COUNTRY COMPARATIVE GUIDES 2021

The Legal 500 Country Comparative Guides

United States

EMPLOYEE INCENTIVES

Contributing firm

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This country-specific Q&A provides an overview of employee incentives laws and regulations applicable in United States.

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UNITED STATES
EMPLOYEE INCENTIVES

1. What kinds of incentive plan are most commonly offered and to whom?

The types of plan and the recipients of awards will vary with the maturity and industry of the company and whether it is a corporation or a "pass-through" for US tax purposes such as a partnership or a limited liability company ("LLC").

Established companies whose shares trade on a US stock exchange usually issue restricted stock units ("RSUs") or a combination of RSUs and stock options. However, the usage of stock options continues to decline in favour of RSUs. For executives, the RSUs will often have performance conditions in which case the awards are referred to as performance stock units or "PSUs." Some high-growth public companies such as biotechs will issue only stock options.

Many US private companies are organized as LLCs which issue rights to future appreciation known as "profits interests." Private companies organized as corporations will issue restricted stock and/or stock options.

While some start-ups and high-tech companies offer equity broadly to a substantial percentage of employees and many consultants, except for publicly-traded companies (which offer employee stock purchase plans) most mature companies, companies in other industries and LLCs confine awards to executives and key managers of the company.

This chapter will focus mainly on equity awards issued by entities taxed as corporations.

2. What kinds of share option plan can be offered?

Most US share incentive schemes are "omnibus" plans in that they permit the company's compensation committee of the board of directors to grant restricted stock, RSUs, PSUs, stock appreciation rights ("SARs") and stock options.

Stock options may be issued as incentive stock options ("ISOs") or nonqualified stock options ("NQSOs").

ISOs are subject to strict statutory limitations and conditions on features such as award size (no more than USD100,000 of grant value may become first exercisable in any one calendar year), time limits on exercising (generally ISOs must be exercised within 3 months of termination of employment), and a requirement that the plan be approved by shareholders. ISOs may only be granted by corporations.

NQSO are more commonly issued than ISOs and are not subject to such limitations and conditions.

When any equity awards are granted by a US publicly-traded corporation the plan must be approved by shareholders under an exchange listing requirement, except for certain inducement grants that may be made to new employees without shareholder approval.

3. What kinds of share acquisition/share purchase plan can be offered?

Companies that are publicly-traded in the US usually offer most US employees the opportunity to purchase shares at a discount with after-tax payroll deductions through an employee stock purchase plan ("ESPP") that complies with Section 423 of the US tax code. Such plans customarily have offering periods of 6 or 12 months during which time funds are accumulated for the purchase of company stock, usually at the lower of 85% of fair market value at the beginning or end of the offering period. Purchases must be capped at USD25,000 per calendar year. ESPPs may be offered only by a company that is taxed as a corporation, including an LLC which makes an election to be taxed as such.

Private corporations rarely offer ESPPs. They may, however, allow executives to purchase restricted stock.

4. What other forms of long-term

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incentives (including cash plans) can be offered?

In lieu of granting NQSOs, companies sometimes grant SARs. SARs provide the same economic benefits of an NQSO but do not require a participant to tender the exercise price.

So-called "phantom" share plans are popular with private companies where the owners do not wish to give employees voting rights or access to books and records. In such cases, employees will obtain the economic benefits of any share appreciation as if they were owners of common (ordinary) shares, but the awards will be settled in cash.

Private equity-backed portfolio companies (often organized as LLCs) usually award profits interests.

Private companies may also provide cash retention bonuses payable upon a sale or other exit event.

5. Are there any limits on who can participate in an incentive plan and the extent to which they can participate?

Generally, US incentive plans may be extended to employees, consultants, independent contractors and directors (executive and non-executive directors) but not to those engaged primarily in capital-raising activities on behalf of the company. Recently, the US Securities and Exchange Commission ("SEC") has proposed rules that would temporarily permit (for the purpose of evaluation) "platform" or "gig" workers to be granted equity under certain conditions even though they are not employees or consultants.

ISOs and ESPPs, however, may only be offered to employees of entities that are taxed as corporations.

ESPPs must adhere to certain non-discrimination rules. ESPPs must allow all employees of a participating employer to subscribe for shares except that there may be excluded (i) employees who have been employed less than 2 years, (ii) employees whose customary employment is 20 hours or less per week, (iii) employees whose customary employment is not for more than 5 months in any calendar year, and (iv) highly-compensated employees (those earning USD130,000 or more in 2021).

