

EMPLOYEE BENEFITS ALERT

IRS ISSUES FINAL ESPP REGULATIONS, WHICH BECOME EFFECTIVE JANUARY 1, 2010

The Internal Revenue Service (IRS) and Treasury Department have issued final regulations for employee stock purchase plans (ESPPs) designed to qualify for favorable tax treatment under Section 423 of the Internal Revenue Code of 1986, as amended. The final regulations provide guidance to assist taxpayers in complying with Section 423 and also clarify certain existing rules. The final regulations apply with respect to any option grants that are intended to qualify for favorable tax treatment under Section 423 on or after January 1, 2010. Taxpayers may rely on the final regulations for the treatment of any statutory options granted prior to January 1, 2010. We recommend that companies with ESPPs review their plans to determine whether any amendments will be required to comply with the final regulations. This alert briefly summarizes the key provisions of the final regulations.

MULTIPLE OFFERINGS

The final regulations provide that offerings under an ESPP may be consecutive or overlapping and clarify that the terms of each offering under an ESPP may be different, even where multiple offerings overlap, so long as the terms of each offering (together with the plan) satisfy Section 423's requirements.

EMPLOYEES COVERED

Section 423 generally provides that an ESPP or offering must, by its terms, provide that options are to be granted to all employees of any corporation whose

employees are granted options. However, Section 423 permits an employer to exclude certain categories of employees from participation in an ESPP, including employees who have been employed less than two years; employees who customarily work 20 hours or fewer per week; certain seasonal employees; and highly compensated employees. The final regulations clarify that an ESPP or an offering will not fail to satisfy Section 423's coverage requirements if the employer excludes a subset of any such groups (e.g., employees who have been employed less than one year or those who customarily work 10 hours or fewer per week). In the case of highly compensated employees, the final regulations provide that the terms of an ESPP or offering may exclude highly compensated employees (i) with compensation above a certain level or (ii) who are officers subject to Section 16(a) of the Securities Exchange Act's disclosure requirements. The terms of each offering may provide different exclusions of employees, even where multiple offerings overlap, so long as the exclusions with respect to a particular offering are applied in an identical manner to all employees.

FOREIGN EMPLOYEES

Section 423 generally requires that all employees granted options under an ESPP have the same rights and privileges. This requirement has been problematic for employers with employees in foreign jurisdictions with different or conflicting legal requirements. Accordingly, the final regulations provide that an ESPP or an offering will not fail to satisfy Section 423's requirements if, in order to comply with the laws of a foreign jurisdiction, the terms of an option or offering to citizens or residents of foreign jurisdictions are less favorable than the terms of options granted under the ESPP or offering to U.S. employees.

STOCKHOLDER APPROVAL

Section 423 requires that an ESPP be approved by the stockholders of the granting corporation within 12 months before or after the date the ESPP is adopted. In light of some uncertainty regarding the application of this rule in certain situations, the final regulations provide a more comprehensive list of the situations in which new stockholder approval is required. In particular, the final regulations clarify that new stockholder approval is required if there is a change in the shares with respect to which options are issued or a change in the granting corporation, for example, in the case of certain corporate transactions.

ANNUAL \$25,000 LIMITATION

Under Section 423, an ESPP must provide that no employee will be permitted to accrue the right to purchase stock at a rate which exceeds \$25,000 in fair market value of the stock (determined on the date of grant) for each calendar year in which an option granted to the employee is outstanding. Section 423 further provides that the right to purchase stock under an ESPP accrues when the option first becomes exercisable. There has been some interpretive disagreement regarding whether or not exercisability should be taken into account when applying the \$25,000 annual limit. In response to comments, the Treasury Department and the IRS decided to modify the proposed regulations and provide that no employee may purchase stock under all ESPPs of an employer corporation and its related corporations at a rate that increases by more than \$25,000 of stock (based on the fair market value of the stock on the grant date) for each calendar year that an option is outstanding (without regard to exercisability).

DATE OF GRANT

Setting the grant date of an option under an ESPP is essential, as it is the relevant date for compliance purposes, including ensuring that the participation requirements are satisfied and applying the annual \$25,000 limitation. Under prior regulations, the determination of when an option was granted appeared to include a requirement that the minimum option price be fixed or determinable. Because options granted under an ESPP may be priced at the lesser of an amount equal to 85 percent of the fair market value of the stock at the time the option is granted and an amount equal to 85 percent of the fair market value of the stock at the time the option is exercised, it is not always possible to determine the minimum option price on the first day of an offering. However, many granting corporations intend for the first day of the offering period to be the date of grant. Like the proposed regulations, the final regulations generally provide that the grant date of an option means the date when the maximum number of shares that can be purchased under the option is fixed or determinable, even if the minimum option price is not fixed or determinable. The final regulations further provide that the date of grant will be the first day of an offering period if the terms of an ESPP or offering designate a maximum number of shares that may be purchased by each employee during the offering, or if the terms of the ESPP or offering provide a formula on the first day of the offering to determine the maximum number of shares that may be purchased. If the maximum number of shares that may be purchased under an

option is not fixed or determinable until the date the option is exercised, then the date of exercise will be the date of grant of the option.

CONSEQUENCES OF INCONSISTENT TERMS

The final regulations provide that, in order to receive favorable tax treatment, an option must be consistent with the terms of the ESPP or an offering made under the ESPP. If an option with terms that are inconsistent with the terms of the ESPP or the offering is granted to an eligible employee, and the employee is not granted an option under the offering that is consistent with the terms of the ESPP or offering, then none of the options granted under the offering will be eligible for the favorable tax treatment.

CONTACT INFORMATION

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