BNA, INC.

PENSION & BENEFITS

DAILY

Reproduced with permission from Pension & Benefits Daily, 50 PBD, 03/17/2010. Copyright © 2010 by The Bureau of National Affairs, Inc. (800-372-1033) http://www.bna.com

Many companies are preparing for increased IRS audit activity in the executive compensation and employment tax areas, including compliance with the Employee Stock Purchase Plan (ESPP) final regulations. In this article, Jeff Kroh and John McGuiness point out pitfalls to compliance and highlight improvements in ESPP design flexibility provided by the final rules.

Design Flexibility and Potential Pitfalls in IRS Final Rules for Employee Stock Purchase Plans

BY JEFFREY W. KROH AND JOHN F. MCGUINESS

Late in 2009, the Internal Revenue Service finalized the rules governing Employee Stock Purchase Plans (ESPPs) under § 423 of the Internal Revenue Code (I.R.C.) [1] and the related reporting rules under I.R.C. § 6039.[2] These final rules essentially adopt, with limited revisions, the comprehensive update to existing ESPP regulations and reporting rules published as proposed regulations in July 2008.[3] As many companies prepare for increased IRS audit activity in the executive compensation and employment tax areas, it may also be a good time to review and update ESPPs to ensure compliance with, and take advantage of, the design flexibility provided in the final rules.

These final rules under I.R.C. § 423 generally apply to options granted under an ESPP after 2009, and the new reporting rules apply to shares transferred after 2009. This article highlights significant clarifications in the final rules that should be of interest to employers that already maintain, or may be considering establishing, an ESPP.

Background

Under a typical ESPP, employees are permitted to periodically purchase employer stock on a discounted basis (at generally up to a 15 percent discount). Typically, an employer deducts the contributions elected by employees from paychecks during an ''offering period'' under the ESPP that may last for three or six months. At the end of an offering period, an employee's accumulated contributions are used to purchase shares of employer stock at the discounted price.

For federal income tax purposes, shares purchased under an ESPP are treated as shares purchased pursu-

[1] 74 Fed. Reg. 59,074 (Nov. 17, 2009).
[2] 74 Fed. Reg. 59,087 (Nov. 17, 2009).
[3] 73 Fed. Reg. 43,875 (July 29, 2008); 73 Fed. Reg. 40,999 (July 17, 2008).

Jeff Kroh and John McGuiness are principals with Groom Law Group, Chartered, in Washington, D.C.

ant to the exercise of an option. Ordinarily, the taxation of options granted to employees as compensation for services is governed by I.R.C. § 83. Under I.R.C. § 83, options are normally not taxed when they are granted, but an employee is taxed on the ''spread'' between the exercise price and the value of the share when the employee exercises the option.

Incentive stock options and ESPP options receive special tax treatment under I.R.C. § 421, if they meet certain requirements. Not only is there no income at grant, but there is no income to the employee at the time the option is exercised. Taxation occurs later, when the acquired shares are sold or otherwise disposed of. At that time, the discount element is taxed as ordinary compensation income and any additional value is taxed as capital gain.

To qualify for the favorable ESPP tax treatment, all of the requirements under I.R.C. § 423 must be met. These include a requirement that the purchase price for an ESPP option not be less than the lower of 85 percent of the fair market value of the stock at the time the option is granted or exercised. Importantly, options granted under ESPPs that meet the I.R.C. § 423 requirements are also exempt from the rules under I.R.C. § 409A that apply to discounted stock options.

Clarifications in Final Rules

The requirements under I.R.C. § 423 have changed over the years. The final rules affirm the existing requirements and provide clarity in a number of areas covered in the proposed regulations, as described below.

Need for Share Purchase Limit. As noted above, the exercise price for an ESPP option must be no less than 85 percent of the lower of the stock's value on the date of grant or on the date of exercise. Consistent with the proposed ESPP regulations, in order for the first day of the offering period to be treated as the date of grant, the plan or offering must designate a maximum number of shares (or apply an immediately determinable formula) that may be purchased by each employee during the offering.[4] The final rules make clear that neither the aggregate number of shares reserved for issuance under the plan nor the annual $25,000 limitation on shares that may be purchased under I.R.C. § 423 is sufficient to establish the maximum number of shares for this purpose. Although establishing this separate maximum share limit is not a requirement under I.R.C. § 423, if the maximum number of shares is not fixed or determinable until the option is exercised, then the date of exercise will be treated as the date of grant.

Before the final rules, this separate maximum share limit was often omitted in ESPPs. Unless these plans are amended, the unexpected shift of the date of grant from the first day of the offering to the exercise date could cause significant problems. This situation is illustrated in the example below.

Example 1.

