Employee Stock Options in the EU and the USA

FINAL REPORT

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USA

Contents

USA

1. General remarks

1.1 History

1.1.1 The practice of granting stock options was started in the mid 1950s when option grants were generally limited to senior executives. High-technology companies started granting broad-based options in the 1960s, and by 1970, many more employees were receiving regular option grants. With the flat stock markets of the early 1980s, options fell out of favour, but when PepsiCo initiated a new broad based stock option plan in 1989, they came back as a popular compensation vehicle.

1.1.2 Stock option legislation has developed largely through case law, and was codified by the enactments of Section 83 of the Internal Revenue Code in 1977.

1.2 Current situation

1.2.1 There are two types of stock options, differentiated by the tax treatment they receive: Incentive Stock Options ("ISOs") and Non-Qualified Stock Options ("NQSOs"). ISOs were preceded by qualified stock options that were enacted in 1963. ISOs were codified in the Internal Revenue Code in 1976.

1.2.2 The stock option plans are not aimed specifically at certain companies (e.g. IT sector, small/medium/large companies), although options tend to be more widely used in technology and similar cash-strapped companies. However, there are general distinctions between those employees receiving ISOs and those receiving NQSOs. Generally, ISOs are limited to senior management while NQSOs are granted throughout the organization.

1.2.3 According to a 2000 ("NASPP") stock survey which received responses from 345 US headquartered companies listed on a US Stock Exchange, almost every company had granted options in one form or another (although there have been a few notable exceptions e.g., Berkshire Hathaway). It is estimated that between seven and ten million employees (approx. 7% of total workforce) in the U.S. currently receive stock options. There has been a sharp increase in the use of employee stock options during the 1990s.

1.2.4 The taxation of stock options has not been reformed in the recent past. However, federal income tax rates have recently been decreased and new legislation on withholding and reporting for ISOs stock option plans will take effect in 2003[1]. The decrease in marginal tax rates was prompted by the policy goals of the Bush Administration.

[1] See Economic Growth and Tax Relief Reconciliation Act of 2001 (P.L. 107-16) and Treasury Notice 2002-47, 209-16 I.R.B 516)

1.2.5 Most recently proposed tax amendments are aimed at reforming the corporate tax and accounting implications of stock options. For example, a bill was proposed to amend Section 83 and provide that the tax deduction otherwise allowable at the time an option is exercised would be limited to the amount recorded as a book expense (see section 3.5 below). This limit would also apply for purposes of determining the amount of wages for which a research credit is available under Section 41 (a research credit is a credit that can offset taxable income for corporate taxpayers who engage on qualified research activities). For the vast majority of companies that include stock option information only in financial statement footnotes, no deduction or research credit would be allowed. Even for companies that fully implemented FAS 123, the deduction and credit would be limited to the Black-Scholes (or similar) value recorded at the time of grant. (See section 9 below for additional information on FAS 123.)

2. Key features of stock option plans

2.1 Incentive stock options ("ISOs")

2.1.1 There is no minimum term for which ISOs must be granted.

2.1.2 Section 422 of the Internal Revenue Code ("IRC") provides the various criteria necessary to receive ISO treatment[2]:

- The options must be granted pursuant to a written plan that is approved by the shareholders of the company within one year of the plan's adoption by the board of directors.
- The plan must specify the aggregate number of shares that may be issued.
- The plan must indicate the employees, or class of employees, eligible to receive the options.
- The exercise price must be at least equal to the fair market value ("FMV") of the underlying shares at the grant date.
- The options must be granted only to employees and must be exercised during employment or within three months of termination of employment.
- The options cannot be exercisable more than ten years after grant.
- Options granted to an employee that are first exercisable in any one year must be capped at $100,000 in underlying share value based on the value of the shares at the date of grant (any options granted in excess of this amount are treated as non-qualified stock options).

[2] Section 422 of the Internal Revenue Code ("IRC") provides the various criteria necessary to receive ISO treatment.

2.1.3 There are no discrimination laws in the US that relate to stock options (see section 6.2 below). As such, the company has discretion on who shall receive options and how many options are to be granted. However in practice ISO grants are generally limited to senior executives[3].

2.1.4 There are generally no restrictions as to the class of shares one can grant options over. For example, employees of a Parent company A can receive Subsidiary B shares.

2.1.5 There is no restriction on the type of company that may grant options under this type of plan.

2.2 Non-qualified stock options ("NQSOs")

2.2.1 There is no minimum term for which the stock options must be granted and no maximum term for which the stock options may subsist. In practice, companies have generally limited the option term to ten years.

2.2.2 If options are not exercised within the option term specified in the plan, the employee forfeits his/her right to exercise such option, i.e. the option expires.

2.2.3 Within the plan itself, there are provisions on who may receive option grants under the plan. The eligibility criteria outlined in the plan, however, is left to the discretion of the company. Most plans are limited to employees of the parent or any consolidated subsidiary.

2.2.4 There are no discrimination laws in the US that relate to stock options (see section 6.2 below). As such, the company has discretion on who shall receive options and how many options are to be granted[4].

2.2.5 There are generally no restrictions as to the class of shares one can grant options over. For example, employees of a Parent company A can receive Subsidiary B shares. Due to negative accounting implications, options are rarely granted to employees of a non-consolidated entity, considered a grant to a non-employee under FIN 44 (see section 9 below).

