

Document Summary

This document provides a compilation of questions asked and answers given during the Stock & Option Solutions Webinar presented on September 17th, 2008: Taxing Matters: Proposed Changes to Sections 6039 & 423.

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The slides for the presentation are available here:

http://www.sos-team.com/PDFS/SOS_Taxing_Matters.pdf

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Section 6039

Requirement to Include Social Security Number

Regarding the requirement to include Social Security Number on the participant communications designed to comply with the reporting requirements of section 6039: Could you format the SSN ending in ###-##-1234?

The requirement is to include the identifying number. So, no, we don't believe this would satisfy the requirement.

Do you know what the consequences to the company are for not including SSN on the form? Several employees have complained LOUDLY due to fear of identity theft.

We are unaware of the IRS pursuing any punitive action for failure to comply with Section 6039 requirements. We have raised this issue with the IRS in our comment letter on the proposed changes to section 6039.

Duration of Requirement

If your ESPP plan ended 5 years ago and shares are held at a brokerage house, do we need to file a form when the associate sells the shares in 2009?

We are in the same boat – our ESPP was suspended in 2005 and all unsold shares would be a qualified disposition. Could there be a point when you can claim "immaterial"?

Under the terms of Section 423, all qualifying dispositions are reportable as ordinary income with respect to the discount element and under section 6039, all "first transfers" must be reported to the participant (and soon the IRS). There is no language around a limit to the amount of time that these dispositions must be tracked. So to stay true to the letter of the regulation, you must make an effort to track these dispositions and report them, even after a substantial period of time has passed.

Required for Qualifying Dispositions with a Loss?

What if the "transfer" is a qualifying disposition, however the shares were sold at a loss? Is reporting for Section 6039 still required?

Under the terms of Section 6039, all "first transfers" must be reported to the participant (and soon the IRS). There is no language around a limit to the amount of time that these transfers must be tracked or reported nor is there any exclusion for qualifying dispositions. You should make an effort to track these dispositions and report them, even after a substantial period of time has passed.

Do we have to issue a Form W-2 for qualifying dispositions for a person who terminated employment, say five years ago? Is a Form 1099 acceptable instead?

Yes, you do have to report them on a W-2, a 1099 is not permissible.

Under the terms of Section 423, all qualifying dispositions are reportable as ordinary income with respect to the discount element. And page 10 of the IRS Publication 15-B: [Employer's Tax Guide to Fringe Benefits](#) states specifically that ". . .the employer must report as income in box 1 of Form W-2. . .the discount portion of stock acquired by the exercise of an employee stock purchase plan upon disposition of the stock. . ."

There is no language around a limit to the amount of time that these dispositions must be tracked or that a 1099-MISC is acceptable after the employee terminates.

Obtaining Disposition Information

Some of our employees transfer their shares away from our broker "of choice." We survey the share holders to obtain the disposition information, but we cannot be sure we are told everything. Are we liable if an employee sells the shares and we are not notified?

In general, as long as you are making a best effort to comply with the requirements, you should be fine. You cannot compel your employees to provide the information, but you should be requesting it or obtaining the information in some other way, if possible.

Section 423

Qualifying Disposition Income Calculation

For the qualifying disposition income calculation purposes, if the 423 ESPPs has no lookback, is the Fair Market Value (FMV) of the first day of the offering period still considered as the "grant" price? Or is it the FMV on the date of purchase?

Yes, regardless of whether the plan has a lookback or not, for a qualifying disposition of 423-ESPP shares, the ordinary income is still calculated as the lesser of:

- actual gain (sales price minus your purchase price), and
- the purchase-price discount (if the purchase price is based on the lower value of the stock on either the first or the last day of the offering period, the purchase-price discount is computed as of the first day of the offering period).

Consequences to the Plan if a Single Option Disqualified

If a single participant's option becomes disqualified, what are the consequences to participant and to issuer?

Per the proposed regulations, if an eligible participant's option is initially qualified but later does not satisfy the terms of the grant, only the option is disqualified, not the entire plan.

Eligible Employee Accidentally Excluded

If an eligible employee is accidentally missed on a grant due to a system issue with their record and later identified, would this disqualify the entire plan?

The regulations are not specific on this point. Failing to include the employee might constitute a failure to apply the requirements in an "identical manner" to all employees. To avoid that result, we believe the best practice would be to treat the participant as if he or she had been enrolled, collect the contributions, and purchase shares for the participant.

