Employee Stock Purchase Plans: The Introductory Course

Presentation for:
Executive Compensation Webinar Series
November 14, 2019

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About David Branham

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- David practices in the areas of taxation, executive compensation and employee benefits
- Before entering private practice, David:
  - Obtained his B.A. from Brigham Young University
  - Obtained his J.D. from Notre Dame Law School
    - Symposium Editor, Notre Dame Journal of Legislation
- David is licensed to practice in:
  - District of Columbia
  - Ohio

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- Upcoming 2019 webinars:
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  - Upcoming Proxy Season: Compensatory Thoughts from ISS (Annual Program) (01/16/2020)
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  - ABC's in Drafting Proxy Tabular Disclosure (Part II of II) (03/12/2020)
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  - Compensation Committee Governance (08/13/2020)
  - Preparing for Proxy Season: Start Now (Annual Program) (09/10/2020)
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Our Compensation Practice – What Sets Us Apart

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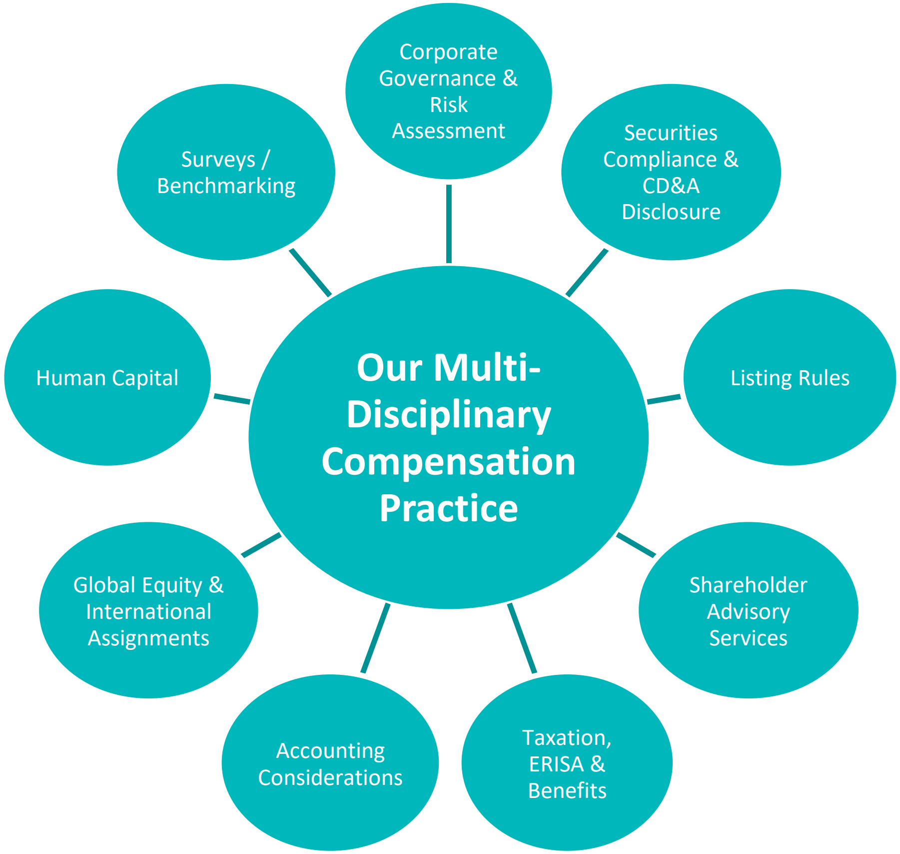
- Compensation issues are complex, especially for publicly-traded issuers, and involve substantive areas of:
  - Tax,
  - Securities,
  - Accounting,
  - Governance,
  - Surveys, and
  - Human Resources

- Historically, compensation issues were addressed using multiple service providers, including:
  - Tax lawyers,
  - Securities/corporate lawyers,
  - Labor & employment lawyers,
  - Accountants, and
  - Survey consultants

Our Compensation Practice – What Sets Us Apart (cont.)

