NCEO
NATIONAL CENTER FOR
EMPLOYEE OWNERSHIP

CERTIFIED EQUITY PROFESSIONAL INSTITUTE

GPS 2024

GUIDANCE | PROCEDURES | SYSTEMS

Combined 4-in-1 Volume

Employee Stock Purchase Plans, 2022 ed.
Restricted Stock and Restricted Stock Units, 2022 ed.
Performance Awards, 2021 ed.
Global Equity Plans, 2024 ed.

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Performance Awards, 2021 ed.

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Preface

The Certified Equity Professional Institute is part of the Santa Clara University's Silicon Valley Executive Center. The CEPI was founded in 1989 by a group of Santa Clara University alumni involved in the equity compensation field who saw that there was a need to create a professional body of knowledge. Since the institute's founding, thousands of individuals have benefited from the self-study certification program. More than 2,000 people have achieved the Certified Equity Professional designation, and that number continues to grow annually. The CEP designation is a widely recognized professional achievement.

Organizations and individuals use the CEP exams as a measurement of knowledge, skills, and abilities related to equity compensation tax; corporate and securities law; accounting; and equity plan design, analysis, and administration.

The three levels are:

Level 1 (basic): Those who pass this exam become Equity Compensation Associates (ECAs).

Level 2 (intermediate)

Level 3 (advanced): Those who pass this exam become Certified Equity Professionals (CEPs).

Additionally, in 2020 the CEPI introduced the Advanced Equity Compensation Accounting Certificate program, which allows accounting professionals to demonstrate their advanced knowledge of accounting for employee stock plans.

The CEPI's ongoing GPS (guidance, procedures, systems) project has produced a series of books designed to provide impartial guidance for everyone working in the field. This volume combines the four GPS books currently assigned to candidates at all levels; the book on global plans has been newly updated for 2024. Each book here is separately paginated.

This 4-in-1 volume is published by the National Center for Employee Ownership (NCEO), a nonprofit membership and research organization that was founded in 1981. The NCEO is qualified as a Section 501(c)(3) nonprofit charitable organization. Its mission is to provide practical resources and objective, reliable information about employee ownership to businesses, employees, and the public. It is the main publisher in the field, with dozens of titles ranging from issue briefs to lengthy books. The NCEO conducts dozens of webinars yearly and also holds in-person meetings around the U.S., including a large annual conference. It provides training, speaking, and introductory consulting, conducts surveys and other research, and has extensive contacts with the press.

The NCEO has been involved with the CEPI for many years. The NCEO publishes most of the assigned reading for candidates taking all of the CEPI's exams and also runs a test preparation course for candidates taking the CEPI's exams. Additionally, the NCEO's executive director is a member of the CEPI's advisory board (see next page).

CEPI Advisory Board

Ex-Officio

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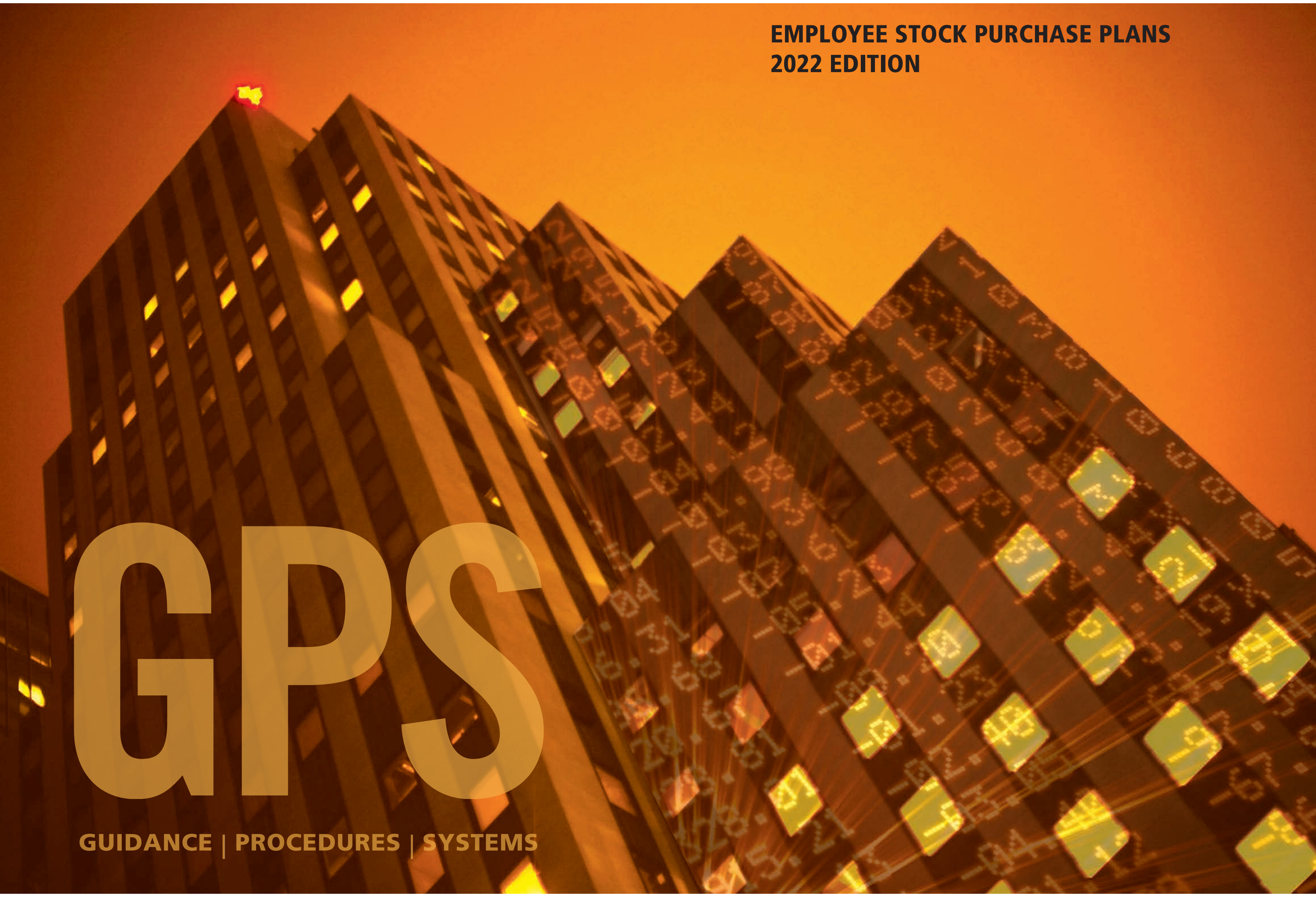
SANTA CLARA UNIVERSITY

ESPP

EMPLOYEE STOCK PURCHASE PLANS
2022 EDITION



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Exhibits

1. Introduction

1.1. Overview.

1.1.1. Employee stock purchase plans (ESPPs) are an important component in a company's total rewards structure. As fewer companies grant stock options, restricted stock, or restricted stock units to all employees, ESPPs provide a way for the company to offer a broad group of employees the opportunity to purchase discounted stock while minimizing the financial statement impact.

1.1.2. An ESPP allows employees to purchase company stock, frequently at a discount from fair market value (FMV). An employee chooses to participate by enrolling in the plan and electing to have a percentage of after-tax compensation deducted from each paycheck during an offering period. During the offering period, the employer holds the funds deducted from each paycheck. The purchase is facilitated by the company and the employee pays no fees at the time of purchase. At the end of the offering period, the funds are used to purchase company shares. The employee can sell the shares or hold them. The specific provisions of ESPPs vary widely. Some companies may provide a discount in the purchase price of the stock at the purchase date or a look-back feature with a discount off the FMV of the stock on the offering date or the purchase date (whichever is lower). Many plans conform to the requirements of IRC §423, which allows the participants' shares to be eligible for preferential individual tax treatment, and are therefore referred to as "qualified plans."

1.2. Scope of Publication.

1.2.1. This publication focuses on the key concepts and challenges associated with employee stock purchase plans offered to US employees by publicly traded companies headquartered in the US. The publication addresses plans that qualify for special tax treatment under IRC Section 423 as well as nonqualified plans. Non-US employees frequently also participate in such plans. This publication highlights various non-US issues, but is not intended to be a comprehensive review of the issues associated with extending ESPPs to a global workforce. Except as otherwise noted, this publication assumes US employees are US taxpayers and non-US employees pay tax in other countries. Many countries also allow beneficial tax treatment for ESPPs that would be tax-qualified under local tax laws. Such qualified plans are outside the scope of this publication.

Each paragraph in this publication is numbered and cross-referenced. This document should be used in its entirety. Readers of one section will need to reference other sections for a comprehensive understanding.

1.2.2. For purposes of this publication the following terminology will be used:

TERMINOLOGY	
ESPP	Qualified and nonqualified employee stock purchase plans
Grant date	Tax term for offering date
Exercise of an option	Tax term for purchase date
Exercise price	Tax term for purchase price
Look-back	Plan design feature in which the purchase price of the shares is based on the lower of FMV at beginning or end of the offering period
Nonqualified plans	Plans that are not qualified under IRC §423
Qualified plans	Plans that meet the criteria outlined in IRC §423; Does not include tax-qualified plans that may be defined under local law in other countries

A more extensive glossary of terms can be found in Appendix B.

1.2.3. ESPPs and associated processes can be varied and complex. This publication is not intended to cover all possible variations. The processes described represent standard practice, but each company's processes may differ to reflect its unique needs and resources. These recommendations should be considered general guidelines and applied as appropriate. Topics covered in this publication should be considered within the particular facts and circumstances applicable to a company. For those reasons, clarifications such as "typically" and "generally" are not always included, but should be assumed. Please consult your own professional advisors with respect to the application of the information in this publication to company-specific circumstances.

1.2.4. Previous publications specifically address issues of stock options, restricted stock/restricted stock units, global stock plans, and performance awards. Much of the guidance in those publications is applicable to ESPPs as well. For copies of those publications and information about future publications, visit www.scu.edu/business/cepi/.

1.2.5. This publication was last updated in late 2021.

1.3. Public Comment.

1.3.1. The CEPI invited individuals and organizations to submit written comments on all matters related to a draft version of this publication. All comments received were reviewed and incorporated as appropriate into this final publication.

2. Strategic Issues

2.1. Overview.

2.1.1. ESPPs are frequently the only form of equity compensation offered to a broad base of employees. To be an effective benefit for the employee and the company, the plan must balance the company's objectives, the employees' benefit, administrative costs and challenges, as well as the financial statement impact. Expectations regarding participation rates plus the company's growth plans should also factor into the decision-making. Simplified plans are generally easier and less costly to administer. Automation will streamline administration, minimize errors, and reduce costs. Although the design of ESPPs may have significant variation, commercially-available software will be of limited use in automating highly-customized plans, and administrative costs will be significantly higher for these plans. This section discusses the considerations when making strategic and tactical decisions.

2.2. Selecting the Appropriate Plan.

2.2.1. An ESPP must be designed to meet the company's objectives. The company may want to increase employee motivation by providing a qualified plan that provides a 15% discount with a look-back feature and a 24-month offering period with interim purchases. Qualified plans are used frequently to increase the tax effectiveness of the employee benefit. The company may encourage employee loyalty by offering a nonqualified plan with matching shares that vest one year after the purchase date of the offering. For companies in which obtaining shareholder approval is challenging, the plan may be designed with no look-back feature to manage share usage and make the plan more acceptable to shareholders. The company may strive to enhance the employees' sense of ownership by increasing personal stock holdings. In this case, the company may design a plan that includes post-purchase restrictions on selling the shares to encourage stock ownership. If the goal is to minimize the financial impact, the plan may offer a 5% discount and no look-back feature. These design features are discussed in more detail in Section 3, Plan Design.

2.2.2. Consider workforce demographics when designing a plan. The ability of new hires to participate in the next offering of the plan may be a critical advantage in attracting new employees. This feature may be important to companies expanding their workforce. A less sophisticated workforce with limited access to technology may be better served with a simplified ESPP as opposed to a plan with complicated features. A quick sale provision may increase participation in a newly designed ESPP. Companies should evaluate the interaction of stock price and average wages. Some low-wage employees may be unable to contribute a sufficient amount during an offering period to purchase a single share at the end of the period. In this case, the plan may include a feature to roll forward contributions representing a partial share to the next offering period. See paragraph 2.3.1 to 2.3.3 for a more complete discussion of the considerations when extending ESPPs to non-US employees.

An ESPP must be designed to meet the company's objectives. Additionally, workforce demographics should be considered when designing a plan. Weigh the employee benefit against the company's financial and administrative costs.

2.2.3. When designing a plan, weigh the employee benefit against the company's financial and administrative costs. In most cases as the plan provides more benefit to the employee, the expense for financial reporting is higher. Exhibit 2-1 illustrates the financial statement impact of the following key design features:

- The length of the offering period
- Look-back or no look-back
- Discount on the purchase of a share of stock

EXHIBIT 2-1: FINANCIAL IMPACT OF PLAN DESIGN FEATURES

Assumptions:

- **$10 stock price**
- **50% volatility**
- **0.25% risk-free interest rate**
- **0% dividend yield**

	6 Months	12 Months	24 Months
No look-back, 5% discount	$0	$0	$0
Look-back, 5% discount	$1.90	$2.47	$3.26
No look-back, 15% discount	$1.49	$1.49	$1.48*
Look-back, 15% discount	$2.90	$3.47	$4.25*

* *Slight variation on 24 months reflects the impact of a greater amount of interest foregone over a longer period.*

A plan with no look-back and a 5% discount is considered noncompensatory (i.e., has no cost) for financial reporting purposes. As expected, the financial cost increases for the other plans with a longer offering period, a look-back feature, or a larger discount. However, the cost of a plan with a look-back, a 5% discount, and a six-month offering period ($1.90) is only slightly higher than cost of a plan with no look-back, a 15% discount, and a 24-month offering period ($1.48). The financial cost of the plan design can be weighed against the employee perception of the benefits of a look-back feature as compared to a 15% discount.

2.2.4. More complex design features like resets (discussed in subsection 11.4.11), rollovers (discussed in subsection 11.4.12), and allowing for increases in contributions (discussed in subsections 11.4.13 to 11.4.15) can increase the total expense associated with an offering. These features are triggered after an offering period has started and the expense is not recorded until the event occurs. Such design features provide potential significant value to employees, but can be costly to administer, difficult for employees to understand, and may significantly increase financial reporting expense and complexity. In many cases employees may prefer a larger discount, which is more readily understood, to more complex design features, even though the financial reporting impact may be comparable.

2.2.5. It is important to consider the impact of certain design features on employee participation. A noncompensatory plan, as discussed in paragraph 11.2.1, may seem attractive from an expense standpoint, but is likely to have low participation rates, as employees may not see much value in this type of plan. At the other end of the spectrum, a plan that contains rollovers and allows for increases in contributions may have high employee participation, but the expense can be unpredictable. A plan with a 15% discount and a look-back offers predictable expense patterns.

2.3. Extending Plans to Non-US Employees.

2.3.1. Many companies extend an ESPP to non-US employees. The non-US employees may have a different perception of the benefits of participating in an ESPP and their participation rate may be lower than that of US employees. Subsection 3.6 discusses the special design features to consider when extending an ESPP to non-US employees. Subsection 3.4.3 discusses the specific benefits of a separate offering to achieve the flexibility needed to meet the regulatory and tax requirements in other jurisdictions. The tax benefits of participating in qualified plans are typically not available for non-US employees. See subsection 8.6 for a discussion of the tax impact to non-US employees. The financial benefits also vary for non-US employees because the risk of holding stock in a US company includes the risk of currency fluctuation (e.g., the rate of conversion from US dollars to local currency will fluctuate) in addition to the risk of stock-price fluctuation.

2.3.2. The administrative costs of extending plans to non-US employees may be significant. The local payroll system may be unable to support payroll deductions for the ESPP (and in some countries deductions may be prohibited). Tracking and plan administration may be decentralized at the local level or centralized. Decentralized administration requires properly training personnel at the local level. Centralized administration may require extensive data transfers to and from the local entity.

2.3.3. In addition a variety of country-specific issues must be addressed, including:

- Securities, labor, insider trading, and exchange control filings and registration requirements
- Tax implications for employees and employers
- Currency conversion procedures
- Currency restrictions
- Requirements that employee contributions be held in a separate account or interest be paid on the contributions
- Prohibitions or limitations on payroll deductions
- Labor law issues, such as approval by works councils, discrimination guidelines, or treatment of the plan as a protected benefit
- Data privacy rules
- Translation requirements
- Acceptability of electronic acceptance and communications

The cost of offering an ESPP to non-US employees should be balanced against the benefit of participation and the likely participation level. An ESPP need not be offered in all jurisdictions and, where appropriate, employees in certain countries may be excluded from participation. See paragraph 3.4.2 for a discussion on designating a parent or subsidiary to participate in the plan.

3. Plan Design

3.1. Overview.

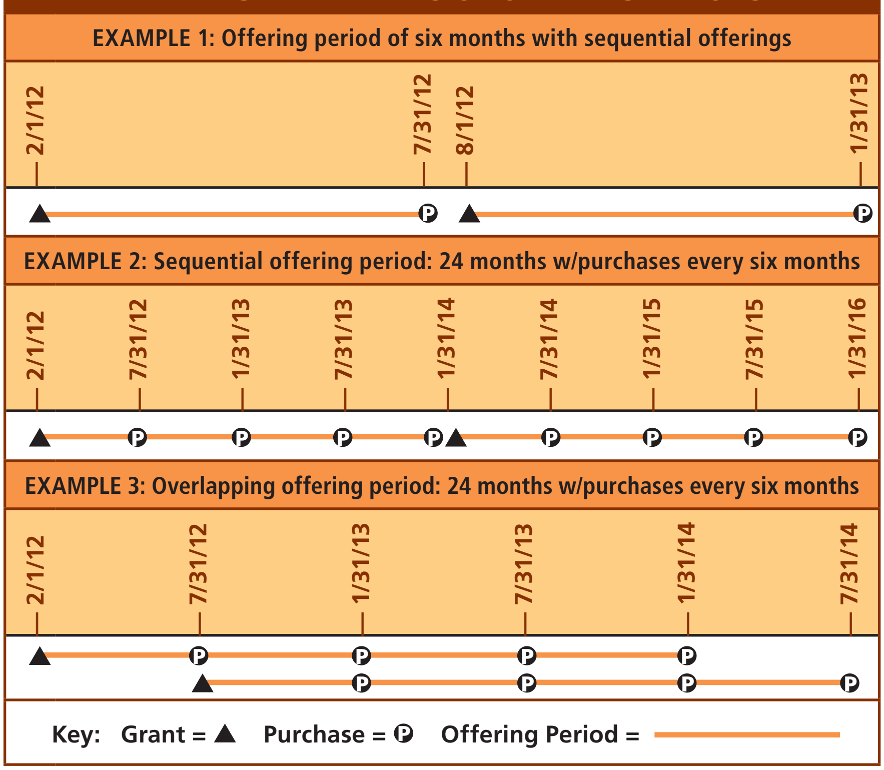
3.1.1. An ESPP is a vehicle for employees to purchase company stock. The design of a specific ESPP may vary depending upon the objectives of the company. For example, a company may design a plan to encourage stock ownership, provide additional benefits to employees, and/or increase retention. The plan should incorporate appropriate features to achieve the company's objectives. The common design features of ESPPs are discussed in subsection 3.2 and examples of these features are shown in Exhibit 3-2 to 3-4. Items that should be addressed in all plans are discussed in subsection 3.3. The financial statement implications of various design features are discussed in Section 11, Financial Reporting.

3.1.2. ESPPs are frequently designed to meet the requirements of IRC §423 to provide tax benefits to US employees. The requirements of qualified plans are discussed in subsection 3.4. The tax benefits of qualified plans are discussed in subsection 8.3. Nonqualified plans, which do not meet the requirements of IRC §423, are discussed in subsection 8.2.

