



IRS Issues Final Regulations on ESPPs and Reporting Requirements for Statutory Stock Options

The IRS has issued two sets of final regulations on employee stock plans, finalizing proposed regulations it issued last year. The first set relates to options granted under Internal Revenue Code Section 423 employee stock purchase plans (ESPPs), and includes minor changes to the regulations that apply to Section 422 incentive stock options (ISOs). The second set addresses IRS reporting requirements for ISOs and stock options granted under an ESPP.

Background

Equity compensation plans, including ESPPs and ISO plans, continue to be an important part of the total compensation package at many companies, giving employees the opportunity to invest in the companies they work for. Section 421 provides special tax treatment for stock transferred to employees under Section 422 ISOs or under Section 423 ESPPs, and Section 424 contains special rules for these statutory stock options.

Historically, Section 6039 required both privately held and publicly traded companies to provide a written information statement to each employee who exercised ISOs or sold or transferred shares acquired under an ESPP. The Tax Relief and Health Care Act of 2006 added a new requirement for companies to file an information return with the IRS for these same transactions. The IRS waived this requirement for 2007, 2008 and 2009.

In 2008, the IRS separately released proposed regulations on ESPPs and on reporting requirements for statutory stock options. (See our September 19, 2008 [For Your Information](#).) The IRS has now issued final regulations.

Final Regulations on ESPPs

The [final regulations](#) update existing ESPP regulations to reflect statutory changes, conform to ISO regulations, and clarify certain rules regarding options granted under an ESPP. Although the substantive rules are largely the same as existing rules, the regulations provide some additional guidance.

Special Tax Treatment. Like the proposed regulations, the final regulations enumerate the requirements that must be satisfied for an ESPP to receive special tax treatment under Section 421 and provide that the requirements may be satisfied through the terms of the plan or an offering under the plan. The final regulations clarify that even if the terms of the plan are inconsistent with these requirements, the option may still qualify for special tax treatment if it is granted under an offering with terms that satisfy them. For plans under which more than one offering is made, the final regulations provide that –

- The terms of each offering do not have to be identical as long as the terms of the plan and each offering together satisfy the enumerated requirements.
- The terms of each offering may provide different exclusions of employees (including highly compensated employees), as long as the exclusions are permitted and within certain limitations.
- The rights and privileges of each offering do not have to be identical, as long as the offering provides the same rights and privileges for all employees of every corporation whose employees are granted options under it.

Grant Date. Like the proposed regulations, the final regulations confirm that the date of grant will be the first day of the offering period if the ESPP or offering designates a maximum number of shares an employee may purchase during the offering or establishes a formula by which the maximum number can be determined on the first day of the offering period. If, however, the number of shares that can be purchased under the plan or offering is not fixed or determinable before the option is exercised, the date of exercise will be the date of grant. The plan provision on the \$25,000 limit discussed below is not sufficient to establish a share limit for this purpose.

Annual \$25,000 Limit. Section 423(b)(8) places a \$25,000 limit on the aggregate amount of stock an employee can purchase under all of the ESPPs of the employer and related corporations for each calendar year in which an employee option is outstanding. Although the proposed regulations provided that the limit increases by \$25,000 for each calendar year during which the option is both outstanding and exercisable, the final regulations provide instead that the limit increases by \$25,000 for each calendar year that an option is simply outstanding.

Stockholder Approval Requirements. Section 423(b)(2) requires the shareholders of the granting corporation to approve the ESPP within 12 months before or after the date the plan is adopted. The final regulations clarify that new shareholder approval is required if there is a change in the shares subject to option under the plan or a change in the granting corporation. They further clarify that the stockholders of a subsidiary corporation include the parent corporation and any other stockholders of the subsidiary. In an acquisition context, the acquiring corporation (not its shareholders) must approve the amendment of the acquired corporation's option plan to issue parent stock instead of subsidiary stock.

Correction Program. Although the IRS previously invited comments on whether a correction program would be appropriate for ESPPs, this guidance did not address the issue.

Final Regulations on Reporting Requirements

The IRS has also released [final regulations](#) on the reporting and information statement requirements under Section 6039 for the exercise of options under ESPPs and ISOs. The final regulations are generally similar to the proposed regulations.

While the final regulations apply as of January 1, 2007, corporations are not required to comply with the return requirements for stock transfers that occur during the 2007, 2008 and 2009 calendar years. However, they must

still provide information statements to employees for these transfers, and may rely on existing regulations, proposed regulations or the final regulations in doing so.

Unless there is a further waiver, the IRS reporting requirements will apply beginning with stock transfers that occur during the 2010 calendar year. The returns (and information statements) must be made using Form 3921 for the exercise of ISOs and Form 3922 for the transfer of stock acquired through an ESPP (or substitute Forms 3921 and 3922 in accordance with the guidelines set forth in IRS Publication 1179). They must be filed with the IRS (or delivered to the employee) on or before January 31 of the year following the calendar year for which they are required. Thus, the first returns under the final regulations would have to be filed by January 31, 2011. The IRS has indicated that it intends to release Forms 3921 and 3922 in the near future.

Effective Dates

The final regulations on ESPPs are effective as of January 1, 2010, and will apply to statutory options granted on or after that date. However, taxpayers may rely on them with respect to statutory options granted before January 1, 2010.

The reporting requirements took effect on November 17, 2009, and retroactively apply as of January 1, 2007. Although employers are not required to comply with the return requirements for stock transfers that occurred during 2007, 2008 or 2009, they must provide employees information statements for stock transfers made during that time.

Conclusion

In view of the updated ESPP regulations, employers should review their existing plans to ensure that they will continue to qualify as ESPPs, and are designed to maximize opportunities for participation and tax benefits for all eligible employees. To preserve their favorable tax treatment for employees, some plans may have to be amended prior to January 1, 2010.

Although employers have another year to prepare for the new reporting requirements, the release of the final regulations suggests that there may not be any further extensions. Employers should begin to review their systems to ensure that they are collecting the necessary information to comply with the requirements.

Buck's consultants would be pleased to assist you in preparing for the new IRS reporting requirements and in reviewing and amending your plans to ensure that they qualify as ESPPs.

This FYI is intended to provide general information. It does not offer legal advice or purport to treat all the issues surrounding any one topic.