- The members of our Compensation Practice Group are multi-disciplinary within the various substantive areas of compensation. As multi-disciplinary practitioners, we take a holistic and full-service approach to compensation matters that considers all substantive areas of compensation



Our Compensation Practice – What Sets Us Apart (cont.)

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- Our Compensation Practice Group provides a variety of multi-disciplinary services within the field of compensation, including:

Traditional Consulting Services

- Surveys
- Peer group analyses/benchmarking
- Assess competitive markets
- Pay-for-performance analyses
- Advise on say-on-pay issues
- Pay ratio
- 280G golden parachute mitigation

Corporate Governance

- Implement “best practices”
- Advise Compensation Committee
- Risk assessments
- Grant practices & delegations
- Clawback policies
- Stock ownership guidelines
- Dodd-Frank

Securities/Disclosure

- Section 16 issues & compliance
- 10b5-1 trading plans
- Compliance with listing rules
- CD&A disclosure and related optics
- Sarbanes Oxley compliance
- Perquisite design/related disclosure
- Shareholder advisory services
- Activist shareholders
- Form 4s, S-8s & Form 8-Ks
- Proxy disclosures

Design/Draft Plan

- Equity incentive plans
- Synthetic equity plans
- Long-term incentive plans
- Partnership profits interests
- Partnership blocker entities
- Executive contracts
- Severance arrangements
- Deferred compensation plans
- Change-in-control plans/bonuses
- Employee stock purchase plans
- Employee stock ownership plans

Traditional Compensation Planning

- Section 83
- Section 409A
- Section 280G golden parachutes
- Deductibility under Section 162(m)
- ERISA, 401(k), pension plans
- Fringe benefit plans/arrangements
- Deferred compensation & SERPs
- Employment taxes
- Health & welfare plans, 125 plans

International Tax Planning

- Internationally mobile employees
- Expatriate packages
- Secondment agreements
- Global equity plans
- Analysis of applicable treaties
- Recharge agreements
- Data privacy

Purpose of this Presentation

- Provide overview of Employee Stock Purchase Plans ("***ESPPs***")
- Provide basic requirements of qualified ESPPs
- Provide basic overview of securities requirements for ESPPs
- Discuss ESPPs in the context of a global workforce
- Discuss a newly available method for boosting enrollment in ESPPs

