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IRS Provides Guidance on Reporting Requirements for Statutory Stock Options and Updates ESPP Regulations

The IRS recently issued two sets of proposed regulations on employee stock plans. The first set addresses IRS return and employee information statement requirements related to statutory stock options, i.e., incentive stock options under Internal Revenue Code Section 422 (ISOs) or employee stock purchase plans under Section 423 (ESPPs). The second set essentially updates previous regulations to provide a comprehensive set of rules for statutory stock options granted under ESPPs, and conforms them, where appropriate, to the regulations for ISOs.

Background

Many employers provide employees with opportunities to receive stock under incentive stock options or employee stock purchase plans. IRC Section 421 provides special tax treatment for stock transferred to employees under Section 422 incentive stock options or under Section 423 employee stock purchase plans. Section 6039 provides reporting requirements with respect to stock received by employees under ISOs and ESPPs, including information reporting to the IRS for transfers made after January 1, 2007. In Notice 2008-8, the IRS waived this latter reporting requirement for 2007 stock transfers, pending further guidance. (See our January 11, 2008 *For Your Information*.)

The IRS has now issued proposed regulations on the Section 6039 reporting requirements and proposed regulations updating existing ESPP regulations.

Regulations on Reporting Requirements

The proposed regulations generally require the same information to be reported to employees as under current regulations and prescribe the information that must be included in the return to be filed with the IRS. However, with respect to a stock transfer upon the exercise of an ISO, the proposed regulations would require that the corporation report the exercise price per share rather than the total cost of all shares acquired, as currently required. With respect to transfers of ESPP shares, the proposed regulations would require information to be included in the information return and in the statement furnished to employees that is not currently required, such as the date the option was granted, the fair market value on the grant date, the exercise price per share, and the fair market value of the stock on the date the option was exercised. Employers would be required to disclose per share data along with data underlying the calculation of the ESPP's purchase price discount (e.g., the 15% discount from the lesser of the beginning or ending fair market value for the purchase period).

The IRS indicates that it will issue two forms that can be used to satisfy the information and return requirements – Form 3921 for ISOs and Form 3922 for ESPPs. Rules regarding furnishing information statements electronically and by mail will be set forth in accompanying instructions. Both forms are to be furnished to employees and filed with the IRS by January 31 of the year following the calendar year for which the information return is made. Although the requirement to provide information to the employee when an ISO is exercised or an ESPP share is transferred is currently in effect, the IRS reporting requirement would apply beginning with 2009 plan years. Thus, the first returns would not have to be filed until January 2010.

Proposed Regulations on ESPPs

As noted above, the second set of proposed regulations provides a comprehensive set of rules under Section 423 governing ESPPs. Although the substantive rules under the new proposed regulations are largely the same as the previous rules, the new regulations provide some additional guidance.

Eligibility for Special Tax Treatment Under Section 421

Only options that are "granted under an employee stock purchase plan" will be eligible for special tax treatment under Section 421. To qualify as an ESPP, the plan (or offering) must be in writing or electronic format and must satisfy all of the current nine requirements set forth in Section 423(b). Whether an option qualifies as an option granted under an ESPP will be determined at the grant date. Under the proposed regulations, the option will qualify only if its terms are consistent with the terms of the ESPP or an offering under the plan.

The proposed regulations clarify that all employees who are entitled to option grants under the terms of the ESPP or plan offering must be granted options consistent with those terms or none of the options granted under the offering would qualify for special tax treatment. However, an option grant to an ineligible individual (e.g., non-employee) will not disqualify the options granted under the offering. Similarly, failure on exercise to satisfy the terms of an option (e.g., share price) that qualifies as an option granted under an ESPP at the time of grant will not disqualify the other options granted under the plan or offering.

Stockholder Approval Required for ESPP

Under existing regulations, stockholder approval of the ESPP must comply with the corporation's charter and by-laws, as well as applicable state laws. The proposed regulations clarify the stockholder approval requirements and, in some circumstances, requirements for reapproval. Additional stockholder approval would be required when there is –

- an increase in the aggregate number of shares that may be issued (other than reflecting a change in the number of shares outstanding, e.g., due to a stock dividend or split)
- a change in the corporations whose employees may be offered options under the plan, unless the plan provides for changes in corporate structure (e.g., companies that become parents or subsidiaries of the granting corporation after the ESPP was adopted and approved)
- a change in the granting corporation or in the stock available for purchase or grant under the plan.

Any other changes in the ESPP's terms are not considered the adoption of a new plan that would require stockholder approval.

