

IRS Issues Final Regulations Governing Options Granted Under Employee Stock Purchase Plans

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On November 16, the Internal Revenue Service (IRS) issued final regulations with respect to options granted under an employee stock purchase plan (ESPP) under Section 423 of the Internal Revenue Code (the Code). The IRS also issued final regulations relating to the reporting requirements with respect to incentive stock options and options granted under ESPPs.¹ This LawFlash highlights the key provisions of the final regulations governing options granted under ESPPs.

Options granted under an ESPP are afforded special tax treatment if the ESPP meets the regulatory requirements under Section 423 of the Code (the Tax Code Requirements), which, for example, place limitations on the amount of ESPP benefit that may be granted to a recipient annually. The regulations under Section 423 of the Code were last updated in 2004. In July 2008, the IRS issued proposed regulations under Section 423 of the Code. The IRS has adopted the proposed regulations with a few modifications to reflect comments received with respect to those regulations. The final regulations provide a comprehensive set of rules to govern options issued under an ESPP.

The final regulations are effective as of November 17, 2009, and will apply to any options granted under an ESPP on or after January 1, 2010. Employers may apply these rules retroactively to options granted prior to January 1, 2010. The key provisions added or modified by the final regulations are highlighted below.

Offering-by-Offering Basis

- Employers may establish multiple offerings under an ESPP, which may be overlapping or consecutive. The terms of each offering may be different and the employer may designate which subsidiary corporations of the parent organization may participate in a particular offering, as long as the ESPP and the relevant offering together satisfy the Tax Code Requirements.
- Each offering may apply separate rights and privileges applicable to participants of the offering, as long as the rights and privileges are applied in an identical manner to all

1. For further information regarding that set of final regulations, see our December 21, 2009 LawFlash, "IRS Issues Final Regulations on Reporting Requirements for Incentive Stock Options and Employee Stock Purchase Plans," at http://www.morganlewis.com/pubs/EBLF_IRSFinalRegsOnReportingReqsForIncentiveStockOptions_21dec09.pdf.

employees of every corporation whose employees are granted options under that specific offering.

Inconsistent Terms

- The Tax Code Requirements may be satisfied either by the terms of an ESPP or an offering made under the ESPP.
- If the terms of an option are inconsistent with the terms of an ESPP or an offering under the ESPP, then the option will not be treated as granted under the ESPP or offering.
- If the terms of an ESPP are inconsistent with the Tax Code Requirements, the option may still qualify for special tax treatment if the option is granted under an offering with terms that comply with the Tax Code Requirements.
- If an employee is entitled to receive an option under an ESPP or offering, but receives an option that is inconsistent with the terms of the ESPP or offering, then none of the options granted under the ESPP or the offering will qualify for special tax treatment.
- If an employee who is not entitled to receive an option receives an option with terms that do not meet the Tax Code Requirements, the option will not be treated as granted under the ESPP or offering. The grant of this option will not disqualify the other options granted under the ESPP or offering.
- If an option fails to qualify as an option granted under an ESPP or offering after the date of grant, the option will not be treated as granted under the ESPP or offering. This failure will not disqualify the other options granted under the ESPP or offering.

Coverage

- An ESPP or an offering may exclude employees who have completed fewer than two years of service and who work fewer than 20 hours per week or fewer than five months per year, as long as this exclusion is applied in an identical manner to all employees of every corporation whose employees are granted options under the ESPP or that specific offering.
- An ESPP or an offering may also exclude highly compensated employees as long as this exclusion is applied in an identical manner to all highly compensated employees of every corporation whose employees are granted options under that specific ESPP or offering.
- Non-resident aliens may be excluded from participation in an ESPP or an offering if the grant of an option under the ESPP or offering is prohibited by the laws of the foreign jurisdiction or compliance with the laws of the foreign jurisdiction would cause the ESPP or offering to violate the Tax Code Requirements. In order to comply with the laws of a foreign jurisdiction, the terms of an option granted to non-resident aliens may be less favorable than the terms of options granted to U.S. citizens.

Grant Date and Option Price

- The date of grant of options under an ESPP is the date the employer completes the corporate action constituting an offer of stock for sale under the terms of the ESPP, and will be determined without regard to whether the minimum option price is fixed or determinable at such time.

- The date of grant will be the first day of an offering if the terms of an ESPP or offering either designate a maximum number of shares that may be purchased by each employee during the offering, or require the application of a formula to establish, on the first day of the offering, the maximum number of shares that may be purchased by each employee during the offering. The ESPP or offering is not required to designate the maximum number of shares or a formula to establish the maximum number of shares. However, if the maximum number of shares that can be purchased under an option is not fixed or determinable until the date the option is exercised, the date of exercise will be the date of grant of the option. This is significant because the special tax treatment afforded to options under an ESPP is based on the date of grant of the options. Specifically, the special tax treatment applies only if the employee disposes of the shares *after* two years following the date of grant and one year following the date of exercise of the option (the holding period). In order to avoid extending the holding period, we recommend that the ESPP or offering designate the maximum number of shares that can be purchased by each employee under an option (stated as either a number of shares or as a formula).
- For purposes of establishing the option price, employers may determine the fair market value of the relevant stock pursuant to any reasonable valuation method, including those permitted under the estate tax regulations.

\$25,000 Annual Limit

- An employee may not purchase more than \$25,000 worth of stock under all ESPPs maintained by his or her employer and its related corporations for each calendar year the option is outstanding. The annual limit is based on the fair market value of the stock on the date of grant and increases by \$25,000 for each calendar year that the option is outstanding. While it is necessary to state this limit explicitly in the ESPP document, doing so is not sufficient to meet the requirement of a statement of the maximum number of shares that can be purchased under an option by an employee.

Stockholder Approval

- A change in the granting corporation or the stock available for purchase under an ESPP is considered the adoption of a new plan, and new stockholder approval must be obtained within 12 months before or after the date the plan is adopted. Stockholders of a subsidiary corporation will include the parent corporation and any other stockholder of the subsidiary.

Employers planning on offering shares under an ESPP in 2010 should take note of the above, particularly the practical requirement that the ESPP document state the number of shares that can be purchased by each employee during the offering. In our experience, a number of ESPP documents omit this provision. As noted above, omission of that provision is not violative of the Tax Code Requirements but will typically have the disadvantageous effect of deferring the commencement of the holding period until the purchase date.

As a general matter, we believe that amendments to an ESPP to comply with the above should not require shareholder approval, and instead can be adopted by a compensation committee or by a full board of directors. However, it is important to review that issue in light of the company's specific corporate governance documents (charter, bylaws, etc.). In addition, it is advisable to review any

contemplated ESPP revisions with the company's financial accounting advisors to ensure that the financial accounting effects, if any, are understood.

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