2.2.6 There is no restriction on the type of company that may grant options under this type of plan.

2.2.7 While in theory there need not be any limit to the number of options an employee is eligible to receive, the plan will typically impose a limit (based on number and not value).

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3 See Title VII of the Civil Rights Act of 1964, which discusses discrimination generally.

4 See Title VII of the Civil Rights Act of 1964, which discusses discrimination generally.

3. Taxation

3.1 Time of taxation

3.1.1 *ISOs*

3.1.1.1 There will be no charge to tax at grant. US taxes are based on the constructive receipt doctrine. As ISOs are not considered property (under Section 83) the mere grant of an ISO will not give rise to a taxable event.

3.1.1.2 There is no charge to tax at vesting of an ISO[5].

3.1.1.3 ISOs are not taxable at the time of exercise. income tax is deferred until sale. However, the difference between the FMV at exercise and the exercise price (the “exercise spread”) is included in income for the alternative minimum tax ("AMT") (see section 3.3 below)[6].

3.1.1.4 There are no social security contributions due at grant, vesting or exercise. However, there is legislation proposed to apply social security at the time of exercise for options exercised beginning 1 January 2003. IRS REG-142686-01 would treat the exercise spread as wages for FICA and Federal Unemployment Tax Act (“FUTA”) purposes.

3.1.2 *NQSOs*

3.1.2.1 There is no tax or social security charge at grant. The US taxes for nonqualified stock options are based upon Section 83 of the Internal Revenue Code[7]. As NQSOs are not considered property (under Section 83), the mere grant of a NQSO will not give rise to a taxable event, provided that the option does not have a readily ascertainable FMV at grant (generally this would require that the option is tradable, or is transferable free of restrictions that would constitute a substantial risk of forfeiture, or is immediately exercisable and had a readily ascertainable FMV as determined under Reg. 1.83 – 7(b)(3)).

3.1.2.2 There is no charge to tax or social security at vesting[8].

3.1.2.3 The employee is subject to income and social security contributions at the time the options are exercised[9].

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5 See Regulation s 1.83-7

6 See I.R.C. Section 56(b)(3) and Section 56 generally.

7 Reg Section 1.83-7.

8 Reg. Section 1.83-7

9 Reg Section 1.83-7 (timing of tax), Section 1401 (withholding of income tax) and Section 3121 (social tax).

3.2 Taxable gain

3.2.1 *ISOs*

3.2.1.1 While income tax is not levied at the time the ISO is exercised, the spread at exercise is included in income for AMT purposes. The AMT is a complex system that assesses tax using a different definition of income than is used for regular income tax purposes.

3.2.2 *NQSOs*

3.2.2.1 The taxable income is calculated as the excess of the FMV at the time of exercise over the option exercise price.

3.3 Type of tax

3.3.1 *ISOs*

3.3.1.1 At exercise the difference between the FMV of the shares and the exercise price will be considered income for AMT purposes and must be reported on Form 6251 (*Alternative Minimum Tax for Individuals*) to determine if the employee is subject to the Alternative Minimum Tax. This form should be filed with the employee's annual tax return for the year of exercise. No AMT reporting obligations arise if a same day sale occurs.

3.3.2 *NQSOs*

3.3.2.1 Income tax and social security contributions are levied at the time of option exercise.

3.3.2.2 Income is taxed for federal income tax purposes at progressive rates from 10% to 38.6%, not including state rates (if applicable):

3.3.2.3 Social security contributions are levied at the following rates for 2002:

- Old Age, Survivors and Disability Insurance ("OASDI") is imposed at a rate of 6.2% on annual income up to $84,900.
- Medicare is imposed at a rate of 1.45% on all income.

3.3.3 The AMT was designed to ensure that every individual and corporation pays at least some tax every year. In practice, the AMT is a separate tax system that runs alongside the regular tax system. It includes a broader range of income and a smaller range of allowable deductions and credits.

3.3.3.1 The AMT is a two-tier system. Individuals with AMT income ("AMTI") up to $175,000 or ($87,500 for married filing separately) over the exemption amount are subject to a 26% tax rate. A 28% tax rate applies to AMTI above these amounts. The exemption amounts are:

- $49,000 – Married filing jointly or surviving spouses.
- $37,750 – Single or head of household.
- $24,500 – Married filing separately.

3.3.3.2 The AMT exemption amount phases out for higher-income individuals. For married individuals filing jointly or surviving spouses, the phase-out begins at AMTI of $150,000 and ends at $346,000. For single or head of household, the phase-out range is $112,500 – $255,500. For married filing separately, the phase-out range is $75,000 - $173,000. Married persons who file separate returns not only lose their exemptions when AMTI reaches $173,000 but must increase AMTI by 25% of the amount by which is exceeds $173,000 up to an overall increase of $24,5000 to bring them in parity with married individuals filing jointly.

3.3.3.3 These exemption amounts only apply for 2001 to 2004 unless Congress takes additional action. If not, the exemption amounts will drop back to the 2000 level in 2005.

