

News from our Compensation & Benefits Group

IRS Issues Final Regulations for Employee Stock Purchase Plans

Overview

An employee stock purchase plan (“ESPP”) allows employees of corporations (typically publicly traded companies) to purchase company stock or stock of an affiliate at a discount with the potential for favorable tax treatment under Section 423 of the Internal Revenue Code (“Section 423”) if certain conditions are met. Under an ESPP, eligible employees receive options to purchase company stock (usually at a discount) pursuant to an “offering.” Employees typically participate in an ESPP by authorizing voluntary payroll deductions during an “offering period.”

In November 2009, the IRS issued final regulations [www.cooley.com/files/2009-27452_ESPPfinalRegs.pdf] under Section 423. While the final regulations clarify and amend certain long-standing ESPP rules in a manner that is generally helpful to companies sponsoring ESPPs and their employees, we anticipate that there will be an increased focus on proper administration of ESPPs. Accordingly, as noted below, we recommend that companies with existing ESPPs take certain steps to ensure continued compliance with Section 423 for their ESPPs and also to take advantage of the increased flexibility in designing offerings afforded by the final regulations.

This *Alert* highlights certain changes in the final regulations, provides examples of how the final regulations apply in practice and offers suggested action items. In this *Alert*, we refer to ESPPs, offerings and options that meet the requirements under

Section 423 as “qualified,” and those that do not meet the requirements under Section 423 as “nonqualified.”

Effective date

The final regulations are immediately effective and will apply to offerings that have a grant date on or after January 1, 2010. In some circumstances, the final regulations may also be relied upon for offerings commencing prior to January 1, 2010.

Summary of key changes

- ▶ **Liberalized \$25,000 limit:** Under Section 423(b)(8) of the Code, an ESPP must provide that no employee may be permitted to accrue the right to purchase stock under the ESPP at a rate that exceeds \$25,000 in fair market value of the stock for each calendar year (referred to here as the “\$25,000 limit”). In a welcome reversal of the position in the proposed regulations issued in July 2008, the final regulations clarify that the limit increases by \$25,000 for each calendar year that the option is *outstanding*, regardless of whether it was exercisable in each year. (*See Q/A 1 below.*)
- ▶ **“Offering-by-offering” approach:** The final regulations explicitly adopt an “offering-by-offering” approach, where the terms of the ESPP and the offering document together may satisfy the requirements of Section 423, but the terms of each offering under the ESPP need not be identical. (*See Q/A 2-3 below.*)

- ▶ **Inconsistent option terms:** If, contrary to the terms of the ESPP and/or offering, an option is granted to an individual who is not eligible to participate in the ESPP, that option will not be qualified, but it will not disqualify other options

KEY ATTORNEY CONTACTS

Wendy Davis	650/843-5157 wdavis@cooley.com
Renee Deming	650/843-5115 rdeming@cooley.com
Soo Kim	212/479-6760 skim@cooley.com
Michelle Lara	858/550-6011 mlara@cooley.com
Laura McDaniels	650/843-5167 lmcDaniels@cooley.com
Dan Meehan	720/566-4061 dmeehan@cooley.com
Buff Miller	650/843-5351 bmiller@cooley.com
Amy Muecke	858/550-6058 amuecke@cooley.com
Tom Reicher	415/693-2381 treicher@cooley.com
David Walsh	703/456-8021 dwalsh@cooley.com
Thomas Welk	858/550-6016 twelk@cooley.com

This information is a general description of the law; it is not intended to provide specific legal advice nor is it intended to create an attorney-client relationship with Cooley Godward Kronish LLP. Before taking any action on this information you should seek professional counsel.