6. Can awards be made subject to performance criteria, vesting schedules and forfeiture?

US equity awards are universally subject to vesting schedules and forfeiture provisions, and often to performance criteria. (When reference is made in this chapter to "vesting," it is understood that the term refers to the lapsing of a "substantial risk of forfeiture" under US tax laws meaning that the participant no longer is required to perform substantial services to retain the right to the award and that any performance condition has been satisfied.)

The equity incentive plans of US public companies allow for the grant a mix of award types (e.g., stock options, restricted stock and RSUs) but awards for senior executives are heavily weighted toward PSUs. PSUs vest over time, but performance thresholds such as those based upon relative total shareholder return ("TSR") and/or financial metrics (such as return on invested capital or earnings) must also be reached for a pay-out to be made. Most US public companies rely on two or more performance metrics and assess them over a three-year performance period. Awards are usually made annually. TSR vesting is usually based upon relative performance with respect to a peer group of companies.

Vesting of awards at private companies is usually time-based, but some private companies require an exit event such as a sale or initial public offering for an equity award to vest. Private equity-backed companies typically require an exit event for participant liquidity with a substantial portion of equity subject to the attainment of pre-established multiple of invested capital ("MOIC") and/or internal rate return ("IRR") thresholds for vesting.

Share rights and shares are typically subject to forfeiture in the US upon termination of employment prior to satisfaction of time-based or performance-based vesting conditions. A participant's rights to shares that do not vest because a time-based or performance-based condition is not satisfied will lapse.

In addition, awards are often subject to forfeiture for violation of restrictive covenants or if the participant's employment is terminated by the employer for certain bad acts or omissions referred as a "for cause" termination. Forfeiture provisions are governed by state law and the provisions of the plan, grant agreements as well as employment agreements and separate non-disclosure/non-compete agreements.

7. Can awards be made subject to post-vesting and/or post-employment holding periods. If so, how prevalent are these

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provisions both generally and by reference to specific sectors?

It is possible to delay the delivery of vested shares that are subject to an equity award. The main concern in doing so is whether the deferred delivery postpones the timing of taxation to the date of receipt of the shares.

Care must be used in the design of the award to avoid premature taxation under Section 409A of the US tax code and under constrictive receipt principles that are part of US tax law. Generally speaking, it should be possible to structure the award as an RSU or PSU that is subject to (a) time-based and/or performance-based forfeiture conditions, and (b) a contractual stipulation that the shares will not be delivered until a stated anniversary of the date of grant. For example, an award could have a three-year vesting schedule measured from the grant date with any earned shares delivered five years after the date of grant.

Additional care must be taken should a company desire to defer delivery of the shares until termination of employment or beyond. In some instances, the systematic deferral of compensation to termination of employment or beyond could be viewed as a "deferred compensation plan" that could unwittingly become subject to a US pension law known as "ERISA" that is designed to regulate employer sponsored retirement plans. There are techniques to avoid the application of most aspects of ERISA which are beyond the scope of this chapter.

Rather than imposing post-vesting and/or post-employment holding periods, most US public companies require executives to hold a stated percentage of vested awards (e.g., 50% of the net after-tax award) or a multiple of their base salary (generally 5x or 6x) in company stock at all times.

According to a 2016 industry survey by the National Association of Stock Plan Professionals, only 18% of US public companies at that time imposed a post-vesting holding period on all shares. That said, the percentage of US public companies adopting mandatory holding periods after vesting is growing as it can help executives achieve their stock ownership guidelines, facilitate clawbacks, improve corporate governance ratings from proxy advisory firms, and reduce the financial accounting expenses of equity awards. Of course, there is a trade-off in that mandatory holding periods can hurt employee acquisition and retention if the terms are too onerous.

Rarely are post-vesting holding periods imposed on employees below the C-suite or direct reports to the chief executive officer.

Anecdotally, post-vesting holding periods seem to be confined to mostly large cap US public companies especially in energy, banking and retail.

8. How prevalent malus and clawback provisions are and both generally and by reference to specific sectors?

Malus and clawback provisions are common in the US but for unknown reasons they are collectively referred to by the single term "clawback."

In 2015, the SEC promulgated proposed rules to implement a requirement under the Dodd-Frank Act (expanding limited existing clawback rules under the Sarbanes-Oxley Act of 2002) that US public companies be required to adopt and disclose clawback policies to recover from all executive officers excess incentive-based compensation earned during the three fiscal years preceding the date on which the company is required to prepare a financial restatement to correct a material error. The proposed clawback rules have not been finalized as of January 2021 but considering various corporate scandals and pressure from institutional investors US public companies have overwhelmingly moved to adopt broader clawback policies than is required under Sarbanes-Oxley.

