specific date or dates, including over a period of dates. The notice also describes certain arrangements available under the current federal tax law that may assist employers and employees, including employee pre-funding of the employee portion of FICA tax and employer advances of funds to satisfy the employee portion of FICA tax.

The IRS is publishing a second notice that proposes rules regarding an employer's income tax withholding and reporting obligations upon the sale or disposition of stock acquired by an individual pursuant to the exercise of a statutory stock option. As indicated above, the proposed rule in this notice would state that the employer has no income tax withholding obligation when an employee sells or disposes of stock acquired by the employee pursuant to the exercise of a statutory stock option.<sup>3</sup>

### Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations, and because the regulations do not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

### Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written (a signed original and eight (8) copies) or electronic comments that are submitted timely to the IRS. All comments will be available for public inspection and copying.

Treasury and the IRS specifically request comments on the clarity of the proposed regulations, how they can be made easier to understand, and the administerability of the rules in the proposed regulations. In addition, the proposed regulations do not include special rules for transactions in which an individual exercising a statutory stock option receives stock subject to a restriction, such as a substantial risk of forfeiture. Treasury and the IRS also

specifically request comments as to whether the proposed regulations should include such special rules, including comments as to the prevalence of incentive stock option plans or employee stock purchase plans that impose such terms on stock received pursuant to the exercise of a statutory stock option.

A public hearing has been scheduled for March 7, 2002, beginning at 10 a.m. in the Auditorium of the Internal Revenue Building, 1111 Constitution Avenue, NW., Washington, DC. Due to building security procedures, visitors must enter at the 10th Street entrance, located between Constitution and Pennsylvania Avenues, NW. In addition, all visitors must present photo identification to enter the building. Because of access restrictions, visitors will not be admitted beyond the immediate entrance area more than 15 minutes before the hearing starts. For information about having your name placed on the building access list to attend the hearing, see the **FOR FURTHER INFORMATION CONTACT** section of this preamble.

The rules of 26 CFR 601.601 (a) (3) apply to the hearing. Persons who wish to present oral comments at the hearing must submit an outline of the topics to be discussed and the time to be devoted to each topic (signed original and eight (8) copies) by February 14, 2002. A period of 10 minutes will be allotted to each person for making comments. An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

### Drafting Information

The principal author of these proposed regulations is Stephen Tackney, Office of the Associate Chief Counsel (Tax Exempt and Government Entities). However, other personnel from the IRS and Treasury Department participated in their development.

### List of Subjects

#### 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

#### 26 CFR Part 31

Employment taxes, Income taxes, Penalties, Pensions, Railroad retirement, Reporting and recordkeeping requirements, Social security, Unemployment compensation.

### Proposed Amendments to the Regulations

Accordingly, 26 CFR parts 1 and 31 are proposed to be amended as follows:

## PART 1—INCOME TAXES

**Paragraph 1.** The authority citation for part 1 continues to read in part as follows:

**Authority:** 26 U.S.C. 7805 \* \* \*

**Par. 2.** Section 1.425–1, as proposed at 49 FR 4519 (February 7, 1984), is amended by adding a sentence immediately after the third sentence of paragraph (e)(5)(i) to read as follows:

#### § 1.425–1 Definitions and special rules applicable to statutory options.

\* \* \* \* \*

(e) \* \* \*

(5)(i) \* \* \* In addition, the application to an outstanding option of any of the methods for the payment or withholding of employment taxes under sections 3101, 3111, or 3301 that may be prescribed under § 31.3121(a)–1(k)(2) or § 31.3306(b)–1(l)(2) of this chapter is not a modification. \* \* \*

\* \* \* \* \*

## PART 31—EMPLOYMENT TAXES AND COLLECTION OF INCOME TAXES AT THE SOURCE

**Par. 3.** The authority citation for part 31 continues to read in part as follows:

**Authority:** 26 U.S.C. 7805 \* \* \*

**Par. 4.** In § 31.3121(a)–1, paragraph (k) is added to read as follows:

#### § 31.3121(a)–1 Wages.

\* \* \* \* \*

(k) *Statutory stock options*—(1) When an individual receives wages—(i) *Statutory stock option defined*. For purposes of this section, a statutory stock option is an option that either satisfies the requirements of section 422(b) or is granted under a plan that satisfies the requirements of section 423(b).

