Employee Stock Purchase Plans: Mechanics and Design Choices

<u>Presentation for:</u>

Hunton's Executive Compensation Webinar Series
July 9, 2026

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- Questions during this presentation
  - We encourage questions (even though your audio lines are muted)
  - To submit a question, use the Q&A icon on your Zoom tool bar to submit a question
  - If time permits, your questions will be answered at the end of this presentation. And if there is insufficient time, the speaker will respond to you via e-mail after this presentation

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  - This presentation is being recorded for internal purposes only
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  - A purpose of the webinar series is to provide FREE CE credits
  - To that end, each presentation is intended to provide 1 credit hour in the following areas:
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About Anthony “Tony” Eppert

Anthony Eppert, Partner
Hunton Andrews Kurth LLP
Tel: +1.512.542.5013
Email: AnthonyEppert@Hunton.com

- Tony practices in the areas of executive compensation and employee benefits
- Before entering private practice, Tony:
  - Served as a judicial clerk to the Hon. Richard F. Suhrheinrich of the United States Court of Appeals for the Sixth Circuit
  - Obtained his LL.M. (Taxation) from New York University
  - Obtained his J.D. (Tax Concentration) from Michigan State University College of Law
    - Editor-in-Chief, Journal of Medicine and Law
    - President, Tax and Estate Planning Society

Upcoming 2026 Webinars

- 2026 webinars:
  - Hot Compensation Topics (8/13/26)
  - Preparing for Proxy Season: Start Now (an Annual Program) (9/10/26)
  - Carrot and the Stick: Delving Into Various Stick-Related Retention Ideas 10/8/26)
  - Form 4 Training Course (11/12/26)
  - Compensation: Year-End Review of 2026 Items (12/10/26)

Sign up here: https://www.hunton.com/en/insights/executive-compensation-webinar-schedule.html

Our Compensation Practice – What Sets Us Apart

- Compensation issues are complex, especially for publicly-traded companies, and involve substantive areas of:
  - Tax,
  - Securities,
  - Accounting,
  - Governance,
  - Surveys, and
  - Human resources

- Historically, compensation issues were addressed using multiple service providers, including:
  - Tax lawyers,
  - Securities/corporate lawyers,
  - Labor & employment lawyers,
  - Accountants, and
  - Survey consultants

Our Compensation Practice – What Sets Us Apart (cont.)

- The members of our Compensation Practice Group are multi-disciplinary within the various substantive areas of compensation. As multi-disciplinary practitioners, we take a holistic and full-service approach to compensation matters that considers all substantive areas of compensation

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Our Compensation Practice – What Sets Us Apart (cont.)

- Our Compensation Practice Group provides a variety of multi-disciplinary services within the field of compensation, including:

Traditional Consulting Services

- Surveys
- Peer group analyses/benchmarking
- Assess competitive markets
- Pay-for-performance analyses
- Advise on say-on-pay issues
- Pay ratio
- 280G golden parachute mitigation

Corporate Governance

- Implement "best practices"
- Advise Compensation Committee
- Risk assessments
- Grant practices & delegations
- Clawback policies
- Stock ownership guidelines
- Dodd-Frank

Securities/Disclosure

- Section 16 issues & compliance
- 10b5-1 trading plans
- Compliance with listing rules
- CD&A disclosure and related optics
- Sarbanes Oxley compliance
- Perquisite design/related disclosure
- Shareholder advisory services
- Activist shareholders
- Form 4s, S-8s & Form 8-Ks
- Proxy disclosures

Design/Draft Plan

- Equity incentive plans
- Synthetic equity plans
- Long-term incentive plans
- Partnership profits interests
- Partnership blocker entities
- Executive contracts
- Severance arrangements
- Deferred compensation plans
- Change-in-control plans/bonuses
- Employee stock purchase plans
- Employee stock ownership plans

Traditional Compensation Planning

- Section 83
- Section 409A
- Section 280G golden parachutes
- Deductibility under Section 162(m)
- ERISA, 401(k), pension plans
- Fringe benefit plans/arrangements
- Deferred compensation & SERPs
- Employment taxes
- Health & welfare plans, 125 plans

International Tax Planning

- Internationally mobile employees
- Expatriate packages
- Secondment agreements
- Global equity plans
- Analysis of applicable treaties
- Recharge agreements
- Data privacy

Overview of ESPPs

- The primary purpose of an ESPP is to facilitate an employee's purchase of employer stock through payroll deductions
  - Only employees may participate, and generally, all employees must be eligible to participate (though the ESPP is permitted to exclude (i) employees who have less than 2 years of service and (ii) part-time employees)
  - Such purchase is typically at a discount
  - The discount may be up to 15% from the lower of the Fair Market Value of the stock as of the first day of the "offering period" or the Fair Market Value of the stock as of the last day of the "offering period"
  - An offering period is typically 6 months, but can be as long as 27 months
  - No employee may accrue a right to purchase more than $25,000 of stock per calendar year (such value limitation determined as of the 1st day of the offering period - though unused portions of such $25,000 limit can be carried forward to the next calendar year)
  - For ESPPs intended to qualify under Section 423, shareholder approval is not required under NYSE and NASDAQ listing rules (applicable to publicly-traded companies), however, under applicable tax laws shareholder approval is required within 12 months before or after the Board acts to adopt an ESPP (applicable to BOTH public and private companies)
  - For ESPPs intended to NOT qualify under Section 423, shareholder approval is required under NYSE and NASDAQ listing rules and under 423 in accordance with the above (applicable to public companies) and not required for private companies,