Typically, clawback policies are triggered by misconduct leading to a financial restatement or a financial restatement without cause, but also often for ethical misconduct without a financial restatement and sometimes for the violation of non-compete agreements, creating unacceptable reputational risk or failing to supervise others.

Clawback policies cover current executive officers but also sometimes extend to former executive officers.

In most instances, the application of a clawback policy is discretionary with the board of directors but that could change if the final Dodd-Frank regulations are implemented.

Increasingly, companies are relying upon forfeiture of existing unvested awards (rather than recoupment of paid awards) as a starting point because the potential adverse tax consequences to executives and restrictions imposed at the state-level on off-setting wage payments make applying a clawback to previously settled awards rather complex.

Except perhaps for the financial services firms, the usage of clawback policies does not seem to vary much

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by industry.

9. What are the tax and social security consequences for participants in an incentive plan?

i) on grant;

No income or social security consequences at grant.

ii) on vesting;

No income tax consequences upon vesting for stock options (NQSOs and ISOs) or SARs, as long as the award was granted with a fair market value exercise price. Nil-cost or discounted stock options are not taxed at vesting if the options are only exercisable until March 15th of the calendar year following the calendar year in which the option (or tranche) first becomes exercisable, or if later the 15th day of the third calendar month following the fiscal year of the employer in which the option (or tranche) first becomes exercisable.

RSUs are not subject to income taxation at vesting but are subject to Social Security and Medicare taxes upon vesting.

A participant owes the employee portion of Social Security taxes upon RSU vesting at the rate of 6.2% (2021) until the participant has Social Security wages (e.g., salary, bonus, equity compensation) for the calendar year of USD142,800 (2021).

Medicare taxes are owed by employees upon RSU vesting at the base rate of 1.45% of Medicare wages (2021) with no limit or cap. Higher-income participants (those earning more than USD200,000 (2020) that are single taxpayers or USD250,000 (2021) that are married taxpayers filing joint tax returns) pay an additional 0.9%.

Restricted stock issued by a corporation is subject to ordinary income taxes (the maximum US federal income tax rate is 37% in 2020), Social Security taxes and Medicare taxes at vesting unless a so-called “Section 83(b) election” was timely made by the participant by filing a statement including IRS-prescribed information with the IRS and the employer within 30 days of grant and including any “bargain element” in income for that year. If a Section 83(b) election is not made, applicable taxes are calculated by reference to the fair market value of the shares as determined on the vesting date.

Profits interests granted in LLCs are taxed at vesting in a manner similar to restricted stock of a corporation unless a Section 83(b) election is timely made or the requirements of an IRS revenue procedure relating to the taxation of profits interests are satisfied.

ESPP awards are not taxed until the acquired shares are sold.

iii) on exercise;

NQSOs are taxed upon exercise. A participant has ordinary income (taxed in the same manner as wages) upon exercise in an amount equal to the “option spread” (i.e. the aggregate fair market value of the option shares at date of exercise over the aggregate fair market value of the option shares at date of grant). The participant also owes Social Security and Medicare taxes on the option spread at exercise.

SARs are taxed upon exercise in the same manner as NQSOs.

ISOs are not taxed upon exercise nor are ESPP awards.

iv) on the acquisition, holding and/or disposal of any underlying shares of securities; and

RSUs are subject to income taxation upon payment or settlement. In a 2020 clarification the IRS stated that the amount included in income is equal to the fair market value of the shares determined as of the date that the company initiates payment, not the date that the shares are actually deposited in the participant’s brokerage account.

With respect to any type of award, the resulting shares that are sold or transferred are subject to taxation upon their disposition. The amount taxed is the “gain” on the shares (i.e. the excess of the fair market value at disposition over the sum of the amount paid for the shares, if any, and the amount of income previously recognized upon vesting or exercise of the award, as the case may be).

The gain is a long-term capital gain if the shares are held for more than 12 months. If the shares are held for a shorter period, the gain is a short-term capital gain. Long-term capital gains are subject to federal income taxes of up to 20% (2021). Short-term capital gains are taxed at rates equal to ordinary income tax rates.

In addition, upon disposition of the shares a participant who has “adjusted gross income” of USD200,000 (2021) (USD250,000 (2021) for married couples filing joint tax returns) owes a 3.8% “net investment income” tax on any capital gains.

