ESPP for Everyone!

Here at SOS we are firm believers in broad-based employee stock purchase plans, both qualified and non-qualified. In this era of dramatic and frenzied market volatility there's a lot to be said for an equity instrument that encourages employees to save money, is never underwater, generates cash flow and tax deductions for the company while being (usually) fairly well understood, and generally valued by employees.

Just to refresh those unfamiliar with the difference between 423-qualified and non-qualified plans: qualified plans are designed in compliance with IRC Section 423 and give tax-advantaged treatment to participants if they hold the shares more than one year from purchase and two years from enrollment (grant). There are regulations on length of offering period, eligibility requirements, and many other facets of qualified plans. Non-qualified plans are not designed in accordance with any IRC section and may be structured in many different ways.

In this SOS Xtra, we thought we'd highlight a few of the results from the NCEO / CEPI 2009 Employee Stock Purchase Plan Survey (conducted last summer) to give our readers a sense of what companies are (and aren't) doing with their ESPPs. In general, qualified plan offerings seem to be a bit "richer" for employees, but then again, the flexibility of non-qualified plans is appealing to many companies. (In fact, some companies elect to have a non-qualified plan even if the terms look like at 423 plan!)

The online questionnaire was available from June 9 to July 24, 2009. Data was compiled from 412 respondents -

The full report and survey data set is available on the NCEO website.

Options in Offering Periods

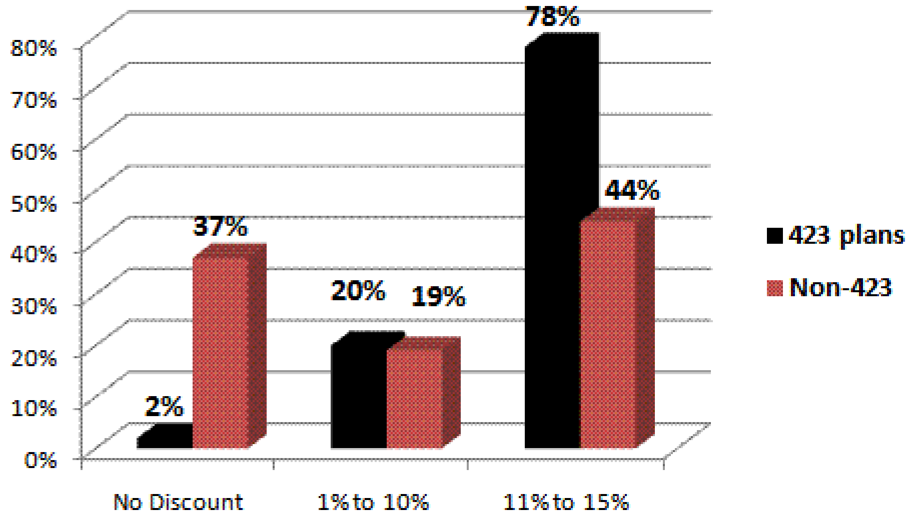
Companies with non-qualified ESPPs tend to have shorter offering period than those with 423-qualified ESPPs. Fifty-three percent of all companies with qualified plans have 6-month offering periods, while only 26% of non-qualified plans have 6-month offerings. Non-423 plans have much higher rates of monthly and quarterly purchases, at 32% each.

Anecdotally, here at SOS, we have definitely seen the average length of an offering period drop since the halcyon pre-expensing days (decreasing the offering period is one way to reduce the expense, since the term of the "option" is shorter, the fair value is also less). But many had predicted the demise of ESPPs and that prediction has thankfully proved false.

Other ways we've seen companies reduce expense include: reducing the discount, eliminating the lookback (which is generally not as well understood as the discount, so often perceived as "less valuable" by employees), eliminating the "reset provision", and adding a beginning price limit, which prevents the employee from buying more shares if the price drops during the purchase period.

