EMPLOYEE STOCK PURCHASE PLANS

Many large companies offer Employee Stock Purchase Plans (ESPP) that let you buy your employer's stock at a discount. These plans are offered as an employment incentive, giving you an opportunity to share in the growth potential of your company's stock (and, by implication, work hard to keep the stock price soaring).

Usually, you make contributions to a stock purchase fund for a certain period of time through payroll deductions. At designated points in the year, your employer then uses the accumulated money in the fund to purchase stock for you.

In many plans, the price that you pay for the stock is the stock price at the time you started contributing to the fund, or the stock price at the time you purchased the shares (whichever is lower) with a discount of up to 15 percent. Either way, you get to buy the stock at a price that's lower than the market price. Your discounted price is known as the offer or grant price, because your employer has offered it to you, or granted it to you.

The company keeps the stock in your name until you decide to sell it. At that point you have to begin thinking about taxes.

But What About Taxes?

When the company buys the stocks for you, you do not owe any taxes. You are exercising your rights under the ESPP. You have bought some stock. So far so good.

When you sell the stock, the discount that you received when you bought the stock is generally considered additional compensation to you, so you have to pay taxes on that as regular income.

And, depending on when you were granted the right to purchase the stock (the grant date), and how long you have held the stock, any profit that you make, over and above the compensation, may be considered a long-term capital gain, which can be taxed at lower rates than the compensation.

If you've participated in one of these plans, you probably know how it works. Come tax time, though, trying to figure out how to report the stock you sold through your plan can be daunting. You may wonder what gets reported and where on your return.

How Much of the Sales Price is Compensation?

That depends on whether your sale of the stock is a "qualifying disposition" or a "disqualifying disposition". Selling the stock is thought of as disposing of it, but the question is, what makes the sale qualify as a capital gain, at least in part?

- **Qualifying Disposition**: You sold the stock at least two years after the offering (grant) date and at least one year after the exercise (purchase) date. If so, a portion of the gain is considered ordinary income and will need to be reported as earned income on your Form 1040, as "compensation". Any additional gain is considered capital gain and should be reported on Schedule D, Capital Gains and Losses. (The capital gain rate is usually less than the rate you pay on ordinary income.)
- **Disqualifying Disposition**: You sold the stock within two years or less after the offering (grant) date or within one year or less from the exercise (purchase) date. In this case, your employer will report the bargain element as compensation on your Form W-2, so you will have to pay taxes on that as ordinary income. The bargain element is the market price at the exercise date minus the actual price you paid for the stock, multiplied by the number of shares. Any additional gain is considered capital gain and should be reported on Schedule D.

The exact amount you pay as ordinary income, and as capital gains, depends on which situation you find yourself in.

1. You sell your ESPP shares within one year of purchasing them. (A disqualifying disposition).
2. You sell your ESPP shares more than one year after purchasing them, but within two years of the date on which you were offered the stock. (A disqualifying disposition).
3. You sell your ESPP shares more than one year after purchasing them, and more than two years after the offering date, and the market price decreased from the offering date to the exercise date. (A qualifying disposition).
4. You sell your ESPP shares more than one year after purchasing them, and more than two years after the offering date and the market price increased from the offering date to the exercise date. (A qualifying disposition.)

Situation 1 (Disqualifying Disposition)

In this situation, you sell your ESPP shares within one year of purchasing them.

Example:

Offering date: 01/01/2006	Market price:
Exercise (purchase) date: 06/30/2006	Market Price: $25.00
15 percent discount	Actual cost: $21.25
Actual sale date: 01/20/2007	Market price: $50.00
Commission paid at sale $10.00	
Number of shares: 100	

This is a disqualifying disposition (sale) because you sold the stock less than two years after the offering (grant) date and you sold the stock less than a year after the exercise date.

Because this is a disqualifying disposition, your employer should include the bargain element in box 1 of your W-2, as compensation. The bargain element is calculated this way:

1. Subtract the actual price paid from the market price at the exercise date
2. Multiply the result by the number of shares: ($25.00 - $21.25) x 100 = $375.00.

Even if your employer didn't include the bargain amount in Box 1 of Form W-2, you must add this amount to line 7 on the Form 1040.

You must also show the sale of the stock on Schedule D, Part I, for short-term sales because there was less than one year between the date you acquired the stock (6/30/2004) and the date you sold it (1/20/2005).

The sales price you report on Schedule D is $4,990.00, and the cost is $2,500.00. Your net gain is the difference between these two, or $2,490.00.

How did we come up with these amounts?

The sales price is the market price at the date of the sale ($50.00) times the number of shares sold (100), or $5,000.00. You then subtract any commissions paid at the sale ($10.00 in this example), arriving at $4,990.00. Your broker will show this amount on Form 1099-B that you'll receive at the beginning of the year following the year you sold the stock.

The cost is the actual price you paid per share (the market price times the discount) times the number of shares ($21.25 x 100 = $2,125.00) plus the amounts already included in your W-2 (the $375.00 bargain element we calculated above), for a final cost of $2,500.00.

