EMPLOYEE STOCK PURCHASE PLAN (ESPP)

STONEHEARTH CAPITAL MANAGEMENT

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WHAT ARE THEY?

An Employee Stock Purchase Plan (ESPP) is a type of stock plan offered by employers as a benefit to employees. The primary feature of ESPPs is that they allow you to purchase your company's stock at a discount from the current stock market price. Most companies offer a 15% discount, which is the maximum discount allowed. On set dates, determined by the plan, you purchase company shares at the stated discount, using the after-tax payroll deductions that you have allocated to the plan. These plans allow you to make regular, ongoing purchases of your employer's stock at a discounted price. Most ESPPs are designed to qualify under Section 423 of the IRS tax code. When plans meet these requirements, they offer tax advantages for the employee participants.

There are many important details and key terms related to these plans, which we will explain below. Let's start by looking at the key terms used by these plans, then we'll look at examples to illustrate the tax benefits of these plans.

- **Enrollment Period** - This is the period of time that you can elect to participate in your company's plan. This can also be referred to as the Offering Period by some companies.

- **Offering Period** –During the offering period, after-tax payroll deductions are accumulated from your pay until the end of the period. Companies can use an offering period of 6 months, or a multiple of 6 months. Typical offering periods are 12 to 24 months.
    - **Purchase Period** –This term can be used interchangeably with "offering period" depending on the length of an offering period. For example, if a company uses an offering period of 12 months, there are usually two six-month purchase periods within that one offering period.
    - **Grant Date** –This date is marked by the first day of the offering period and it is an important date for the tax provisions of an ESPP. This is the date used to determine the stock price used in the calculation of the annual purchase limit of $25,000 and this date is used in plans that have a lookback feature, described below.
- **Purchase Date** –This is the date that you purchase shares of company stock and it is usually the last day of the offering or purchase period. The after-tax payroll contributions that you have made during the offering period are used to purchase the shares at the discount stated in the plan, usually 15%.

(1) For ESPPs that qualify under The Internal Revenue Code Section 423, employees are permitted to purchase a maximum of $25,000 of stock under the plan per calendar year.

The Lookback Provision
Along with the chance to buy stock at a discount, some plans also feature an additional benefit called the lookback provision. This feature means that you buy the shares at the lower of two price points – the stock price at the beginning or the end of the purchase period. As discussed above, the typical purchase period is six months, even if this means there are multiple purchase periods with a longer offering period. Let's look at an example of buying company stock with a plan that has a lookback provision and a 15% discount.

Example:
Assume your company's stock price is $20 at the beginning of the purchase period and six months later the price grows to $25 dollars at the end of the period. With the lookback feature, you buy the shares at a 15% discount off $20. This means your purchase price is $17. The lookback feature provides even extra leverage since your purchase price of $17 is a discount of 32% off the $25 price at the end of the purchase period when you buy the shares.

WHAT HAPPENS WHEN YOU SELL YOUR SHARES?

You can leverage potential tax benefits with Section 423 ESPPs when you hold the shares for at least one year from the purchase date and two years from the beginning of the purchase period. You do not trigger a taxable event until you sell your shares. When you sell your shares, the purchase price discount (or your actual gain, if lower) is taxed at ordinary income rates. The rest of your gain is taxed as long-term capital gain. Let's look at a couple of examples.

Example 1:

The ESPP uses a 15% discount and has a lookback provision. Assume you have met the holding period requirements for favorable tax treatment, described above.

Stock price at offering period start:	$10.00
Stock price at offering period end:	$16.00
Sale Price:	$22.00
Ordinary Income:	$1.50 (15% of $10)
Cost-basis:	$1.50 of ordinary income + $8.50 purchase price
Long-term capital gain:	$12.00 ($22 - $10)

Note: In the example above, since the plan had a lookback provision, the purchase price is based on the first day of the offer period price of $10, since that was lower than the last day of the offer period price of $16.

Example 2:

Same assumption as Example 1, but you sold the stock for less than the pre-discount purchase price.

Sale Price:	$9.00
Ordinary Income:	$0.50 (use actual gain ($9.00 - $8.50), since less than discount)
Capital gain:	$0.00

Your ordinary income is the lesser of 1) your actual gain (the amount that your sale price exceeds your actual purchase price, or 2) the purchase price discount.

(2) Note that if the stock price dropped to $15 at the end of the purchase period, you would buy the shares at a $12.75, which is a 15% discount off $15.
(3) This income item should be included as compensation income on your tax return.

TAX alert

When a plan has a lookback provision and the purchase price is based on the lower value of the stock on either the first or last day of the offering period, the purchase price discount for tax purposes is calculated as of the first day of the offering period. Note that this start date price is used regardless of whether it is the higher price. This means that the amount of your ordinary income (assuming the stock is sold with a gain more than your discount) is always the discount applied to the stock price at the beginning of the offering period. This is true even for plans without a lookback or for plans with a lookback and the price was lower at the end of the offer period. This can be a potential tax trap leading to mistakes in reporting the correct amount of ordinary income.

PLANNING CONSIDERATIONS

Participating in your company's Employee Stock Purchase Plan can be an effective way to build wealth over time by investing in your company's stock at a discounted price. These plans are popular with many public companies. If you have a plan available to you, it is important that you understand the provisions of your specific plan before committing a portion of your income to buy shares. You will want to know whether your plan has a lookback provision, how long the purchase period is and what discount percent is being offered. Remember, 15% is the maximum discount companies can use, but it could be less. If your plan is a tax-qualified ESPP, also knows as a Section 423 ESPP, your tax reporting will depend on whether you meet the holding period requirements, described above, after you purchase shares.

ESPPs are generally regarded as being a favorable benefit plan for employees. A plan with a lookback provision offers an even better deal. These plans can offer a better benefit than stock options because they will not go underwater (a stock option can expire with no value). With an ESPP that has a lookback, even if the stock price falls by the end of the purchase period, you still make out since the discount comes off the lower price.

As with any stock-based benefit plan offered to you by your employer, you want to pay attention to how much company stock you accumulate in your portfolio over time. It is important to remain properly diversified and that your portfolio reflects the overall risk level that you are comfortable with. It is recommended that you have a plan for how these company shares will play a role in your comprehensive financial plan. With the proper planning, participation in an ESPP can help you to obtain your financial goals.

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