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Employee Stock Purchase Plans (ESPP)

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An Employee Stock Purchase Plan (ESPP) is classified as a type of option program under tax law. An ESPP grants employees the right to buy company stock at a computed price, at some future date. The market price (FMV) used to compute the discount is often determined on the *offer date* – the date the option was granted. (Some plans compute the discount and the strike price on the purchase date.) An ESPP option granted at a 15% discount to a then-FMV of $100 can be used to purchase stock some time later for $85. That $85 figure is analogous to the *strike price* of regular

options. In the rest of this article, I will use the term "strike price" in the interest of clarity.

At the time of the grant or offer, and at the time of actual purchase, no tax event has occurred. The tax treatment will be determined when the ESPP shares are sold[1]. A sale of the stock falls into one of two categories:

- **Qualifying.** This is when the stock is sold at least two years after the grant date, *and* one year after the purchase date.
- **Disqualifying**: This is when the stock is sold earlier than either of the above time frames.

Disqualifying Sale

Some participants in an ESPP sell their shares as soon as they are purchased. Their goal is to pocket the difference between the strike price and the sale price on the purchase date, and not hold the stock for the longer term. Perhaps they have a schedule of Restricted Stock Units ("RSUs") that will vest over time, or hold other types of options, and do not wish to over-concentrate in the company stock.

If the stock is sold any time sooner than one year after purchase (and/or sooner than two years after the offer date), there are two types of income incurred:

- **Ordinary Income** = The difference between the FMV on the purchase date, and the strike price.
- **Short-term capital gain** = The actual sale price minus the cost basis. Note that the actual sale price might differ from the FMV on the purchase date, even if the stock is sold on the same day. The cost basis equals the strike price, plus any ordinary income incurred in the first step above. In practical terms, the cost basis equals the FMV on the purchase date.

In our example of a grant with a strike price of $85, let's say the average of the high/low for the stock (its FMV) on the purchase date is $120. The stock is sold on that day, or soon after, for $135.

- **Ordinary Income** = $120 - $85 = **$35** (FMV – Strike Price)
- **ST Capital Gain** = $135 – ($85 + $35) = **$15** (Sale Price – Cost Basis)

The employee here would incur $35 of ordinary wage income, and $15 of short-term capital gain.

[1] This is in contrast to other types of option programs, wherein tax liabilities exist upon execution/purchase.

Regarding Tax Documents and Tax Returns:

Companies will include the ordinary income component on a paystub and the year-end W-2[2]. Most companies will include this additional income when figuring withholding. The ordinary income incurred will not in and of itself trigger a need for the employee to compute and pay additional quarterly estimates.

The company *will not* include the capital gain portion on a paystub or W2, nor withhold taxes on that income. It is up to the taxpayer to determine if quarterly estimates are needed. The sale price and a cost basis figure will be provided after year-end on a Form 1099-B by the brokerage firm that manages the ESPP program for the company.

Warning: *It is quite common that the Form 1099-B does not explicitly provide the correct cost basis figure.* In most cases that we deal with in the course of preparing tax returns, the brokerage firm will report the *strike price alone* as the cost basis. Recall from above that the cost basis equals the strike price *plus* any ordinary income reported. Some brokerage firms will provide the reported income figure in a supplement section. Many do not provide any income information. If the strike price alone is included in cost basis, the taxpayer will over-report the capital gain on the sale (or under-report a loss). There is a method to properly adjust the cost basis upwards on the tax return.

We urge participants in these plans to obtain and save the Form 3922 that the company issues each year. That form will include all of the details on the ESPP grant and the purchase, including reported income. *Save this form, and provide it to your tax preparer.* This is particularly important if you have held the stock for several years and are at risk of losing track of the original purchase date information.

Qualifying Sale

If the employee has held on to the stock for more than one year after purchase, and two years after the offer date, the sale triggers a different tax treatment. As before, there are two types of income incurred, but the ordinary income component is computed differently compared to the disqualifying sale.

- **Ordinary Income** = The lesser of:
  - The discount determined at the beginning of the offer period, using the offer date FMV; or
  - The difference between the sale price and strike price.

[2] An exception could arise if the employee no longer works at the company when selling the shares. In this case, the income reporting obligation is on the employee.

- **Long-term capital gain** = The actual sale price, minus the cost basis. The cost basis equals the strike price, plus any ordinary income incurred in the first step above.

This variation of the ordinary income mechanism ensures that the reported income is not higher than the actual gain upon sale. This would occur if the stock price dropped between offer and sale.

Re-stating our example:

FMV at offer date = $100

Strike Price & Discount = $85 & $15

Sale price = $135

- **Ordinary Income** = Lesser of:
    - $15 (Discount from offer date FMV of $100)
    - $135 - $85 = $50 (Actual cash gain on purchase and sale)

  Ordinary Income = **$15**

- **LT Capital Gain** = $135 – ($85 + $15) = **$35** (Sale Price – Cost Basis)

As in the disqualifying example, the company will likely report the ordinary income amount on a paystub and W-2, but *will not report* the long-term capital gain. Also as before, the brokerage 1099-B is likely to under-report the true cost basis. The same reminder applies: Obtain and save Form 3922.

Comparing the two outcomes…

	Disqualifying Sale	**Qualifying Sale**
Ordinary Income	**$35**	**$15**
Short-Term Capital Gain[3]	**$15**	**--**
Long-Term Capital Gain	**--**	**$35**

By holding the stock for more than one year, the employee with the qualifying sale has less income in higher tax brackets, and more in the lower long-term capital gain bracket. The bottom-line tax difference will depend

[3] In most situations, this is taxed like ordinary income.

on the employee's personal tax profile: filing status, total household income, state of residence[4], other stock or option activity, etc.

We have used one simple example here. Outcomes will vary in other circumstances, such as a stock price that has fallen over time. Companies might craft different mechanisms for setting the discount and strike price. As always, consult your tax or investment advisor.

We at Parallel are available to assist our clients with these analyses.

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[4] Our friends in the State of Washington now experience a state tax on long-term capital gains, but none on short-term capital gains. This can influence their strategy choices.

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