

KIRKLAND ALERT

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IRS Releases Final Regulations That May Require Changes to Employee Stock Purchase Plans

The Internal Revenue Service released final regulations in late November relating to employee stock purchase plans (ESPPs) intended to qualify under Section 423 of the Internal Revenue Code. Generally, ESPPs are plans that give employees the “option” to purchase employer stock at a discount without having to pay income tax on that discount, so long as the stock acquired is held for at least two years after the date of the grant of the option and one year after the date the stock is acquired, and various other plan requirements are satisfied. Typically, ESPPs are structured by creating various “offering periods.” At the beginning of each offering period participating employees elect to have a certain percentage of the after-tax proceeds of each paycheck withheld during the offering period. At the end of each offering period, the withheld amounts are used to acquire stock of the employer. The purchase price for the stock may be as low as the lesser of (i) 85% of the fair market value of the stock on the date the “option” to acquire stock is granted (generally thought to be the beginning of the offering period, but see below) and (ii) 85% of the fair market value of the stock on the date this “option” is exercised, which is generally the end of the offering period when the withheld amounts are used to acquire employer stock.

The final regulations contain a rather unusual quirk regarding the identification of the “grant date” of “options” issued under an ESPP. Under the new rules, the “grant date” is the day on which the maximum number of shares that can be purchased by a participant in the ESPP is fixed and determinable. Accordingly, the regulations provide that:

the “date of grant” is the first day of the offering period if the maximum number of shares that individual participants can purchase during the particular offering period is determined prior to that date; and

the “date of grant” is the day the “option” is exercised (i.e., the date the stock is purchased) if the maximum number of shares that individual participants can purchase during the particular offering is NOT determined prior to the commencement of the offering period.

The final regulations make clear that simply designating the total number of shares reserved under the ESPP (an existing requirement under the ESPP rules) is not sufficient to fix the “date of grant” at the beginning of the offering period. Rather, the terms of the ESPP itself or the offering materials must affirmatively specify a maximum limit prior to the commencement of the relevant offering period.

The identification of the “date of grant” is important for two primary purposes. First, the two-year holding period mentioned above for qualification for favorable tax treatment starts to run on the “date of grant” of the option. Accordingly, if the maximum limit is not set prior to the commencement of the offering period, this two-year period will begin to run on the date the shares are purchased under the ESPP. Second, participants may not be eligible to defer tax on all or a portion of the discounted ESPP purchase price if that price is determined by “looking back” to the price at the commencement of the offering period unless a maximum limit is set before the commencement of the period. Failure to comply with these rules may not only spoil the program’s qualification for the Code Section 423 tax benefits, it can also cause the options to become subject to

the draconian 20% excise tax under Code Section 409A. Accordingly, we STRONGLY urge corporations that sponsor ESPPs that use this “look back” method of determining the stock purchase price to fix a maximum number of shares before the commencement of the next offering period.

The final regulations are effective for offering periods that commence on or after January 1, 2010. Unfortunately, January 1 is a common date for an ESPP offering period to commence, and therefore there is not much time to make this update to an ESPP. Other changes in the final regulations include clarification on how to apply the rule in Section 423 that limits purchases under ESPPs to \$25,000 of stock each calendar year, the treatment of non-U.S. employees, and when shareholder approval of plan modifications is required.

Our Recommendation:

Any employer maintaining an ESPP that does not have a specific limit on the number of shares that can be purchased in an offering period should add such a specific limit before the first offering period to begin on or after January 1, 2010. This change typically would not require stockholder approval; however, such changes likely will require action by the plan administrator, the board of directors, or the Compensation Committee, depending on the specific amendment or administration provisions contained in the ESPP. The Executive Compensation Group is, of course, happy to assist in any way with a review of any ESPP or answer any further questions.

The Executive Compensation Group counsels clients on a full spectrum of compensation issues, communicating complex and technical legal concepts in a practical, business-oriented fashion. For more information, please feel free to contact any member of the Executive Compensation Group, including:

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