3.3.3.4 In general, the AMT is calculated as follows:

- Begin with regular taxable income.
- Add any personal exemption amounts claimed.
- Add any net operating loss.
- Subtract itemized deductions that cannot be claimed on Schedule A because of certain limits for high-income individuals.
- Adjust taxable income for certain deductions and preference items, including any AMT net operating losses to arrive at AMT.
- Subtract the AMT exemption amount.
- Multiply by the AMT rate.
- Subtract AMT credits.
- Compare with regular tax and pay AMT to the extent it exceeds regular tax.

3.3.3.5 The AMT may increase an individual's tax bill if he/she has one or more of the following items and they are sizeable in relation to total taxable income:

- Itemised deductions, especially state and local income taxes, real property taxes, certain interest, and miscellaneous deductions.
- A large number of dependents.
- Accelerated depreciation.
- Interest income on certain tax-exempt private activity bonds issued after 7 August 1986.
- Large bargain elements (spread between the option price and FMV of stock at time of exercise) on exercise of ISOs.
- Certain deductions generated in oil, gas or other natural resource business operations, and.
- Large long-term capital gains.

3.3.3.6 There are no wealth taxes applicable to stock options.

3.4 Capital gains taxation[10]

3.4.1 *ISOs*

3.4.1.1 There will be tax implications for the employee at the time the shares received upon ISO exercise are sold.

3.4.1.2 ISOs are subject to certain holding period requirements. To obtain the preferential treatment available to this special type of option, individuals are required to hold the stock for at least two years from the date of grant and at least one year from the date of exercise[11].

3.4.1.3 If the employee satisfies these holding period requirements before selling the shares, the employee will be deemed to have performed a "qualifying disposition" and will recognise a long-term capital gain or loss. Disposition includes a sale, exchange, gift, or transfer of title. The gain or loss will be equal to the difference between the sales proceeds and the exercise price. No employer reporting or withholding obligations exist. If the employee does not meet the holding requirements he will have performed a disqualifying disposition and may be subject to both income tax and capital gains tax.

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[10] See generally I.R.C. 1231

[11] Section 422 of the IRC.

3.4.2 *Qualifying disposition*

3.4.2.1 If the employee does not meet the holding requirements he will have performed a disqualifying disposition and may be subject to both income tax and capital gains tax.

3.4.2.2 If the employee meets the holding requirements the capital gain will be subject to tax at a flat rate of 20%. If the shares were acquired listing after 31 December 2000, and held for more than five years after exercise, the capital gain will be taxed at a maximum federal rate of 18%.

3.4.2.3 The company will not withhold any taxes or report this gain or loss on the Form W-2 for the year of sale. The employee is responsible for reporting the gain or loss and for timely payment of the appropriate taxes to the Internal Revenue Service and his/her state tax authorities.

3.4.3 *Disqualifying disposition*

3.4.3.1 The taxable benefit at sale will be calculated as follows:

- *Ordinary Income* – the employee will pay ordinary income tax on the FMV of the shares at the date of exercise less the exercise price. Ordinary income is taxed at regular federal tax rates of up 38.6%. The employee may also be subject to state and local taxes, depending on where (s)he lives. If the sales price of the shares are less than the FMV on the date of exercise, the amount of ordinary income is limited to the amount of gain, if any. If the sales price of the shares is less than the exercise price, the employee will recognize either a long-term or short-term capital loss on the sale, depending on the length of time the shares are held. This gain or loss is reported on the individual's annual tax return on Schedule D to Form 1040.

- *Capital gain (loss)* – The employee will pay capital gains tax on the sales proceeds less the FMV of the stock on the date of exercise. The applicable tax rate will depend on how long the shares were held before sale. If the shares are held for at least one year the capital gain will be subject to tax at a flat rate of 20% (18% for shares acquired after 31 December 2000 and held for 5 years). If the employee holds the shares for one year or less, the capital gain will be subject to tax at marginal tax rates up to 38.6%.

3.4.3.2 Social security contributions are not currently levied on ISO generated income, at exercise or at sale although from 2003, social security contributions are expected to be levied upon ISO exercise but not on sale.

3.4.3.3 If shares are sold at a loss, the capital losses can be offset against capital gains, whether short-term (one year or less) or long-term (more than one year). Any excess capital loss may be applied to ordinary income but is limited to $3,000 in losses. Any further loss must be carried over and applied against the following year's capital gains and $3,000 of those losses can be used to offset ordinary income. This $3,000 loss carry-over may be carried over indefinitely.

3.4.4 *NQSOs*

3.4.4.1 An additional tax liability will arise at the time of sale if and to the extent that the sales proceeds exceed the FMV of the shares at the time of exercise.

3.4.4.2 The gain, if any, is subject to capital gains tax. The applicable tax rate will be determined according to how long the shares were held prior to sale.

3.4.4.3 If the employee holds the shares for at least one year, the capital gain will be subject to tax at a flat rate of 20%. If the shares were acquired after 31 December 2000, and held for more than five years after exercise, the capital gain will be taxed at a maximum federal rate of 18%.

3.4.4.4 If the employee holds the shares for one year or less, the capital gain will be subject to tax at marginal tax rates up to 38.6%.

3.4.4.5 Capital losses can be offset against capital gains, whether short-term or long-term. Any excess capital loss may be applied to ordinary income but is limited to $3,000 in losses. Any further loss must be carried over and applied against the following year's capital gains and $3,000 of those losses can be used to offset ordinary income. This $3,000 loss carry-over may be carried over indefinitely.

