

Client Alert

Latham & Watkins
Tax Department

Employee Stock Purchase Plans: IRS Issues Final Regulations

On November 16, 2009, the Internal Revenue Service (IRS) issued final regulations¹ governing options granted pursuant to employee stock purchase plans (ESPPs) under Section 423 of the Internal Revenue Code (Code). The final regulations are effective November 17, 2009 and apply to all ESPP options granted on or after January 1, 2010.

Proposed regulations under Section 423 were issued on July 28, 2008 and introduced a number of important changes to the ESPP regulations previously in effect.² The final regulations generally adopt the proposed regulations with certain clarifications. The more significant clarifications are summarized in this *Alert*.

- **Offerings Tested Separately.** The final regulations clarify that each offering under an ESPP will be analyzed separately for purposes of determining whether the offering satisfies the requirements of Section 423. Thus, a company can implement separate ESPP offerings (including concurrent or partially overlapping offerings) for the employees of different subsidiary corporations. For example, a company could make an offering to all employees of one subsidiary, and separately make an offering to only non-highly compensated employees of another subsidiary.

- **Application of \$25,000 Limitation.** Section 423 provides that no employee may be granted an option that permits the employee's right to purchase shares to accrue at a rate that exceeds \$25,000 in fair market value of stock (determined at the grant date) for each calendar year the option is outstanding. The final regulations clarify that, for purposes of applying this limit, an employee may be granted an option to purchase up to \$25,000 of ESPP shares for each calendar year in which the option is outstanding, without regard to whether the option is exercisable in such calendar year. Thus, if an option is granted in a calendar year, and first becomes exercisable in the next calendar year, the option can permit the employee to purchase up to \$50,000 in fair market value of ESPP shares.
- **Option Grant Date.** The final regulations clarify that the grant date of an ESPP option is the first day of the offering if, on such date, the maximum number of shares of stock that may be purchased by an employee under the option is fixed or determinable. If the maximum number of shares purchasable by an employee in the offering is not fixed or determinable until the date the option is exercised, then the exercise

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date is treated as the grant date. The option grant date is important in determining the minimum permissible option exercise price and applying other important requirements under Section 423. The final regulations make clear that neither the \$25,000 limitation nor the required aggregate limit on shares that may be issued under an ESPP will be sufficient to establish the maximum number of shares for purposes of grant date determination.

- **Information Reporting Requirements.**

The final regulations governing an employer's reporting and notice requirements relating to employee stock options (under Section 6039 of the Code) also generally follow the proposed regulations, with a few changes.³ Under the final regulations, the transfer of stock to an employee's brokerage account upon the exercise of an option will be treated as the first transfer of legal title. As a result, the employer will be required to report the transfer (if a stock certificate is issued instead, generally the transfer of legal title will not be deemed to have occurred until the employee sells the stock or transfers the stock to a brokerage account). The final regulations include other changes to reporting and notice requirements applicable to shares purchased under an ESPP.

Companies should review their employee stock purchase plans to determine whether any revisions are necessary in light of the final regulations.

Endnotes

- ¹ To view the text of the final regulations, please [click here](#).
- ² For a discussion of these important changes, please [click here](#) to view our previous *Client Alert* regarding the proposed regulations entitled, "Employee Stock Purchase Plans: IRS Issues Proposed Regulations."
- ³ For a discussion of the proposed regulations under Section 6039, please [click here](#) to view our previous *Newsletter* entitled, "IRS Issues Proposed Regulations under Section 6309 of the Internal Revenue Code."

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