Because your sale did not qualify, you must pay taxes on your net gain ($2490) at your regular tax rate, rather than the lower rate available for long-term capital gains.

Situation 2 (Disqualifying Disposition)

In this situation, you sell your ESPP shares more than one year after purchasing them, but within two years of the offering date.

Example:

Offering date: 06/30/2005	Market price: $30.00
Exercise (purchase) date: 01/01/2006	Market price: $25.00
15 percent discount	Actual cost: $21.25
Actual sale date: 01/02/2007	Market price: $50.00
Commission paid at sale $10.00	
Number of shares: 100	

This is a disqualifying disposition because you sold the stock less than two years after the offering (grant) date. As in the previous example, your employer should include the bargain element in your wages on Form W-2. The bargain element is the same as in the first example ($375.00). You must add this amount to line 7 on the Form 1040.

You must also show the sale of the stock on Schedule D, Part II for long-term sales. It's considered long-term because more than one year passed from the date acquired (1/01/2006) to the date of sale (1/02/2007). That is good, because long-term capital gains are taxed at a rate that is usually lower than your regular tax rate.

In this example, as in the previous one, the sales price you report on Schedule D is $4,990.00, and the cost basis is $2,500.00. The net gain is the difference of $2,490.00.

Situation 3 (Qualifying Disposition and Market Price Decreased)

In this situation, you sell your ESPP shares more than one year after purchasing them, and more than two years after the offering date, and the market price decreased during the period from the offering date to the exercise date. You have a qualifying disposition here.

Example:

Offering date: 01/01/04	Market price: $35.00
Exercise (purchase) date: 06/30/04	Market price: $25.00
15 percent discount	Actual cost:$21.25
Actual sale date: 01/02/2007	Market price: $50.00
Commission paid at sale $10.00	
Number of shares: 100	

This sale is a qualifying disposition because over two years have passed between the offering date and sale date, and more than one year has passed between the date of purchase and the date of sale. But the price per share decreased from the offering date to the purchase date.

Because this is a qualifying disposition, your employer may not report anything on your Form W-2. But you need to report some ordinary income on line 7 on the Form 1040, as "compensation". You report the lesser of:

- The sales price per share minus the actual price paid per share times the number of shares. ($50.00-$21.25) x 100 shares = $2,875.00, or
- The offering price per share times the company discount, if any, times the number of shares. ($35.00 x .15) * 100 shares = $525.00

You report $525.00 on line 7 on the Form 1040 as "ESPP Ordinary Income".

Report the sale of your stock on Schedule D, Part II, as a long-term sale. It's long term because there was over one year between the date you acquired it (6/30/04) and the date you sold it (1/02/2007).

For reporting on Schedule D, the sales price is $4,990.00, and the cost basis is $2,650.00. The net gain is the difference of $2,340.00.

The sales price is computed as in the previous examples. The cost, however, is the actual price paid per share times the number of shares ($21.25 x 100 = $2,125.00) plus the amount ($525.00) that you're reporting on Form 1040. Thus, your total cost is $2,650.00.

Situation 4 (Qualifying Disposition and Market Price Increased)

In this situation, you sell your ESPP shares more than one year after purchasing them, and more than two years after the offering date and the market price actually increased from the offering date to the exercise date.

Example:

Offering date: 1/01/04	Market price: $15.00
Exercise date: 6/30/04	Market price: $25.00
15 percent discount	Actual cost: $12.75
Actual sale date: 1/02/2007	Market price: $50.00
Commission paid at sale $10.00	
Number of shares: 100	

This too is a qualifying disposition (sale) because over two years have passed between the offering date and the sale date, and over one year has passed between the date of purchase and the date of sale. And this time, the price per share increased from the offering date to the purchase date.

Again, your employer may not report anything on your Form W-2 as compensation. But you still must report some ordinary income on line 7 on the Form 1040, as "compensation". You report the lesser of:

- The sales price per share minus the actual price paid per share times the number of shares. ($50.00-$12.75) x 100 shares = $3,725.00, or
- The offering price per share times the company discount, if any, times the number of shares. ($15.00 x .15) * 100 shares = $225.00

So you must report $225.00 on line 7 on the Form 1040 as "ESPP Ordinary Income".

You must also report the sale of your stock on Schedule D, Part II as a long-term sale. It's long term because there is over one year between the date acquired (6/30/04) and the date of sale (1/02/2007).

For reporting on Schedule D, the sales price is $4,990.00, and the cost basis is $1,500.00. The net gain is the difference of $3,490.00.

The sales price is computed as in the previous examples. The cost, however, is the actual price paid per share times the number of shares ($12.75 x 100 = $1275.00), plus the amount ($225.00) that you're reporting on Form 1040. Your total cost is $1,500.00.

Bottom Line

Your employer is not required to withhold FICA taxes when you exercise the option to purchase the stock. Also, your employer is not required to withhold income tax when you dispose of the stock. But you still owe some income tax on any gain resulting from the sale of the stock.