

2010 Reporting Obligations of Companies with ISO or ESPP Arrangements

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Companies with employee exercises of either ISO or ESPP awards during 2010 will be subject to a new IRS tax reporting obligation. The requirements are substantially different than for IRS Form W-2, however, many of the vendors and consultants that specialize in the administration and record-keeping for stock plans can provide assistance.

Companies with incentive stock option (ISO) or employee stock purchase plan (ESPP) arrangements will be subject to new tax reporting obligations for the first time in 2010. These obligations include both an information return filing to be made with the IRS and a more comprehensive employee information statement if an employee has either exercised ISOs or transferred the legal title to shares of stock in connection with exercising the option of an ESPP arrangement (including the transfer to a broker or financial institution).

The IRS Information Return Requirement

On November 5, 2010, the Internal Revenue Service (IRS) released the long-awaited final Form 3921, Exercise of Incentive Stock Option under Section 422(b), and Form 3922, Transfer of Stock Acquired Through an Employee Stock Purchase Plan under Section 423(c). Beginning with ISO exercises and ESPP transfers occurring in 2010, companies will have to file these information returns with the IRS *by February 28, 2011*, for paper filings, or *March 31, 2011*, for electronic submissions (most cases).

The general rules for information returns, which also apply to Forms 3921 and 3922, require a company to file its information returns electronically with the IRS if it has to file 250 or more. However, this electronic requirement applies separately to each type of information return or IRS Form. Thus, if a company had more than 500 ESPP transactions, but only 30 ISO exercises for 2010, the company would be required to file Form 3922 with the IRS electronically, but could *choose* whether to file Form 3921 with the IRS electronically or on paper. Many employers may choose to file electronically for 2010 simply to take advantage of the later filing deadline.

It bears noting that only one transaction can be reported per Form 3921 or 3922. Thus, if an employee completes two ISO exercises during 2010, the company would be required to file two Forms 3921.

Compliance Deadline for Filing Information Returns with the IRS

For those companies filing electronically, the Forms 3921 and 3922 reporting 2010 ISO and ESPP exercises must be submitted to the IRS by March 31, 2011. The deadline for filing with the IRS on paper Forms 3921 and 3922 is February 28, 2011.

Many companies may struggle with the transition for the first year of complying with this new information requirement. Companies may request an automatic 30-day extension of time for filing Forms 3921 and 3922 by filing IRS Form 8809, Application for Automatic Extension of Time to File Information Returns, with the IRS on or before the regular filing deadline. (If necessary, an additional 30-day extension may be granted at the discretion of the IRS.)

Separate Information Statement Required to be Provided to Employees

In addition to the IRS filing, companies are required to provide an information statement to affected employees by January 31, 2011. The information statement has been required under IRC Section 6039 since the early 1980s, but remained dormant for many years until final regulations were issued in 2004. The regulations provided a lengthy transition period which, in most cases, first applied to the exercise of ISOs or the transfer of ESPP shares in connection with statutory options which had been granted after January 1, 2006.

With the introduction of the information return requirement, the IRS has also imposed specifications on the information statement requirement as well. Most employers are likely to issue the information statements in paper form, even if the information returns are filed electronically, simply because the requirements for electronic information statements are so demanding. For example, the company is required to obtain advance consent to provide the statement electronically to employees. Employees are permitted to withdraw their consent and request a paper copy at any time. (IRS Publication 1179, General Rules and Specifications for Substitute Forms 1096, 1098, 1099, 5498, W-2G and 1042-S.)

The final regulations require companies to provide a copy of the actual Forms 3921 or 3922 that are filed with the IRS as information statements to employees. Many companies may choose to supplement these forms with additional explanatory documents or reports which would be helpful to employees. However, until the IRS guidance for substitute information statements provided in IRS Publication 1179 is updated to specifically include Forms 3921 and 3922, there are many unresolved questions regarding the content and format for a substitute statement. In particular, it is unclear whether companies will be permitted to include additional information which would be helpful to employees, but is not *required* under the final regulations, such as the price and value of the shares.

Practical Considerations: Complying with the IRS Information Return Requirement

Who can help with filing these information returns within your company?

In many cases, your company's payroll department may not be able to assist with the filing of Forms 3921 and 3922. This is because employment tax returns (*i.e.*, IRS Form W-2) are filed with the Social Security Administration (SSA), rather than the IRS. Forms 3921 and 3922 are required to be filed directly with the IRS and are subject to a completely different set of specifications, whether filing on paper (if eligible) or via the IRS "FIRE" (Filing Information Returns Electronically) system.

Thus, for companies considering doing this filing themselves, the department most likely to have had experience using the IRS FIRE system would be your company's accounts payable department, which may already file the company's Form 1099 electronically.

Which third-party service providers can help with these information returns?

As noted above, both the specifications for Forms 3921 and 3922 and the IRS FIRE system used for electronic submission are very different from the specifications and system for submitting payroll tax returns. Third-party payroll services and vendors offering electronic filing services for Form 1099 and other information returns are not currently offering assistance in complying with these requirements. However, many of the vendors and consultants that specialize in the administration and record-keeping for stock plans offer a wide range of solutions from software and support to assist with in-house administration, to comprehensive outsourcing for the filing of both the IRS information returns and the employee information statements.

In many cases, third-party vendors will be filing an information return using a conforming substitute for IRS Forms 3921 and 3922. We suspect this may be the result of both the late issuance of the final forms and an effort to mirror a more helpful format for the information statements to be provided to employees.

Potential Exposure for Failure to Meet Information Return Filing Requirements

Companies may potentially be subject to information return penalties of \$50.00 per return, either for reporting erroneous amounts or failure to meet the March 31, 2011, IRS filing deadline (February 28 for paper forms). (IRC §§6721; 6723.) Companies may also be subject to a separate penalty of \$50 per return for the failure to file Forms 3921 and 3922 electronically if they were required to do so (due to filing more than 250 of each form). Treas. Reg. §§ 301.6011-2(f); 301.6721-1(a)(2)(ii).

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