IN THIS ISSUE
- Our Updated Survey of Employee Stock Purchase Plans
- Corporate Hedging Policies Will Now Have to be Disclosed
- New IRS Guidance on Tax Changes for Employee Parking
- Our 2019 Executive Benefits Survey
- Did You Know....?

Our Updated Survey of Employee Stock Purchase Plans

Employee stock purchase plans (ESPPs) allow a broad base of employees a means to acquire company stock, often at a discount from market value. This often under-appreciated and sometimes misunderstood benefit plan differs in many ways from other stock acquisition opportunities, such as within a company’s 401(k) plan or equity awards under a shareholder approved long-term incentive plan. These can include stock options, restricted stock, restricted stock units and/or performance shares.

There is no uniformity in the design of ESPPs. In addition, these plans have terms that are somewhat unique and can be confusing, such as “offering date”, “purchase period”, “lookback feature”, “holding period”, and “disqualifying disposition”. Understanding exactly how a company’s plan works can be a challenge for some employees. However, there are features that can make this plan a valuable employee benefit, even if often underutilized by many of those eligible to participate.

Participation levels can be modest at many companies with ESPPs. This can be due to the technical details as to plan design, the fact that employees have to buy in on an after-tax basis to participate, thereby reducing their net pay and then hold the stock for a period afterward for the most favorable tax treatment. In addition, higher level employees and executives may receive company stock as compensation and would need to be cognizant of the risks of overweighting their stock holdings. But the upside can outweigh the downside for many, once plan terms are understood and properly navigated.

Participation in ESPPs is voluntary and the funds to purchase stock can be accumulated over time through the convenience of payroll deduction. Eligible employees can “turn on” and “turn off” when they want to participate. With most companies no longer providing a match in company stock in their 401(k) plan, an ESPP can be a relatively low cost means of offering a large spectrum of employees the opportunity to acquire company stock.

Our recent informal survey of 350 publicly-traded U.S. and multinational companies that use Ayco to provide financial counseling or financial education services reveals that 55% now maintain some type of stock purchase plan. Among our survey group of 200 companies with a plan, we have illustrated below a breakdown of the types of plans being currently offered. This chart reflects relative stability in the plans offered to eligible employees through similar surveys we conducted two, four, and six years ago.
Design of Plans
While ESPPs give employees the right to purchase company stock in a convenient manner, those eligible must choose to participate. Plans have a defined "offering period" (typically 12 months), which then is usually divided into "purchase periods" (typically 3 or 6 months). Employees may have amounts regularly deducted from their salary each pay cycle during these defined purchase periods, with the shares acquired at the end of each purchase period. Shares are acquired based on the purchase price formula set by the plan. A plan may also allow for voluntary lump sum purchases without payroll deduction.

Plans that meet the requirements of Internal Revenue Code (IRC) §423 are considered "qualified" ESPPs. Such plans have characteristics and tax consequences similar to incentive stock options (ISOs). This includes having income taxes on the purchase price discount deferred until the stock is sold or disposed of. There also is the concept of a "disqualifying disposition" if the stock is sold relatively soon after purchase.

Plans that do not meet the statutory rules are considered "nonqualified" plans. These plans can be structured for executives only, offer a company match to assist in the purchase, or can have a greater discount than allowed under qualified §423 plans. The taxation for these plans is different than under a qualified ESPP, as will be discussed.

A third type of purchase plan is one under which employees may acquire company stock without any discount or company contribution. These are what we will call "direct purchase plans". Essentially, these are simply a convenient means for employees to purchase company stock when they wish to without transaction costs.

Rules For Qualified §423 Plans
Section 423 authorizing the adoption of qualified ESPPs was added to the Internal Revenue Code in 1964. Here are several of the technical rules incorporated in the IRS regulations for qualified ESPPs:

- The right to purchase stock must be granted only to employees of a corporation, its parent, or subsidiary. Generally, all employees must be eligible to participate, although a plan is permitted to exclude employees employed less than two years, or those who customarily work 20 hours or less per week, or customarily work not more than 5 months in any calendar year. A plan may exclude highly compensated employees and non-resident aliens or foreign citizens, if necessary, to comply with foreign laws.