3.5 Tax consequences for the granting company

3.5.1 *Social security contributions*

3.5.1.1 *ISOs*

3.5.1.1.1 There is no charge to social security contributions at grant or vesting.

3.5.1.1.2 There is no employer social security contributions at exercise for the current year 2002. However, there are proposed regulations that could impose social security contributions on the spread element at the time of ISO exercise (see section 3.1.1 above.)

3.5.1.2 *NQSOs*

3.5.1.2.1 There is no charge to social security contributions at grant or vesting.

3.5.1.2.2 On exercise, the employer is subject to the same social security contributions rates as the employee (see section 3.3.2 above). This is not affected by whether the cost of the option is recharged to the subsidiary employing the shareholders.

3.5.2 *Corporate tax deduction*

3.5.2.1 *ISOs*[12]

3.5.2.1.1 Typically no corporate tax deduction is available with respect to ISOs. However, in the case of a disqualifying disposition, the employer can claim a corporate tax deduction equal to the spread at exercise (e.g. the excess of the FMV of the shares at the time of exercise over the exercise price). This deduction is only allowed for costs associated with employees of the US company that perform disqualifying dispositions on the ISOs. The company may also deduct general management/administrative expenses associate with stock options.

3.5.2.1.2 There are no specific requirements / formalities for securing the deduction. However, the income must be reported as wages on the employee's W-2 (year end payslip).

3.5.2.1.3 The timing of the deduction would correspond with the time of inclusion of the wages in the employees W-2 (although administrative costs may be deducted as they are incurred). This means a deduction is available at the time the taxable event arises.

3.5.2.1.4 The deduction should be claimed no later than the year in which the income is recognised.

3.5.2.1.5 No recharge is needed in order to process a tax deduction associated with a disqualifying disposition so long as the costs deducted relate to employees of the US company.

3.5.2.2 *NQSOs*

3.5.2.2.1 The US company may claim a corporate tax deduction with respect to the exercise spread. This deduction is only allowed for costs associated with employees of the US company. The company may also deduct general management/administrative expenses associate with stock options[13].

3.5.2.2.2 There are no specific requirements / formalities for securing the deduction. Provided the income is reported as wages on the employee's W-2, a corresponding tax deduction is allowed.

3.5.2.2.3 The timing of the deduction would correspond with the time of exercise (although administrative costs may be deducted as they are incurred). The deduction should be claimed no later than the year in which the income is recognised.

3.5.2.2.4 No recharge is needed in order to process a tax deduction, so long as the costs deducted relate to employees of the US company.

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[12] See Reg. Section 1.83-6 for the rules address tax deductions for shares granted to an employee under a stock option program.

[13] See Reg. Section 1.83-6 for the rules that address tax deductions for shares granted to an employee under a stock option program.

3.5.3 *Other*

3.5.3.1 VAT / sales tax and stamp duty/transfer tax do not have any impact on the operation of employee stock option plans.

4. Issues for employees

4.1 Reporting obligations

4.1.1 *ISOs*

4.1.1.1 There will be no reporting obligations for the employee at grant, vesting or exercise[14].

4.1.1.2 If the employee satisfies the holding period requirements before selling the shares, the employee is responsible for reporting the gain or loss and for timely payment of the appropriate taxes to the Internal Revenue Service and his/her state tax authorities.

4.1.1.3 In the case of a "disqualifying disposition" the resulting gain or loss is reported on the individual's annual tax return on Schedule D to Form 1040.

4.1.2 *NQSOs*

4.1.2.1 There will be no reporting obligation at grant or vesting.

4.1.2.2 The employee will have a reporting obligation at the date of exercise. The employee will need to file his W-2 (see section 5.1.2) along with his/her annual tax return at the time (s) he files his/her annual tax return.

4.1.2.3 The employee must report the capital gain recognized at sale, on his/her personal income tax return (Form 1040) by 15 April of the year following the year of sale. Note that while extensions for filing the return will automatically be granted to 15 August and 15 October, the tax is due by 15 April (otherwise, penalties and interest will be imposed). Individuals may also be subject to state and local taxes depending upon where they live.

4.2 Cashflow issues

4.2.1 *ISOs*

4.2.1.1 There are unlikely to be cashflow issues in relation to the grant of ISOs since employees rarely pay money for the grant of ISOs, and no tax liability arises until the shares are sold.

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[14] Sec. 6038D

4.2.2 *NQSOs*

4.2.2.1 There are no methods for alleviating cashflow problems that may arise at exercise. However, please note that withholding is effected at the statutory minimum rate for withholding on supplemental wages of 27% (plus the applicable state and social security contributions rates). Any excess tax due should the employee be subject to a federal tax in excess of 27% would be settled at the time the employee files his/her annual tax return.

4.3 Change in employee's residence status

4.3.1 *ISOs*

4.3.1.1 The employee's residence status would not change the tax position at grant, vesting or exercise.

4.3.2 *NQSOs*

4.3.2.1 The employee's residence status at grant and vesting would not change the tax position at grant or vesting.

4.3.2.2 The employee's residence status would impact the income tax and social security positions at exercise as follows:

- Where the employee is tax resident at the exercise of the option but was not tax resident at the date the option was granted the income tax and social security contributions position would not differ, assuming the employee participates in the US social security system at the time the option is exercised. If this is the case, there will be both an income and social security charge.