Overview of ESPPs

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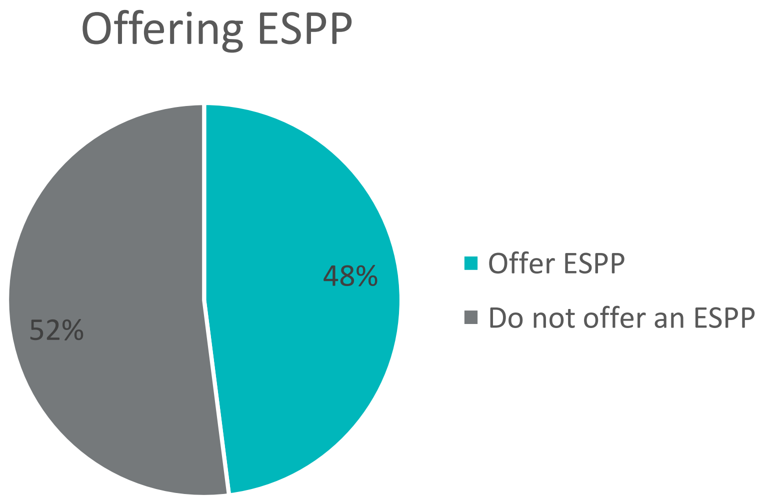
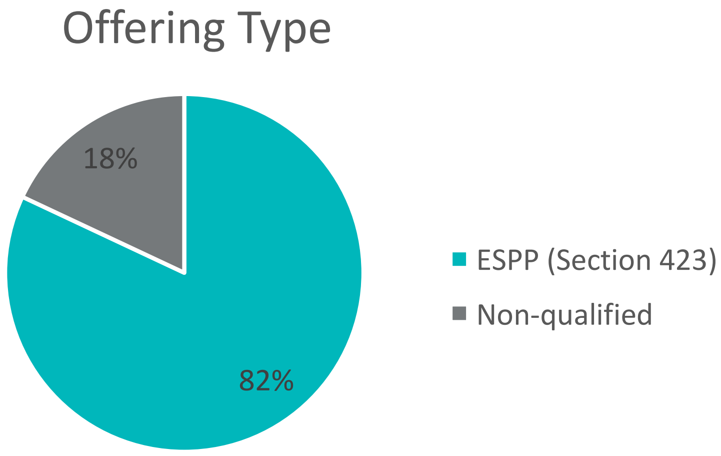
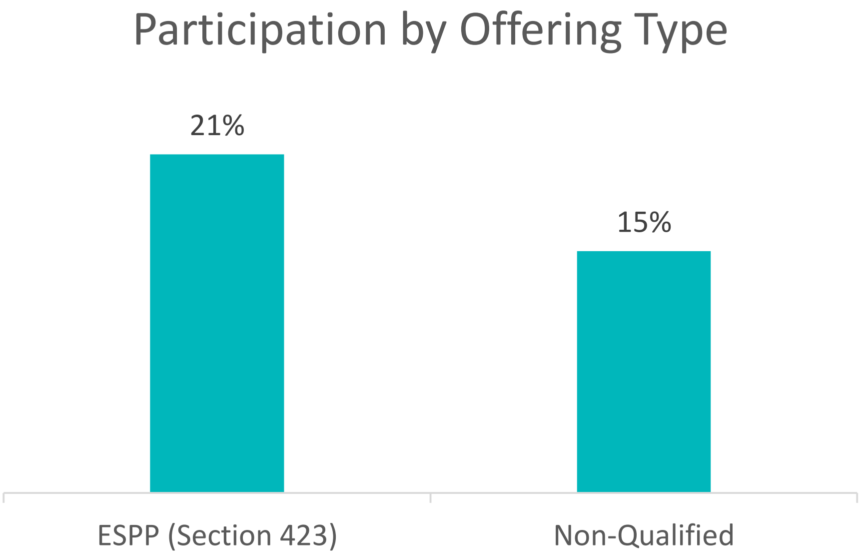
- The primary purpose of an ESPP is to facilitate an employee's purchase of employer stock through payroll deductions
  - Such purchase is typically at a discount
- To receive favorable tax treatment comparable to Incentive Stock Options ("***ISOs***"), an ESPP must comply with Section 423 of the Internal Revenue Code of 1986, as amended ("***Section 423***")
  - However, an employer could sponsor an ESPP that is intended to NOT qualify under Section 423

Overview of ESPPs







Source: Fidelity 2019 ESPP data analysis; 227 ESPP plans – 4.9 million eligible participants

Source: NASPP 2017 Stock Plan Administration survey

Overview of ESPPs

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	Qualified	Non-qualified
Regulatory code	§423	N/A
Design Flexibility	§423 and regulations	No limitations (except ISS factors)
Discount/Match	Maximum 15% discount (+ lookback)	Flexible (ISS – 20% discount/25% match)
Lookback	Available	Available
Eligibility	All employees (few permissible exceptions)	Flexible (ISS – plan must be broad-based)
Tax (to participants)	Tax at sale of stock (Qualifying or Disqualifying)	Tax at purchase
Withholding obligation	No	Yes

Overview of ESPPs

	Qualified	Non-qualified
Tax (to company)	Disqualifying dispositions only: Tax deduction for spread at purchase	Tax deduction for spread at purchase
Required reporting	§6039 Disposition tracking	None (aside from regular wage tax reporting)
Shareholder approval	Yes	Yes
Limits	$25,000 value per year	None

- *[Note to Slide: Unless otherwise indicated, all further references to an ESPP or Plan in this webinar is intended to mean an ESPP that is qualified under Section 423]*