Copyright © 2009 Cooley Godward Kronish LLP, 3000 El Camino Real, Palo Alto, CA 94306. Permission is granted to make and redistribute, without charge, copies of this entire document provided that such copies are complete and unaltered and identify Cooley Godward Kronish LLP as the author. All other rights reserved.

granted to eligible employees in an otherwise qualified offering under the ESPP. Note that in the reverse scenario (*i.e.*, if an eligible employee is not granted an option), *all* of the options granted under the offering would be disqualified. Despite requests from commentators, the IRS declined to provide relief in the final regulations for an unintentional omission of an eligible employee from an offering. (*See Q/A 5-6 below.*)

► **Traps for the unwary:** The final regulations point out two traps for the unwary:

► **Grant Date:** If an ESPP does not include a maximum number of shares (or a formula to establish the maximum number of shares) that an employee may purchase in an offering that is fixed and determinable as of the beginning of the offering, then the “grant date” for that offering will be deemed to be the purchase date. The preamble to the final regulations clarifies that the \$25,000 limit alone is not sufficient to establish a grant date for an option or an offering. (*See Q/A 7-9 below.*)

► **Shared Plan Reserve:** An ESPP does not satisfy Section 423 if it does not have a separately stated share reserve but instead shares a reserve with another ESPP. (However, note that the result desired by having two plans with a common share reserve can be achieved in a permissible manner if there is only one ESPP that has two separate offerings.) (*See Q/A 4 below.*)

Applying the final regulations: a hypothetical example

FACT PATTERN A: ABC Corp, a publicly traded company, adopted a Section 423 qualified ESPP effective August 1, 2009. The ESPP provides

for 12-month offering periods (the first offering started August 1, 2009) with 6-month purchase periods (e.g., January 31, 2010 and July 31, 2010). Purchases under the ESPP may only be made on the last day of each purchase period (a “purchase date”). A new offering commences every 6 months. An employee of ABC Corp is eligible to participate in an offering if the employee has been employed at least 3 months as of the first day of the offering, and such employee may purchase up to 6,000 shares of stock on each purchase date. An eligible employee may participate in only one offering at a time. The ESPP provides that the exercise price on each purchase date is 85% of the lower of (x) the value of the ABC Corp common stock on the first day of the offering (e.g., August 1, 2009) or (y) the value of ABC Corp common stock on the relevant purchase date. Assume that the fair market value (“FMV”) of ABC Corp common stock on August 1, 2009 was \$6.00 per share. ABC Corp has no subsidiaries or branch offices.

Annual \$25,000 Limitation

Q1. Employee W commenced participation in the ABC Corp ESPP on August 1, 2009. If Employee W purchased 4,000 shares of ABC Corp common stock on the January 31, 2010 purchase date (worth \$24,000 based on the FMV of ABC Corp common stock on August 1, 2009), what is the maximum number of shares that Employee W may buy on the July 31, 2010 purchase date?

A1. As the current offering began in 2009 and spans two separate calendar years, Employee W may purchase on July 31, 2010 up to an additional 4,333 shares (worth \$25,998 based on the FMV of ABC Corp common stock on August 1, 2009).

Offering-by-Offering Approach

Q2. How does the offering-by-offering approach apply to the ABC Corp ESPP?

A2. Under the ABC Corp ESPP, a new offering starts every 6 months and lasts for one year. For example, the first offering started on August 1, 2009 and will end on July 31, 2010. Another offering will start on February 1, 2010 and end on January 31, 2011. As there will be two offerings outstanding simultaneously, each offering must comply independently with the Section 423 requirements. The terms of the August 1, 2009 offering will not be considered in determining whether the February 1, 2010 offering is qualified, and vice versa; the qualification of each offering will be determined on the basis of its own terms.

FACT PATTERN B: Assume the same facts as in Fact Pattern A and now assume that ABC Corp has a wholly-owned foreign subsidiary (“FS”), and provides for a separate offering under the ABC Corp ESPP for employees of FS (the “FS Offering”). The terms of the FS Offering limit the eligibility to participate in offerings to manager-level and above employees of FS, which does not comply with the eligibility requirements of Section 423.

Q3. Does the fact that the FS Offering fails to comply with Section 423 taint the qualification of the offering to U.S. employees of ABC Corp?

