Counting the Costs and Balancing the Benefits: Financial Engineering for ESPPs

Fidelity Investments and Infinite Equity teamed up to explore how ESPP elements fit together to help companies engineer a plan to manage financial implications and deliver balanced benefits.

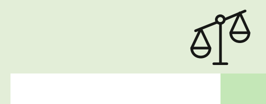
Employee Stock Purchase Plans (ESPPs) have long been favored for delivering equity compensation to a broad base of employees. The case for an ESPP has never been stronger—companies are looking to equity to manage cash and provide compelling pay and benefits to all employees. ESPPs can be designed in a variety of ways to balance these seemingly conflicting objectives and still meet a company's financial goals. **From cash flow to dilution to tax benefits, companies at any stage of their life cycle, or in any financial situation, can engineer the benefits offered and the source of the shares of an ESPP to achieve specific financial statement goals.**

The benefits of an ESPP are well established, ranging from increased productivity and improved tenure to employee satisfaction. Rather than rehashing these benefits, the focus of this paper is on dissecting the various financial impacts of ESPPs so they can be balanced against corporate objectives and other benefits.

ESPPs at a glance

51%
of companies offer an ESPP[1]

30%
average participation[2]



80/20
80% §423
20% nonqualified[3]

75%
of companies report ESPP represents <1% of total compensation costs[4]

Financial impact

The prominent financial concerns of an ESPP is the noncash compensation expense and increased share dilution. Often overlooked are the more positive financial implications of creating additional paid-in capital (APIC) and tax deductions. Consider these two hypothetical scenarios and the possible outcomes for each financial implication.

Each plan assumes $10 FMV at enrollment and $12 FMV at purchase.

PLAN A

- Section 423
- 15% discount
- Lookback
- Six-month offering

PLAN B

- Nonqualified plan
- 15% match
- Three-month offering

[1]"2020 Domestic Stock Plan Administration Survey," NASPP and Deloitte Consulting.
[2]Fidelity Internal Analysis for Section 423 plans with a 15% discount and a lookback.
[3]Fidelity ESPP Data Analysis 2020.
[4]"The 2016 Survey of Employee Stock Purchase Plans," NCEO.

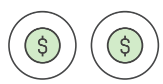
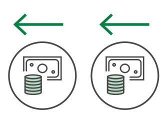
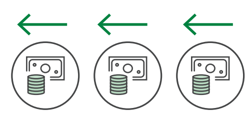
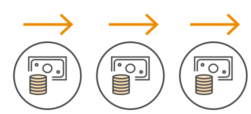
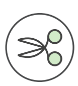
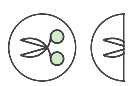
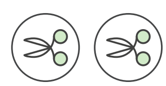
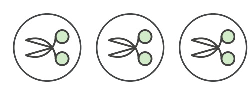
Financial Impact	Description	Impact	Seeing It in Action
Compensation Expense	Unless an ESPP qualifies as a "safe harbor" plan under ASC 718 (generally, a maximum discount of 5% and no lookback feature), companies must recognize compensation expense for an ESPP.	Expense is determined according to the plan features; the greater the benefit offered, the greater the expense. Tax qualification does not affect expense. Because employees bear a large portion of the price of the shares in an ESPP, the compensation cost on a per-share basis is typically significantly lower than other types of equity arrangements. More attractive designs have higher participation and contribution levels, resulting in higher total expense.	**For every $1M in contributions:** **Plan A:** About $300,000 compensation expense, or 30% of total contributions (assumes 40% volatility). **Plan B:** $150,000 compensation expense, or 15% of total contributions. **Both Plans:** Decreasing the discount/match (or increasing it for Plan B) will have a commensurate impact on the expense.
Dilution	The dilutive impact depends on the source of the shares. Companies may use more than one source for the shares, or the source may change over time. Shares may be Treasury shares, new issue shares, or shares purchased on the open market.	Treasury and new issue shares are dilutive to shareholders while shares purchased on the open market are not. Dilutive impact is directly related to the number of shares purchased, which is driven by participation and contribution levels.	**Plan A:** While dependent on specific facts, dilution would typically be less than 1% per year. **Plan B:** Shares are purchased on the open market with no dilution.
Cash Flow	Employee contributions to purchase shares divert payroll cash outflow, effectively representing cash inflow to the company. Plan features like matches require cash outlay by the company.	Greater levels of participation increase contributions. Larger matches require company cash to purchase more shares.	**For every $1M in contributions:** **Plan A** $1M Additional Paid In Capital. **Plan B** $150,000 cash outflow.
Tax Deduction	For qualified ESPPs, companies only realize a tax benefit upon a disqualifying disposition. On average, about a third of Section 423 shares are sold in a disqualifying disposition.[5] For nonqualified ESPPs, companies realize a tax benefit when shares are purchased.	On a per-share basis, nonqualified plans are more beneficial in terms of the tax benefit to the company because every share results in a tax deduction. However, 423 plans with more attractive design elements may have higher per-share income and significantly higher participation, ultimately resulting in greater total tax deductions.	**For every $1M in contributions:** **Plan A:** $137,000 tax deduction. ($1M in contributions purchases 117,647 shares. Tax deduction based on typical disqualification.) **Plan B:** Creates a $150,000 tax deduction.
"Hidden Costs"	Qualified plans require a Section 6039 filing, often at additional expense. Qualified plans may result in additional administrative costs associated with tracking dispositions (though such costs can be mitigated with transfer restrictions). Purchase frequency may affect administrative costs.	6039 reporting is binary – either it is required (for 423 plans) or not (for nonqualified plans). Plan design (i.e., purchase frequency) doesn't affect 6039 cost. Volume may have an effect on 6039 costs – plans with greater benefits have higher participation, requiring more 6039 filings.	**Plan A** About $3–$4 per participant. **Plan B** $0.

