

IT'S A TAX FACT: QUALIFYING DISPOSITIONS OF ESPP STOCK



If your company offers a qualified ESPP, you are responsible for tracking and reporting all qualified dispositions, even from former employees

Sharpen those pencils and gather those forms. Tax season is near, but before you begin preparing those tax documents for mailing, read on for important information regarding the tax reporting requirements for qualifying dispositions of shares purchased under a Section 423(b) employee stock purchase plan (ESPP).

What is a qualifying disposition?

How long a person owns their ESPP shares determines how the sale is categorized—either as a qualifying or disqualifying disposition, and how the transaction is categorized determines how the income is taxed. Under Section 423(b), when a participant sells their ESPP shares after two years from the date of grant (offering date) and one year from purchase date, it is categorized as a qualifying disposition for tax purposes and the income is calculated as the lesser of:

- > The sales price minus the discounted purchase price (but not less than zero), or
- > The fair market value of the stock at the beginning of the offering period x the discount % offered

This calculation has to be performed for each separate purchase lot of the shares sold.

What's the issue?

Year after year, one of the top questions we are asked is whether the company that maintains the plan is required to track and report qualifying dispositions of ESPP shares for current and former employees. There is a common misconception that companies who manage these plans do not need to track and subsequently report, for both current and former employees, the compensation income from ESPP shares in a qualifying disposition at the time of sale on a Form W-2. But that is not the case.

The rules

The general rule (see an excerpt from [IRS Publication 15-B](#) below) is that if shares purchased under an ESPP are held long enough to avoid a disqualifying disposition, the company offering the plan is required to report the compensation income recognized at the time of the sale on a Form W-2 for both current and former employees.

From IRS Publication 15-B

There are three kinds of stock options—incentive stock options, employee stock purchase plan options, and nonstatutory (nonqualified) stock options.

Wages for social security, Medicare, and FUTA taxes don't include remuneration resulting from the exercise of an incentive stock option or an employee stock purchase plan option, or from any disposition of stock acquired by exercising such an option.

Additionally, federal income tax withholding isn't required on the income resulting from a disqualifying disposition of stock acquired by the exercise of an incentive stock option or an employee stock purchase plan option, or on income equal to the discount portion of stock acquired by the exercise, after October 22, 2004, of an employee stock purchase plan option resulting from any qualifying disposition of the stock. The employer must report as income in box 1 of Form W-2 (a) the discount portion of stock acquired by the exercise of an employee stock purchase plan option upon a qualifying disposition of the stock, and (b) the spread (between the exercise price and the fair market value of the stock at the time of exercise) upon a disqualifying disposition of stock acquired by the exercise of an incentive stock option or an employee stock purchase plan option.

Further, federal income tax withholding is not required on any income recognized resulting from a qualifying disposition of ESPP stock nor is the company entitled to a tax deduction for the resulting disposition where the holding period requirement has been satisfied.

Tracking qualifying dispositions

Companies should make reasonable efforts to track qualifying dispositions for both current and former employees. So, even where the employee left the company years ago, the company that maintains the plan is required to make reasonable efforts to obtain information about any qualifying dispositions of ESPP shares purchased while an employee of the company.

From requiring the shares to be held with a company-designated broker or imposing transfer restrictions on the shares until sale to surveying former employees at their last address of record, companies use a number of different methods to track qualifying dispositions and ensure disposition tracking compliance. Computershare can help with this.

Reporting qualifying dispositions for former employees

Companies have varying ways in which they manage the Form W-2 reporting requirements for participants who purchased ESPP shares while an employee of the company, but are no longer employed with the company at the time of the qualifying disposition. Some keep all former employees in the payroll system until there is a reporting requirement, reactivate them and produce the required Form W-2 at the appropriate time. Others choose to add the participant back into the payroll system or manually produce a Form W-2 at the time of sale.

Penalties for non-compliance

There are penalties for non-compliance with IRS Publication 15-B, which can be significant, particularly where the company is aware of the reporting obligations and intentionally disregards them.

Tax reporting is complicated but every company has to do it. Listen to our recent webcast on year-end reporting for more on this important and timely topic.

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