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MANAGEMENT ALERT

June 2003

Statutory Option Regulations Give Welcome Clarification

The Internal Revenue Service (IRS) has issued Proposed Regulations governing statutory options. Although "statutory options" include both Incentive Stock Options (ISOs) and Section 423 (Employee Stock Purchase Plan) Options, the main coverage of the Proposed Regulations is ISOs.

These Proposed Regulations withdraw and replace regulations proposed in 1984. The new Proposed Regulations are intended to provide a comprehensive framework that incorporates much of the 1984 effort with additional guidance under Sections 421 and 424 of the Internal Revenue Code (Code).

Updates

A few of the provisions of the Proposed Regulations reflect a modernization of the rules, in light of law changes or compensation planning trends:

- The Proposed Regulations make it clear that a plan or option agreement in electronic form will satisfy the Code's documentation requirements if the electronic form is enforceable under applicable law.
- The Proposed Regulations make it clear that a "corporation" (which an entity must be in order to grant statutory options) will include an LLC that is taxable as a corporation.
- Despite the prohibition on lifetime transfers of statutory options under the Code, the Proposed Regulations provide that an option may be pledged, or may be transferred to a trust if the grantee remains the sole beneficial owner of the trust. However, if a statutory option is transferred in a divorce, it will cease to constitute a statutory option.

Incentive Stock Options

Most of the rules relating to ISOs were apparent in the language of the statute, or were clarified by the IRS in the past.

- Although it is required that an ISO plan specify the classes of employees eligible to receive option grants, a designation of "all employees" suffices.
- The statutory requirement that the number of shares authorized for issuance be specified in the plan permits use of a number or a formula. However, the formula must make it possible to determine the actual number authorized from time to time, at the time the plan is adopted. Thus, it is sufficient for a plan to specify that the authorized shares will be equal to an increasing percentage of the number of outstanding shares on the effective date of the plan. It would not be permissible, though, to specify that the authorized number is the percentage of outstanding shares as in effect at the beginning of each year (a so-called "evergreen" provision). The Proposed Regulations also make it clear that recapture provisions (which reuse shares that were subject to grants that expired) are permissible.
- Shareholders must approve the above aspects of the plan (i.e., eligible recipients and number of shares) and any changes to those elements. The Proposed Regulations also make it clear that any changes in the type of the stock offered under the plan must be approved by shareholders.
- As in the past, any reasonable determination of value may be used for purposes of pricing an ISO. The Proposed Regulations also contain the statutory rule that provides that, even if it turns out that the value determined in good faith is less than the fair market value (so that the grant is priced below fair market value), the grant will not be disqualified as an ISO. However, this special "good faith" rule does not apply in the case of a grant to a 10% shareholder; there, the variance from fair market value will disqualify the option if the 105% minimum option price rule is violated.
- The Proposed Regulations clarify application of the $100,000 annual limit, which states the maximum amount of ISOs that may first become exercisable each calendar year. Previously, the IRS's thinking in this regard was included in a Revenue Ruling that provided that if the $100,000 limit is exceeded in any year, the first-granted options will retain the ISO character until the $100,000 limit is met. The Proposed Regulations provide for an exception to this ordering rule for an option that becomes exercisable in a year by virtue of an acceleration provision

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(such as one that accelerates exercisability as a result of performance or due to a change in control). An accelerated option will not be considered exercisable in that year until the acceleration event occurs. Once it does occur, its nature will be determined under the ordering rule, except that any ISO that became exercisable and was actually exercised prior to the acceleration will be treated as if it had been granted before the accelerating option (even if it was granted after the accelerating option).

- As provided in the Code, the Proposed Regulations provide that the special disqualifying disposition tax treatment rule (which calculates taxable income at the lesser of exercise date spread and disposition date spread) will only apply if the disposition is one in which a loss, if sustained, would be recognized for tax purposes. The example in the Proposed Regulations involves an individual's purchase of the same shares a short time after the disqualifying disposition occurs (a wash sale, for which deductions are generally not recognized). The same result would follow if the disqualifying disposition were a gift. In either case, the exercise date value is used, even if it produces a higher income amount.

Other Statutory Option Rules

Although several of these rules are covered in the Proposed Regulations, the most significant deal with the substitution of options in corporate transactions (which are treated as not being "modifications" and therefore are not new grants of statutory options requiring current compliance with the option pricing rules).

Two significant changes were made in the Proposed Regulations. The first is the elimination of the requirement that the transaction must result in a significant number of employees being transferred or discharged or the creation or breaking up of a parent-subsidiary relationship. The second change is an attempt to create a new rule to take the place of that eliminated requirement. Under the new rule, the substitution by an "eligible corporation" in a "corporate transaction" will not be a modification as long as the substitution is "by reason of" the transaction. The connection will be presumed unless there is an unreasonable delay in substituting the option or there is no business purpose for the transaction.

Effective Date

The Proposed Regulations will be effective for options granted 180 days after publication of the final regulations. The Proposed Regulations may be relied upon for options granted after June 9, 2003 (the date the Proposed Regulations were published in the Federal Register). Comments are due in August and there is a public hearing scheduled for September 2, 2003.

It has been more than 20 years since Congress adopted then Section 422A, to establish ISOs as a vehicle to compensate and provide incentives to employees. Executive compensation professionals and their advisors should find the Regulations to be helpful in resolving many of the issues that arise in plan design and operation.

If you have any questions about statutory options and option plans, please contact the Seyfarth Shaw Employee Benefits Group attorney with whom you work or any employee benefits attorney listed on the website at www.seyfarth.com.

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