# The ESPP Guide

> An employee stock purchase plan often advertises a 15 percent discount, but with a lookback the real return can be far larger. This guide shows why, and the tax that follows.

An employee stock purchase plan is one of the most reliable deals in personal finance, and most people underrate it. The headline is a modest discount, but a common feature called the lookback quietly turns that into a much larger effective return.

## How the discount and lookback work

An ESPP lets you buy company stock at a discount, commonly 15 percent, through payroll deductions over an offering period. On its own, a 15 percent discount is a solid, low-risk return.

The lookback is where it gets powerful. With a lookback, the discount applies to the lower of the price at the start of the offering period and the price on the purchase date. So if the stock rose during the period, you still buy at a discount off the old, lower price, capturing both the discount and the appreciation.

## A worked example you can reproduce

Say the stock was 100 dollars at the start of the offering period and 120 dollars on the purchase date, with a 15 percent discount and a lookback. The discount applies to the lower price, so you pay 85 percent of 100 dollars, which is 85 dollars a share.

You immediately own something worth 120 dollars for 85 dollars, a gain of 35 dollars a share. That is a 41 percent return on your money, and an effective discount of about 29 percent off the current price, far more than the 15 percent headline. The ESPP Calculator computes this for your plan.

## The tax, and when to sell

The discount you receive is taxed as ordinary income, and any gain beyond that is a capital gain. How it is split depends on how long you hold. A disqualifying disposition, selling soon after purchase, taxes more of the benefit as ordinary income. A qualifying disposition, holding more than two years from the offering date and more than one year from purchase, shifts more of the gain to lower long-term capital gains rates.

Many people sell immediately to lock in the discount and avoid holding a concentrated position in their employer, accepting the ordinary-income tax as the cost of a near-guaranteed return. Others hold for the tax break if they are comfortable with the single-stock risk. The Capital Gains Tax Guide covers the holding-period rates.

**Key takeaway.** A 15 percent ESPP discount with a lookback can be a 25 to 30 percent effective return. It is often the best low-risk deal an employee has, even after the ordinary-income tax.

## Assumptions

- The plan offers a discount off the purchase price, often 15 percent, and many plans add a lookback.
- The lookback applies the discount to the lower of the price at the start of the offering period and the price on the purchase date.

## Sources


- IRS, employee stock purchase plans (Pub. 525)
- IRS, stock options and ESPP dispositions