3.2. Design Features.

3.2.1. An ESPP allows employees to contribute funds during an offering period. The offering period is the time over which the employee contributes to the plan. The offering period starts on predetermined dates established by the Plan. The term of the offering period may be short (e.g., one month) or long (e.g., two years). A purchase period is the interval during the offering period when contributions are accumulated for a stock purchase. At the end of the purchase period, stock is automatically purchased on the employee's behalf. The offering period may contain a single purchase period or multiple purchase periods. Offering periods may be sequential or overlapping. See Exhibit 3-1 for examples of offering periods. The most common offering is shown in Example 1.

EXHIBIT 3-1: EXAMPLES OF OFFERING PERIODS



An ESPP is typically a broad-based plan and all employees are eligible to participate. ESPPs can be designed to meet the requirements of IRC §423 to provide tax benefits to US employees, or as nonqualified plans.

3.2.2. An ESPP is typically a broad-based plan and all employees are eligible to participate. Plans may have unique eligibility requirements. For example, a company may require a new hire to wait a prescribed period before participating in the plan or seasonal/part-time employees working less than 10 hours a week may be excluded from participation. Qualified plans must follow specific rules on who may or may not participate. These rules are discussed in paragraph 3.4.4.

3.2.3. The purchase price is the price the employee pays for the stock and usually is at a discount to the current FMV of the stock. A larger discount provides a greater benefit to the employee and typically results in a larger expense for the company. In qualified plans the discount ranges from 0% to 15%, with 15% most commonly used. Nonqualified plans may provide for discounts in excess of 15%. Some nonqualified plans provide for matching shares in lieu of a discount. For example, an employee may purchase five shares; the company would match one share, resulting in six shares to the employee.

3.2.4. The method of determining the FMV may be specified in the Plan (e.g., the price at market close on the previous day or high/low average for the day). If the purchase date falls on a holiday or weekend, the Plan may specify which date should be used (e.g., prior or next trading day). The FMV of shares purchased under an ESPP may be determined differently than the FMV of other equity awards. The purchase price may also be defined in the Plan as the lower of FMV at beginning or end of the offering period. This is commonly referred to as a look-back. A look-back feature provides additional benefits to an employee when the stock appreciates during the offering period. Exhibits 3-2 and 3-3 show examples of a qualified plan with and without a look-back. Exhibit 3-4 shows the impact of a look-back when combined with a longer offering period and multiple purchase dates.

3.2.5. Upon enrollment the employee determines how much to contribute to the plan. Contributions can be in any form, including payroll deductions and lump sum payments. A lump sum payment is a one-time payment made in lieu of deducting contributions from an employee's paycheck. Payroll deductions are most common; but in some non-US jurisdictions, contributions through payroll deductions may be prohibited by local law. The method used to collect employee contributions has no impact on financial reporting. Except as otherwise noted, this publication will assume contributions are made through payroll deductions. The contribution rate is usually a percentage of income. Contributions are made on an after-tax basis. Employee contributions are typically limited for each employee by either a percentage of salary, a number of shares that may be purchased, or a contribution dollar amount. Define the compensation components (such as base, overtime, bonus, and commissions) to which the contribution rate applies. If variable compensation (e.g., overtime, bonuses, and commissions) is eligible compensation for the ESPP, include it in the initial share estimate to stabilize the period expense, rather than adjusting for the impact of variable compensation at the time of purchase.

3.2.6. The Plan may allow employees to withdraw or increase/decrease the contribution rate during the offering period. Providing the right to increase or decrease the contribution rate is at the discretion of the company; there is no requirement to allow changes in the contribution rate for qualified plans. The Plan should specify when and how often an employee may change his or her contribution rate. Usually a withdrawal from the plan is applicable for the current offering period and the employee must re-enroll in the plan in order to participate in the future. In some cases the employee may need to wait an extended period of time to reenroll. The Plan should define when an employee may re-enroll and detail any restrictions on the enrollment. Employee terminations are usually treated as withdrawals from the plan. Changes to the contribution rates require additional administration—the Equity Compensation department must record the change and Payroll must process it. Contribution rate increases trigger modification accounting and will generate additional financial reporting expense. The benefit to the employee of being allowed to change the contribution rate mid-offering should be balanced against the administrative burden and cost. Many companies allow no changes or only one change during an offering period. For administrative convenience, prohibit changes within two weeks prior to the purchase date. Furthermore, consistent application of these features is important to ensure qualified plans continue to meet the equal rights and privileges requirements (discussed in paragraph 3.4.4) and the plan does not become disqualified. See subsections 11.4.13 to 11.4.15 for a discussion of the financial reporting impact of changes to contribution rates.

3.2.7. On the purchase date employee contributions are used to purchase shares of stock at the designated purchase price. The company, at its discretion, may issue whole or fractional shares. Some stock plan record-keeping systems, brokerage firms, or transfer agents do not support fractional shares. Illustration Exhibit 3-2 assumes fractional shares are issued.

3.2.7.1. If only whole shares are issued, the number of shares purchased is rounded down and the excess contribution, representing a fractional share, may be refunded to the employee or recorded as an employee contribution for the next offering period. Refunds of excess contributions are typically processed through payroll.

3.2.7.2. Using fractional shares may maximize the benefit employees receive from the ESPP. In addition fractional shares may simplify administration since excess contributions from rounding to whole shares do not need to be refunded or tracked. Fractional shares are also advantageous if employee contributions are insufficient to purchase a whole share during an offering period. This is most appropriate for non-US employees with a low wage base. On the other hand, employee confusion may arise with fractional shares, some brokerage firms do not support the sale of fractional shares, and additional complications can arise when shares are sold.

3.2.8. Choosing an appropriate offering period and purchase date helps minimize administrative challenges. The purchase date should not fall on days when the stock market is closed, during periods when trading windows are scheduled to be closed, at quarter end, or at year end. Vesting dates for other equity programs, especially restricted stock or units, should be considered when setting the purchase date for the ESPP due to staffing considerations. For example, if the annual restricted stock unit (RSU) grant vests on April 10, the ESPP purchase date should not be April 10. Where possible, the purchase should occur in the middle of a pay cycle to allow sufficient time to gather and reconcile contribution data before the purchase date.

EXHIBIT 3-2: QUALIFIED PLAN WITH NO LOOK-BACK

Plan Provisions:			
Offering period	6 months		
Offering price	85% of fair market value on purchase date		
Contribution	$1,000 total (prorata amount deducted from each paycheck)		
Inclusion of look-back	No		
	Depreciating Stock Price	**Flat Stock Price**	**Appreciating Stock Price**
Assumptions:			
Stock price at beginning of offering period (A)	$10.00	$10.00	$10.00
Stock price at end of offering period (B)	$8.00	$10.00	$12.00
Purchase price (C=85% of B)	$6.80	$8.50	$10.20
Shares purchased (D=1,000 divided by C)	147.0588	117.6471	98.0392
Shares purchased not limited by Plan			
Fractional shares issued			
Value from discounted offering price	$176.47	$176.47	$176.47
Value from look-back	$0.00	$0.00	$0.00
Total value delivered [(B - C) X D]	$176.47	$176.47	$176.47

EXHIBIT 3-3: QUALIFIED PLAN WITH LOOK-BACK

Plan Provisions:			
Offering period	6 months		
Offering price	85% of fair market value on lower of FMV on grant date or purchase date		
Contribution	$1,000 total (prorata amount deducted from each paycheck)		
Inclusion of look-back	Yes		
	Depreciating Stock Price	**Flat Stock Price**	**Appreciating Stock Price**
Assumptions:			
Stock price at beginning of offering period (A)	$10.00	$10.00	$10.00
Stock price at end of offering period (B)	$8.00	$10.00	$12.00
Purchase price (C=85% of lesser of A or B)	$6.80	$8.50	$8.50
Shares purchased (D=1,000 divided by C)	147.0588	117.6471	117.6471
Shares purchased not limited by Plan			
Fractional shares issued			
Value from discounted offering price	$176.47	$176.47	$176.47
Value from look-back	$0.00	$0.00	$235.29
Total value delivered [(B - C) X D]	$176.47	$176.47	$411.76

EXHIBIT 3-4: QUALIFIED PLAN WITH LOOK-BACK AND MULTIPLE PURCHASE DATES	
Plan Provisions:	
Offering period	24 months with purchases every 6 months
Offering price	85% of fair market value on lower of FMV on grant date or purchase date
Contribution	$1,000 total (prorata amount deducted from each paycheck)
Inclusion of look-back	Yes
	Stock Price
Assumptions:	
FMV on February 1, 2012 (A)	$10.00
FMV on July 31, 2012 (B)	$8.00
FMV on January 31, 2013 (C)	$9.00
July 31, 2012 purchase	
FMV on February 1, 2012 (A)	$10.00
FMV on July 31, 2012 (B)	$8.00
Lesser of 85% of lesser of A or B ($8.00 x 85%)	$6.80
January 31, 2013 purchase	
FMV on February 1, 2012 (A)	$10.00
FMV on January 31, 2013 (C)	$9.00
Lesser of 85% of lesser of A or C ($9.00 x 85%)	$7.65

3.3. General Plan Requirements.

3.3.1. As with any equity plan, the formal plan document should incorporate broad language and function as a conceptual framework. Administrative details (e.g., the use of fractional or whole shares) should be subject to management approval and documented outside the plan. The Plan design should be flexible to accommodate the unique needs of non-US employees, even though participation by non-US employees is limited. For example, the Plan should allow the ESPP funds to be held in a separate bank account or interest to be paid on ESPP contributions, as required in certain countries. This approach will allow companies flexibility to meet their changing business requirements without forcing them to secure additional shareholder approvals for administrative changes to the plan.

3.3.2. Any changes to the plan or the administrative details supporting the plan must be communicated internally and externally. Administrative processes and the stock plan record-keeping system may require modification. Changes to the maximum contribution rates may require modification to the payroll system. Vendor interfaces and processes may change. Notify employees of and educate them about changes that will affect them. Consult legal counsel to determine if shareholder approval is required for changes to the formal plan document.

3.3.3. All qualified plans are required to specify the maximum number of shares that may be issued under the plan and the maximum number that may be issued per person and per offering. The maximum number of shares that an employee may purchase can be a specific number of shares or a formula, provided the maximum number of shares per employee can be determined at the offering begin date. The stated maximum that may be purchased by the employee does not have to be realistic. It can be set with the expectation that no employee will reach the limit. Including this limit is critical to establishing a grant date for tax purposes. One technique for controlling share use is for the plan to specify a beginning price limit which limits the number of shares that may be purchased based upon the price at the date of grant. A beginning price limit will control share use when the stock price is volatile and a significant price drop may occur. See Exhibit 3-5 for an example of a beginning price limit. See Exhibit 3-6 for an example of limiting the number of shares purchased.

EXHIBIT 3-5: USING A BEGINNING PRICE LIMIT	
Plan Provisions:	
Offering period	6 months
Offering price	Lower of FMV on grant date or purchase date
Contribution	$10,000 total (prorata amount deducted from each paycheck)
Inclusion of look-back	Yes
Beginning price limit	Yes
Assumptions:	
FMV on grant date	$10.00
FMV on purchase date	$4.00
Maximum shares to be purchased	1,000 shares ($10,000/$10)
Price paid **($6,000 of excess contributions refunded to the employee)**	$4,000 (1,000 x $4)

3.3.4. Predicting the number of shares that will be purchased can be challenging due to changes in contribution rates, compensation increases, purchase price, and number of participants. Safeguards should be put in place to identify when the maximum number of shares will be reached. Develop processes for dealing with insufficient shares. This is extremely important during periods of declining stock price for both qualified and nonqualified plans. The most common method of dealing with share shortfalls is reducing the shares purchased on a prorata basis.

EXHIBIT 3-6: LIMITS ON THE NUMBER OF SHARES PURCHASED PER EMPLOYEE	
Plan Provisions:	
Offering period	6 months
Offering price	85% of fair market value on purchase date
Contribution	$10,000 total (prorata amount deducted from each paycheck)
Inclusion of look-back	No
Maximum purchased shares	1,500 shares per offering period
Assumptions:	
Stock price at beginning of offering period (A)	$10.00
Stock price at end of offering period (B)	$5.00
Purchase price (C=85% of B)	$4.25
Possible shares purchased (D=10,000 divided by C)	2,352.94
Maximum purchased shares (E)	1,500
Shares purchased (lesser of D or E)	1,500
Cost of shares (1,500 x $4.25)	$6,375
Refunded to employee ($10,000 – $6,375)	$3,625

3.3.5. Plans that have multiple purchase periods within a single offering period may contain a reset or a rollover feature that provides for the termination of the offering period on any purchase date when the share price is lower than it was on the first day of the offering period. The current period purchase is completed as usual, and the day after the purchase becomes the first day of a new offering period.

If the plan has a reset feature, the new offering period will end on the same day the original would have ended. If the plan has a rollover feature, all employees will be rolled into a new offering period that is as long as the original would have been had the rollover not been triggered.

In both cases, the subsequent purchase price in plans with look-back features will be calculated based on the new price (typically the FMV the day after the reset is triggered) or the FMV on the purchase date. The financial reporting impact is reflected on a prospective basis. The prevalence of reset and rollover features has diminished due to the adverse accounting treatment.

3.3.6. Plans may restrict when employees can sell shares or transfer after the purchase. While such restrictions are not common, they are most frequently associated with qualified plans to ensure a two-year holding period from date of grant and a one-year holding period from date of purchase to maximize the employee tax benefits. Restricting the disposition of shares is at the discretion of the company and should reflect the company's objectives for the plan. For example, if the company's objective is to encourage share ownership, requiring employees to hold shares for a certain period after purchase achieves that objective. Employees may perceive such restrictions negatively. The inability to sell the shares and access the sales proceeds may reduce employee participation in the plan. This restriction may be particularly difficult for employees enrolled in nonqualified plans and non-US employees since the difference between the FMV at purchase and the purchase price is taxed at the purchase date. The taxable transaction may result in a financial hardship to the employee if the shares cannot be sold immediately to fund the required tax and the required tax is withheld from the employee's paycheck. In addition administering such restrictions can be time consuming and require close coordination with a designated brokerage firm and/or third-party administrator. See Exhibit 3-7 for a summary of the advantages and disadvantage of restricting sale of shares.

EXHIBIT 3-7: ADVANTAGES AND DISADVANTAGES OF RESTRICTING SALE OF SHARES

Advantages	Disadvantages
• Encourages share ownership • Maximizes tax benefits of qualified plans • Reduces administrative burden of tracking dispositions for qualified plans	• Limits employee flexibility to take advantage of market fluctuations in the stock price • May limit participation rates, especially for non-US employees • Taxable transaction for nonqualified plans or non-US employees with no sales proceeds to fund the required tax (i.e., tax may need to be withheld from payroll)

3.3.7. Plans may include a provision that facilitates an immediate sale of shares purchased by an employee. This is commonly referred to as a "quick sale" and is similar to a same-day-sale for the exercise of a stock option. The employee may authorize the sale the shares when he or she enrolls in the plan, during the contribution period, or immediately before the purchase. A broker facilitates the sale of the shares purchased. A quick sale will minimize the employee's impact of the market fluctuation in the stock price and provide the employee with cash. The company may facilitate the quick sale for non-US employees by distributing the sales proceeds, net of any required tax withholding, through local payroll. Allowing quick sales may increase participation in the plan. On the other hand such a provision discourages shares ownership and may be contrary to the objectives of the Plan.

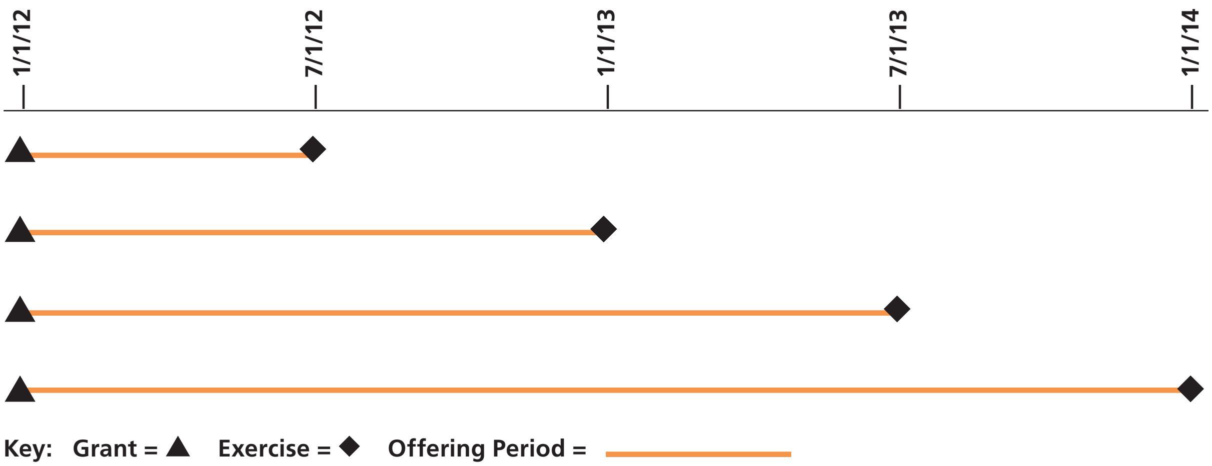
3.4. IRC §423 Requirements.

3.4.1. A plan is qualified and participants in it can receive preferential tax treatment if it meets the requirements of IRC §423. See Section 8, Tax Issues, for a discussion and examples of the tax consequences to employees of purchasing and selling shares in a 423 plan. For tax purposes a 423 plan is considered a statutory stock option plan. The option is "granted" at the beginning of the offering period and "exercised" on the purchase date. See Exhibit 3-8 for a comparison of common terms for stock and tax purposes. This publication will use the terminology of grant and exercise when describing the tax requirements associated with 423 plans.

EXHIBIT 3-8: STOCK VERSUS TAX TERMINOLOGY

Stock Terminology	Tax Terminology
Participant/employee	Optionee
Enroll in the plan	Participate in the plan
Offering date/offering begin date	Grant date
Offering period	Option period
Purchase period	Option period*
Purchase date	Exercise date
Purchase price	Exercise price
Look-back	Option price is the lesser of • 85% of the FMV when the option is granted or • 85% of the FMV when the option is exercised

* For example, for tax purposes a 24-month offering period with purchase periods every six months is considered a series of options - See diagram on next page.



3.4.2. To qualify as a 423 plan, the written plan must specify the maximum number of shares that may be issued under the plan and designate the corporations or class of corporations whose employees may be offered options under the plan.[1] The sponsoring corporation (i.e., the company that grants the option) may designate the corporations that may participate in the plan. Any subsidiary in the corporate group that is at least 50% owned may participate and any branch of a participating company will automatically participate. The designated subsidiaries must also be treated as subsidiaries for US tax purposes and the sponsoring corporation must take into account whether the entity is subject to a "check-the-box" election to be disregarded and/or treated as a subsidiary. The sponsoring corporation can designate a subsidiary formed under US law or non-US law. The rules regarding which entities may participate in a plan are complex and dependent on the company's corporate structure. Where appropriate, Corporate Tax should determine which corporate entities may participate in the plan.

3.4.3. IRC §423 permits separate consecutive or overlapping offerings for each entity or group of entities within the corporate group. The separate offerings can include variations in terms among corporate entities during the same offering/purchase period. This can be particularly useful when dealing with non-US employees. For example, one offering could permit contributions by payroll deductions for one entity and another offering could permit lump sum payments. Each separate offering must meet the requirements regarding employee coverage and equal rights and privileges, which are discussed in paragraph 3.4.4. Separate offerings can be established for each entity or group of entities in the Plan and/or by Board or Compensation Committee resolution. In either case, appropriate language must be included in the Plan to permit separate offerings.

3.4.4. In addition a 423 plan must meet the following requirements:

- **Employees only.**
  Only employees of the sponsoring corporation or its parent or designated subsidiaries can participate in a 423 plan. IRC §423(a) provides a limited exception for employees who terminate within three months before the purchase date. Such terminated employees may continue to participate in the Plan for the remainder of the offering period; however, in practice most plans treat terminated employees as withdrawing from the Plan upon termination.

