ESPPs at a Glance:

Implementation & Participation

An employee stock purchase plan (ESPP) allows eligible employees to buy their employer's stock at a discounted price.

After-tax payroll deductions are set aside and once an accumulation threshold is reached, employees can automatically purchase stock at a discounted price.

In the United States, there are currently over 6,500 employee stock purchase plans that hold more than $2.1 trillion in assets.[1] ESPPs can be offered in addition to traditional 401(k)s to give employees another option for growing their retirement savings. This type of equity plan is becoming more popular because it can give employers a recruitment edge, increase employee engagement, boost retention rates and create a culture of ownership. Employees who become shareowners have a vested interest in organizational performance.

If your company is considering implementing an ESPP, the following information on eligibility, implementation, communication and participation can help you determine if this type of plan might be a good fit for your company's equity compensation goals.

1 "Employee Stock Ownership Plan (ESOP) Facts," National Center for Employee Ownership, 2024

How Does Participation in an ESPP Work?

Generally speaking, under Internal Revenue Service (IRS) rules, all employees at a company are eligible to participate in a tax-qualified ESPP. However, there are a few exceptions. Companies can exclude employees who have been with them for fewer than two years, those who work 20 or fewer hours per week and those who work fewer than five months in a calendar year.[2]

Typically, only U.S. employees are eligible, but companies with operations outside of the U.S. often create separate "nonqualified" plans for employees who don't live in the U.S.; these are generally tailored to each country of residence. A "nonqualified" plan refers to the fact that participants do not get preferential tax treatment from the U.S. government.

Another common plan limitation is that a participant must be enrolled in the plan from the beginning of the offering period through the end of the purchase period to be able to purchase shares.

The statutory rules for limiting participation in an Employee Stock Purchase Plan (ESPP), as outlined by the IRS, include:[3]

- **Eligibility:** Only employees can participate.
- **Contribution Limit:** Employees can purchase no more than $25,000 in shares during any one year in which an offering is open.
- **Ownership Restrictions:** Participants cannot own more than 5% of the company's stock.
- **Plan Terms:** The purchase price cannot be lower than 85% of the stock's market value.

These rules are designed to ensure that ESPPs remain compliant with tax benefits and other legal guidelines.

2 Comments in "The Role Of Employee Stock Purchase Plans In Today's Workplace," made by Jason Flaherty, Partner at Orrick, Herrington & Sutcliff LLP.

3 Key rules set by Section 423 of IRC.

Designing Your ESPP

Every plan rollout is unique, but often, an ESPP is designed during the pre-initial public offering (IPO) phase as a company prepares to transition from private to public. The board of directors or a compensation committee creates the overall plan design and its rules and requirements. Once a pre-IPO plan is approved and adopted, the employer implements the ESPP by setting the specific terms for an offer through an offering document, which typically includes clauses on:

- **Discounts** from fair market value of the stock. These are often set at 15%, which is the maximum allowed.
- **"Lookback" Periods,** which are a retroactive window that allows employees to purchase company stock at its lowest point during the entire offering window. This window can be as long as 27 months.[4]
- **Share Reserve** is the number of shares that can be issued under the plan without requiring shareholder approval for an increase. Most companies define an IPO share reserve (typically 1% to 2% of outstanding shares) but include an evergreen provision that automatically adds shares each year without the need for additional shareholder approval (typically 1% annually). To satisfy IRS regulations, employers also set a hard share cap, an amount determined by the board (typically 1% at the time of plan inception).

Once any clauses have been accepted, the company files a registration statement (S-8) and can begin issuing shares to employees. Employers also need to create a prospectus that summarizes what the ESPP is, the material terms and the tax implications. This is typically an easy-to-read Q&A or FAQ offered to all eligible employees.

The Value of Flexibility

By building flexibility into the master plan design, employers can modify the terms for any subsequent future offering. Some employers build flexibility in discounts and lookback periods into the plan's provisions but choose to write an initial offering document with a conservative 10% discount and a six-month lookback period. These provisions are permitted under the regulations of qualified plans. This approach provides maximum flexibility for different offerings without requiring shareholder approval for each offering.

Learn about boosting employee engagement and retention with ESPPs, what young investors care about and how to maximize the value your ESPP is contributing to your company.

Read our article.

4 Comments in "The Role Of Employee Stock Purchase Plans In Today's Workplace," made by Jason Flaherty, Partner at Orrick, Herrington & Sutcliff LLP.

Enrollment

Once an ESPP is officially registered, participants can decide whether to enroll. In the case of an IPO, some plans auto-enroll eligible employees so they receive the benefit of the IPO price as the lookback price. After the IPO period, employees can elect to stay enrolled or opt out. If employees do not complete their paperwork by a specific deadline, they are withdrawn from the ESPP and no longer a participant.

Be sure to convey the value of your ESPP early and often to Millennials and Gen Z and use tactics that resonate with them. Younger investors are partial to stories and themes, so building narratives in digital channels can engage these potential shareholders.

Read our article to find out more.

Communicate Best Practices to Maximize Participation

Employee communication and education are the keys to a successful equity compensation program. To maximize plan participation, your benefits administrator or human resources team must educate your employees, so that they have a solid understanding of your plan's design and benefits, and the advantages of long-term stock ownership.

Maximize your communication launch strategy by leveraging all channels. For instance, use technology to distribute your plan materials via electronic devices, including computers, laptops, tablets and smartphones. Hosting a benefits fair so employees have an opportunity to discuss plan details one-on-one, as well as learning about ESPPs in the context of their full benefits — including 401(k)s — can be highly effective.

ESPP participation rates vary but achieving **20%+** of a company's total eligible employee population is typically deemed a success.

Communicate information about your ESPP, not just during the enrollment period, so your employees understand your ESPP and view it as a must-have.

Learn more about specific communication tactics and education plans that can boost your participation rates in our **article**.

Attracting and retaining top talent is a critical component of your company's success. An ESPP can help by signaling your investment in your employees, particularly when presented alongside other benefits like medical and dental insurance, and a 401(k).

For more about EQ's approach, **watch the video**.

ABOUT EQ

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