ISOs and ESPPs are taxed differently.

An ISO is taxed upon disposition of the shares. If shares are held at least two years from grant and one year from

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exercise (a "qualifying disposition"), all appreciation is taxed at long-term capital gains rates. A premature disposition (known as a "disqualifying disposition") causes the option to be taxed in the same manner as a NQSO in the year of sale of the ISO shares, except that no Social Security or Medicare taxes are due.

An ESPP also requires the participant to recognize income in the year of disposition of the purchased shares.

If the disposition of ESPP shares occurs more than two years after the start of the offering period in which the shares were purchased and more than one year after the actual purchase date, then the participant recognizes ordinary income in the year of the qualifying disposition equal to the lesser of (i) the fair market value of the shares at the time of sale less the purchase price, and (ii) the fair market value of the shares as of the beginning of the offering period less the purchase price. Any difference between the sales proceeds and the participant's "basis" (purchase price plus amount of ordinary income recognized) is treated as a long-term capital gain.

If the participant fails to satisfy the ESPP holding periods and makes a disqualifying disposition, the participant has ordinary income equal to the fair market value of the shares at purchase less the purchase price. The participant has capital gains (long or short, depending on whether the shares were held for more than 12 months) equal to the sales proceeds less the fair market value of the shares on the purchase date.

Neither ESPPs nor ISOs are subject to taxation for Social Security or Medicare purposes.

It should also be noted that officers, certain shareholders and highly-compensated individuals may be subject (there are common exceptions) to an additional 20% tax upon a change of control or sale of substantially all of the assets of a corporation under Sections 280G and 4999 of the US tax code if the present value of certain accelerated payments or certain payments contingent upon the transaction equal or exceed 3 times the average compensation paid to such person during the previously-completed 5 calendar years (the so-called "golden parachute" tax).

v) in connection with any loans offered to participants (either by the company operating the incentive plan, the employer of the participant (if different) or a third party) as part of the incentive plan.

Loans to purchase company stock are rare at public companies. In fact, public company executive officers are prohibited by law from borrowing money from the issuer.

It is not uncommon, however, for private corporations to lend money to executives to purchase stock when valuations are relatively low such as when the company is in its start-up phase.

To avoid recharacterization of a loan to purchase stock as a stock

option (under which all gain on sale would be ordinary income) and to avoid characterization that the loan is compensation, loans are structured (i) with substantial personal recourse to the participant, (ii) with payment of interest at applicable federal rates that vary with the duration of the loan ("AFR") (which are generally less than commercial rates) unless the loan is for no more than USD10,000 in which case it may be interest-free, and (iii) without a promise by employer to pay a bonus equal to the loan amount or to forgive the indebtedness.

If funds are lent to purchase shares, the participant usually will make a Section 83(b) election which reflects no income being recognized at that time because the amount paid with the borrowed proceeds equals the fair market value of the shares purchased.

LLCs generally avoid lending money to participants to purchase equity because equity awards may be granted as profits interests for which the purchase price is nil.

State and local tax consequences, if any, vary and are beyond the scope of this Guide.

10. What are the tax and social security consequences for companies operating an incentive plan?

i) on grant;

No consequences at grant.

ii) on vesting;

Upon vesting of restricted stock or a profits interest in cases where a Section 83(b) election has not been timely made, the employer is generally entitled to an income tax deduction equal to the amount of income recognized by the employee.

RSUs and (unless timely Section 83(b) elections have been made) restricted stock and profits interest awards are subject to taxation at vesting for Social Security and Medicare purposes. Employers owe the employer portion of such taxes which are equal to the amount of Social Security and Medicare taxes paid by employees

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(described above), except that employers do not owe the additional 0.9% Medicare tax payable by higher-income employees.

iii) on exercise;

Upon exercise of an NQSO or SAR, an employer is generally entitled to an income tax deduction equal to the amount of income recognized by the employee.

Employers owe the employer portion of Social Security and Medicare taxes (save for the additional 0.9% Medicare tax) when the participant exercises a NQSO or a SAR.

Neither ESPPs nor ISOs are subject to taxation for Social Security or Medicare purposes.

iv) on the acquisition, holding and/or disposal of any underlying shares of securities;

No taxes are assessed against the employer upon acquisition, holding or disposal of the shares by the participant.

v) in connection with any loans offered to participants (either by the company operating the incentive plan, the employer of the participant (if different) or a third party) as part of the incentive plan.

