



AMERICAN BENEFITS COUNCIL

SUMMARY

IRS/Treasury Release Proposed ESPP Regulations

On July 28, the Internal Revenue Service and the U.S. Treasury Department released proposed regulations relating to options granted under an employee stock purchase plan (ESPP) as defined in Section 423 of the Internal Revenue Code (Code). The regulations provide guidance on complying with Section 423 and also amend regulations under Code Sections 421 and 422.

Section 422 applies to incentive stock options (ISOs) and Section 421 governs the taxation of stock transferred to an individual under either Section 422 or 423. Under Section 421, if a stock is transferred to an individual under the requirements of Sections 422 or 423, the individual will not be taxed on the exercise of the option and the employer will receive no deduction. The regulations are proposed to apply as of January 1, 2010, and would apply to any options issued under an ESPP that is granted on or after that date.

This special tax treatment only applies to the transfer of stock to an employee pursuant to the exercise of an option granted under an ESPP if the stock is not disposed of within two years from the date of grant or within one year from the date of transfer of the share. In addition, the exercise price must be between 85 and 100 percent of the fair market value of the stock at the time the option was granted (or at the time of exercise, if less).

The proposed regulations provide several clarifications of the rules governing ESPPs including:

Inconsistency of Terms

- If the terms of an option are inconsistent with the terms of the ESPP or an offering under the plan, the option will not be treated as granted under an ESPP.
- If an employee is entitled to the grant of an option under the terms of the plan but only receives options that have terms that are inconsistent with

the terms of the ESPP, then none of the options granted under the ESPP will be eligible for the special tax treatment of Section 421.

- If an individual who is not entitled to a the grant of an option under the terms of the plan receives one, the option will not be treated as an option granted under an ESPP but the grant will not disqualify options granted under the terms of the ESPP.
- If an option qualifies as an option granted under the ESPP but the terms of the option are not satisfied, the option will not be treated as granted under an ESPP but will not disqualify other options granted under the ESPP.

Shareholder Approval

- New shareholder approval (within 12 months before or after the date the plan is adopted) is required if there is a change in the shares with respect to which options are issued or a change in the granting corporation.
- If corporation S, a wholly owned subsidiary of P, adopts a shareholder-approved ESPP under which employees of S will be granted options for S stock, and the ESPP is later amended to grant options to acquire P stock (rather than S stock), S must obtain approval from the shareholders of S. This conclusion differs from an example in the existing regulations under Code Section 422 which concludes that the shareholders of P would need to approve the plan, rather than shareholders of S. The proposed regulations also propose a conforming amendment to the 422 regulations and invite comment on the change.

Eligibility

- Section 423 allows employers to exclude employees who have been employed less than two years, employees who customarily work 20 hours or less per week, and employees who customarily work not more than five months in any calendar year. The proposed regulations indicate that ESPPs can exclude employees who have completed a shorter period of service or whose customary employment is for fewer hours per week or fewer months in a calendar year.
- The preamble indicates that the IRS and Treasury believe they do not have the statutory authority to allow exclusion of citizens or residents of a foreign jurisdiction or collectively bargained employees. However, the proposed regulations do allow exclusion of foreign citizens or foreign residents if the grant of the option is prohibited under the laws of the foreign jurisdiction (or compliance with the laws of the foreign jurisdiction would cause the plan to violate the requirements of Section 423). In addition, the terms of an option granted to a foreign citizen or resident may be less favorable if necessary to comply with the laws of a foreign jurisdiction.

Option Price and Grant Date

- Option price may be determined in any reasonable manner, including the valuation methods permitted under the estate tax regulations.
- The date of grant of an option (important for determining whether the requirements for favorable tax treatment are met), is the date when the granting corporation completes corporate action constituting an offer of stock for sale under the terms of the ESPP. The regulations under Section 422 relating to ISOs indicate corporate actions are not complete until the date on which the maximum number of shares that can be purchased under the option and the minimum option price are fixed and determinable. The proposed regulations under Section 423 indicate that the principles of the Section 422 regulations will be applied to ESPPs except that the requirement that the minimum option prices be fixed or determinable will not apply (because of the pricing rules for ESPPs, it is not always possible to determine the minimum option price on the first day of an offering).
- The date of grant will be the first day of an offering if the terms of the ESPP either (1) designate a maximum number of shares that may be purchased by each participant during the offering, or (2) 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 participant during the offering.
- 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, then the date of exercise will be the date of grant of the option (and the \$25,000 annual limit and the limit on the aggregate number of shares that may be issued under an ESPP are not sufficient to establish the maximum number).
- No employee is permitted have outstanding and exercisable stock options (under all of the ESPPs of the employer and related corporations) that exceeds \$25,000 in fair market value of the stock for any calendar year. The proposed regulations allow the \$25,000 limitation to be calculated using the rules (to the extent possible) applicable to the \$100,000 limitation for ISOs. The timing of both measures is based on when the option first becomes exercisable and both measures are based on the fair market value of the stock determined at the date of grant.

Misc.

- The regulations incorporate changes to the statutory definition of highly compensated employees (which can be excluded from the ESPP).
- The proposed regulations invited comments on whether a correction program is appropriate for ESPPs (including the statutory authority for such a program).