A3. No. Under the offering-by-offering approach, a company may establish separate offerings under its ESPP with different terms where each such offering (taken on its own) may be designed to qualify under Section 423. A company may also design offerings that are not intended to comply with Section 423 requirements without endangering the status of its qualified offerings. Therefore, the terms and eligibility criteria for ABC Corp’s offering for certain

employees of FS, even though that offering does not qualify under Section 423, do not affect qualification under Section 423 of ABC Corp's domestic offering.

Shared Plan Reserve

FACT PATTERN C: Assume the same facts as in Fact Pattern B except that instead of separate offerings for FS employees under the ABC Corp ESPP, ABC Corp ESPP has adopted a separate subplan (the "FS Subplan") under which it provides for separate offerings to FS employees. The language of the FS Subplan is not clear as to whether it merely provides for different terms governing separate foreign offerings under the ABC Corp ESPP, or whether it is a separate stand-alone plan that shares a stock reserve with the main ABC Corp ESPP.

Q4. Is there a problem if the FS Subplan is a separate plan rather than a separate offering?

A4. Potentially. From the facts presented, it is not clear how the IRS would treat the FS Subplan. If the IRS treats the FS Subplan as a separate plan, then under the final regulations the ABC Corp shareholders would need to have approved a separate share reserve for each of the ABC Corp ESPP and the FS Subplan. Without such separate share reserves, options under the ABC Corp ESPP could be disqualified. Therefore, it is recommended that ABC Corp amend its ESPP and the FS Subplan prior to the commencement of its next offering on February 1, 2010 to make clear that the FS Subplan is merely a separate offering under the ESPP and is not a separate plan.

Inconsistent Option Terms

Q5. ABC Corp accidentally issued an option in the current offering under its domestic offering to an employee of FS (employees

of FS are not eligible to participate in the domestic offering). Does this error disqualify all options granted to eligible employees under the domestic offering?

A5. No, it does not. If, contrary to the terms of the ESPP or offering, an option is granted to an ineligible individual, that option will be treated as if it had not been issued under the ESPP and thus it will not be eligible for favorable tax treatment, but other options granted to eligible employees pursuant to the terms of the otherwise qualified offering will not be disqualified.

FACT PATTERN D: ABC Corp recently acquired in an M&A deal that closed on October 1, 2009 all of the interest of an entity that operates in Country X (the "Country X Entity"). The Country X Entity is treated like a corporation for Country X tax purposes but is a disregarded entity for US income tax purposes. Accordingly, the Country X Entity is treated essentially as a branch office of ABC Corp.

Q6. ABC Corp would like to exclude employees of the Country X Entity from participation in the next offering under its ESPP beginning on February 1, 2010. Is this OK?

A6. Because the Country X Entity is a disregarded entity, its employees are treated as if they are employees of the parent ABC Corp for U.S. tax purposes. (See, for example, PLR 200046013.) As a result, ABC Corp must include the Country X Entity employees that meet the eligibility criteria in the next offering under its ESPP on February 1, 2010 in order for such offering to qualify for favorable tax treatment under Section 423. If ABC Corp excludes these employees, all options issued in such offering to ABC Corp's eligible U.S. employees will be disqualified.

Grant Date Issues

FACT PATTERN E: Assume the same facts as Fact Pattern A, except that the ABC Corp ESPP does not limit the purchase of shares by an employee to 6,000 shares on any purchase date or otherwise specify a maximum number of shares that may be purchased by any employee in any offering other than the limitation contained in Section 423(b)(8) (*i.e.*, the "\$25,000 limit" discussed above).

Q7. Why is it important that the grant date of an option under the ABC Corp ESPP be the first day of the offering and not the purchase date?

