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Employee Benefit Plan Review

Ask the Experts

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Employee Stock Purchase Plans

Q As a private company considering whether to offer an employee stock purchase plan, what legal issues should we be considering?

A An employee stock purchase plan (ESPP) (not to be confused with an employee stock ownership plan or ESOP) is a compensation plan that permits employees to use after-tax payroll deductions to acquire stock in their company at a discount of up to 15 percent if certain conditions are met. Internal Revenue Code (IRC) Section 423 allows employees to purchase stock at a discount from the fair market value and defers taxes on the discount at the time of purchase. ESPPs are attractive because they offer employees an opportunity to share in their employer's upside and can help to align employee and employer interests.

For private companies, ESPPs may pose unique challenges under securities laws. Although Rule 701 of the Securities Act of 1933 (Securities Act) provides a registration exemption for compensation plans of private or non-reporting companies, blue sky laws vary among states regarding the requirements that a private company must meet in order to offer its securities to an employee.

IRC Section 423

IRC Section 423 governs ESPPs from a tax perspective. Section 423 imposes limits on the exercise price and the term of options granted under the plan, and generally requires that a tax-qualified ESPP be approved by shareholders and extended broadly to all employees. Additionally, for the full tax benefits to be realized, the shares acquired through an ESPP are subject to a post-acquisition holding period requirement.

Specifically, under Section 423(b), to be tax-qualified, an option to purchase stock under an ESPP must be granted to "all employees," with limited exception. The permitted exclusions include certain part-time employees (defined as employees customarily employed less than 20 hours a week or for not more than five months in a calendar year), employees who have been employed for less than two years, and highly compensated employees under IRC Section 414(q) for tax-qualified plan purposes. Additionally, all employees under a tax-qualified ESPP must be granted options to purchase stock with the same rights and privileges; however, the amount of stock available to the employee for purchase may bear a relationship to the employee's compensation.

Under a tax-qualified plan, the discount price can be up to 15 percent below the stock's fair market value, determined either at grant or exercise. As long as the plan complies with the requirements of Section 423, employees do not recognize income when the stock is purchased. Instead, employees recognize income when the stock is later sold. Under Section 423, the

holding period for stock acquired through an ESPP is the latter of two years after the date of grant of the option or one year from the date of transfer of the stock pursuant to the option. If the employee sells the stock acquired by exercise of an option under a tax-qualified ESPP before the expiration of the holding period, a "disqualifying disposition" occurs, and the employee will recognize as ordinary income (in the year of the disqualifying disposition) the amount by which the fair market value of the stock at that time exceeds the option exercise price. On the other hand, if the stock sale occurs after the holding period expires, an amount equal to the excess of the sale proceeds over the exercise price is recognized as capital gain at the time of the sale.

Under Section 423, employees may not accrue the right to purchase stock under the plan at a rate that exceeds $25,000 of the stock's fair market value (determined when the option is granted) for each calendar year for which the option is outstanding. While Section 423 governs the tax components of ESPPs, plans are also governed by securities laws because they entail securities offerings.

Federal Securities Laws

Federal securities laws generally exempt securities of private companies offered through an ESPP. While Section 5 of the Securities Act generally requires issuers of securities to register their securities, there are potentially applicable exemptions to registration.[1]

Rule 701 exempts private companies from registering securities offered as stock-based compensation pursuant to a compensatory benefit plan. Although Rule 701 has no filing requirement, the availability of the exemption is subject to conditions concerning disclosure and volume. Under Rule 701, investors must be provided with a copy of the compensatory benefit plan. Additionally, if the aggregate sales price or amount of securities sold during any consecutive 12-month period exceeds $10 million, the company must deliver certain disclosures – including risk factors and financial statements not more than 180 days old – to investors within a reasonable time period before the sale date.

The maximum amount of securities that can be issued in a 12-month period under Rule 701 is the greatest of an aggregate offering price of $1 million, 15 percent of the outstanding shares of the class, or 15 percent of the value of the company's total assets.

New York takes a unique approach to private securities offerings, including those offered by a private company under an ESPP.

Nevertheless, because Rule 701 does not preempt state securities regulations – known as "blue sky" laws – non-reporting employers must comply with applicable state laws when offering stock-based compensation to employees.

Blue Sky Laws

Because Rule 701 does not preempt blue sky laws, a private company offering securities through an ESPP must consider applicable state laws, including those in which the employee plan participant resides. As such, the sponsor company may be required to register its offering or qualify for an exemption on a state-by-state basis. States vary in their approaches: While some states, such as New Jersey, provide an exemption so that issuers do not have to register their securities in the state when offering them through an ESPP, others may require that issuers take certain steps before taking advantage of an exemption. Because employers must extend the option to participate in an ESPP to all of their employees, this can pose a challenge for employers with out-of-state employees.

New York State Approach

New York takes a unique approach to private securities offerings, including those offered by a private company under an ESPP. While the law provides an exemption for securities offered through an ESPP, employers must apply and be approved for the exemption prior to sponsoring the ESPP.

New York General Business Law Section 359-F(2)(e) exempts securities offered in connection with an "employees' stock purchase, savings, pension, profit-sharing or similar benefit plan" from registration in New York state, provided that the issuer files an application with the attorney general and that the attorney general grants an exemption. The application includes an affidavit or petition from the principal officer of the issuer, as well as a copy of the compensatory plan and a filing fee. Applicants for an exemption may not offer or sell securities within or from New York state prior to receiving approval from the state Department of Law. ❂

Note

1. Securities Act Section 3(a)(11) and Regulation D may be available but are likely to be of limited utility due to their restrictions.

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