



**Final IRS Regulations for Section
6039 and Section 423: You've Got
Questions, We've Got Answers**

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Webcast Materials

<http://www.sos-team.com/PDFS/423.pdf>

Please note that URL is case-sensitive!

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Agenda

Section 6039 Changes

- Final Regulations
 - Good news
 - Key changes
- Questions

Key Section 423 Changes & Clarifications

- Background
- 1. Additional Guidance on Inclusion / Exclusion of Employees
- 2. Less favorable options for foreign employees
- 3. Multiple Offerings Allowed under Same Plan
- 4. Determination of date of grant
- 5. \$25K limitation
- 6. Other considerations & key take-aways

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FINAL SECTION 6039 REGULATIONS

Final Regulations on Section 6039

First the bad news:

- Information reporting to IRS is now required in addition to participant information statements
- Expanded reporting requirements to include new information for ESPP
 - Goal is to provide necessary information for participants to complete taxes

Final Regulations on Section 6039

Now the good news:

- Information reporting to IRS is only required for ESPP transactions occurring in calendar year 2010 and later years
 - Employee statements still due 1/31 of the year following the triggering event, even before 2010
- For virtually all companies, the triggering event for both the employee statement and the IRS report will be the purchase/exercise
 - Assumes shares are deposited into brokerage account on behalf of employee upon purchase

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Final Regulations on Section 6039

More good news:

- For the 2009 employee statements, companies can rely on the 2004 final regs, the 2008 proposed regs, or the new 2009 final regs
 - Remember, no statement required to the IRS for 2009 transactions
- Substitute forms for employee information statements are allowed
 - Pursuant to instructions in IRS Publication 1179

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Summary of Changes to Section 6039

Returns must be filed with the IRS on Forms

- 3921 (for ISOs) and 3922 (for ESPPs),
- IRS expects to release forms in April 2010
- If > 250 forms, must e-file with IRS

Forms must also be used to report the information to employees

- for transactions after January 1st, 2009

Participant reporting must be completed by January 31st

- In year following the calendar year in which transaction occurred (so first due date is 1/31/11)

IRS reporting likely due March 1st of the following year

- Watch for final instructions when Forms 3921 and 3922 are published
- e-filing due March 31st
- <http://www.irs.gov/pub/irs-pdf/i1099gi.pdf> (page 4)

Final 6039 regulations – Information required

ESPP reporting now must include:

- Name, address, and identifying number (SSN) of the employee (“transferor” per the regs)
- Name, address, and employer identification number (FEIN) of the corporation whose stock is being transferred
- The date the option was granted** (typically the beginning of the offering period or enrollment date, assuming grant date requirements are met...)
- The fair market value of the stock on the date the option was granted** (enrollment date, usually)
- The actual exercise price paid per share** (the actual purchase price on a per share basis)

Final 6039 regulations – Information required

ESPP reporting now must include (continued):

- vi. The exercise price per share determined as if the option was exercised on the grant date
(only if actual purchase price is not known on grant date...used to compute ordinary income for qualifying dispositions)
- vii. The date of exercise (i.e. the purchase date)
- viii. The fair market value of the stock on the purchase date
- ix. The date the legal title of the shares was transferred by the transferor (in most cases this will be the purchase date under the final regs)
- x. The number of shares to which legal title was transferred

Form 3921

What it MAY look like (from www.form3921.com)

2525 <input type="checkbox"/> VOID <input type="checkbox"/> CORRECTED		1 Date option granted		OMB No. 1545-XXXX	Exercise of an Incentive Stock Option Under Section 422(b)
THIS FORM IS A WORKING DRAFT AND IS SUBJECT TO CHANGE TILL OFFICIALLY RELEASED BY THE INTERNAL REVENUE SERVICE.		2 Date option exercised		Form 3921 (Rev. December 2008)	
TRANSFEROR'S federal identification number	TRANSFEEE'S identification number	3 Exercise price per share	4 Fair market value per share on exercise date		Copy A For Internal Revenue Service Center File with Form 1096. File with Form 1096. For Privacy Act and Paperwork Reduction Act Notice, see the 2009 General Instructions for Forms 1099, 1098, 3921, 3922, 5498, and W-2G.
TRANSFEEE'S name		\$	\$		
Street address (including apt. no.)		5 No. of shares transferred			
City, state, and ZIP code		6 If other than TRANSFEROR, name, address, and EIN of corporation whose stock is being transferred			
Account number (see instructions)					
Form 3921 (Rev. December 2008)		Cat. No. 411790		Department of the Treasury - Internal Revenue Service	
Do Not Cut or Separate Forms on This Page		—		Do Not Cut or Separate Forms on This Page	