- Where the employee is not tax resident at exercise but was tax resident at the date of grant the taxable amount would depend on how the income was apportioned. If no income were apportioned to the US, then no US tax liability would arise.

- Where the employee is not resident at grant, not resident at exercise but resident in between, typically, no US tax liability would arise. However, if the gain was apportioned the taxable amount would depend on how the gain was apportioned (say on a time basis spent resident in the US).

- The decision to apportion is left to the company as it relates to corporate reporting obligations and to the employee when he or she files their US tax return.

5. Issues for employers

5.1 Reporting obligations

5.1.1 *ISOs*

5.1.1.1 There are no obligations for the company to report the grant of options to the IRS. However, there are company reporting obligations with respect to accounting for stock options (see section 9).

5.1.1.2 There are no employer reporting obligations at vesting.

5.1.1.3 Technically the employer should file an information statement with the IRS providing them with details of option exercises. There is no prescribed form for this. The information to be included in the submission is contained in Reg Sec 1.6039-2 and should be submitted by 31 January following the year.

5.1.1.4 If the employee satisfies the holding period requirements before selling the shares, the employer will not report this gain or loss on the Form W-2 for the year of sale. If a disqualifying disposition is made, the requirements are as for non-qualified options.

5.1.2 *NQSOs*

5.1.2.1 There are no obligations for the company to report the grant of the options to the IRS. However, there are company reporting obligations with respect to accounting for stock options (see section 9).

5.1.2.2 There are no employer reporting obligations at vesting.

5.1.2.3 The employer is responsible for the following reporting requirements at exercise:

- The employer must report income and social security contributions withheld on Form 941, which is due on or before the last day of the month following the exercise. However, the taxes should be deposited with the US tax authorities either daily, semi-weekly, monthly, or quarterly depending on the amount of the accumulated liability (e.g. the size of the payroll).

- The employer must also report the taxable benefit and taxes withheld on the employee's Form W-2 for the year of exercise. A copy of Form W-2 must be given to the Internal Revenue Service, the Department of Social Security, and the employee by 31 January of the year following the year of exercise. The W-2 contains all employment compensation related information.

5.1.2.4 There are no reporting obligations for the employer at the date of sale.

5.2 Withholding obligations

5.2.1 *ISOs*

5.2.1.1 There is no withholding obligations at grant or vesting.

5.2.1.2 There are no withholding obligations at exercise for the current year 2002. However, there are proposed regulations that could impose social security contributions withholding at the time of ISO exercise. (See section 3.1.1).

5.2.1.3 No employer withholding obligations exist on sale of the shares.

5.2.2 *NQSOs*

5.2.2.1 There is no withholding obligations at grant or vesting.

5.2.2.2 There are withholding obligations at exercise. All income and social security contributions should be withheld by the Company and remitted to the tax authorities with the normal payroll for the period. The deposits are made to an authorized bank either daily, semi-weekly, monthly, or quarterly, depending on the employer's specific circumstances.

5.2.2.3 The statutory withholding rate for federal income tax is 27% plus the applicable social and state tax. Because the employee's marginal rate of tax may be higher than 27%, the employee may elect to have additional federal income tax withholding or may consider making an estimated tax payment. Failure to withhold or pay a minimum amount of income tax may result in an underpayment of tax charge when the tax return is filed. As such, the employee would be required to pay any additional tax liability at the time (s)he files his/her annual tax return.

5.2.2.4 Tax withholding can be applied against any employment income (e.g., stock option income, regular payroll payments, etc.).

5.2.2.5 Any tax due in excess or monthly payroll could be withheld from sale proceeds of shares or taken from future income.

6. Legal issues

6.1 Process/timeframe

6.1.1 Implementation of a stock option plan typically takes from two to four months, longer if shareholder approval is required (see section 6.4).

6.1.2 The process involves:

- A review of all relevant business, accounting, tax, and legal issues.
- Determination of the principal terms of the plan based on the review.

- Plan rules drafted.
- Board of directors of the company approves the plan.
- Shareholder approval may also be required, depending upon the charter documents of the company, whether ISOs are to be granted, and the particular federal and state securities laws being relied upon for the grant of securities under the plan.
- If the securities under the plan are being registered with the US Securities and Exchange Commission (the "SEC"), then filings with the SEC will be required.
- Filings may be required with the relevant state authorities depending upon the applicable laws.
- Drafting of a disclosure document for use in connection with the plan if desired or required.
- Disclosure documents are circulated to participants under the plan for informational purposes and may or may not be required under federal and state securities laws (again, this is dependent upon the particular federal and state securities laws being relied upon).
- State authorities may review the disclosure document (dependent upon the particular state law).
- The company may wish (or be required) to circulate a copy of the plan and financial statements to participants[15].

6.2 Employment law

6.2.1 Discrimination laws in the US differ significantly from those in the European Union. Similarities include discrimination laws covering sex and race. It is important to establish eligibility criteria that do not expressly exclude certain protected classes of employees or have a disparate impact on minority groups or which favour men over women or younger employees over older ones. However, it is not generally unlawful to exclude part-time employees. Age discrimination legislation exists in the US

[15] Board of directors approval is usually dictated by general principles of corporate law (the state where the company has been incorporated). Filings with the SEC and other requirements would be dictated by the US Securities Act of 1933, as amended (the "1933 Act"), and the US Securities Exchange Act of 1934, as amended (the "1934 Act"). Filings with state authorities and other requirements would be dictated by the state securities laws of the relevant states (determined by residence of the participants). State securities laws are often referred to as Blue Sky laws.

