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Compensation & Benefits & Emerging Companies Alert

ALERT

Annual Reporting Requirements for Incentive Stock Options and Employee Stock Purchase Plans

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Annual Information Statements and IRS Returns

Requirement to Report

For any exercise of an incentive stock option (ISO) or transfer of a share previously purchased pursuant to a tax-qualified employee stock purchase plan (ESPP) where the purchase price paid for the share was (a) less than 100% of the fair market value on the date of grant or (b) not fixed or determinable on the date of grant, the Internal Revenue Code requires companies to:

- furnish, by January 31, 2013, annual information statements to the participant who exercised the ISO or transferred the ESPP share; and
- file, by February 28, 2013 (for paper filers) or by April 1, 2013 (for electronic filers), an information return with the IRS (please note that companies may request an automatic 30-day extension of this deadline by filing a Form 8809, Application for Automatic Extension of Time to File Information Returns, with the IRS on or before the applicable filing deadline).

With respect to reporting ESPP transactions, companies are required to report the first transfer of legal title to any share purchased under an ESPP plan. When a participant's shares are put into a brokerage account on behalf of such participant, the transaction is considered a transfer of legal title and, if it is the first transfer of legal title of the shares, it must be reported to the IRS and to the participant. If instead a participant's shares are issued directly to the participant or registered in the participant's name on the company's records, the transaction does not need to be reported to the IRS or to the participant because such transaction is not considered a transfer of legal title.

Participant information statements may either be delivered or mailed to the participant’s last known address or, if the participant has given his or her consent to receive the statement electronically, provided in electronic format. The consent to receive the statement electronically must be made in a way that demonstrates that the participant can access the statement in the electronic format in which the statement will be provided. For example, if the statement will be sent as a Word attachment to an e-mail message, the consent also must be sent as a Word attachment to an e-mail message. Further, the participant must be provided with certain disclosures related to the consent, including the right to receive a paper copy and the manner in which consent may be withdrawn.

Format of Statement/Return

Returns for ISO and ESPP transactions must be submitted to the IRS on Form 3921 (for ISOs) and Form 3922 (for ESPPs). You may order Form 3921 and/or 3922 by calling the IRS at 1-800-829-3676 or through the IRS website (please note that, even though Forms 3921 and 3922 may be found on the IRS website, you are not permitted to print and file these forms with the IRS; the IRS will only accept the official forms ordered from the IRS).

Participant statements may be provided on Form 3921 (for ISOs) and Form 3922 (for ESPPs) or may be provided using a different format that complies with the substitute form requirements found in IRS Publication 1179. At a minimum, substitute forms will need to contain all of the same information as the actual Form 3921 and 3922.

We expect that companies with a limited number of transactions will likely use Forms 3921 and/or 3922 (as opposed to substitute statements) since these forms will need to be prepared and submitted to the IRS in any event. Further, we expect that companies that provide Form 3921 and/or 3922 to participants (again, as opposed to providing substitute statements) will deliver the form(s) to their participants, along with a cover letter explaining the statement in a manner similar to this statement for ISO transactions and this statement for ESPP transactions.

The IRS requires that a separate Form 3921 or Form 3922 as applicable be filed with the IRS for each transaction (*i.e.*, each ISO exercise), even if one participant has multiple transactions during the course of the year. If a company provides participants with an information statement that meets the substitute statement requirements, the IRS has indicated that the company may aggregate transactions and provide only one substitute statement to each participant who had multiple transactions during the year.

Whether you use Forms 3921 and/or 3922, or you use substitute forms, certain information must be included in the form, including for ESPP transactions, the price per share of ESPP stock transfers. If the exercise price is not fixed or determinable on the date of grant (*e.g.*, the exercise price is the lesser of 85% of the fair market value on the first day of an offering period or 85% of the fair market value on the last day of an offering period), you must report the exercise price as if the purchase occurred on the grant date (*i.e.*, the first day of the offering period). In addition, if any individual participant has more than one ISO transaction or more than one ESPP transaction in a calendar year, you must include a unique account number on the form. The IRS has indicated that this number may be any number, not longer than 20 digits, and can contain numbers, letters and special characters. The unique number assigned to exercises/purchases by some stock plan administration programs could be used for this purpose. Otherwise, you should create a system to assign numbers to each transaction. Finally, even though you are only required to assign unique account numbers if a participant has more than one ISO or ESPP transaction in a year, we recommend that you assign a number to every ISO and ESPP transaction, as we expect that this will be used by the IRS to track/locate transactions and will likely be easier to ensure compliance if it is done consistently for all transactions.

