

A Primer On Employee Stock Purchase Plans Under IRC § 423

Prepared

for Clients and Friends of the Firm

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I. Business Considerations

- A. Stock compensation plans that satisfy the conditions of Internal Revenue Code (“IRC”) § 423 are called “employee stock purchase plans” (“ESPP’s”). A public company may establish an ESPP to enable its employees to purchase, on a regularly recurring basis, limited amounts of the company’s stock at a discount of up to 15% (and, in some cases, effectively even more than 15%) off the stock’s fair market value (“FMV”) without the employee’s owing any federal income tax on either the discount or any further appreciation until the shares are sold, and with the employee’s possibly paying federal income tax mostly at the long-term capital gains rate. An employer generally does not incur a compensation charge under generally accepted accounting principles (“GAAP”) at any time in connection with an ESPP, and may or may not receive a federal income tax deduction for the portion of the employee’s gain represented by the discount, depending on how soon the employee sells the stock after acquiring it. Unlike Employee Stock Ownership Plan (“ESOP’s”), with which ESPP’s are sometimes confused by persons not familiar with either type of arrangement, ESPP’s are generally not a way to require, or even encourage, rank and file employees to acquire a significant long-term ownership stake in their employer. This is because ESPP’s typically place no restraint on employees’ ability to resell the shares they purchase, and in fact most employees sell the stock they acquire under an ESPP shortly after purchasing it. Such sales typically net the employees a cash profit, at no cash expense to the company (indeed, the employer will typically experience significant cash inflows in connection its ESPP, since it is typically issuing new shares to its employees for cash), with the only economic downside being shareholder dilution to the extent of the discount.
- B. The discount under an ESPP may be up to 15% off the lower of FMV at (i) a date usually referred to as the “offering commencement date” or (ii) the actual “purchase date.”

1. Because the purchase date may be up to 27 months after the offering commencement date, in a rising market employees can obtain an effective discount in excess of 15%, while secure at all times in the knowledge that they will never have to pay more than 85% of FMV at the purchase date. The ability to buy stock at the lower of FMV at the offering commencement date or the purchase date is commonly called a “lookback” feature. ESPP's are not required to have a lookback and can use a discount of less than 15%, but in fact most have a lookback and use the maximum 15% discount.
- C. Because of their broad participation requirements (see below), ESPP's are only practical for public companies.
1. During the IPO “bubble” of the late 1990's and early 2000, many companies adopted ESPP's effective on their IPO commencement date to lock in the initial price to public as the ESPP's lookback price for the first offering period. This gave employees, including rank and file employees who may not have participated previously in the company's equity compensation programs, a way to participate in the post-IPO, post-lockup market.
- D. Although formally option plans, the way ESPP's operate is that an employee makes an election to have a certain amount or percentage of his or her salary or wages (typically between 1% and 10%) deducted each payroll period on an after-tax basis from his or her compensation. These payroll deductions are accumulated (notionally in an accounting sense, not in a separate trust, and typically without interest), for a period of time called the “offering period” that typically lasts six months to a year, but can be as long as 27 months. Either once at the end of the offering period, or on multiple purchase dates during the offering period, the funds accumulated for each employee are used to purchase employer stock.
1. If the stock appreciates and the plan uses a lookback, then the longer the accumulation period, the better the potential bargain for the employee, but also the greater the potential dilution to existing shareholders.
 2. The employee, by electing to make payroll contributions, is deemed to have elected to exercise an option to purchase on the next scheduled purchase date the number of shares determined by dividing the lower of the employer's stock price at the offering commencement date or the purchase

date, minus the up to 15% discount, into the total amount of payroll contributions accumulated for the employee as of the purchase date.

Example 1: XYZ Corp. sponsors an ESPP with a lookback feature and 15% discount. The ESPP's offering commencement dates are January 1 and July 1, and the purchase dates are June 30 and December 31. Employee A earns \$30,000 a year and elects to have 2% of her pay withheld on an after-tax basis from each of her paychecks. From January 1, 2001 through June 30, 2001, \$300 is withheld from Employee A's pay, and from July 1, 2001 through December 31, 2001 another \$300 is withheld. Assume XYZ Corp.'s stock trades at \$23.53 per share on January 1, 2001 and at \$34 per share on June 30, 2001. On June 30, 2001, 15 shares of XYZ Corp. stock (\$300 divided by 85% of \$23.53, the lower of XYZ Corp.'s stock price on January 1, 2001 or June 30, 2001) will be purchased for Employee A under XYZ Corp.'s ESPP. Assume further that on July 1, 2001, XYZ Corp.'s stock trades at \$34 per share, and that on December 31, 2001 XYZ Corp.'s stock trades at \$29.41 per share. On December 31, 2001, 12 shares (\$300 divided by 85% of \$29.41, the lower of XYZ Corp.'s stock price on July 1, 2001 or December 31, 2001) will be purchased for Employee A under XYZ Corp.'s ESPP.

3. Employees who change their mind about ESPP participation during an offering period are typically permitted to withdraw their accumulated payroll contributions without penalty and without prejudice regarding their ability to participate in future offering periods. If a participating employee terminates employment during an offering period, the plan will typically provide for an automatic refund of accumulated contributions and an immediate termination of ESPP participation.