SEPARATE OFFERINGS

Separate offerings can be used to permit a variation in terms among corporate entities during the same offering/purchase period. Each separate offering must meet the requirements of IRC §423 regarding employee coverage and equal rights and privileges. Separate offerings are frequently used for non-US employees to permit lump sum payments, provide different participation for part-time employees, define country-specific compensation components (e.g., thirteenth-month payments), and avoid risk of administrative failures that would disqualify the entire offering.

- **Shareholder approval.**

  The plan must be approved by the shareholders of the sponsoring corporation within 12 months before or after the date the plan is adopted. Most companies begin the first offering after the shareholders have approved the plan. If shareholder approval has not been received prior to the first offering, the offering should be contingent upon the plan receiving shareholder approval to avoid tax complications.

- **5% owners excluded.**

  No employee can be granted an option under the plan if the employee, immediately after the option grant, would own stock comprising 5% or more of the total voting power or value of all stock of the sponsoring corporation or its parent or subsidiary.

- **Nondiscriminatory.**

  Options must be granted to all employees of any corporation covered by the plan with the exception of:

  - Employees who have been employed less than two years
  - Employees whose customary employment is 20 hours or less per week
  - Employees whose customary employment is not for more than five months in any calendar year
  - Highly compensated employees as defined in IRC §414(q).

  Although corporations may exclude employees who have been employed less than two years, most compnies permit new employees to participate in the plan during the next offering period. In addition employees who are citizens or residents of a non-US jurisdiction may be excluded from the plan if the grant under the plan is prohibited under local law or if compliance with local law would cause the plan to violate the IRC §423 requirements. A separate offering for a specific subsidiary is permitted to accommodate requirements under local law. For example, German and UK employees working less than 20 hours a week could participate in the ESPP as required by the EU part-time employee coverage requirements, provided the specific German and UK subsidiaries employing these individuals are in a separate offering. US employees working less than 20 hours a week would be excluded from participating in the same plan provided they are in a separate offering in which part-timers are excluded.

- **Equal rights and privileges.**

  All employees participating in an ESPP or offering must have the same rights and privileges. This requirement is not violated if the plan specifies that an employee may not contribute more than a maximum percentage of compensation or limits the maximum dollar (or other currency) amount that can be contributed or number of shares that can be purchased. For example, a plan that specifies an employee can contribute up to 8% of compensation would not violate the equal rights and privileges requirement. Less favorable terms may be offered to citizens or residents of a non-US jurisdiction if required under local law without violating this requirement. If non-US employees require more favorable terms under local law, such terms must be offered to all plan participants within the same offering. The carry forward of excess contributions representing a fractional share, discussed in paragraph 3.2.7, does not violate the equal right and privileges requirement. The carry forward of contributions in excess of a fractional share, (i.e., where employee or offering limits have been reached) would be a violation of the equal rights and privileges requirement unless all other employees within the same offering were permitted to make lump sum payments of equal amounts.[2]

- **Option price.**

  Under the terms of the plan, the purchase price must be at least 85% of the stock's FMV on the date of grant or exercise. The FMV of the stock can be determined in any reasonable manner such as the price at market close or the high/low average on the grant date.

- **Option period.**

  If the purchase price is based upon the lesser of the stock's FMV on the date of grant or exercise, the offering period cannot exceed 27 months. If the option price is at least 85% of the stock's FMV on the exercise date, regardless of the FMV on the grant date, the offering period cannot exceed five years.

  The grant date is the first day of the offering period, provided the plan designates the maximum number of shares that may be purchased by each employee during an offering period or a formula for determining the maximum number of shares each participant can purchase during an offering period.

ESTABLISHING THE GRANT DATE

Establishing the grant date as the first day of the offering period is important because the grant date –

- **Serves as one of the dates on which the purchase price may be determined in a plan with a look-back feature**
- **Is the start date for the two-year holding period for qualifying dispositions**
- **Determines the FMV used in calculating the $25,000 limit**

To establish the grant date for tax purposes on the first day of the offering period, the plan must designate the maximum number of shares that may be purchased by each employee during the offering period or give a formula for determining the maximum number of shares each participant can purchase. If these requirements are not met, the grant date is deemed to occur on the purchase date.

Unless otherwise stated, this publication assumes that the grant date is established as the first day of the offering period.

- **Annual limit on stock purchased.**
  IRC §423 limits the purchase of stock under a qualified plan to no more than $25,000 of stock each calendar year based on the FMV determined at the time of grant. See Exhibit 3-9 for an example of how the $25,000 limit is calculated. If an employee has the right to purchase more than $25,000 in a calendar year, none of the purchase qualifies for beneficial tax treatment under IRC §423 and the entire offering may be disqualified. Grants of other equity awards such as nonqualified stock options or restricted stock units are irrelevant when determining the $25,000 limit. The $25,000 limit increases by $25,000 for each calendar year that an option is outstanding.[3] If an offering overlaps one or more calendar years, the unused portion of the $25,000 limit may carry over to subsequent years of the same offering period and an employee may purchase more than $25,000 in a calendar year. See Exhibit 3-10 for an example of the carryover of the $25,000 limit. If an offering period exceeds one year calendar year, the stock purchased will apply against the $25,000 limit for the earliest year of the offering period. The limit for each succeeding year is applied in order.[4] (Note – The Plan may have a lower limit on the number of shares that may be purchased in a calendar year and restrict the carryover of the $25,000 limit.)

EXHIBIT 3-9: $25,000 LIMITATION FOR QUALIFIED PLANS

Assumptions:	
Offering period	January 1 – December 31, 2012
Offering price	85% of FMV on lower of FMV on grant date or purchase date
FMV on grant date	$10.00
FMV on purchase date	$12.00
Purchase price	$ 8.50

An employee could purchase a maximum of 2,500 shares ($25,000 / $10 per share FMV on grant date) on December 31, 2012.

EXHIBIT 3-10: CARRYOVER OF $25,000 LIMIT

Assumptions:	
Offering period	September 1, 2012 – August 31, 2013
Offering price	85% of FMV on lower of FMV on grant date or purchase date
FMV on grant date	$10.00
FMV on purchase date	$12.00
Purchase price	$ 8.50

An employee could purchase a maximum of 5,000 shares ($50,000 / $10 per share FMV on grant date) on August 31, 2013, representing $25,000 relating to 2012 and $25,000 relating to 2013.

- **Not transferable.**

  The plan must specify that the option is not transferable other than by will or the laws of descent and distribution. Only the employee may exercise the option to purchase the shares.

3.4.5. Develop and document appropriate internal controls for verifying the requirements of qualified plans have been met. Document the administrative processes, as discussed in Section 4, General Administration. Identify how the $25,000 limit will be calculated and document the calculation at each purchase.

3.4.6. Adherence to the IRC §423 requirements is determined at the time the option is granted. The grant date is normally the first day of the offering period, provided the terms of the offering are fixed and determinable. To establish the grant date at the beginning of the offering period, the maximum number of shares an employee may purchase must also be specified. For this purpose, the $25,000 limitation discussed above is not sufficient. The maximum number of shares must be a specific number of shares or a formula, provided the maximum number of shares per employee can be determined. If the terms are not fixed and determinable at the beginning of the offering period, the grant date is the purchase date. This treatment can have a profound impact on the employee tax consequences discussed in subsection 8.3.

3.4.7. If the terms of an option are inconsistent with the plan or the offering under the plan, the option will not be treated as granted under a 423 plan. In addition, none of the options granted under the offering will be eligible for the preferential tax treatment.[5] An oversight can taint the beneficial tax treatment of the entire offering. For example, if the definition of compensation in the Plan includes commissions and a commission payment to an employee is overlooked when calculating employee contributions to the Plan, the equal rights and privileges requirement will be violated. All purchases during the offering period will be tainted (i.e., will not be treated as purchases under a qualified plan) and employees will not receive beneficial tax treatment. The employees will be taxed on the FMV on the purchase date minus the purchase price at the time of purchase. One offering period's disqualification will not affect other offering periods that meet the IRC §423 requirements.

3.4.8. If an option with terms that are inconsistent with the terms of the plan or an offering under the plan is granted to an employee who is not entitled to the grant under the terms of the plan or offering, the option will not be treated as having been granted under a 423 plan. However, the grant of the option will not disqualify other options granted under the plan or offering. If, at the time of grant, an option qualifies as an option granted under a 423 plan, but after the time of grant one or more of the requirements is not satisfied with respect to the option, the option will not be treated as granted under a 423 plan. This failure to comply with the terms of the option will not disqualify the other options granted under the plan or offering.[6]

3.5. Nonqualified Plans.

3.5.1. Plans that do not meet the requirements of IRC §423 are nonqualified plans. A nonqualified plan may be similar to a qualified plan, but the design of a nonqualified plan has more latitude since the requirements of IRC §423 need not be met. For purposes of this publication, direct purchase plans (i.e., plans that only facilitate the employee purchase of company stock with no discount or match) are excluded from the discussion of nonqualified plans because these plans are typically noncompensatory, have no tax consequences, and result in no accounting charge.

3.5.2. A nonqualified plan should be structured to meet the specific objectives of the company. The resulting plan may be similar to a 423 plan, but minor differences in plan design can occur. For example, the plan may limit employee participation or provide different benefits for different employee groups. The nondiscrimination requirements and equal rights and privileges features of IRC §423 are irrelevant to nonqualified plans. The plan may provide for extended offering periods or offer a discount of more than 15% from the current FMV of the stock. In lieu of allowing the purchase of shares at a discount, the company may provide matching contributions in stock or cash. The amount of stock that may be purchased under the plan may be unlimited. Standard functionality of recordkeeping systems may not support some of the provisions of nonqualified plans.

3.5.3. Nonqualified plans generate a larger corporate tax benefit than qualified plans because a corporate tax deduction is allowed for the income reported by the employee on the purchase of the stock. The corporate tax deduction associated with qualified plans is limited to income recognized upon disqualified dispositions. No corporate deduction is permitted for qualified dispositions. See subsection 8.5 for a more detailed discussion of the corporate tax ramifications of qualified and nonqualified plans.

MERGERS AND ACQUISITIONS

When a company merges with or acquires another company with an ESPP, the transition process requires special handling. Review a copy of the merger agreement to determine how the ESPP will be treated. Identify the exchange ratio that will be used. Address issues associated with Section 6039 reporting, disposition tracking, and cost basis reporting.

Determine how employees participating in the current offering will be treated. Participation by non-US employees adds complications. Identify new countries where the acquired company has employees and determine whether the ESPP will be offered in these new countries. Address country-specific requirements related to the merger. Develop a detailed project plan to ensure the appropriate issues are addressed, including system transition issues. Keep management up to date on potential issues and problems. Communicate critical details to employees to avoid misunderstandings.

3.6. Issues Related to Non-US Employees.

3.6.1. An ESPP offered to non-US employees may be designed solely as a 423 plan, as a 423 plan with a separate non-423 plan component, or as an omnibus plan accommodating both 423 and non-423 requirements. There are advantages and disadvantages to each of these approaches. When selecting an approach, consider the potential need for a staggered rollout of a global ESPP to allow time to address the complexities and the pre-implementation requirements.

3.6.1.1. A plan designed solely as a 423 plan is easiest to administer, but the company may not be able to offer the plan in all jurisdictions where employees reside. Administration of the plan is easy because there is one share pool to track, one prospectus to prepare, and one plan to manage from a compliance standpoint. If US employees move to work for a foreign subsidiary, they may continue to participate in the 423 plan without a loss of benefits. Separate offerings as discussed in paragraph 3.4.3 in non-US jurisdictions can be used to accommodate local legal requirements; however, there may be situations where the company's foreign structure or local legal requirements cannot easily fit within the confines of a 423 plan. For example, a company may wish to offer the ESPP to employees of an entity that is not a subsidiary or to avoid having to offer the ESPP to employees in a country where compliance is difficult, but be obligated to because the entity flows into a designated subsidiary as a result of a "check-the-box" election. A "check-the-box" election is a corporate tax election that allows the company to treat certain foreign entities as US entities.

3.6.1.2. Another approach is to offer a 423 plan in the US and a non-423 plan outside the US; however, the offering of two plans often means higher administrative costs and may be difficult if the company has mobile employees. If the non-423 plan is a stand-alone plan, then it must receive separate shareholder approval (due to stock exchange rules, rather than 423 plan requirements), and have a separate share pool, and prospectus. The company also must complete any compliance filings or registrations for the 423 plan and the separate non-US plan. An employee who moves to another country and becomes an employee of the local entity leaves one plan and must re-enroll in the other plan. When a US employee moves outside the US to be employed by a non-US employer, the IRC §423 employee tax benefit will be lost. (In contrast, a mobile employee who is temporarily assigned to another country but continues as an employee of the home country entity does not lose the tax benefit.) On the other hand, the company would be free to offer participation in the non-423 plan as it sees fit, regardless of the type of entity or local compliance issues. Another advantage of maintaining separate plans is that there is no need to consider whether any modifications made to the 423 plan trigger compliance issues for employees outside the US.

3.6.1.3. The third possible structure for global ESPPs is an omnibus plan that accommodates both 423 and non-423 components. This approach is permitted under the IRC §423 regulations and avoids some of the difficulties with the other two approaches. The plan may have one share pool (as long as the shares available under the 423 plan are quantified), one prospectus (although the terms of the non-423 plan must be disclosed), and a single set of compliance filings. The company must identify which foreign subsidiaries are in the 423 plan (and whether they are in a separate offering) and which entities are in the non-423 plan. As mobile employees move from one employer to another, they do not need to re-enroll. However, US employees may lose the IRC §423 benefit if they move from the 423 component of the plan to the non-423 offering. If plan changes are made, whether to the non-423 or 423 plan, the company must consider both what approvals must be obtained to accommodate the changes and any compliance implications.

3.6.2. Where an ESPP is offered to employees outside the US either as a 423 plan or the 423 component of an omnibus plan, the IRC §423 regulations permit separate offerings for employees working for a specific subsidiary or group of subsidiaries to accommodate requirements under local law. Administrative errors are more frequent for non-US employees (e.g., excluding eligible employees or defining compensation incorrectly). Because such errors may disqualify an entire offering, consider using separate offerings for non-US employees.

3.6.3. There are specific design features that should be included in the ESPP to ensure compliance with local legal requirements or to allow a company to take advantage of tax benefits outside the US. These features may form the basis of a separate offering under a 423 plan or they may be available through a non-423 plan.

3.6.3.1. Outside the US employees have employment agreements, rather than working at will, and may be subject to specific protections under local law or agreement. For this reason, a company may need to accommodate different definitions of "employee" in different jurisdictions and the plan should be designed to anticipate this need. In some jurisdictions, companies must offer any benefits, including the right to participate in an ESPP, to all employees or risk claims of discrimination. Therefore, the ESPP should allow the company to establish a definition of employee on a jurisdictional basis so as to include employees who are part-timers, on a fixed-term of employment, or on a protected leave of absence where necessary.

3.6.3.2. Consider whether employees should remain eligible to participate in the plan during a non-working termination notice period. Employees outside the US may be entitled to a notice period when employment is terminated. Sometimes employees continue to work during this notice period, but other times it is a non-working notice period. In both cases, the individual is considered an employee for local law purposes. The Plan should address whether termination will follow local law or strictly track whether the employee is providing services. Details about changes in employee status that are conveyed to Equity Compensation should include appropriate information so that the plan provisions can be properly followed.

3.6.3.3. The definition of compensation for ESPP purposes, as discussed in paragraph 3.2.5, should consider variations by job classification and local jurisdictional differences. Employees in certain countries may be entitled to "thirteenth" month salary, holiday pay, and other forms of compensation. Companies need to consider whether these items are eligible compensation for purposes of the plan and, if so, how this compensation will be considered in determining the contribution percentage.

3.6.3.4. Because some countries prohibit deductions from compensation for purposes of participating in an ESPP, consideration should be given to permitting contributions by check, wire transfer, or lump sum payment. Allowing contributions in the form of lump sums, rather than deducting a percentage of pay, may avoid the need for a special approval from labor authorities in some countries.

3.6.3.5. Some countries allow employees to contribute to an ESPP by payroll deduction, provided that the funds are held in a separate bank account. In some jurisdictions these accounts must also be interest-bearing. The plan should allow for funds to be held in a bank account and interest paid, if necessary under local law.

Footnotes

[1] IRC §1.423-2(c)(3)
[2] IRC §1.423-2(f)(5)
[3] IRC §1.423-2(i)(4)
[4] Ibid
[5] IRC §1.423-2(a)(4)
[6] Ibid

4. General Administration

4.1. Overview.

4.1.1. Close coordination between internal and external parties is required to ensure the ESPP is administered efficiently and effectively. Payroll's responsibilities may include deducting employee contributions from each paycheck, tracking contributions during a purchase period, and refunding excess contributions to the employee. Coordination with Payroll may be particularly challenging when the payroll process is outsourced to a third party or when the payroll function is decentralized, as is frequently the case for non-US employees. Financial Reporting is responsible for calculating the associated expense and meeting various financial reporting requirements. Companies whose plans include more complex features may use third-party vendors to perform financial reporting calculations. Human Resources is typically responsible for the plan design and communication, ensures eligible participants are identified and those who elect to participate are able to participate, and maintains the data regarding changes in employee status. Legal is responsible for adherence to a variety of legal requirements, including SEC registration and reporting requirements, exchange controls, and other aspects of the plan operated outside the US . The transfer agent issues the shares purchased under the plan. Corporate Tax considers the deductibility of certain plan costs. The designated brokerage firm(s) deposits the shares into employee accounts and facilitates employee access to and sale/tracking of the shares after the purchase. See the appropriate sections of this publication for detailed information regarding coordination with internal and external parties, recommended steps in the process, and appropriate internal controls.

4.1.2. Primary ESPP activities may occur only a few times a year. Because it is easy to forget some of the many steps in the process, documentation of administrative procedures is important. Exhibit 4-1 summarizes the major activities in administering ESPPs. Section 5, Plan Enrollment; Section 6, Contributions to the Plan; and Section 7, The Purchase, include more detailed process charts relating the specific activities of each section. Each section discusses the overall process, but each company's processes will reflect its unique needs and resources. These recommendations should be considered general guidelines and applied as appropriate.

4.2. Plan Details.

4.2.1. Each plan is unique and has distinct attributes and administrative requirements. Plans may have very broad terms or narrow terms. The key features to include in a plan document include:

- Limits on number of shares per plan, offering, or employee
- Eligibility requirements
- Foreign subsidiary participation
- Compensation definition
- Allowable contribution methods
- Maximum contribution amounts
- Methodology for determining purchase price
- IRC §423 requirements, if applicable
- Offering and purchase periods
- When participants have the right to change contribution rates
- Treatment on termination, leaves of absence, and other employee changes of status
- Post-purchase restrictions on sale or transfer of shares
- Consequences of a low or depleted share pool
- Impact of change in corporate structure

Equity Compensation most often has primary responsibility for administering an ESPP, but in some companies other departments can hold the primary responsibility.

Develop a standard template to document the plan requirements. Document how the requirements are incorporated into the administrative processes, system functionality, and documentation provided to employees. Pay particular attention to new plans implemented or changes in plan requirements.

4.2.2. Use unique, company-assigned employee numbers to identify each employee. Numbers should not be recycled when employees terminate. The company-assigned number may include a prefix that designates a country of employment.

