



**Taxing Matters :
Proposed Changes to Sections
6039 & 423**

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Agenda

Proposed Section 6039 Changes

- Background
- Proposed Regulations
- Questions

Proposed Section 423 Changes

- Background
- 1. Additional Guidance on Inclusion / Exclusion of Employees
- 2. Less favorable options for foreign employees
- 3. Option price determined like an ISO
- 4. Determination of date of grant
- 5. Proposed changes to the ISO regulations
- 6. \$25K limitation

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Tax avoidance means that you hire a \$250,000-fee lawyer, and he changes the word 'evasion' into the word 'avoidance.'

- Franklin D. Roosevelt

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Background on Section 6039

Applies to 423-qualified ESPPs and ISOs

Requires companies to provide an information statement to employees:

- upon exercise of an ISO AND
- upon *first transfer of legal title of shares* acquired pursuant to an ESPP

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Background on Section 6039

Current Reporting Requirements

ISOs

- Name, address, and ID of the company
- Name, address, and ID of the employee
- Grant date
- Exercise date
- Number of shares exercised
- Total cost of the shares acquired
- FMV of the stock on the date of exercise
- Type of option exercised

ESPP

- Name, address, and ID of the company
- Name, address, and ID of the employee
- Date the stock was purchased
- Date of transfer of legal title
- Number of shares transferred
- Type of "option exercised"

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New Proposed Regulations on Section 6039

Tax Relief and Health Care Act of 2006 amended Section 6039, effective as of January 1, 2007

- Information reporting to IRS in addition to the participant

July 17th, 2008 IRS Released Proposed Regs

- http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=2008_register&docid=fr17jv08-22
- Expanded reporting requirements for 6039 to include new information for ESPP
 - Goal is to provide necessary information for participants to complete taxes

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Summary of Changes to Section 6039

Transactions occurring in 2007 and 2008 are exempt from the revised requirements

ESPP disclosures have been expanded to include:

- Enrollment / offering period begin date (“date the option was granted”)
- Enrollment date market value (“fair market value of the stock on the date the option was granted”)
- Purchase price (“exercise price per share”)
- Purchase date (“date the option was exercised”)
- Purchase date market value (“fair market value of the stock on the date the option was exercised by the transferor”)

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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),
- The IRS expects to release the forms later this year

Forms must also be used to report the information to employees

- for transactions after January 1st, 2009

IRS and participant reporting must be completed by January 31st

- In the year following the calendar year in which the transaction occurred

Comments on the proposed requirements are due to the IRS by October 15, 2008

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Tax reform means “Don’t tax you, don’t tax me,
tax that fellow behind the tree.”

- Russell B Long, US Senator

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Section 6039: ESPP “Transfer”

Background

- Section 6039 Requires Reporting to Participant¹ for tax qualified transactions by 1/31 of following year
 - ISO: Exercise
 - ESPP: “Every corporation which records, or has by its agent recorded, a *transfer of the title* to stock acquired by the transferor pursuant to the transferor’s exercise”
[emphasis added]

¹ Will also report to the IRS for transactions in 2009.

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Section 6039: ESPP “Transfer”

What is the definition of transfer?: Opinions vary!

Opinion One:

- The first time the participant transfers legal title of the shares AFTER receiving shares from the company
 - Includes transfer from broker A to broker B

Opinion Two:

- Transfer from one brokerage account to another, employee is still the owner of the shares and the account, does not give rise to a reporting responsibility.
- The legal owner is still the employee--not the broker.
- Operationally, all that happens is that the book-entry shares move from one broker's sub-account at DTC to another

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Section 6039: ESPP “Transfer”

What is the definition of transfer?

Opinion Two:

- Private Letter Ruling 91107022, dated January 22, 1991 states:
 - “transfer of legal title”
 - “No statement to a participant is required on the transfer of record title to shares of stock from the Agent (or its nominee) to the participant through the issuance of a certificate registered in the name of that participant.”
 - Interpretation: transfer from “one agent to another” does not equal transfer of legal title

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All Transfers or Only Qualifying?

Does Section 6039 Apply to All ESPP Transfers? Or Only Qualifying Transfers?

Section 6039 specifically references Section 423(c),

- Section 423(c) applies only to qualifying dispositions under a 423-qualified plan
- Therefore does Section 6039 only apply to a qualifying transfer?
- Or does it mean that it only applies upon a transfer of shares acquired under a plan where the purchase price is less than 100% of the fair market value on the date of grant?

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I am proud to be paying taxes in the United States. The only thing is – I could be just as proud for half the money.

- Arthur Godfrey, entertainer

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Additional or Equivalent Information?

Proposed Goal of the New Regs:

- “to furnish employees with sufficient information to enable them to calculate their tax obligations upon disposition of the shares “
- Two necessary elements are not included in the revised reg:
 - Sales Price
 - Discount %

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Additional or Equivalent Information?

