Employee Stock Purchase Plan

An "Employee Stock Purchase Plan" (ESPP) is an employee benefit program under which the employees of a corporation are granted the right to purchase shares in the employer corporation at a specified price (the "exercise" price), within a limited period of time. If all statutory requirements are met, and the stock acquired through the exercise of an ESPP option is sold at a profit, the gain is taxed at preferential capital-gains rates, rather than at higher, ordinary income tax rates.[1]

Employee stock purchase plans are typically used in large, publicly held corporations, to provide additional "equity" type compensation to broad classes of employees. Many employers offer this benefit through a payroll deduction plan.

Requirements To Qualify For ESPP Tax Treatment

Federal income tax law contains a number of requirements[2] that an ESPP must meet in order for stock acquired via options granted under the plan to receive preferential ESPP income tax treatment, including:

- **Only issued to employees:** Options may be granted only to employees. The individual receiving the option must, at all times, be an employee of the corporation from the date the option is granted until the day three months before the date of exercise.
- **Plan approval by corporate shareholders:** The shareholders of the corporation must approve the ESPP within 12 months of the plan's adoption by the board of directors. The ESPP must specify the maximum number of shares that may be issued as well as identify the employees who may be granted options under the plan.
- **5% owners:** Options may not be granted to an employee who owns 5% or more of the stock of the corporation. In considering whether an employee owns 5% or more of the corporation, the attribution rules of IRC Sec. 424(d)(1) apply.[3]
- **All employees covered:** The ESPP must provide, by its terms, that options are to be granted to all employees. However, certain classes of employees may be excluded:
    - Employees who have been employed less than two years,

[1] The discussion here concerns federal income tax law. State or local income tax law may differ.

[2] See IRC Sec. 423.

[3] Including stock owned by the employee's spouse, brothers or sisters, ancestors, and lineal descendants, or through a corporation, partnership, estate, or trust.

    - Employees whose customary employment is 20 hours or less per week,
    - Employees whose customary employment is not for more than five months in any calendar year, and
    - Highly compensated employees, as defined in IRC Sec. 414(q).[1]

- **Equal rights and privileges:** The plan must provide that the same rights and privileges apply to all employees. An ESPP may limit the amount of stock that can be purchased by an employee in any one year to a uniform percentage of compensation, subject to an annual dollar maximum.
- **Option price:** The exercise price may not be less than the lesser of (1) 85% of the stock's fair market value on the date the option is granted, or (2) 85% of the stock's fair market value when the stock is purchased.
- **Option expiration:** The time period in which an option may be exercised is generally limited to 27 months. If the option price is not less than 85% of the stock's fair market value at the time the option is exercised, this time period may be up to five years.
- **Required holding period:** In order to qualify for preferential tax treatment, stock acquired under the plan must be held for the longer of (1) two years from the date the option was granted, or (2) one year from the date the stock is acquired by the employee.
- **Dollar limitation:** No more than $25,000 of employer stock may be purchased by an employee in any single calendar year.
- **Limited transferability:** The option must not be transferable by the individual to whom it is granted other than by will or the laws of descent and distribution, and it must be exercisable, during the individual's lifetime, only by such individual.

Federal Income Tax Treatment Of ESPP Options

Under an ESPP, the employee has no taxable income at the time an option is granted nor at the time an option is exercised. Similarly, the employer has no deductible business expense with regard to the option at the time of grant nor at the time of exercise. A taxable event will

[1] Generally, either a 5% owner or an employee who, in 2017, had compensation from the employer in excess of $120,000.

generally occur, however, when stock acquired via an ESPP option is sold or otherwise transferred. The tax treatment, for both the employee and the employer, will vary, depending on whether the stock is disposed of in a "qualifying" or a "disqualifying" transaction:

- **Qualifying disposition:** If an option qualifies as an ESPP option, and the employee holding the option exercises it, purchases the stock, and then keeps the stock long enough to meet the holding period requirements, a sale of the stock will be treated as a capital transaction. The capital gain or loss will be measured by the difference between the amount paid for the stock (the exercise price) and the amount received for the stock upon sale.