6.2.2 Employment in most states in the US can generally be "at will", e.g. terminable without notice and without any particular reason. Stock option plans can adopt this policy with respect to unvested options. However, vested options belong to the employee and cannot be forfeited. Further, it is open to the employer/employee to agree to periods of notice or fixed term employment. A wrongfully discharged employee can bring a legal claim for the loss of stock option rights denied to him/her by reason of the discharge. Discrimination claim awards can also take into account the loss of option rights.

6.2.3 Other issues to note:

- There has been significant litigation in the US on the rights of freelancers to join stock option plans. Where a plan is generally open to all employees, an individual who is held in reality to be an employee but has been wrongly classified as self-employed would have the basis of a legal claim.

- As in Europe, case law in the US has stressed the need to ensure that communications concerning option benefits made outside the formal rules are drafted carefully to avoid the risk of the grantor making independent self-standing promises about the benefits being offered, perhaps in wider terms than contained in the rules. Claims have been made by scheme participants based on misrepresentation about the value of benefits available.

- In certain cases, the benefit of a stock option gain must be taken into account in calculating the overtime payments which a non-exempt employee may be entitled to receive at law. A non-exempt employee is one who receives hourly wages and is generally subject to wage and hour laws (such as overtime pay). This typically applies to non-professional employees.

- There has also been considerable litigation over the vesting of options in the event of a termination of employment (whether for cause or not). Therefore, it is very important to draft carefully vesting rules and the consequences of a termination of employment.

- Options, once vested, cannot generally be forfeited even if the employee goes to work for a direct competitor. There are only very limited exceptions to this general rule.

- There is no federal requirement to consult with a trade union unless the union (collective bargaining agreement) contract so provides. State laws may impose a specific consultation requirement.

6.2.4 Requirements to consult with a trade union or similar representative body prior to implementing stock option plans would vary from state to state.

6.3 Data protection

6.3.1 The employer generally does not require the employee's consent to transfer information relating to the employee outside of the US. For best practice purposes however, it is recommended that the employee is notified that their personal data is being held by the employer for employment purposes. In the case of data transfer within the US, there is no requirement to obtain the employee's consent to transfer information to relevant parties who need to know this information for the purposes of operating a stock option plan.

6.4 Stock exchange issues

6.4.1 Shareholder approval is required for any company wishing to grant ISOs under a plan. Shareholder approval may also be required by state law (depending upon the relevant state law). State laws vary considerably, and are subject to amendment and repeal from time to time. The company and securities laws for the state(s) in which the employee resides and works always need to be considered. If shareholder approval is required, shareholders must usually be provided with a copy of the plan or a summary of the material tems of the plan. Stock exchange rules may also impose a shareholder approval requirement in some instances[16].

6.4.2 Under the broad anti-fraud provisions of federal and state securities laws, companies are required to provide adequate disclosure about the plan. As such, companies typically provide a copy of the plan and/or a disclosure document (summarising the material terms of the plan). This may also be required by the federal and state securities laws that are being relied upon in connection with the plan[17].

6.4.3 There are no restrictions on employees holding foreign shares (or options over foreign shares). However, the issuing company must still comply with US federal and state securities law.

6.5 Securities law

6.5.1 For companies that are not registering the securities under the plan with the SEC, federal securities laws will typically restrict the aggregate amount of securities that may be offered under the plan in any one twelve month period (e.g., the exemption from SEC registration provided by Rule 701 of the 1933 Act). If the securities under the plan are registered with the SEC on Form S-8, there are no restrictions on the number of participants or the aggregate offering amount (other than the number of unissued shares available for issuance upon exercise of the options)[18]. State securities law may restrict the number of participants. This will depend upon an analysis of the securities law for the relevant state.

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[16] See I.R.C. s422

[17] See generally 1933 Act, 1934 Act and relevant Blue Sky Laws.

[18] See 1933 Act, 1934 Act, SEC No-Action Letters, and state Blue Sky laws. (SEC No-Action Letters are written administrative responses to written inquiries. Although SEC No-Action Letters are publicly available, they are not legally binding upon the SEC and are limited to the facts and circumstances described within the response and may only be relied upon by the inquiring party.)

6.5.2 Companies that already have securities registered with the SEC must register the securities under the plan with the SEC. A Form S-8 is typically used and is effective upon filing with the SEC (in some cases, a Form S-3 may be used instead of a Form S-8). Companies that do not have any securities registed with the SEC will typically attempt to avoid registration with the SEC (of the securities underlying the plan) by reliance upon an exemption from registration. Common exemptions from registration include Rule 701 and Regulation D (both under the 1933 Act). State securities laws provide for a similar scheme of registration/exemptions.

6.5.3 Companies must comply with all federal and state securities laws, in many cases prior to making the first offer of securities under a plan.

6.5.4 Failure to comply with federal and state securities laws can lead to recission rights for participants, administrative investigations, administrative censure, and fines. In some cases, criminal penalties may also be imposed.