EXHIBIT 4-1: ADMINISTRATION OF AN ESPP
Confirm any changes to the Plan and update processes as necessary
Confirm there are enough shares under the plan for the upcoming purchase(s)
Communicate changes in the Plan to the employees
Confirm any changes in the subsidiaries eligible to participate in Plan and update processes as necessary
Determine eligible employees
Conduct enrollment process and record enrolled employees
Value the award and calculate the period expense
Accumulate cash through payroll deductions, as appropriate
Track payroll contributions
Summarize contributions per employee
Convert non-US employees' contributions in local currencies to US dollars
Calculate the number of shares to be purchased
Execute purchase
Issue shares (transfer agent)
Deposit shares into employees' accounts
Refund or carry forward excess contributions
Calculate and collect tax withholding, if required
Track and report disposition of shares, if required
Report purchase information to internal departments or international entities, if required
Perform tax reporting, upon purchase and at year-end

4.3. Stock Plan System Functionality.

4.3.1. The stock plan record-keeping system may incorporate various software products, including the record-keeping system, an employee portal, and a financial reporting package. The system may be used internally by the Company or by a third-party outsourcer. Most commercially-available systems handle the requirements of qualified plans; however, the support of nonqualified plans with unusual design features may be limited. When selecting a vendor for an ESPP, the request for proposal should seek information tailored to the unique needs of the plan. Some common questions regarding the administrative functionality of stock plan systems are summarized in Exhibit 4-2. Review the contract for service closely to ensure it incorporates all requirements for supporting the plan and types of participants (e.g., non-US-based).

4.3.2. Understand the functionality of the stock plan record-keeping system and how it provides data to Financial Reporting. Establish and document a process to provide required information to value ESPP awards. See Section 11, Financial Reporting, for a more detailed discussion.

EXHIBIT 4-2: COMMON QUESTIONS REGARDING THE ADMINISTRATIVE FUNCTIONALITY OF STOCK PLAN SYSTEMS

Plan Design

- How does the system support the unique requirements of the plan (e.g., matching shares, reset features, rollover of contributions, etc.)?
- Can the system support multiple offerings covering the same time period?
- What methods of tracking fair market value does the system support? Can the system support multiple fair market values?
- How does the system calculate the $25,000 limit for qualified plans?
- Does the system support fractional shares? How are fractional shares handled?

General Administration

- What information is maintained in the stock plan record-keeping system (e.g., employee eligibility, employee contributions, increases or decreases to contributions)?
- How is the stock plan record-keeping system integrated with other systems?
- How does the system support post-purchase restrictions?
- How does the system support selling shares immediately after purchase?

Plan Enrollment

- What information is provided to the employee on-line?
- How are country-specific requirements handled?
- How are hard-copy enrollment forms processed?
- What are the interactive voice response (IVR) capabilities?
- Which languages are supported?
- Are employee accounts activated at the enrollment date?

Contributions to the Plan

- Does the system accept multiple contribution files?
- Does the system accept contribution files in various formats?
- How does the system handle contributions in non-US currencies? What exchange rate is used for the translation from local currency to dollars?
- How are lump sum payments handled?
- How does an employee change the contribution rate during an offering period?
- Can the system limit the number of times an employee may change the contribution rate during an offering period?
- How does an employee withdraw from an offering and how are contributions refunded to the employee?
- How does the system support testing of the contribution data during the contribution period and/or before the purchase?

Purchases

- How soon after the purchase can employees access shares in their accounts?
- What reporting is provided to non-US employees?
- In what currencies can the employees receive funds?
- How are post-purchase restrictions on the sale of shares handled?
- Are shares held in an omnibus account or an individual employee's brokerage account?
- Are individual employees' brokerage accounts limited-purpose or full-service accounts?
- Are there any countries where individual brokerage accounts cannot be supported?

Tax Requirements

- How does the system handle required tax withholding?
- How does the system track disqualified dispositions?
- How does the system track qualified dispositions?
- How does the system support Form 3922 reporting requirements?
- How does the system support Form 1099-B and the cost basis reporting requirements?

Employee Communications

- What on-line communication tools are incorporated in the system?
- Can the on-line communication tools be modified?
- What information is available on the employee portal (e.g., employee contribution amounts, refunds, purchase dates)?

4.4. Outsourcing.

4.4.1. The company may outsource certain aspects of ESPP administration. The processes discussed in this publication will apply regardless of whether the company outsources plan administration; however, the group responsible for implementing the processes may differ. In all cases, the Company maintains the official books and records in addition to retaining overall responsibility for the internal controls. In general, the Company:

- Determines eligibility of employees
- Communicates the plan
- Collects and tracks contributions from the employee
- Tracks status changes
- Refunds excess contributions to the employee
- Prepares Form W-2
- Manages share pools

The Company may outsource:

- Processing enrollments
- Calculating the purchase price, shares, limits, and employee purchase
- Valuing the award and calculating the period expense
- HRIS management
- Disposition tracking
- 6039 Reporting

In some cases the company may use a hybrid approach. In this case the company may fully outsource for some jurisdictions, while for others, the company handles all aspects of plan administration and merely transfers a file to the broker to advise them how shares are to be allocated into the employee's brokerage accounts.

4.4.2. Multiple vendors may be required to administer ESPPs. One vendor may be responsible for the employee interface and another for 6039 reporting. Using multiple vendors for various parts of the process increases complexity. Depending upon the services provided, these vendors may need only a subset of the information stored in the stock plan record-keeping system. In cases where vendors must share information, the data should be transferred through the company. In this way the company can certify the timeliness, correctness, and completeness of the vendor-to-vendor transfers. See previous GPS publications for a more detailed discussion of working with an outsource provider.

4.5. Issues Related to Non-US Employees.

4.5.1. ESPPs offered to employees outside of the US may not operate in the same manner as they do in the US. For legal, compliance, or tax reasons, the plan may need to be implemented differently from one jurisdiction to another, one company to another, or one group of employees to another. Before offering the plan to non-US employees, the following areas must be reviewed:

- Acceptability of the enrollment process under local law
- Contribution methods (e.G., Payroll deductions, lump sum payments, special authorization requirements)
- Capability of the local payroll system to process contributions via payroll deduction
- Requirements that employee contributions be held in a separate account or interest be paid on the contributions
- Special procedures required when shares are purchased
- Taxability of the purchase
- Payment of required tax through payroll withholding or other means

5. Plan Enrollment

5.1. Overview.

5.1.1. Any employee who meets the eligibility requirements discussed in paragraph 3.2.2 may participate in an ESPP; however, an employee must take specific steps to participate in the Plan. Once an employee enrolls in the Plan, contributions are deducted from the employee's paycheck during the offering period subject to the limitations of the Plan. The enrollment form authorizes Payroll to deduct contributions from the employee's paycheck. See Section 6, Contributions to the Plan, for a discussion of the issues regarding contributions. Plan provisions may allow employees to change the level of contributions to the Plan during an offering or withdraw from the Plan. See subsection 6.3 for discussions of changes in contribution rates and withdrawal from a Plan. Enrollment in a plan usually covers all future offering periods and continues until the employee withdraws from the Plan or terminates employment. Exhibit 5-1 summarizes the significant activities in the enrollment process.

EXHIBIT 5-1: ENROLLMENT PROCESS
BEFORE ENROLLMENT PERIOD BEGINS
Determine eligible employees
Establish enrollment period start and end dates
Identify employees who require special handling (e.g., new hires, employees without on-line access)
Alert appropriate internal personnel (e.g., local human resources) of enrollment period
Communicate open enrollment to employees and include required disclosures
DURING ENROLLMENT PERIOD
Advise employees one week before enrollment period ends
Employees enroll in Plan and establish contribution rate
Confirm enrollment and contribution rates with employees who enroll in Plan
AFTER ENROLLMENT PERIOD ENDS
Prepare file summarizing contribution rates by employee by payroll and transmit file to the appropriate payroll for processing
Estimate the number of shares required for purchase and advise appropriate department

5.1.2. Efficient and effective communication with employees regarding the benefits of the plan and the administrative processes for participating in it will increase employee participation. Section 10 discusses employee communication in more detail.

During the enrollment process, an employee elects to participate in the Plan and chooses how much to contribute as a fixed amount per pay period or as a percentage of after-tax compensation in accordance with the Plan.

5.2. Enrollment Process.

5.2.1. An ESPP is an offer to sell stock of a company to its employees. As with any offer to sell publicly traded securities, the company must provide employees with a prospectus summarizing the significant features of the Plan. If the plan is offered to employees outside the US, the offering may require registration or an exemption from registration for the offering to be made. Some countries may require the offering to be made through a licensed financial advisor in the country. In addition the company may provide additional information to help the employee to make an informed decision about investing in the Plan. This additional information may include:

- A summary of the Plan benefits and risks
- The mechanics of participating in the Plan
- Instructions for withdrawing from the Plan
- Instructions for changing Plan contributions
- The process for purchasing shares

Where possible, electronically distribute the information. Consult Legal to ensure the communications meet the company's disclosure requirements. See Section 10, Employee Communication, for a full discussion of best practices related to employee communications.

5.2.2. An employee who meets the eligibility requirements and chooses to participate in the Plan must formally enroll during the enrollment period. An enrollment period has a specific start and end date. When establishing the enrollment period, allow sufficient time at the end to process the enrollments prior to the beginning of the offering period. There is no requirement that an employee participate in the Plan, and no employee may elect to participate after the enrollment period ends.

5.2.3. To enroll in the Plan the employee must complete an enrollment form. The enrollment form specifies the contributions to be made to the Plan from the employee's compensation and provides the employee authorization that allows the company to deduct such contributions and, where relevant, to withhold taxes. The enrollment form may also provide employee authorization for a quick sale of the shares purchased as discussed in paragraph 3.3.7. Enrollment may be through an on-line system, IVR (interactive voice response) technology, or by hard copy. On-line enrollment systems simplify administration by minimizing human intervention, facilitating employee access to enrollment information, and minimizing data entry errors. On-line access may be limited in certain locations such as remote work sites. In those cases, IVR or paper enrollment forms may be required. Additional internal controls may be required when using paper enrollment forms as discussed in paragraph 5.3.3. The enrollment method may be limited for non-US employees in certain jurisdictions under local law. See subsection 5.4 for a further discussion of enrollment issues for non-US employees.

5.2.4. On-line enrollment systems are available through a variety of vendors. These systems frequently can process employee enrollments, changes in contribution rates, and withdrawals from the Plan. The enrollment process can be outsourced to a third party. Activities that can be outsourced include:

- Communication regarding the Plan and the enrollment process
- Employee enrollment during the enrollment period
- Summarization of employee contribution rates for transmission to payroll
- Changes in employee contribution rate
- Withdrawals from the Plan

The company maintains responsibility for determining employee eligibility and transmits a file of eligible employees to the third-party vendor prior to the enrollment process.

5.2.5. A brokerage account may be established for the employee during the enrollment process. Establishing the employees' individual brokerage accounts at this time will facilitate the purchase of the shares at the end of the offering period. In certain circumstances initialization of the employee brokerage account may be delayed until purchase if experience shows a significant number of employees withdraw from the Plan prior to the purchase date.

5.2.6. The process details and the group responsible for each activity described in Exhibit 5-1 depends upon a variety of factors, including the use of third-party vendors, system capabilities, centralization/decentralization of administration, and participation of non-US employees. For example, a company may outsource certain aspects of its enrollment process. In that case, the company determines which employees are eligible to participate in the Plan and transmits a file to the third-party vendor. The vendor communicates with the employees, oversees the enrollment process, and provides Equity Compensation with a file that summarizes employees' contribution elections. Equity Compensation distributes the details of the contribution elections to the appropriate payroll group. Payroll withholds employee contributions from each paycheck.

5.3. Post-Enrollment Activities.

5.3.1. After the enrollment period ends, summarize the employee contribution rate by employee and appropriate payroll. When Plan administration is centralized, this process is usually handled by Equity Compensation, which transmits the contribution rate to local payroll for processing. When Plan administration is decentralized, the employing subsidiary may summarize the contribution rate for appropriate employees and transmit the information directly to local payroll.

5.3.2. Estimate the number of shares required for purchase based on the initial employee contribution rate. Validate that sufficient shares will be available at the purchase date.

5.3.3. Confirm the receipt of the enrollment form and verify the appropriate contribution rate with the employee. For on-line elections, the confirmation may be a reference number automatically provided by the system when the enrollment form has been completed. Confirming enrollment is critical if hard-copy enrollment forms are used so as to maximize data integrity. As discussed in paragraphs 3.4.7 and 3.4.8 problems with the enrollment process could jeopardize the favorable tax status of qualified plans.

5.3.4. Coordinate with Financial Reporting to provide the necessary data (e.g., employee ID, contribution rates, contribution amounts) to perform the expense and tax calculations. Financial Reporting will also need to be notified of subsequent changes such as terminations and contribution changes.

5.4. Issues Related to Non-US Employees.

5.4.1. The method of enrollment may be different or limited in some countries. If non-US employees are offered the right to participate under a qualified plan, then they must be provided with a copy of a prospectus before deciding whether to participate. If the company operates a nonqualified plan outside the US, then the US prospectus requirements do not apply to the offering. The laws of the countries where the employees reside may require similar or more elaborate disclosure be provided to employees as part of the enrollment process.

5.4.2. To comply with securities laws in some countries, the company may need to provide employees with disclosures or other materials that meet local securities law requirements. Often these materials must be provided to employees at the same time as other materials about the plan and while they are able to enroll in the program. Such documents may include both information about the risks of participating in the plan and tax and/or currency exchange information. Some countries consider the offering of an ESPP to be a public offering of securities and require that a registration or prospectus filing be completed before the plan is offered to employees. Alternatively, a summary of the plan along with a list of eligible participants may need to be lodged with securities authorities before enrollment starts or within a certain period thereafter. If advance approval is required, the company should plan accordingly to ensure that the offering does not need to be delayed in the jurisdiction until the necessary governmental approval is in place.

5.4.3. Some countries limit the use of an employee's paycheck and how much of the paycheck may be used to contribute to a foreign ESPP. The company may need to seek approval from a labor authority in a jurisdiction before local employees contribute funds from their paychecks. In a few countries, the employees must sign a special consent form to participate in the plan. These forms are in addition to any enrollment forms that the company may be using. In some countries a representative of the employees must first agree to the plan terms and agree that contributions may be taken via payroll deduction before enrollment materials are distributed to employees themselves. The plan may need to be included in certain local work rules before the enrollment process begins. Lastly, it may be necessary to translate the enrollment form, or at least the portion of the form that authorizes the payroll deductions, to satisfy certain language requirements related to the protection of an individual's compensation.

5.4.4. Enrollment of non-US employees through an on-line or IVR system may not create a binding contract. It may be necessary to have employees print out the forms and sign them in hard copy to create an enforceable agreement. This enforceable agreement will allow for contributions through payroll deductions, authorize tax withholding, and give permission to collect, process, and transfer abroad employee personal data as detailed on the enrollment form.

6. Contributions to the Plan

6.1. Overview.

6.1.1. Once the enrollment period ends, enrollment information is summarized in a file and transmitted to the appropriate payroll group (e.g., US payroll, local country payroll, AsiaPac regional payroll). The enrollment file includes a list of employees participating during the offering period and each employee's contribution rate. Payroll has responsibility for deducting contributions from each employee's compensation as defined by the Plan. Since US payroll systems include functionality to track contributions for each employee, Payroll usually assumes responsibility for this tracking and transmits the information to Equity Compensation before the purchase date. Payroll systems in other jurisdictions may not include this functionality and alternative tracking methods may be required. See paragraph 6.5.1 for the issues associated with tracking contributions of non-US employees. Exhibit 6-1 summarizes the significant processes surrounding contributions to the Plan.

EXHIBIT 6-1: CONTRIBUTIONS TO THE PLAN
Establish and document a process for collecting and tracking employee contributions
Establish and document a process for collecting employee contributions associated with variable pay (e.g., overtime, bonuses, and commissions)
Establish and document a process for employees changing their contribution rates
Establish and document a process for implementing plan limits, offering limits, the maximum number of shares per employee, or the $25,000 limit
Identify the group responsible for processing employee changes to contribution rates
Determine how changes will be communicated to Payroll and reflected in the payroll system
Establish and document a process for coordinating contribution changes and terminations with Financial Reporting
Prior to the purchase date, collect contribution data from Payroll and audit the data to ensure • Employee changes during the offering period have been reflected properly • Contributions are collected for all employees who are enrolled in the Plan • Contributions are not collected for employees who are not enrolled in the Plan • Contributions are not collected for employees who have withdrawn from in the Plan
Develop and document a procedure for processing refunds to employees who withdraw from the Plan prior to the purchase date
Develop and document a procedure for identifying terminated employees and processing refunds from the Plan

The Plan may allow employees to change their contribution rates, suspend contributions for a specified time, or withdraw from the Plan prior to the purchase date.

6.2. Contribution Methods.

6.2.1. As noted previously, contributions to the Plan can be in any form, including payroll deductions and lump sum payments. Lump sum contributions may be an attractive alternative in jurisdictions with few participating employees. For example, Company ABC has five employees in Country X and uses an outside vendor to administer local country payroll. The per-person administrative cost of collecting employee contributions through payroll may be prohibitively expensive for five people. Allowing the employees to make lump sum contributions to the Plan by personal check would minimize the cost of payroll administration. Of course, this cost savings may be offset by the additional administrative cost of Equity Compensation collecting lump sum contributions from appropriate employees via check or wire transfer. Lump sum contributions can also be used in jurisdictions where local law prohibits deductions from an employee's compensation. Care must be taken to ensure the equal rights and privileges requirement is not violated. Companies that want to allow employees to make lump sum contributions in lieu of payroll deductions should establish separate offerings to avoid a violation. See paragraph 3.4.3 for details on separate offerings.

6.3. Changes in Contribution Rates.

6.3.1. The Plan may allow employees to change their contribution rates, suspend contributions for a specified time, or withdraw from the Plan prior to the purchase date. Unlimited changes to contribution rates may be allowed during an offering period or a company can allow decreases but not increases or limit each employee to a specific number of changes. For administrative ease, allow sufficient time for administrative handling of Plan withdrawals (e.g., prohibit withdrawals in the two weeks prior to the end of the offering period to allow sufficient time to process them before the purchase date). Notify Financial Reporting about any contribution rate changes since contribution increases will increase the expense recognized. This includes changes in contribution amounts due to changes in pay (salary, bonuses, etc.). Exhibit 6-1 summarizes the significant activities associated with changes in contribution rates.

6.3.2. Most plans include a feature that automatically withdraws employees from the Plan upon termination and refunds their contributions. No interest is paid on the refunded contributions unless required in a specific non-US jurisdiction. (See paragraph 3.4.4 for a discussion of the employment requirements for qualified plans.) Factors to be considered when defining responsibility for identifying terminated employees and processing refunds from the plan include:

- How Payroll and Equity Compensation receive notification that an employee has terminated
- The tracking mechanism used for Plan contributions
- Frequency of payroll processing
- Administrative and legal requirements for the timing of refunded contributions

For example, if Payroll receives early notification of terminations to facilitate the processing of final paychecks and tracks Plan contributions, local Payroll may assume responsibility for refunding contributions in the employee's final paycheck. On the other hand, if Equity Compensation tracks Plan contributions, Payroll and Equity Compensation are notified of terminations simultaneously, and refunded contributions are paid by separate check, then Equity Compensation may assume primary responsibility for refunding Plan contributions to terminated employees.

6.4. Testing Contribution Data.

6.4.1. To verify the integrity of the contribution data and minimize problems with the actual purchase, Equity Compensation should review contribution details during the offering period and/or prior to the purchase date. This review should include data from local payroll showing actual contributions by employees. The data should reflect any changes in contribution rates, Plan withdrawals, and terminations. Equity Compensation should test that all employees who have made contributions are enrolled in the Plan and all employees who enrolled in the Plan have contributions. Reconcile the data as follows:

	Employees who enrolled in the plan
Minus	Terminated employees
Minus	Employees who withdrew from the plan
Minus	Employees on leaves of absence with no compensation or contributions
Equals	Employees with contributions to the plan

6.5. Issues Related to Non-US Employees.

6.5.1. Payroll for non-US employees may be processed locally or in the appropriate region. Frequently the local or regional payroll does not include functionality to deduct or track ESPP contributions. Manual processes may be required at the local level to administer the ESPP. Additional internal controls may be required to ensure the integrity of the data. Coordination with numerous payroll groups is administratively difficult. Each local and/or regional payroll should use a standard spreadsheet to accumulate required data. The transfer of data should be clearly defined and clarify when the data is required to be provided.