  - **Example 1:** George is an employee of X Corp. Three and one-half years ago, X Corp. granted George an ESPP option to buy 100 shares of X Corp. stock, at $10 per share. At the time of the grant, X Corp. stock was trading at $10 per share. Two years after receiving the option, George exercised it and purchased 100 shares of X Corp. stock, for a total price of $1,000. At the time he exercised the option, X Corp. stock was trading at $12 per share. However, there was no tax impact on either George or his employer in the year he exercised his option. Earlier this month, George sold his X Corp. stock for $1,500. On his income tax return for this year, George will list a long-term capital gain of $500, the difference between his basis, $1,000, and the amount received for the stock, $1,500. In this situation, X Corp. has no business deduction with regard to the option granted to George.

- **Disqualifying disposition:** A "disqualifying" disposition refers to a sale or transfer of stock acquired through exercise of an ESPP option where one or more of the statutory requirements needed to qualify for preferential income tax treatment have not been met. This can occur when the options are issued at a discount, or if the holding period requirements are not met.

<u>Option issued at a discount:</u> If, at the time an option is granted, the exercise price is less than 100% of the fair market value of the stock, and the employee disposes of the stock after meeting the holding period requirements, or dies while holding the shares, the employee is required to include in income as "compensation" the <u>lesser</u> of:

  - The excess of the fair market value of the shares at the time the option was granted over the option price, or

- The excess of the fair market value of the shares at the time of disposition or death over the amount paid for the shares.

Any excess gain is treated as capital gain.

- **Example 2:** Sally's employer, Y Corp., grants her an option to buy 100 shares of Y Corp. stock at $20 per share at a time when the stock is trading at $22 per share. 18 months later, when the stock is trading at $23 per share, Sally exercises the option and purchases the stock. 14 months after buying the stock, Sally sells her shares for $30 per share. In the year of sale, Sally is required to include in income, as compensation, $200 ($2 per share x 100 shares), the difference between the exercise price ($20) and the fair market value on the date the option was granted ($22). The remaining gain, $800 ($8 per share x 100 shares) is treated as long-term capital gain.

Selling Price ($30 x 100 shares)	$3,000
Purchase price ($20 x 100 shares)	- 2,000
= Gain	$1,000
Amount reported as wages	-200
Amount reported as capital gain	**$ 800**

In the year of sale, Y Corp is entitled to a business deduction for the "compensation" included in Sally's income. If there were a loss on the sale, it would be a capital loss and Sally would not be required to include any compensation in income.

Holding period requirement not met: If the holding period requirement is not met, the amount that is required to be included in income as compensation is the amount by which the stock's fair market value exceeds the exercise price on the date the stock is purchased.

- **Example 3:** Mike's employer, Z Corp., grants him an option to buy 100 shares of Z Corp. stock at $20 per share at a time when the stock is trading at $22 per share. 12 months later, when the stock is trading at $23 per share, Mike exercises the option and purchases the stock. Six months after buying the stock, and before he fully meets the holding period requirements, Mike sells his shares for $30 per share. In the year of sale, Mike is required to include in income, as compensation, $300 ($3 per share x 100 shares), the difference between the exercise price ($20) and the fair market value on the date the shares were purchased ($23). His basis in the stock is thus $2,300. The remaining gain, $700, is treated as long-term capital gain.

Selling Price ($30 x 100 shares)	$3,000
Purchase price ($20 x 100 shares)	- 2,000
= Gain	$1,000
Amount reported as wages	-300
Amount reported as capital gain	**$ 700**

In the year of sale, Z Corp is entitled to a business deduction for the "compensation" included in Mike's income. If the stock is sold at a loss, it is a capital loss.

Seek Professional Guidance

An employee stock purchase plan represent an opportunity to benefit, on a tax-favored basis, from the long-term growth of a corporate enterprise. Given the complexities of income tax law, and the sometimes volatile nature of securities markets, the guidance of tax and investment professionals is strongly recommended.