Form 3922

What it MAY look like (from www.form3921.com)

2626 <input type="checkbox"/> VOID <input type="checkbox"/> CORRECTED		1 Date option granted to TRANSFEROR		OMB No. 1545-XXXX	Transfer of Stock Acquired Through an Employee Stock Purchase Plan Under Section 423(c)	
THIS FORM IS A WORKING DRAFT AND IS SUBJECT TO CHANGE TILL OFFICIALLY RELEASED BY THE INTERNAL REVENUE SERVICE.		2 Date option exercised by TRANSFEROR		Form 3922 (Rev. December 2008)		
CORPORATION'S name, street address, city, state, and ZIP code	CORPORATION'S federal identification number	TRANSFEROR'S identification number	3 Fair market value (FMV) per share on grant date	4 Fair market value (FMV) per share on exercise date	Copy A For Internal Revenue Service Center File with Form 1096. <small>For Privacy Act and Paperwork Reduction Act Notice, see the 2009 General Instructions for Forms 1099, 1098, 3921, 3922, 5498, and W-2G.</small>	
TRANSFEROR'S name			\$	\$		
Street address (including apt. no.)			5 Exercise price per share	6 No. of shares transferred		
City, state, and ZIP code			\$	7 Date legal title transferred by TRANSFEROR		
Account number (see instructions)						
Form 3922 (Rev. December 2008)		Cat. No. 41180P		Department of the Treasury - Internal Revenue Service		
Do Not Cut or Separate Forms on This Page		—		Do Not Cut or Separate Forms on This Page		

Substitute Forms 3921 & 3922

Publication 1179

- <http://www.irs.gov/pub/irs-pdf/p1179.pdf>
- Does not (yet) refer to 3921 or 3922
 - But general instructions for 3921/3922 refer to 1179 for substitute details
- Requirements:
 - Format at discretion of filer except for:
 - Tax year, form number, form name
 - "Generally, information returns may be furnished electronically with the consent of the recipient. See Section 4.5.1."
 - Except for state income tax withholding information, information not required by the official form should not be included
 - » Other transactions should not be included
 - Must contain all applicable form recipient instructions provided on the front and back of official IRS form. May provide instructions on separate sheet of paper.

Substitute Forms 3921 & 3922

Publication 1179

- Requirements (continued):
 - Must include:
 - "This is important tax information and is being furnished to the Internal Revenue Service. If you are required to file a return, a negligence penalty or other sanction may be imposed on you if this income is taxable and the IRS determines that it has not been reported."
 - OMB Number "OMB No. XXXX-XXXX"
 - Include Tax Year, Form Number, and Form Name
 - » Together on one area of the statement
 - » Exercise of an Incentive Stock Option Under Section 422(b)
 - » Transfer of Stock Acquired Through an Employee Stock Purchase Plan Under Section 423(c)
 - "Copy B"
 - Box Numbers
 - Filer's and form recipient's identifying info
 - Envelope: "Important Tax Return Document Enclosed"
 - Composite statement?
 - » Any information required by the official IRS forms that would otherwise be repeated in each information block is required to be listed only once in the first information block on the composite form.
 - » As clear as original form

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Substitute Forms 3921 & 3922

Publication 1179

- Do not Include:
 - "Substitute for" or "in lieu of"
 - slogans, advertising, and other logos not allowed
 - additional enclosures, such as advertising, promotional
- IRS Encourages
 - Use of boxes
 - Black ink
- Not required
 - Direct Access Telephone #? (<http://www.irs.gov/pub/irs-pdf/i1099gi.pdf> page 9)

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Are Statements Required for International Participants?

