IRS Finalizes Employee Stock Purchase Plan Regulations

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On November 16, the IRS issued final regulations under Section 423 of the Internal Revenue Code applicable to qualified "employee stock purchase plans" or "ESPPs." The final regulations apply to options to purchase shares granted under an ESPP on or after January 1, 2010.

The final regulations generally follow the 2008 proposed regulations, but include several important clarifications discussed below.

Determining the Grant Date of an Option

The "grant date" of an option is important because the holding periods to receive favorable tax treatment when the shares acquired upon exercise of the option are later sold begin running on this date. The final regulations provide that the "grant date" will be the first day of an offering period if either the plan or offering designates the maximum number of shares that can be purchased or includes a formula to make this determination. Merely including the $25,000 annual limit in the plan does not satisfy this requirement.

If this requirement is not satisfied, the applicable holding periods begin running on the purchase date. As a result, sponsors may wish to consider fixing the number of shares that can be purchased or including a formula in their plans.

Coverage of Employees

ESPPs historically have required that each employee of all corporations participating in the plan be given an opportunity to participate in an offering on the same terms and conditions as all other employees. The final regulations now allow plans to adopt an offering-by-offering approach to determine whether the plan satisfies this requirement. As a result, the final regulations allow plans to make different offerings to different employees on different terms.

This change gives sponsors significant additional flexibility to extend participation in ESPPs to subsidiaries, particularly foreign subsidiaries. As a result, this is an opportunity for sponsors who maintain non-qualified stock purchase plans to take advantage of the benefits of offering an ESPP.

Treatment of Non-U.S. Employees

An ESPP must grant "equal rights and privileges" to all employees who may participate in a particular offering. Frequently, this requirement is problematic when participation is extended to non-U.S. employees. Although the final regulations do not permit sponsors to exclude non-U.S. employees who receive no U.S.-source income or who are under a certain age, sponsors may grant options to foreign employees on terms less favorable than to U.S. employees in order to comply with foreign law.

$25,000 Annual Limitation
An employee cannot accrue options to acquire more than $25,000 of stock of the sponsor in any year. The proposed regulations provided that this $25,000 annual limitation is increased by $25,000 for each year that an option is both outstanding and exercisable. The final regulations relax this standard and provide that the $25,000 annual limitation is increased by $25,000 for each year that an option is outstanding.

This change greatly simplifies the determination of the $25,000 annual limitation and may allow employees to accrue additional options.

Shareholder Approval
ESPPs must be approved by shareholders within 12 months prior to, or following, their adoption by the sponsor. The final regulations clarify that only changes to the shares with respect to which options are issued or to the sponsor of the plan, are changes requiring shareholder reapproval.

Conclusions
The final regulations become effective for options granted or offering periods beginning on or after January 1, 2010. Although in many cases no changes are required to plans, the final regulations do provide sponsors with an opportunity to expand participation in ESPPs and ensure that employees receive the benefits of such participation.
