

IRS Issues Final Regulations on Reporting Requirements for Incentive Stock Options and Employee Stock Purchase Plans

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On November 16, the Internal Revenue Service (IRS) issued final regulations relating to the reporting requirements under Section 6039 of the Internal Revenue Code (the Code) for incentive stock options (ISOs) and employee stock purchase plans (ESPPs). The IRS also issued final regulations relating to options granted under ESPPs on the same day.¹ This LawFlash highlights the key provisions of the final regulations governing the reporting requirements for ISOs and ESPPs.

Section 6039 of the Code sets forth two reporting requirements for employers sponsoring plans that provide for ISOs and ESPPs: (1) employers must provide employees with a written summary of important details regarding the transfer of stock acquired upon exercise of either an ISO or an option under an ESPP and (2) employers must furnish an information return to the IRS with the same details. The requirement that employers provide employee information statements has been in the Code for some time. However, the requirement to file an information return with the IRS was added in 2006. Until now, the IRS has not issued any final guidance regarding the implementation of this requirement.

At the end of 2007, the IRS waived the requirement to file information returns with the IRS for stock transfers that occurred in 2007.² In 2008, the IRS issued proposed regulations under Section 6039 of the Code, which described the information required to be furnished on the information returns and statements. The proposed regulations also waived the requirement to file information returns with the IRS for stock transfers that occurred in 2008.

The final regulations retain the information required to be reported with respect to ISOs as set forth in the proposed regulations, but clarify and modify certain aspects of the information required to be reported with respect to ESPPs. The final regulations clarify that the ESPP reporting requirement is not limited only to stock transfers where the exercise price is less than 100% of the value of the stock on the date of grant, but also applies where the exercise price is not fixed or determinable on the date of grant. In both cases, reporting under section 6039 applies, regardless of whether the transfer of legal title of the stock is a qualifying or disqualifying disposition. However, in an important change created as a response

¹ For further information regarding the final regulations, see Morgan Lewis's November 18, 2009 LawFlash, online at http://www.morganlewis.com/pubs/EB_ReqMinDistribProcedures_LF_18nov09.pdf.

² For further information on the reporting requirements for 2007 stock transfers, see Morgan Lewis's December 21, 2007 LawFlash, online at http://www.morganlewis.com/pubs/EB_IRSWavesISOandESPP_LF_21dec07.pdf.

to public comments, the final regulations provide a special definition of the “transfer date” that triggers information reporting, which in most cases will permit employers to avoid tracking the date of ultimate sale of the stock by the employee (possibly many years after the date of exercise).

Specifically, for purposes of the ESPP reporting requirements, an employer is only required to file a return relating to the first transfer of “legal title.” If, as is typically the case for public companies, an employer maintains a system to deposit shares acquired by employees under an ESPP directly into a brokerage account, the first transfer of legal title occurs when the shares are deposited into the brokerage account. If, however, an employer either issues a stock certificate directly to an employee or registers the shares in the employee’s name on the employer’s record books, and the employer or its transfer agent holds the shares for the employee in book-entry form, the first transfer of legal title does not occur on the issuance of the stock certificate or the registration of the stock ownership on the record books.

Instead, the first transfer of legal title would occur, for example, when the employee sells the stock or transfers it to a brokerage account established on behalf of the employee. We believe, however, that in most cases this transfer of “legal title” will typically occur within 12 months after ESPP option exercise, even if an actual “disposition” of the stock is delayed until a later year. This will ensure that at least the reporting under Code section 6039 will occur in the year of exercise, or the following year. However, as is discussed below (under the heading “Continuation of Form W-2 Reporting”), employers may nevertheless be required to continue to track both disqualifying and qualifying dispositions of stock for purposes of Form W-2 reporting, even though the IRS has been generous in allowing Code section 6039 reporting to occur at or shortly after option exercise, in most instances.

If the exercise price per share of the option was not fixed or determinable on the date the option was granted, employers must report the exercise price per share determined as if the option granted under the ESPP was exercised on the date of grant. This additional piece of information, along with the other pieces of required information, will ensure that employees have sufficient information to calculate their tax liability.