Corp A sponsors an ESPP that provides for six-month offering periods beginning each April 1 and October 1. The options granted under the ESPP are only exercisable on the last day of an offering period (the ''Purchase Date''). The ESPP uses a look-back period to determine the exercise price and thus provides that the exercise price on each Purchase Date is 85 percent of the lower of the value of Corp A stock on (i) the first day of the offering or (ii) the Purchase Date. The ESPP does not limit the maximum number of shares that may be purchased by an employee under an offering, so the date of exercise will also be treated as the date of grant. Assume that at the beginning of an offering period on April 1, 2010, Corp A stock is worth $100, and by the Sept. 30, 2010, Purchase Date, the stock is worth $120. The exercise price would be $85 (85 percent of lesser of $100 or $120). Because the Purchase Date is also treated as the grant date under the I.R.C. § 423 rules, the exercise price could be no lower than $102 (85 percent x $120) and comply with I.R.C. § 423. Because the $85 exercise price is lower, the shares purchased on Sept. 30, 2010, will fail to meet the 85 percent exercise price requirement. As a result, this option will not receive favorable tax treatment as an ESPP option and will likely be subject to I.R.C.§ 409A as a discounted stock option (i.e., an option granted with an exercise price less than fair market value on the date of grant).

This date of grant concept is also important in the ESPP context for purposes of determining the required holding period for favorable tax treatment, the annual $25,000 limitation on purchases under I.R.C. § 423, and the employees eligible to participate in an offering.

Exclusions of Employees. I.R.C. § 423 requires that ESPP participation be available to all employees of an employer participating in the ESPP. However, not all companies in a controlled group must participate in an ESPP. The final rules make clear that an ESPP may exclude subsets of the following excludable groups:

- employees who have worked for the employer less than two years,
- employees who customarily work 20 hours or less per week,
- employees who customarily work five months or less per year, and
- highly compensated employees within the meaning of I.R.C. § 414(q).[5]

In addition, the final rules confirm that an ESPP may exclude employees who are citizens or residents of a foreign jurisdiction if granting them an option under the ESPP would violate the laws of such jurisdiction, or if compliance with the laws of the jurisdiction would cause the ESPP to violate I.R.C. § 423.[6]

Unfortunately, the final rules make no significant changes to the proposed regulations in terms of permitting wholesale exclusions of groups of employees. Thus, for example, an employer cannot simply exclude collectively bargained employees, nonresident alien employees, or employees under a specified age from its ESPP. Moreover, the final rules confirm that if one employee entitled to an option under an ESPP offering does not receive an option, none of the options granted in the offering will be entitled to the favorable tax treatment for options granted under an ESPP.[7] Thus, employers need to ensure that no eligible employees are excluded from ESPP participation.

Plan vs. Offering Terms. The final rules clearly delineate which requirements must be satisfied by an ESPP ''plan'' and which requirements may be satisfied by the

[4] Treas. Reg. § 1.423-2(h)(3).

[5] Treas. Reg. § 1.423-2(e)(1) and (2).

[6] Treas. Reg. § 1.423-2(e)(3).

[7] Treas. Reg. § 1.423-2(e)(4).

COPYRIGHT © 2010 BY THE BUREAU OF NATIONAL AFFAIRS, INC.

terms of an offering made under the plan. Generally, the plan must only (i) provide that options under the ESPP to purchase stock in a corporation may only be granted to employees of such corporation or of a related corporation, and (ii) be approved by the shareholders of the granting corporation within 12 months before or after the date of adoption.[8] All of the other I.R.C. § 423 requirements may be met by the terms of each offering under the ESPP. Importantly, if the terms of an ESPP plan fail to comply with any of the other I.R.C. § 423 requirements (e.g., impermissibly excluding a group of employees), the final rules clarify that an option may still qualify for favorable tax treatment if granted under an offering with compliant terms.[9]

Different Participation Rules Allowed In Different Offerings. It was unclear under the proposed regulations whether more than one offering was permitted under an ESPP at any given time. The final rules clarify that one or more separate offerings may be made under an ESPP at the same time. In addition, these separate offerings may contain different rights and privileges (e.g., discount percentages) and exclude different groups of employees in each offering so long as the terms of each offering (together with the ESPP) independently satisfy the requirements of the final rules.[10] For example, a parent corporation may have different offerings for different subsidiaries participating in its ESPP. The parent could designate which subsidiaries may participate in a particular offering and provide a different discount percentage and exclusions for each offering.[11] This flexibility in the rules makes sense as a parent need not include all subsidiaries in its ESPP.

This clarification provides companies with significant design flexibility to use multiple offerings with different terms regarding discount, eligibility, payment method, or other features. In particular, this flexibility is helpful when managing grants to employees of subsidiaries in foreign jurisdictions, to employees of different subsidiaries, or to employees of a newly acquired subsidiary.

Example 2.

