

United States

Gary Rothstein, Morgan Lewis & Bockius

www.practicallaw.com/8-203-9695

1. Is it common in your jurisdiction for employees to be offered participation in an employee share plan, involving either the grant of share options or the purchase of shares?

Employee incentives through share-based plans are a long-standing practice in the US and are generally thought to improve company performance. In the 1980s and 1990s, there was large growth in the use of share options in particular. However, in recent years there has been a shift away from share options to other forms of equity compensation.

In most cases, share-based plans focus on rewarding key senior employees, although, depending on the industry, it is not unusual to have share-based plans extending far beyond the executive level in the company. In addition, many listed companies make available broad-based plans in which all employees of the company can acquire shares.

Virtually all US listed companies offer some form of share-based compensation. Privately-held companies that aim to undergo an initial public offering (or even a sale) as an exit strategy for their investors also typically operate share plans. US companies with a foreign parent company may also offer plans based on the foreign parent company's shares to successfully compete in the labour pool.

2. Is it lawful to offer participation in an employee share plan where the shares to be acquired are shares in a foreign parent company?

A non-US company is not prohibited from offering shares to employees of its US subsidiaries. In addition, there are no exchange controls that would prevent money from leaving the US in consideration for shares. However, offering any shares, whether in a domestic company or a foreign company, must either be through a registration statement filed with governmental authorities, or exempt from such registration (see *Question 8*).

3. What are the main types of plans available? For each plan, please set out its main features, including how the plan is taxed, and provide an indication of its popularity.

Share options

Share options are the most common type of share-based plan in the US. However, excessively generous share option grants were

blamed, at least in part, for the accounting scandals at Enron and other companies. These scandals were the reasons behind many legislative and regulatory changes that were unfavourable to share options, the most important being the adoption of fair value accounting principles for share-based plans.

Share options can no longer be awarded without any compensation charge being added to the company's books: the option's fair value must be included as a charge to the company's earnings. This means that share options are treated the same as other share-based plans from an accounting standpoint, and many companies have moved away from share options to less dilutive plans under which smaller numbers of shares are awarded free (see *below*, *Restricted shares/restricted share units (RSUs)*).

Share options can be one of two types:

- Non-qualifying share options (NQSOs).
- Incentive share options (ISOs).

Generally, tax liability does not arise when either type of option is granted.

NQSOs. If the option is an NQSO, the employee is taxed when the option is exercised, on the difference between the:

- Fair market value of the shares at the time of exercise.
- Exercise price paid by the employee.

This income is taxed at ordinary rates and is subject to wage-based withholding and reporting requirements. The employer is generally entitled to a tax deduction against its US income.

Any additional gain on the sale of the shares over the fair market value at exercise is taxed as capital gains when the shares are sold. Capital gains on shares held for more than one year after acquisition are taxed at favourable rates.

ISOs. Exercising an ISO is not subject to tax, although exercise is considered a taxable event for the purpose of determining any alternative minimum tax (a form of tax that targets favourable tax treatment). Instead, the employee is subject to tax when the shares are sold. If the shares are held at least one year after exercise (or two years from grant, if later), then the difference between the sale price and the exercise price is taxed at favourable capital gains rates. However, the employer company is not entitled to any tax deduction.

If the shares are sold before these holding periods have expired, the difference between the fair market value of the shares at the

date of exercise and the exercise price is taxed as ordinary income (although it is not subject to wage-based withholding).

If the value of the shares subject to ISOs that first become exercisable in any calendar year exceeds US\$100,000 (about EUR79,210) (based on the value of the shares on the grant date), the excess is treated as an NQSO.

Restricted shares/restricted share units (RSUs)

Restricted shares. A restricted share plan in its simplest form is an outright grant of shares to an employee. Until a specified future vesting date has been reached, the shares cannot be transferred by the employee and will be forfeited if employment is terminated.

