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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR PATRICIA A. DONAHUE
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DISTRICT CC:WR:NCA:SF

FROM: ASSOCIATE CHIEF COUNSEL (INCOME TAX AND ACCOUNTING) CC:ITA

SUBJECT: Basic lobbying costs and nondeductible lobbying costs

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LEGEND

Taxpayer =

ISSUE

Whether the same amount includible in an employee's W-2 wages from the exercise of nonstatutory stock options and the disqualifying sale of stock obtained through incentive stock options is includible in basic lobbying labor costs for purposes of determining the amount of nondeductible lobbying costs pursuant to the gross-up method under Treas. Reg. § 1.162-28(e)?

CONCLUSION

We agree that the same amount includible in an employee's W-2 wages from the exercise of nonstatutory stock options and the disqualifying sale of stock obtained through incentive stock options is includible in basic lobbying labor costs for purposes of determining the amount of nondeductible lobbying costs pursuant to the gross-up method under Treas. Reg. § 1.162-28(e).

FACTS

Taxpayer offers employees incentive stock options and nonstatutory stock options, which do not have readily ascertainable fair market values at grant. In the years at issue, some of Taxpayer's employees exercised nonstatutory stock options and/or made a disqualifying disposition of stock obtained through incentive stock options, thereby causing the employee to recognize income. Taxpayer increased such employee's W-2 wages by the fair market value of the stock at the time the nonstatutory stock options were exercised less the amount the employee paid for the option. Taxpayer also increased the employee's wages reported on the W-2 by the sale price less the amount paid for incentive stock options sold in a disqualifying disposition.

Some of Taxpayer's employees engaged in lobbying activities. Taxpayer does not dispute that these activities are nondeductible pursuant to I.R.C. § 162(e). To calculate the nondeductible amount attributable to the lobbying activities, Taxpayer elected to use the gross-up method under Treas. Reg. § 1.162-28(e). Under the gross-up method, a taxpayer multiplies the basic lobbying labor costs by a certain percentage.

In determining the amount of time an employee spent on nondeductible lobbying activities, Taxpayer would request that an employee review his or her calendar and approximate the percentage of time. This percentage was then multiplied against

the employee's compensation for the entire year to compute the basic lobbying labor costs. Taxpayer then multiplied this amount by the gross-up factor to arrive at the nondeductible amount.

It is the employees' compensation amount to be used in determining "basic lobbying labor costs" that is at issue. Taxpayer determined that the amount of compensation to be used did not include any compensation from stock sales or options exercised. Examination determined that compensation included such stock sales or options exercised as reflected as employees' wages on the form W-2. Taxpayer asserts that stock options are both an employee benefit and a form of profit sharing and thus are not part of "basic lobbying labor costs" under Treas. Reg. § 1.162-28(e).

LAW AND ANALYSIS

Section 162(e) denies taxpayers a deduction for certain lobbying and political expenditures. Section 162(e)(1) provides that no deduction shall be allowed for any amount paid or incurred in connection with certain lobbying expenses (influencing legislation, participating in political campaigns, attempting to influence the public, or direct communication with certain officials in an attempt to influence those officials).
Treas. Reg. § 1.162-28(a)(1) restates the rule that certain amounts paid or incurred for lobbying activities are nondeductible and also provides that a taxpayer must allocate costs to lobbying activities.

Treas. Reg. § 1.162-28(b)(1) provides that a taxpayer must use a reasonable method to allocate costs to lobbying activities. Among the methods available for allocation, taxpayers are permitted to use the gross-up method. Treas. Reg. § 1.162-28(b)(1)(ii).

Treas. Reg. § 1.162-28(c)(1) provides that costs properly allocable to lobbying activities include labor costs and general and administrative costs. Labor costs include all elements of compensation, such as basic compensation, overtime pay, vacation pay, holiday pay, sick leave pay, payroll taxes, pension costs, employee benefits, and payments to a supplemental unemployment benefit plan. Treas. Reg. § 162-28(c)(2).

Treas. Reg. § 1.162-28(e) provides rules for allocating lobbying costs under the gross-up method. In general, under the gross-up method, a taxpayer allocates to lobbying activities the sum of its third-party costs allocable to lobbying activities and 175 percent of its basic lobbying labor costs of all personnel. Treas. Reg. § 1.162-28(e)(1).

Treas. Reg. § 1.162-28(e)(3) provides that the basic lobbying labor costs are the basic costs of lobbying labor hours which are wages or other similar costs of labor,

including, for example, guaranteed payments for services. Basic lobbying labor costs do not include pension, profit-sharing, employee benefits, and supplemental unemployment benefit plan costs, as well as other similar costs.

Section 421(a)(1) provides that if a share of stock is transferred to an individual as an incentive stock option, no income shall result at the time of the transfer of such share to the individual upon his or her exercise of the option with respect to such share, provided that all of the requirements of section 422(a) are met. Similarly, no deduction is permitted by the employer at the time with respect to the share so transferred. Section 421(a)(2). Similarly, section 83(e) states that an employee is not taxed on the grant of an option if, at the time of the grant, the option does not have a readily ascertainable value (as was the case here).

