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IRS Issues New Final Regulations for Employee Stock Purchase Plans ("ESPP")

The Internal Revenue Service (the "IRS") issued final regulations on November 17, 2009 relating to options granted under an ESPP as defined in section 423 of the Internal Revenue Code (the "Code"). Also, on the same date, the IRS issued new reporting requirements for ESPPs (see our November 19, 2009 blog). Under an ESPP, an employee can purchase shares at a discount from fair market value and also receive favorable tax treatment upon the sale of such shares if certain requirements are satisfied.

Final regulations for Code Section 423 ESPPs were most recently issued in August 2004. In July 2008, the IRS proposed revisions to the ESPP regulations and these final regulations generally reflect the terms of the 2008 proposed regulations. The final regulations include the following highlights:

- *$25,000 Annual Limit* – Code Section 423 provides that no more than $25,000 of fair market value of stock (measured at the time of the option's grant) can be purchased in a calendar year. Under the final regulations, this $25,000 statutory limit applies for each calendar year that an option is outstanding (as opposed to the option needing to be outstanding *and* exercisable);

- *Date of Grant* – The regulations state that the date of grant will be the first day of an offering *only* if the terms of an ESPP or offering: (i) specify a maximum number of shares that may be purchased by each participant during the offering or (ii) provide 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. In other words, to establish that the date of grant is the first day of an offering (which is generally desired with respect to the tax requirement that shares cannot be disposed of prior to two years after the date of grant), an ESPP or offering must expressly enumerate such share limit and cannot just rely on reciting the $25,000 annual limit and/or the overall plan limit on the number of shares that can be issued;

- *Inconsistent Terms* - If the terms of an option are inconsistent with the terms of the ESPP document or an offering under the ESPP, then the option will not be treated as being granted under a Code Section 423 ESPP which could of course negatively impact the tax treatment of the option;

- *Non-Identical Offerings* - While the terms of each offering under an ESPP need not be identical, the terms of the ESPP and each offering together must satisfy the requirements of the final regulations;

- *Exclusions* – There is greater flexibility to exclude sub-groups of highly compensated employees ("HCE") from participating in the ESPP. ESPPs may exclude HCEs: (i) with compensation above a certain level or (ii) who are officers or subject to the disclosure requirements of section 16(a) of the Securities Exchange Act of 1934. However, an ESPP cannot provide exclusions for nonresident aliens or employees under a specified age; and

- *Shareholder Approval* - Shareholder re-approval of an ESPP is needed if there is a change in the underlying shares with respect to which options are issued or a change in the granting corporation. Shareholder approval will not otherwise be needed except for increases in the number of shares that may be issued under the ESPP or a change in the participating corporations not covered in the ESPP document.

The final regulations will apply to any offering periods that commence or that have a grant date on or after January 1, 2010, but may be relied upon by taxpayers for the treatment of any option under an ESPP that is granted prior to January 1, 2010. Accordingly, sponsoring employers should review their ESPPs and processes for future ESPP offerings to ensure that they are complying with the new final regulations and that they are taking advantage of the added clarifications/flexibility provided by the new regulations.

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