The issuance of bona fide loans does not give rise to income tax consequences for the employer.

11. What are the reporting/notification/filing requirements applicable to an incentive plan?

Except for compliance with securities laws of certain US states discussed below, it is not necessary to file the plan with a government regulator or to seek permission from the government to use the plan in the US unless request is made by an authority for a copy of the plan.

It is, however, necessary for a US employer to report income related to plan awards to the IRS, the Social Security Administration ("SSA") and any applicable state and/or local tax authorities. The resulting income must be reported to participants on a Form W-2 shortly after the close of year in which the income-producing event occurs.

Employers are required to furnish an informational report, Form 3921, Exercise of Incentive Stock Option, to participants to whom stock was transferred in the previous calendar year pursuant to the exercise of an ISO. Similarly, employers are required to furnish Form 3922, Transfer of Stock Acquired Through an Employee Stock Purchase Plan, when shares are transferred pursuant to an ESPP. Copies of each form are also sent to the IRS.

Employers have significant tax withholding obligations for equity incentive awards. Whenever a federal tax arises upon vesting, exercise or settlement of an equity award, the US employer must remit the employee's and employer's portions of federal income, Social Security and Medicare taxes to the IRS and SSA, generally within 1 business day of the tax event. Form 841 must be filed quarterly to report the amounts withheld.

12. Do participants in incentive plans have a right to compensation for loss of their awards when their employment terminates? Does the reason for the termination matter?

In the US, employees are usually employed "at will" meaning that either the employer or the employee may terminate the employment relationship at any time without prior notice for any reason or for no reason at all. Absent a contractual provision to the contrary (such as in an employment agreement, plan rules or a grant agreement), any shares that are then unvested will lapse and be forfeited.

Contracts between the employer and the participant may, however, specify that if the termination is by the employer "without cause" or by the employee for "good reason," then the participant may be entitled to all or a portion of an otherwise unvested equity award.

Regardless of contractual provisions, it is not uncommon for participants to assert that they were terminated by the company, or constructively discharged, for reasons prohibited by law such as discrimination due to age, gender, race, sexual orientation, whistle blower status and the like, and therefore unlawfully deprived of continued vesting of equity and the grant of future awards.

Because the US does not maintain a "loser pays" approach to attorney's fees, employment litigation thrives.

Many US employers confront this situation by obtaining a release of all employment and compensation claims in exchange for the payment of cash severance benefits.

13. Do any data protection requirements

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apply to the operation of an incentive plan?

There are no specific data protection issues which currently restrict the operation of incentive plans beyond general US and state privacy data transmission laws. That said, the State of California has recently adopted the California Consumer Privacy Act of 2018 which bears some resemblance to GDPR. It is recommended that the employee explicitly accept that his personal information can be used in accordance with the plan, and that any data transferred not include an employee's Social Security number. Further, as a best practice, it would be advisable to follow the EU data privacy rules for US participants.

Vendor contracts for plan administration should be reviewed to assess the standard of care and remedies for breach of level of service including data protection.

14. Are there any corporate governance guidelines that apply to the operation of incentive plans?

If an issuer is organized under the laws of a US state (such as Delaware), the company must operate its plan in compliance with that state's corporation laws.

Each state varies, but one of the important governance points is whether shareholder approval of the plan is required (it is always required for public companies, ISOs, ESPPs and often for plans seeking exceptions from registration in California).

State law may also regulate whether and under which circumstances the company's executives may be delegated the power to make equity awards to non-executive employees on behalf of the company's compensation committee.

Public companies may only grant equity to executive officers through a properly constituted compensation committee (generally, directors who are "independent" for stock exchange purposes and who satisfy certain other criteria for purposes of Section 16 of the Securities Exchange Act of 1934 ("'34 Act")).

In light of stock option "backdating" and other US corporate governance failures, US public companies typically only grant equity at certain regular, pre-established dates throughout the year, avoiding times just before and after earnings releases and outside of periods when material non-public information could affect the grant price.

15. Are there any prospectus or securities law requirements that apply to the operation of incentive plans?

US federal and state securities laws are complex, including for US private companies and public companies whose shares do not trade on a US stock exchange.