- The plan must be approved by shareholders within a 24-month window beginning twelve months before the date the plan is adopted.

- If there is a discount in the purchase price available under a qualified ESPP, it cannot exceed 15% of the price as of the offering date.

- No employee may purchase shares for a calendar year that exceed $25,000 in value as of the beginning of an offering period. A plan can limit the number of shares that can be purchased or more commonly, the percentage of compensation used to purchase shares (e.g., 10% or 15%). We reviewed whether companies use $25,000 as their annual maximum or some other amount. Nearly 10% of our survey group use a lower dollar limit of between $21,250 - $23,750 to help ensure that employees do not inadvertently exceed the annual limit – which is based on the value at the beginning of the offering period rather than the purchase date.

- The right to purchase stock must expire within five years (if the option price is not less than 85% of FMV at the date of acquisition) or 27 months otherwise.

- The right to ESPP shares held in the account may not be transferred to others, except by will, and may only be exercised by the employee during the employee’s lifetime. We counted around 10% of our survey group that allow a beneficiary designation to receive the shares or balance in the account upon death.

Lookback Feature
This is an interesting and potentially valuable feature for plan participants. A qualified plan can, but is not required to, provide that the purchase price be calculated based on the stock price as of the offering date or the purchase date, whichever is less. This favorable way of determining the purchase price is called a “lookback” feature.

A plan with this feature can provide a significant opportunity for an eligible employee to benefit from short-term stock price appreciation. For example, if the stock price is $20 at the beginning of the offering period and $25 at the purchase date, with a 15% purchase price discount and a lookback feature, the purchase price will be $17 (85% of $20), which means the true economic discount at the purchase date is actually 32%.
When the stock market or company stock price is volatile, this feature also can provide a valuable benefit. [For example, if a 6-month purchase period ended on December 31, 2018, being able to receive a discount based on the stock’s value on July 1, 2018, could have provided a valuable benefit.] So, tax planning can maximize net realized benefits in this situation.

According to a 2017 study by Stock & Option Solutions, 39% of companies surveyed have a lookback feature in their qualified plan. We estimate that just over 40% of the companies in our survey group with a §423 plan currently have a lookback feature.

- Impact of Accounting Rule Change

Under accounting rules (Financial Accounting Standard Certification Topic 718 or ASC 718), companies must expense the “fair value” of ESPP shares purchased, unless the plan meets certain safe harbor requirements. These accounting rules were modified in 2005 when the purchase price discount was limited to no more than 5% to meet the safe harbor (even though it is permissible under tax rules for a qualified ESPP to offer a discount of up to 15%). The revised rules also prohibit lookback periods for the most favorable accounting. As a result, several of the plans in our survey group eliminated their lookback provision.

Some suggested that this accounting modification would lead companies to eliminate qualified ESPPs or reduce the discount to no more than 5%. In fact, we have found that few of the companies in our survey group (8 companies) eliminated their §423 plan, and fewer than a quarter reduced the discount to 5% to come within the accounting safe harbor. We also noted that several companies have reduced the purchase price discount offered, but to an amount higher than the 5% safe harbor amount.

For those qualified plans in our survey group offering a discount, the following are the current discount amounts at the purchase date:

<table>
<thead>
<tr>
<th>Amount of Discount</th>
<th>% of Companies</th>
</tr>
</thead>
<tbody>
<tr>
<td>15%</td>
<td>70%</td>
</tr>
<tr>
<td>10%</td>
<td>10%</td>
</tr>
<tr>
<td>7.5%-8%</td>
<td>1%</td>
</tr>
<tr>
<td>5%</td>
<td>19%</td>
</tr>
</tbody>
</table>

A rationale for not adopting the accounting safe harbor is that this change could be seen as a take-away by employees who viewed ESPPs as a valuable broad-based employee benefit. Thus, continuation of a perceived valuable benefit with no tax consequences trumped accounting consequences. In addition, survey data from Fidelity indicates that plans with a 15% discount have double the participation rates compared to plans with a 5% discount and no lookback feature.