Electronic Submission of IRS Returns

Companies that are required to file 250 or more ISO returns or 250 or more ESPP returns to the IRS must file the ISO or ESPP returns, as applicable, electronically through the IRS' Filing Information Returns Electronically (FIRE) system. To submit through the FIRE system, you will need to set up a FIRE account through the IRS website and you will need a Transmitter Control Code (TCC). If you are using a stock plan administration firm that will be submitting these returns on the company's behalf, they will likely use their TCC. If you are not filing through a stock plan administration firm and/or do not have a TCC, you will have to submit a Form 4419, Application for Filing Information Returns Electronically, so that a TCC can be assigned to the company. Form 4419 must be submitted to the IRS at least 30 days prior to filing a return electronically, and thus, must be submitted no later than March 1, 2013 (or March 31, 2013 if an extension is obtained) in order to timely file Forms 3921 or 3922 electronically. Also, to submit returns through FIRE, you will need to create a submission file that meets the FIRE requirements. These formatting requirements for FIRE are somewhat onerous and, as a result, companies will likely need assistance in creating the submission file due to the formatting requirements (a number of stock plan administration firms are equipped to provide this assistance). In addition, while you are permitted to voluntarily file electronically, because the process is challenging and potentially involves some cost to prepare the necessary file, most companies with limited transactions will find it more practical to prepare and file paper returns.

Penalties

The Internal Revenue Code imposes up to a US$100 penalty for each statement not furnished, or for each statement furnished to a participant with incomplete or incorrect information, up to a maximum penalty of US$1,500,000 per year. In addition, the Internal Revenue Code imposes up to a US$100 penalty for each return not filed with the IRS, or for each return filed with the IRS with incomplete or incorrect information, up to a maximum penalty of US$1,500,000 per year. Greater penalties will apply if a company intentionally fails to provide a statement or file a return with the IRS.

<u>Assistance</u>

Please contact any member of Orrick's Compensation and Benefits Group for further assistance on meeting these information statement and return requirements. If you use an external stock plan administrator, your stock plan administrator may also be of assistance as many stock plan administrators have developed specific services to help companies comply with these requirements.

Additional Annual Reporting Requirements

<u>Disqualifying Disposition of ISO Shares</u>

A company must report any ordinary income that an optionee recognizes in connection with a disqualifying disposition of ISO shares during the 2012 calendar year in box 1 of the optionee's 2012 Form W-2. Failure to report this income will prevent a company from taking a deduction for the ordinary income that results from the disqualifying disposition and may subject the company to certain reporting penalties.

A sale of ISO shares before the later of the date which is two years after the date of grant and the date that is one year after the date of exercise is treated as a disqualifying disposition. The ordinary income recognized on a disqualifying disposition is equal to the difference between the ISO exercise price and the <u>lesser of</u> the fair market value of the shares on the date of exercise or the sale price of the shares.

<u>Disposition of ESPP Stock</u>

If any person transferred ESPP stock for the first time during the 2012 calendar year, a company must report in box 1 of the person's 2012 Form W-2 the amount of the purchase price discount (described below), if any, on ESPP stock and, if the ESPP stock was transferred in a disqualifying disposition, any ordinary income that the person recognized when the shares were transferred. The "purchase price discount" is the difference between the fair market value of the shares on the first day of the offering period and the purchase price that would result if the shares were actually purchased on the first day of the offering period. For example, if the purchase price of the ESPP stock is equal to the lesser of 85% of the fair market value on the first day of the offering period and 85% of the fair market value on the last day of the offering period (the purchase date), the purchase price discount is 15% of the fair market value on the first day of the offering period. Failure to report this income will prevent a company from taking a deduction for the ordinary income and may subject the company to certain reporting penalties.

A transfer of ESPP stock before the later of the date which is two years after the first day of the offering period or the date which is one year after the purchase date is treated as a disqualifying disposition.

The ordinary income recognized on a disqualifying disposition is equal to the difference between the purchase price and the fair market value of the shares on the purchase date.

If you would like additional information on the topic discussed in this Compensation and Benefits Alert, please contact any member of Orrick's Compensation and Benefits Group.

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