

Employee Communications to Accompany Form 3922

For the first time, in January 2011, employees who participate in the company ESPP will receive an official IRS Tax Form (Form 3922) (or acceptable substitute) that looks a lot like a Form W-2 or 1099.

Should companies be concerned that employees may be confused or not know what to do with this form?

Premises:

1. Taxation of sale of ESPP shares is complicated and confusing
2. Employees receiving Form 3922 on January 31, 2011 won't have a clue what to do with it or how it impacts their tax return
3. Many employees will overreport income on sale of ESPP shares

Conclusion: Companies should include a communication piece to explain the purpose and use of Form 3922 and how it, along with Forms W-2 and 1099B, can be used to properly report the sale of ESPP shares on the employee's personal tax return (Schedule D, Form 1040).

To properly communicate, the company must first determine whether it reports ordinary income on (1) disqualifying dispositions and (2) qualifying dispositions.

For an employee to properly report the ordinary income and capital gain on a disposition of ESPP shares, the company needs to tell the employee whether it is reporting the ordinary income on Form W-2. (Most companies attempt to do this for disqualifying dispositions; most don't for qualifying dispositions despite a likely requirement to do so, or to make a reasonable attempt to do so). This item is not separately identified on Form W-2, so an employee won't know unless he/she is told what the company's procedure is.

Next, the company needs to understand in detail the tax treatment of ESPP sales under its particular plan design, the proper reporting on Forms W-2, 3922 and 1099B, and how an employee needs to complete Schedule D on Form 1040. In other words, if the drafter of the communication does not understand this, it will not be properly communicated.

So, what should the communication cover?

1. Examples of sales of ESPP shares using the actual purchase price and relevant values for the year (usually, FMV at beginning and end of each purchase period), with assumed sale dates and prices to illustrate both disqualifying and qualifying dispositions and sales at varying prices to illustrate the quirky rules (e.g., the possibility of having both ordinary income and capital loss on a disqualifying disposition, the limitation of ordinary income to actual gain in a

qualifying disposition, the quirky result where there is more ordinary income from a qualifying disposition than a disqualifying disposition if share price has dropped between the beginning of purchase period and purchase date, even in a plan with no lookback but only a purchase date discount).

2. Indicate how, in the examples, Form 3922 and 1099B can be used to properly report the gain on Schedule D of Form 1040, and the ordinary income on line 7 of Form 1040 if it was not included by the company on Form W-2 for the year of sale. (As noted, for most companies, this will depend on whether this is a qualifying or disqualifying disposition.) If the company's broker on the 1099Bs reports gross proceeds rather than proceeds net of commissions, the company should provide information regarding the amount of the commissions (which affects the gain reportable on Scheduled D).

Another key thing to communicate is how to read the terminology on Form 3922. That form uses "option", "grant of option" and "exercise" of option while participants would more likely understand, "purchase right", "purchase of shares", and "purchase price of shares".

A Final Point:

Any communications containing what might be considered as tax advice should contain an appropriate disclaimer:

1. Not intended as tax advice specific to employee's particular situation
2. Not all nuances that may effect taxes are discussed, e.g., wash sales, identification of shares, impact of stock splits, etc.
3. Tax laws change frequently and may change before employee files any relevant tax return
4. See your tax advisor for specific advice