- Tax Treatment

Qualified ESPPs offer special tax benefits to participants. However, these rules can be confusing to understand. Purchases are made with after-tax dollars, which means that shares acquired have a basis. If there is a discount in the purchase price from the 5% safe harbor amount to the 15% maximum, this discount is to be reported as ordinary income on the employee’s Form W-2. For a qualified §423 plan, this is to be reported when the shares are sold or disposed of. In contrast, under a nonqualified plan, it is to be reported as compensation income as of the purchase date and is subject to tax withholding. This ordinary income component will increase the basis of the shares, but generally will not be reflected in the basis of the shares reported by the recordkeeper.

Similar to the tax rules for ISOs, if the employee holds the ESPP shares for two years from the offering date (which is different than the purchase date) and one year from the date of purchase, all appreciation above the fair market value when the shares are acquired is eligible for long-term capital gain treatment. However, this does not change the ordinary income treatment of the discount. If the shares are sold or disposed of within a year from purchase/two years from first day of the offering period, the result is a “disqualifying disposition.” In this situation, the entire amount of any discount will be ordinary income reportable on a Form W-2 (even if the stock’s value has decreased since it was purchased), and any gain in excess of this amount will be eligible for capital gain treatment. As with ISOs, there is no FICA tax payable either when shares are purchased or in the event of a disqualifying disposition, with respect to a qualified ESPP. Dividends payable on shares acquired are taxable when paid or accrued.

This was intended to be a brief summary of the federal tax rules. While most states follow the federal rules for ESPP income, not all do. In addition, the quirky rules applicable to employees who work in multiple states can apply here.

- Termination of Employment

Most plans provide for an automatic cessation of plan participation upon termination of employment for any reason. This will mean that amounts held to purchase shares at the end of the next offering period are distributed in cash rather than being held to buy additional shares.
Income is not recognized on the purchase discount until shares are sold or otherwise disposed of. This can be years after the individual has left employment. A gift of shares, including to a charity, also is treated as a disposition, which triggers income recognition – often to the surprise of the employee.

- **Nonqualified Plans**
  We counted 27 companies that now offer a nonqualified stock purchase plan. These plans do not meet the IRS §423 qualified plan requirements – for example, are offered to a select group of executives rather than all employees, or provide a purchase price discount in excess of 15%. Under some plans, the company will match a portion of employee dollars that are used to acquire stock. Different tax consequences apply to stock acquired under a nonqualified plan. Any match or discount amount is immediately taxable to the employee, rather than being deferred until sale or disposition, and FICA becomes payable.

- **Section 16 Reporting**
  Qualified ESPPs preclude employee discretion as to when stock is actually purchased (if we exclude any voluntary lump sum purchase option which, if offered under a plan, typically is not available to Section 16 insiders). As a result, the acquisition of stock under a qualified ESPP by a Section 16 insider is an exempt transaction (under Rule 16(b)-3(c), applicable to tax conditioned plans) and not treated as a matchable purchase of stock. Thus, no Form 4 reporting is required. However, all shares acquired should be included in the number of shares controlled by an insider reported on any Form 4 required to be filed and in a proxy statement. In contrast, shares acquired under a nonqualified plan may not be exempt from Form 4 reporting. In addition, all sales of ESPP stock by an insider are reportable on a Form 4 and subject to any window period or blackout period restrictions.

- **Tax Reporting Requirements & Penalties**
  For qualified ESPP shares purchased and transferred directly to an employee (or to a brokerage account for the employee) or when shares are sold, employers must provide Form 3922 to the employee by January 31 of the following year. A copy is also filed with the IRS. This form, in conjunction with the Form 1099-B that a broker or the company’s transfer agent will issue upon any sale of the shares, will assist employees in proper tax reporting of ESPP shares that are sold or are gifted. The employee reports gains and losses on Form 8949 which are then carried to Schedule D. Understanding the basis reporting rules can sometimes be challenging for employees.

