



May 21, 1998

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John R. McGinley, Jr.
Chairman
Independent Regulatory Review Commission
14th Floor
333 Market Street
Harrisburg, PA 17101

RECEIVED REGULATORY
REVIEW COMMISSION

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Re: Public Comment - 15-402
Howard Roger Sklaroff

Dear Chairman McGinley:

In accordance with section 5(c) of the Regulatory Review Act (71 P.S. § 745.5(c)), please find enclosed one public comment received by the Department on May 18, 1998, relating to Regulation 15-402, Payments for Employee Welfare Benefit Plans and Cafeteria Plans.

If you have any questions regarding this matter, please contact me at (717) 787-1382.

Sincerely,

A handwritten signature in cursive script that reads "Anita M. Doucette".

Anita M. Doucette
Regulatory Coordinator

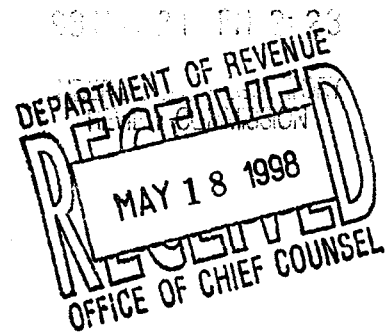
Enclosure

AMD:tlch

Howard Roger Sklaroff
1856 Watson Road
Abington, PA 19001

May 14, 1998

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Anita M. Doucette, Esq.
Office of Chief Counsel
PA Department of Revenue
Dept. 281061
Harrisburg, PA 17128-1061

Re: Comments to Proposed Amendments to 61 Pa. Code § 101.6.

Dear Ms. Doucette:

Upon review of the proposed amendments to 61 Pa. Code § 101.6, there are a few comments that I hope the Department will consider before issuing the regulation in final form.

1. Amend 61 Pa. Code § 101.6(e) to reflect the exclusion from “compensation” of the “personal use of an employer’s owned or leased property or of employer provided services” recently enacted in H.B. 1766.

2. Amend 61 Pa. Code § 101.6(f) to indicate that “stock options” refer to incentive stock options (ISO) and nonqualified stock options, if that is the Department’s intention. There is a great deal of confusion in the community as to whether the term “stock options” found in 61 Pa. Code § 101.6(b) includes ISOs. For ease of administration in the business community, the Department’s treatment of ISOs should conform to the federal treatment. The Department’s proposed treatment of ISOs and nonqualified stock options is contrary to the Commonwealth Court’s recent decisions in *Marchlen v. Township of Mt. Lebanon*, No. 1133 C.D. 1997 (Pa. Commw. Ct. Feb. 20, 1998) and *Newbrey v. Township and School District of Upper St. Clair*, No. 2096 C.D. 1997 (Pa. Commw. Ct. March 24, 1998). Under the court’s rationale in those two decisions, only the fair value of an ISO or nonqualified stock option at the date of grant would constitute “compensation.” The difference between the fair market value of the underlying stock received upon the option’s exercise and the sum of the option price and the amount of “compensation” recognized upon its exercise would constitute investment income. Therefore, if the Department treats the later of the date of exercise or lapse of restrictions as the date of receipt, the transaction must be bifurcated into a compensation component and investment income component.

The statutory definition of “compensation” is broad and includes “salaries, wages, commissions, bonuses and incentive payments whether based on profits or otherwise, fees, tips and similar remuneration received for services rendered, whether directly or through an agent, and whether in cash or in property.” 72 Pa.C.S. § 7301(d). The regulations further defines “compensation” to include stock options. 61 Pa. Code § 101.6(a). Under the regulations, “[s]tock options shall be considered to be received when the option is exercised, exchanged, sold or otherwise disposed.” 61 Pa. Code § 101.6(b). The regulations do not distinguish between an ISO and a nonqualified stock option.

Under the published proposed amendment to 61 Pa. Code § 101.6:

(e) Compensation paid in a medium other than cash shall be valued at its current market value [upon receipt]. ...

(f) Stock options shall be considered to be received:

(1) When the option is exercised if the stock subject to the option is free from any restrictions having a significant effect on its market value.

(2) When the restrictions lapse if the stock subject to the option is subject to restrictions having a significant effect on its market value or when exchanged, sold or otherwise disposed of.