6.5.2. The local jurisdiction may limit the use of payroll deductions. In some circumstances, employee contributions may consist of lump sum payments made during the offering period. Lump sum contributions are more frequently used for non-US employees for administrative ease or due to restrictions under local law. As discussed in paragraph 3.4.3, a separate offering may be used to allow contributions by lump sum payments for employees in certain countries. See paragraph 6.2.1 for a more detailed discussion of lump sum payments.

6.5.3. In certain countries, the employees' contributions must be held in a separate bank account and/or interest paid on amounts contributed to comply with certain securities laws or to ensure that certain financial protections on individual salaries are in place. In some countries the separate bank account requirement may be eliminated if the payroll deductions are immediately sent to the US, even if the purchase is not to occur for several months. If employees' contributions must be held in a separate bank account, rather than comingled in a company's general account as they are in other jurisdictions, then the offering in which the contributions are held in the account should be established as a separate offering under the ESPP.

6.5.4. ESPP contributions for non-US employees are deducted in local currency and these funds must be converted to US dollars prior to the purchase of the shares. The process for exchanging currency should be considered prior to offering the plan in a particular jurisdiction. Written authorization or a power of attorney from the employee may be required to allow the employer to convert the funds on the employees' behalf. Incorporate this authorization into the enrollment process to simplify the administration of the plan.

6.5.4.1. In addition to the employee's authorization, the company may need to obtain approval from or give notice to the exchange control authorities in a particular jurisdiction before converting contributions made in the local currency into US dollars. The authorities may need to be provided with a copy of the plan and a list of the participants.

6.5.4.2. Payroll deductions may be converted each pay period; however, the more common practice is to convert the funds into US dollars at the end of the period for administrative ease. Converting the funds at the end of the purchase period means that the employees bear the risk of any currency fluctuation over the purchase period.

6.5.5. Another challenge when offering an ESPP to a global workforce is dealing with the contributions of employees who move from country to country during a purchase period. See paragraph 8.6.6 for a discussion of the tax issues associated with employee moves.

6.5.5.1. If the employee stays within the same offering under a qualified plan or a nonqualifed plan, then moving from one country to another may not create significant issues. The employee will simply continue to make payroll deductions. At the end of the purchase period, the employee's contributions will be converted from the various local currencies into US dollars and used to purchase shares.

6.5.5.2. Issues are more complicated when an employee moves from one country to another where each country is included in a separate offering. The employee may need to withdraw from one offering and to enroll in a different offering because it is on a different basis and/or has different terms. The company will need to review the plan terms and the offerings to determine whether withdrawal and re-enrollment is necessary and whether contributions may continue to be made or need to be refunded. Significant administration may be required to track employee movement between separate offerings and ensure the proper withdraw/enrollment procedures are followed. Similar issues arise when an employee transfers between qualified and nonqualified plans.

7. The Purchase

7.1. Overview.

7.1.1. On the purchase date, employee contributions are used to purchase shares. Advance preparation is required to minimize issues associated with the purchase. Paragraph 7.2.1 discusses the steps to be taken to prepare for the purchase. The steps vary depending upon which department is responsible for retaining and tracking the enrollment and contribution data. Frequently Payroll tracks contributions and transmits details to Equity Compensation immediately prior to the purchase date. Equity Compensation audits the data prior to importing it into the stock plan record-keeping system. In other cases Equity Compensation tracks employee contribution rates, including increases and decreases to the contribution rate, in the stock plan record-keeping system and advises Payroll of the appropriate amount to withhold. In this case Equity Compensation reconciles the payroll contribution file with the data in the stock plan record-keeping system prior to purchase.

7.1.2. The number of shares purchased equals the employee contribution divided by the appropriate purchase price, taking into account appropriate share limits (e.g., Company Plan or IRS limits) that need to be imposed. Subsection 7.3 discusses issues associated with calculating the purchase price. Since purchases are usually infrequent, detailed documentation of the purchase process will avoid errors and oversights. Exhibit 7-1 summarizes the significant processes surrounding the purchase.

7.2. Preparing for the Purchase Date.

7.2.1. As noted in paragraph 6.4.1, Equity Compensation should review contribution details during the offering period. Reviews should also occur one to two weeks prior to the purchase date and immediately before the purchase. If appropriate, process a "practice" purchase to identify potential issues with the purchase process. In addition to the steps noted in paragraph 6.4.1, immediately before the purchase Equity Compensation should confirm that terminations have been properly recorded to ensure that only appropriate employees are included in the purchase. In addition verify that all employee brokerage accounts have been activated (assuming shares will be transferred to individual brokerage accounts) and confirm that sufficient shares are available for the purchase. Confirm that amounts carried forward from a prior offering period, representing a fractional share, are properly included as contributions during the current period. Ensure a process is in place to transfer funds from any non-US jurisdiction to the US on a timely basis to ensure purchases will not be delayed. If Equity Compensation tracks employee contributions, reconcile total contributions in the payroll system to contributions in the stock plan record-keeping system.

CHANGE OF STATUS

Caution – When Equity Compensation is not timely notified of an employee change of status such as a termination, the employee may inappropriately participate in the purchase and shares may be released to the employee. Develop a process for handling the inappropriate release of shares. Involve Legal to ensure the Company's risks are considered appropriately when resolving these issues. Document the process.

The purchase process requires close coordination with internal and external contacts including Payroll, Human Resources, Financial Reporting, Legal, the transfer agent, and the brokerage firm.

EXHIBIT 7-1: PURCHASE ACTIVITIES
Assumptions: **Qualified Plan** **Administered internally** **Payroll tracks employee contributions to the Plan** **The purchase is calculated internally** **Whole shares are issued** **A broker is used to transfer shares into the employee's brokerage account**
2-3 WEEKS BEFORE THE PURCHASE DATE
Remind Payroll of the deadline for the upcoming purchase
Remind the transfer agent and broker(s) of the upcoming purchase
Confirm all employees have activated their brokerage accounts
Verify sufficient shares are available for the purchase
IMMEDIATELY BEFORE THE PURCHASE DATE
Receive the contribution file and import it into stock plan record-keeping system (or other appropriate system)
Confirm contributions have been recorded for all employees participating in the plan
Confirm all employees are active employees
Confirm no contributions have been recorded for employees who withdrew from the plan, are on leaves of absence, or have terminated
Confirm contribution amounts carried over from the prior offering period representing a fractional share are properly included in this period
PURCHASE DATE
Document the calculation of FMV and the source of the pricing data
Process the foreign exchange conversion for non-US employees to convert contributions to US dollars
Calculate the purchase for each employee
Verify purchases do not exceed plan limits, offering limits, the maximum number of shares per employee, or the IRS $25,000 limit
Confirm sufficient shares are available for the purchase
Reconcile total contributions to shares purchased, refunds, and carry forward amounts
Instruct the transfer agent to issue shares
Provide instructions to the broker
IMMEDIATELY AFTER THE PURCHASE DATE
Provide purchase data to Financial Reporting, specifying any contribution changes and terminations
Advise employees of purchase details
Notify employees who exceeded the share or contribution limit to adjust their contribution rates
Advise Payroll of the contributions that exceeded contribution limits; Payroll to refund the excess in the next pay cycle
Track carry forwards of excess contributions representing a fractional share to the next offering period; advise Payroll as appropriate
Prepare a management report summarizing the purchase

7.3. Calculating the Purchase.

7.3.1. The number of shares purchased for each employee equals the employee's contributions (including any carry forward that could not purchase a full share in the previous purchase period) divided by the purchase price. The purchase price is the FMV of the stock on the purchase date (or the offering date if less and the plan includes a look-back feature) discounted in accordance with the Plan. The Plan may specify how the FMV is determined (e.g., the previous day market close or the average FMV for the trading day). If the purchase period ends on a non-trading day, extra care must be taken to verify the correct FMV is used. Regardless of how the FMV is determined, verify the price from multiple sources and document the calculation. Calculating the purchase price for an offering period that has only a single purchase period is straightforward. Calculating the purchase price when the plan uses overlapping offering periods, resets, and rollovers may be more complicated and different purchase prices may be applicable for employees participating in different offerings.

7.3.2. The purchase may be calculated internally or by a third-party administrator. The calculation is usually done after market close on the purchase date when the FMV is determined (e.g., price at market close or the average FMV for the trading day). The number of shares purchased may be whole shares or fractional shares. See paragraph 3.2.7 for a discussion of issuing whole shares or fractional shares. Confirm that sufficient shares are available for the purchase.

7.3.3. The number of shares available for purchase may be limited by the Plan. The limits may be by Plan, by offering, or by employee. Qualified plans must limit the amount an employee can purchase to $25,000 for each calendar year based on the grant date FMV. Paragraph 3.4.4. discusses the calculation of the $25,000 limit in more detail. Prior to executing the purchase, verify that neither the total purchase nor any individual employee's purchase exceeds the appropriate limits. Where limits have been exceeded, excess contributions will be refunded to the employee. Exhibits 3-9 and 3-10 provide examples of limiting the number of shares purchased.

7.3.4. Where possible, limit excess employee contributions. In some cases payroll systems permit the company to stop deducting employee contributions when the IRS and/or Plan contribution limits have been reached. Because no interest is paid on excess contributions, limiting excess contributions is employee-friendly. In addition administration and employee communications are minimized because there are no excess contributions to refund to the employee.

7.3.5. Reconcile the purchase details as follows:

	Total shares purchased x purchase price
Plus	Excess contributions refunded to the employees
Less	Excess contributions carried forward from last offering period
Plus	Excess contributions carried forward to next offering period
Equals	Total contributions during this purchase period

7.4. Issuing Shares.

7.4.1. Purchased shares may be held by the employee or sold immediately. Shares may be held in a variety of ways including:

- Deposited in an individual employee brokerage account
- Deposited in an omnibus account
- Direct registration
- Issued to the employee as certificates

Each method of holding shares is discussed below. Brokerage firms and third-party administrators may support one or more methods. The company at its discretion may determine which methods to use. In some countries the method of holding shares may be limited under local law.

7.4.2. The most common method is to deposit purchased shares into individual employees' brokerage accounts. The deposited shares are readily available to the employee and the subsequent sale of shares is more efficient. The brokerage firm may permit whole or fractional shares to be held in individual employees' accounts. The employees' brokerage accounts can be limited-purpose or full-service. Limited accounts merely hold company stock and cash and may provide the employer with more control over the account. Full-service brokerage accounts can include other investments. In certain countries the brokerage firm may be unable to support individual brokerage accounts. To simplify administration most companies use a limited number of designated brokers. If a designated broker is used, the shares are electronically transferred in block to the brokerage firm, which disperses the shares to the individual employees' accounts based on information provided by Equity Compensation. See paragraph 7.4.6 for a discussion of coordinating with the transfer agent and paragraph 7.4.7 for a discussion of coordinating with the brokerage firm.

7.4.3. An omnibus account is an account in which the assets of more than one person are comingled and the account is managed by a custodian. Shares purchased from an ESPP would be held in a custodial account at a brokerage firm or transfer agent for all employees. From the employee's perspective an omnibus account is similar to holding shares in a mutual fund in that the employee's access is limited to his or her own holdings. Employee reporting in an omnibus account can be in whole shares or fractional shares. Omnibus accounts cannot hold cash. Proceeds from any sale of the shares or cash dividends paid on the shares purchased would be distributed directly to the employee or to the employee's separate brokerage account. Any sales of stock from an omnibus account would result in transaction fees that would normally be borne by the employee. In some limited cases, the company may agree to bear the transaction fees on behalf of the employee. An omnibus account may give the company more flexibility to change service providers. In certain countries the use of omnibus accounts may be limited by exchange control restrictions or other local regulations.

7.4.4. Direct registration allows ownership of shares to be electronically registered on the company's books through the transfer agent. A brokerage account or share certificates are not required to hold the shares. Shares may be sold directly through the transfer agent or later electronically transferred to a broker for sale.

7.4.5. In some limited circumstances individual share certificates may be issued and the shares registered in the employee's name. This method is administratively cumbersome since physical share certificates are issued and mailed to the employee. This may result in significant delays in the receipt of the shares by the employee and carries the risk that the certificate may be lost or stolen. Issuing of individual certificates can increase the cost for the company and the employee. For these reasons, this method of delivering shares to participants is rarely used.

7.4.6. The transfer agent will issue shares based upon instructions provided by the company. The transfer agent electronically transfers shares from the share reserve for this purpose to a brokerage account via Deposit/Withdrawal at Custodian (DWAC), electronically registers the shares (DRS), or issues physical certificates. Limiting the number of brokerage firms receiving shares minimizes transfer agent fees. Instructions to the transfer agent include:

- Name of the applicable plan
- Purchase date
- Total shares
- Number of shares to be issued to each brokerage firm
- Delivery instructions
- Details of any restrictive legends
- Control number
- Reserve name and number

Clarify the purchase process with the transfer agent prior to the purchase date to ensure the information provided conforms to the transfer agent's unique requirements. Periodically reconcile Plan reserve balances with the transfer agent's records.

7.4.7. Notify the brokerage firm(s) of the shares to be delivered. Provide details for allocating the shares to the appropriate employee's brokerage accounts including the:

- Name of the employee
- Number of shares purchased
- Employee account number
- Instructions regarding the sale of shares, as appropriate (i.e., quick sales authorized by employees)
- Control number

Where multiple brokerage firms are used, confirm which firm the employee is using and prepare instructions for each firm. Using multiple brokerage firms creates extra work because coordination with each firm is required. Limiting the number of brokerage firms minimizes costs and risk of error.

7.5. Post-Purchase Activities.

7.5.1. Immediately after the purchase, advise employees of the purchase details. The following information should be included:

- Date of offering period
- The purchase date
- The amount contributed
- The number of shares purchased
- An explanation of how the purchase price was calculated, including applicable exchange rate for non-US employees
- An explanation of how shares will be issued
- Details about when shares will be in the employee's account and available for sale
- Details about any excess contributions, the reason for the excess contribution, how the excess contribution will be treated (i.e., refunded or carried forward), and suggestions for minimizing excess contributions in the future
- An explanation of restrictions on subsequent sale of shares

For taxable transactions (i.e., purchases from nonqualified plans or purchases from qualified plans for non-US employees), the tax consequences should be summarized and the amount of tax withholding, if any, disclosed.

7.5.2. Coordinate with Financial Reporting to provide the final purchase data, information about terminations, and details on changes in contribution rates. This process may involve electronically transmitting a data file, notifying Financial Reporting that reports in the stock plan record-keeping system are ready to be accessed, or a combination of both. Expense calculations may be outsourced to a third party. In that case the data requirements and processes remain the same, even though the responsible party may be different.

7.5.3. Refunds of excess contributions should be processed in the next pay cycle. Provide Payroll with appropriate details to process the refunds. Track carry forwards of excess contributions representing a fractional share to the next offering period and advise Payroll as appropriate. Reset purchase period contributions to zero.

7.5.4. Prepare a report to management summarizing the purchase details, such as:

- Number of employees participating
- Participation rate for the current purchase as compared to previous purchases
- Number of shares purchased
- Number of shares sold immediately
- Purchase price
- FMV on purchase date
- Value delivered to the employees and the gain per share
- Balance of shares in the plan and projected usage of the shares

7.6. Issues Related to Non-US Employees.

7.6.1. Local and/or regional payroll is responsible for providing Equity Compensation with contribution details prior to the purchase date. Coordinating with numerous payroll groups can be an onerous task. A delay in the receipt of information from one payroll group could potentially delay the purchase for the entire offering. To avoid such issues, implement a policy that if information is not timely received from local payroll that location will not participate in the scheduled purchase. An additional purchase(s) will be processed to include late payroll submissions. Consult Legal to confirm the acceptability under local law.

8. Tax Issues

8.1. Overview.

8.1.1. The tax treatment available for ESPP shares depends upon whether the plan is qualified or nonqualified. Nonqualified plans are subject to the general tax rules, which are discussed in subsection 8.2. The special tax rules that apply to qualified plans are discussed in subsection 8.3. See Exhibit 8-2 for a comparison of the employee tax consequences of nonqualified and qualified plans. Exhibits 8-3 to 8-6 provide examples of these rules.

8.1.2. Employers have a variety of tax withholding and reporting responsibilities relating to ESPPs. These responsibilities are discussed in subsection 8.4. See Exhibit 8-7 for a comparison of the employer withholding and reporting responsibilities relating to nonqualified and qualified plans. Most states' withholding and reporting requirements follow federal rules. Except as noted, the discussion of tax requirements refers to federal and state rules. In addition the employer may be entitled to a corporate tax deduction for the ordinary income reported by the employee. The corporate tax implications are discussed in subsection 8.5. Previous GPS publications address the administrative requirements and internal controls associated with tax withholding and reporting. (Note – Previous GPS publications can be accessed at www.scu.edu/business/cepi/.)

8.1.3. US employees who participate in qualified plans are eligible for special tax treatment. The tax implications for non-US employees participating in qualified and nonqualifed ESPPs are determined under local law, not US law, and the preferential tax treatment as provided by US law does not apply. Many countries also allow preferential tax treatment for ESPPs that would be qualified under local tax laws. Locally qualified plans may be similar, but are not identical, to US qualified plans. Such qualified plans are outside the scope of this publication. The tax issues associated with US qualified and nonqualified plans offered to non-US employees are discussed in subsection 8.6.

An ESPP is considered a stock option plan for tax purposes. The option is granted at the beginning of the offering period. The option vests and is exercised at the purchase date.

8.2. Employee Tax Consequences – Nonqualified Plans.

8.2.1. Most nonqualified plans are considered stock option plans for tax purposes. The option is granted at the beginning of the offering period. The general rule regarding the transfer of property in connection with the performance of services is incorporated in IRC §83, which states the transfer of property is taxable income to the recipient/employee. However, the grant of an option to purchase stock does not constitute a transfer of property.[1] Therefore, according to IRC §83, the grant of the option has no tax impact to the employee. Contributions used to purchase stock are not tax deductible and contributions by the employee are made with after-tax dollars.

8.2.2. For tax purposes the purchase of stock through a nonqualified plan is considered an exercise of an option and taxable to the employee. The difference between the FMV on the purchase date and the purchase price is taxable compensation to the employee. This ordinary income is subject to income and social tax withholding and reporting. When the stock is sold, the difference between the sales price and the FMV on the purchase date is a capital gain or loss. The capital gain/loss is short term if the stock was held one year or less from the purchase date. The capital gain/loss is long term if the stock was held more than one year from the purchase date. See Exhibits 8-3 to 8-6 for applications of these rules.

8.2.3. The tax treatment of shares purchased under a nonqualified plan that offers matching shares is dependent on the plan structure and any restrictions placed on the matching shares. In general the difference in FMV at the purchase date and the purchase price is taxable income to the participant. The matching shares are taxable when they vest. A complete discussion of the tax treatment of nonqualified plans with matching shares is beyond the scope of this publication.

8.2.4. If the employee sells substantially identical shares at a loss within 30 days before or after the purchase of ESPP shares in an unrelated transaction, special tax rules apply. IRC §1091 disallows the loss on the stock sale. The basis of the ESPP shares is increased for the disallowed loss. This transaction is commonly referred to as a "wash sale." See Exhibit 8-1 for an example of the wash sale rules.

