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Is Broad-Based Equity the Wave of the Future? ESPPs Usher New Era in Employee Ownership.

There are many factors to consider when adding an ESPP plan to your benefits program. This article explores the rise of ESPPs and ways to ensure effective design and implementation.

In the overwhelmingly competitive talent marketplace, employee benefits are a top concern when recruiting and retaining employees. While historically cash has often been called king, stock-based compensation and other opportunities for employee stock ownership, have moved to the forefront. What is the reason for this change?

Today's increasing focus on human capital management and the social implications of environment, social and governance (ESG) metrics have turned attention to ensuring holistic benefits of the broad employee base rather than only top management. Employee stock purchase plans (ESPPs) are a common way to achieve broad-based employee ownership.

Exploring ESPP Plans

An ESPP is a company-established program that allows employees to purchase company stock via payroll contributions, often at a discount or "match" of shares purchased. For certain kinds of ESPPs, there are tax benefits for U.S. employees that bring taxation from ordinary income levels to long-term capital gains levels, allowing for wealth creation in excess of the norm. The overarching purpose of these plans is to push the shareholder mentality further down into the organization – even further than with traditional stock-based compensation – and allow employees to have a vested interest in the long-term growth of the company.

ESPPs are broken into two categories from a taxation perspective: qualified and non-qualified. A qualified plan, which over 80% of companies with an ESPP adopt, has restrictions that must be followed to adhere to IRS requirements under Internal Revenue Code Section 423. These restrictions are in place to allow equal rights and privileges to all employees (within reason), and include:

- A limit of up to a 15% discount, with specific exclusions of certain groups of employees (part-time workers, seasonal workers, etc.);
- a maximum offering period of up to 27 months;
- a maximum share purchase of $25,000 annually;
- and the purposeful exclusion of 5% shareholders, amongst others.

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A non-qualified plan does not adhere to IRC Section 423 regulations. These plans are often more creative, adopting very rich match ratios (i.e. for every share purchased, the company will match the same amount) or steep discounts that are in excess of the Section 423 limitation. It could also offer the ESPP to a specific subset of an employee group that would again be outside of the limitations of a qualified plan. Most commonly, non-qualified plans are utilized in international jurisdictions alongside a qualified plan in the U.S. and are structured to mimic the design of the qualified plan so that employees are treated equally.

Why Choose ESPPs?

There has been a noticeable shift towards companies offering an ESPP when they did not previously or making more aggressive design changes to their current plan. ESPPs are an easy, effective and relatively inexpensive way to generate employee ownership in a company, hence becoming an important part of the total rewards discussion. This is especially true during recruiting and retention efforts, whereby other companies are offering more attractive programs.

Providing employees with an avenue to invest in the company through an ESPP also aligns their interest with shareholders, which is why these programs almost always receive unwavering shareholder support. This, in turn, also gives way to a broader base having significant interest and desire to see the company succeed. It’s a win-win situation. In fact, studies by the National Center of Employee Ownership reveal that companies with broad-based employee ownership outperform companies that do not provide equity opportunities.

Implementation and Design

As with any other employee benefit, administration costs are often factored into design discussions. In a “plain vanilla” ESPP with a 15% discount, a lookback (purchasing at the lower end of the offering date price or purchase date price) and a six-month offering period with one purchase, the valuation and accounting is relatively straight forward. In a “Cadillac” ESPP with a 15% discount, lookback and a 24-month offering period with four purchases and the potential to reset the lookback price to a lower number, the valuation and accounting can get expensive to outsource.

Cadillac ESPPs have become a hot topic, particularly in the technology and life sciences industries, when it comes to recruiting and retention strategies. Therefore, companies are constantly balancing the cost of administration with the overall benefit to the employee base. It should also be noted that most stock administration platforms can handle extremely complex plans from an administrative perspective, so the employee experience would not be interrupted even by the most creative of designs.

One of the more integral aspects of an ESPP implementation is not the design or the valuation and accounting, but rather the communication of the benefit to employees. This is especially true outside of the U.S., where there could be additional registration needed, various tax treatments and different considerations from a payroll, offering document and plan document standpoint. Global due diligence is paramount to the success of the rollout, followed by further education and employee communications to ensure that employees understand not only the benefit, but also their obligations and potential tax events. Without a well-thought-out communication strategy, even the richest and most employee-friendly ESPP can fail.

Next Steps

There is no doubt that implementation of an ESPP presents many unique challenges. As a broad-based plan, it impacts almost all departments of a company — human resources, tax, financial reporting, legal, investor relations, payroll, communication and executive engagement. The successful implementation of an ESPP includes a thought-out timeframe in which all of the constituents involved can plan and test their procedures and ensure that, at launch, there are no unanswered questions.

The communication of the rollout plan to participants should occur over a period of time that allows the company to generate necessary buzz around the plan to obtain adequate participation. Constant communication throughout the life of an ESPP is essential, including sending notes to new hires, new participants, employees who have participated but might need a reminder to contribute more, and so on.

Aon has the unique ability to assist with all aspects of ESPP implementation. With subject matter expertise in governance share evaluation, tax compliance, financial reporting, communication and education, and project management, coupled with a strong global presence, we provide start-to-finish execution of a successful ESPP.

If you need help with an ESPP or have questions about this topic and want to speak with one of our experts, please write to rewards-solutions@aon.com.

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