

Office of Government Ethics

99 X 3

Letter to a Federal Employee
dated March 16, 1999

This is in response to your letter dated March 3, 1999. By your letter you ask for reconsideration and elimination of the language in [a] Certificate of Divestiture that clarifies its applicability to capital gains derived from the sale of stock received through the exercise of incentive stock options. Certificates of Divestiture are issued under the provisions of Internal Revenue Code section 1043 (26 U.S.C. § 1043), as implemented by the regulations at 5 C.F.R. § 2634.1001 *et seq.*

This is a matter that has been extensively explored. On January 25, 1999, you and representatives of [your agency] had a meeting at our offices with [two members of our staff] to discuss this issue. It has also been thoroughly discussed between the staffs of our agencies. We note further that you are advised by your privately retained tax attorneys and accountants and that your attorneys have been in contact with the National Office of the Internal Revenue Service about your situation.

We, of course, understand the importance of this matter to you. However, there is a threshold limitation to the application of Internal Revenue Code section 1043. It is fundamental to that provision that it is a mechanism for "deferral of capital gains taxes".¹ The Office of Government Ethics does not have statutory authority to extend the tax-deferral mechanism of section 1043 to compensation income. This statutory limitation on the application of section 1043 was confirmed to your attorneys in their consultations with the National Office of the Internal Revenue Service.

This Office is concerned that the practices and policies of the Certificate of Divestiture program be as clear as possible. With respect to options, such as incentive stock options, the following language appears at 5 C.F.R. § 2634.1002(e)(3):

Certain property received as compensation for services. Such an unfair and unintended benefit would occur upon certification of property received as compensation for services, the gain from which would otherwise

¹ Detailed Explanation Prepared by House and Senate Legislative Counsel, Ethics Reform Act of 1989: Technical Amendments, *reprinted* in 1990 U.S.C.C.A.N. 169, 173.

be treated as earned income. For example, with respect to the contemplated exercise of a stock option granted by an employer, such an unfair and unintended benefit would occur upon certification if such exercise or the sale of the resultant stock would otherwise result in earned income to the employee.

The regulatory language explains the outcome in your situation. However, its authority is derived from the statutory threshold limitation on the application of section 1043, not administrative discretion.

During the consultations we have had concerning your situation, we have stressed that this Office is not attempting to interpret tax law. We merely applied well-understood principles concerning the application of tax law to income derived from the sale of stock obtained through the exercise of incentive stock options. This is a matter controlled by specific provisions of the Internal Revenue Code.² The tax treatment of such sales is well settled under Internal Revenue Service interpretations and practice.³ The application of section 1043 to cases involving incentive stock options has been confirmed by the Internal Revenue Service in your case as well as previous cases. The provision's reference to gain refers only to amounts required to be treated as capital gain under the provisions of the Internal Revenue Code. However, as you know, if you obtained a contrary opinion from the Internal Revenue Service, we would have adhered to that opinion.

We regret that our response could not be more favorable. Unfortunately, however, we are unable to take any other action, except to the extent authorized by statute as we have done through the issuance of [the Certificate of Divestiture] to defer capital gains taxation on the sale of your securities.

Sincerely,

Stephen D. Potts
Director

² See I.R.C. § 422 (26 U.S.C § 422).

³ See, e.g., I.R.S. Publication 525 (1998), *Taxable and Nontaxable Income* 9.