(ii) *Wages at exercise*. If an individual is granted a statutory stock option, the individual receives wages when stock is transferred to the individual pursuant to the exercise of the option. The amount of the wages received by the individual is equal to the excess of the fair market value of the stock, determined at the time of exercise, over the amount paid for the stock by the individual. The provisions of this paragraph (k) are illustrated by the following example:

*Example.* (i) Individual X is granted an option under a plan that satisfies the requirements of section 423(b). The option allows X to acquire 50 shares of stock of X's employer, Y, at an exercise price equal to 85% of the fair market value of the stock at the time the option is granted. The fair market value of the Y stock at the time the option is granted is \$100 per share. X exercises the option later when the fair

<sup>3</sup> These proposed regulations, along with the two notices, are intended to clarify the application of employment taxes to statutory stock options in a manner that recognizes and addresses the practical burdens that are imposed, including the imposition of withholding when neither the employer nor any other person (other than the employee) has control over a payment of remuneration, while also ensuring that "amounts exempt from income tax withholding should not be exempt from FICA unless Congress provides an explicit FICA tax exclusion." Social Security Amendments of 1983 at S. Rep. No. 98–23, 42, 98th Cong., 1st Sess.

market value of the Y stock is \$120 per share. Thus, at the time of exercise, X acquires 50 shares of Y stock having a fair market value of \$120 per share for \$85 per share.

(ii) In this *Example*, at the time of exercise, X has received wages equal to the excess of the fair market value of the stock (\$120 per share) over the amount paid for the stock (\$85 per share). Thus, for purposes of section 3121, X has received wages equal to \$35 per share, for a total of \$1,750.

**(2) Rules of administrative convenience.** The Commissioner may prescribe rules of administrative convenience for employers and employees to satisfy obligations under sections 3101 and 3111 that arise with respect to wages received pursuant to the exercise of a statutory stock option. Such rules may include, but are not limited to, permitting employers to deem the payment of wages due to the exercise of the statutory stock option as occurring at a specific date or dates, including over a period of dates.

**(3) Effective date.** This paragraph (k) is applicable to the exercise of a statutory option that occurs on or after January 1, 2003.

**Par. 5.** In § 31.3306(b)–1, paragraph (l) is added to read as follows:

**§ 31.3306(b)–1 Wages.**

\* \* \* \* \*

(i) *Statutory stock options*—(1) *When an individual receives wages*—(i) *Statutory stock option defined.* For purposes of this section, a statutory stock option is an option that either satisfies the requirements of section 422(b) or is granted under a plan that satisfies the requirements of section 423(b).

(ii) *Wages at exercise.* If an individual is granted a statutory stock option, the individual receives wages when stock is transferred to the individual pursuant to the exercise of the option. The amount of the wages received by the individual is equal to the excess of the fair market value of the stock, determined at the time of exercise, over the amount paid for the stock by the individual. The provisions of this paragraph (l) are illustrated by the following example:

*Example.* (i) Individual X is granted an option under a plan that satisfies the requirements of section 423(b). The option allows X to acquire 50 shares of stock of X's employer, Y, at an exercise price equal to 85% of the fair market value of the stock at the time the option is granted. The fair market value of the Y stock at the time the option is granted is \$100 per share. X exercises the option later when the fair market value of the Y stock is \$120 per share. Thus, at the time of exercise, X acquires 50 shares of Y stock having a fair market value of \$120 per share for \$85 per share.

(ii) In this *Example*, at the time of exercise, X has received wages equal to the excess of

the fair market value of the stock (\$120 per share) over the amount paid for the stock (\$85 per share). Thus, for purposes of section 3306, X has received wages equal to \$35 per share, for a total of \$1,750.