II. Federal Income Tax Rules

- A. The requirements of IRC § 423 can be broken down into five categories: Eligibility; shareholder approval; grants; exercise; and holding period.
1. The eligibility requirements are:
 - a. All employees must be eligible, except that new (less than 2 years), part-time (20 hours or less per week), seasonal (5 months or less per year), and highly compensated (\$85,000 or more per year) employees may be excluded.
 - b. All eligible employees' rights under the ESPP must be the same, except that the amount of stock available for purchase may be proportional to compensation.
 - c. Each corporation in an affiliated group is treated separately, i.e., a parent can extend participation to 50% or more owned subs, but is not required to.
 - i) It is often desirable not to extend participation to employees of foreign affiliates unless the cost of dealing with foreign tax, securities, and employment law is justified.
 - (A) Sometimes it is best to implement for the employees of a foreign affiliate a separate, similar plan that does not comply with U.S. tax rules, and therefore is not a U.S. tax-qualified ESPP, but that may conform to foreign tax, securities and labor law requirements.
 - d. 5% or more shareholders cannot participate.
 2. The shareholder approval requirements are:
 - a. The plan must be approved by shareholders within 12 months before or after adoption by the board.
 - i) The only provisions requiring shareholder approval under the Internal Revenue Code, and which therefore cannot be amended after initial approval without resubmission to shareholders, are:

- (A) Total number of shares that may be issued under the plan;
 - (B) Corporations within affiliated group whose employees will be eligible; and
 - (C) Classes of employees eligible (i.e., any permissible exclusions that will apply).
- ii) Generally, unless state law, stock exchange rules, or the company's bylaws impose greater requirements, only a majority of a quorum is necessary for shareholder approval.
 - iii) Note that while an ESPP can be put into effect before shareholder approval, subject to shareholder approval before the first purchase, doing so risks having to post a charge to earnings under GAAP if the company's stock increases in value between the plan's effective date and the date of shareholder approval; therefore, this practice is often undesirable.

3. The grant requirements are:

- a. A participant must be an employee at the option's grant date.
 - i) Note that nonemployee directors and independent contractors may **not** be eligible for an ESPP.
 - ii) Employees of 50% or more parents or subsidiaries of the plan sponsor are generally treated as employees of the plan sponsor for eligibility purposes.
- b. The purchase price for ESPP stock must not be less than the lesser of (i) 85% of FMV at date of grant or (ii) 85% of FMV at date of exercise.
- c. The participant's right to purchase stock under the plan must not be transferable during the employee's life, even to family members or by gift.
- d. The total value of stock that any individual employee may purchase in any calendar year with respect to any single offering period cannot exceed \$25,000,

based on the stock's value (i.e., without application of any plan discount) at the offering commencement date (i.e., regardless of whether the purchase occurs at a price determined with respect to the offering commencement date or the exercise date).

- e. The stock cannot be purchased more than 27 months after the offering commencement date
 - i) Actually, can be purchased up to 5 years from the offering commencement date if the purchase price before subtracting the discount is pegged to FMV at the purchase date rather than the offering commencement date, but such plans are rarely seen in practice.

4. The purchase requirement is:

- a. The participant must have been employed by the corporation continuously up to a date no more than three months (one year in the case of disability) before the purchase date.

5. The holding period requirements are:

- a. In order for the employee to receive favorable tax treatment, the shares purchased under an ESPP must not be disposed of earlier than the later to occur of:
 - i) The date that is two years after the offering commencement date; or
 - ii) One year after the purchase date.

B. If all of the requirements explained above are satisfied, the federal income tax treatment of ESPP activity is:

- 1. The employee's receipt of the option is not taxable to him or her.
- 2. The employee's purchase of shares is not taxable to him or her either, even though at the date of exercise the stock will typically be readily tradable and will have a value at least 15% in excess of what the employee pays for it.
 - a. Unlike with incentive stock options under IRC § 422 ("ISO's"), with ESPP shares the excess of the shares'

FMV over the amount paid for them by the employee is not an alternative minimum tax (“AMT”) preference item.

Example 2: Assume the same facts as in Example 1 and also that Employee A does not dispose in 2001 of any of the XYZ Corp. stock that she acquired in 2001 under XYZ Corp.'s ESPP. Employee A will not owe any federal income tax for 2001 based on her participation in XYZ Corp.'s ESPP.

3. The IRS has taken the position that although it escapes income taxation, the excess of the FMV of ESPP shares at the purchase date over the amount paid by the employee is subject to FICA (i.e., social security) and FUTA (i.e., unemployment) tax. However, in IRS Notice 2000-14 (see below), the IRS stated that it would not attempt to enforce this position until 2003.
4. As with an ISO, however, except in the case of a disqualifying disposition (see below), the employer does not receive a federal income tax deduction for an employee's purchase of ESPP shares, not even for the 15% discount received by the employee.

Example 3: Assume the same facts as in Examples 1 and 2. XYZ Corp. will not receive a 2001 Federal income tax deduction in connection with Employee A's participation in XYZ Corp.'s ESPP.

5. IRC § 423(c) contains a special rule that in the case of a **qualifying** disposition of stock acquired under an ESPP (that is, in the case of a sale that meets the “two years from offering commencement date/one year from purchase date” holding period requirements) taxes as ordinary income to the employee at the time of disposition the lesser of the excess of the FMV of the stock at the offering commencement date over the purchase price (i.e., the up to 15% discount measured at the offering period commencement date) or the gain ultimately realized by the employee on the sale of the stock. In other words, if the stock is disposed of in a disposition that meets the ESPP holding period requirements, the IRS compares the FMV of the stock at the

offering commencement date with the “option price” (i.e., the purchase price based on the offering commencement date FMV), and then compares that amount with the amount that the employee actually earned on the stock when he or she disposed of it. The lesser of the two amounts is ordinary income to the employee, and any remaining amount of gain is capital gain, long-term since in order to be a qualifying disposition the employee will have to have met the “two years from offering commencement date/or one year from purchase date” ESPP holding period requirements and therefore will by definition have met the one-year long-term capital gain holding period requirement as well. Note that for the purpose of calculating the employee’s ordinary income on a qualifying disposition the IRS uses the shares’ FMV at the offering commencement date even if FMV declined between the offering commencement date and the purchase date, so that the employee ended up paying 85% of the lower purchase date FMV, and effectively received a smaller actual discount amount.