Maximum Number of Shares

The proposed regulations clarify existing regulations requiring a plan to designate the maximum number of shares that can be issued under the ESPP. Under the proposed regulations, the ESPP (like ISO plans) can specify that the maximum number of shares will increase annually by a specified percentage of the company's issued, outstanding or authorized shares as of the plan's adoption date. The regulations would also allow for a change in the maximum number of shares that can be issued under options based on specific circumstances (e.g., by a percentage of the then outstanding shares each year on the anniversary of the plan's adoption) as long as the stockholders approve an "immediately determinable" number of shares that may be issued under the plan in any event. If there is more than one ESPP, a separate maximum aggregate number of shares available for issuance of options must be established and approved for each plan.

Employees Covered by the Plan

An ESPP must designate the corporations whose employees may be offered options under the plan. Although a Section 423 plan must be broadly based, certain categories of employees may be excluded from coverage. Employees with less than two years of service, part-time employees (i.e., working 20 hours or less per week), seasonal employees (i.e., working no more than five months in any calendar year), and highly-compensated employees may be excluded from plan coverage as long as the same exclusions apply to all similarly situated employees. In certain circumstances, the plan may also exclude employees who are citizens or residents of another country (whether they have dual citizenship with the U.S. or are resident aliens).

The proposed regulations incorporate changes to the statutory definition of highly-compensated employees, and clarify that the ESPP may exclude certain highly-compensated employees (i.e., officers or those whose compensation exceeds a certain level) and include all others. The plan may also adopt less restrictive exclusions (e.g., employees employed less than one year rather than two).

As noted above, if an option is not granted to any employee who is entitled to the grant under the terms of an offering, none of the options granted under the offering will be treated as having been granted under an ESPP. However, eligible employees who elect not to participate do not have to be granted options.

Equal Rights and Privileges

The proposed regulations provide certain exceptions and clarifications to the Section 423 requirement that all employees granted options under an ESPP have the same rights and privileges. For example, the proposed regulations would allow the plan to grant options to foreign employees on less favorable terms than to others if intended to comply with the law of a foreign jurisdiction.

The proposed regulations clarify that the ESPP may limit the amount of stock an employee may purchase and may determine the maximum amount on the basis of a uniform relationship to the total compensation or the basic or regular rate of compensation of all employees. The proposed regulations also clarify certain circumstances under which employees would be permitted to carry forward to a subsequent plan or offering amounts that were withheld – but not used – to purchase shares (including amounts representing fractional shares) under a current plan or offering. The regulations would also permit delaying an option grant to any employee who cannot receive it solely because the employee has not yet met the minimum service requirement until that requirement is met.

Option Price

Under the proposed regulations, the option price may be determined in any reasonable manner (including valuation methods permitted under estate tax regulations) as long as it meets certain minimum pricing requirements. As a result, ESPP options would be treated in a manner consistent with ISOs.

Option Period

The proposed regulations provide two important clarifications as to when an option is considered to have been granted under an ESPP. First, a grant date could be established without a fixed or determinable minimum option price.

> ***BUCK COMMENT.*** *This clarification is especially helpful for ESPPs that include a "look back" feature to determine the option exercise price. It would allow companies with such plans to use the first day of the offering as the grant date, even though the option price will not be determined until the date of exercise at the end of the offering period.*

Second, the option grant date would be the first day of the offering period if the ESPP or offering designates a maximum number of shares an employee may purchase during an offering period or establishes a formula by which the maximum number can be determined on the first day of the offering period (e.g., 10% of an employee's annual salary divided by the fair market value of one share on the first day of the offering). Reserving a certain number of shares that can be issued under the plan and including the $25,000 limitation discussed below would not establish the maximum number of shares that may be purchased during an offering period.

The proposed regulations clarify that the plan or offering does not have to designate a maximum number or formula. If, however, the plan or offering does not fix the maximum number of shares that may be purchased during an offering period or if the maximum number cannot be determined until the exercise date, the date the option is exercised would be considered the grant date – not the first day of the offering period.

Annual $25,000 Limitation

Under Section 423, the amount of stock an employee can purchase under all of the ESPPs of the employer and related corporations may not exceed $25,000 in fair market value (determined at grant date) for any calendar year in which an option is outstanding and exercisable. The proposed regulations clarify that the calculation of the $25,000 limit will be based on when the option first becomes exercisable and the stock's fair market value at grant. This $25,000 limit on the amount of stock an employee may purchase applies only to options granted under ESPPs, and does not apply to ISOs or to other stock options unless Section 423 applies.

Effective Date

The ESPP regulations are proposed to take effect on January 1, 2010, and would apply to any options granted under an ESPP on or after that date.

Conclusion

Employers should begin to review their systems to ensure that they will have the necessary information available to comply with the new reporting requirements for the 2009 plan year.

Buck's consultants would be pleased to assist you in reviewing and amending your plans to ensure that they qualify as ESPPs and allow you to maximize the benefit to your employees while minimizing the tax burden to your company.