Many companies include information that will allow participants to compute their taxes, but not necessarily the information prescribed by section 6039.

For example, a statement to the participant may include:

- Total Purchase Price
- Total Sale Price
- Total Discount on Subscription Date
- W-2 Income (based on the "lesser of" calculation)

More and easier-to-use information that the proposed requirements of Section 6039

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Substitute Forms 3921 & 3922

Will “substitute forms” be permissible?

- Multiple transactions on one form
- Enhanced (or different?) information for each transaction
 - Still allows computation of taxes!
- Different layout

Other substitute forms

- 1099B
- W-2
- W-9

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What is the difference between a taxidermist and a tax collector? The taxidermist takes only your skin.

- Mark Twain [Samuel Langhorne Clemens]

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Does it Apply to International Participants?

The regulation says “any person” but again
Inconsistent with the perceived purpose of the
regulation to require this reporting for
participants that are not subject to US taxation

- Do issuing firms have information on tax status? (W-9 vs. W-8 Ben, etc.?)
- Safer to just send to all?
- Send to all persons with an SSN?
- Is there “harm” in requiring it be sent to “all”?
 - Cost, environmental impact?

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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?

What ID should be used for international
participants that do not have a Social Security
Number?

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Give women the vote, and in five years there
will be a crushing tax on bachelors.

- George Bernard Shaw

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Electronic Delivery

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

If SSN is required, generally not good practice to e-mail SSN,
instead the participant should log on to a secure website
to retrieve the information (after an e-mail alerts them)

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We don't pay taxes. Only the little people pay taxes.

- Leona Helmsley (b. 1920), U.S. businesswoman. Quoted in New York Times (July 12, 1989).
 - Reported by Helmsley's former housekeeper during her trial for tax evasion; in March 1992 Leona Helmsley was sentenced to four years' imprisonment.

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Proposed ESPP Regulations

Issued July 29, 2008

The proposed regulations incorporate substantially all rules in the existing regulations

- Updates existing regulations to incorporate statutory changes
- Makes them consistent with the ISO regulations, where appropriate
- Removes obsolete rules

The IRS & Treasury are soliciting comments on the proposed regulations through 10/27/08

Effective January 1, 2010

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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)

- if the exercise price of an ESPP option is between 85% and 100% of FMV on the date of grant,
- Income recognized is the lesser of:
 - The excess of the FMV of the share on the date of disposition or death over the exercise price, and
 - The excess of the FMV of the share on the date of grant over the exercise price.

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Background: ESPP Tax Treatment

If the plan has a “lookback” provision

- For tax purposes, exercise price is determined as if the option were exercised on the date of grant
- Capital gain on amounts in excess of spread

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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Summary of Changes to ESPP Regulations

1. Additional Guidance on Inclusion / Exclusion of Employees
 - Inconsistent Option Treatment
 - Ineligible Optionee Receipt & Later Inconsistent Operation
 - Clarifies the employees that may be excluded from the plan, including foreign employees in limited instances
2. Provides that less favorable options may be granted to foreign employees in certain instances
 - When/if foreign laws/regs require it
3. Provides that the option price may be determined in a manner consistent with the ISO requirements (fair market value rules)

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Summary of Changes to ESPP Regulations

4. Clarifies the manner in which the date of grant may be determined
 - Important for
 - Is discount > 15%? The elimination of the lookback?
 - Determination of whether the holding period is met
 - \$25K limitation and
 - Employees who are eligible to participate
5. Provides for proposed changes to the ISO regulations
6. Provides that \$25K limitation is determined in a manner consistent with the ISO \$100K limitation

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"Like mothers, taxes are often misunderstood,
but seldom forgotten."

- Lord Bramwell, 19th Century English jurist

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The logo for Stock & Option Solutions, featuring a stylized red and white circular icon to the left of the text "Stock & Option Solutions".

1. Additional Guidance on Inclusion / Exclusion of Employees

Consequences of Options Inconsistent with ESPP Requirements

If an eligible employee, but receives options that
are inconsistent with the terms of the ESPP,

- Disqualifies the whole plan!
- Plans may lose tax-favored status due to inadvertent exclusion of employees
- IRS and Treasury requested comments on:
 - whether a correction program is appropriate for inadvertent failures and
 - suggestions of violations and correction methods that might be covered

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1. Additional Guidance on Inclusion / Exclusion of Employees

Consequences of Options Inconsistent with ESPP Requirements

But... if an ineligible employee receives options,

- Disqualifies ONLY the option, not the whole plan!

If an eligible employee's grant later does not satisfy the terms of the grant

- Disqualifies ONLY the option, not the whole plan!

