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# Stock Options in an Employee Stock Purchase Plan: Mastering the New IRS Regs

## Meeting the Comprehensive Rules for Plan Qualification and Tax Treatment

## A Live 110-Minute Teleconference/Webinar with Interactive Q&A


**Today's panel features:**

Edward Burmeister, Partner, Global Equity Compensation and Executive Compensation Practice, **Baker & McKenzie**, San Francisco

Mark Ritter, Atlanta Compensation and Benefits Practice Leader, **Grant Thornton**, Atlanta


## Thursday, February 11, 2010

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# Stock Options in an Employee Stock Purchase Plan: Mastering the New IRS Regs Webinar

**Feb. 11, 2010**

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# Today's Program

- New IRS Rules On Stock Options In ESPPs, slides 3 through 20 (*Edward Burmeister*)

- New IRS Rules On Stock Option Information Returns Under Sect. 6039, slides 21 through 32 (*Mark Ritter*)

- Additional Code Sections Relevant To The New Rules, slides 33 through 38 (*Mark Ritter*)

# New IRS Rules On Stock Options In ESPPs

# New Rules On Employee Stock Purchase Plans

- Key tax rules under Sect. 423
- Final regulations under Sect. 423
  - $25,000 Limit
  - Grant date issues
  - Separate offering issues
- Key action items for 2010

# Key Tax Rules Under Sect. 423

- If requirements of Sect. 423 are satisfied, no income tax/FICA/FUTA to employee on purchase of shares at a discount
- No employer withholding
- No employer deduction (if shares held for statutory holding period)

# Key Tax Rules Under Sect. 423 (Cont.)

- Tax rules for qualifying/disqualifying dispositions (holding period = two years from grant date, one year from purchase date)
  - Example:
    - ESPP with a six-month purchase period
    - Lookback: 85% of current FMV price on beginning or ending date (lower of)
    - FMV: Beginning of purchase period = $100
    - FMV: End of purchase period = $120
      - » Grant date discount (deemed exercise at grant date): $100 - $85 = $15
      - » Purchase date discount: $120 - $85 = $35
    - Sale price = $125

# Key Tax Rules Under Sect. 423 (Cont.)

- Tax rules for qualifying/disqualifying dispositions
  - Example (Cont.):
    - For disqualifying disposition
      - Ordinary income = Purchase date discount = $35 (even if shares sold at a loss)
      - Capital gain = $5 ($125 - $120)
    - For qualifying dispositions
      - Ordinary income (limited by actual gain) = Grant date discount = $15
      - Capital gain = $25 ($125 - $100)

# Final Regulations Under Sect. 423

- Issued Nov. 16, 2009
- Effective for offerings commencing on or after Jan. 1, 2010
- May electively apply to prior offerings

# Final Regulations Under Sect. 423 (Cont.)

- Key changes from proposed regulations
  - Liberalized $25,000 limit
  - Introduced flexibility in applying employee coverage and equal rights and privileges requirements, through concept of "separate offerings" by entity
  - Reiterated and clarified "grant date" issues

# Final Regulations Under Sect. 423 (Cont.)

- $25,000 limit in ESPPs
  - Key concepts in $25,000 limit
    - (1) The $25,000 limit is an annual limit that applies per calendar year (or any part of a calendar year) in which the option is outstanding
    - (2) The rate (not amount) of accrual of a right to purchase shares is regulated per calendar year the option is outstanding
    - (3) The right to purchase stock is deemed to occur when it first becomes exercisable
    - (4) Options are aggregated
    - NOTE: Quite different than $100,000 limit for ISOs, which simply limits the $$ amount that can first become exercisable in any calendar year. No concept or relevance for ISOs as to time option is outstanding or any rate of vesting or exercisability

# Final Regulations Under Sect. 423 (Cont.)

- $25,000 limit in ESPPs (Cont.)
  - Issue: If ESPP purchase period overlaps the calendar year, can $25,000 limit carry over if not fully used in first year?
    - For example: If first purchase period for an employee is Oct. 1, 2009 through March 31, 2010, can he or she purchase $50,000 on March 31, 2010 or only $25,000?

