

Frederic W. Cook & Co., Inc.

New York • Chicago • Los Angeles

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**IRS PROPOSES NEW REGULATIONS
FOR INCENTIVE STOCK OPTIONS AND
EMPLOYEE STOCK PURCHASE PLANS**

On June 9, 2003, the Internal Revenue Service (“IRS”) issued its proposed regulations¹ relating to the treatment of incentive stock options (“ISOs”) and options granted under employee stock purchase plans (“ESPPs”) that update, reorganize, and replace the regulations under Internal Revenue Code Sections 421 through 424.

Highlights of Proposed Regulations

The IRS proposed regulations on the treatment of ISOs and options granted under ESPPs that are largely the same as the previous rules; however, this new proposal does provide additional guidance and clarification by adding new provisions and incorporating previously existing interim guidance. The new rules (i) specify that ISOs may only be granted from a plan that states the maximum number of shares that may be granted for all stock-based awards under the plan, (ii) modify the definition of corporate transaction and specify that ISOs assumed in a corporate transaction must be granted by the buyer from a plan that satisfies the ISO requirements, (iii) clarify the types of corporations that may grant ISOs, (iv) provide that ISOs may be transferred to certain grantor trusts, (v) expand upon previous guidance relating to the \$100,000 limitation, and (vi) permit certain discretionary actions, such as stock-for-stock exercise or loans extended at the time of exercise, if such discretion is provided for at the time of grant.

This letter serves as a summary of the relevant changes of the proposal and is not intended to be a comprehensive overview of the regulations. The following are significant changes:

1. ISOs Must Be Granted From a Plan where the Maximum Number of All Stock-Based Awards Permitted Under the Plan is Specified

The proposed regulations specify that the aggregate number of shares that may be granted pursuant to all types of options and other stock-based awards must be specified in the plan from which ISOs are granted. For example, a plan that specifies the number of ISOs

¹ REG-12917-02

that may be granted, but does not specify the number of shares that may be granted as both ISOs and non-qualified stock options does not meet the requirements of the regulations.

ISOs may be granted from plans that provide for an increase in the number of shares each year over the life of the plan (i.e., evergreen) if the basis for determining the number of shares added is as of the effective date of the plan. For example, if a plan authorizes 2% of the common shares outstanding on the effective date of the plan, ISOs may be granted under the plan. If a plan allows the calculation to be based on shares outstanding on future dates, the plan does not meet the requirements.

Further, plans that allow option exercise proceeds to add shares back to the pool will not be permitted to grant ISOs due to the uncertainty in the number of shares that may be added back in the future (i.e., the number of shares that may be issued under the plan is not fixed at the time of adoption).

2. *Definition of Corporate Transaction Expanded and Deemed Modifications to an ISO in a Transaction Specified*

The new regulations remove the condition that a significant number of employees be terminated or transferred to the new employer to be considered a corporate transaction. This is meaningful in that ISOs modified in connection with a corporate transaction will not be treated as such (assuming specified certain requirements are met) and will retain their tax favorable status. Generally, if a modification is made to an ISO absent a transaction, the option is no longer eligible for favorable tax treatment.

The proposal also provides that ISOs assumed by a buyer within the context of a corporate transaction must be granted from a plan that meets the requirements for granting ISOs or such ISOs will be deemed modified.

3. *Clarification of Certain Definitions*

Code Section 421 specifies that special tax treatment only applies to options to purchase stock of a corporation; however, the proposed regulations clarify that options can be issued on stock of C Corporations, S Corporations, foreign corporations and limited liability companies that have elected to be treated as corporations for federal income tax purposes. In addition, warrants are also included if they meet the specific requirements of the proposal. Finally, option grants qualifying for special tax treatment must be evidenced in writing, which includes either paper or electronic forms.

4. *Clarification in the Deemed Adoption Date of the Plan*

The proposal requires that ISOs must be granted from a plan that is approved by shareholders within 12 months before or after the date the plan is adopted, with the date of adoption typically being the date the plan is approved by the Board. The proposal, however, adds that ISOs granted under a plan that was adopted by the Board subject to

shareholder approval will be adopted on the date the plan is approved by shareholders. In this instance, the shareholder approval of the plan could occur more than 12 months after Board approval because the Board stipulated a condition for adoption, and the deemed adoption date under the proposal is when that condition is satisfied. This requirement, however, is not included in the rules related to employee stock purchase plans.

5. *Clarification of Option Transferability*

The proposed regulations allow ISOs to be transferred to a grantor trust as long as the employee is the sole beneficial owner of the option while held in the trust under applicable law. ISOs transferred to a former spouse as a result of a divorce will be disqualified.

6. *\$100,000 Limitation Incorporated Into the Rules and Expanded Upon*

The proposed regulations now incorporate the current limitation that does not permit options on stock having a fair market value of more than \$100,000 to vest in any one year, whereas previous guidance for this limitation was provided in Notice 87-49. The proposal also clarifies the following:

- Generally, ISOs will count toward the \$100,000 annual limitation in the order they were granted. However, if vesting is subject to acceleration (e.g., due to a performance condition or in the event of a change in control), these options will be subject to the \$100,000 limitation in the year in which the acceleration occurs (irrespective of when they were granted). If the \$100,000 limitation was already met prior to the date acceleration, these options will be disqualified.
- If options are modified, transferred, or cancelled and, as a result, are disqualified from special tax treatment, they will not be included when determining whether the \$100,000 limit is exceeded as long as the disqualification occurs prior to the year in which the options vest. In all other situations, the options will be treated as outstanding until the end of the year in which they were first exercisable.
 - For example, disqualifying dispositions have no effect on the \$100,000 limitation (i.e., if \$100,000 of ISOs vest and are exercised and sold immediately, and future ISO shares that vest in the year will be disqualified)

7. *Not a Modification if Employer Retains Discretion to Allow Stock-For-Stock Exercise or Extend a Loan at Exercise*

If an option initially provides for a discretionary action at the time of grant such as stock-for-stock payment of the exercise price or the extension of a loan upon exercise of the ISO, that discretionary action will not be treated as a modification and the tax qualified status of the ISO will be preserved. Using discretion where not initially provided at the time of grant will disqualify the option.

Effective Date

The new regulations will go into effect 180 days after the publication of the final rules in the Federal Register and will apply to ISOs and options under ESPPs granted after that date. Since the issuance of this proposal replaces that which was proposed in 1984, taxpayers may rely on these proposed regulations for such options granted after June 9, 2003.

Comments Requested

Written or electronic comments as well as requests to speak at the public hearing currently scheduled for September 2, 2003 must be received by August 12, 2003. Submissions should be sent to CC:PA:RU (REG-122917-02), room 5226, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044, or may be sent electronically via the IRS internet site, <http://www.irs.gov/regs>.

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Questions on this letter may be addressed to Michael Chavira in the Los Angeles Office (310) 277-5070. Copies of this letter and other published materials are available on our web site, <http://www.fwcook.com/>.