Final 6039 regs provide limited exception, but only for **nonresident aliens** and only if:

- No W-2 is required for any calendar year that includes any part of the time between the grant and exercise (or first transfer of legal title if later)

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“Identifying Number”

Social Security Number? Or Employee ID?

The regulation states that the “identifying number” be included on the report to the participant

In practice most companies use the participant’s Social Security Number

- Some companies substitute employee ID instead
 - Is this an acceptable practice?

Is masking SSN on participant statements permissible?

- No, not at this time...

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Electronic Delivery of Participant Statements

Many clients have asked about e-mailing these statements

Must comply with all the requirements applicable to issuing Forms W-2 electronically

- Must obtain the participants' consents,
- Obtain consents in a manner which demonstrates they can access the statements electronically
- Must be a method by which participants can revoke their consent
- Specific security requirements must be complied with
- Must have a system for dealing with undelivered emails
- IRS Reg §31.6051(1)(j) for the full list of requirements

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Electronic Filing of IRS Returns

If you have more than 250 3921 or 3922 forms , must file with the IRS electronically

- Not aggregated with other forms to assess 250 requirement
- Payers under 250 are also encouraged to file electronically
- Rev. Proc. 2009-30, page 27. Electronic filing; 2009 form specifications
 - <http://www.irs.gov/pub/irs-irbs/irb09-27.pdf>
- Updates and changes to Publication 1220, Specifications for Filing Forms 1098, 1099, **3921**, **3922**, 5498, 8935, and W-2G Electronically (revised 7-2009)
- List of vendors who do e-filing: <http://www.irs.gov/pub/irs-pdf/p1582.pdf>
- Most of you are likely already filing some forms electronically, so will not have to “apply”
 - If not, apply to e-file via form 4419 to obtain Transfer Control Code (TCC)
- Filing Information Returns Electronically (FIRE) <https://fire.irs.gov/>

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Electronic Filing of IRS Returns

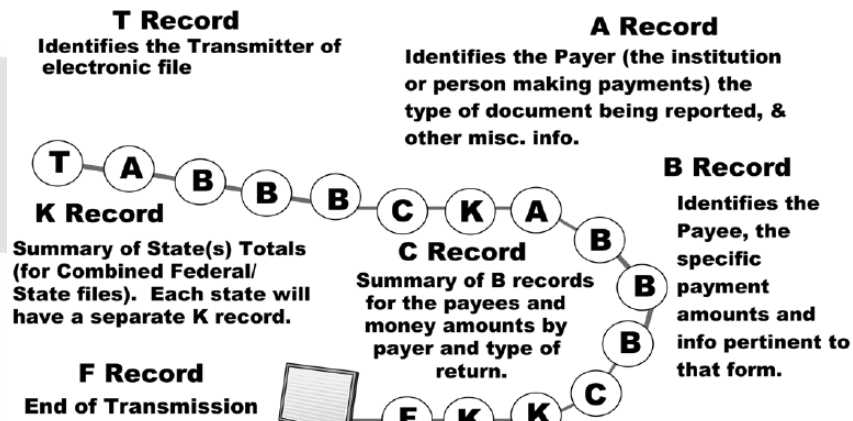
Requirements (continued)

- Files in standard ASCII code
- Do not send paper AND e-file – duplication = Penalties
- Proper format – fixed width
- Test files allowed
- Files larger than 10,000 records should be compressed
 - WinZip & Pkzip only acceptable formats

Electronic Filing of IRS Returns

File Format

Each record must be 750 positions.