As previously referenced, the discount amount for a qualified plan is reported on the employee’s Form W-2 when the shares are sold or disposed of. In contrast, the discount for a nonqualified plan is reported on the employee’s W-2 in the year of purchase or vesting.

An employer that fails to file (or timely file) Form 3922 with the IRS is subject to a penalty of $50 per form (capped at a maximum of $250,000 annually), with a similar penalty for failure to provide an employee with the form. Employers have until March 31 (if an electronic filer, which is mandatory if 250 or more forms are filed) or Feb. 28 (if paper filer) to file a copy of each Form 3922 provided to employees with the IRS.

- **Benefits Associated With ESPPs**
  An employee stock purchase plan can provide a great benefit to both employees and employers. Some of the primary benefits include:

  - employee may be able to buy company stock at a discount from its market value;
  - employee can start and stop participation when they choose;
  - shares are bought with after-tax dollars with subsequent appreciation (but not the discount amount) eligible for capital gain treatment;
  - common offering periods of 3 or 6 months means shares are being purchased on a regular basis;
  - dividends on purchased shares can be paid out in cash or used to buy additional shares;
  - convenience of payroll deduction with modest or no administrative fees;
  - employee controls when stock is sold and, thus, when taxes are incurred;
  - no penalty taxes if sale before age 59½;
  - sale can meet current cash flow needs and help achieve financial wellness, including saving more within company’s 401(k) plan;
  - a broad-based benefit that can help attract and retain employees;
  - have gained popularity among global companies and can be offered to foreign-based employees;
  - shares acquired count toward meeting share ownership guidelines; and
  - qualified §423 plans generally have the approval of shareholder voting organizations, including Glass Lewis.

Fidelity reported that only one-third of employees who have access to §423 plans use them. Similarly, participants in the NASPP/Deloitte 2017 Domestic Stock Plan
Administration Survey indicated that less than 40% of eligible employees participated in their ESPP. Because participation is voluntary and requires after-tax dollars, participation rates can also vary widely by company.

Over 70% of companies with qualified ESPPs reported being satisfied with their plan, with another 25% being neutral, according to a National Center of Employee Ownership survey.

Offering an ESPP does not necessarily lead to long-term stock ownership. Participation for most employees should be secondary to 401(k) plan contributions. A Wall Street Journal article reported that non-management employees held stock acquired through an ESPP for just five months, on average. Fidelity reported that nearly half of those who purchased shares through an ESPP sold all the shares purchased within two years of the purchase date, often to pay bills or expenses. But, Fidelity research also reported that the age of an employee often impacted employee action. While nearly 60% of employees under age 30 sold all shares purchased within two years, a similar percentage over age 60 retained all shares purchased.

Research by Computershare concluded that ESPPs can help motivate employees and that plan participants take a greater interest in company stock price and performance. So, they clearly can have a role in a comprehensive employee benefits package. As with most voluntary employee benefits, eligible employees often need guidance as to their personal participation levels for ESPPs and then when to sell the shares acquired.

Because corporate executives usually have access to company stock through executive compensation plans, and also may be overweighted in company stock holdings, they may not be the primary candidates for ESPPs. Among our survey group with a qualified §423 plan, we counted what other equity awards were offered to executives. Here is what we found (total exceeds 100% due to almost all companies offering multiple awards):

<table>
<thead>
<tr>
<th>Restricted Stock Units</th>
<th>Stock Options</th>
<th>Performance Shares</th>
<th>Performance RSU/RS</th>
<th>Restricted Stock</th>
</tr>
</thead>
<tbody>
<tr>
<td>61%</td>
<td>51%</td>
<td>50%</td>
<td>25%</td>
<td>11%</td>
</tr>
</tbody>
</table>

Corporate Hedging Policies Will Now Have to be Disclosed

The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 directed the Securities and Exchange Commission (SEC) to adopt rules requiring U.S. public companies to disclose their corporate policies on the hedging of corporate securities. It took the SEC nearly five years to propose such rules in 2015 and last month, the SEC issued final rules on the required disclosures.