Prop. 61 Pa. Code §§ 101.6(e) and (f). The regulation and the proposed amended regulation do not distinguish between an ISO and a non-qualified stock option. For Personal Income Tax purposes, it should be noted that principles of federal income taxation are not binding upon Pennsylvania. See e.g., *AMP Products Corporation v. Commonwealth*, 140 Pa. Commw. 346 (1991), *aff'd per curiam*, 530 Pa. 249 (1992). However, for ease of administration, the Department should conform to the federal treatment of an ISO. There is a great deal of uncertainty in the business community with regard to this issue.

The Commonwealth Court’s recent decisions in *Marchlen v. Township of Mt. Lebanon*, No. 1133 C.D. 1997 (Pa. Commw. Ct. Feb. 20, 1998) and *Newbrey v. Township and School District of Upper St. Clair*, No. 2096 C.D. 1997 (Pa. Commw. Ct. March 24, 1998), limit the amount of “compensation” income that an employee could recognize at the exercise date, to the value of the stock option at the date of grant or exercise.¹

¹ The *Marchlen* court did not address the timing issue for recognizing any income from the grant or exercise of a nonqualified stock option.

In *Marchlen*, the court held that “the increase in the value of the stock encompassed by Marchlen’s options from the time that the options were awarded until the time that he exercised the options constituted investment income, and not earned income, as that term is defined in [the] L[ocal] T[ax] E[nabling] A[ct] (“LTEA”) and Mt. Lebanon’s earned income tax.” The LTEA and Mt. Lebanon’s earned income tax regulations define “earned income” to include: “[s]alaries, wages, commissions, bonuses, incentive payments, fees, tips and other compensation received by a person or his personal representative for services rendered, whether directly or through an agent, and whether in cash or in property” 53 Pa.C.S. § 6913 and The Earned Income Tax and Net Profits Tax Regulations of the Twp. of Mt. Lebanon § 101(f).

In finding that the spread did not constitute “earned income”, the court noted that “the options themselves do not represent earned income subject to Mt. Lebanon’s earned income tax because the options themselves have no ascertainable value[.] ... ALCOA did not give Marchlen the stock at issue in this case; it merely offered Marchlen the opportunity to purchase the stock with his own money.” The court rejected Mt. Lebanon’s attempt to tax the spread attributable to the underlying stock as “earned income” because

[t]he record clearly indicates that the stocks did not increase in value as a result of any services that Marchlen performed for ALCOA. Nor did the market value of the stock increase as part of any effort by ALCOA to compensate Marchlen for services rendered or as an incentive for Marchlen to increase his productivity at ALCOA. Rather, the value of the stock increased as a natural result of market forces; their value would have risen even if Marchlen no longer worked for ALCOA.

In addition, the court noted that “Marchlen would not realize any gain from the stock until he actually sold the stock.. “Until that time, he has received nothing for the increase in the value of the stock and consequently has realized no gain. Furthermore, ... unless Marchlen immediately sold the stock after he exercised the option, he would not be guaranteed any certain economic gain due to potential fluctuation of the market price.” Any gain upon the sale of the stock would constitute investment income. The LTEA does not allow a local jurisdiction to impose a tax on investment income. (*Newbrey* involved the same issue.)²

Although *Marchlen* dealt with what constituted “earned income” under a local earned income tax, the decision has Personal Income Tax implications. The definition of “compensation” for Personal Income Tax purposes is similar to the definition of “earned income” under the LTEA. Because of the similarity in definitions of “earned income”

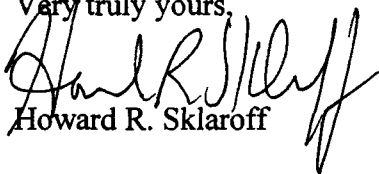
² The Township of Mt. Lebanon has filed a Petition for Allowance of Appeal with the Supreme Court of Pennsylvania.

and “compensation”, and the Commonwealth Court’s determination that the spread between the fair market value of the stock at the time of exercise and the option price constituted investment income, the “compensation” element upon the exercise of a stock option may only include the value of the stock option at the grant or exercise date.

Pennsylvania also can tax investment income. *See* 72 Pa.C.S. §§ 7301(k), 7303(3) and 7308. Because a stock option is property, arguably its disposition could trigger a taxable event. The amount of gain would be the difference between the fair market value of the underlying stock received upon the option’s exercise and the sum of the option price and the amount of “compensation” recognized upon its exercise. The bifurcating of income or gain attributable to the exercise of a stock option into two classes of income is necessitated as a result of the Commonwealth Court’s recent decisions.

If you have any additional questions, please contact me at (215) 299-3174. Thank you for your consideration.

Very truly yours,



Howard R. Sklaroff

cc: Jim Bruce, Esq., Office of Chief Counsel