Rev. Rul. 67-257

Advice has been requested whether liability is incurred by a company for the withholding of income tax under section 3402(a) of the Internal Revenue Code of 1954 with respect to the compensation element in certain stock options allotted to its key employees.

Pursuant to a stock option plan adopted by the company, its key employees are encouraged to increase their proprietary interest in the company by the allotment and sale to them of shares of the company's common stock. This is accomplished through the granting of options to the employees to purchase shares in accordance with the terms of the plan. At the time these options are granted, they do not have a readily ascertainable fair market value. When the options allotted by the company to its employees to buy shares of the company's stock are exercised, the employees have an unconditional right to receive the stock subject to the options upon payment of the option price.

The terms of the options do not permit them to qualify for the treatment provided by section 421 of the Code.

Section 3401(a) of the Code provides, in part, that the term "wages" means all remuneration (other than fees paid to a public official) for services performed by an employee for his employer, including the cash value of all remuneration paid in any medium other than cash, with certain exceptions not material here.

Section 31.3401(a)-1(a)(4) of the Employment Tax Regulations provides, in part, that generally the medium in which the remuneration is paid is immaterial and that it may be paid in cash or in something other than cash, as for example, stocks, bonds, or other forms of property.

Section 3402(a) of the Code provides, in part, that every employer making a payment of wages shall deduct and withhold upon such wages a tax equal to a certain percentage of the employee's wages depending upon such factors as the number of withholding exemptions claimed by the employee.

Section 31.3402(a)-1(b) of the regulations provides, in part, that the employer is required to collect the tax by deducting and withholding the amount thereof from the employee's wages as and when paid, either actually or constructively. Section 31.3402(a)-1(c) of the regulations provides, in part, that an employer is required to deduct and withhold the tax notwithstanding the wages are paid in something other than money (for example, wages paid in stocks or bonds) and to pay over the tax in money. If wages are paid in property other than money, the employer should make the necessary arrangements to insure that the amount of the tax required to be withheld is available for payment in money.

Since the employees have an unconditional right to receive such stock upon payment of the option price, the excess of the fair market value of the stock on the date of exercise over the option price is compensation includible in the employee's gross income at the time the option is exercised. See section 1.421-6(d)(1) of the Income Tax Regulations. Accordingly, such compensation is remuneration for services performed in the company's employ and, therefore, wages subject to the withholding of income tax under section 3402(a) of the Code.

In the instant case, when an employee exercises his stock option, the difference between the purchase price of the stock under the terms of the option and the fair market value of the stock may be treated as a supplemental wage payment for purposes of the income tax withholding. Revenue Ruling 66-190, C.B. 1966-2, 457, sets forth guidelines for use by an employer in determining the amount of income tax to be withheld where an employee received both regular wages and supplemental wages. See also Rev. Rul. 66-294, C.B. 1966-2, 459.