

News from our Compensation & Benefits Group

Special Reporting Requirements Regarding Incentive Stock Options and Employee Stock Purchase Plans—Final Regulations Issued Under Section 6039

Background

Section 6039 of the Internal Revenue Code of 1986, as amended (the “Code”), imposes reporting requirements on corporations with respect to the exercise of incentive stock options and the transfer of stock acquired under employee stock purchase plans.

In November 2009, the Internal Revenue Service (“IRS”) issued final regulations under Section 6039 of the Code, which must be followed for incentive stock option exercises and transfers of stock acquired under employee stock purchase plans occurring on or after January 1, 2010. The final regulations, which expand on proposed regulations previously issued in 2008, require enhanced disclosure in the employee information statements that corporations are required to furnish to employees. Beginning with options exercised or stock transferred during 2010, the final regulations require corporations to file an information return with the IRS.¹ The new rules aim to provide employees with more accurate information to enable them to calculate their tax obligations upon disposition of shares acquired by the exercise of an incentive stock option and transfer of shares acquired under an employee stock purchase plan.

Because the final regulations need not be followed until next year, we recommend that companies continue to follow the current regulations for reporting that is due on or before January 31, 2010 for exercises and transfers occurring during

2009. However, for exercises and transfers in 2010, employee information statements must be furnished no later than January 31, 2011, and information returns must be filed with the IRS no later than February 28, 2011 (or March 31, 2011 if filing electronically), all in compliance with the final regulations. For employee information statements covering exercises and transfers occurring during 2010, we will provide new forms that comply with the final regulations.

Employee information statement

Every corporation that in 2009 issued stock upon the exercise of an incentive stock option (meaning a stock option described in Section 422 of the Code) must furnish to the employee who exercised the option, on or before January 31, 2010, a written statement containing the following information (with changes under the final regulations noted in parentheses):

1. The name, address and employer identification number (the “EIN”) of the corporation issuing stock upon the exercise of the option;
2. The name, address and EIN of corporation whose stock was issued upon the exercise of the option, if different from the corporation identified in (1);
3. The name, address and identifying number of person to whom stock was issued upon exercise of the option;
4. The date the option was granted;
5. The date the option was exercised;

6. The aggregate option exercise price (under the final regulations, the exercise price per share);

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7. The fair market value of the stock at the time of exercise (under the final regulations, the fair market value of a share of stock at the time of exercise);
8. The number of shares of stock issued upon exercise of the option; and
9. A statement that the shares issued were acquired pursuant to the exercise of an incentive stock option described in Section 422(b) of the Code (not required under the final regulations).

Similarly, every corporation that in 2009 recorded (or has recorded by its transfer agent) the first transfer by an employee or former employee of stock acquired by such employee exercising an option under an employee stock purchase plan (meaning a plan that is established under Section 423 of the Code, if the purchase price is either less than one hundred percent of the value of the stock on the grant date or is not fixed or determinable on the grant date)² must furnish to the employee transferring the stock, on or before January 31, 2010, a written statement containing the following information (with changes under the final regulation noted in parentheses):

1. The name, address and EIN of the corporation whose stock was transferred;
2. The name, address and identifying number of the person who transferred stock originally acquired under the employee stock purchase plan (the “transferor”);
3. The date the option was exercised by the transferor;
4. The number of shares to which title was transferred by transferor during the year; and
5. A statement that the shares issued were acquired pursuant to a purchase under an employee stock purchase plan meeting the requirements of Section 423(b) of the Code and with respect to which Section 423(c) of the Code applies (not required under the final regulations).

Additionally, under the final regulations:

6. The date the option was granted to the transferor (typically the offering date);
7. The fair market value of the stock on the date of grant of the option;
8. The actual purchase price per share at which the shares were purchased;
9. If the purchase price per share was not fixed or determinable on the date of grant, the purchase price per share, determined as if the shares were purchased on the date of grant;³
10. The fair market value of the stock on the purchase date; and
11. The date the legal title to the shares was transferred by the transferor.

The final regulations clarify that the “first transfer” that triggers the reporting requirements for the transfer of shares acquired under an employee stock purchase plan includes a transfer of shares immediately deposited into a brokerage account established on behalf of the employee. If, however, the shares are issued directly to an employee or registered in the employee’s name on the corporation’s record books, the corporation does not have a reporting requirement under Section 6039 of the Code until the employee subsequently sells the shares or transfers them to a brokerage account.