EXHIBIT 8-1: WASH SALE RULES

- **Employee A owns 10 shares of XYZ Co., which were purchased for $100 per share on January 1**
- **On January 15 Employee A sells the shares for $80 per share**
- **On February 1 Employee A purchases 10 shares under the XYZ ESPP for $85 per share**

Tax consequences:

- No loss is recognized on the sale on January 15
- The basis of the shares purchased on February 1 is $105 per share ($85 purchase price plus $20 loss disallowed on January 15 sale)
- The acquisition date is adjusted to include the period the original stock was held. The new acquisition date is January 17 for capital gain/loss purposes

8.2.5. IRC §409A addresses the taxation of nonqualified deferred compensation (NQDC). In some limited situations the purchase of stock through an ESPP may be considered NQDC, depending on the terms of the award. With proper planning, nonqualified plans can be designed to avoid the application of IRC §409A. A complete discussion of IRC §409A is beyond the scope of this publication. Consult tax and/or legal counsel to confirm the Plan meets the requirements of IRC §409A.

8.3. Employee Tax Consequences – Qualified Plans.

8.3.1. IRC §83 also applies to employees participating in qualified plans. The grant date is normally the beginning of the offering period, provided the maximum number of shares any one employee may purchase has been specified. The maximum number of shares can be a specific number of shares or a formula (e.g., $20,000 divided by the FMV of the stock on the first day of the offering), provided the maximum number of shares per employee can be determined as of that date. If the terms are not fixed and determinable at the beginning of the offering period, the grant date for tax purposes is the purchase date. As noted above, the grant of the option is not a taxable event for the employee.

8.3.2. Contributions to the plan are made using after-tax dollars. The purchase of stock under a qualified plan is considered an exercise of an option, and employees will qualify for beneficial tax treatment if the following requirements are met:

- The plan meets the requirements of IRC §423 (see subsection 3.4 for a complete discussion of the requirements of IRC §423)
- The employee holds the stock at least two years from the date of grant and one year from the date of purchase
- The employee remains an employee from the date of grant to three months before the purchase date

QUALIFYING VERSUS DISQUALIFYING DISPOSITIONS

Caution – To receive preferential tax treatment an employee must hold shares purchased under a qualified plan at least two years from the date of grant and one year from the date of purchase. A sale of the stock on the one-year anniversary date of the purchase is a disqualifying disposition. For example –

Beginning of the offering period	**February 1, 2011**
Purchase of the stock	**February 1, 2012**
Sale of the stock	**February 1, 2013**

The sale of stock on February 1, 2013, would be a *disqualifying* disposition. The sale of shares on February 2, 1013, would be a *qualifying* disposition.

TREATMENT UPON DEATH

Special rules apply if the employee dies while owning shares purchased under a qualified plan. In this event the shares are deemed transferred in a qualifying disposition, even if the required holding period has not been met (i.e., the stock may not have been held two years from the date of grant and one year from the date of purchase). The ordinary income is the lesser of:

- **The difference between the FMV of the stock at the grant date and the purchase price at the grant date**

or

- **The difference between the FMV of the stock at death and the purchase price and is reported on the employee's final Form W-2. No income or social tax withholding is required.**

8.3.3. If the above requirements are met, the employee is not taxed upon the purchase of the stock. When the stock is sold, the sale is a qualifying disposition and ordinary income is recognized in an amount which is the lesser of:

- The difference between the FMV of the stock at grant and the purchase price as if it were calculated on the grant date (i.e., 85% of the grant date FMV) or
- The actual gain (sale price minus the purchase price), if any

No income or social tax withholding is required on the ordinary income, but the ordinary income will be reported on Form W-2 for the year of sale. This requirement applies to current and former employees. See subsection 8.4 for a discussion of the employer's reporting requirements. In addition to the reported ordinary income, any additional gain or loss upon the sale of stock is treated as a long term capital gain/loss. See Exhibits 8-3 to 8-6 for applications of these rules.

8.3.4. If an employee under a qualified plan does not meet the requirements of paragraph 8.3.2 (e.g., the employee does not meet the required holding period of the purchased shares), the disposition of the stock is deemed a disqualifying disposition. Ordinary income is recognized upon sale to the extent the FMV at the purchase date exceeds the purchase price, even if no gain is realized upon the sale of the stock. No income or social tax withholding is required on the ordinary income, but the ordinary income must be reported on Form W-2 for the year of sale. The difference between the sale price and the FMV on the purchase date is a capital gain or loss. The capital gain/loss is short term if the stock was held one year or less from the purchase date. The capital gain/loss is long term if the stock was held more than one year from the purchase date. See Exhibits 8-3 to 8-6 for applications of these rules.

EXHIBIT 8-2: TAX CONSEQUENCES TO THE EMPLOYEE

	Nonqualified Plans	**Qualified Plans**
Grant	None.	None.
Contributions	Made with after-tax dollars.	Made with after-tax dollars.
Purchase	FMV on the purchase date minus the purchase price is taxable ordinary income at the time of purchase.	None.
Sale	Sale price minus the FMV on the purchase date is a capital gain or loss.	Qualifying Disposition - If the stock **is held** at least two years from the date of grant and one year from the date of purchase, ordinary income is recognized on the lesser of: • The difference between the FMV of the stock and the purchase price on the grant date, or • The actual gain (sale price minus the purchase price), if any If the sales price is less than the purchase price, the difference will be a long term capital loss. If the sales price is greater than the FMV of the shares on the grant date, the difference will be long term capital gain.
		Disqualifying Disposition - If the stock **is not held** at least two years from the date of grant and one year from the date of purchase, ordinary income is the FMV at the purchase date minus the purchase price. The sales price minus the FMV on the purchase date is a capital gain or loss.

8.3.5. The wash sale rules described in subsection 8.2.4 may apply to any sale of substantially identical stock within 30 days before or after the purchase of ESPP shares in an unrelated transaction.

EXHIBIT 8-3: APPRECIATING MARKET VALUE DURING OFFERING PERIOD AND GAIN ON DISPOSITION

Plan Provisions/Assumptions:			
Offering price	85% of fair market value on lower of FMV on grant date or purchase date		
FMV on grant date	$10.00		
FMV on purchase date	$12.00		
Sale price	$15.00		
Calculations:			
Purchase price ($10.00 x 85%)	$8.50		
Discount calculated at the grant date ($10.00 x 15%)	$1.50		
Gain realized on purchase ($12.00 - $8.50)	$3.50		
Additional gain realized at sale ($15.00 - $12.00)	$3.00		
Total gain	$6.50		
Tax Consequences:	**Qualified Plan**		**Nonqualified Plan**
	Qualified Disposition	**Disqualified Disposition**	
Taxable as ordinary income recognized on purchase date	N/A	N/A	$3.50
Taxable as ordinary income on sale of stock	$1.50	$3.50	N/A
Taxable as capital gain on sale of stock	$5.00	$3.00	$3.00

EXHIBIT 8-4: APPRECIATING MARKET VALUE DURING OFFERING PERIOD AND LOSS ON DISPOSITION

Plan Provisions/Assumptions:			
Offering price	85% of fair market value on lower of FMV on grant date or purchase date		
FMV on grant date	$10.00		
FMV on purchase date	$12.00		
Sale price	$ 5.00		
Calculations:			
Purchase price ($10.00 x 85%)	$8.50		
Discount calculated at the offering date ($10.00 x 15%)	$1.50		
Gain realized on purchase ($12.00 - $8.50)	$3.50		
Additional loss realized at sale ($5.00 - $12.00)	($7.00)		
Total loss	($3.50)		
Tax Consequences:	**Qualified Plan**		**Nonqualified Plan**
	Qualified Disposition	**Disqualified Disposition**	
Taxable as ordinary income recognized on purchase date	N/A	N/A	$3.50
Taxable as ordinary income on sale of stock	N/A	$3.50	N/A
Taxable as capital loss on sale of stock	($3.50)	($7.00)	($7.00)

EXHIBIT 8-5: DECLINING MARKET VALUE DURING OFFERING PERIOD AND GAIN ON DISPOSITION

Plan Provisions/Assumptions:	
Offering price	85% of fair market value on lower of FMV on grant date or purchase date
FMV on grant date	$10.00
FMV on purchase date	$ 8.00
Sale price	$ 9.00

Calculations:	
Purchase price ($8.00 x 85%)	$6.80
Discount calculated at the offering date ($10.00 x 15%)	$1.50
Gain realized on purchase ($8.00 - $6.80)	$1.20
Additional gain realized at sale ($9.00 - $8.00)	$1.00
Total gain	$2.20

Tax Consequences:	**Qualified Plan**		**Nonqualified Plan**
	Qualified Disposition	**Disqualified Disposition**	
Taxable as ordinary income recognized on purchase date	N/A	N/A	$1.20
Taxable as ordinary income on sale of stock	$1.50	$1.20	N/A
Taxable as capital gain on sale of stock	$ .70	$1.00	$1.00

EXHIBIT 8-6: DECLINING MARKET VALUE DURING OFFERING PERIOD AND LOSS ON DISPOSITION

Plan Provisions/Assumptions:	
Offering price	85% of fair market value on lower of FMV on grant date or purchase date
FMV on grant date	$10.00
FMV on purchase date	$ 8.00
Sale price	$ 5.00

Calculations:	
Purchase price ($8.00 x 85%)	$6.80
Gain realized on purchase ($8.00 - $6.80)	$1.20
Additional loss realized at sale ($5.00 - $8.00)	($3.00)
Total loss	($1.80)

Tax Consequences:	**Qualified Plan**		**Nonqualified Plan**
	Qualified Disposition	**Disqualified Disposition**	
Taxable as ordinary income recognized on purchase date	N/A	N/A	$1.20
Taxable as ordinary income on sale of stock	N/A	$1.20	N/A
Taxable as capital loss on sale of stock	($1.80)	($3.00)	($3.00)

8.4. Employer Withholding and Reporting Responsibilities.

EXHIBIT 8-7: EMPLOYER WITHHOLDING AND REPORTING RESPONSIBILITIES

	Qualified Plans*	Nonqualified Plans
Grant	None.	None.
Contributions	None.	None.
Purchase	None.	Difference between the FMV at exercise and the purchase price paid is taxable as ordinary income. Income tax and social tax must be withheld. Ordinary income is reported on Form W-2, box 1.
First transfer of legal title of shares purchased**	Reported on Form 3922 to the IRS and the employee.	None.
Sale	Qualifying Disposition: Ordinary income on the lesser of: • The difference between the FMV of the stock and the purchase price on the grant date or • The actual gain. This amount is reported on Form W-2, box 1. No income or social tax withholding is required. Disqualifying disposition: Ordinary income on the FMV at the purchase date minus the purchase price and is reported on Form W-2, box 1. No income or social tax withholding is required.	None.

* Some states do not recognize the preferential tax treatment of qualified plans. In such states, qualified plans are treated as nonqualified plans.

** Usually when the purchased shares are transferred into the individual employee's brokerage account or an omnibus account.

8.4.1. When a non-qualified stock option is exercised, the difference between the FMV at exercise and the option price is taxable as ordinary income. Income and social tax withholding are required, and the income is reported on Form W-2. For tax purposes the purchase of stock from an ESPP is deemed the exercise of an option. Therefore, the purchase of stock under a nonqualified ESPP is subject to income and social tax withholding and reporting. The difference between the FMV at purchase and the purchase price (i.e., purchase discount) is ordinary income. For income tax purposes the income is typically treated as a supplemental wage and tax is withheld using supplemental tax rates rather than regular withholding rates. When year-to-date supplemental wage payments from all sources exceed $1 million for an individual in a calendar year, federal withholding must be increased to the maximum tax rate. The employer is not required to withhold tax or report income associated with the sale of the stock.

8.4.2. The employee can pay tax related to the purchase discount by:

- Having the appropriate amount withheld from compensation
- Selling a portion of the shares
- Having a portion of the shares withheld to fund the required tax payment

The advantages and disadvantages of each method are briefly discussed below. See previous GPS publications for a more detailed discussion of methods for collecting tax from the employee.

8.4.2.1. The most common method for collecting tax on the purchase discount is withholding the appropriate amount from the employee's compensation through the regular payroll process. The discount is calculated and communicated to Payroll as additional income in the current pay period. Income and social taxes are withheld. The disadvantage of this method is that the employee's paycheck is impacted.

8.4.2.2. An alternative is to sell a portion of the purchased shares to fund the required tax (i.e., sell-to-cover). Using this method, the required tax is estimated and sufficient shares are sold to generate cash to fund the payment. The number of shares to be sold is rounded up to equal whole shares, not fractional shares, and to cover market fluctuation in the shares. (Market fluctuation is the difference between the estimate of the proceeds from the stock sale and the actual proceeds from the stock sale.) This method ensures that the employee's paycheck for the month of the purchase is not affected by the transaction. The sale usually occurs on the day after purchase. This method of withholding has administrative challenges for the company because estimating the number of shares to be sold to pay tax and the complications of handling proceeds that exceed or fall short of the required tax requires significant time and effort. The employee must authorize the sale of the shares. The authorization is typically incorporated in the enrollment form.

8.4.2.3. Another method is to withhold a portion of the purchased shares to fund the required tax (i.e., withhold-to-cover). This method also ensures that the employee's paycheck for the month of the purchase is not affected by the transaction. The employee's tax is paid by withholding shares equal to the amount of tax divided by the FMV of a share. Most companies do not allow for the issuance of fractional shares. Therefore, the calculation of the number of shares that must be withheld is rounded to whole shares. See paragraph 8.4.2.4 for a discussion of the accounting implications of rounding shares. The company credits the current value of the shares withheld against the tax required to be withheld on the purchase discount. Since no shares are sold in a withhold-to-cover transaction, there are no sales proceeds to fund the employee's tax. Instead, company funds are used to pay the employee's withholding tax liability.

8.4.2.4. Withholding shares to cover the required tax is commonly referred to as a "tender of shares." When shares are tendered from those currently being purchased, the tax withholding must be limited to the minimum required statutory payment. For companies that have adopted ASU 2016-09, tendering shares in excess of the maximum statutory requirements will result in the award being treated as a liability rather than an equity instrument. In addition, if there is a pattern of withholding shares in excess of the maximum statutory requirement, it may cause all grants under the plan to be treated as liability instruments. Using whole shares to cover the tax may result in slightly more tax than the minimum amount required to be withheld. A company's external auditors should be consulted to ensure this approach does not affect the classification of the award as an equity instrument.

8.4.3. Purchases under a qualified plan are not taxable at the time of purchase. Some states do not recognize the preferential tax treatment of qualified plans. In such states, qualified plans are treated as nonqualified plans. When the stock is sold, ordinary income and capital gain/loss are realized as discussed in subsection 8.3. The employer is not required to withhold income tax or social taxes on the ordinary income. Ordinary income must be reported on Form W-2, box 1, provided the wages are in aggregate $600 or more in a calendar year.[2]

8.4.4. To properly report the sale of stock under a qualified plan, the company must track the disposition of the stock. This means the company must track the stock held by current and former employees until the stock is sold. Some companies avoid the issue by implementing post-purchase restrictions such as those discussed in subsection 3.3.6. Frequently the broker or third-party administrator will track subsequent dispositions on behalf of the company and transmit reports summarizing qualified and nonqualified dispositions to the company. In certain cases, the broker or third-party administrator may calculate taxable income from the disqualified disposition using purchase price provided by the company. Using a designated broker will simplify the tracking process. If the information is not available from the broker or third-party administrator, the company must gather appropriate information directly from the employee.

8.4.5. IRC §6039 requires every company that has transferred legal title of shares acquired under a 423 plan to file Form 3922 for each transfer made during the year. Forms are filed with the IRS and also sent to the employee or former employee. The reporting requirement applies only to the first transfer of legal title of shares of stock purchased. Immediately depositing the purchased shares into the individual employee's brokerage account or an omnibus account is considered the "first transfer of legal title." Post-purchase restrictions on the sale of shares do not affect the determination of the "first transfer of legal title." Subsequent transfers of legal title (e.g., sale of the shares) do not require reporting under IRC §6039. Nonqualified plans are exempt from the reporting requirements of IRC §6039. In addition Form 3922 is not required for an employee who is a nonresident alien for US tax purposes and to whom the corporation is not required to provide a Form W-2.[3]

8.4.5.1. The following information must be provided for each transfer:

- The employee's name, address, and Social Security number
- The name, address, and employer identification number of the corporation whose stock is being transferred
- Grant date (i.e., beginning of the offering period)
- Purchase date (i.e., date the option was exercised)
- FMV per share on the grant date
- FMV of the stock on the purchase date
- The actual purchase price (i.e., exercise price) paid per share
- Number of whole shares to which legal title was transferred (i.e. fractional shares must be rounded up to the next whole share)
- Date the legal title of the shares was transferred
- Purchase price per share determined as if the purchase occurred on the grant date

    This information is not required if the purchase price is based solely on the FMV at the beginning of the offering period or the grant date occurs on the purchase date. It is required only if the purchase price was not fixed and determinable on the grant date, which occurs if the plan has a look-back feature or the purchase price is based on the FMV at the purchase date.
- Account number

    A unique transaction number should be used on each Form 3922 to facilitate IRS matching of forms. If an employee has more than one purchase per year, each purchase must be reported separately and have a unique account number.

The filing requirements of Form 3922 are summarized in Exhibit 8-8. Significant penalties may be incurred for late filing, not filing the required forms with the IRS, or failing to distribute the statements to the employees.

EXHIBIT 8-8: FORM 3922 FILING REQUIREMENTS

	Due Date	Other Comments
Paper filing	February 28 of the following year	Permissible only if the company has fewer than 250 reportable transactions
Electronic filing	March 31 of the following year	Required if the company has 250 or more reportable transactions in a year
Employee	January 31 of the following year	Substitute forms may be used to combine multiple transfers on a single form. Substitute forms must include "substantially the same" information noted above.

8.4.5.2. Frequently a company will electronically file Form 3922 with the IRS and use a substitute form to distribute to employees. Where appropriate, the company may include additional information for the employees to explain the information provided and describe the tax consequences of the transactions.

8.4.5.3. Form 3922 can be prepared internally or outsourced. If prepared internally, Equity Compensation is usually responsibility for filing the form. In some companies Accounts Payable, Payroll, or another department assume responsibility for the filings.

8.4.6. Stock purchased through an ESPP after January 1, 2011, is subject to cost basis reporting (because the shares are purchased for cash, they are considered "covered" shares). The broker is responsible for reporting the cost basis at sale to the employee and the IRS on Form 1099-B. The reportable cost basis includes only the price the employee paid for the stock. To calculate capital gain or loss upon sale of the shares, the employee must add any ordinary income subsequently recognized in connection with the sale of stock to the cost basis that was reported on Form 1099-B. The employee will make this adjustment on Form 8949 when completing Form 1040 in the year of sale.

8.4.6.1 For stock acquisitions on or after January 1, 2011, but prior to January 1, 2013, the broker must record a cost basis at least equal to the amount the employee paid for the stock. (Note – This may not be the same as the cost basis for tax purposes.) From 2011-2013, a broker may have, but was not required to, include ordinary income in cost basis reporting.

COST BASIS

The cost basis regulations require brokers to report only the discounted purchase price as the cost basis. Employees will have to increase the reported cost basis on Form 1099-B by reportable ordinary income from qualifying or disqualifying dispositions. Companies should be careful to report this income properly on Form W-2 and to advise employees how to adjust the cost basis of the shares sold to avoid over-reporting capital gains or underreporting losses.[6]

8.4.6.2 Although the broker is responsible for filing Form 1099-B, the plan administrator (e.g., the company) typically tracks and maintains the cost basis data. When the shares are purchased in the ESPP and the plan administrator transfers custody over the shares to the broker, the plan administrator is required to furnish to the receiving broker a transfer statement that must include the cost basis and acquisition date of any covered shares. For acquisitions after January 1, 2014, only the amount paid for the stock will be furnished to the receiving broker.

8.4.6.3 For nonqualified plans, calculating the complete adjusted cost basis is relatively straightforward, since ordinary income is calculated when the shares are purchased. The cost basis of shares purchased under a nonqualified plan is typically the FMV on the purchase date. This data should be readily available on the purchase date. For qualified plans, ordinary income is calculated when the shares are sold. Each purchase lot will have a unique cost basis, which must be separately calculated by the employee after the sale of shares. When the sale occurs after the shares are transferred to a broker, it is unlikely that the ordinary income component of cost basis reporting will be calculated by the broker for qualified plans.