A company whose shares trade on a US Stock exchange customarily will register its plan shares for use under the '33 Act on SEC Form S-8 and deliver a prospectus (the terms of which are prescribed by the SEC) to plan participants that describes the main features of the plan and incorporates by reference other previously-filed SEC materials. The result is that employees need only be given a summary of the plan's provisions, a description of the tax consequences of plan participation, a copy of the most recent annual report and a copy of the plan. No state filings are necessary when an S-8 is filed. In late 2020 the SEC proposed relaxing certain rules relating to Form S-8 such as clarifying the ability to add multiple plans to a single Form S-8, expanding the eligibility for former employees and extending eligibility to certain entities owned by consultants.

Companies whose shares are listed on a US stock exchange are subject to burdensome disclosure obligations. For example, equity awards made to Section 16 officers must be promptly disclosed via SEC Form 4 filings. If the terms of those awards differ significantly from previously disclosed forms of grant agreements the company must make that information public shortly after grant on a Form 8-K. In addition to extensive tables and narratives regarding the compensation of "named executive officers," public companies must include in their shareholder proxy statements information for a non-binding shareholder say-on-pay vote, a description of payments that would be made upon termination of employment or a

change of control, and a disclosure of the ratio of the CEO's pay to that of the median-paid employee of the company.

Other federal securities laws regulate executive and employee behaviour. Employees and others are prohibited by federal securities laws from trading shares of a public company on the basis of material non-public information. Senior executives must sell their shares in accordance with SEC Rule 144 which requires a Form 144 to be filed with the SEC, the executive to satisfy a holding period for the shares, and for certain sales volume limitations to be observed.

A private company's path to securities law compliance is also difficult. Private companies, and foreign issuers who

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shares do not trade on a US stock exchange, must be concerned with becoming subject to the '34 Act (which essentially requires the registration of companies) and the Securities Act of 1933 (the " '33 Act") (which requires the registration of securities), in each case unless there is an applicable registration exemption.

Offering equity to US participants should not standing alone require a private or non-US traded company to register under the '34 Act. The test for one of the available exemptions for '34 Act registration does not count persons who receive securities pursuant to an employee compensation plan in a transaction exempt from the registration requirements of the '33 Act against the '34 Act's 2,000 person limit on shareholders of record.

Avoidance of registration under the '33 Act and state "blue sky" laws registration requires more effort.

The most significant '33 Act registration exemption is Federal Rule 701. Subject to certain limitations, Rule 701 exempts from registration securities issued pursuant to a written compensatory benefit plan or written contract by a company that is otherwise not subject to the '34 Act. Rule 701 is available where the aggregate sales price or amount of securities sold under the plan in reliance on Rule 701 (with options treated as a sale upon grant) during any consecutive 12-month period does not exceed the greatest of (i) USD1,000,000, (ii) 15% of the group's total assets, or (iii) 15% of the outstanding securities of the class being sold.

If the amount of securities sold by an issuer in the US under employee incentive plans in reliance on Rule 701 exceeds USD10,000,000 during a 12-month period, additional requirements apply (including a risk disclosure obligation and a financial statement freshness requirement) which can be quite difficult for a company especially one not maintaining its financial statements in accordance with US GAAP.

In late 2020 the SEC proposed a relaxation of several provisions of Rule 701, including the timing of providing the disclosure required to exceed the USD10,000,000 limit, the freshness of the financial statements, the USD1,000,000 floor, the cap related to the group's total assets and the current inability to exempt

grants to consultant-owned entities.

There are other '33 Act (federal) exemptions such as Rule 506 of Regulation D for senior executives that are "accredited investors" and the "no-sale" doctrine that may be available in certain situations.

In addition to compliance with the above federal securities laws, companies must also satisfy the securities laws of the states in which its participants are resident.

Each state has its own requirements and exemptions. Many simply require compliance with federal Rule 701 or a similar uniform exemption. Some (notably California and New York) require much more, including advance notice requirements, affidavits, consents to service of process and substantive plan provisions changes.

16. Do any specialist regulatory regimes apply to incentive plans?

Companies in the financial services industry must be mindful of reproposed regulations issued under Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank") which would (i) prohibit incentive plans that regulators deem to encourage inappropriate risk-taking by certain large financial institutions by providing excessive compensation or that could lead to material financial loss, and (ii) require those financial institutions to disclose information concerning incentive compensation plans to regulators.

