Advisory

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# Final Regulations Issued for Employee Stock Purchase Plans

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*Employers that offer their employees an opportunity to purchase company stock under an employee stock purchase plan ("ESPP") (as defined in Section 423 of the Internal Revenue Code of 1986, as amended (the "Code")) should review their ESPPs for compliance with newly released final regulations to ensure that shares issued under the plan remain eligible for favorable tax treatment and to consider the options available for new offerings under the ESPP.*

## Background

The sale of employer stock through an option granted under an ESPP is treated as a qualifying transfer under the Code, resulting in special tax treatment. No taxable event takes place at the time of purchase, and a portion of any gain realized upon the participant's subsequent "qualifying disposition" of such shares may be characterized as capital gain rather than ordinary income. For a qualifying disposition, the participant must (i) remain employed by the company from the option grant date until three months prior to the date of purchase, and (ii) retain the shares until the expiration of two holding periods. If either condition is not satisfied, then the entire gain is taxed as ordinary income. The amount of a qualifying disposition treated as capital gain is the excess, if any, of the gain on the sale over the amount of any discount offered under the plan (determined as of the grant date). The holding periods are one year after the date of purchase and two years after the date of grant. Companies granting stock under ESPPs must file informational returns and statements under Section 6039 of the Code when the participant first transfers legal title of such shares after exercising their option.

The Internal Revenue Service ("IRS") issued final regulations under Code Sections 423 and 6039 concerning ESPPs and the related reporting obligations on November 16, 2009; the regulations become effective as of January 1, 2010.

## ESPP Final Regulations

The final regulations clarify several issues relating to ESPP compliance, including the noteworthy issues described briefly below.

**Flexibility Among Offerings.** ESPPs must meet numerous documentation and operational requirements to ensure the tax advantages noted above. The final regulations note that different offerings made under an ESPP are treated individually for compliance purposes. Thus, employers have flexibility in choosing the terms and conditions that may apply to various offerings, provided each offering satisfies the ESPP criteria. Separate offerings may be customized for different subsidiaries of a parent corporation, for example.

**Grant Date for Extended Offering Periods.** Many ESPPs feature an offering period during which participants may defer a portion of their after-tax compensation to purchase company shares at the close of the period. The grant date for such plans is the *first day* of such an offering period, provided that, as of such date, the maximum number of shares a participant may purchase is either fixed or will be determined under an existing formula. Otherwise, the grant date is the purchase date (or the first date the maximum number of shares becomes fixed or such formula is established). An ESPP is not required to impose such a maximum, but the first-day rule can shorten participants' holding periods by as much as a year. The final regulations make an important distinction between this share purchase limit, the statutory limits on the number of shares a plan may issue to an individual each year and the $25,000 limitation on accruals. Although the latter limitations must be described in documentation for all ESPPs, such provisions will not cause the initial day of an offering period to be considered the grant date.

**$25,000 Accrual Limitation.** Existing law caps the amount of shares a participant may become entitled to purchase under an ESPP, for each calendar year that an option remains outstanding, at $25,000 of the fair market value of the stock, determined as of the grant date. The IRS had taken the position that an increase in this amount occurs only for subsequent years in which an option is both outstanding and exercisable. The final regulations eliminate the "exercisable" requirement, so that the increase applies for any year that the option remains outstanding, regardless of whether it was exercisable. For example, on September 1, 2010, Corporation ABC under its ESPP grants to X, an employee, an option that will be automatically exercised on August 31, 2011 and August 31, 2012. The terms of the option provide that no more than 500 shares may be purchased on each date that the option is automatically exercised. On August 31, 2011, X may purchase under the option an amount of ABC stock equal to $50,000 in fair market value (determined at the time the option was granted). On August 31, 2012, X may purchase under the option an amount of ABC stock equal to the difference between $75,000 in fair market value of ABC stock (determined at the time the option was granted) and the fair market value of ABC stock (determined at the time the option was granted) purchased during 2011.

**Shareholder Approval.** An ESPP requires approval of the shareholders within the 12 months before or after the plan is adopted. If the granting corporation makes certain changes, the ESPP may be considered a new plan requiring a new shareholder vote. The final regulations specify that the only modifications that are considered to result in a new plan are:

- an increase in the aggregate number of shares that may be issued under the ESPP (other than due to a stock dividend, stock split, etc.);
- a change in the designation of corporations whose employees may receive ESPP options (unless the change falls within parameters established in the plan document); or
- a change in the granting corporation or the stock available for purchase under the ESPP.

## Reporting Obligation Final Regulations

Under Section 6039 of the Code, companies granting shares under an ESPP must furnish information statements to participants and file information returns with the IRS when the legal title of shares issued under the ESPP is initially transferred by the participant. IRS Form 3922 is used to satisfy both reporting requirements. The statement and filing must be made on or before the January 31 following the year in which the transfer occurs. Code Section 6039 imposes similar reporting obligations in connection with grants of incentive stock options (see our January 3, 2008 Client Alert, "Reminder: January 31 Deadline for Information Statements for Incentive Stock Options and ESPPs"). Companies should be aware of one clarification and one change for ESPPs under the final regulations:

- **Timing.** Many companies arrange for shares purchased under their ESPP to be transferred to a brokerage account established on behalf of the participants. The transfer of the legal title of shares directly to a broker or financial institution in such cases is treated as a transfer that triggers the reporting obligations. On the other hand, if the company issues certificates to participants upon exercise of ESPP options, or shares are registered in the participants' name and the company (or its agent) holds such shares for participants in book entry form, then the initial transfer of shares does not occur until a subsequent legal transfer of title.

- **Content.** A new requirement applies to ESPP options for which the exercise price is not determinable on the grant date (e.g., if the exercise price may be based on the fair market value per share on a later purchase date). For such ESPPs, the calculation of a participant's tax liability upon a sale of shares acquired under the plan may depend on the exercise price per share determined as if the option were exercised on the grant date. Thus, the new Form 3922 requires companies to report this information.

## Recommended Action

Companies should review the ESPP offerings they have planned for 2010 and beyond to ensure compliance with the new rules. They may also consider how the flexibility offered under the final regulations may be used to better complement the company's overall compensation strategy.

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If you have any questions about the content of this advisory, please contact the Pillsbury attorney with whom you regularly work or any of the members of the Executive Compensation & Benefits group.

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