8.4.6.4 Coordination is required between the plan administrator and broker to ensure the 1099-B reporting requirements are met. Processes and responsibilities should be clearly defined. The following areas should be addressed:

- How the information will be provided to the broker
- Whether the broker identifies ESPP shares on its system
- Whether the broker follows up with the administrator or issuer to obtain the complete cost basis in the event of a sale of ESPP stock
- Whether the broker provides supplemental information to the employee advising them either:
  - ✧ That the cost basis requires adjustment when reporting the sale on the employee's tax return, and/or
  - ✧ The dollar amount of basis adjustment required

8.4.6.5 Employee communications should be enhanced to include an explanation of the interaction of cost basis reporting and reporting the sale of stock for tax purposes. This will minimize misunderstandings and incorrect reporting of the sale of stock and is especially important if the 1099-B includes only the amount the employee paid for the stock and not the compensatory income.

8.5. Corporate Tax Deductions.

8.5.1. Normally a corporate tax deduction may be claimed for the ordinary income recognized by the employee upon the exercise of stock options. When an employee purchases stock under a nonqualified plan, the FMV at purchase less the purchase price is ordinary income to the employee. The company is entitled to a compensation deduction in the same amount provided the employer reports the compensation on a Form W-2 or the employee reports the compensation on his/her annual tax return.

8.5.2. The sale of stock under a qualified plan may result in a qualifying or disqualifying disposition. No corporate deduction is permitted under IRC §421(a)(2) for a qualifying disposition. The employer will be entitled to a deduction upon a disqualifying disposition equal to the amount the employee must include in income.[4] The employer may take this deduction in its taxable year in which the disqualifying disposition occurred.[5]

8.5.3. The corporate tax deduction may be limited under IRC §162(m) for certain employees whose compensation exceeds the $1 million cap for the year. A complete discussion of IRC §162(m) is outside the scope of this publication.

8.5.4. A US tax deduction is only permitted for employees working for the benefit of the US company. A non-US tax deduction may be allowed for the purchase discount of non-US employees in the location where the employees work. Certain steps must be taken to secure this non-US tax deduction including tracking the cost and allocating the cost to the employing companies. A non-US tax deduction may be available for qualified and nonqualified plans. Any decision to recharge the costs of the ESPP to a non-US jurisdiction must be discussed with the US issuer's tax department because it may impact the company's larger global tax strategy or transfer pricing arrangements.

8.5.4.1. For the company to obtain a tax deduction for the discount at the time of the purchase, an agreement needs to be in place between the US issuer and the employing company under the terms of which the employing company agrees to bear the cost of the ESPP for its employees. This agreement (i.e., recharge or reimbursement agreement) normally needs to be in place at the time the ESPP is first offered to the employee. In certain countries a formal recharge agreement is not required to claim a statutory deduction. To put a recharge agreement in place, an employing company may need to follow certain administrative steps such as having its shareholders approve the use of funds for this purpose. Exchange controls should also be considered to determine whether the recharge payment itself requires the approval of the exchange control authorities.

8.5.4.2. If such a recharge agreement is in place, the company needs to develop certain procedures to track the purchase of the shares and to charge the cost of those purchases to the employing company. This record is important for the company to be entitled to take the deduction. A recharge agreement may also impact the tax consequences for the employees and the employing company in the jurisdiction where the employees reside.

8.6. Issues Related to Non-US Employees.

8.6.1. Outside the US, employees generally will be subject to tax on the amount of the discount at purchase (i.e., FMV at purchase less the purchase price) in the country in which they reside. These non-US taxes apply to the purchase of shares by employees outside the US regardless of whether they are participating under a qualified or nonqualified plan. In some countries a special tax exemption may apply to exclude some portion of the discount from taxation if certain requirements are met.

8.6.2. For most non-US jurisdictions, the FMV of the shares is based on the value of the shares on the exchange on which they are listed on the day of the purchase. Some countries require that shares be valued for tax purposes at the average share price over the month prior to purchase, at a weighted-average price, or at the opening price on the day of purchase. Other countries require that a local bank or broker value the shares even though the shares are listed on a recognized stock exchange in the US or elsewhere. A company offering a global ESPP should determine which countries require a special tax valuation of the shares so that value is determined on a timely basis.

8.6.3. Because the purchase generally is a taxable event, a number of administrative and practical hurdles arise including:

- Meeting the company withholding and reporting requirements
- Paying the employer social tax obligations
- Calculating the taxable amount
- Determining the appropriate tax rate

These administrative issues mean that operating an ESPP outside the US may be more challenging than it is within the US.

8.6.3.1. The employing company may be required to withhold and report income and social tax on the discount. In addition, the employing company may be required to pay the employer's portion of any social tax on the discount. In some countries, the employer social tax is very high (e.g., 46% uncapped).

8.6.3.2. The calculation of the taxable amount and the associated withholding requires cooperation between the issuer and the company employing the participant. The number of shares to be purchased and the price paid for such shares must be determined employee-by-employee. The taxable income resulting from the discount is the taxable value of the shares under local country rules minus the purchase price. Once the discount is determined, the tax rate can be applied to determine the amount of tax that must be withheld.

8.6.3.3. The non-US tax rate generally is based upon the participant's marginal tax rate. The income is included in the employee's compensation in the month in which the purchase occurs and the appropriate marginal tax rate is applied. In some countries, employees are able to factor the discount into their income over the taxable year, rather than in the month in which the purchase occurs. This income averaging may result in a lower tax rate on the discount.

8.6.4. Once the taxable amount is determined and a country withholding obligation is identified, the company must decide how the tax amount will be collected from the participant and paid to the tax authorities in the jurisdiction in which the participant resides. The tax may be collected from the employee by:

- Withholding from the employee's compensation
- Selling a portion of the shares
- Withholding a portion of the shares

The advantages and disadvantages of each method are discussed in subsection 8.4.2. Note – In the US determining the minimum required statutory payment is relatively simple since the US provides for a flat withholding rate on supplemental payments. Most countries do not apply flat withholding rates to supplemental payments such as equity compensation. Income from equity awards is generally subject to tax at regular payroll tax rates.

8.6.5. The purchase of stock of a US issuer under a nonqualified ESPP is also subject to US withholding and reporting. Non-US tax residents can avoid this requirement by having a Form W-8 BEN – Certificate of Foreign Status – on file with the broker or the company. By completing a Form W-8BEN, the employee certifies under penalty of perjury that they are neither a US citizen nor a resident alien, and are not subject to certain US information return reporting and back-up withholding.

8.6.6. The purchase of shares may trigger taxation in multiple countries if during the offering period an employee moves from one jurisdiction to another or is a tax resident in more than one country. The company may be required to withhold and/or report taxes in multiple countries at the time of the purchase. The company should develop a system to identify mobile employees or employees who are resident in more than one tax jurisdiction and determine how to allocate the discount among jurisdictions for tax purposes. This requirement may also apply to a US taxpayer participating in the ESPP while a resident of a non-US tax jurisdiction. In this case the US taxpayer may be liable for tax in the non-US jurisdiction at the time of the purchase. A complete discussion of the issues related to mobile employees is beyond the scope of this publication.

Footnotes

[1] IRC § 1.83-3(a)(2)
[2] IRC §1.6041-2(a)(1)
[3] IRC §1.6039-1(e)(2)
[4] IRC §421(a)(2)
[5] IRC §1.421-2(b)(1)(i)
[6] ASC 718-740-25-2

9. Legal

9.1. Overview.

9.1.1. Companies and employees are subject to a variety of legal requirements relating to ESPPs. Companies must consider:

- Federal, state and local (city or county) tax regulations governing qualified plans
- Federal and state securities registration and prospectus delivery requirements
- Stock exchange listing requirements
- The source of shares (e.g., original issuance versus repurchased on market)

Certain employees are subject to additional legal requirements such as:

- Section 16 officers, who must file SEC Forms 3, 4, and 5
- Section 16 officers and other affiliates, who are subject to Rule 144 for sales of ESPP stock
- Section 16 officers and other individuals with access to material, nonpublic information, who are considered Insiders and are subject to trading restrictions such as window periods

Each country has different legal requirements that govern equity compensation for non-US employees. It is important to understand and follow the requirements in each country where employees will participate in the ESPP. In many cases the legal issues must be addressed and resolved before the non-US employees are allowed to participate in the Plan. A detailed discussion of country-specific requirements is outside the scope of this publication.

9.1.2. This publication will focus on unique requirements associated with ESPPs including:

- Section 16 reporting
- Impact of closed trading windows
- Global issues

See other GPS publications for detailed discussions of other legal topics.

9.2. Section 16 Reporting.

9.2.1. Section 16 officers are required to advise the SEC about ownership in the company and changes in their stock ownership. Form 4 – Statement of Changes in Beneficial Ownership of Securities – is filed periodically upon events changing beneficial ownership. Enrollment in an ESPP and contributions to the plan are not reportable transactions. Purchases under a qualified plan are exempt from reporting. Shares purchased are included in the number of shares owned on the next Form 4 or Form 5 (where they are typically identified in a footnote as ESPP shares).

9.2.2. A sale of shares purchased under an ESPP is not exempt from Section 16. The sale must be reported on Form 4 and is subject to the short-swing profits rule.

Companies and employees are subject to a variety of legal requirements relating to ESPPs. This publication focuses on some of the unique requirements of Section 16 reporting, trading windows, and global issues.

9.3. Trading Windows.

9.3.1. A closed trading window is a period during which the securities of a corporation cannot be traded by Section 16 officers and other Insiders who hold material, nonpublic information about the company and its affairs. The initial election to participate in an ESPP should be made during an open trading window. If so, the ESPP essentially serves as a 10b5-1 trading plan that has pre-set purchase dates, so that purchases under the plan are not generally prohibited during closed window periods nor are they affected by the Insider's possession of material, non-public information. Although trading restrictions should not affect the purchase of shares in an ESPP, a closed window period may restrict the sale of shares after purchase.

9.3.2. Primary responsibility for compliance with trading restrictions resides with the employee, not the company. Develop and implement a program to educate the appropriate employees about their responsibilities. As appropriate, notify employees when the trading window is open or closed. Equity Compensation should work closely with the company-designated broker to ensure the broker does not process trades during closed window periods. When multiple brokers are used, additional controls must be implemented.

9.4. Issues Related to Non-US Employees.

9.4.1. Determining the legal and regulatory requirements in each country can be challenging. Filings may be required from a securities, labor, and/or exchange control standpoint. The filings may be necessary before the plan is offered in a country, at the time of the enrollment, at the time of the purchase of shares, when shares are resold, or thereafter. Legal issues may impact all aspects of the ESPP process and may require the commitment of compliance resources as long as the ESPP is offered to employees in a country.

Caution – This section is an overview of the legal issues associated with global ESPPs and is not intended to address country-specific requirements. Noncompliance with local law may result in civil and criminal penalties. Consult with legal counsel to determine the country-specific requirements and the risks associated with noncompliance.

9.4.2. Most companies use outside legal counsel to determine the local country requirements. Because securities law compliance issues apply to the issuer, rather than to the local employer, best practice is to manage compliance at the US corporate level. In contrast, the exchange control and labor law issues often involve both the employing company and the issuer, so compliance may need to be managed on both corporate and local jurisdiction level.

9.4.3. Since each country has its own requirements, best practice is to develop a country-specific administration guide summarizing each jurisdiction's key requirements. Update this guide regularly or as legal requirements change. Once a filing has been completed for a country, share a copy and the details of the filings with the people responsible for the legal compliance and administration of the plan.

9.4.3.1. The offering of the ESPP may raise certain "acquired rights" issues if the plan is offered outside the US. An "acquired right" is a regularly offered employer-sponsored benefit that is deemed non-discretionary. The ESPP is more likely to be considered an acquired right under local law than options or RSU offerings because:

- Employees participate by means of contribution from their salaries
- Participation is offered to all employees working for the entity in the country
- The ESPP is offered continuously, and shares are purchased at each purchase period automatically unless the employee withdraws from the plan or terminates employment

If the plan is deemed to be an acquired right, the company may need the employees' consent or to offer some equivalent benefit should it wish to discontinue or change the ESPP provisions. The income from acquired rights may also need to be included in employees' severance calculations upon termination of employment.

9.4.3.2. Payroll deductions also require the approval of labor authorities in some non-US countries since portions of employees' paychecks are used to purchase foreign securities. Many countries restrict whether an employee's compensation can be used for this purpose or how much of the compensation can be used. The labor authorities may require a list of the employees participating in the plan and want copies of the signed employee consents to participate in the plan before they will allow the company to offer the plan in the country.

9.4.3.3. Offering the right to participate in the ESPP to employees residing in a non-US jurisdiction may be considered a securities offering in that jurisdiction. The purchase and the resale of the shares by employees may also be considered a securities offering in the jurisdiction. If the offer of the ESPP is deemed to be a securities offering in a country, then the issuer may need to register its shares or rights to shares, obtain an approval from the securities authorities in the jurisdiction, and/or prepare and distribute a prospectus to employees concerning the offering of securities.

9.4.3.4. Many countries exempt an issuer from the registration, approval, or prospectus requirements if the offering of securities is restricted to employees, is limited in terms of the number of offerees or the value of the offering, or is restricted in the manner in which the offering is made to employees. The issuer should determine whether such exemptions exist in a particular jurisdiction where the employees reside and, if so, whether they are self-executing or require the company to make a filing or give notice to the securities authorities and/or the employees. The exemption may need to be renewed periodically or at each purchase.

9.4.3.5. Exchange control restrictions may limit the conversion of currency, require special approvals of the exchange control authorities in a non-US jurisdiction, or mandate procedures be followed in connection with the purchase of shares. These exchange control requirements are discussed in detail in subsection 6.5.4.

A well-thought-out communication strategy is essential to explaining the benefits of the plan to employees. Because ESPPs are by nature broad-based, some eligible employees will be less sophisticated investors than participants in other equity plans.

10. Employee Communication

10.1. Overview.

10.1.1. Effective communication will increase employee perception of the value received from the ESPP and should increase participation in the Plan. A well-thought-out communication strategy is essential to explaining the benefits of the plan to employees. A strong communication program will take this into account. Describe the plan in a way that allows someone with minimal understanding of what stock is and how its price changes to make an informed decision about participating in the plan.

10.2. Communication Strategies.

10.2.1. Communications must be tailored to fit the details of the company's plan. When communicating, avoid inadvertent messages. Examples should reflect a stock price that is close to the company's actual trading price and show the stock price moving by realistic increments, both up and down. The communications budget will affect the forms of communication that are used. Most vendors offer cost-effective communications tools that can help with initial communication and automate ongoing communication.

10.2.2. The communication tools offered to employees should include tangible tools, if possible, so that employees can run their own scenarios. This allows them to model "what if" calculations without the company presenting implausible scenarios.

10.2.3. Some plan communications are mandatory. Publicly traded companies are required to distribute a plan prospectus that summarizes the key terms and conditions of the plan. A full discussion of SEC requirements is outside the scope of this publication.

10.2.4. When plans are revised, changes must be communicated in a clear and straightforward manner that genuinely addresses the reason for the change. Clear, honest, and direct communication of the change and what it means for employees is essential.

10.3. Ongoing Communications.

10.3.1. Ongoing communication is important. Exhibit 10-1 summarizes the key components of communication.

EXHIBIT 10-1: KEY COMPONENTS OF COMMUNICATION

When To Communicate	What To Communicate
Before enrollment period begins	Details of the plan Tax consequences of the plan Changes to the plan How to enroll in the plan
Start of enrollment period	Enrollment open How to enroll in the plan When the enrollment period ends Required disclosures
1 week before enrollment period ends	When the enrollment period ends
After enrollment period ends	Confirm enrollment status Confirm contribution rate
Before the purchase date	Requirements for opening a brokerage account, if any What to expect upon purchase, including When the shares will be in the employee's account
Purchase	Summary of the offering period Purchase date Amount contributed Number of shares purchased How the purchase price was calculated, including applicable exchange rate for non-US employees How shares will be issued When shares will be in the employee's account and available for sale Any excess contributions, the reason for the excess contribution, how the excess contribution will be treated (i.e., refunded or carried forward), and suggestions for minimizing excess contribution in the future Restrictions on subsequent sale of shares Explanations of the tax treatment of the purchase and sale of the shares Required tax withholding

10.3.2. Before the enrollment period begins, communicate the details of the plan and how to enroll in it. Clearly identify the deadline for submitting an election to participate. Remind employees at the beginning of the enrollment period and again one week before the period ends. As discussed in paragraph 5.2.1, some of the items that should be included in this communication are the Plan prospectus, a summary of the Plan benefits and risks, and the mechanics of participating in the Plan. Ensure all communications in connection with the plan are written in a manner that is comprehensible to a broad range of employees. Reference other appropriate resources that are available for employee use.

10.3.3. Once an employee has enrolled, confirm enrollment status and contribution rates, electronically or via hard copy. Before the purchase, communicate what employees should expect upon purchase, including whether to expect tax withholding. If the plan is a qualified plan, include an explanation of the required holding period to maximize the tax benefits and explain the difference in tax treatment between qualifying and disqualifying dispositions.

10.3.4. After the purchase, communicate the purchase price of the shares, when the shares will be deposited into employees' accounts, and any required tax withholding. If contributions were made in another currency, disclose the appropriate exchange rate. In many cases, these communications can be automated using vendor software. If necessary, advise employees of excess contributions, the reason for the excess contribution, how excess contributions will be treated (i.e., refunded or carried forward), and suggest ways of minimizing excess contributions in the future.

10.4. Communication Methods.

10.4.1. Employee demographics should be considered in determining which communication methods to use. Consideration should be given to employees' access to computers and familiarity with various communication methods. As appropriate, in-person communication should be part of the education effort.

10.4.2. Where possible, formal communications should be done electronically to improve employees' access to up-to-date information such as the current stock price and provide additional resources for finding answers to more detailed questions. Any employees who do not have access to computers in the ordinary course of business should be given access to hard copies of the materials. Consult Legal to determine the acceptability of using electronic communication.

10.4.3. For less formal communications, the company can take advantage of the broad-based nature of ESPPs by using social media such as Facebook, Twitter, and company message boards to generate interest in the plan. When these methods are used, monitor what the employees are saying and correct any incorrect information posted. Before posting information on such sites, clear the content with Legal to determine whether it is appropriate for legal purposes.

10.5. Issues Related to Non-US Employees.

10.5.1. While a complete discussion of global communications issues is beyond the scope of this publication, it is important to recognize that each country has its own rules governing the extent and delivery of employee communications about stock plans. In some cases, the company will be required to translate communications into a local language. Engage legal counsel that understands the specific rules of any country in which the ESPP is offered.

11. Financial Reporting

11.1. Overview.

11.1.1. Calculating the financial statement impact of an ESPP requires special expertise. The stock plan record-keeping system may be able to calculate the expense associated with ESPPs with common design features (e.g., 15% discount, look-back, 12-month offering period). For plans with more complex features, the company may need to use outside resources. Equity Compensation may play a direct role in the detailed accounting calculations using the stock plan record-keeping system or the department may focus on providing ESPP and payroll data to Financial Reporting.

11.1.2. This section provides an overview of the key concepts regarding the financial reporting for ESPP plans. In this section the term "withholdings" will be used to indicate contributions to an ESPP made through either payroll deduction or lump sum payments. This is consistent with terminology used in the accounting literature. The fair value of an ESPP is determined using the component measurement approach. Each design feature of an award is valued separately, and the respective values are added to determine the fair value of the award. These concepts apply to qualified and nonqualified plans and to US and non-US employees. This section discusses the most common types of ESPPs, the associated design features, and how each component is valued. A thorough discussion of the financial reporting requirements associated with ESPPs is outside the scope of this publication.

Generally accepted accounting principles (US GAAP) are normally used for preparing financial statements of US-headquartered companies. The Financial Accounting Standards Board (FASB) establishes standards for financial accounting and reporting.