A7. Under the current offering for the ABC Corp ESPP, the purchase price is 85% of the lower of the fair market value of the stock on August 1, 2009 (the first day of the offering) or the purchase date. If January 31, 2010 is the grant date for the current offering (not August 1, 2009), then the offering will likely fail the requirement found in Section 423(b)(6) that the purchase price be not less than 85% of the lesser of the FMV of the stock on the grant date or the purchase date, because by the terms of the ABC Corp ESPP the purchase price would be set at \$5.10 (85% of the FMV on August 1, 2009) which is lower than what would be the minimum allowable price under Section 423.

Q8. What is the grant date for purposes of the ABC Corp offering that commenced on August 1, 2009?

A8. The final regulations apply to offerings that commence (or that have a grant date) on or after January 1, 2010. Based on informal guidance from IRS officials, we believe that the "grant date" for purposes of the offering that commenced on August 1, 2009 will be deemed to be August 1, 2009. Accordingly, the current offering will not be disqualified.

Q9. What is the grant date for purposes of the ABC Corp offering commencing on February 1, 2010?

A9. The ABC Corp ESPP does not contain a maximum number of shares that may be purchased by an employee other than the \$25,000 limit and the total share reserve. Unless ABC amends its ESPP or offering document prior to February 1, 2010 to provide for a fixed and determinable maximum number of shares that may be purchased by any employee in the ABC Corp offering commencing on February 1, 2010 (and any future ABC Corp offering), the grant date for such offering will not be February 1, 2010 but instead will be the relevant purchase date. As noted in Q&A7, such offering will likely not be a qualified offering. However, if ABC Corp timely amends its ESPP or offering document to specify such a maximum purchase limit, then the grant date for purposes of the offering commencing on February 1, 2010 will be deemed to be February 1, 2010.

Action items

- ▶ Check whether your ESPP includes a limit on the total number of shares that may be purchased by an employee in any offering period, either through a fixed number or a formula that results in a fixed number as of the first day of the offering. Note that such a limit could include a formula based on the fair market value of the stock on the first day of the offering. For example, an acceptable limit would be a number of shares having a value based on the closing price on the first day of an offering equal to \$25,000.
- ▶ Clarify in your ESPP that any sub-plans are intended to be separate offerings under an ESPP, rather than separate plans sharing the same share reserve.
- ▶ Verify that any subsidiaries for which you either provide for separate offerings or exclude from participation in offerings

are not treated as a “disregarded entity” for tax purposes.

This may also be a convenient time to review your current internal procedures for operating your ESPP and revisit plan structure to take advantage of the additional flexibility afforded by the final regulations. Some things to consider:

- ▶ Revisit your internal process for identifying eligible employees prior to the beginning of an offering period. Omitting an eligible employee from an offering results in severe tax consequences—namely, the loss of qualified status of an offering. Common problems we see in this area include:
 - ▶ Lack of documentation required by the ESPP to include or exclude (as appropriate) corporate subsidiaries from participating in the plan.
 - ▶ Failing to timely provide offering materials and election forms to all eligible employees, or failing to timely process completed election forms.
 - ▶ Excluding the employees of a branch office (that is not structured as a separate subsidiary that is treated as a corporation for tax purposes) from an offering.
- ▶ Consider amending your ESPP to allow for offerings with different terms, as well as potential nonqualified offerings.
- ▶ If you allow participation in your ESPP by employees who primarily work outside of the United States, work with local counsel to determine how best to comply with local laws while still achieving the desired business goals and tax treatment for U.S.-based employees.

If you have questions regarding this *Alert*, please contact any of the attorneys listed above. ■

CIRCULAR 230 DISCLOSURE

The following disclosure is provided in accordance with the Internal Revenue

Service’s Circular 230 (31 CFR Part 10). This *Alert* is not intended to constitute tax advice to any specific taxpayer or for any specific situation. Any tax advice contained in this *Alert* is intended to be preliminary, for discussion purposes only, and not final. Any such advice is not intended to be used for marketing, promoting or recommending any transaction or for the use of any person in connection with the preparation of any tax return. Accordingly, this advice is not intended or written to be used, and it cannot be used, by any person for the purpose of avoiding tax penalties that may be imposed on such person.