# Final Regulations Under Sect. 423 (Cont.)

- $25,000 limit in ESPPs
  - The answer is now clear: $50,000
    - Rate of accrual for calendar years (or partial years) “option” outstanding is $25,000, since “option” outstanding in 2009 and 2010

# Final Regulations Under Sect. 423 (Cont.)

- Significance of "grant date"
  - Allows lookback to beginning of offering period to set price (which can be as low as 85% of that price)
  - Starts two-year holding period for determining disqualifying/qualifying dispositions
  - Determines calculation of $25,000 limit (share value on grant date)
  - Key to calculation of ordinary income on qualifying dispositions
  - Final regulations clarify importance of grant date and clarify requirements for determining it

# Final Regulations Under Sect. 423 (Cont.)

- How to ensure that beginning of offering is grant date
  - Set maximum member of shares an employee may purchase in that offering period (*e.g.*, 1,000 shares); does not have to be realistic
  - Provide a formula that fixes maximum number (can be based on $25,000 limit, but needs to pin down maximum for each offering)
  - Can be in plan document or board/committee resolution
  - If is short offering period and no lookback, may be preferable to have purchase date be grant date

# Final Regulations Under Sect. 423 (Cont.)

- Equal rights and privileges and eligible employees requirements
  - Proposed regulations were quite restrictive
    - Applied across corporate entities, not entity-by-entity approach
    - Could exclude all employees in a separate corporate entity (be careful with check-the-box disregarded entities), but could not apply different rules across entities unless treating non-U.S. employees less favorably is necessary to comply with foreign law

# Final Regulations Under Sect. 423 (Cont.)

- New separate offering concept in final regulations
  - Permits consecutive or overlapping "offerings" to groupings of one or more separate corporate entities within the corporate group (e.g., one offering to U.S. parent, one offering to subsidiaries in Europe, etc.)
  - This permits variations in terms among corporate entities for same offering/purchase period
  - Can use to solve excludable employee and equal rights and privileges problems presented by approach of proposed regulations

# Final Regulations Under Sect. 423 (Cont.)

- Key requirements for each separate offering
  - Each offering must encompass one or more entities that qualify as a “parent” or “subsidiary” as defined in Code sections 424(e) and 424(f)
  - *Within* each offering, employee coverage and equal rights and privileges requirements must be met

# Final Regulations Under Sect. 423 (Cont.)

- Example of separate offerings
  - For U.S. parent, offering excludes part-time (20 hour or less per week employees) and allows only payroll deductions
  - For European subsidiaries, offering includes part-time employees due to EU part-time directive
  - For Hong Kong and Argentine subsidiaries, no payroll deductions permitted, only direct contributions

# Final Regulations Under Sect. 423 (Cont.)

- How to make offerings “separate”
  - Could spell out in plan document
    - For each offering period, unless otherwise specified by the committee, a separate offering will be made to the company and each participating subsidiary
    - Could accomplish this by board or committee resolution (review plan authorization language)
    - Additional plan language is desirable to permit acceptable variation in terms among the separate offerings and to provide for default treatment

# Action Items Under Final Regulations

- Focus on $25,000 limit and ensure plan language, administrative process and employee communications are (1) consistent, and (2) comply with final regulations
- Examine plan coverage, covered/excluded entities and any required variations for global workforce
- Amend plan or adopt resolutions to utilize separate offering concept
- Be sure proper grant date is established and prospectus/tax reporting/employee communications are all consistent and correct

# New IRS Rules On Stock Option Information Returns Under Sect. 6039

# Information Reporting For Statutory Stock Options

- §6039 establishes reporting requirements
  - Applies to:
    - Incentive stock option exercises
    - ESPP qualifying dispositions

- Employer to report such information, at such time, as shall be prescribed by regulation

# Information Reporting For Statutory Stock Options (Cont.)

- Why require information reporting in this area?
  - Income tax rules compliance
  - Complexity of rules for employees

# Information Reporting For Statutory Stock Options (Cont.)

- Before 2006, required disclosure only to option holders
- §6039 expanded by Tax Relief and Health Care Act of 2006

# Information Reporting For Statutory Stock Options (Cont.)

- Tax Relief and Health Care Act of 2006 changes effective retroactive to stock transfers occurring on or after Jan. 1, 2007
- Effective date delayed: Not required for 2007-2009

# Information Reporting For Statutory Stock Options (Cont.)

- Before 2006, required disclosure only to option holders
  - ESPP share transfers
    - The name and address of the corporation whose stock is being transferred;
    - The name, address, and identifying number of the transferor;
    - The date such stock was transferred to the transferor;
    - The number of shares to which title is being transferred; and
    - The type of option under which the transferred shares were acquired (that is, Sect. 423 stock)