ESPPs: Tax and Document Requirements

- Requirement No. 1 – only employees can participate
  - The plan document must limit participation in the ESPP to employees of the employer and/or its parent/subsidiary
  - Whether an individual is an employee is determined in accordance with the withholding tax rules under Section 3401(c)
  - For this rule, the employment relationship continues to exist if the individual is on military leave, sick leave or any other bona fide leave of absence (but only if the leave period does not exceed 3 months, or if longer, the individual's right to reemployment is required by statute or contract) – this rule also applies to ISOs
  - If reemployment is not required by statute or contract, then the employment relationship terminates on the first day following such 3-month period

- Under this Requirement No. 1, all employees of the employer, except the following, must be provided participation rights:
  - Those who have been employed by the employer less than 2 years;
  - Those whose customary employment is 20 hours or less per week;
  - Those whose customary employment is less than 5 months per calendar year; and
  - Highly compensated employees (as defined under Section 414(q)), which for 2026 is defined as earning more than $160,000 in 2025

ESPPs: Tax and Document Requirements (cont.)

- Requirement No. 2 – exclude 5% owners
  - Either the plan document or the offering must exclude any employee who owns 5% or more of the voting power or value of all classes of stock of the employer or its affiliates
  - Such ownership test is applied immediately after the option is granted to the employee
  - Such ownership test is applied as though all stock options held by the employee were exercised (*e.g.*, even unvested stock options are deemed exercised)
  - The constructive ownership rules of Section 424(b) apply (*i.e.*, ownership by certain family members and proportionate ownership owned by certain entities are attributed to the employee)

ESPPs: Tax and Document Requirements (cont.)

- Requirement No. 3 – stockholder approval
  - Stockholders of the granting corporation must approve the ESPP within 12 months before or after the ESPP is adopted by the Board of Directors
  - As approved by the stockholders, the plan document must:
    - Specify the number of shares that can be issued under the ESPP; and
    - Specify the corporations whose employees are eligible to participate
  - Stockholder approval would again be required if:
    - There is an increase in the number of shares to be issued under the ESPP,
    - There is a change in the corporations whose employees are eligible under the ESPP, or
    - There is any other change to the ESPP that is deemed to be the adoption of a new ESPP
  - For Section 423 compliant ESPPs, stockholder approval is not required under NYSE and NASDAQ listing rules, however, such approval is still required under Section 423
- Requirement No. 4 – same rights and privileges
  - Either the plan document or the offering must state that all employees who participate in the ESPP must have the same rights and privileges
  - Such is applied on an offering-by-offering basis, which means separate offerings could have different terms
  - Which means, for example, an offering to employees of a foreign jurisdiction pursuant to a sub-plan could have terms that are less favorable than an offering to U.S.-based employees, provided both offerings are separate offerings

ESPPs: Tax and Document Requirements (cont.)

- Requirement No. 5 – annual calendar year limitation of $25,000
  - Either the plan document or the offering must provide that an employee cannot accrue the right to purchase more than $25,000 of stock for each calendar year in which the offering was outstanding
    - Such value is determined by the underlying stock's fair market value on the date such right is granted
  - Important to understand that unused portions of the $25,000 can be carried forward from one calendar year to the next
    - Example: assume an offering to an employee spans two calendar years. If such employee implements no purchases in calendar year 1, then the applicable limit in calendar year 2 would be $50,000 (again, value determined at the time of the stock's fair market value on the date the grant)

ESPPs: Tax and Document Requirements (cont.)

- Requirement No. 6 – determine the date of grant
  - The date of grant is either the first day of the offering OR the purchase date
  - For the date of grant to be deemed the first day of the offering period the plan or offering must include the maximum number of shares that may be purchased by any participant during an offering period
    - Most companies prefer that the date of grant be the first day of the offering period because the shares must be held two years from the date of grant (and one year from the date of purchase) to receive favorable tax treatment
    - No particular number of shares is necessary to satisfy this requirement and the number may be formulaic
  - If the ESPP does not include a maximum number of shares then the date of grant is the purchase date
  - If a "look back" feature is utilized that allows the employee to purchase shares at FMV at the lower of either the date of grant or the purchase date, then the maximum number of shares that may be purchased by participants must be included in the plan or offering
    - If such maximum number of shares is not included then the look back accomplishes nothing because the date of grant and the purchase date become one in the same
  - The date of grant also has various employee tax implications which inure to the benefit of the employee if the date of grant is the first day of the offering (*i.e.*, starts the clock for the holding period, determines stock price for purposes of the $25,000 limitation, etc.)

ESPPs: Tax and Document Requirements (cont.)

