



FENWICK & WEST LLP

Corporate and Securities Law Update

Final Regulations on ISOs and ESPPs

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On August 2, 2004 the IRS published final regulations (the “Final Regulations”) on incentive stock options under Section 422 of the Internal Revenue Code (the “Code”) and purchase rights under 423 of the Code (“ISO” and “ESPP Right” respectively, and “SSOs” collectively). The IRS previously had published proposed regulations on June 3, 2003 (the “Proposed Regulations”). The IRS also published proposed ISO regulations in 1984 (the “1984 Regulations”). The Final Regulations largely reaffirm the Proposed Regulations. Significant aspects of the Final Regulations are covered below.

No Shareholder Approval re Assumption of ISOs in Corporate Transactions

The Final Regulations clarify that shareholder approval will not be required where an acquiring company assumes or substitutes ISOs for previously granted target ISOs that are outstanding at the time of the corporate transaction. The Proposed Regulations had required that the “new” option in the corporate transaction be assumed or substituted for under a plan approved by the stockholders of the corporation substituting or assuming the option.

Plan Documents need only state ISO Limits

The Final Regulations do not require the plan from which ISOs are granted to include the maximum number of shares that may be issued pursuant to nonstatutory stock options or other stock-based awards. Thus, the Final Regulations clarify that the plan must designate only the maximum aggregate number of shares that may be issued under the plan as ISOs.

No Protective 83(b) Elections

Prior to the Proposed Regulations, it was unclear whether the Service would consider valid an election made under Section 83(b) of the Code with respect to unvested ISO shares to limit the recognition of ordinary income for a disqualifying disposition of such ISO shares. The Proposed Regulations did not permit such election. The Final Regulations now confirm that the Service’s position is that

an 83(b) election covering unvested ISO shares is only applicable to the timing of the calculation of the taxpayer’s alternative minimum tax liability.

Annual Notice under Section 6039 of the Code

Section 6039 of the Code requires each issuer of shares purchased pursuant to exercise of either an ISO, or an ESPP Right in which the purchase price can be between 85% and 100% of the stock’s fair market value, to provide purchasers of such shares with certain information regarding those shares. The IRS has thus confirmed its previous position that these notices must be provided. The deadline for furnishing such information is the first January 31 following (i) the calendar year in which the purchase occurs (in the case of shares issued under an ISO) or (ii) the first transfer of legal title of each share purchased under an ESPP Right. The Final Regulations now permit furnishing these statements in electronic form.

The significant development here is with respect to ESPP Rights. Code Sec. 6039 requires that for each share purchased under an ESPP Right the notice relates to the first transfer of legal title of such share. In nearly all cases this notice will relate to the placing of legal title in the name of the brokerage firm that assists the issuer in administering its employee stock purchase plan. Some issuers, however, may still permit participants to have certificates issued directly to them. Issuers who allow the direct issuance of shares to participants should eliminate this practice, unless they wish to arrange with their transfer agent a means to identify these shares and track when legal title of each share is transferred to someone else.

Effective Date and Transitional Reliance

The Final Regulations take exclusive effect on January 1, 2006. Until then, certain transition rules apply. The table below summarizes which SSOs are eligible for continuing reliance on the Proposed Regulations or the 1984 Regulations. The period for continuing reliance only extends

to the earlier of (1) the first regularly-scheduled stockholders meeting occurring six (6) months after August 3, 2004, and (2) January 1, 2006.

Grant Date Category	1984 Regs	Proposed Regs	Final Regs
SSOs granted prior to June 10, 2003	X	X	X
SSOs granted after June 9, 2003 and prior to the earlier of (1) the first regularly-scheduled stockholders meeting occurring six (6) months after August 3, 2004, and (2) January 1, 2006		X	X
SSOs granted after the earlier of (1) the first regularly-scheduled stockholders meeting occurring six (6) months after August 3, 2004, and (2) January 1, 2006			X

The Final Regulations specify, however, that reliance on a given set of regulations must be in their entirety and with respect to all SSOs in a given grant date category.

Note on Withholding of Federal Employment Taxes and Further Review on ESPP Rights

For the past several years, the IRS has been preparing to require withholding of federal employment taxes on the exercise (including disqualifying dispositions) of ISOs and ESPP Rights (the states generally follow federal practice). Recently, Congress passed legislation (H.R. 4520/S. 1637 – The Jump-start Our Business Strength (JOBS) Act) that may exempt from federal employment tax withholding on the exercise of ISOs and ESPP Rights (including disqualifying dispositions). Meantime, the IRS moratorium on such withholding remains in effect.

The IRS is also preparing to review its regulations regarding ESPP Rights in the areas of (1) participation by highly-compensated employees and employees outside the U.S.A., and (2) correction methods for inadvertent exclusion of employees.

We will provide more information on these developments as they take shape.

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