



August 24, 2004

IRS Issues Final ISO Rules and Requests Comments on ESPP Rules

The IRS issued a complete set of final regulations on incentive stock options (“ISOs”) on August 3. 69 Fed. Reg. 46401. The regulations provide guidance under the following Code sections:

- section 422, which authorizes ISOs and spells out the requirements;
- section 421, which governs the income tax treatment of ISOs as well as transactions under employee stock purchase plans governed by Code section 423 (“ESPPs”); and
- section 424, which provides special rules for ISOs and ESPP options.

The final regulations essentially adopt the proposed regulations issued in June 2003 with limited revisions. On the same date the final ISO regulations were issued, the IRS issued a Notice requesting comments on possible revisions to the ESPP regulations under Code section 423. Notice 2004-55 (August 9 IRS Bulletin).

We describe below some of the more significant changes the final ISO regulations made to the proposed regulations, and summarize the IRS request for comments on the ESPP regulations.

Final ISO Regulations

Maximum Number of Shares – In order for an option to qualify as an ISO, the plan under which the option is granted must specify the maximum number of shares that may be issued under the plan pursuant to ISOs. This requirement could present a problem for a purported ISO issued under a plan that was previously approved by shareholders and does not contain such a limit. The final regulations eliminated a provision in the proposed regulations that would have required a plan to contain limits on the number of shares that could be issued pursuant to nonqualified options and other stock-based awards.

The preamble to the final regulations indicates that only the net number of shares issued upon exercise of an option counts against the maximum number of shares issuable under ISOs (i.e., shares used to pay the exercise price do not count).

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Modifications – A modification of a statutory option results in a new grant that will qualify as a statutory option only if it meets the applicable requirements on the date of grant. The final regulations provide that the following will not result in modifications:

- an offer to change the terms of an option, if the change is not made and the offer remains outstanding for less than 30 days;
- an "inadvertent" change to an option's terms that would otherwise constitute a modification, to the extent the change is reversed by the earlier of the date of exercise or the end of the calendar year in which the change occurred; and
- the exercise by the granting corporation of discretion specifically reserved under the option related to the payment of employment taxes and/or withholding taxes related to the exercise of the option.

Shareholder Approval – In a corporate transaction, statutory options held by employees of a target company are often assumed by the acquiring company or replaced with options on the acquiring company's stock. The final regulations removed a rule in the proposed regulations that could have required shareholders of the acquiring company to approve such assumptions or replacements.

Electronic Statements – Code section 6039 generally requires an employer to provide a statement to an optionee who receives shares pursuant to the exercise of a statutory option during a year by the following January 31. The final regulations provide that such a statement may be furnished electronically with the consent of the optionee.

Section 83(b) Elections – The regulations provide that a Code section 83(b) election made upon the exercise of a statutory option will apply only for purposes of the alternative minimum tax, not for regular federal income tax purposes.

Effective Date - The regulations are effective August 3, 2004, but the following transitional rules apply:

- For statutory options granted on or before June 9, 2003, taxpayers may rely on the 2003 proposed regulations, proposed regulations issued in 1984, or the final regulations until the earlier of January 1, 2006 or the first regularly scheduled stockholders meeting occurring six months after August 3, 2004.

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- For statutory options granted after June 9, 2003 but before the earlier of January 1, 2006 or the first regularly scheduled stockholders meeting occurring six months after August 3, 2004, taxpayers may rely on the 2003 proposed regulations or the final regulations.

Taxpayers may not rely on the 1984 or 2003 proposed regulations after December 31, 2005. Reliance on any set of regulations must be in its entirety and all statutory options granted during the reliance period must be treated consistently.

Request for Comments on ESPP Regulations

The IRS announced in Notice 2004-55 that it is considering whether revisions should be made to the longstanding ESPP regulations under Code section 423 to make them consistent with the newly finalized ISO regulations. The Notice also listed eight additional issues that could be addressed in such revisions, including:

- whether any subcategory of employees may be excluded from plan participation and whether the exclusion of foreign employees should be addressed;
- the effect of an inadvertent exclusion of employees;
- the treatment of new employees and new plan participants;
- whether the \$25,000 annual limit on purchases under an ESPP should be determined in a manner consistent with the \$100,000 limit for ISOs;
- limitations on changes to contribution amounts under a plan; and
- whether employees should be able to carry over contributions from an earlier plan or offering period to a new plan or offering period.

Taxpayers are encouraged to comment – by October 1 – on whether these issues and/or others should be addressed in revisions to the ESPP regulations.