Under the final regulations, employers are not required to provide either information returns or statements with respect to stock transfers by employees who are nonresident aliens, and to whom the employer is not required to provide a Form W-2, Wage and Tax Statement during the relevant time periods.

Information Required to Be Reported by Code Section 6039

The information required to be reported in information returns and information statements with respect to stock transferred upon exercise of an ISO includes the following:

- The name, address, and employer identification number of the company transferring the stock, or the same information for the company whose stock is being transferred, if it is not the same company
- The name, address, and social security number of the optionee
- The date the option was granted
- The exercise price per share
- The date the option was exercised by the optionee
- The fair market value of a share of stock on the date of exercise

- The number of shares of stock transferred to the optionee

The information required to be reported in information returns and information statements with respect to stock transferred under an ESPP include the following:

- The name, address, and social security number of the employee transferring the shares
- The name, address, and employer identification number of the company whose stock is being transferred
- The date the option was granted to the employee
- The fair market value of the stock on the date the option was granted
- The actual exercise price paid per share
- The exercise price per share determined as if the option were exercised on the date the option was granted to the employee (to be provided to ensure compliance with Code section 423(c)(2) in the event of an ultimate qualifying disposition of the stock, but required to be reported only where the exercise price per share was not fixed or determinable on the date the option was granted)
- The date the option was exercised by the employee
- The fair market value of the stock on the date the option was exercised
- The date the legal title of the shares was transferred by the employee
- The number of shares to which legal title was transferred by the employee

Notably, the information in these last two bullets will likely be misleading to many employees, since it has no relevance to the actual *disposition* of the stock (which is what triggers the compensation income). Instead, the relevant information to be used in reporting compensation income on the disqualifying or qualifying disposition of the ESPP stock will be provided to the employee and the IRS on a Form 1099-B. The IRS did not delete this information, however, despite public comments making that recommendation.

Even more importantly, it appears that at least some brokerage firms are not equipped to provide all this listed information, and intend simply to require employers to complete and file these information returns. We understand that the IRS is considering allowing some minor variances in these reporting requirements, particularly in the case of the information return provided to the employee (to allow omission of the employee's social security number, for example). Any such changes likely will be announced in connection with release of the reporting forms.

Forms

Both the information returns and statements must be made on Form 3921, Exercise of an Incentive Stock Option Under Section 422(b), or Form 3922, Transfer of Stock Acquired Through an Employee Stock Purchase Plan Under Section 423(c), as applicable. The IRS expects to release both forms early in 2010. Employers may satisfy the reporting requirements by submitting substitute Forms 3921 and 3922 in accordance with the guidelines set forth in Publication 1179.

Information returns must be submitted to the IRS in accordance with the guidelines and procedures set forth in the instructions to Form 3921 and Form 3922. The deadline for providing information

statements to employees has not changed. These statements must be provided on or before January 31 of the year following the year for which the statement is required.

Continuation of Form W-2 Reporting Requirements (Possibly Even for Qualifying Dispositions)

These new information reporting requirements certainly do not replace employers' obligation to report compensation income from ISOs and ESPPs on Form W-2. However, while nearly all employers use these forms to report deductible compensation, considerable confusion still exists as to employers' obligation to report the compensation income generated from a *qualifying disposition* of ESPP stock (which is not deductible by the employer for income tax purposes). Notice 2002-47, 2002-2 C.B. 97 had instructed employers to report all "compensation income" from statutory stock options, but concluded with a specific statement requiring reporting only of income from "disqualifying dispositions." We understand that the IRS is considering issuing additional guidance about this Form W-2 reporting obligation, including specifically whether (and for how long after exercise) it applies to ESPP options.

Effective Date and Transition Relief

The final regulations under Section 6039 of the Code are effective as of November 17, 2009, but will apply retroactively as of January 1, 2007. However, the final regulations provide transition relief for stock transfers in 2007, 2008, and 2009. Specifically, employers are not required to submit information returns to the IRS for stock transfers in 2007, 2008, and 2009. However, employers are still required to provide information statements to employees for such stock transfers. In order to comply with this requirement for each year in question, employers may rely on the prior regulations under Code section 6039 as last updated in 2004 or as proposed to be modified in 2008. For stock transfers that occur in 2009, employers may rely on these final regulations as well.

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