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Nonqualified Response: Revisiting the Case for Non-423 ESPPs

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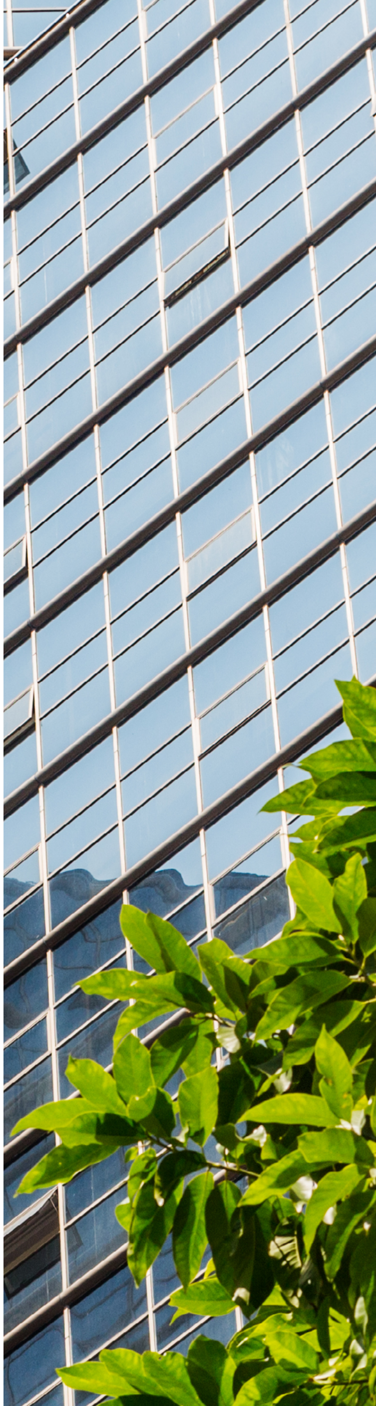

Nonqualified Response: Revisiting the Case for Non-423 ESPPs

In 2019, we noted the growing U.S. market interest in adopting nonqualified employee stock purchase plans (ESPPs) in lieu of U.S. Internal Revenue Code § 423 tax-qualified ESPPs ("423 plan" or "423 ESPP"). As momentum continues to grow around this approach, we revisit here the case for nonqualified ESPPs amongst publicly traded companies as a way to foster a sense of ownership among employees and interest in the long-term success of a company.

While many employers deploy a mix of stock-based compensation vehicles broadly (e.g. restricted stock units, stock options, performance stock units or other vehicles), ESPPs are typically designed to be the broadest stock-based compensation offering across employee levels. ESPPs have predominantly been structured such that employees purchase shares in their employer company, by way of payroll deductions, at a discount to market value; the most common design in the United States is a qualified stock purchase plan, also known as a 423 plan, due to the potential tax benefits that it provides for employees.

However, 423 ESPPs are subject to a number of technical requirements, imposing restrictions that often result in talent and compensation leaders choosing a plan that offers some potential tax savings (which often do not fully materialize) over a design that may be more aligned with talent strategy, less administratively burdensome, and much more flexible in terms of plan adjustments.

From a design perspective, nonqualified plans offer a "blank page" in terms of structure. While this may initially seem overwhelming, we believe the starting point is to assess what challenge an employer is trying to address via a stock purchase plan.

- Are we struggling to attract talent because we lack an otherwise broad-based equity program?
- Do we have a talent retention issue that could at least in part be addressed by equity with a retentive hook?
- Rather than mirroring our competitors, can we create a program that differentiates our offering and enhances our employee value proposition?
- Is there a lack of motivation within certain parts of the business that could be addressed with compensation that is more closely aligned with the company's performance?
- What appetite do we have to carry more or less expense with respect to a new stock purchase program?

With these, and other related questions, in hand the design journey can begin.

We set out below some potential advantages that a non-qualified ESPP can offer compared to a traditional 423 plan.

No cap on purchase discounts:

Nonqualified ESPPs can be structured with any level of discount an employer chooses, and may even add a matching element whereby participants receive bonus shares tied to the number of shares purchased under the ESPP (e.g. for every 3 shares purchased 1 free share will be granted to the plan participant. (which is tantamount to additional discount). Conversely, 423 plans are typically structured to provide an economic benefit in the form of a discount to the employer's stock price (sometimes with a "lookback" feature built in to provide a discount to a defined prior date stock price). However, 423 ESPP purchase discounts are capped at 15%.

Less administration relative to 423 plans:

From a tax, information reporting, payroll, and participant inclusion/exclusion perspective, 423 plans can impose a range of additional administrative obligations on employers and their various internal stakeholders.

- Purchases made under a 423 plan are taxed at sale rather than at purchase, so employers should track participant purchases up to the time of sale to understand their own employer payroll reporting compliance obligations. Conversely, nonqualified ESPPs are typically taxed at purchase and the tax rules are generally more straightforward.
- Form 3922s should be generated to plan participants, and shared with the IRS, where shares are transferred under a 423 plan. No such reporting is required for a nonqualified plan.

Targeted Employee Eligibility:

The 423 plan rules and regulations impose strict requirements regarding who should be allowed to participate in an ESPP and what limited groups of service providers may be excluded, as well as on what terms employees may participate. Failure to follow these rules can raise broad consequences, including risk of disqualifying the plan. Nonqualified plans are considerably more flexible in terms of including/excluding different groups of employees (who may already have access to different compensation and benefit programs) and adjusting the terms of participation for different employee groups.

Principal tax benefit of 423 plans often does not materialize:

The principal income tax benefit from 423 plans arises if a plan participant satisfies certain share holding period requirements, in which case there may be an opportunity for some capital gains treatment versus the full ordinary income treatment which would otherwise apply. However, many plan participants often do not satisfy those post-purchase holding periods (either due to lack of clarity on requirements, or simply a desire to monetize their benefit), in which case the principal income/capital gain tax benefit is lost. Further, where share holding periods are satisfied, no tax deduction may be claimed by the employer even for the ordinary income realized at sale.

Global alignment and fairness:

An often-cited rationale for implementing a non-qualified plan is the desire to have a single plan that aligns all employees. While Section 423 plans may offer potential tax benefits for participants in the US, many employers view "fairness" in plan design and rewards as a cultural cornerstone. As a result, some employers have migrated to a non-qualified plan design to better support that goal.

Both discount and matching share strategies have been deployed amongst nonqualified ESPPs, and employers may want to consider:

- A matching share program where employee participants receive bonus shares tied to the number of shares purchased under the ESPP (e.g. for every 3 shares purchased 1 free share will be granted to the plan participant.
- If a matching share is utilized, is that match restricted or unrestricted (for tax, talent, or other purposes).
- A discount program where discounts potentially vary by level and by target employee group.
- Programs where increased ESPP participation results in a correlated increase in other benefits to encourage participation.

Nonqualified plans are often generally easier for plan participants to grasp, especially as 423 plan participant communications tend to place a premium on the notion of qualified and disqualified stock dispositions and the associated tax benefits, distracting from the wealth building opportunities within such purchase programs. We often hear that low participation rates are a significant issue, and perhaps rigid plan design with a limited purchase discount opportunity coupled with complex (even if potentially beneficial) tax implications of 423 ESPPs may be contributing to these lower rates.

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