

IRS Issues Final Regulations Regarding Holding Periods and Reporting Requirements for ESPPs

On November 17, 2009, the Internal Revenue Service issued final regulations under Section 423 of the Internal Revenue Code of 1986 (the “Code”) governing employee stock purchase plans (“ESPPs”). The regulations had two principal consequences that can affect both employers and employees.

Holding Period

To receive capital gains treatment for options awarded under an ESPP, an employee must hold the stock received on exercise for the longer of (a) two years from the date of grant, or (b) one year from the date of exercise. The regulations provide that an option will be treated as granted only when the maximum number of shares that may be purchased by each employee is either (a) fixed or (b) may be determined by a formula. If the maximum number of shares is not fixed or determinable until the option is exercised, the exercise date will also be the grant date. The practical effect of this for many plans (which do not specify a maximum) will be that employees will have to hold shares for two years following exercise or be taxed at ordinary income rates on an earlier disposition.

For example, if an ESPP provides that each employee/participant may purchase a maximum of 1000 shares at the lesser of 85% of the stock’s fair market value on the first or last day of an offering, the option is treated as granted on the first day of the offering (because the maximum number of shares is fixed at that time). Thus, the employee would be entitled to capital gains treatment if he disposed of the shares one year following exercise. Conversely, if the plan did not provide the 1000-share maximum, the grant date would be the last day of the offering (*i.e.*, the exercise date), and the employee would have to hold the shares for an additional year.

New Reporting Requirements

The regulations require employers to file a return with the IRS when an employee transfers stock received under a discounted ESPP to a third party for the first time (not when the employer transfers the stock to the employee). The new requirement will not take effect until 2010, so the first report will not have to be filed until 2011. Many ESPPs provide for an automatic (or elective) transfer of shares to a broker when an option is exercised. This will constitute a transfer for purposes of the reporting requirement, even if the shares are not disposed of at that time.

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