17. Are there any exchange control restrictions that affect the operation of incentive plans?

There are no exchange control issues in the US. That said, the maintenance of financial interests and/or financial accounts outside of the US to hold securities such as bank or brokerage accounts or (potentially) the use of offshore employee benefits trusts ("EBTs") can give rise to annual reporting by individual plan participants. For example, depending upon specific facts and circumstances, a US employee may need to file a Report of Foreign Banks and Financial Accounts (FBAR), FinCEN Form 114, if the employee holds more than USD10,000 of a non-US company's shares in an account, and/or a Statement of Specified Foreign Financial Assets, Form 8938 pursuant to the Foreign Account Tax Compliance Act, if the employee has interests in foreign assets exceeding USD50,000 on the last day of the tax year or USD75,000 at any time during the calendar year (thresholds amount are doubled for married individuals filing jointly). A full analysis of this topic is beyond the scope of this Guide.

18. What is the formal process for granting awards under an incentive plan?

Corporations whose shares are publically-traded on a US

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stock exchange must grant equity awards to executives through a formal compensation committee. The members of the committee must consist of two or more outside (non-executive)

members of the board of directors who qualify as "non-employee directors" under Section 16 of the '34 Act. As such, compensatory transactions between the company and its Section 16 officers will qualify for an exception from "short-swing" profits recovery.

Generally, a non-employee director is a director who (i) is not currently an officer or employee of the issuer or a parent or subsidiary, (ii) does not receive compensation, directly or indirectly, from the issuer in excess of USD120,000 from a group member for services rendered as a consultant or in any other capacity other than as a director, and (iii) does not possess an interest in any other transaction for which "related person" disclosure would be required under the US proxy statement rules.

The grant of an award must also follow any requirements set forth under the laws of the state in which the corporate is organized and, if applicable, the corporation's articles of association, by-laws, the terms of the compensation committee's charter and the plan documents.

Awards made to employees other than Section 16 officers may, if permitted by state corporation law, be made by the chief executive officer, president, and/or other duly authorized persons under authority granted to such persons by the compensation committee. The grant of authority usually must place limits on the size of the pool of awards, the size of any one award and the vesting conditions.

Awards of private companies are usually made by the company's board of directors.

19. Can an overseas corporation operate an incentive plan?

An overseas corporation may operate an incentive plan in the US subject to adjustments in documentation and operation necessary to comply with US tax laws (including Section 409A of the US tax code), federal and state securities laws and, (in the case of ISOs, ESPPs and awards to California participants) obtaining shareholder approval of the plan.

Section 409A has no impact upon stock options granted with option exercise prices at least equal to fair market value as of the date of grant. The fair market value needs to be established by trading prices, or if none, an independent appraisal or another recognized method of establishing fair market value. Note that US "fair market value" is not necessarily the same as "market value" in other jurisdictions. Modifications of NQSOs originally issued at fair market value can result in adverse tax consequences to participants under 409A.

Nil-cost options or those granted at a discount are regulated by Section 409A. Such options must be exercisable, if at all, only until March 15 of the calendar year following the calendar year in which such option is first exercisable, or if later, until the 15th day of the third calendar month following the fiscal year of the US employer in which such options first became exercisable. Failure to meet this requirement subjects the US participant to taxation in the year the option vests (rather than

ordinarily when it is exercised), and to further taxation for subsequent appreciation in subsequent years until it is exercised.

RSUs and PSUs must also be compliant with Section 409A by either providing in the award for settlement within the applicable 2.5 month period described above for NQSOs, or by linking settlement to one or more of several permissible payment events such as a fixed date or separation from service. Due to Section 409A, "translating" foreign plan good leaver provisions is often difficult.

If an award does not comply with Section 409A at grant the participant is also subject to a 20% penalty tax and potentially other tax penalties and interest although there may be ways to correct awards prior to the calendar year in which a non-compliant award vests.

ISOs, ESPPs and restricted stock awards are not subject to Section 409A.

Although beyond the scope of this Guide, the use of an EBT can give rise to unintended adverse tax consequences for both US participants and US subsidiaries.

20. Can an overseas employee participate in an incentive plan?

There are no prohibitions on extending US incentive plans to overseas employees, but there are limitations and restrictions that must be observed.

The terms of the US plan must provide that it can be extended to overseas employees. Typically, those employees will be employed by a separate entity. With some plan designs it may be necessary for the US board of directors to authorize the extension of the plan to

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those foreign subsidiaries. Many US plans authorize the creation of "sub-plans" to facilitate overseas awards and allow the main plan rules to be varied to comply with local laws.

Obviously, US companies must comply with the securities and prospectus laws, tax laws, data protection laws, currency exchange requirements and labor/employment laws of foreign countries.

21. How are share options or awards held by an internationally mobile employee taxed?

Employees relocating to the US may be taxed in full or in part on options or other awards previously made, as well as on options or awards made while present in the US.