First, let’s define the concept of hedging. Essentially, it is the ability of an individual to purchase securities or other financial instruments, or otherwise engage in transactions, that hedge or offset any decrease in the value of equity granted as compensation, or shares held directly or indirectly by an employee or director. The SEC’s final rules do not define the term hedge. However, they do provide a list of hedging transactions which include pre-paid variable forward contracts, equity swaps, collars and exchange funds. The SEC indicates that the term “hedge” should be broadly applied to cover any financial transaction designed to hedge or offset any decrease in market value of the company’s equity securities.

Essentially, all U.S. public companies will now be required to disclose corporate policies and practices with regard to the ability of any employees or directors to engage in hedging transactions with respect to company securities. Thus, these disclosures are not just for corporate insiders.

This requirement could be satisfied either by providing an accurate summary of the policies and practices, including those individuals they affect and the categories of the transactions that are specifically allowed or specifically disallowed. Alternatively, a company may disclose in full their practice and policies. In addition, if a company does not have policies or practices currently in place, the new rule will require the company to disclose that fact and indicate that hedging transactions could be permitted.

The new rules do not prevent a company from allowing hedging transactions, per se, but there will now be a disclosure in proxy statements or any document relating to the election of directors. Companies also will need to report or reference hedging policies covering named executive officers (NEOs) in the CD&A of the proxy. However, duplicative disclosures are not required and a company may simply include in its CD&A a cross-reference to a disclosure in the proxy’s governance section.
In contrast to hedging, the pledging of shares is where an individual uses equity compensation as collateral to secure a loan. It also can apply to the donation of shares to a charity during a blackout period when corporate insiders or others are generally prohibited from trading in company stock. Companies currently are required to disclose any actual pledging of company stock by NEOs and directors. Companies with existing written policies on hedging may also cover pledging, although the latter is not specifically addressed in the new SEC final rules.

These new disclosure requirements will be effective in proxy statements for fiscal years beginning on or after July 1, 2019. Certain smaller reporting companies and emerging growth companies will have an extra year to come into compliance, while foreign private issuers will not be subject to the new disclosure rules. The rules will require disclosure of policies of the company, any parent of the company, any subsidiary of the company or any subsidiary of any parent of the company.

Currently, a large number of companies already do disclose policies and practices with regard to the hedging and pledging of company stock for executive officers. This is largely due to the shareholder voting policies of ISS and Glass Lewis that generally recommend that companies adopt a policy prohibiting insiders from hedging and pledging company stock. But the new hedging disclosure rule will apply to any policy or lack of policy for all employees. We might expect this to lead to greater disclosures beginning with proxies issued later this year, even though these new rules will not generally impact most companies until their 2020 proxy season.

New IRS Guidance on Tax Changes for Employee Parking

Do you provide free parking for employees or reimburse employees for their parking costs? If so, your tax specialists should review recent IRS guidance relating to the deductibility of parking expenses (Notice 2018-99).

Under IRC §132(a)(5), an employee is not taxed on the value of “qualified transportation fringe” (QTF) benefits, subject to a maximum monthly amount - $260 in 2018 and $265 in 2019. Qualified transportation fringes include: (1) transportation in a commuter highway vehicle between an employee’s residence and place of employment; (2) a transit pass; and (3) qualified parking. (As of 2018, qualified bicycle commuting reimbursements no longer qualify as a QTF).

Qualified parking is defined as parking provided to an employee on or near the business premises of the employer or on or near a location from which an employee commutes to work. However, it does not include the cost of parking on or near an employee’s residence.

The Tax Cuts and Jobs Act of 2017 made significant changes regarding the tax treatment to employers’ on qualified transportation fringes. As an example, effective as of 2018, an employer may no longer take a corporate tax deduction for the cost of qualified transportation fringes provided to employees. There has been uncertainty as to exactly how to determine the costs of employer-provided parking which could then be non-deductible. Last month, the IRS issued interim guidance on this topic, which can be relied on by employers, at least until any further guidance is issued.