- a. The employer still does not receive a deduction for any portion of the amount realized by the employee in a **qualifying disposition**, even for the ordinary income amount described immediately above.

Example 4: Assume the same facts as in Examples 1, 2, and 3, and assume also that in 2004 Employee A sells for \$900 all 27 of the shares she acquired for \$600 in 2001. Of Employee A's total economic gain of \$300 (\$900 sales price - \$600 actually paid for the shares), \$114.14 ([15 shares x 15% x \$23.53 per share] + [12 shares x 15% x \$34.00 per share]) represents the 15% discount that Employee A received under the ESPP based on the offering period commencement date prices of each of the two blocks of shares she acquired in 2001. Therefore, \$114.14 of Employee A's \$300 gain is taxed to her in 2004 as ordinary income. This \$114.14 amount is added to Employee A's federal income tax basis in the 27 shares, so that her remaining gain is

\$185.86 (\$900 – [\$600 + \$114.14]). This gain is taxed to Employee A as long-term capital gain, since the one-year holding period requirement was met with respect to both blocks of shares. XYZ Corp. has no deduction in connection with Employee A's sale of the shares, not even for the \$114.14 that is taxable to Employee A as ordinary income. See Treas. Reg. § 1.423-2(k)(ii).

6. If the employee makes a **disqualifying** disposition (i.e., sells the shares purchased before either two years have elapsed from the offering period commencement date or one year from the purchase date), then the employee will have ordinary income in an amount equal to the excess of the shares' FMV at the purchase date over the amount the employee paid for them.
 - a. Any excess of the total amount received by the employee on his or her ultimate disposition of the shares over this ordinary income amount will be capital gain, long- or short-term depending on whether the shares were held by the employee for more than one year after being purchased by him or her under the ESPP.
 - b. In a **disqualifying** disposition, the employer receives a deduction for the amount of ordinary income realized by the employee or former employee.

Example 5: Assume the same facts as in Example 2, except that Employee A sells all 27 shares in the second half of 2002, before two years have elapsed since the offering commencement date. Because this is a disqualifying disposition, \$262.93 of Employee A's gain [15 shares x (\$34.00 per share - .85 x \$23.53 per share)] + [12 shares x (\$29.41 per share - .85 x \$29.41 per share))] will be ordinary income to her, and XYZ Corp. may receive a \$262.93 federal income tax deduction. Employee A's remaining

\$27.07 (\$300 - \$262.93) of gain will be capital gain. It will be long-term to the extent, if any, attributable to the first block of shares, since these were held for more than one year, and short-term to the extent, if any, attributable to the second block of shares, since these were held for less than one year.

- c. Note that the ordinary income calculations for qualifying and disqualifying dispositions are quite different. In a **qualifying** disposition, the ordinary income amount is the lesser of the discount percentage, e.g. 15%, times the stock's offering commencement date FMV (the offering date FMV is used for this purpose even if the stock's FMV declined between the offering commencement date and the purchase date and the shares are actually purchased at the lower purchase date FMV, minus the discount) or the employee's actual gain on the stock's sale. In a **disqualifying** disposition, the ordinary income amount is simply the excess of the stock's FMV at the purchase date over the amount paid by the employee to purchase the shares on the purchase date. This will never be lower than the shares' offering commencement date FMV times the discount percentage, but it may be a higher amount if the stock's FMV increased between the offering commencement date and the purchase date. Moreover, the employee's actual gain on the eventual sale of the shares is irrelevant for the purpose of this calculation. That is, in a disqualifying disposition of ESPP stock, the employee will recognize ordinary income equal to the excess of the stock's FMV at the purchase date over the amount the employee paid for the shares on the purchase date even if, after the purchase date and before the employee's sale of the shares, the stock's FMV declined so that the employee's actual gain was less than the spread at the purchase date.
- i) This rule for determining the taxable amount on a disqualifying disposition of ESPP stock also differs from the rule for ISO disqualifying dispositions. In an ISO disqualifying disposition, the employee's ordinary income is

limited to the employee's gain on the disposition of the shares. That is, if the employee's gain on an ISO disqualifying disposition is less than the spread at the ISO's exercise, the employee's ordinary income is equal to his or her gain at the shares' disposition.

- d. Note that the employee's or former employee's ordinary income on a disqualifying disposition is always equal to the excess of the shares' actual FMV at the purchase date over the actual price paid by the participant at purchase date, regardless of whether the discounted price paid by the employee was pegged to the shares' FMV at the offering period commencement date or the purchase date, and regardless of whether the ordinary income amount, so calculated, exceeds the employee's gain on the ultimate disposition of the shares.

Example 6: Assume the same facts as in Example 5, except that when Employee A sells the shares in 2002, the total proceeds are only \$500, that is, Employee A has a \$100 (\$600 paid for the shares - \$500 sales proceeds) economic loss. Employee A still has \$262.93 in ordinary income, and XYZ Corp. may still receive a \$262.93 federal income tax deduction. Employee A also has a \$362.93 capital loss (\$600 actually paid for shares + \$262.93 phantom gain treated as ordinary income and added to tax basis - \$500 sale proceeds). This \$362.93 capital loss will be long-term to the extent, if any, attributable to the first block of shares and short-term to the extent, if any, attributable to the second block.

