

## IRS Issues Final Regulations on Employee Stock Purchase Plans

On November 16, 2009, the Internal Revenue Service (“IRS”) issued final regulations governing employee stock purchase plans (each, an “ESPP”), as defined in section 423 of the Internal Revenue Code (the “Code”). Section 423 of the Code provides favorable tax treatment for stock acquired through an option granted under an ESPP that meets the requirements set out in section 423 of the Code. At the time the option is exercised under the ESPP, the employee is not taxed, nor is there a deduction by the employer, so long as the purchase price is discounted by no more than 15% of the lower of the stock’s fair market value on the date the option is granted (typically, at the beginning of the offering period) or on the date it is exercised (at the end of the offering period), the employee retains the stock for at least two years from the date the option was granted and one year from the day it was exercised, and the other requirements of section 423 are satisfied.

The final regulations largely adopt the regulations as proposed by the IRS on July 28, 2008, with some notable changes and clarifications.

- **Effective Date:** The final regulations apply to any option under an ESPP granted on or after January 1, 2010.
- **Annual \$25,000 Limitation:** Under section 423 an ESPP (or offering) must state that no employee may accrue the right to purchase stock under all ESPPs of his or her employer and related corporations at a rate which exceeds \$25,000 in fair market value of the stock (determined as of the grant date) for each calendar year in which an option granted to such employee is outstanding. Section 423 provides that the right to purchase stock under an option accrues when the option first becomes exercisable. Due to inconsistent interpretations by practitioners, the final regulations modify the proposed regulations to provide that the limit increases by \$25,000 for each calendar year that an option is outstanding (as opposed to outstanding and exercisable).
- **Determination of the Grant Date:** In order for the commencement of an offering period to qualify as the “grant date” required to calculate holding periods, the \$25,000 stock value limitation and if applicable, the purchase price under section 423, the ESPP (or offering) must include either (i) a maximum

number of shares an employee can purchase during the offering period or (ii) a formula to determine, as of the first day of the offering, such maximum number of shares. If such maximum number of shares or formula is not fixed or determinable until the date the option is exercised, then the grant date for purposes of section 423 will be the date of exercise (as opposed to the first day of the offering). The final regulations also reiterate that merely referring to the \$25,000 limit will not satisfy this maximum number of shares/formula requirement. In respect of any offerings that will commence on or after January 1, 2010, employers that wish to treat the first day of the offering as the grant date for purposes of section 423 must amend their ESPPs to provide for such maximum number of shares or formula prior to such date or ensure that each offering thereunder contains such term.

- ***Options with Inconsistent Terms:*** The final regulations clarify that an option will not be treated as granted under a tax-qualified ESPP if its terms are inconsistent with the terms of such ESPP or the applicable offering thereunder. However, the regulations also clarify that options granted under an ESPP that fails to comply with any of the requirements of section 423 (other than those set forth in Treasury regulation section 423-2(a)(2), which require (i) that options under an ESPP may only be granted to employees of the employer corporation or a related corporation and in respect of the stock of any such corporation and (ii) shareholder approval of the ESPP) may still qualify for favorable tax treatment under section 421 of the Code so long as the terms of the offering pursuant to which the option is granted comply with such requirements.
- ***Overlapping Offerings:*** The final regulations provide that an employer may have multiple offerings that may be successive or overlapping under the ESPP and may be made separately to each related corporation that participates in the ESPP. The final regulations also clarify that the terms of the options and the rights and privileges of participating employees may vary from offering to offering. For example, it is now permissible for an offering under the ESPP to be made to all employees of one affiliated company, while there is a concurrent offering under the ESPP to a separate subsidiary that excludes, in accordance with section 423, all highly compensated employees (as discussed in more detail below). The only limits on an employer's flexibility in designing each offering is that the terms of the ESPP and each offering together must satisfy the requirements of section 423 (other than rights and privileges) and that the rights and privileges under each specific offering must be applied identically to all employees of each affiliated corporation that is participating in such offering.
- ***Employees Covered by the Plan:*** Though requested by several commenters, the final regulations do not permit employers to exclude from ESPP

participation employees who are nonresident aliens and who receive no earned income that constitutes income from sources within the U.S. or employees who are under a specified age. With respect to highly compensated employees (within the meaning of section 414(q) of the Code), the final regulations adopted the proposed regulations' provision permitting exclusion of highly compensated employees (i) with compensation above a certain level or (ii) who are officers or subject to section 16(a) of the Securities Exchange Act of 1934, as amended.

- ***Shareholder Approval:*** The final regulations clarify that new stockholder approval is required in the event there is a change in the shares with respect to which the options under the ESPP are issued or a change in the granting corporation. The regulations also clarify that, for this purpose, the stockholders of a subsidiary corporation include the parent corporation and any other stockholders of the subsidiary.

In light of the foregoing, employers should review their ESPPs for compliance prior to any offering commencing on or after January 1, 2010 and, if necessary, amend the terms of the ESPP or otherwise ensure compliance of any such offerings thereunder.

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Please feel free to call any of your regular contacts at the firm or any of the partners and counsel listed under Employee Benefits in the Practices section of our website ([www.cgsh.com](http://www.cgsh.com)) if you have any questions.

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