Subject to these restrictions, the employee is the legal owner of the shares and entitled to voting and dividend rights. Restricted share awards were, at one time, viewed as attendance certificates because they reward employees merely for remaining employed through the vesting period, even where the share price falls. However, there has been a clear movement among US listed companies away from share options to restricted share awards. As these are full value awards, it takes far fewer shares to deliver an employee a desired value at the date of grant than a share option with a fair market value exercise price. This, therefore, addresses the dilution concerns typical of institutional investors (*see above, Share options*).

Tax. Generally, tax liability does not arise until the vesting date has been reached, at which time the value of the shares is subject to ordinary income tax and wage-based withholding and reporting. The employer is generally entitled to a corresponding tax deduction, although for listed companies the tax deduction for annual compensation paid to each of the top-five executive officers that is not performance-based is limited to US\$1 million (EUR792,098) (*section 162(m), Internal Revenue Code of 1986 (IRC)*).

Employees can elect to include the value of the shares on the grant date into income immediately, and realise capital gains on all further appreciation when the shares are sold. However, because the taxes paid at grant generally cannot be recovered if the shares are forfeited, this election is typically not made unless the employee either paid for the shares, or the grant date value of the shares is low.

RSUs. RSUs are similar to restricted share plans, except that actual delivery of the shares does not occur on the grant date, and instead occurs either when or after vesting conditions are met. To comply with applicable tax law, a specific delivery date or event must be specified at the time of grant, at which time the shares are automatically delivered.

Unlike restricted share awards, RSUs can defer the employee's tax liability until after the vesting date, when the shares are actually delivered. This is particularly useful for:

- Listed companies that have instituted hold until retirement policies for shares awarded to their senior executives.
- Non-listed companies where shares may not be able to be sold to fund payment of the tax liability.

Share appreciation rights (SARs)

SARs are similar to share options in that the employee has the right to the increase in value of the shares between the date of grant of the SAR and the date of exercise (*see above, Share options*). However, the employee does not pay the exercise price but receives this difference in share value between grant and exercise either in the form of cash or in the form of free shares having a value equal to the difference.

SARs payable in cash give unfavourable mark-to-market variable accounting and for that reason are not very popular, particularly among listed companies. Under the new fair value accounting standards, SARs payable in shares are not variably accounted for, and are treated exactly the same as share options. This change in accounting treatment, together with the fact that share-settled SARs are less dilutive than comparable share options (because only shares representing the net gain are issued, rather than the gross value under a share option), some listed companies have replaced their share option programs with share-settled SARs. From a tax standpoint, the cash or value of the shares received on exercise of a SAR is taxed as ordinary income, subject to wage-based withholding, and the employer is generally entitled to a corresponding tax deduction.

Broad-based share plans

There are a variety of methods by which the opportunity to acquire employer shares is made available on a broad basis. Generally, these methods are only offered by listed companies (including non-US companies) because of the difficulty unlisted companies have in complying with an applicable exemption in US securities laws. Listed companies can register the method on a Form S-8 registration statement.

423 employee share purchase plan (ESPP). Under an ESPP that meets certain requirements, employees are offered the right to purchase shares at up to a 15% discount off either the:

- Value of the shares at grant.
- Value of the shares at purchase.

No tax liability arises until the shares are sold. Depending on how long the employee holds the shares, the employee may also be entitled to favourable tax treatment relating to the sale of the purchased shares, and apportioning capital gains and ordinary income components of the gain realised.

Under a typical ESPP, employees sign up before the offering date and agree to have an amount or percentage withheld from their salary for an agreed period and credited to a share purchase account. At the end of the purchase period, the amount credited to the accounts is used to purchase shares at the formula price. The shares are issued in the employee's name and, from the date of exercise, the employee is the shareholder in all respects, although the shares can be held in the usual kind of depository account established with a bank or broker.

Employees can stop participating in the programme at any time, although many plans impose penalties for withdrawals. To qualify for favourable tax treatment, all employees other than certain part-time and seasonal employees, and employees who have satisfied less than two years of service, must be eligible to participate in the plan. High-earning employees, however, can be excluded.