- e. In order to obtain a deduction in connection with an employee's disqualifying disposition, the employer must:

- i) Have an administrative system (e.g., require that any sales until the expiration of the ESPP holding period be made through a “captive broker,” or institute a system of employee and former employee self-reporting) to capture disqualifying disposition information.
- ii) Report the amount of ordinary income realized by the employee or former employee on the disqualifying disposition on an IRS Form W-2 or a 1099-MISC.

Example 7: Assume the same facts as in Examples 5 and 6. If XYZ Corp. doesn't know that Employee A has made a disqualifying disposition, it won't report to the IRS on a Form W-2 or 1099-MISC the \$262.93 in ordinary income realized by Employee A on her sale of the stock, and XYZ Corp. will not deduct this amount for federal income tax purposes.

- (A) In the author's experience, employers have not had uniform procedures for collecting or reporting data regarding disqualifying dispositions.
 - (1) The data collected by the employer for purposes of reporting under Section 6039 of the Code, discussed below, may be insufficient, because the first transfer by the employee, which may be the last transfer about which the employer is required to collect information, may be to the employee's own broker in street name, and thus may not be a true disposition, disqualifying or otherwise.

- f. After many years of controversy, the Internal Revenue Service (the “IRS”) recently issued Notice 2001-14,

which provides that no federal income tax **withholding** is required with respect to disqualifying dispositions of ESPP stock (or ISO's, for that matter) until 2003.

7. Section 6039 of the Code requires employers with ESPP's to provide participants annually on or before January 31 each year with a notice regarding the employee's ESPP activity in the prior year.

III. ERISA

- A. Since ESPPs do not provide "welfare benefits" and also do not provide retirement income or defer the receipt of compensation until termination of employment, they are not covered by ERISA. See ERISA §§ 3(1), 3(2), and 3(3).

IV. Securities Law

- A. Since virtually all employees are eligible for an ESPP, there generally is no applicable exemption from registration (ESPP's and stock sold under them are typically registered on an SEC Form S-8).

V. Financial Accounting

- A. APB 25, which notwithstanding its favorable rules for stock options generally requires a charge to earnings for any discount at the date of grant of an option, contains a special favorable rule for ESPP's and other broad-based plans that permit employees to purchase stock in their employer. These plans will not cause an earnings charge if they meet certain requirements.
 1. To qualify for this rule that the discount is not charged to earnings, a plan must have the following features:
 - a. Subject to certain minimum service requirements, substantially all full-time employees must be eligible;
 - b. Stock must be offered to all eligible employees either equally or based on a uniform percentage of pay;
 - c. The purchase period must be limited to a reasonable length;
 - d. The purchase price discount must be no greater than would be reasonable in an offer to shareholders or others.

- i) FASB Interpretation No. 44 (“FIN 44”) provides that a discount of up to 15% from FMV at the offering period commencement date will generally be reasonable, and that a discount equal to the lower of 15% of FMV at the offering commencement date or the purchase date will be reasonable for an ESPP, i.e., a plan that qualifies under IRC § 423.

Example 8: Assume the same facts as in Examples 1 through 7. XYZ Corp. does not incur a charge to earnings under GAAP in connection with XYZ Corp.’s ESPP during any of the years involved in the Examples.

VI. ESPP Design

- A. While the Internal Revenue Code generally limits to \$25,000 per year the amount of stock that any one employee may purchase under an ESPP, measured based on 100% of the stock’s FMV at the offering period commencement date, most companies effectively impose a lower average limit by restricting the percentage of an employee’s pay that can be set aside to purchase stock.
 1. The Employer can also use a flat dollar amount at any point below \$25,000 to limit purchase by highly compensated employees.
- B. An aggressive plan design used by many technology companies (and that any company whose stock price is hitting historic lows and that wants to implement a strong employee retention device may wish to consider) features long offering periods (e.g., 24 months), multiple purchase dates in each offering period (e.g., every 6 months) and staggered offering commencement dates (e.g., every 6 months). This design locks in the lowest possible lookback price for the longest period of time, but also permits a disadvantageous lookback price to be jettisoned if the stock “goes south”

Example 9: Assume an ESPP is implemented with 24-month offering periods, six-month

purchase dates, and the commencement of a new offering period every six months. If six months after the first offering commencement date the employer's stock price has increased, then on the first six-month purchase date employees in the first offering period will buy at 85% of the stock's FMV at the beginning of the first offering period, that is, at an effective discount in excess of 15% when compared to FMV at the actual date of purchase, and the first offering period, with its favorable lookback price, remains in effect for the employees who made it into the first offering period. On the other hand, if the stock price declined between the offering commencement date of the first offering period and the first purchase date of the first offering period, then the employees buy at the lower 85% of FMV at the purchase date and are shifted into the second offering period, while the first offering period, with its now disadvantageous lookback price, is shut down. Whether or not the stock price has increased or decreased, new employees who joined the company in the last six months go into the new offering period that commences on the day following the first offering period's first purchase date.

- C. The most significant issue for setting a ceiling on the number of shares subject to an ESPP, and for determining the length of the offering period and whether to have Silicon Valley-style 24-month staggered offering periods, is shareholder dilution.
 - 2. The range of percentages of the total number of an employer's outstanding shares available through the employer's ESPP generally appears in the market-place to be from 1% to 9%, with 3% to 4% being a common figure.
 - a. Depends on industry, e.g. tech companies will typically be at higher percentages.
 - b. "Evergreen" provisions to constantly replenish pool of available shares are becoming more popular, although some institutional shareholders may oppose these.