Delightful Discounts

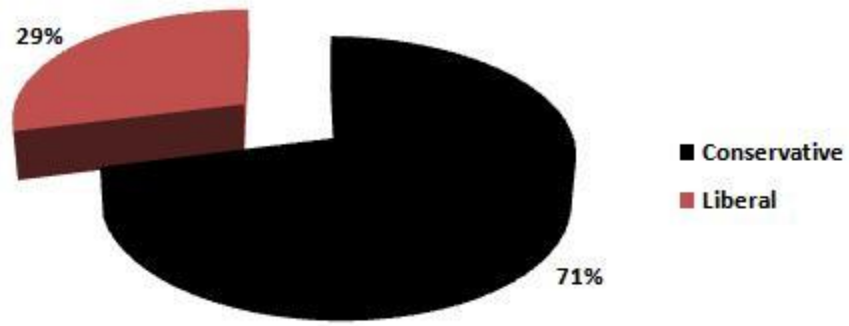
Again with 423 plans it seems the employee benefit is a bit higher than those of non-qualified plans with 78% of all 423 plans offering between discounts ranging between 11% and 15%. Non-423 plans ran the gamut as the chart below illustrates.



The Sky's the Limit!

A data byte that surprised us was the number of 423 plans that use the "conservative approach" to apply the mandated $25K limit. Many of the plans in the Silicon Valley, where SOS is headquartered, apply the "liberal" approach - which allows the inclusion of any unused portion of the $25,000 limit to "roll into" the next year when the offering period spans the calendar year. The "conservative" approach does not roll forward any amounts from previous years, but simply counts the $25K limit on a straight calendar-year basis for the year in which the purchase occurs.

There was much ado about nothing last year when the proposed revisions to the 423 regulations said that the liberal approach was not appropriate. The final regulations clarified that the liberal approach is acceptable. From the data shown, only 29% of respondents use the liberal approach in any case.



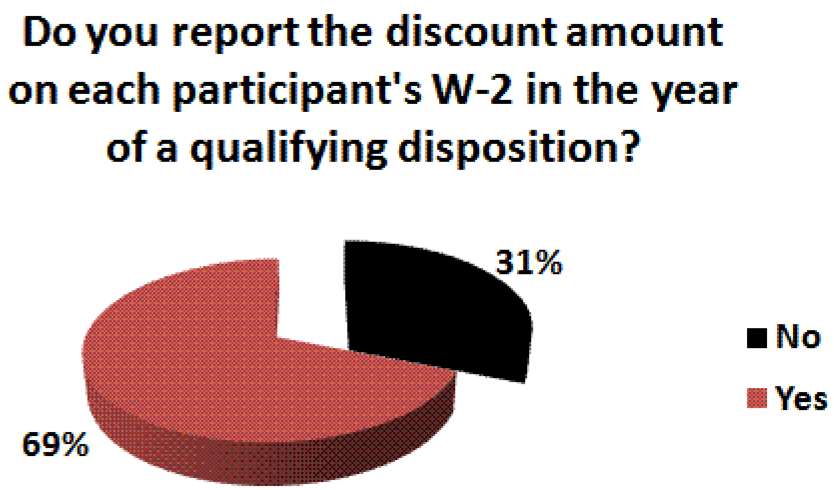
Limits of a Different Color

Something that does look concerning at the outset is that 45% of respondents did not have a limit other than the $25K limit in place per participant per purchase period. However, under the revised 423 regulations, such a limit is required in order to establish a "grant date" at the beginning of the offering period.

Hopefully all those respondents have reviewed their plans and made some changes in order to avoid having the grant date set at the time of purchase (and triggering negative accounting and tax holding period consequences).

Daunting Dispositions

Probably the biggest downside to 423-qualified plans is the requirement to track and report dispositions, even after the holding period for preferential tax treatment has passed. (Honestly, who can track dispositions on shares for employees who terminated 10 years ago? Is that really realistic? But then who ever said the tax code was realistic?) Many companies surveyed reported that they do not report qualified-disposition income on W-2s, as is required by the tax code.



Our experience has been that most companies use their designated broker to track and report dispositions via a report download. Some companies go so far as to restrict participants from transferring shares out of the designated brokerage account while they are employed at the company. The participants can sell anytime they want, but cannot transfer the shares out, so that dispositions can be easily tracked by the broker - sometimes just during the holding period, sometimes beyond. Some even go so far as to restrict sales AFTER the participant has terminated. While this approach seems draconian to some, it does facilitate and ease compliance with IRS regulations.

Give us your thoughts! Does your company restrict transfers? If not, why not? [Complete our Xpress survey today.]

All-in-all, though some features of ESPPs may be cumbersome, we still see many companies (and participants, for that matter) that are devoted to their plans. These companies feel that the benefits really do outweigh the headaches and the hassles.

Questions or comments? Please email us at xtra@sos-team.com

About Stock & Option Solutions

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