# Information Reporting For Statutory Stock Options (Cont.)

- Before 2006, required disclosure only to option holders
  - ISO exercises:
    - The name, address and employer identification number of the corporation transferring the stock;
    - The name, address, and identifying number of the person to whom the share or shares of stock were transferred;
    - The name and address of the corporation whose stock is the subject of the option (if other than the corporation transferring the stock);
    - The date the option was granted;
    - The date the shares were transferred to the person exercising the option;
    - The fair market value of the stock at the time the option was exercised;
    - The number of shares of stock transferred pursuant to the option;
    - The type of option under which the transferred shares were acquired; and
    - The total cost of all the shares

# Information Reporting For Statutory Stock Options (Cont.)

- Final regulations issued Nov. 16, 2009
- Effective for transfers made on or after Jan. 1, 2010, similar information reporting is now required to IRS
- Reporting will be on Form 3921 for ISOs and Form 3922 for ESPP shares
- Statement due by following Jan. 31 for each year
  - **Key point:** Should begin gathering data for transfers effective <u>now</u>

# Information Reporting For Statutory Stock Options (Cont.)

- ISO reporting required
  - Name, address and employer identification number of the corporation transferring the stock; or, the same information for the transferring entity, if it is not the same corporation;
  - Name, address and Social Security Number of the recipient of the stock;
  - Date the option was granted;
  - Exercise price per share;
  - Date the option was exercised by the employee;
  - Fair market value of the stock on the date of exercise; and
  - Number of shares of stock transferred to the employee

# Information Reporting For Statutory Stock Options (Cont.)

- ESPP reporting required
  - The name, address and Social Security Number of the transferor;
  - The name, address and employer identification number of the corporation whose stock is being transferred;
  - The date the option was granted to the transferor;
  - 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 grant date (required only if the exercise price is not fixed or determinable on the date of grant);
  - The date the option was exercised by the transferor;
  - The fair market value of the stock on the exercise date;
  - The number of shares of stock to which legal title was transferred; and
  - The date the legal title of the shares was transferred by the transferor

# Information Reporting For Statutory Stock Options (Cont.)

- Reporting required regardless of whether a qualifying or disqualifying disposition

- For ESPPs:
  - Applies where exercise price is less than 100% of the FMV of the stock on the date of grant, or
  - Where exercise price is not fixed or determinable on date grant

# Information Reporting For Statutory Stock Options (Cont.)

- Exception provided for non-resident aliens
  - As defined at §7701(b)
  - Where Form W-2 was not required during reporting period

# Additional Code Sections Relevant To The New Rules

# Accounting Rules For ESPPs

- FAS 123(R) (now ASC Topic 718)
  - Under Topic 718, ESPPs are usually considered compensatory because of the amount of the discount (usually greater than the 5% safe harbor) and because they usually have look-back features
  - This means that GAAP expense is recognized immediately upon grant
    - No more "printing money in the basement" without consequences
  - Rumors of the death of equity compensation were greatly exaggerated

# Accounting Rules For ESPPs (Cont.)

- Very little written guidance on ESPPs
- The GAAP compensation expense recognized for ESPP grants has two components:
  - The fair value of the options granted, and
  - The amount of the discount of the exercise price below the FMV of the stock on the date of grant

# Accounting Rules For ESPPs (Cont.)

- Fair value of the option is treated the same as for an incentive stock option
  - This expense component is treated as a permanent book/tax difference
    - No deferred tax asset created

# Accounting Rules For ESPPs (Cont.)

- Disqualifying dispositions
  - Income tax benefit is recognized by multiplying the compensation expense by the tax rate
  - Any additional actual tax benefit in excess of that amount is recognized in APIC (i.e. a windfall)
  - If deduction is less than compensation expense, then income tax benefit amount that is recognized is equal to the actual income tax benefit (i.e. no shortfall because no DTA)

# Accounting Rules For ESPPs (Cont.)

- Qualifying dispositions
  - Employee recognizes income equal to:
    - Lesser of the spread at grant or the excess of the FMV of the stock over the exercise price on the date of disposition
    - This picks up the discount expense component
  - However, employer receives no deduction for this amount
    - And so, this also is treated as a permanent book/tax difference