ESPPs: Tax and Document Requirements

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- Requirement No. 1 – only employees can participate
  - The plan document must limit participation in the ESPP to employees of the employer and/or its parent/subsidiary
  - Whether an individual is an employee is determined in accordance with the withholding tax rules under Section 3401(c)
  - For this rule, the employment relationship continues to exist if the individual is on military leave, sick leave or any other bona fide leave of absence (but only if the leave period does not exceed 3 months, or if longer, the individual's right to reemployment is required by statute or contract) – this rule also applies to ISOs
  - If reemployment is not required by statute or contract, then the employment relationship terminates on the first day following such 3 month period

- Under this Requirement No. 1, all employees of the employer, except the following, must be provided participation rights:
  - Those who have been employed by the employer less than 2 years;
  - Those whose customary employment is 20 hours or less per week;
  - Those whose customary employment is less than 5 months per calendar year; and
  - Highly compensated employees (as defined under Section 414(q))

ESPPs: Tax and Document Requirements

- Requirement No. 2 – exclude 5% owners
  - Either the plan document or the offering must exclude any employee who owns 5% or more of the voting power or value of all classes of stock of the employer or its affiliates
  - Such ownership test is applied prior to the contemplated purchase under the ESPP by the employee
  - Such ownership test is applied as though all stock options held by the employee were exercised (*e.g.*, even unvested stock options are deemed exercised)
  - For purposes of determining the employer's outstanding shares (to calculate 5%), only issued and outstanding shares immediately after the purchase are included (treasury shares and shares subject to outstanding stock options are not counted)
  - The constructive ownership rules of Section 424(b) apply (*i.e.*, ownership by certain family members and proportionate ownership owned by certain entities are attributed to the employee)

ESPPs: Tax and Document Requirements

- Requirement No. 3 – stockholder approval
  - Stockholders of the granting corporation must approve the ESPP within 12 months before or after the ESPP is adopted by the Board of Directors
  - As approved by the stockholders, the plan document must:
    - Specify the number of shares that can be issued under the ESPP; and
    - Specify the corporations whose employees are eligible to participate
  - Stockholder approval would again be required if:
    - There is an increase in the number of shares to be issued under the ESPP,
    - There is a change in the corporations whose employees are eligible under the ESPP, or
    - There is any other change to the ESPP that is deemed to be the adoption of a new ESPP
  - Stockholder approval is not required for NYSE and NASDAQ listing rules which alleviates some timing concerns that may otherwise arise with the stockholder vote
- Requirement No. 4 – same rights and privileges
  - Either the plan document or the offering must state that all employees who participate in the ESPP must have the same rights and privileges
  - Such is applied on an offering-by-offering basis, which means separate offerings could have different terms
  - Which means, for example, an offering to employees of a foreign jurisdiction could have terms that are less favorable than an offering to U.S.-based employees

ESPPs: Tax and Document Requirements

- Requirement No. 5 – annual calendar year limitation of $25,000
  - Either the plan document or the offering must provide that an employee cannot accrue the right to purchase more than $25,000 of stock for each calendar year in which the offering was outstanding
    - Such value is determined by the underlying stock's fair market value on the date such right is granted
  - Important to understand that unused portions of the $25,000 can be carried forward from one calendar year to the next
    - Example: assume an offering to an employee spans two calendar years. If such employee implements no purchases in calendar year 1, then the applicable limit in calendar year 2 would be $50,000 (again, value determined at the time of the stock's fair market value on the date the grant)

ESPPs: Tax and Document Requirements

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- Requirement No. 6 – determine the date of grant
  - The date of grant is either the first day of the offering OR the purchase date
  - For the date of grant to be deemed the first day of the offering period the plan or offering must include the maximum number of shares that may be purchased by any participant during an offering period
    - Most companies prefer that the date of grant be the first day of the offering period because the shares must be held two years from the date of grant (and one year from the date of purchase) to receive favorable tax treatment
    - No particular number of shares is necessary to satisfy this requirement and the number may be formulaic
  - If the ESPP does not include a maximum number of shares then the date of grant is the purchase date
  - To utilize a "look back" feature allowing the employee to purchase shares at FMV at either the date of grant or the purchase date, then the maximum number of shares that may be purchased by participants must be included in the plan or offering
    - If such maximum number of shares is not included then the look back accomplishes nothing because the date of grant and the purchase date become one in the same
  - The date of grant also has various employee tax implications which inure to the benefit of the employee if the date of grant is the first day of the offering

