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IRS Issues Final Regulations Affecting Employee Stock Purchase Plans

Recently, the Internal Revenue Service issued final regulations under Internal Revenue Code Section 423, which update the rules governing employee stock purchase plans with only a couple of important changes. Section 423 governs employee stock purchase plans, through which a company may offer its employees the option to purchase company stock at favorable prices through after-tax payroll withholdings. These "favorable prices" cannot be less than 85% of the fair market value of the stock at the time the option is granted or at the time the option is exercised, whichever is less.

New Grant Date Definition. One of the attractive features of an employee stock purchase plan is that the options granted through the employee stock purchase plan, much like incentive stock options, are eligible for favorable tax treatment under Section 421. To obtain the favorable tax treatment, one of the requirements is that no disposition of the common stock acquired upon exercise of the option may be made within two years of the "date of grant" of the option or within one year of the date of exercise of the option. The final regulations provide a new definition for "date of grant" for employee stock purchase plan purposes. Specifically, in order for the beginning of a particular employee stock purchase plan offering period to be the "date of grant," the employee stock purchase plan must set forth a limit on the number of shares that can be purchased by each employee through each offering, either by reference to a specific number or to a fixed formula. Simply referring to the \$25,000 annual limit set forth in Section 423, which applies per employee, is not sufficient. Companies that want to provide their employees with the best chance of obtaining favorable tax treatment should take note of this change. While conforming to this change in the definition of "date of grant" is not required, the failure to do so means that employees' two-year holding period to obtain favorable tax treatment does not begin until the specific offering period ends.

\$25,000 Annual Limit Carry-Over. As noted above, Section 423 imposes a limit on the value of common stock that an employee can purchase through an employee stock purchase plan. That limit is \$25,000 per year. The final regulations make clear that any unused portion of this \$25,000 annual limit may be carried forward to subsequent years in the offering period (that is, the \$25,000 limit is not a "use-it-or-lose-it" limit each calendar year).

Other Requirements. The final regulations under Section 423 also make clear, among other requirements, that:

- an employee stock purchase plan must be set forth in a written plan document and/or offering document;
- multiple offerings, consecutive or overlapping, may be issued under one plan document, and each offering need not have identical terms;

- each offering must generally apply to all employees of the particular company (although certain categories of employees set forth in the regulations may be excluded) and must provide eligible employees with "equal rights and privileges" with respect to the options granted; and
- an employee stock purchase plan must be approved by the stockholders of the granting company within twelve months before or after the date that the employee stock purchase plan is adopted by that company.

Employers sponsoring employee stock purchase plans should review their plans carefully to ensure that each of the requirements set forth in the new regulations are met. The final regulations are effective as of January 1, 2010.

Our client alerts are for general informational purposes and should not be regarded as legal advice. If you would like additional information or have any questions, please contact:

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