

NEW ISO AND ESPP RULES EFFECTIVE FOR 2010

January 20, 2010

To Our Clients and Friends:

The Internal Revenue Service has issued two sets of regulations that are effective for 2010. The regulations (i) impose new reporting requirements with respect to tax-qualified incentive stock options (“ISOs”) and stock purchased through tax-qualified employee stock purchase plans (“ESPPs”), and (ii) update and clarify technical aspects of the rules governing ESPPs.¹

NEW INFORMATION REPORTING REQUIREMENTS

Companies are required to deliver information statements to employees following certain transfers of stock received in connection with the exercise of ISOs or ESPP options. As of January 1, 2010, companies will also be required to provide information returns to the IRS.

Reporting Requirements Triggers. For ISOs, the reporting requirements are triggered when the option is exercised. For ESPPs, the requirements are generally triggered when the employee transfers the purchased shares, whether or not in a disqualifying disposition. However, the requirements are also triggered if the shares are deposited into a brokerage account established on the employee’s behalf, even where the employee retains beneficial ownership of the shares (but no return is required when the employee later sells the shares). The regulations contain additional guidance on implementing these requirements, including an exemption from providing information statements to certain nonresident aliens.

Required Information. The information generally required to be disclosed includes the company issuing the stock, the person exercising the option, the exercise price, the exercise date, and the fair market value of each share on the option exercise date. For ISOs, the company must also state the number of shares acquired on the exercise. For ESPPs, the company must state the option grant date, the fair market value of the stock on that date or, if the exercise price is not fixed at grant, what the exercise price would have been if the option had been exercised on the grant date, and the date the legal title of the shares was transferred by the employee to another person and number of shares so transferred. To ensure compliance, companies that grant ISOs or options under ESPPs should confirm that they are able to track the new information required to be reported.

¹ The IRS publications adopting the new rules (T.D. 9470 and T.D. 9471) are available at http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=2009_register&docid=fr17no09-7 and http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=2009_register&docid=fr17no09-6.

Filing Dates. Information statements are required to be delivered to employees by January 31 of the year following the calendar year in which the relevant stock transfer took place. The deadline for information returns to be filed with the IRS for 2010 transfers has not yet been specified. Employee information statements may be delivered a transfer agent.

New Identification Requirement for ESPP Shares. A company that transfers shares under an ESPP must identify the stock in a manner sufficient to enable accurate reporting, including by color-coding the stock certificates or assigning special serial numbers.

Information Statements for Pre-2010 Transfers. Note that while IRS returns are not required for transfers taking place prior to 2010, information statements are required to be provided to employees for stock transfers that took place during 2007, 2008 and 2009. Accordingly, companies should review their records to confirm that they have furnished (or will by January 31 furnish) information statements to their employees with respect to all relevant stock transfers that occurred during 2007, 2008 and 2009.

ESPP RULES CLARIFIED

The IRS also clarified the ESPP rules to make them more consistent with the rules for ISOs. The new regulations apply to any option granted under an ESPP on or after January 1, 2010 but employers may also apply the new regulations to options granted prior to January 1, 2010. The following summary highlights some of the new rules in the final regulations.

Grant Date. The grant date is the first day of an offering if the terms of the plan or offering either (1) designate a maximum number of shares that may be purchased by each employee during the offering or (2) require the employer to apply a formula on the first day of the offering to establish the maximum number of shares. Note that this requirement applies only for purposes of determining the grant date; the rules do not require the maximum number of shares to be fixed and determinable as of the first date of the offering in order to be tax-qualified ESPP options. However, if the maximum number of shares that can be purchased under an ESPP option is not fixed or determinable until the date the option is exercised, then the grant date will be the date of exercise, not the first day of the offering. The grant date determination has important implications for determining the exercise price (and any discount), the period during which the option may be exercised, and how the annual \$25,000 limit is to be applied.

Annual \$25,000 Limitation. The number of shares of stock that each participating employee may purchase under the ESPPs sponsored or maintained by a company and its affiliates is limited to an annual amount equal to \$25,000 in fair market value of the stock. The final rules clarify that the limit increases by \$25,000 for each calendar year during which an ESPP option granted to the employee is outstanding. The IRS specifically noted that the option need not be currently exercisable for the annual \$25,000 increase to occur.

Equal Rights and Privileges. A company must afford all employees with equal rights and privileges with respect to eligibility and benefits under an ESPP. The new rules provide an offering by offering approach, allowing different terms for consecutive or overlapping offerings (although it may be a violation to permit employees to carry forward amounts that were not used in an earlier offering). The terms of options granted to citizens or residents of a foreign jurisdiction may be *less* favorable than the terms applicable to employees resident in the United States if those terms are designed to comply with the laws of the foreign jurisdiction.

Inconsistent Terms. If the terms of an option grant are inconsistent with the terms of the ESPP, the option will not be treated as granted under the ESPP. This would not, however, disqualify the favorable treatment afforded other options granted in compliance with the ESPP.

Stockholder Approval. The new rules clarify that an ESPP must be re-approved if it is amended in a way that could be considered the adoption of a new plan, such as increasing the number of shares that may be issued under the plan. In addition, a change in the granting company or the stock available for purchase (including due to a merger or other corporate transaction) will be considered the adoption of a new plan requiring stockholder approval within 12 months prior to or after the change.

Eligibility. The new rules modify which classes of employees may be excluded from participation in an ESPP or a particular offering, including employees who are citizens of a foreign jurisdiction, but only if the grant of an option is prohibited under the laws of that jurisdiction or if compliance with the laws of that jurisdiction would cause the plan to violate the ESPP requirements. Under the new rules, officers and supervisors are no longer permitted to be excluded unless those individuals are “highly compensated employees” (as defined in Code Section 414(q)).

Please feel free to contact us with any questions.

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