The preamble to the proposed regulations states:

One commentator suggested that the regulations be amended to provide that an offering will not lose its tax-favored status due to the **inadvertent exclusion of employees from plan participation**. Rather, the commentator suggested that the granting corporation be permitted to correct certain errors in plan administration through a corrections program that would permit the excluded employees to participate in past offerings under a plan. Such a corrections program is beyond the scope of these regulations. However, the IRS and the Treasury Department invite comments on whether such a program is appropriate (including the statutory authority for such a program) and suggestions for the types of violations that might be covered and the methods of correction.

Exclusion of Employees in One Country

Can we exclude all employees in one country (i.e. China) from participation in the plan, and include everyone else and still be a qualified plan?

Our understanding is that you can exclude employees of subsidiaries from participating by not including that subsidiary as a corporation whose employees are eligible to participate in the plan. Changes in eligible employees (e.g., adding or removing a subsidiary as a participant) would require shareholder approval. In addition, the proposed regulations provide that employees who are citizens or residents of foreign countries may be excluded from participation, if local laws prohibit the grant of the option, or if compliance with local laws would cause the plan to violate the ESPP requirements. However, if none of the above are true (the employee is not an employee of an excluded subsidiary, the local laws do not prohibit the grant, and compliance with local laws would not cause a violation of the ESPP requirements), then the plan must be offered to the employees in that country to avoid violating the ESPP requirements and disqualifying the entire offering.

The preamble to the proposed regulations state:

“...section 423 does not provide an exclusion for such nonresident aliens. Accordingly, the IRS and the Treasury Department are constrained by statutory authority from providing a general exclusion from plan participation for employees who are nonresident aliens and who receive no United States source income. Therefore, § 1.423–2(e)(3) of these proposed regulations would provide that employees who are citizens or residents of a foreign jurisdiction (without regard to whether they are also citizens of the United States or resident aliens (within the meaning of § 7701(b)(1)(A))) may be excluded from the coverage of an employee stock purchase plan only if the grant of an option under the plan to a citizen or resident of the foreign jurisdiction is prohibited under the laws of such jurisdiction or if compliance with the laws of the foreign jurisdiction would cause the plan to violate the requirements of section 423.”

The only other relief available under the proposed regulations is that the terms of an option can be less favorable if required by foreign law. If foreign law requires terms that are more favorable, however, all grants must provide the more favorable terms.

Are U.S. expats that are on assignment to a foreign subsidiary considered an employee of the foreign subsidiary or of the U.S. entity? The employee is still on U.S. payroll but providing services, and essentially "loaned" or seconded to foreign entity and providing services to that entity?

That would depend on the definition of the employment for the employee. This falls under the larger area of employment law. Is the participant an employee of the parent or the subsidiary? If s/he is an employee of the parent corporation, and the subsidiary is excluded from the purchase, that participant may not participate.

Changes to Existing Plans Prior to Effective Date

Can we make changes to our existing plans prior to the effective date? For example to exclude part time less than 30 hours per week for the entire company?

The proposed regulations do not preclude changes to your plan prior to the effective date.

However, please note that a plan that excludes all part-time employees under 30 hours/week would not meet the requirements of Section 423, which allows you to exclude part-time employees that work under *20 hours/week*:

Section 423(b)(4) permits an employer to exclude from participation one or more of the following categories of employees: Employees who have been employed less than two years; Employees **who customarily work 20 hours or less per week**; Employees who customarily work not more than five months in any calendar year; and Highly compensated employees (HCEs) within the meaning of section 414(q). [emphasis added]

No changes have been proposed to the requirement regarding part-time employees.

Exclusion of Part-time Employees

We prohibit those working part time from participating in the 423 plan, but due to foreign laws we must allow some foreign part-timers to participate. By allowing only the foreign part-timers to participate (we still are not allowing US part-timers to participate), are we disqualifying the plan? Should we move the foreign participants to our non-qualified plan?

Our understanding is that exclusions must be applied in an identical manner to all employees.

If the foreign jurisdiction required you to offer terms that were less-favorable, then you could make the terms less favorable and still satisfy the rights and privileges requirements.

However, since the terms are more favorable, it seems that the terms should either be made identical for the US employees, or a different plan (such as your non-qualified plan) should be offered to your foreign employees (if they are part of a foreign subsidiary, so can therefore be excluded from the US plan).

Exclusion Based on Age

Can you exclude employees under the age of 18? We have a growing number of retail employees. My concern is that we would require individual ESPP captive brokerage accounts and trying to open minor accounts seems problematic.

There is nothing in the existing or proposed regulations that allows you to exclude employees on the basis of age, however, it is an excellent question and SOS will raise this issue with the IRS in the comment letter we intend to write on the proposed regulations for Section 423.

Exclusions

Is the whole plan disqualified as in the slides or the offering period as seems to be what's being said?