- Requirement No. 7 – determine the purchase price
  - Either the plan or the offering must provide that the purchase price be no less than the lesser of:
    - 85% of the stock's fair market value at the date of grant,
      or
    - 85% of the stock's fair market value at the time of purchase
  - It is common for a "look back" pricing methodology to be used pursuant to which an employee is able to purchase stock at the lesser of the above during the offering period (*e.g.*, up to 27 months) or a series of purchase periods within an offering period (*e.g.*, increments of 6 months)
  - A "look back" effectively provides for discounts in excess of the statutory limit of 15%
  - For example: Assume your company allows for the full 15% discount with a 6-month lookback
    - Date of Offer/Date of Grant stock price: $10
    - Date of Purchase stock price: $12
    - With a lookback, your purchase price for stock worth $12 is only $8.50 (15% of $10)
    - This gives you an effective discount of *41%* off the FMV of the stock at the time of purchase ($3.50 spread at exercise divided by $8.50 purchase price)

ESPPs: Tax and Document Requirements (cont.)

- Requirement No. 8 – limit on offering period
  - The maximum limit for an offering period depends upon the structure of the ESPP
  - If the ESPP is structured as a “look back” (*e.g.*, the lesser of 85% of the fair market values on the date of grant or the date of purchase), then
    - Either the plan or offering must provide for a maximum offering period of 27 months or less from the date of grant
  - If the ESPP is structured so that the purchase price is at least 85% of the fair market value of the stock on the date of purchase, then
    - Either the plan or offering must provide for a maximum offering period of 5 years or less from the date of grant
- Requirement No. 9 – restrictions on transfer
  - The plan document must prohibit transfer except by will or the laws of descent and distribution
  - Additionally, only the employee may exercise a purchase right during his or her lifetime

ESPPs: Employee Tax Consequences

- Date of grant
  - No tax consequence to the employee

- Date of exercise
  - No tax consequence to the employee

- Employee sells the stock after an exercise
  - Similar to ISOs, the tax consequences depend upon whether the sale was before or after the statutory holding period, such holding period being the later of (i) 1 year from the date of purchase and (ii) 2 years from the date of grant

ESPPs: Employee Tax Consequences (cont.)

- If the sale is after the holding period, then the employee recognizes (in the year of sale) ordinary income on the lesser of: (i) the FMV of the stock on the "date of grant" minus the exercise price, or (ii) the amount realized on the sale minus the exercise price
  - Any additional gain or loss would be recognized at long-term capital gains rates

- However, if the sale is during the holding period, then the employee recognizes (in the year of sale) ordinary income equal to the FMV of the stock on the date of purchase minus the exercise price
  - Any additional gain of loss would be recognized as short-term or long-term capital gains, depending on the holding period
  - Note that this a "disqualifying disposition" and is similar to the tax treatment upon employee exercise under a non-qualified ESPP
    - In the event of a disqualifying disposition the employer may take a deduction to match the employees ordinary income

ESPPs: Employer Tax Consequences

- Generally, and similar to an ISO, an employer would NOT be entitled to a deduction at the date of grant or the date of exercise
  - However, if the employee sells the stock without satisfying the holding period requirement, then the employer is entitled to a deduction equal to the amount the employee recognized as income

- Wage withholding is not required
  - This is true even if the employee sells the stock without satisfying the holding period

- 6039 information statements and returns
  - Employers who sponsor an ESPP have a year end reporting requirement under Section 6039
  - For transfers of stock acquired under an ESPP, the employer must provide information statements to employees no later than January 31st, and must file information returns to the IRS no later than February 28th (or March 31st if filing electronically)
  - The information statement to the employee must be on Form 3922 or must be contained on a substitute form that satisfies IRS Publication 1179

ESPPs: Federal Securities Laws

- Generally, all "offers" and "sales" to sell "securities" must be made pursuant to:
  - An effective registration statement filed with the SEC, or
  - An exemption from registration
- A Form S-8 is a short form registration statement that may be used for offerings under an "employee benefit plan"
  - Such statement is effective immediately upon filing with no waiting period and no SEC review
  - It is a "shelf registration statement" that remains effective until deregistration
- A Form S-8 consists of two parts:
  - A prospectus which must be provided to eligible employees, but not filed with the SEC, and
  - A short-form registration statement filed with the SEC, but not provided to employees
- The SEC's position is that an employee makes an "investment decision" when he or she elects to authorize payroll deduction under the ESPP
  - This means that the Form S-8 should be filed prior to any employee authorizations for payroll deductions

U.S. Voting Guidelines: Equity & Incentive Plans (cont.)

- Vote in favor of a proposal to implement an ESPP if:
  - The discount is no greater than 15%,
  - The offering period is 27 months or less, and
  - The number of shares allocated to the ESPP is 10% or less of the outstanding shares

- Vote against an ESPP proposal if:
  - The discount is greater than 15%,
  - The offering period is more than 27 months, or
  - The number of shares allocated to the ESPP is more than 10% of the outstanding shares

Don’t Forget Next Month’s Webinar

- Title:
  - Hot Compensation Topics
- When:
  - 10:00 am to 11:00 am Central
  - August 13, 2026