Tax Traps for ESPPs: A Short Summary

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Employee Stock Purchase Plans (ESPPs) can be a significant benefit to employees and the issuing company. The opportunity to purchase stock at a discount, deferral of taxation on the benefit received, and a source of capital for the company are just a few of the advantages. Administering an ESPP, however, can be challenging when considering the numerous regulatory limitations.

What follows is a list of top tax-related traps to look out for when administering an ESPP:

- **Watch the $25,000 limit:** Participants in a qualified §423 ESPP are limited to purchasing $25,000 worth of stock in any one calendar year. The calculation is one of the most confusing calculations in equity compensation, and even an automated system should be double-checked via a separate, manual calculation. It's important to remember that the calculation is based on the price at the beginning of the offering period. The consequences for not correctly applying the $25,000 limit could be that participants purchase shares in excess of the limit and disqualify the entire plan.
- **Be prepared to manage qualifying dispositions & W-2 reporting:** Keeping track of when §423 ESPP shares are transferred or sold (a "disposition" in IRS terminology) and the resulting compensation income requires a system. Some issuers concentrate only on tracking disqualifying dispositions, because of the tax benefit those bring to the company. Qualifying dispositions, however, may occur many years after purchase – long after the employees have left the company. Even though the associated W-2 reporting may require additional effort to manually restore personnel into the payroll system, the company is not entitled to a deduction for the reported qualifying disposition income.
- **Look out for tax withholding implications among states and non-qualified plans:** The purchase or sale of qualified §423 ESPP shares is not subject to federal or FICA payroll withholding, although some states require the reporting and taxation of the ESPP benefit. In contrast, discounts on share purchases in a non-qualified (non §423) ESPP are subject to federal and FICA payroll tax withholding at purchase date, and reporting on Form W-2.
- **Clearly communicate the rules for cost basis reporting:** Calculating the capital gain or loss on equity sales requires subtracting the cost basis of the shares from the net sales proceeds. For ESPP shares, the cost basis is the discounted purchase price, plus the compensatory income recognized on Form W-2. Under new IRS rules, starting in 2014, brokers who sell any ESPP shares will only be allowed to report the discounted purchase price of ESPP shares as the cost basis on Form 1099-B. Employees, and many tax preparers, will not intuitively know this, and risk reporting excess capital gains on Form 8949/Schedule D—and overpaying taxes unnecessarily. Timely communication to employees in layperson's terms is essential.
- **Adjust the cost basis and FMV after a corporate action:** Recapitalization of a company's shares can change not only the number of shares owned, but also the cost basis per share. For §423 plans, administrators also have to remember to adjust the FMV at the beginning of the offering period, the FMV at purchase date, and the purchase price, in order to preserve the integrity of the qualified and disqualified disposition income calculations.
- **Know the rules for transfers upon death:** If a participant in a §423 ESPP dies, there is more to do than just transfer the shares to a new account. Special rules apply to any uninvested contributions, as well as to the transfer of shares in the account, which is considered a qualifying disposition and affects cost basis going forward.
- **Make sure your participant reporting clearly accounts for wash sales:** When shares are sold at a loss, and the participant purchases the same stock within 30 days before or after the sale, the loss is disallowed for tax purposes and added to the cost of the repurchased shares. ESPP plans that offer monthly purchases, or dividend reinvestment, are likely going to generate wash sale issues. This is apart from the effect of other company equity awards, such as stock options, restricted stock, or 401(k) company stock purchases may have on participant wash sale calculations.

- **Provide a plain-English guide to Section 6039 reporting for your participants:** Any time a transfer of ESPP shares occurs, issuers are required to provide an IRS Form 3922 to participants after the calendar year-end. Form 3922 is required whenever a "transfer of legal title" has occurred under Section 6039. This trigger may vary if an ESPP plan is administered at a broker versus transfer agent, or if ESPP shares are withdrawn from a reserve versus purchased in the open market. In addition, the form contains confusing elements such as "Exercise price per share determined as if the option was exercised on the date shown in Box 1." Administrators should provide a basic English translation to participants.
- **For non-US companies, watch the levels of foreign tax withholding:** Some non-US companies offer ESPPs to their US employees, often in the form of ADRs which are tradable in the US. When dividends are paid, however, the local country may withhold in excess of the treaty rate. The effort and expense for participants to recover the excess withholding may not be worth the amount they could reclaim, thus participants will forfeit that benefit.

Computershare can help you avoid these traps—as well as many others encountered in ESPP administration. Please visit www.computershare.com or call 888 404 6333 to learn more.

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Andrew has over 13 years of experience with the administration and taxation of equity compensation and is a frequent speaker at equity compensation and securities industry forums. For the past ten years, Andrew has managed the Executive Services team for Computershare's US Plan Managers, responsible for all Rule 144 / Section 16 equity sales and 10b5-1 plans for the employee plan and transfer agency business. He has also been a lead advisor to Computershare's US Plan Managers on tax and regulatory issues. Andrew earned an M.B.A. in Taxation from the Stern School of Business at New York University, and a B.A. from the University of California at Davis. He has been a Certified Public Accountant since 1992, earned the CEP (Certified Equity Professional) designation in 2002, and holds FINRA series 7, 24, and 63 securities licenses. He is a member of the AICPA, NCEO, GEO, and NASPP.