The focus of this recent guidance is with regard to how to determine the cost of parking when an employer owns or leases a parking facility or pays a third party for parking spots. The easiest answer is where an employer pays a specific cost to a third party. That is the amount which is used to calculate any QTF and also the amount of any disallowed deduction to the employer. It is where an employer owns or leases a parking facility, such as an indoor or outdoor garage or parking lots where employees may park on or near a business premises that there has been some uncertainty. Here, value is not used to determine non-deductible cost.

Notice 2018-99 allows employers to use any reasonable method to calculate the cost of parking provided to employees. The Notice outlines a four-step method that is deemed to be reasonable. However, it also specifies certain elements that are not to be considered in calculating the cost, including any depreciation and expenses paid for items not located on or in the parking facility. It should be noted that an employer may deduct the cost of parking that is treated as taxable to an employee.

While the cost of parking spots reserved for employees is not deductible, the cost of spots reserved for non-employees may be fully deductible. Non-employees include visitors and customers. Until March 31, 2019, an employer that has reserved employee parking spots may change the parking arrangements to decrease or eliminate the reserved employee spots. This can help meet the threshold since if more than 50% of the remaining non-employee spots are available to the general public, then those remaining parking expenses become fully deductible (retroactive to 2018).
Example: Employer A owns a multi-level parking garage adjacent to its office building. A incurs $10,000 of total parking expenses. A’s parking garage has 1,000 spots that are used by its visitors and employees. However, one floor of the parking garage is segregated by an electronic barrier and can be entered only with an access card provided by A to its employees. The segregated floor of the parking garage contains 100 spots. The other floors of the parking garage are not used by employees for parking during normal business hours on a typical business day.

Step 1. Because A has 100 reserved spots for employees, then $1,000 \((100/1,000) \times 10,000 = $1,000\) is the amount of total parking expenses that is nondeductible for reserved employee spots.

Step 2. The primary use of the remainder of A’s parking lot is to provide parking to the general public because 100% (900/900=100%) of the remaining parking spots are available and used by the public. Thus, expenses allocable to those spots are excepted from the disallowance of deduction under the primary use test, and only $1,000 is subject to the IRC §274(a)(4) disallowance.

The Notice also discusses how nondeductible parking expenses could increase the amount of unrelated business taxable income for tax-exempt organizations.

Ayco’s 2019 Executive Benefit Survey Now Open

We invite you to participate in our 2019 Survey of Select Executive and Broad-Based Benefits. An interactive survey form is attached to the homepage of this month’s edition.

All companies or entities that participate in this survey will receive complimentary copies of the survey results when published, likely in June.
Did You Know...?

- The Standard Mileage Rate which taxpayers may use in computing the deductible costs of operating an automobile for business increases to 58c for 2019 – up from 54.5c in 2018. Many companies use this as the basis of reimbursement to employees for the business use of their automobile.

- The aggregate funding status of 389 of the Fortune 1000 companies with qualified pension plans was estimated at 84% at the end of 2018 per an analysis by Willis Towers Watson. This was down slightly from the aggregate funded status of 85% at the end of 2017 and also down from the 90% funded level as of September 2018.

- While the exclusion from income of up to $20 per month for qualified bicycle expenses has been eliminated, there is a bill pending in Congress that would permit up to $500 annually as a medical care tax deduction for certain costs relating to sports and fitness. This would include gym memberships and fitness programs – but not golf, horseback riding, hunting, sailing, videos or books.

- Ohio announced late last year that it would accept bitcoin in payment of state taxes, the first state to authorize this.

- February 2 is Groundhog Day. It was in 1887 that a newspaper editor who was a member of the Punxsutawney Groundhog Hunting Club declared that Phil, the Punxsutawney, PA groundhog, was America’s only true weather-forecasting groundhog. If he sees his shadow when he comes out of his hole that day, he is predicting 6 more weeks of winter; no shadow means an early spring. Wait for it – or watch the 1993 movie starring Bill Murray.

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