If the purchase price is fixed at the offering date, the purchase period can extend for up to five years. However, if the purchase price is not determinable on the offering date (for example, if the purchase price is to be 85% of the market value on the offering date or the exercise date, whichever is lower), then the maximum purchase period is 27 months.

401(k) plan with employer share fund. A 401(k) plan is a type of tax-qualified retirement plan that allows employees to elect to contribute, on a pre-tax basis, a portion of their salary (*section 401(k), IRC*). The employer typically provides a matching contribution equal to some percentage of the contribution made by the employee, and can make a discretionary contribution to be allocated based on the relative compensation of each employee.

The employee's own contribution is always fully vested, while the employer's contribution can vest over a period not exceeding five years. All assets of the plan must be held in a trust that is not subject to the claims of the employer's creditors. Generally, on termination of employment, the employee's vested account balance is distributed from the trust. These distributions are generally taxable at ordinary income tax rates, although special deferral rules can apply to distributions of employer shares. 401(k) plans usually allow employees to direct the investment of their account balance among a variety of investment options, typically mutual funds. Many companies add an employer share fund as an investment alternative available to participants under the plan. Participants can be permitted to direct the investment of all or a limited percentage of their own pre-tax contributions and/or employer contributions into the share fund. As with all tax qualified retirement plans, coverage and features must be made available in a manner that does not discriminate in favour of high-earning employees.

401k plans are taxed in the same way as employee share ownership plans (*see below, Employee share ownership plan (ESOP)*).

Employee share ownership plan (ESOP). An ESOP is also a type of tax-qualified retirement plan that is designed to invest primarily in employer shares. As employees are not generally required or permitted to direct their own contributions into employer shares, securities laws do not pose a problem because no investment decision is being made. Therefore, non-listed companies can establish ESOPs. ESOPs can incur debt to acquire employer shares, and are often used to provide liquidity to a founding shareholder who sells shares to the ESOP. If the ESOP acquires at least 30% ownership of the company, then the selling founder can defer taxation on the sale of his shares.

As is the case with 401k plans (*see above, 401(k) plan with employer share fund*), employees are not liable to pay tax when the shares are allocated to their account under the ESOP trust until those shares (or cash in lieu of shares) are actually distributed. However, the employer is generally entitled to a tax deduction as and when the contributions to the trust are made. Special rules may allow an employee to further defer any appreciation realised on shares while held in the trust until those shares are sold.

4. Is consultation or agreement with, or notification to, employee representative bodies required before the employee share plan can be launched?

Employees that are members of a collective bargaining unit (union employees) are generally not selected to participate in share options, restricted shares, or other share-based plans which are typically limited to key employees. The inclusion of union employees in broad-based share plans is subject to collective bargaining, just as any other term or condition of employment.

5. Do exchange control regulations prevent employees sending money from your jurisdiction to another to purchase shares under an employee share plan?

There are no exchange control restrictions in the US.

6. Do exchange control regulations permit employees to repatriate proceeds derived from selling shares in another jurisdiction?

There are no exchange control restrictions in the US.

7. What is the tax position when an employee who is ordinarily resident in your jurisdiction at the time of grant under the share plan leaves your jurisdiction before exercising the option? Will double taxation apply?

Employees that are US citizens are subject to US taxation on their worldwide income, subject to certain exclusions for foreign earned income and credits for foreign taxes paid. Therefore, US expatriates in other jurisdictions remain subject to US income tax to the same extent as they would had they remained in the US.

If non-US employees are granted options regarding employment in the US, and the employees are repatriated to their home jurisdictions before exercising the option, then the amount subject to tax can be apportioned between jurisdictions. The amount apportioned to sources in the US is generally based on the number of days of performing services in the US compared with the total number of days performing services during the vesting period, depending on whether a double taxation treaty between the US and the other jurisdiction applies.