The proposed regulations would provide that an offering is disqualified in the event an eligible employee is excluded or an eligible employee is granted shares under an offering that has terms that are inconsistent with the ESPP rules (and not granted a compliant option). Generally, only the affected grant will be disqualified, but not the entire offering, if a grant is made to an individual who is not eligible under the ESPP or at the time of grant, the grant was consistent with the ESPP rules but the terms were not satisfied.

\$25,000 Limit

Withdrawing from the Plan Once the Limit is Met

When you meet the 25K limit are you required to formally withdraw from the Offering? Example: 24 month offering.

As far as we are aware, there is no language in the regulations that require the participant to withdraw from the plan. The prohibition is on the purchase of shares exceeding the \$25,000 limit. However, as a best practice, you may want to consider halting the payroll deductions from participants that have met

the limit since having contributions deducted from payroll and then no purchase made, may be considered lost opportunity by the participant. In addition, a payroll deduction cut off would reduce the risk of inadvertent over-purchases.

If an employee hits the limit and contributions are stopped, does the individual remain in the offering period at the same original offering price?

That depends on the language in your plan; however, as stated earlier, as far as we are aware, there is no language in the regulations that require the participant to withdraw from the plan. The prohibition is on the purchase of shares exceeding the \$25,000 limit during a calendar year. Therefore the participant should be able to stay enrolled and maintain the enrollment date purchase price for the next purchase period rather than withdrawing from the offering and having to re-enroll with a different price.

Carryforward of Unused Limit

We have 6 month offering periods: February through August and August through February. How would the \$25K limit affect our purchase that occurs in Feb that began in the prior year? If I understand it, the \$25K limit would now be based on purchase dates, not offering periods?

Correct. The “right to purchase shares” under the \$25,000 limit would only accrue during the year in which the shares are exercisable. Since, with most 423-qualified purchase plans, shares are only exercisable on the day of purchase, any unused portion of the limit would not be carried over from one calendar year to the next. The \$25,000 limit would be limited just to the year in which the shares are purchased.

If we purchase April 30 and October 31 then only \$25K can be purchased - no roll over? When does this start - 2009?

Yes, no roll over from prior calendar years would be permissible.

As stated earlier, since the IRS has described this as a “clarification” to the existing regulations rather than a change to the regulations, some practitioners have suggested that companies that:

- a) Have offering periods that span the calendar year and
- b) Currently use the “liberal” approach

should consider whether they should change to the conservative approach prior to the adoption of the finalized regulations. You should discuss this issue with your legal counsel.

Adoption of Conservative Approach

So if a company uses the "liberal" approach for \$25K limit, when should we change to conservative approach? Now? Or in 2010?

Is there guidance on when should company's adopt this "conservative" approach to the IRS \$25K limit if they have not done so already?

Excellent questions. Since the IRS has described this as a "clarification" to the existing regulations rather than a change to the regulations, some practitioners have suggested that companies that:

- a) Have offering periods that span the calendar year and
- b) Currently use the "liberal" approach

Companies should consider whether they should change to the conservative approach prior to the adoption of the finalized regulations. You should discuss this issue with your legal counsel.

I was under the impression you can still carry forward the unused portion of the \$25k limit since it was exercisable (not that there is no carry forward any more).

This impression does not agree with our interpretation of the clarification of the regulation. Our interpretation (which seems to be widely-shared across practitioners in the industry) is that no carry forward is appropriate since the right to purchase shares under the limit does not begin to accrue until the year in which the shares become exercisable (generally the year of the purchase). So only \$25,000 would be available in a given year.

Definition of Grant Date – Maximum Share Limit

What if the limit is a percent of pay that can be deducted?

Section 1.423-2(h)(3) of the proposed regulations state:

"The date of grant will be the first day of an offering if the terms of an employee stock purchase plan or offering designate a maximum number of shares that may be purchased by each participant during the offering."

We do not believe that a limit on the percent of pay deducted would fulfill the requirements of the proposed regulation. The maximum number of shares must be fixed for each participant or able to be determined via a formula.

What if the maximum amount allowed is less than the \$25K max and you have a lookback?

It is acceptable that your maximum share limit be lower than the \$25,000 limit. However, you must be able to determine the maximum number of shares that can be purchase by the participant on the enrollment date. Otherwise a grant date will not be deemed to exist until the purchase date.

Regarding the determination of grant date: If the minimum price must be determinable, it is not when we have a lookback. If the stock price drops the discount is applied to the purchase date price. Don't we still have an issue even with a share limit?

Per the proposed regulations, the minimum price need not be determinable (see the bottom bullet of slide 38). However the maximum number of shares does need to be determinable.