- c. Institutional shareholders will look closely at potential dilution, but tend to view ESPPs, which are broad-based, more favorably than executive option plans.

AN EXAMPLE “PLAIN VANILLA” ESPP PLAN DOCUMENT IS ATTACHED

XYZ CORPORATION, INC.
EMPLOYEE STOCK PURCHASE PLAN

1. **Purpose.** The purpose of this XYZ Corporation, Inc. Employee Stock Purchase Plan is to provide employees of the Company and its Designated Subsidiaries with an opportunity to purchase Common Stock of the Company through accumulated payroll deductions. It is the intention of the Company to have the Plan qualify as an "Employee Stock Purchase Plan" under Section 423 of the Internal Revenue Code of 1986, as amended. The provisions of the Plan, accordingly, shall be construed in a manner consistent with the requirements of Section 423 and related sections of the Code.

2. **Definitions.**

(a) "**Board**" shall mean the Company's Board of Directors.

(b) "**Code**" shall mean the Internal Revenue Code of 1986, as amended.

(c) "**Common Stock**" shall mean the Common Stock, \$.01 par value, of the Company.

(d) "**Company**" shall mean XYZ Corporation, Inc., a Delaware corporation, and any Designated Subsidiary of the Company.

(e) "**Compensation**" shall mean all cash compensation received by an Employee from the Company or a Designated Subsidiary and includable in the Employee's gross income for federal income tax purposes, other than any taxable reimbursements. By way of illustration, but not limitation, "Compensation" shall include regular compensation such as salary, wages, overtime, shift differentials, bonuses, commissions, and incentive compensation, but shall exclude relocation reimbursements, expense reimbursements, tuition or other reimbursements, and income realized as a result of participation in any stock option, stock purchase, or similar plan of the Company or any Designated Subsidiary.

(f) "**Designated Subsidiary**" shall mean any Subsidiary of the Company designated by the Board from time to time in its sole discretion as eligible to participate in the Plan.

(g) "**Employee**" shall mean any individual who is an employee of the Company for tax purposes. For purposes of the Plan, the employment relationship shall be treated as continuing intact while the individual is on sick leave or other leave of absence approved by the Company., except that where the period of leave exceeds 90 days and the individual's right to reemployment is not guaranteed by either statute or contract, the employment relationship shall be deemed to have terminated on the 91st day of such leave.

(h) "**Fair Market Value**" shall mean, as of any date, the value of Common Stock determined as follows:

(1) If the Common Stock is listed on an established stock exchange or national market system, including, without limitation, the Nasdaq National Market or the Nasdaq SmallCap Market of The Nasdaq Stock Market, its Fair Market Value shall be the closing sales price for such stock (or the closing bid, if no sales were reported) as quoted on such exchange or system for the last market trading day on the date of such determination, as reported in *The Wall Street Journal* or such other source as the Board deems reliable, or;

(2) If the Common Stock is regularly quoted by a recognized securities dealer, but selling prices are not reported, its Fair Market Value shall be the mean of the closing bid and asked prices for the Common Stock on the date of such determination, as reported in *The Wall Street Journal* or such other source as the Board deems reliable, or;

(3) In the absence of an established market for the Common Stock, the Fair Market Value thereof shall be determined in good faith by the Board.

(i) "Offering Commencement Date" shall mean the first day of each Offering Period.

(j) "Offering Period" shall mean a period of approximately six months during which funds may be accumulated for the exercise of option, commencing and ending as follows: Commencing on the first Trading Day on or after January 1, and terminating on the last Trading Day in the period ending June 30; and commencing on the first Trading Day on or after July 1, and ending on the last Trading Day in the period ending the following December 31. The duration of Offering Periods may be changed pursuant to Section 4 of this Plan.

(k) "Parent" shall mean a corporation, domestic or foreign, that owns not less than 50% of the voting shares of the Company or of another Parent, whether or not such corporation now exists or is hereafter organized or acquires the Company or a Parent.

(l) "Participant" shall mean an eligible Employee who has elected to participate in the Plan.

(m) "Plan" shall mean this XYZ Corporation, Inc. Employee Stock Purchase Plan.

(n) "Purchase Date" shall mean the last day of each Offering Period.

(o) "Purchase Price" shall mean an amount equal to 85% of the Fair Market Value of a share of Common Stock on the Offering Commencement Date or on the Purchase Date, whichever is lower; provided, however, that the Purchase Price may be adjusted by the Board pursuant to Section 20 of this Plan.

(p) "Reserves" shall mean the number of shares of Common Stock covered by each option under the Plan that have not yet been exercised and the number of shares of Common Stock that have been authorized for issuance under the Plan, but not yet placed under option.

(q) "Subsidiary" shall mean a corporation, domestic or foreign, of which not less than 50% of the voting shares are held by the Company or another Subsidiary, whether or not such corporation now exists or is hereafter organized or acquired by the Company or a Subsidiary.

(r) "Trading Day" shall mean a day on which national stock exchanges and the Nasdaq System are open for trading.

3. Eligibility.

(a) Any Employee employed by the Company on a given Offering Commencement Date shall be eligible to participate in the Plan, except:

(1) Any Employee employed by the Company for less than three (3) months before the applicable Offering Commencement Date;

(2) Any Employee whose customary employment is less than 20 hours per week; and

(3) Any Employee whose customary employment is not more than five (5) months in any calendar year.