6.6 Financial assistance

6.6.1 As far as we are aware, no state law prohibits the giving of financial assistance. Generally, companies are allowed to provide employees with loans to be used to purchase company shares. However, the structure of the loan agreement will dictate the tax and accounting implications.

6.6.2 If the loan is to be used to fund the option exercise, then to avoid negative accounting it is crucial that the loan be characterized as a recourse loan (that is, the loan can be enforced against all assets of the employee including, but not limited to the underlying stock issued for the loan). Non-recourse loans (where the company can only enforce the loan against the stock underlying the loan), even where a market interest rate is paid, will likely trigger variable accounting[19] (see section 9).

6.7 Other

6.7.1 There are no foreign exchange control filings to consider.

6.7.2 Generally, option holders have no rights and/or privileges of a shareholder prior to option exercise. However, the activation of certain anti-takeover arrangements (e.g. "poison pills") may give rise to such rights.

[19] See FAS 123 and APB 25, see also EITF 95-16

6.7.3 There are legal constraints on the remuneration of employees and directors that need to be taken into account when drafting stock option plans. Congress enacted Sec. 162(m) to protect shareholders by curbing the abuse it perceived of executives, who controlled the compensation committee of public companies, granting themselves potentially excessive compensation. Sec. 162(m) provides that a publicly held corporation is denied a deduction for compensation paid to a "covered employee" to the extent the compensation exceeds $1,000,000. A "covered employee" includes the Chief Executive Officer (CEO), as well as any other individual whose compensation is required to be reported to the SEC by reason of that individual being among the four highest compensated officers for the taxable year (other than the CEO), as of the end of the corporation's taxable year.

6.7.4 The most important exception to this deduction limitation is one for performance-based compensation. To qualify as performance-based compensation, the remuneration must be payable solely on account of the attainment of one or more performance goals, but only if:

- The goals are determined by a compensation committee consisting solely of two or more outside directors.

- The material terms under which the compensation is to be paid are disclosed to the shareholders and approved by a majority in a separate vote before payment is made.

- Before any payment is made, the compensation committee must certify that the performance goals and any other material terms have been satisfied.

6.7.5 Affiliates also have special rules that need to be considered. An affiliate is an officer, director, substantial shareholder or other person that can exert control over the company. An affiliate must sell company stock under Rule 144 of the Federal Securities Act of 1933. An affiliate must file Form 4 for any option exercise either ten days after the month of exercise or on the next Form 4. The sale must be reported within ten days after the month of sale. US counsel should be consulted for more details on these rules.

7. Sourcing shares for stock option plans

7.1 Typically, when the employee exercises his options, he sends funds to the plan administrator or broker. The broker then transfers those funds to the Company, whose transfer agent issues the specified number of shares and forwards those shares to the plan administrator or broker. The employee's account is then credited with the appropriate number of shares. There are no additional employee registration requirements with respect to the transfer of ownership upon option exercise other than a requirement to complete the option exercise form.

7.2 When the shares are issued to employees via option exercise, the employer would issue new shares or transfer treasury shares by executing a stock transfer form to register the shares in the name of the employee. Thereafter, the employee can transfer the shares only by executing a stock transfer form in favour of the transferee, and delivering the form and the original stock certificate (if the shares are certificated) to the company or its transfer agent. A transfer of shares is not effective until it is recorded on the books and records (share register) of the company. Then, the company or its transfer agent will issue a new share certificate in the name of the transferee.

7.3 The costs associated with the transfer of shares are normal commissions if sold through a broker.

7.4 It is generally permitted for a company to hold its own shares, or for a subsidiary to hold shares in its parent but it is a matter of state law (of the jurisdiction where the company is incorporated) and may vary from state to state.

8. Role and influence of existing shareholders

8.1 Shareholders must approve an ISO plan within twelve months before or after the plan is adopted. There currently is no general requirement for shareholder approval of broad-based plans. However, on 6 June 2002, the New York Stock Exchange ("NYSE") released proposed rules that would mandate more-stringent standards for corporate governance and disclosure practices for NYSE-listed companies. The proposal comes in response to SEC Chairman, Harvey L. Pitt's 2 February 2002 request that the NYSE review its corporate governance listing standards. One of the new proposals require that shareholders vote on all equity-based compensation plans. This has not been finalised or approved yet.

9. Accounting

9.1 Companies have the choice of whether to account for stock options under Accounting Principles Board Opinion 25 ("APB 25") or under Financial Accounting Standard 123 ("FAS 123"). The accounting treatment is unaffected by whether the shares are newly issued or treasury stock.

9.2 *APB 25:*

9.2.1 Under APB 25, stock options are generally either given "fixed" or "variable" accounting, although fixed accounting is the more preferable. In order for a company to receive fixed accounting, four criteria must be met:

- The number of shares to be acquired under the options must be known.
- The exercise price must be known.
- The option must vest at a defined date.

- The option must be granted to an “employee”, as defined under Financial Interpretation Number 44 (“FIN 44”).