Electronic Filing of IRS Returns

Alternatives

- Software / System / OS Vendor?
 - Talk to your vendor about their plans
- Payroll department via existing relationship for 1099 filings?
 - (W-2s are separate system/process)
 - Talk to your vendor about their plans
 - Flat file upload from stock plan system to vendor?
- Custom report?
 - Upload file to FIRE

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FINAL ESPP REGULATIONS

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Background: ESPP Tax Treatment

Like ISOs, ESPP “options” are considered statutory options and receive 421 tax-favored treatment

- If certain document and operational requirements are satisfied

No federal income tax at grant or “exercise” (purchase)

In the event of a **qualifying** disposition, (or upon the employee’s death)

- Income recognized is *the lesser* of:
 - Discount as of grant date
 - Actual gain on sale
- No deduction to employer with respect to the amount included in income

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Background: Disqualifying Disposition

Failure to satisfy holding period constitutes a “Disqualifying Disposition”

Employee recognizes income, as follows:

- Ordinary compensation income
 - On spread at purchase / exercise
 - Income recognized at the time of the disqualifying disposition
- Capital gain
 - On gain over the spread

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Key Changes/Clarifications to ESPP Regulations

1. Additional Guidance on Inclusion / Exclusion of Employees
2. Provides that less favorable options may be granted to foreign employees in certain instances
3. Allows company to issue multiple offerings with different terms under the same plan
4. Clarifies need to establish a maximum number of shares that any participant can purchase in order to have the grant date be the first day of the offering
5. Provides that \$25K amount accrues each year that the option is outstanding, whether or not exercisable

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1. Additional Guidance on Inclusion / Exclusion of Employees

Basic rule is that options must be granted to all employees of any corporation whose employees are granted options under the plan

- Key point is that if an employee who is entitled to receive a qualified option does not, then none of the options under the plan will be qualified. i.e. the entire offering will be disqualified!

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1. Additional Guidance on Inclusion / Exclusion of Employees

If an eligible employee receives options that are inconsistent with the terms of the ESPP or offering, and does NOT receive another qualifying option:

- Can disqualify the whole plan!
 - May be okay if option terms qualify, but option is administered in such a way that it violates terms
 - Example 4 from final regs (1.423-2(a)(5)): Option terms for eligible employees say price will be 90% of FMV, but purchase allowed at 85% for one employee. Only that option is disqualified
- Plans may lose tax-favored status due to inadvertent exclusion of employees
- **IRS and Treasury did not provide a corrections program for inadvertent errors in the final regs; but still interested in ideas**

If an **ineligible** employee receives options,

- Disqualifies **ONLY** the option, not the whole plan

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1. Additional Guidance on Inclusion / Exclusion of Employees

Changes to Covered Employees

- Final regulations clarify that employers may exclude:
 - Employees who have completed less than 2 years of service (or a period less than 2 years)
 - Employees whose customary employment is for fewer hours per week (20 or less) or fewer months in a calendar year (5 months or less)
 - Highly-Compensated Employees (HCE)
 - Compensation above a certain level or
 - Section 16 officers
 - Exclusions must be applied in an identical manner to all employees eligible to participate in that particular offering

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1. Additional Guidance on Inclusion / Exclusion of Employees

Changes to Covered Employees (continued)

- Employees of foreign subsidiaries can be excluded by not having that subsidiary participate
- However, a foreign employee of a participating corporation must be allowed to participate unless:
 - The option grant is prohibited under local law of the foreign jurisdiction, or
 - Compliance with the laws of the foreign jurisdiction would cause the plan to violate the ESPP requirements (without regard to US citizenship or green card status)
- In response to requests for general exclusions of nonresident aliens, collectively-bargained employees, and employees under a specified age
 - IRS and Treasury Department stated they were statutorily constrained from providing such exclusions

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2. Less Favorable Plans for Foreign Employees

Rights and privileges requirement satisfied if...

- the terms of options granted to citizens or residents of a foreign jurisdiction (disregarding US citizenship or green card status) are less favorable than the terms of options granted to employees who are US residents, but only if:
 - Terms are less favorable in order to comply with the laws of a foreign jurisdiction
 - Note that this is different from the prior discussion on excluding foreign employees from participating
- Not satisfied if citizens or residents of foreign jurisdictions are granted options that are more favorable
 - Could be mitigated with use of a separate offering for the foreign corporation

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3. Multiple Offerings Allowed under Same Plan