(b) Any provisions of the Plan to the contrary notwithstanding, no Employee shall be granted an option under the Plan (i) to the extent that, immediately after the grant, such Employee (including by attribution under Section 424(d) of the Code) would own capital stock of the Company and/or hold outstanding options to purchase stock of the Company constituting in the aggregate five percent (5%) or more of the total combined voting power or value of all classes of the capital stock of the Company, or (ii) to the extent that his or her option rights to purchase stock under this Plan and any other employee stock purchase plans of the Company and its subsidiaries exceeds Twenty-Five Thousand Dollars (\$25,000) worth of stock (determined at the fair market value of the shares at the time such option is granted) in the aggregate for each calendar year in which such option right is outstanding at any time.

4. Offering Periods. The Plan shall be implemented by consecutive Offering Periods of six (6) months' duration, with a new Offering Period commencing on the first Trading Day on or after January 1 and July 1 each year, or on such other date as the Board shall determine, and continuing thereafter until terminated in accordance with Section 20 hereof[; provided, however, that the first Offering Period shall not commence until the Plan has been approved by the Company's shareholders and may commence on a trading day after the first Trading Day on or after January 1 or July 1, and that the first Offering Period may be of less than six (6) months' duration]]. The Board shall have the power to change the duration and timing of Offering Periods with respect to future offerings without shareholder approval.

5. Participation

(a) An eligible Employee may become a Participant in the Plan by completing a subscription agreement authorizing payroll deductions in the form provided by the Company and filing it with the designated human resources representative of the Company before the applicable Offering Commencement Date, unless a later time for submission is set by the Board for all eligible Employees with respect to a given Offering Period.

(b) Payroll deductions for a Participant shall commence on the first payroll date occurring on or after the applicable Offering Commencement Date and shall end on the last payroll date occurring on or before the Purchase Date of the Offering Period to which such authorization is applicable, unless sooner terminated by the Participant as provided in Section 10 hereof.

6. Payroll Deductions.

(a) At the time a Participant files his or her subscription agreement, he or she shall elect to have payroll deductions made on each pay day during the Offering Period in an amount equal to a whole percentage (e.g., 1%, 2%, etc.), but not exceeding fifteen percent (15%), of the Compensation that he or she receives on each pay day during the Offering Period.

(b) All payroll deductions made for a Participant shall be credited to his or her account under the Plan. A Participant may not make any additional payments into such account. A Participant's account shall be only a bookkeeping account maintained by the Company, and neither the Company nor any Subsidiary shall be obligated to segregate or hold in trust or escrow any funds in a Participant's account. Except for amounts not expended because of the Plan rule that fractional shares shall not be purchased, no amount of accumulated payroll deductions shall be carried over with respect to any Participant from the end of one offering period to the beginning of another.

(c) A Participant may discontinue his or her participation in the Plan as provided in Section 10 hereof, but no other change can be made and, specifically, a Participant may not alter the rate of his or her payroll deductions during an Offering Period. A Participant's subscription agreement shall remain in effect for successive Offering Periods unless terminated as provided in Section 10 hereof.

(d) Notwithstanding the foregoing, to the extent necessary to comply with the limitations of Section 423(b)(8) of the Code and Section 3(b) hereof, a Participant's payroll deductions may be decreased to zero percent (0%) at any time during an Offering Period. In such event, payroll deductions shall recommence at the rate provided in such Participant's subscription agreement at the beginning of the

first Offering Period scheduled to end in the following calendar year, unless terminated by the Participant as provided in Section 10 hereof

(e) At the time the option is exercised, in whole or in part, or at the time some or all of the Company's Common Stock issued under the Plan is disposed of, the Participant must make adequate provision for federal, state, or other tax withholding obligations, if any, arising upon the exercise of the option or the disposition of the Common Stock. The Company may, but shall not be obligated to, withhold from the Participant's compensation the amount necessary for the Company to meet applicable withholding obligations related to the Participant's tax obligations, including any withholding required to make available to the Company any tax deductions or benefits attributable to sale or early disposition of Common Stock by the Employee that may be available to it.

7. Grant of Option. Effective on the Offering Commencement Date of each Offering Period, each eligible Employee participating in such Offering Period shall be granted an option to purchase on the Purchase Date of such Offering Period, at the applicable Purchase Price, a number of shares of the Company's Common Stock determined by dividing such Employee's total payroll deductions actually made before such Purchase Date and retained in the Participant's account as of the Purchase Date by the applicable Purchase Price without adjustment for changes in the Compensation of the Participant

8. Exercise of Option. Unless a Participant withdraws from the Plan as provided in Section 10 hereof, or except to the extent that the limitation of Section 423(b)(8) of the Code would otherwise be violated, his or her option for the purchase of shares shall be exercised automatically on the Purchase Date, and the maximum number of full shares subject to the option shall be purchased for such Participant at the applicable Purchase Price with the accumulated payroll deductions in the Participant's account. No fractional shares shall be purchased; any payroll deductions accumulated in a Participant's account that are insufficient to purchase a full share shall be retained in the Participant's account for the subsequent Offering Period, subject to earlier withdrawal by the Participant as provided in Section 10 hereof. Any other funds left over in a Participant's account after the Purchase Date shall be returned to the Participant. During a Participant's lifetime, a Participant's option to purchase shares hereunder is exercisable only by him or her.

9. Delivery. As promptly as practicable after each Purchase Date on which a purchase of shares occurs, the Company shall arrange for the delivery to each Participant or his or her broker, or to a broker designated by the Committee, of a stock certificate evidencing the shares purchased upon exercise of the option. Shares may be registered in the name of the Participant or jointly in the name of the Participant and his or her spouse as joint tenants with right of survivorship, or as community property.