ESPPs: Tax and Document Requirements

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- Requirement No. 7 – determine the purchase price
  - Either the plan or the offering must provide that the purchase price be no less than the lesser of:
    - 85% of the stock's fair market value at the date of grant,

      or
    - 85% of the stock's fair market value at the time of purchase
  - It is common for a "look back" pricing methodology to be used pursuant to which an employee is able to purchase stock at the lesser of the above during the offering period (*e.g.*, 24 months) or a series of purchase periods within an offering period (*e.g.*, increments of 6 months)
  - A "look back" effectively provides for discounts in excess of the statutory limit of 15%
  - For example: Your company has allows for the full 15% discount with a 6 month lookback
    - Date of Offer/Date of Grant stock price: $10
    - Date of Purchase stock price: $12
    - With a lookback, your purchase price for stock worth $12 is only $8.50 (15% of $10)
    - This gives you an effective discount of *41%* off the FMV of the stock at the time of purchase ($3.50 spread at exercise divided by $8.50 purchase price)

ESPPs: Tax and Document Requirements

- Requirement No. 8 – limit on offering period
  - The maximum limit for an offering period depends upon the structure of the ESPP
  - If the ESPP is structured as a "look back" (*e.g.*, the lesser of 85% of the fair market values on the date of grant or the date of purchase), then
    - Either the plan or offering must provide for a maximum offering period of 27 months or less from the date of grant
  - If the ESPP is structured so that the purchase price is at least 85% of the fair market value of the stock on the date the purchase, then
    - Either the plan or offering must provide for a maximum offering period of 5 years or less from the date of grant
- Requirement No. 9 – restrictions on transfer
  - The plan document must prohibit transfer except by will or the laws of descent and distribution
  - Additionally, only the employee may exercise a purchase right during his or her lifetime

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ESPPs: Employee Tax Consequences

- Date of grant
  - No tax consequence to the employee

- Date of exercise
  - No tax consequence to the employee

- Employee sells the stock after an exercise
  - Similar to ISOs, the tax consequences depend upon whether the sale was before or after the statutory holding period, such applicable holding period being the later of (i) 1 year from the date of purchase and (ii) 2 years from the date of grant

ESPPs: Employee Tax Consequences (cont.)

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- If the sale is after the holding period, then the employee recognizes (in the year of sale) ordinary income equal to the lesser of: (i) the FMV of the stock on the date of grant minus the exercise price, or (ii) the amount realized on the sale minus the exercise price
  - Any additional gain or loss would be recognized at long-term capital gains rates

- However, if the sale is during the holding period, then the employee recognizes (in the year of sale) ordinary income equal to the FMV of the stock on the date of purchase minus the exercise price
  - Any additional gain of loss would be recognized as short-term or long-term capital gains, depending on the holding period
  - Note that this a "disqualifying disposition" and is similar to the tax treatment upon employee exercise under a non-qualified ESPP
    - In the event of a disqualifying disposition the employer may take a deduction to match the employees ordinary income

ESPPs: Employer Tax Consequences

- Generally, and similar to an ISO, an employer would NOT be entitled to a deduction at the date of grant or the date of exercise
  - However, if the employee sells the stock without satisfying the holding period requirement, then the employer is entitled to a deduction equal to the amount the employee recognized as income

- Wage withholding is not required
  - This is true even if the employee sells the stock without satisfying the holding period

- 6039 information statements and returns
  - Employers who sponsor an ESPP have a year end reporting requirement under Section 6039
  - For transfers of stock acquired under an ESPP, the employer must provide information statements to employees no later than January 31st, and must file information returns to the IRS no later than February 28th (or March 31st if filing electronically)
  - The information statement to the employee must be on Form 3922 or must be contained on a substitute form that satisfies IRS Publication 1179