**(2) Rules of administrative convenience.** The Commissioner may prescribe rules of administrative convenience for employers to satisfy obligations under section 3301 that arise with respect to wages received pursuant to the exercise of a statutory stock option. Such rules may include, but are not limited to, permitting employers to deem the payment of wages due to the exercise of the statutory stock option as occurring at a specific date or dates, including over a period of dates.

**(3) Effective date.** This paragraph (l) is applicable to the exercise of a statutory option that occurs on or after January 1, 2003.

**Par. 6.** In § 31.3401(a)–1, paragraph (b)(15) is added to read as follows:

**§ 31.3401(a)–1 Wages.**

\* \* \* \* \*

(b) \* \* \*

(15) *Statutory stock options*—(i) *When stock is transferred pursuant to an exercise*—(A) *Statutory stock option defined.* For purposes of this section, a statutory stock option is an option that either satisfies the requirements of section 422(b) or is granted under a plan that satisfies the requirements of section 423(b).

(B) *Withholding at exercise.* If an individual is granted a statutory stock option, withholding is not required when stock is transferred to the individual pursuant to the exercise of the option to the extent that the individual does not recognize income by reason of section 421(a)(1). The provisions of this paragraph (b)(15) are illustrated by the following example:

*Example.* (i) Individual X is granted an option under a plan that satisfies the requirements of section 423(b). The option allows X to acquire 50 shares of stock of X's employer, Y, at an exercise price equal to 85% of the fair market value of the stock at the time the option is granted. The fair market value of the Y stock at the time the option is granted is \$100 per share. X exercises the option later when the fair market value of the Y stock is \$120 per share. Thus, at the time of exercise, X acquires 50 shares of Y stock having a fair market value of \$120 per share for \$85 per share. X continues to hold the Y stock after exercise. Under section 421(a), no income is recognized at the time of exercise.

(ii) In this *Example*, for purposes of section 3401, X has not received wages at the time of exercise.

(ii) *Effective date.* This paragraph (b)(15) is applicable to the exercise of a

statutory stock option that occurs on or after January 1, 2003.

\* \* \* \* \*

**Robert E. Wenzel.**

Deputy Commissioner of the Internal Revenue.

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**NATIONAL AERONAUTICS AND SPACE ADMINISTRATION**

**48 CFR Parts 1827, 1835, and 1852**

**RIN 2700-AC33**

**Scientific and Technical Reports**

**AGENCY:** National Aeronautics and Space Administration (NASA)

**ACTION:** Proposed rule.

**SUMMARY:** This proposed rule would amend the NFS to clarify the review requirements for data produced under Research and Development (R&D) contracts including data contained in final reports and the review requirements for final reports prior to inclusion in NASA's Center for AeroSpace Information (CASI).

**DATES:** Comments should be submitted on or before January 14, 2002.

**ADDRESSES:** Interested parties should submit written comments to Celeste Dalton, NASA Headquarters, Office of Procurement, Contract Management Division (Code HK), Washington, DC 20546. Comments may also be submitted by e-mail to: [cdalton@hq.nasa.gov](mailto:cdalton@hq.nasa.gov).

**FOR FURTHER INFORMATION CONTACT:**

Celeste Dalton, (202) 358-1645, e-mail: [cDALTON@HQ.NASA.GOV](mailto:cDALTON@HQ.NASA.GOV).

**SUPPLEMENTARY INFORMATION:**

**A. Background**

NFS clause 1852.235–70, Center for Aerospace Information—Final Scientific and Technical Reports, is required in all R&D contracts. Paragraph (e) of the current NFS clause 1852.235–70 requires that contractors not release the final report required under the contract, outside of NASA, until a document availability authorization (DAA) review has been completed by NASA and availability of the report has been determined. The DAA review completed by NASA is intended to insure that NASA disseminates NASA scientific and technical information (STI) in a manner consistent with U.S. laws and regulations, Federal information policy, intellectual property rights, technology transfer protection requirements, and budgetary and technological limitations.