Hypothetical example for illustrative purposes only.
[5] Fidelity Internal Analysis for 2017-2018 purchases.
[6] 117,647 shares x 33% disqualified x ($12 purchase FMV - $8.50 purchase price) = $137,000 in tax deductions.

Common Plan Types

There is a wide variety of plan designs available by mixing and matching features. Section 423 limits design options, however, still permits a great amount of variability. With nonqualified plans, there are even more possibilities. Companies can engineer the design to achieve a wide range of financial goals or constraints. Below are common plan design combinations along with company impact summaries.

The impact is on a scale of 1 to 3, with 1 being the lowest impact and 3 being the highest.

Cost Component	Safe Harbor Plan	"Lite" Plan	"Standard" Plan	Match/Discount Plan
Plan Description	Qualified plan 5% discount No lookback Three-month purchase period	Qualified plan 10% discount No lookback Three-month purchase period	Qualified plan 15% discount Lookback Three- or six-month purchase period*	Nonqualified plan 25% match Open market purchase Three-month purchase period
Compensation Expense	—			
Dilution				—
Cash Inflow/ Outflow				
Tax Deduction				

*Plans with a 15% discount and a lookback can also be structured as "Cadillac" plans, offering a 12- or 24-month offering period with multiple purchase periods.

NOTE: ESPP plan design can vary widely. The above table is for illustrative purposes only and represents common plan designs, but it does not include of all plan design variables. The chart does not address direct stock purchase plans where employees can purchase company stock through payroll deductions, but there is no discount, match, or other benefit offered.

Safe harbor plans have the lowest financial statement impact overall but also have the lowest participation rates and may not achieve other corporate objectives of broad-based ownership and engaging employees through differentiated benefits.

Standard ESPPs have a greater financial statement impact but are more likely to see strong participation rates and align with objectives around ownership and employee engagement, which ultimately achieve greater improvements to a company's bottom line. Additionally, these plans are likely to generate more APIC through higher participation and contribution rates. This is illustrative of how companies can counterbalance competing goals by picking and choosing different features for an ESPP.

Example Use Cases

Meet different corporate objectives by properly engineering plan design.

Plan X

A technology company with a strong belief in broad-based ownership wants to maximize ESPP participation. Company A sees an opportunity to improve cash on the balance sheet, which could potentially be used to increase company match in the 401(k) plan. The company has an ample share pool from a plan that was approved pre-IPO but never launched and has minimal concerns about compensation expense.

Plan Design Features

Section 423 using new issue shares.

Broad eligibility, including the IRS-permissible exclusions.

15% discount with a lookback.

Maximum contributions: 25% of eligible pay, which includes salary, bonus, commissions, and overtime pay.

Transfer restriction through end of the disqualifying disposition period.

Company A is likely to achieve high participation and contribution levels, which will result in higher compensation and dilution but achieves the goal of adding more cash to the balance sheet. To minimize the administrative headache and pick up all the tax deductions, Company A implements a transfer restriction through the DD period. Compensation expense and dilution are likely higher than for other ESPP designs as a result of high participation and contribution amounts.

Plan Y

A mature manufacturing company removes company stock from the 401(k) plan and is looking for an alternative path to employee stock ownership. The company has a significant gap between management, which are long-term incentive (LTI) eligible, and manufacturing, which are largely nonexempt employees and not LTI eligible. The company wants to ensure that the manufacturing population sees the value of company stock ownership. Because of shareholder concerns, the company is highly sensitive to increasing dilution.

Plan Design Features

Nonqualified plan with open market monthly purchase.

Eligibility for all employees on payroll with exclusion of top three salary grades.

Company match: 25% for first $500 (per month); 15% for contributions in excess of $500.

Maximum contributions: 10% of eligible pay, which includes salary, overtime pay, and shift differential.

Company B is likely to attract solid participation in its nonexempt population with an attractive match designed to cover most contributions from this population. Additionally, eligible compensation is tailored to this population, focusing the ESPP benefit on the non-LTI-eligible population. The open market purchase arrangement eliminates any plan dilution, and the nonqualified plan delivers a tax deduction equal to the match provided.

Conclusion

Understanding the possible features of an ESPP can help companies engineer a plan to meet corporate objectives. Whether a company seeks to increase employee benefits without expending cash, provide a benefit that doesn't affect dilution, maximize tax deductions, or something in between, ESPPs provide the flexibility to pick and choose what works for a company's specific situation. Even better, well-drafted plans provide flexibility to change features over time as the company's financial situation changes, without needing shareholder approval, so the plan can grow and change with the company. Whether implementing a new ESPP or refreshing an existing plan, counting the costs and balancing the benefits of an ESPP are crucial to engineering a successful program.

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