ESPPs: Federal Securities Laws

- Generally, all “offers” and “sales” to sell “securities” must be made pursuant to:
  - An effective registration statement filed with the SEC, or
  - An exemption from registration

- A Form S-8 is a short form registration statement that may be used for offerings under an “employee benefit plan”
  - Such statement is effective immediately upon filing with no waiting period and no SEC review
  - It is a “shelf registration statement” that remains effective until deregistration

- A Form S-8 consists of two parts:
  - A prospectus which must be provided to eligible employees, but not filed with the SEC, and
  - A short-form registration statement filed with the SEC, but not provided to employees

- The SEC’s position is that an employee makes an “investment decision” when he or she elects to authorize payroll deduction under the ESPP
  - This means that the Form S-8 should be filed prior to any employee authorizations for payroll deductions

ESPPs: International Workforce

- If you have a global workforce or a workforce that is expanding globally you need to be aware of some of the requirements for ESPPs. With respect to our prior requirements, two to pay particular attention to are:
  - Requirement No. 1, all employees of the employer must be provided participation rights
    - Employees of a foreign branch must be provided participant rights
    - Employees of a foreign subsidiary (as a separate legal entity) do not need to be provided participation rights
  - Requirement No. 4, the same rights and privileges are to apply to all employees
    - Such is applied on an offering-by-offering basis, which means an offering to foreign jurisdictions could have terms that are less favorable than an offering to U.S.- based employees
- Many employers want to provide similar benefits across all countries for continuity and the optics of equality

ESPPs: International Workforce (cont.)

- Three ways to structure ESPP with an international workforce:
  - Qualified ESPP with separate offerings in the U.S. and outside the U.S.
  - Omnibus plan with qualified ESPP component in the U.S. and a non-qualified ESPP component outside the U.S.
  - Qualified ESPP in the U.S. and separate plan that is a non-qualified ESPP outside the U.S.

- As an additional option:
  - Qualified ESPP in the U.S. and seek out the closest alternative to a qualified ESPP in the foreign country

- The following are some examples of programs in foreign countries that approximate qualified ESPPs in the U.S.

United Kingdom – Share Incentive Plans

- Shares awarded under a Share Incentive Plan ("***SIP"***) are held in trust and provided they are held for at least five years, the SIP is tax-efficient for both the employer and the employees

- SIPs can have a number of elements, including:
  - Partnership Shares: pre-tax purchases by employees of up to £1,800 each year with a "look back" type feature determining purchase price
  - Matching Shares: when Partnership Shares are offered, the company may also offer matching shares- up to a maximum ratio of 2 matching shares for every Partnership Share purchased
  - Free Shares: shares awarded to all employees worth up to £3,600 each year
  - Dividend Shares: dividends received on SIP shares can be reinvested into further shares with no limit on the value of dividends that may be reinvested

United Kingdom – Share Incentive Plans (cont.)

- If the employee elects to releases the shares from the SIP trust at or beyond a five year holding period and sells the shares on the same day, the employee pays no income tax or capital gains tax upon sale
  - If, the employee withdraws the shares from the trust after the five year holding period and continues to hold the share for investment he will only owe capital gains tax on gains that occur after withdrawing shares from the trust

- The employer is entitled to tax relief for:
  - The employee's salary used to buy partnership shares
  - Any additional costs incurred in providing partnership shares
  - The market value of matching shares and free shares when they are acquired by the trust
  - The set up and running costs of the SIP