9.2.2 If the aforementioned criteria are met at grant, then a compensation charge is fixed at the time of grant and is equal to the excess of the FMV of the shares at the time of grant over the option exercise price. Where options are granted at FMV, no expense charge would arise in connection with the option grant. For the number of shares to be “known” it is not sufficient that the maximum number of shares that may be acquired is known. Other than by reason of termination of employment, the number of shares that can be acquired on option exercise must not be subject to any further condition post grant, e.g. satisfaction of performance criteria.

9.2.3 If the aforementioned criteria are not met, then a variable charge is required as set out in FIN 28. FIN 28 (FASB Interpretation No. 28, Accounting for Stock Appreciation Rights and Other Variable Stock or Award Plans) discusses the accrual of compensation costs for variable plans. Compensation should be accrued as a charge to expense over the period or periods during which the employee performs the related services. If the service period is not defined, it is presumed to be the vesting period. Compensation accrued during this period should be adjusted in subsequent periods up to the measurement date for changes, whether increases or decreases, in the quoted market value of the shares covered by the grant, but should not be reduced below zero. If the shares are unquoted the best estimate of FMV should be used, which in some situations will require an independent appraisal. The offsetting adjustment should be made to the compensation expense of the period in which the changes to the market vale of the shares occurs.

9.3 *FAS 123:*

Under FAS 123, companies are required to charge the “value” of all option grants as a compensation expense at the time of option award, e.g. a Profit & Loss account expense. The options are valued at the time of grant, either using Black-Scholes or similar valuation technique. This charge is then spread out over the vesting period.

9.3.1 FAS 123 requires that the total compensation cost is based only on the number of shares that actually vest. Awards that do not vest because the employee does not meet a performance or employment condition do not result in a compensation cost. Statement 123 permits two methods of estimation the effect of, and recording, forfeitures: (1) estimate forfeitures at the date of grant, accrue compensation costs for the awards to be earned, and adjust the accrual if subsequent information reveals that actual forfeitures will be different from the original estimate. (2) accrue compensation costs for all awards as if all are expected to be earned, and then reverse compensation as awards are forfeited.

9.4 General

9.4.1 For those companies choosing to account under APB 25 (the vast majority), a footnote disclosure is required providing a pro-forma EPS based on FAS 123 accounting treatment described above.

9.4.2 Companies generally prefer the accounting treatment under APB 25, as typically no expense charge for option grants is required. Critics of APB 25 complain because applying APB 25 becomes restrictive when companies want to attach performance conditions to the options, which would generally result in variable accounting. The recommendation to change accounting for stock options (from APB 25 for FAS 123) would adversely impact the income statements of companies that rely heavily on stock options as compensation. Most companies have not changed their accounting as recommended by FAS 123.

9.4.3 Until recently, investors did not pay much attention to the impact of stock options, even when such disclosures became required (in the footnotes under FAS 123). However, recently the issue of stock option accounting has become a hot topic. There are factions of Congress that are looking to change the accounting treatment such that all option grants be treated as compensation expense and accounted for accordingly.

9.4.4 How shares held by a trust are accounted for depends on the type of trust used. Where the shares held in a trust are subject to the claims and creditors (e.g., a Rabbi trust), such shares are treated as assets of the company and accounted for as such. Where the shares are held in a secular trust, they are not deemed to be assets of the company, so no accounting charge would arise. A secular trust holds funds for the sole benefit of the employees. The funds contained within the trust are not subject to the general claims and creditors of the company.

10. Miscellaneous

10.1 The use of a trust is recognised in the U.S. However, trusts are not commonly used in conjunction with stock option plans. The essential requirements for the creation of a trust are the drafting of the trust agreement which includes identification of trustees (one or more) and the funding of a pool of money[20].

10.2 Tax revenues from employee stock option plans are not used for a specific purpose.

11. Special points of note

11.1 Mitigation of income tax

11.1.1 There are no specific provisions for the mitigation of income tax either for ISOs or NQSOs.

11.1.2 There may be ways in which the option gain can be deferred into a nonqualified deferred compensation plan. Although the details of such an arrangement are quite complex and, as such, beyond the scope of this engagement, a proper deferral would defer the application of income tax. It may be possible to defer the application of social security contributions. Note, however, that it is not common to do this, although seen from time to time for senior executives.

[20] See generally Reg. S301.7701-4

11.1.3 There may be alternative ways to reduce tax on NQSOs, but they are complex estate planning ideas and are beyond the scope of this study.

11.2 Mitigation of social security contributions

11.2.1 There are no specific provisions for the mitigation of social security contributions either for ISOs or NQSOs.

11.2.2 There may be alternative ways to reduce social security contributions, but they are complex estate planning ideas and are beyond the scope of this study on NQSOs.

11.3 Mitigation of tax on sale of shares

11.3.1 There are no special provisions for mitigation of tax on sale of shares in the USA.

11.4 Special provisions for SMEs

11.4.1 There are no special provisions for stock options in SMEs.

Note: Individual country reports have been prepared covering employee stock options in the EU and the USA. These individual reports are of a general nature and subject to change based on individual circumstances. PricewaterhouseCoopers has also provided the EU with an overview report. This overview report sets out the basis on which the individual reports were prepared and should be referred to as necessary. In particular, it should be noted that the information in the reports is current as at 1 January 2002, unless otherwise stated. In the case of certain known subsequent changes, reference may be made on occasion but a full update exercise has not been carried out. Further information can be obtained from PricewaterhouseCoopers.