The final regulations provide that corporations do not have reporting requirements under Section 6039 of the Code with respect to employees who are non-resident aliens (defined under Section 7701(b) of the Code) and to whom the corporation is not required to provide a Form W-2 for any calendar year within the time period beginning with the first day of the calendar year in which the option was granted and the last day of the calendar year in which the option was exercised or shares were transferred.

Employee information statements must be delivered in person or mailed to the recipient’s last known address but are not

filed with the IRS. They may be delivered electronically if the recipient properly consents to such a means of delivery.⁴ In order to satisfy the requirement relating to employee stock purchase plans, Section 6039 of the Code also requires that a corporation issuing stock under an employee stock purchase plan identify the stock in a manner sufficient to enable it to carry out its reporting obligation (e.g., by use of special serial numbers or colors, which in practice are typically determined by the transfer agent).

In general, a penalty of \$50 is imposed for each information statement not timely furnished or containing incomplete or incorrect information, up to a maximum of \$100,000 per calendar year.

For purposes of employee information statements delivered on or before January 31, 2010, corporations have the choice of following the requirements of the current regulations, proposed regulations or final regulations. We suggest that corporations continue to follow the current regulations because the proposed and final regulations involve the enhanced disclosure described above.

Most stock administration software can generate these employee information statements. However, as we have provided in prior years for your convenience, the following forms, which, when completed and delivered on or before January 31, 2010, will satisfy the foregoing employee information statement reporting obligation under the current regulations:

ISO employee information statement
(MS Word) www.cooley.com/files/6039_Notice_ISO_Exercise.DOC

ESPP employee information statement
(MS Word) www.cooley.com/files/6039_Notice_ESPP_Transfer.DOC

IRS information return

Beginning with exercises and transfers in 2010, the final regulations under Section

6039 of the Code require a corporation to file an information return with the IRS in addition to providing information statements to employees. The first information returns must be filed no later than February 28, 2011 (or March 31, 2011 if filing electronically).

The information returns must contain the same information required by the final regulations with respect to employee information statements, as described above. Information returns with respect to incentive stock options must be made on Form 3921, and information returns with respect to stock purchased under an employee stock purchase plan must be made on Form 3922. The IRS expects to release both of these forms in 2010.

These reporting obligations are in addition to other reporting obligations that arise upon the disposition of stock acquired under either an incentive stock option or an employee stock purchase plan. In particular, the IRS generally requires that the income of an employee from a disqualifying disposition of stock acquired under an incentive stock option or a qualifying or disqualifying disposition of stock acquired under an employee stock purchase plan be reported as "other compensation" on Form W-2. Compliance with such requirement is necessary in order for the corporation to take a federal income tax deduction for the amount of income recognized by the employee upon a disqualifying disposition of stock acquired under an incentive stock option or an employee stock purchase plan, as well as to satisfy the corporation's reporting obligations.⁵

As an aside, amounts includible in income as a result of the exercise of a nonstatutory stock option (meaning a stock option that

is not an incentive stock option for purposes of Section 422 of the Code) should be reported on a Form W-2 in the case of employees or Form 1099 in the case of non-employees, along with appropriate withholding. For Forms W-2 issued for the 2009 tax year, it is mandatory to report this income in Box 12 using code "V."

The company is exempt from the information return requirements with respect to any nonresident aliens for whom the company was not required to issue a Form W-2 for any year beginning with the date of grant and ending on the date of purchase or exercise.

If you have any questions about this *Alert*, please contact one of the attorneys listed above. ■

NOTES

¹ A summary of the changes to the current and proposed regulations and the complete text of the final regulations are available at www.gpo.gov/fdsys/pkg/FR-2009-11-17/html/E9-27451.htm.

² For example, the purchase price is not "fixed or determinable" on the date of grant if the exercise price is equal to the lesser of 85 percent of the fair market value of the stock on the date of grant or 85 percent of the fair market value of the stock on the date of exercise. In addition, the exercise price will not be known on the date of grant if the exercise price is calculated based on a certain percentage (not less than 85 percent) of the fair market of the stock on the purchase date.

³ To determine the tax liability resulting from a qualifying disposition (which is calculated based on the grant date discount), the employee needs to know the exercise price determined as if the option were exercised on the date of grant.

⁴ Consent to electronic delivery must be obtained by following the requirements under Treasury Regulations §31.6051(j)(2)(i), which requires, among other things, that an individual affirmatively consents in a manner that demonstrates that the individual can access the same electronic format in which the Section 6039 notices will be furnished.

⁵ In the case of a qualifying disposition, however, the company is not required to report the gain and is not entitled to a tax deduction.