Should a mobile employee acquire lawful permanent resident status in the US (a "green card"), he or she will be taxed by the US on his or her worldwide income just as would be the case for a US citizen. Thus, NQSOs and SARs are taxed at exercise, RSUs and PSUs are taxed at settlement and restricted stock is taxed at vesting (unless a timely Section 83(b) election had previously been made).

Mobile employees who are "substantially present" in the US may be subject to US taxation on world-wide income as well. An individual will meet the substantial present test if the person is physically present in the US on at least:

- 31 days during the year in question (e.g., 2021) and
- 183 days during the 3-year period that includes the year in question (e.g., 2021) and the two years immediately before that (e.g., 2019 and 2020), counting:
  - all the days present in the US in the year in question (e.g., 2021),
  - 1/3rd of the days present in the first year before the year in question (e.g., 2020), and
  - 1/6th of the days present in the second year before the year in question (e.g., 2019).

There are special rules to establish when a person's residence begins and ends for someone subject to the substantial presence test.

There are potential work-arounds for the substantial presence test, but they generally require formally notifying the IRS of the individual's tax filing position and they may be difficult to meet if the person has other contacts with the US (such as keeping an apartment in the US). These work-arounds are sometimes available under US tax treaties or they can be based upon a non-treaty exemption for someone who is present in the US for less than 183 days in the calendar year in question.

Care must be exercised when a non-US person holding unvested restricted shares or nil-cost options is about to enter the US for an extended period as they could be exposed to unexpected taxation.

22. How are cash-based incentives held by an internationally mobile employee taxed?

Cash based incentives are generally taxed under the rules described above for equity awards granted to internationally mobile employees. The point of taxation will be when the individual receives the cash payment or sooner if they are in "constructive receipt" of the payment (i.e. the funds are made available to the participant to draw upon).

Also note that the US has tax laws (including Section 409A) that regulate the ability of a participant to defer receipt of cash payments. Generally, any election by an employee must be made no later than December 31 of the calendar year preceding the year in which the relevant services are performed. Employers are generally prohibited from causing cash compensation to be paid later than March 15 of the calendar year following the year in which the services are performed unless the *arrangement complies with or is exempt from Section 409A of the Code.*

US state wage payment laws may need to be reviewed to confirm that cash payments may be deferred.

23. What trends in incentive plan design have you observed over the last 12 months?

The COVID-19 pandemic caused some companies to initially reduce base salaries of officers in the Spring of 2020 with a restoration of base salaries generally occurring by September 2020. Companies also struggled in many instances with their annual cash incentive and their long-term incentive plan designs. Previously established performance metrics were sometimes adjusted downwards where compensation committees had the discretion to do so. Such adjustments were mainly limited to annual incentive plans. When considering any change most companies were thoughtful in their approach taking into account the perception of employees as well as that of shareholders and their proxy advisors. Most companies deferred any

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adjustment to long-term incentives during 2020. A robust stock market made any adjustment of LTIPs unnecessary for most industries other than hospitality and some retail.

Public and private companies expanded their clawback policies to provide for forfeiture of existing awards and recovery of previously settled awards in cases of "bad behaviour" by executives, particularly sexual harassment/misconduct, and failure to follow the Board's instructions.

Excessive public company director pay remains under strict scrutiny by the courts, institutional investors and the media. Many US companies are placing hard caps on total director compensation in their plans (which are developed after consultation with legal counsel and compensation consultants) and obtaining shareholder approval of those limitations.

24. What are the current developments and proposals for reform that will affect the operation of incentive plans over the next 12 months?

Environmental, Social and Governance or "ESG" considerations have begun to take center stage for compensation committee consideration. For example, US public companies are increasingly tying a portion of senior executive pay to the achievement of diversity and inclusion ("D&I") goals and climate change goals.

Climate change metrics (e.g., carbon emissions, water usage, sustainable supply chains) are more easily the subject of objective measurement and therefore more frequently used as a factor for long-term incentive awards.

On the other hand, D&I is presently considered in program design only on a qualitative basis for annual incentives (e.g., 5% to 20% weighting) and by less than 10% of US public companies. It is expected, however, that the percentage of US public companies adopting D&I metrics will increase substantially in 2021.

With the change in the Presidency and the control of Congress some expect top marginal tax rates to be increased in 2021.

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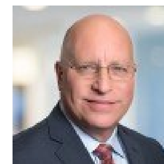

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