10. Withdrawal.

(a) A Participant may withdraw all, but not less than all, the payroll deductions credited to his or her account and not yet used to exercise his or her option under the Plan at any time on or before fifteen (15) calendar days before the Purchase Date by giving written notice to the designated human resources representative of the Company in the form provided by the Company. All of the Participant's payroll deductions credited to his or her account shall be paid to such Participant promptly after receipt of notice of withdrawal, such Participant's option for the Offering Period shall automatically be terminated, and no further payroll deductions for the purchase of shares shall be made for such Offering Period. If a Participant withdraws from an Offering Period, payroll deductions shall not resume at the beginning of the succeeding Offering Period or any Offering Period thereafter unless the Participant delivers to the Company a new subscription agreement.

(b) A Participant's withdrawal from an Offering Period shall not have any effect upon his or her eligibility to participate in any succeeding Offering Period commencing after the termination of the Offering Period from which the Participant withdraws.

11. Termination of Employment. Upon a Participant's ceasing to be an Employee for any reason at any time on or before an Purchase Date of an Offering Period, he or she shall be deemed to have elected to withdraw from the Plan, and the payroll deductions credited to such Participant's account during

such Offering Period shall be returned to such Participant or, in the case of his or her death, to the person or persons entitled thereto under Section 15 hereof, and such Participant's option shall be automatically terminated.

12. No Interest. No interest shall accrue or be payable on the payroll deductions of a Participant in the Plan.

13. Stock.

(a) The shares of Common Stock to be sold to Participants under the Plan may, at the election of the Company, be either treasury shares or shares originally issued by the Company.

(b) Subject to adjustment upon changes in capitalization of the Company as provided in Section 19 hereof, the maximum number of shares of the Company's Common Stock available for sale under the Plan shall be _____ shares. If on a given Purchase Date the number of shares with respect to which options are to be exercised exceeds the number of shares then available under the Plan, the Company shall make a pro rata allocation of the shares remaining available for purchase in as uniform a manner as shall be practicable and as it shall determine to be equitable.

(c) The Participant shall have no interest or voting rights in shares covered by his or her option or in any dividends declared by the Company in respect of its outstanding Common Stock until such option has been exercised.

(d) Shares to be delivered to a Participant under the Plan shall be registered in the name of the Participant or in the name of the Participant and his or her spouse, as designated by the Participant.

14. Administration. The Plan shall be administered by the Board or a designated committee of members of the Board appointed by the Board. Initially, the Board has designated the Compensation Committee of the Board of Directors as responsible for administering the Plan. The Board or its designated committee shall have full and exclusive discretionary authority to construe, interpret and apply the terms of the Plan, to determine eligibility and to adjudicate all disputed claims filed under the Plan. Every finding, decision, and determination made by the Board or its designated committee shall, to the fullest extent permitted by law, be final and binding upon all parties.

15. Designation of Beneficiary.

(a) A Participant may file a written designation of a beneficiary who is to receive any shares and cash, if any, from the Participant's account under the Plan in the event of such Participant's death subsequent to an Purchase Date on which the option is exercised, but before delivery to such Participant of such shares and cash. In addition, a Participant may file a written designation of a beneficiary who is to receive any cash from the Participant's account under the Plan in the event of such Participant's death before exercise of the option. If a Participant is married and the designated beneficiary is not the spouse, spousal consent shall be required for such designation to be effective.

(b) Such designation of beneficiary maybe changed by the Participant at any time by written notice. In the event of the death of a Participant and in the absence of a beneficiary validly designated under the Plan who is living at the time of such Participant's death, the Company shall deliver such shares and/or cash to the executor or administrator of the estate of the Participant or, if to the best of the Company's knowledge no such executor or administrator has been appointed, the Company, in its discretion, may deliver such shares and/or cash to the spouse or to any one or more dependents or relatives of the Participant, or if no spouse, dependent, or relative is known to the Company, then to such other person as the Company may designate.

16. Transferability. Neither payroll deductions credited to a Participant's account nor any rights with regard to the exercise of an option or to receive shares under the Plan may be assigned,

transferred, pledged, or otherwise disposed of in any way (other than by will, the laws of descent and distribution, or as provided in Section 15 hereof) by the Participant. Any such attempt at assignment, transfer, pledge, or other disposition shall be without effect, except that the Company may treat such act as an election to withdraw funds from an Offering Period in accordance with Section 10 hereof.

17. **Use of Funds.** All payroll deductions received or held by the Company under the Plan shall be general corporate funds and as such may be used by the Company for any corporate purpose, and the Company shall not be obligated to segregate such payroll deductions or pay interest thereon.

18. **Reports.** Individual accounts shall be maintained for each Participant in the Plan. Statements of account shall be given to Participants at least annually, which statements shall set forth the amounts of payroll deductions, the Purchase Price, the number of shares purchased, and the remaining cash balance, if any.

19. **Adjustments Upon Changes in Capitalization, Dissolution, Liquidation, Merger, or Asset Sale.**

(a) **Changes in Capitalization.** Subject to any required action by the shareholders of the Company, the Reserves, the maximum number of shares each Participant may purchase per Offering Period, as well as the price per share and the number of shares of Common Stock covered by each option under the Plan which has not yet been exercised shall be proportionately adjusted for any increase or decrease in the number of issued shares of Common Stock resulting from a stock split, reverse stock split, stock dividend, combination or reclassification of the Common Stock, or any other increase or decrease in the number of shares of Common Stock effected without receipt of consideration by the Company; provided, however, that conversion of any convertible securities of the Company shall not be deemed to have been "effected without receipt of consideration." Such adjustment shall be made by the Board, whose determination in that respect shall be final and binding on all parties. Except as expressly provided herein, no issuance by the Company of shares of stock of any class, or of securities convertible into shares of stock of any class, shall affect, and no adjustment by reason thereof shall be made with respect to, the number or price of shares of Common Stock subject to an option.