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1. Additional Guidance on Inclusion / Exclusion of Employees

Changes to Covered Employees

Proposed regulations clarify that employers may exclude:

- Employees who have completed a shorter period of service
- Employees whose customary employment is for fewer hours per week or fewer months in a calendar year
- Highly-Compensated Employees (HCE)
 - Compensation above a certain level or
 - Section 16 officers
- Exclusions must be applied in an identical manner to all employees
 - Or highly compensated employees, as applicable

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1. Additional Guidance on Inclusion / Exclusion of Employees

Changes to Covered Employees

Employees of foreign subsidiaries can be excluded

May also exclude citizens and residents of foreign jurisdictions (without regard to US citizenship or green card status) if

- 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

In response to requests for general exclusions of nonresident aliens and collectively-bargained employees

- IRS and Treasury Department stated they were statutorily constrained from providing such exclusions

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A tax loophole is "something that benefits the other guy. If it benefits you, it is tax reform".

- Russell B. Long, U.S. Senator

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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
 - Applies if the terms are modified in order to comply with the laws of a foreign jurisdiction
 - Not satisfied if citizens or residents of foreign jurisdictions are granted options that are more favorable

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4. Changes to Determination of Grant Date

Under the existing regulations, the date of grant is determined under the principles of the ISO regs

- Grant date = time the granting corporation completes the corporate action constituting an offer of stock for sale to an individual under terms and conditions of a statutory option
- Complete when:
 - Maximum number of shares is determined
 - Minimum option price is fixed or determinable

These principles will apply to ESPPs, with exception of the requirement that the minimum option price be fixed or determinable

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4. Changes to Determination of 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 a formula to establish, on the first day of the offering, the maximum number of shares that may be purchased by each participant

If the maximum number of shares is not fixed or determinable until the purchase, the date of purchase will be the date of grant

- Lookbacks not feasible without specified limit!
 - Discount on grant date must be 15% or less!
- Holding periods will not start until the purchase date!

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5. Proposed Changes to ISO Regulations

Proposed regulations revise Example 1 under 1.422-2(b)(6) of the ISO regulations,

- Involves a subsidiary that granted subsidiary options to subsidiary employees
- After obtaining shareholder approval from subsidiary shareholder (in this case, the parent), the subsidiary amends the plan to grant options on parent stock

Existing ISO regulations:

- In order to implement the change, subsidiary must obtain approval from the parent's shareholders

Proposed changes provide that subsidiary must obtain approval from its own shareholders rather than the parent's shareholders

- The IRS and Treasury Department invite comments on the proposed change.

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The hardest thing in the world to understand is
the income tax.

- Albert Einstein, physicist

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6. ESPP \$25K Limit: Liberal or Conservative?

Background

- IRC: right to purchase stock under the \$25K limit doesn't accrue until "option" is "exercisable"
- Example: Offering begins in 2007, first purchase doesn't occur until 2008, Option granted under that offering technically isn't exercisable in 2007
 - Only exercisable at the time of purchase!
- Many assert that employees aren't entitled to \$25K worth of stock for 2007 (Option wasn't exercisable in that year)
- Regs don't help: assume options are exercisable anytime, not on pre-specified dates

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6. ESPP \$25K Limit: Liberal or Conservative?

One prominent law firm asked IRS for opinion in 2001

- Told by staff member that :
 - “the Service's position on the issue is clear -- if an offering starts in a calendar year but there is no purchase date in that year (i.e., the option does not become first exercisable in that year), the participant is not entitled to a \$25,000 carryover for the following year”
- This law firm now insists on the “conservative” approach

Most Silicon Valley/West Coast companies seem to follow the “liberal” approach

Many East Coast companies follow “conservative” approach

- One east coast outsourcing firm has only 2% of their clients (both west coast companies) using liberal, rest use conservative

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6. ESPP \$25K Limit: Proposed Regs

\$25K Limit “Clarification”

- Participants accrue right to purchase \$25K only in years during which “the options” are outstanding and exercisable
- i.e. no more carry-forward unused \$25K limit from one calendar year to the next

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6. Changes to \$25K Limitation

If the plan terms satisfy the limit but an option provides for stock in excess of \$25K limit, no portion of option is treated as granted under ESPP

- Unlike ISOs, where up to \$100K limit retain ISO status, and the excess is treated as a NQSO
- Will not disqualify the entire offering

If an option that provides for stock in excess of \$25K limit is granted to an employee entitled to an ESPP grant and the employee is not granted an option under the offering that qualifies as an ESPP option, the offering will not satisfy the ESPP covered employee rules

- Disqualifies the entire offering

Limit only applies to options granted under ESPP

- Does not limit amount of ISO or other options that may be granted

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Taxation with representation ain't so hot either.

- Gerald Barzan, humorist

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