



Electronic Dispatch

Employee Benefits Law Action Memo

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[Go to BS&K Employee Benefits Home Page](#)

IRS ISSUES NEW REGULATIONS ON INCENTIVE STOCK OPTIONS Compliance Date as Early as 2005 for Some Entities

The application of Section 421 of the Internal Revenue Code (Code) can delay both the employee's recognition of income (except for alternative minimum tax purposes) and the employer's business expense deduction with respect to stock transferred to the employee pursuant to an incentive stock option (ISO) that satisfies Code Section 422 or an employee stock purchase plan (ESPP) described in Code Section 423 (collectively, "statutory options"). The Internal Revenue Service (IRS) recently issued final regulations that deal primarily with the requirements for ISOs. ESPPs are addressed to a lesser extent.

The final regulations are largely unchanged from the proposed regulations issued in June 2003. Changes and clarifications are noted below. Because amendments to ISO plans may be subject to stockholder approval, current stock-based compensation programs should be evaluated promptly to determine if amendments are necessary.

ISO Requirements

To qualify for favorable tax treatment, an ISO must meet certain key elements:

- **Granted to an employee.** At the time the option is granted, the optionee must be an employee of the corporation granting the option (or a related corporation). Further, the option may not be exercised more than 3 months after the employment relationship is terminated. The final regulations provide that, in the case of an assumption or substitution of options in connection with a corporate transaction, an option will be treated as granted to an employee if the assumption or substitution occurs within the 3-month period following the optionee's termination of employment.

In any case where the optionee has reemployment rights provided by contract or statute (e.g., Family and Medical Leave Act or Uniformed Services Employment and Reemployment Rights Act), the final regulations state that the employment relationship is considered intact until the later of the expiration of the 3-month post-employment period or the date such reemployment rights expire.

- **No disqualifying disposition.** No disposition of the shares may be made within 2 years from the grant of the option or within 1 year after the option is exercised. If a disqualifying disposition occurs, certain amounts are includible in income under Code Section 83(a), and a deduction is allowable to the corporation for the taxable year of the disqualifying disposition. Examples in the final regulations clarify the effect of an exercise involving non-vested stock. The holding period is measured from the date of exercise, but the compensation income (the difference between the fair market value of the stock on the date of vesting and the fair market value on the date of exercise) is determined on the date of vesting (as is the amount of capital gain, if any).

The final regulations further provide that, because Code Section 83 does not govern the exercise of a statutory option, a Section 83(b) election is not available for the purpose of income tax consequences on the date of exercise. However, a Section 83(b) election may be made for purposes of the alternative minimum tax.

- **Stockholder Approval.** An ISO must be granted pursuant to a plan that is approved by the stockholders of the granting corporation within 12 months before or after the date the plan is adopted. Where a plan is assumed in connection with a corporate transaction, an example clarifies that no separate shareholder approval of the assumed plan is necessary where the transactional agreement approved by the stockholders describes the plan, including the maximum number of shares available as ISOs following the transaction and the employees eligible to receive them.
- **Maximum Aggregate Shares.** The final regulations require that the maximum aggregate shares available to be issued through ISOs (but not other forms of stock-based awards) must be stated in the plan. There is some controversy over whether this means that old-style plans that list the aggregate shares to be issued under all forms of stock-based awards must be amended. The authors of the final regulations have informally stated that the regulations will be amended to clarify that this is not necessary; a plan that states the maximum number of shares available under all forms of stock-based awards has implicitly set forth the maximum available for ISOs.

Only the net shares issued in connection with an exercise count against the maximum aggregate. Under an example used in the final regulations, if an employee is allowed to apply the value of 20 shares of stock to pay the exercise price for 100 shares under an option, then the 80 shares actually issued to the employee may be counted against the plan maximum.



- **Option Price.** The exercise price of an ISO must be not less than the fair market value of the stock on the date of grant. The proposed regulations set forth methodologies that could be used in a good-faith effort to meet the option price requirement. Despite requests for liberalization, the final regulations retain the rule that, for non-publicly traded stock, the average of the fair market values determined by independent and well-qualified experts satisfies this requirement.
- **\$100,000 Per Year Limitation.** The aggregate fair market value of stock with respect to which ISOs may be exercised by an individual for the first time in any calendar year may not exceed \$100,000. Amounts in excess of this limitation must be treated as nonstatutory stock options. The final regulations permit a corporation to issue a separate certificate for the ISO, or designate stock as ISO stock on the corporation's transfer books or plan records, without causing a modification that is treated as a grant of a new option (see below). If the corporation does nothing, the final regulations provide that shares are deemed purchased under an ISO first to the extent of the \$100,000 limit, and excess shares are deemed purchased under a nonstatutory option.
- **Substitution, Assumption and Modification of Statutory Options.** Modification (defined as any change that provides the optionee additional benefits under the option), extension or renewal of an option is treated as the grant of a new option. There is an exception for substitutions and assumptions of options in connection with certain corporate transactions, if special rules are satisfied. The final regulations provide that an outstanding option is not treated as substituted or assumed in connection with a stock dividend or stock split that merely changes the number of outstanding shares of the corporation. In such a case, the exercise price of an outstanding option may be proportionally adjusted, and the adjustment is not considered a modification of the option, nor a substitution or assumption in connection with a corporate transaction (and therefore need not satisfy the special rules).

The final regulations also provide that an option will not be deemed to be modified, if the corporation exercises discretion with respect to certain rights that are specifically reserved under the option at the time of grant. The proposed regulations permit discretion with respect to the payment of bonuses at the time of exercise, the availability of a loan at exercise, or the right to tender previously-owned stock. The final regulations add to the list of specifically reserved discretion the payment of employment and withholding taxes.

Finally, an inadvertent change to a statutory option will not be treated as a modification under the final regulations if the change is reversed by the earlier of the date the option is exercised or the last day in the calendar year in which the change occurred.

Compliance in 2005 May Be Required

The final regulations are effective August 3, 2004. However, special transition and reliance rules apply:

- For statutory options granted on or before June 9, 2003, taxpayers may rely on the 1984 proposed regulations, the 2003 proposed regulations or the final regulations until the earlier of January 1, 2006 or the first regularly scheduled stockholders meeting that occurs 6 months after August 3, 2004.
- For statutory options granted after June 9, 2003, taxpayers may rely on the 2003 proposed regulations or the final regulations until the earlier of the dates specified above.
- Reliance on the 1984 or 2003 proposed regulations, or the 2004 final regulations, must be in its entirety (i.e., compliance with some parts of one regulation and some of another is not permitted). All options granted during the reliance period must be treated consistently.

If you have any questions about ISOs, ESPPs or the final regulations, please contact any of the following members of our Employee Benefits Law Practice Group:

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