8. For the offer and participation in an employee share plan, what:

- Prospectus requirements (if any) need to be completed and by when? What exemptions (if any) are available?
- Other regulatory consents or filings (if any) need to be completed and by when? What exemptions (if any) are available?

Prospectus requirements

Companies that are US-listed can register securities offered with the Securities Exchange Commission (SEC) on a Form S-8 registration statement (*see below*). Employees must then receive a prospectus summarising the terms of the plan and describing the relevant tax consequences. Generally, the employees must receive the prospectus before they decide to acquire the shares. Where an exemption from registration with the SEC applies, there is no formal requirement to provide participating employees with a prospectus, but depending on the exemption, certain information must be provided to employees. In addition, regardless of the exemption relied on, there are general anti-fraud rules that may prohibit a failure to disclose information material to a participant's decision to acquire shares.

Other regulatory consents and filings

Under US securities laws, an offer to acquire securities must either be:

- Made through an effective registration statement filed with the SEC.
- Exempt from registration.

Companies that are listed on a US securities exchange (including foreign companies) can generally use Form S-8, which is a relatively simple registration statement that is filed with the SEC and is specifically available for employee share plans.

Companies that are not listed on a US securities exchange cannot use a Form S-8 to register their share plans, and registering an employee offering with the SEC other than pursuant to a Form S-8 is generally cost-prohibitive. Therefore, companies not listed on a US exchange (including foreign companies whether or not listed in their home country) must use an exemption from registration. One such exemption is for a limited offering that is a private placement. However, offerings that extend beyond the top group of executives generally do not qualify as private placements.

There is an exemption specifically available for employee share plans for non-US listed companies under SEC Rule 701. Offers and sales of shares under an employee share plan is exempt to the extent the value of the shares offered to US employees does not exceed in any rolling 12-month period the greatest of (*SEC Rule 701*):

- US\$1 million (about EUR792,098).
- 15% of outstanding shares.
- 15% of the company's net assets.

However, if the offering relates to more than US\$5 million (about EUR3.96 million) worth of shares in any 12-month period, employees must be provided with information describing the risk factors relevant to making an investment in the company, and also must be provided with financial statements that comply with US Generally Accepted Accounting Principles (GAAPs). The costs to a non-US company of preparing financial statements which comply with US GAAPs can be prohibitively high.

Companies not eligible to file a Form S-8 registration statement must also consider state securities law in the state or states in which employees are resident. Many states exempt an employee share offering if the offering is exempt under SEC Rule 701. However, some states can require a notice of exemption to be filed. In addition, other states, notably California, have their own securities laws that operate independently from Rule 701 and can require changes to plan design in order to comply with applicable exemptions.

9. Briefly summarise any proposals for reform of the law on employee incentives in your jurisdiction.

There are two regulatory projects in progress that have an impact on employee share plans. The SEC has recently issued new rules that enhance the disclosure that must be provided to shareholders in relation to various components of executive compensation, including share-based compensation. These enhanced rules will generally affect only those companies listed on US securities exchanges that are subject to the SEC's disclosure requirements as they relate to the solicitation of voting proxies (that is, the process by which a person requests that shareholders execute, not execute, or revoke a proxy card). Generally, non-US companies, even those listed on a US exchange, are not subject to the SEC's proxy rules.

The Internal Revenue Service (IRS) is expected to issue final regulations under section 409A of the IRC, which was enacted in 2004 as part of the Jobs Creation Act. Section 409A imposed new rules relating to the timing of delivery of deferred compensation, with severe tax consequences to the employee for a failure to comply with these rules. Depending on the form of share-based compensation, these rules may be relevant. Generally, share options and share appreciation rights granted at fair market value, and restricted share grants, as well as the broad-based methods (*see Question 3*), are exempt from section 409A. However, other forms of share-based compensation, including RSUs, may not be exempt. In addition, amendments or other modifications to share options and SARs can result in losing the section 409A exemption. The IRS is expected to clarify the rules in this regard when it finalises its regulations.