Spain – EUR 12,000 Stock Plan Exemption

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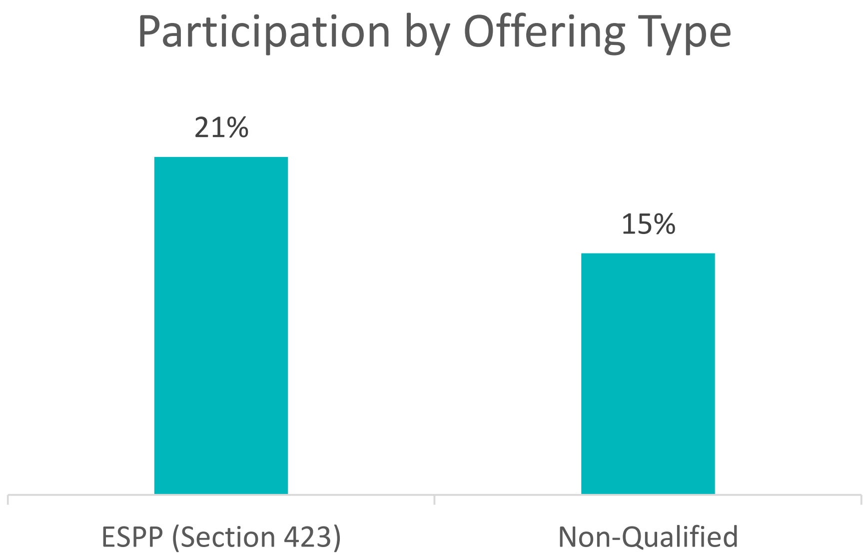
- Spain's EUR 12,000 stock plan exemption does not necessarily mimic the ESPP but it does allow for significant employer stock benefits

- A tax exemption is available to employees on the first €12,000 of income realized from share settled compensation, if the following requirements are met:
  - All current employees are eligible to participate on the same terms and conditions
  - Not available to greater than 5% shareholders
  - The employee holds the shares for at least three years following the acquisition date

- A second program is available which allows an exemption of 30% of income above the €12,000 exemption but is more difficult to obtain because the stock awards must be granted on an irregular basis and must not be vested/exercisable for two years following the grant

- Employer tax benefits are available but will depend on the type of stock program sponsored to assist employees in achieving the exemptions

ESPPs – Increasing Enrollment



Source: Fidelity 2019 ESPP data analysis; 227 ESPP plans – 4.9 million eligible participants

- Reasons for low participation can stem from several factors including:
  - Lack of knowledge of the plan
  - Lack of understanding of how the plan works and the potential benefits
  - Cumbersome or confusing enrollment procedures
  - Inability to afford payroll deductions

ESPPs – Increasing Enrollment (cont.)

- An interesting design has recently been developed and supported by the IRS in PLR 201911002 which will assist when employees feel they cannot afford the payroll deductions to participate in a ESPP

- In sum, the purchase of shares at exercise can be funded by short-term loans which are then repaid by selling some of the shares purchased under the ESPP
  - The employee would retain the remaining shares with the built in discount to FMV

- To accomplish the task, the employer works with a partner (i.e., the entity that helps facilitate the loan process) that will make interest-free loans allowing employees to maximize their participation in the ESPP, as follows:
  - Employees would sign up for a certain level of payroll deduction (*e.g.*, 5%)
  - Immediately prior to the close of the offering period or purchase period, the partner writes a check to the employer through a temporary interest free loan on behalf of the employee, maximizing the employee’s contribution
  - The employer issues the appropriate amount of stock and the partner sells enough shares to repay the loan and the net shares are deposited in the employee’s account

ESPPs – Increasing Enrollment (cont.)

- The legal hurdle is that offerings under the ESPPs must be available to *all* employees under the same rights and privileges (Requirement No. 4 herein) and the Sarbanes-Oxley Act of 2002 prevents loans to certain employees (*e.g*., certain executives)
  - The concern is that if the ESPP does not meet the same rights and privileges requirement for the offering then no awards would qualify for favorable tax treatment under Section 423
  - The IRS, via the aforementioned PLR, stated that an employees inability to use a loan to pay the exercise price because of the application of SOX would not cause the ESPP to violate the same rights and privileges requirement

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- Title:
  - How to Design Restrictive Covenants & Economic Forfeitures

- When:
  - 10:00 am to 11:00 am Central
  - December 12, 2019