

## IRS ISSUES FINAL ESPP REGULATIONS AND REPORTING REQUIREMENTS FOR ISOs AND ESPPs

November 30, 2009

### **Final ESPP Regulations Issued**

Earlier this month, the IRS issued final regulations governing stock options granted under employee stock purchase plans ("ESPPs") that are intended to receive favorable tax consequences under Section 423 of the Internal Revenue Code of 1986, as amended (the "Code").<sup>1</sup> The final regulations adopt most of the provisions of the 2008 proposed regulations, with some modifications and additions. Click [here](#) to access a copy of the final ESPP regulations, and [here](#) to read our previous alert on the proposed ESPP regulations.

The final regulations apply to any option issued under an ESPP on or after January 1, 2010. Companies with ESPPs designed to comply with Code Section 423 should review their plans now to see if the plans need to be amended in order to preserve potentially favorable tax consequences for participants, keeping in mind that many of the requirements must be expressly stated in the plan, or, in some cases, the terms of a particular offering. Overall, the new regulations provide more flexibility and clarity than the existing regulations. The following is a brief summary of some of the key provisions of the final regulations:

**Employee Share Limitation:** The final regulations provide that the date of grant of an ESPP option will be the first day of an offering period only if the terms of the plan or offering designate a maximum number of shares (or formula to calculate the maximum number of shares) that may be purchased by each employee during the offering. If the plan does not contain such a limit, then the date of grant will be the last day of the offering period (the exercise date). The IRS guidance clarifies that the annual \$25,000 participant share limitation (discussed below) and the overall plan share limit do not meet this requirement. This requirement will affect ESPP holding period calculations<sup>2</sup> for participants, so employers should review – and possibly amend – their plans to address this issue before the January 1, 2010 effective date.

**Multiple Offerings:** The final regulations enhance flexibility by providing that one or more consecutive or overlapping offerings may be made under an ESPP even if the terms of the offerings differ, as long as each offering and the plan together comply with the ESPP requirements. Thus, for instance, a parent corporation could establish an ESPP with separate offerings – and different terms – for different subsidiaries, as long as each offering (and the plan) met the applicable Section 423 requirements.

**Inconsistency of Terms:** Under the final regulations, if the terms of an option are inconsistent with the terms of the ESPP or an ESPP offering, the option will not be considered granted under an ESPP and thus

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<sup>1</sup> Under Code Section 421, if stock is transferred to an individual upon exercise of an option granted under an ESPP structured to comply with Code Section 423 or under an incentive stock option ("ISO") granted under Code Section 422, then there is no income to the participant at the time of option exercise.

<sup>2</sup> In order to receive favorable tax treatment, an option granted under an ESPP (like an ISO) is subject to two holding period requirements: the stock acquired upon option exercise may not be disposed of within (i) two years from the option grant date or (ii) one year from the date the stock is transferred to the participant.

will not be eligible for favorable tax treatment. However, even if the terms of plan are inconsistent with the requirements of the regulations, options may still be eligible for special tax treatment if they are granted under an offering with terms that are consistent with the regulations.

**Stockholder Approval of an ESPP:** The final regulations provide additional guidance regarding when stockholder approval of an ESPP is required, for instance, due to a change in the granting corporation or in the context of acquisitions.

**Employee Eligibility:** The final regulations also provide additional guidance regarding when classes of employees may be excluded from participation. For instance, the final regulations permit multiple offerings under the same plan to provide for different exclusions of employees (such as excluding highly compensated employees from one offering but not another), as long as the exclusions are otherwise permitted under the regulations. Thus, whether the terms of a plan and an offering satisfy the requirements of the regulations with respect to who must be covered by the plan is determined on an offering-by-offering basis.

**Equal Rights and Privileges:** Similarly, the final regulations permit employers to make multiple offerings with different rights and privileges. Whether an offering complies with the requirement of the regulations that all employees granted options under the plan or offering have the same rights and privileges is determined on an offering-by-offering basis. The final regulations also impose new requirements regarding how unused participant contributions (e.g., payroll deductions) can be carried forward from one offering to another without violating the equal rights and privileges requirement.

**Annual \$25,000 Limitation:** The final regulations clarify that the \$25,000 annual limit on the fair market value of the stock that may be purchased increases by \$25,000 for each calendar year that an option is outstanding (without regard to exercisability).

### **Final Regulations Regarding Information Reporting Requirements for ISOs and ESPPs Under Code Section 6039**

The Tax Relief and Health Care Act of 2006 (the “Act”) amended the information reporting requirements of Code Section 6039 to require corporations to file an information return with the IRS following a stock transfer pursuant to an exercise of an ISO or a purchase under an ESPP. This new requirement is in addition to the existing requirement that employers provide employees with an information statement upon ESPP and ISO exercises to assist them with calculating their tax obligations. The IRS has now issued final regulations under Code Section 6039, a copy of which can be viewed [here](#). The requirements of the Act originally were to be effective for stock transfers occurring on or after January 1, 2007; however, corporations are not required to comply with the information return requirements for stock transfers that occur during 2007, 2008 or 2009. The first returns will need to be filed by January 31, 2011, for stock transferred during 2010. The final regulations discuss the information that must be provided on the return.

Returns required due to an individual’s exercise of an ISO must be filed on Form 3921, Exercise of an Incentive Stock Option Under Section 422(b). Returns required due to purchases under an ESPP must be filed on Form 3922, Transfer of Stock Acquired Through an Employee Stock Purchase Plan. The IRS is developing these forms.

**Contact Information:** If you have questions regarding the effect of the final ESPP regulations or the information reporting requirements, please contact [Elisa A. Cawood](#) or [Jane Jeffries Jones](#), the principal authors of the alert. You may also contact the Womble Carlyle attorney with whom you usually work, one of our Employee Benefits attorneys or one of our Corporate and Securities Attorneys.

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