Assume the same facts in Example 1, except that the ESPP establishes the maximum number of shares that may be purchased during each offering as 5,000. Corp A is a parent corporation with Subsidiaries B and C in the United States and Subsidiary D in Europe. Corp A commences two offerings under the ESPP on April 1, 2010: One offering to the employees of Corp A and Subsidiary C, and a second offering to employees of Subsidiary D. Under the first offering, the options are granted to all employees of Corp A and Subsidiary C except employees who normally work 20 hours or less per week or who have worked for less than two years. Under the second offering, options are granted to all employees of subsidiary D. The options granted under the offering for Corp A and Subsidiary C will be treated as granted under an ESPP, so long as the exclusions are applied in an identical manner to all employees of Corp A and Subsidiary C. The options granted under the offering for Subsidiary D will be considered granted under an ESPP.

Annual $25,000 Limit. Generally, an ESPP must provide that no employee may be permitted to accrue the right to purchase stock under all ESPPs of his or her employer and its related corporations at a rate which exceeds $25,000 in fair market value of the stock (determined on the date of grant) per calendar year. The proposed regulations provided a conservative interpretation of this annual $25,000 limit to mean that the limit increases by $25,000 for each calendar year which the option is outstanding *and* exercisable. However, the final rules generously expand this interpretation and provide that this limit increases by $25,000 for each calendar year that an option is outstanding regardless of whether it is exercisable.[12]

New Reporting Requirements

Together with the final rules governing ESPPs, the IRS finalized the reporting requirements under I.R.C. § 6039 for transfers of shares acquired under an ESPP. Generally, prior to these final regulations, an employer was required to provide an information statement to an employee following the first transfer of shares acquired pursuant to the exercise of a discounted option under an ESPP (ESPP Shares).[13] In addition to the information statement, effective Jan. 1, 2010, the final regulations require employers to file a new information return on Form 3922 with the IRS for the first transfer of ESPP shares (for qualifying and disqualifying dispositions) made on or after such date. Both this information statement and return must be provided or filed on or before January 31 of the year following such transfer. Importantly, the final regulations provide helpful clarifications and modifications to these reporting requirements, including:

''First Transfer'' of ESPP Shares. For purposes of triggering the reporting requirements discussed above, the ''first transfer'' of ESPP Shares includes a transfer of legal title to a recognized broker or financial institution immediately following the exercise of an option. As a result, the date the option is exercised, and the date legal title is first transferred, is the same. Alternatively, if the employer issues a stock certificate directly to an employee, or registers the ESPP Shares in the employee's name and holds the ESPP Shares for the employee in book-entry form, the first transfer occurs later when the employee sells the stock or the stock is transferred to a brokerage account established on behalf of the employee.[14]

ESPP Exercise Price Not Fixed or Determinable at Grant. One objective of these final regulations is to provide employees with sufficient information to enable them to calculate their tax liability for transferring ESPP Shares. For purposes of this calculation, if the exercise price of the option is not fixed or determinable on the date of grant (e.g., the ESPP uses a look-back period), the final regulations require disclosure of the exercise

[8] Treas. Reg. § 1.423-2(a)(2).
[9] Treas. Reg. § 1.423-2(e)(6), Example 2.
[10] 74 Fed. Reg. 59,074, 59,075 (Nov. 17, 2009) (Offerings Under an Employee Stock Purchase Plan).
[11] Treas. Reg. § 1.423-2(f)(7), Example 5; Treas. Reg. § 1.423-2(e)(6), Example 8.
[12] Treas. Reg. § 1.423-2(i)(4); Treas. Reg. § 1.423-2(i)(5), Example 5.
[13] I.R.C. § 423(c).
[14] 74 Fed. Reg. 59,087, 59,088-89 (Nov. 17, 2009) (Transfers of Legal Title for Stock Acquired Under an Employee Stock Purchase Plan).

price per share determined as if the option were exercised on the date of grant.[15]

Conclusion

Now that the IRS has finalized the rules under I.R.C. § 423, it is a good time for employers to review and update their ESPP plan documents, prospectuses, and other offering materials to ensure compliance with the final rules. At the same time, an employer may also consider auditing its internal procedures for strict operational compliance and preparing for the new reporting requirement for shares transferred after 2009. For example, an employer may wish to review its internal procedures with regard to identifying eligible employees for an offering and collecting share transfer data. Lastly, companies may want to revisit their ESPP structure in order to take advantage of the additional design flexibility provided in the final rules.

[15] 74 Fed. Reg. 59,087, 59,089 (Nov. 17, 2009) (Reporting of Information With Respect to the Special Tax Rule Under Section 423(c)); Treas. Reg. § 1.6039-1(b)(vi).

COPYRIGHT © 2010 BY THE BUREAU OF NATIONAL AFFAIRS, INC.
ISSN