If, however, the requirements of section 421 are not met, it will result in recognition of compensation income to the employee under section 83 and the employer shall be entitled to a deduction for an equal amount if the deduction otherwise meets the requirements of section 162. See sections 83(a), 83(e), and 83(h).

Section 3401(a) defines wages. Wages are all remuneration for services performed by an employee for his or her employer, including the cash value of all remuneration paid in any medium other than cash. Wages, however, do not include pension, profit-sharing, employee benefits, and supplemental unemployment benefit plan. See sections 3401(a)(12), (a)(18), (a)(19), (a)(20), and (a)(21).

Taxpayer does not dispute that some of its employees engaged in lobbying activities and that such activities are nondeductible pursuant to section162(e). Some of these employees earned compensation from stock sales or options exercised, in addition to salary compensation. What Taxpayer disputes is whether, under the simplified allocation method it chose -- the gross-up method, the amounts includible as income from stock sales and options exercised should be included in "basic lobbying labor costs."

As a general rule, Treas. Reg. § 1.162-28(b)(1) provides that a taxpayer must use a reasonable method to allocate costs to lobbying activities. Treas. Reg. § 1.162-28(c)(1) provides that costs properly allocable to lobbying activities include labor costs and general and administrative costs. Labor costs include all elements of compensation, such as basic compensation, overtime pay, vacation pay, holiday pay, sick leave pay, payroll taxes, pension costs, employee benefits, and payments to a supplemental unemployment benefit plan. Treas. Reg. § 162-28(c)(2).

Taxpayers are permitted to use a variety of reasonable methods to allocate costs to lobbying activities. Here, Taxpayer used the gross-up method under Treas. Reg. § 1.162-28(e). The costs included under the gross-up method are different from the

general costs allocable to lobbying activities, labor costs and general and administrative costs. For one, there are no general and administrative costs included under the gross-up method. Also, “basic lobbying labor costs” under the gross-up method are defined more narrowly than labor costs defined under Treas. Reg. § 1.162-28(c)(2). Treas. Reg. § 1.162-28(e)(3) defines “basic lobbying labor costs” as wages or other similar costs of labor, including, for example guaranteed payments for services. Furthermore, basic costs do not include pension, profit-sharing, employee benefits and supplemental unemployment benefit plan costs, or other similar costs.

> Under the gross-up method of the proposed [now final] regulations, a taxpayer allocates costs to lobbying activities by multiplying the taxpayer’s basic labor costs for lobbying labor hours by 175 percent. For this purpose, the taxpayer’s basic labor costs are limited to wages or other similar costs of labor, such as guaranteed payments for services. Thus, for example, pension costs and other employee benefits are not included in basic labor costs.

T.D. 8602 (Preamble), 1995-2 C.B. 15, 17.

The "gross-up method provides a simple way to calculate costs allocated to lobbying activities." T.D. 8602 (Preamble), 1995-2 C.B. 15, 17. Since costs allocable to lobbying activities include an allocable portion of all labor, general, and administrative costs, it is apparent that the gross-up percentage of 175 percent approximates the administrative costs and other lobbying labor costs not included in basic lobbying labor costs.

Basic lobbying labor costs are defined as wages and other similar costs of labor. Wages under section 3401 are defined as all remuneration for services performed by an employee for his or her employer, including the cash value of all remuneration paid in any medium other than cash. Wages, however, do not include pension, profit-sharing, employee benefits, and supplemental unemployment benefit plan. See sections 3401(a)(12), (a)(18), (a)(19), (a)(20), and (a)(21).

The Tax Court held that income generated upon the exercise of stock options constituted, under section 3401, wages paid or incurred to an employee for qualified services performed by such employee in the year of exercise under former section 44F (the predecessor to section 41). Apple Computer, Inc. v. Commissioner, 98 T.C. 232, 236 (1992). See also Sun Microsystems, Inc. and Consolidated Subsidiaries v. Commissioner, TC Memo. 1995-69 (disqualifying disposition of incentive stock options constituted wages for purposes of section 41). Furthermore, courts have long held that unless the receipt of a nonstatutory employee stock option gives rise to taxation at grant, the spread upon exercise of

the option constitutes compensation for services that is includible in the employee's gross income. Commissioner v. LoBue, 351 U.S. 243, 247 (1956); Lighthill v. Commissioner, 66 T.C. 940, 946-48 (1976).

Because the gross-up method is a simple method, we believe the most straightforward application of the words and requirements of the regulation should be used. Accordingly, we believe that the section 3401 definition of wages and the courts' interpretation of that section with respect to stock options is proper for determining "wages" within the definition of "basic lobbying labor costs" under Treas. Reg. § 1.162-28(e)(3). Using this definition for "wages" for purposes of determining basic lobbying labor costs is consistent with the idea that the gross-up method should be a "simplified method."[1] Consequently, we believe that "basic lobbying labor costs," defined as wages and other similar costs of labor, should include amounts recognized from the exercise of nonstatutory stock options and the disqualifying sale of stock obtained through incentive stock options.