(b) **Dissolution or Liquidation.** In the event of the proposed dissolution or liquidation of the Company, the Offering Period then in progress shall be shortened by setting a new Purchase Date (the "New Purchase Date"), and shall terminate immediately before the consummation of such proposed dissolution or liquidation, unless provided otherwise by the Board. The New Purchase Date shall be before the date of the Company's proposed dissolution or liquidation. The Board shall notify each Participant in writing, at least ten (10) business days before the New Purchase Date, that the Purchase Date for the Participant's option has been changed to the New Purchase Date and that the Participant's option shall be exercised automatically on the New Purchase Date, unless before such date the Participant has withdrawn from the Offering Period as provided in Section 10 hereof

(c) **Merger or Asset Sale.** In the event of a sale of all or substantially all of the assets of the Company, or the merger of the Company with or into another corporation, each outstanding option shall be assumed, or an equivalent option substituted, by the successor corporation or a Parent or Subsidiary of the successor corporation. In the event that the successor corporation refuses to assume the option or substitute equivalent options, the Offering Period then in progress shall be shortened by setting a new Purchase Date (the "New Purchase Date"). The New Purchase Date shall be before the date of the Company's proposed sale or merger. The Board shall notify each Participant in writing, at least ten (10) business days before the New Purchase Date, that the Purchase Date for the Participant's option has been changed to the New Purchase Date and that the Participant's option shall be exercised automatically on the New Purchase Date, unless before such date the Participant has withdrawn from the Offering Period as provided in Section 10 hereof.

20. **Amendment and Termination.**

(a) The Board of Directors of the Company may at any time and for any reason terminate or amend the Plan. Except as provided in Section 19 hereof, no such termination can affect options previously granted, provided that an Offering Period may be terminated by the Board of Directors on any Purchase Date if the Board determines that the termination of the Offering Period or the Plan is in the best interests of the Company and its shareholders. Except as provided in Section 19 and this Section 20 hereof, no amendment may make any change in any option theretofore granted that adversely affects the rights of any Participant. To the extent necessary to comply with Section 423 of the Code (or any other applicable law, regulation, or stock exchange rule), the Company shall obtain shareholder approval in such manner and to such degree as required.

(b) Without shareholder consent and without regard to whether any Participant's rights may be considered to have been "adversely affected," the Board shall be entitled to: change the Offering Periods, the maximum amount of permitted payroll deductions, and the frequency and/or number of permitted changes in the amount withheld during an Offering Period; establish the exchange ratio applicable to amounts withheld in a currency other than U. S. dollars; permit payroll withholding in excess of the amount designated by a Participant in order to adjust for delays or mistakes in the Company's processing of properly completed withholding elections; establish reasonable waiting and adjustment periods and/or accounting and crediting procedures to ensure that amounts applied toward the purchase of Common Stock for each Participant properly correspond with amounts withheld from the Participant's Compensation; and establish such other limitations and procedures as the Board determines in its sole discretion are advisable.

(c) In the event that the Board determines that the ongoing operation of the Plan may result in unfavorable financial accounting consequences, the Board may, in its discretion and, to the extent necessary or desirable, modify or amend the Plan to reduce or eliminate such accounting consequences including, but not limited to:

(1) altering the Purchase Price for any Offering Period, including an Offering Period underway at the time of the change in Purchase Price; or

(2) shortening any Offering Period so that the Offering Period ends on a new Purchase Date, including an Offering Period underway at the time of the Board action.

Such modifications or amendments shall not require stockholder approval or the consent of any Plan Participants.

21. Notices. All notices or other communications by a Participant to the Company under or in connection with the Plan shall be deemed to have been duly given when received in the form specified by the Company at the location, or by the person, designated by the Company for the receipt thereof.

22. Conditions Upon Issuance of Shares.

(a) Shares shall not be issued with respect to an option unless the exercise of such option and the issuance and delivery of such shares pursuant thereto will comply with all applicable provisions of law, domestic or foreign, including, without limitation, the Securities Act of 1933, as amended, the Securities Exchange Act of 1934, as amended, the rules and regulations promulgated thereunder, and the requirements of any stock exchange on which the shares may then be listed, and shall be further subject to the approval of counsel for the Company with respect to such compliance.

(b) As a condition to the exercise of an option, the Company may require the person exercising such option to represent and warrant at the time of any such exercise that the shares are being purchased only for investment and without any present intention to sell or distribute such shares if, in the opinion of counsel for the Company, such a representation is required by any of the aforementioned applicable provisions of law.

23. Term of Plan. The Plan shall become effective at the first Offering Commencement Date following its [[adoption by the Board[[, subject to]]]] approval by the shareholders in accordance with Treasury Regulations Section 1.423-2(c) within 12 months [[before or]] after its adoption by the Board. Once effective, the Plan shall continue in effect for a term of ten (10) years unless sooner terminated by the Board pursuant to Section 20 hereof.

24. Additional Restrictions of Rule 16b-3. The terms and conditions of options granted hereunder to, and the purchase of shares by, persons subject to Section 16 of the Exchange Act shall comply with the applicable provisions of Rule 16b-3. In the cases of any such persons, this Plan and options issued to such persons shall be deemed to contain, and the shares issued upon exercise of such options shall be subject to, such additional conditions and restrictions as may be required by Rule 16b-3 to qualify for the maximum exemption from Section 16 of the Exchange Act with respect to Plan transactions on behalf of such persons.