One or more offerings may be made under a single plan

- Parent corporations may designate one or more subsidiaries that will participate in a particular offering
 - Not all subs need be included
- Offerings may be consecutive or overlapping
- Terms need not be the same as long as each offering and the terms of the plan satisfy the rules
- Cannot use two offerings for a single corporation
 - i.e. May have a separate offering for each corporate entity or for a group of corporate entities, but..
 - Can not have some employees (e.g. US) of the same corporate entity in one offering and other employees (e.g. foreign) in a different offering
 - Take care regarding corporate versus branch status

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4. Clarification re. Determination of Grant Date

Establishing the grant date is important for

- Determining compliance with requirements under section 423
- Is discount > 15%? Lookback only works if grant date is first day of offering
- Determination of whether the 2 year holding period is met
- \$25K limitation is based on grant date

The date of grant is the first day of the offering if the offering:

- Designates the maximum number of shares that may be purchased by each participant or
- Requires formula to establish, **on first day of offering**, maximum number of shares that may be purchased by each participant

If the maximum number of shares is not fixed or determinable on the first date of offering, purchase date = grant date

- Lookbacks not feasible
- Holding periods will not start until purchase date

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4. Clarification re. Determination of Grant Date

Examples of setting max limit:

This works:

- An ESPP provides that no employee may be permitted to purchase stock at a rate that exceeds \$25,000 in fair market value of employer stock (determined on date of grant) for each calendar year that an option is outstanding

AND that a maximum of 500 shares may be purchased by each employee during the offering

This does NOT work:

- Same language as above without 500 maximum share limit
- In this case, the grant date will be the date the option is exercised (i.e. purchase date)
 - If discount based on first day of offering and exceeds 15% of FMV on purchase date, offering would be disqualified

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4. Clarification re. Determination of Grant Date

Examples of setting max limit (continued):

However, this does appear to work:

- Maximum number of shares that may be purchased by any employee during an offering beginning on Jan 1 and ending Dec. 31 equals \$25,000 divided by the fair market value of the stock on the first day of the offering
 - Example in regs did not include a lookback on plan, but appears this is okay even with a lookback

And this works (formula based on salary):

- Maximum number of shares that may be purchased by any employee during offering (Jan 1 – Dec 31) equals 10% of employee's annual salary (determined as of January 1st of year in which offering commences) divided by FMV of the stock on first day of offering

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5. ESPP Annual \$25K Limit: IRS adopts liberal approach in Final Regs

Background: Employees may not purchase stock under a qualified ESPP at a rate that exceeds \$25K (based on market value at grant date) for each calendar year in which option is outstanding

Example: Offering begins in 2008, first purchase (i.e. first exercise) doesn't occur until 2009

Differing views existed as to whether employees were entitled to purchase \$25K ("conservative" view) or \$50K worth of stock in 2009 ("liberal" view)

- Answer under proposed regs was \$25K – option had to be both outstanding AND exercisable for the \$25K to accrue

Final Regs adopt liberal view, allowing employee to purchase up to \$25K worth of stock for each calendar year in which the option is merely outstanding, so \$50K for above example

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5. ESPP Annual \$25K Limitation – Other Considerations

Carryover of \$25K limitation from one year to another only applies if for same option (i.e. offering)

- i.e. Any remaining \$25K carryover from one offering can not carry over to new offering in a different year

If plan terms satisfy limit but individual option allows for purchase of stock in excess of \$25K limit, no portion of option is qualified

- May disqualify entire offering if employee whose options are disqualified should have received qualified ESPP option and doesn't
- However, if exceeding \$25K limit is caused by an admin error as opposed to terms of option, may not impact rest of offering
 - Grey area and subject to interpretation

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ESPP Final Regs: A few other cautionary items

Be careful about allowing carryover of withheld but unused amounts from one offering to another

- Have to allow other employees ability to make direct payments of an equal amount (less any amount they carried over)
- Carryover for fractional shares okay

Consider new shareholder vote authorizing any change in granting corporation or shares issued under plan

Final Take-aways:

1. Review and compare terms/language under your plan and individual offerings with final regulations
2. Review and compare your administrative processes to make sure they are consistent with terms of the plan and final regs

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