Taxpayer asserts that stock options are both an employee benefit and a form of profit sharing and thus are not part of "basic lobbying labor costs" under Treas. Reg. § 1.162-28(e). Broadly speaking, of course, a stock option is clearly an employee benefit. Yet, broadly speaking, so are wages. Generally, profit-sharing is a mechanism for employees to benefit on the profitability of a corporation based directly on such corporation's earnings for a given period. In contrast, the value of the options or stock is only indirectly related to the earnings during any given period. Similarly, employee benefits are generally in the form of "perks," such as health care memberships, parking, or meals, provided by the employer which cannot be readily exchanged for cash. In contrast, stock options and stock described herein is readily saleable and thus should not be considered an employee benefit and thus should not be excluded from basis lobbying labor costs.[2]

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[1] Because basic lobbying costs do not include "pension, profit-sharing, employee benefits, and supplemental unemployment benefit plan costs, or other similar costs," not every item includible on a Form W-2 as wages would be included in determining the amount disallowed under the gross-up method. Certain profit-sharing and employee benefits may or may not be included in the Form W-2 as wages, even though such amounts are specifically excluded from basic lobbying labor costs.

[2] The costs specifically excluded, such as pension and other employee benefit costs, are excluded because such costs are included indirectly through the 175 percent gross-up percentage. Furthermore, the costs specifically excluded are all non-discriminatory benefits provided to all employees, as opposed to stock options involved in this case, which were discriminatory benefits provided to chosen employees.

> Many commentators suggested that the proposed gross-up percentage of 175 percent was too high, based on information from their industry. The gross up factors ... are intended to approximate the average gross-up factors for all taxpayers. The IRS and Treasury believe that these factors are the appropriate factors as averages for all taxpayers. If the regulations were further modified to provide a set of gross-up factors to suit the circumstances of various businesses or industries, the gross-up method would no longer be a simplified method. The final regulations clarify that taxpayers may use any reasonable method of allocating costs to lobbying activities. Thus, taxpayers who do not find the gross-up method appropriate to their circumstances may use another reasonable method.

T.D. 8602 (Preamble), 1995-2 C.B. 15, 17.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

[redacted]. We see three approaches, none favorable to Taxpayer. One, Taxpayer uses its gross-up method, but is bound to include as part of "basic labor lobbying costs" "wages" as defined under section 3401 and thus must include the stock options.

We believe that under Taxpayer's choice of the gross-up method, this is the proper result. The gross-up method is a simplified method, not appropriate for all taxpayers. Under the gross-up method, the gross-up percentage of 175 percent approximates the administrative costs and other lobbying labor costs not included in basic lobbying labor costs. Accordingly, we believe that treating amounts from the stock sales and options exercised as "wages" under the basic lobbying labor costs is appropriate.

However, the Preamble to the regulations states that under the gross-up method, "the taxpayer's basic labor costs are limited to wages or other similar costs of labor, such as guaranteed payments." T.D. 8602, 1995-2 C.B. 15, 17 (emphasis added). You could argue that the limitation noted by the Preamble suggests a narrow view of wages as remuneration for services, not as special remuneration like stock options. [redacted]

A second approach is that Taxpayer may be able to use another reasonable method to calculate its costs allocable to lobbying activities. [redacted] perhaps an alternative reasonable method should be calculated for these years,

because of the skewing which occurs from the exercise of the stock options in this particular case. On the other hand, how beneficial this would be to Taxpayer is questionable. Under any other reasonable method, the costs of the stock options would clearly be includible as part of the "labor costs" under Treas. Reg. § 1.162-28(c)(2), which includes all elements of compensation.

As a final approach, the Service could argue, in the alternative, that Taxpayer's use of the gross-up method is improper, and thus Taxpayer must use another reasonable method, which would then require the inclusion of the stock options as part of the compensation defined as "labor costs."

If the Service could argue that Taxpayer did not incur reasonable labor costs for its lobbying personnel, because the bulk of the labor costs paid to such personnel were from stock option income and not salaries, then it could arguably deny Taxpayer the right to use the gross-up method.

> The final regulations provide that all taxpayers may use the ration method, but prohibit the use of the gross-up method by a taxpayer ... that does not pay or incur reasonable labor costs for its personnel engaged in lobbying.

T.D. 8602 (Preamble), 1995-2 C.B. 15, 17. [redacted] it supports our view that the stock option income must be included as wages with the basic lobbying labor costs under the gross-up method. That is, either Taxpayer can use the gross-up method and include the amounts as part of the basic lobbying labor costs' wages or it can use (or be forced to use by the Service) another reasonable method, which would look to "labor costs" under Treas. Reg. § 1.162-28(c)(2) and also require inclusion in determining costs allocable to lobbying activities.

Please call if you have any further questions.

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