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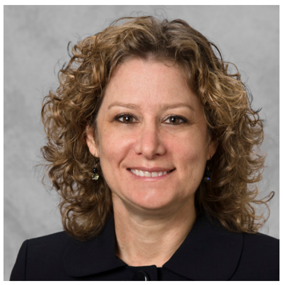
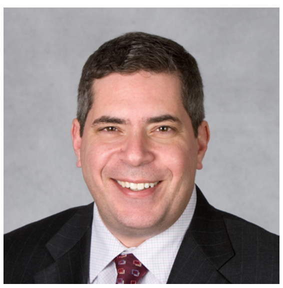
Two New Reporting Requirements Confront Employers in 2011 - Section 6039 Information Returns and Cost Basis Reporting



Lori A. Basilico, Partner



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New Information Returns For ISOs And ESPPs Due In 2011

Beginning in January 2011, employers must begin providing detailed transaction information to employees who have exercised incentive stock options (ISOs) or transferred shares purchased under employee stock purchase plans (ESPPs) during 2010. They must also file the same information with the IRS.[1] Although employers have been providing this information to employees who exercised ISOs or bought shares under an ESPP since 2005, the IRS waived the requirement to file it with the IRS for all years through 2009, so the requirements will first apply to ISO exercises and transfers of ESPP shares occurring during 2010. The information contained in these information returns should ensure that employees will have sufficient information to calculate their tax liability with respect to the disposition of shares acquired under an ISO or ESPP.

The IRS developed new forms -- IRS Form 3921 to report ISO transactions and IRS Form 3922 to report ESPP transactions -- to satisfy these new reporting requirements under Section 6039 of the Internal Revenue Code. Employers must furnish these forms to employees no later than January 31, 2011. The deadline for filing the forms with the IRS is February 28, 2011 for paper filers and March 31, 2011 for electronic filers.[2] Click here[3] for a copy of IRS Forms 3921 and 3922.

The new reporting requirements apply when the employer (i) issues shares to an employee upon the exercise of an ISO or (ii) transfers legal title of shares of stock acquired at a discount by an employee under an ESPP. For ESPP purposes, "a transfer of legal title" occurs when the stock acquired under the ESPP is transferred to a third party. For example, if the employer immediately deposits the shares acquired by an employee under an ESPP into a brokerage account established on behalf of the employee, a transfer of legal title has occurred and the employer will be required to file an information return for that year (even though a real sale has not occurred). In this example, the employer is not required to file a new Form 3922 when those shares are ultimately sold. By contrast, if the employer either issues a stock certificate directly to the employee or registers the stock in the employee's name on the employer's record book and the employer or its transfer agent holds the stock in book entry form, no transfer of legal tile has occurred at that time. No return would need to be filed until the employee later transfers the shares either into a brokerage account or to a third party. No report is required if the purchase price of the ESPP shares is at least equal to 100% of the grant price, unless the purchase price is not fixed or determinable at the date of grant (for example, if the purchase price could be based on a discount from the price at the end of the purchase period). Further, the new Section 6039 reporting rules do *not* replace the existing rules requiring an employer to report compensation income from ISOs and ESPPs on Form W-2.

[1] Section 6039 of the Internal Revenue Code of 1986.

[2] Electronic filing of Forms 3921 and 3922 is required if an employer files 250 or more information returns. The 250-or-more requirement applies separately to each form.

[3] www.irs.gov/pub/irs-pdf/f3921.pdf; www.irs.gov/pub/irs-pdf/f3922.pdf

New Cost Basis Reporting Requirements

A sleeper is about to confront holders of compensatory equity awards and their plan administrators starting in 2011 – cost basis reporting. Employers should begin preparing now to educate employees in order to avoid tax reporting problems.

Brokers will begin cost basis reporting in 2011 for stock acquired after December 31, 2010. They will provide sellers, and file with the IRS, a Form 1099-B that will not only report gross proceeds from a sale of equity securities, but also report the cost basis of the sold shares. Unfortunately, the reported cost basis for compensatory awards may be inaccurate.

The general principle behind cost basis reporting is a good one -- to help investors calculate their gain and/or loss on the shares sold into the market. Unfortunately, in the context of employees holding shares acquired under compensatory plans, such as shares acquired through the exercise of stock options, stock-settled SARs, restricted stock or other equity awards and purchases of shares under an employee stock purchase plan (ESPP), the Form 1099-B may be anything but helpful. In fact, head scratching should be expected since the Form 1099-B may exclude the taxable "compensatory" element of any shares acquired from an employer – which is, of course, part of the employee's cost basis for the shares. Cash paid by an employee to exercise an option or purchase shares will be included in the reported cost basis, but the income recognized on that acquisition transaction may not.

In the starkest example, assume the grant of a compensatory grant of a share of an employer stock with a fair market value of $100, resulting in $100 of taxable income to the employee at grant. When the employee later sells the share into the market for $200, the broker may report on Form 1099-B a cost basis of $0 and a gain of $200 (as opposed to the correct $100). The employee will need to understand this problem in order to report the correct cost basis and income on his or her tax return. And the problem may not end there since the conflict between the Form 1099-B and the employee's tax return may possibly increase the risk of audit.

Additional reporting requirements become effective in 2013 that will correct the problem, but hopefully, these issues will be timely addressed by the IRS soon. In the meantime, what can the Plan Administrator do?

- First, the Plan Administrator should consider whether employees should be warned of this issue when they receive compensatory equity awards. In any event, the Plan Administrator will want to prepare for and be available for inquiries from employees looking for advice on completing their individual tax returns.
- Second, brokers are permitted to include the compensatory element of a stock acquisition in the cost basis numbers. The Plan Administrator should promptly address the issue with any broker that is used to administer the employer's equity plan or is regularly used by plan participants.
- At a minimum, the Plan Administrators should begin to formulate an explanation of the potential inconsistencies in cost basis, and explore upgrading record-keeping services with their participating brokers and the employer's transfer agent.

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