The accounting standard that relates to accounting for equity compensation, including ESPPs, is Accounting Standards Codification (ASC) Topic 718 - Stock Compensation.

The International Accounting Standards Board (IASB) establishes International Financial Reporting Standards (IFRS) that are required or permitted in more than 100 countries. IFRS 2 addresses the treatment of share-based payments under the international accounting standards. Accounting for share-based payment under US GAAP ASC 718 and IFRS 2 are similar, but not identical.

This section assumes that financial results are reported under US GAAP/ASC 718.

11.2. Noncompensatory versus Compensatory.

11.2.1. A "noncompensatory" ESPP has no recognizable compensation cost. For an ESPP to be considered "noncompensatory," the plan must satisfy the following conditions:[1]

- Its terms are no more favorable than those available to all holders of the same class of stock, or the purchase discount from the market price cannot exceed the per-share issuance costs that would be incurred through a public offering of stock (generally assumed to be 5%). A discount of 5% or less is considered a safe-harbor discount and does not require further justification or assessment.
- Substantially all employees may participate on an equitable basis

Equity compensation professionals should understand the impact of the underlying data on the valuation of awards, the allocation of expense to the appropriate period, and the calculation of EPS, regardless of the extent of involvement in financial reporting.

- The plan incorporates no option-like features (e.g., a look-back), except for the following:
  - o Employees are permitted a period not to exceed 31 days after the purchase price has been fixed to enroll in the plan
  - o The purchase price is based on the FMV of the shares on the purchase date
  - o Employees are permitted to withdraw from the plan and receive a refund of any amounts paid

Most ESPPs are compensatory because they either contain a look-back feature or have a discount greater than 5%. The remainder of this section describes the accounting treatment under ASC 718 for compensatory ESPPs.

11.3. Grant Date and Requisite Service Period.

11.3.1. The general definition of the grant date in ASC 718 requires a mutual understanding of the terms and conditions of a share-based payment arrangement. Generally, the date when an ESPP offering begins is the grant date. Treasury regulations connected with IRC §423 specify that the maximum number of shares that an employee can purchase during an offering must be established at the offering date in order to establish a grant date for tax purposes. This is not required to establish a grant date for financial reporting purposes.

11.3.2. The requisite service period is the period over which the employee participates in the plan and pays for the shares. The period from the offering date through the purchase date is generally the requisite service period. Some plans provide for overlapping offering periods with multiple purchase periods. See Exhibit 3-1, Example 3, for an illustration of an overlapping offering period with purchases every six months.

11.4. Fair Value and Amortization by Plan Feature.

11.4.1. The examples in ASC Subtopic 718-50-55 measure total compensation cost at the grant date based on the number of shares that can be purchased using the estimated total withholdings and market price of the stock as of the grant date. The cost is not adjusted for the potentially greater number of shares that may ultimately be purchased if the market price declines.[2] Rather, the possibility of value gained from a decrease in stock price is built into the grant date fair value. No true up is required based on the final ESPP shares purchased except for terminations and changes due to compensation adjustments.

11.4.2. The fair value for a compensatory ESPP is determined as of the grant date and is recognized over the requisite service period. Certain common plan features may be treated as modifications when they are triggered and may lead to additional compensation expense. The fair value of an award under an ESPP with multiple purchase periods should be determined at the grant date in the same manner as a stock option that has graded vesting.[3] See previous GPS publications for more detailed discussions of determining the fair value of options with graded vesting.

11.4.3. The simplest type of ESPP offers a discount on the stock price on the offering date and does not have a look-back. The fair value is essentially the discount multiplied by the grant price (assuming the stock does not pay dividends). Since many ESPPs have features similar to options (i.e., look-backs), the calculation of fair value frequently requires multiple components and option pricing models, including:

- A percentage of a share of stock, representing the discount provided by the Plan
- A percentage of a call option, representing the additional benefit the employee receives if the stock price on the exercise date is higher than the stock price on the grant date
- A percentage of a put option, representing the guaranteed discount on the grant date stock price when the stock price on the exercise date is lower than the stock price on the grant date and additional shares are purchased

PUTS AND CALLS

Share Option: A contract that gives the holder the right, but not the obligation, either to purchase (to call) or to sell (to put) a certain number of shares at a predetermined price for a specified period of time. Most share options granted to employees under share-based arrangements are call options, but some may be put options.[4]

11.4.4. The call option and the put option are generally calculated using the Black-Scholes option-pricing formula. This valuation technique is used in the examples in this publication. Since the purchase or exercise date occurs at a set and known date (i.e., the purchase date), and there is no possibility of early exercise, it is generally not required to use more sophisticated valuation techniques (e.g., binomial model or Monte Carlo simulation). The inputs are the grant date stock price, exercise price, expected life, volatility, risk-free interest rate, and dividend yield. The stock price is equal to the FMV on the grant date, which is typically the offering date. The price is determined according to the Plan, and may be the closing stock price on the offering date, the closing stock price on the day prior to the offering date, or the average of the high and the low prices on the offering date. The exercise price is generally equal to the FMV on the grant date. Note that the exercise price is not reduced by the discount when determining the fair value for financial reporting purposes. In some limited cases the exercise price may be different from the grant price. For example, a company may structure an ESPP to start the same day as the company's IPO. The exercise price for the first offering may be defined as the IPO price, while the grant price is equal to the closing price the day of the IPO, which is likely to be different.

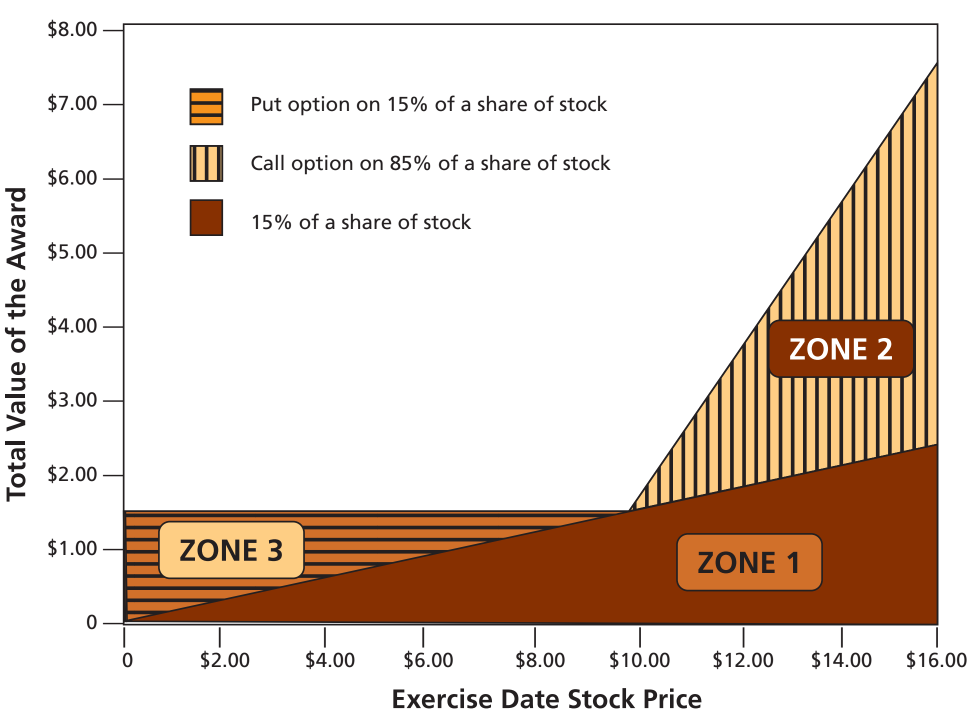
11.4.5. The remaining assumptions are calculated similar to those for stock option or stock appreciation right valuations. The expected life, however, is easier to calculate for ESPPs than for options and is simply equal to the time from the grant date to the purchase date. The volatility is generally calculated as the historical volatility over the expected life, the implied volatility, or some combination of the two. In the case of newly public companies, peer data may be used to determine the volatility. Like stock options, there is no single prescribed methodology for determining the volatility. The methodologies that are listed here are common ones used in practice, but this is not meant to be an all-inclusive list. The risk-free interest rate is the rate over the expected life. The dividend yield is the annualized yield expected to be paid over the expected life.

11.4.6. Exhibit 11-1 illustrates the concepts of the ESPP component valuation for ESPP shares granted at $10 and the potential payouts earned when the ultimate stock price ranges from $0 to $16. The chart is categorized into three zones:

- Zone 1: Represents the value delivered because of the 15% discount.
- Zone 2: Represents the value delivered only when the stock appreciates above $10. This piece illustrates the benefit of the call option from the look-back provision.
- Zone 3: Represents the value delivered only when the stock price depreciates below $10. This piece illustrates the benefit of the put option from the look-back provision.

Since the mathematics underlying the Black-Scholes model reflect a probability distribution of the future possible stock prices upon payout, the fair value of the call and the put options reflect the fair value depicted in Zones 2 and 3.

EXHIBIT 11-1: VALUE OF ESPP COMPONENTS



11.4.7. ASC 718-50 lays out the accounting treatment for common types of ESPP with a look-back feature. A look-back establishes the purchase price as the lower of:

- The stock price on the grant date (offering date) or
- The stock price on the exercise date (purchase date)

The standard defines nine types of ESPP (Types A through I) and details the fair value treatment for each. These are summarized in Exhibit 11-2. The fair values are determined using the component measurement approach, which means that different plan features are valued separately and summed together. Other plan design permutations are possible; however, this concise list covers the majority of plans.

EXHIBIT 11-2: SUMMARY OF ESPP PLAN TYPES

Type	Name	Distinction
Type A	Maximum Number of Shares	Maximum number of shares is determined on the date of grant using the FMV at the grant date
Type B	Variable Number of Shares	When the stock price declines, the employee is able to purchase more shares (i.e., there is no purchase price limit)
Type C	Multiple Purchase Periods	Longer look-back periods offer greater benefit to employees
Type D	Multiple Purchase Periods with a Reset	Reset protects against stock price declines since a look-back price is reset
Type E	Multiple Purchase Periods with a Rollover	If the stock price declines, the offering is restarted at lower price
Type F	Multiple Purchase Periods with Semifixed Withholdings	Allows increases or decreases to future contributions for future purchase periods within the offering period
Type G	Single Purchase Periods with Variable Withholdings	Allows increases or decreases to future contributions at any time
Type H	Multiple Purchase Periods with Variable Withholdings	Allows increases or decreases to future contributions at any time
Type I	Single Purchase Period with Variable Withholdings and Cash Infusions	Allows increases to past contributions and increases and decreases to future contributions at any time

11.4.8. Type A – Maximum Number of Shares.

11.4.8.1. Type A (Maximum Number of Shares) plans feature a look-back and set the maximum number of shares an employee can purchase at the grant date. The maximum number of shares is fixed based on the grant date price. Excess contributions are refunded if the FMV declines during the purchase period. The employee does not purchase more shares if the stock price declines. Exhibit 11-3 illustrates the potential value of a Type A plan.

EXHIBIT 11-3: TYPE A PLAN			
Plan Provisions: **Offering period** **Offering price** **Contribution** **Inclusion of look-back** **Interest paid on payroll deductions**	 6 months 85% of fair market value on lower of FMV on grant date or purchase date $1,000 total (prorata amount deducted from each paycheck) Yes No		
	Depreciating Stock Price	**Flat Stock Price**	**Appreciating Stock Price**
Assumptions:			
Stock price at beginning of offering period (A)	$10.00	$10.00	$10.00
Stock price at end of offering period (B)	$8.00	$10.00	$12.00
Purchase price (C=85% of lesser of A or B)	$6.80	$8.50	$8.50
Shares purchased [D=1,000 divided by (85% of A)]	117.6471	117.6471	117.6471
Number of shares purchased limited based on grant date price			
Fractional shares issued			
Value from discounted offering price	$141.18	$176.47	$176.47
Value from look-back	$0.00	$0.00	$235.29
Total value delivered [(B - C) X D]	$141.18	$176.47	$411.76
Amount Refunded to Employee [$1,000 – (C X D)]	$200.00	N/A	N/A

11.4.8.2. The fair value for a Type A plan consists of three components:

- Discount on a share of stock
- A portion (1 minus the discount percentage) of a call option
- Interest foregone

See Exhibit 11-4 for a summary of the fair value of the award described in Exhibit 11-3. The fair value of the award is fixed at the date of grant. Any subsequent appreciation in the stock price requires no adjustment to the original grant date fair value as the potential appreciation is factored into the value in the call option component of the original calculation. The valuation impact of dividends is discussed in paragraph 11.5.2.

EXHIBIT 11-4: CALCULATION OF FAIR VALUE OF TYPE A AND B PLANS

Plan Provisions:		
Offering period	6 months	
Offering price	85% of fair market value on lower of FMV on grant date or purchase date	
Inclusion of look-back	Yes	
Interest paid on payroll deductions	No	
	Type A Plan	**Type B Plan**
Assumptions:		
Grant date stock price	$10	$10
Expected life	0.50	0.50
Volatility	50%	50%
Risk-free rate	0.25%	0.25%
Dividend yield	0%	0%
15% of stock price	$1.50	$1.50
85% of a call option	$1.20	$1.20
15% of a put option	N/A	$0.21
Interest foregone	-$0.01	-$0.01
Total fair value	$2.69	$2.90

11.4.9 Type B – Variable Number of Shares

11.4.9.1. Type B (Variable Number of Shares) plans are the same as Type A plans except that an employee may purchase as many shares as their withholdings permit. This means that when the stock price is lower on the exercise date than on the grant date, an employee will purchase additional shares of stock with his withholdings. Exhibit 11-5 illustrates the potential value for a Type B plan.

11.4.9.2. Any plan with a look-back feature must state whether the number of shares that can be purchased is fixed (based on estimated contributions and the initial price) or variable. If the number of shares is fixed at the beginning of the offering period and if the stock price subsequently declines on the purchase date, then the employees purchase the shares up to the set limit and would receive a refund of leftover funds. If the plan allows for variable shares, then employees can purchase additional shares when the stock price declines, subject to any IRS or Plan limitations.

EXHIBIT 11-5: QUALIFIED PLAN WITH LOOK-BACK

Plan Provisions:			
Offering period	6 months		
Offering price	85% of fair market value on lower of FMV on grant date or purchase date		
Contribution	$1,000 total (prorata amount deducted from each paycheck)		
Inclusion of look-back	Yes		
Interest paid on payroll deductions	No		
	Depreciating Stock Price	**Flat Stock Price**	**Appreciating Stock Price**
Assumptions:			
Stock price at beginning of offering period (A)	$10.00	$10.00	$10.00
Stock price at end of offering period (B)	$8.00	$10.00	$12.00
Purchase price (C=85% of lesser of A or B)	$6.80	$8.50	$8.50
Shares purchased (D=1,000 divided by C)	147.0588	117.6471	117.6471
Number of shares purchased not limited by Plan			
Fractional shares issued			
Value from discounted offering price	$176.47	$176.47	$176.47
Value from look-back	$0.00	$0.00	$235.29
Total value delivered [(B - C) X D]	$176.47	$176.47	$411.76

11.4.9.3. Exhibit 11-5 illustrates an award with a guaranteed minimum value of 15% of the grant date stock price, which in this example is $176.47. This additional feature is valued as the equivalent of a put option on 15% of the shares with the exercise price equal to the grant price. The put option is valued using the stock price on the grant date and is not adjusted for the discount, similar to the valuation for the call option feature. Thus, the fair value for a Type B ESPP consists of four components:

- Discount on a share of stock
- A portion (1 minus the discount percentage) of a call option
- A portion (the discount percentage) of a put option
- Interest foregone

See Exhibit 11-4 for a summary of the fair value of the award described in Exhibit 11-5. The exhibit compares the cost of a Type A plan with a Type B plan. Note that the only difference is the inclusion of the put option.

11.4.10. Type C – Multiple Purchase Periods

11.4.10.1. Type C (Multiple Purchase Periods) plans have the same features as Type B plans, except that an offering period will have multiple purchase periods within a single offering. These plans set the exercise price at the lesser of the FMV at the beginning or ending of the offering period. An employee gets the additional benefit of a longer look-back period, since in theory the stock price has more time to appreciate. Exhibit 11-6 illustrates this type of plan.

EXHIBIT 11-6: QUALIFIED PLAN WITH LOOK-BACK AND MULTIPLE PURCHASE DATES

Plan Provisions:	
Offering period	Offering period of 24 months (February 1, 2012, to January 31, 2014) with purchases every six months (July 31, 2012, January 31, 2013, July 31, 2013, and January 31, 2014)
Offering price	85% of fair market value on lower of FMV on grant date or purchase date
Contribution	$1,000 total (prorata amount deducted from each paycheck)
Inclusion of look-back	Yes
Interest paid on payroll deductions	No
Assumptions:	
FMV on February 1, 2012 (A)	$10.00
FMV on July 31, 2012 (B)	$8.00
FMV on January 31, 2013 (C)	$9.00
July 31, 2012 purchase	
FMV on February 1, 2012 (A)	$10.00
FMV on July 31, 2012 (B)	$8.00
Lesser of 85% of lesser of A or B ($8.00 x 85%)	$6.80
January 31, 2013 purchase	
FMV on February 1, 2012 (A)	$10.00
FMV on January 31, 2013 (C)	$9.00
Lesser of 85% of lesser of A or C ($9.00 x 85%)	$7.65

11.4.10.2. The components of the fair value calculation are the same as for a Type B plan. The difference is that for a Type C plan a fair value is associated with each purchase period. The longer the look-back period, the greater the expense. The length of the look-back period increases the call and put option fair values and also affects the calculation of the volatility and risk-free rates. Higher volatilities and risk-free rates also increase the call and put option fair values. In practice the volatilities and risk-free rates may not always increase as the life increases. Exhibit 11-7 illustrates the fair value calculations for this type of plan.

EXHIBIT 11-7: VALUATION OF TYPE C PLANS				
	6-Months	**12-Months**	**18-Months**	**24-Months**
Grant date stock price	$10	$10	$10	$10
Expected life	0.50	1.00	1.50	2.00
Volatility	50%	55%	60%	63%
Risk-free rate	0.25%	0.75%	1.25%	1.5%
Dividend yield	0%	0%	0%	0%
15% of stock price	$1.50	$1.50	$1.50	$1.50
85% of a call option	$1.20	$1.87	$2.49	$3.01
15% of a put option	$0.21	$0.32	$0.41	$0.49
Interest foregone	-$0.01	-$0.03	-$0.08	-$0.13
Total fair value	$2.90	$3.66	$4.32	$4.87

11.4.11. Type D – Multiple Purchase Periods with a Reset

11.4.11.1. Type D (Multiple Purchase Periods with a Reset) plans are similar to Type C plans, except that they contain a "reset" feature. If the FMV on a purchase date is less than the grant date FMV, then the reset is triggered. For the remaining purchase periods within the offering period, the look-back will be based on the FMV as of the beginning of the purchase period immediately following the date when the reset is triggered (typically one day after) and the FMV on the exercise date.

11.4.11.2. At the grant date, the fair values of the tranches are calculated, the same way as for a Type C plan. The expense is amortized over the purchase periods in accordance with the company's policy for straight-line or graded amortization. Some practitioners refer to this as "FIN 28," front-loaded amortization, or accelerated amortization. Straight-line amortization spreads the expense evenly from the grant date to the last vesting date (for an ESPP this would be the last purchase date in an offering period). Graded amortization treats each tranche as a separate and standalone award, such that the expense associated with each tranche is recognized from the grant date to the vesting date of the tranche.

11.4.11.3. When the FMV is lower on an exercise date than on the grant date, the employees will purchase shares for the current purchase period based on the discounted exercise price. There is no change to the fair value calculations for this period or prior periods. However, for any future purchase periods remaining in the offering period, the reset feature triggers modification accounting under ASC 718. The modification occurs because the employees are, in essence, exchanging an option to purchase shares at the grant date price for an option to purchase shares at a new lower stock price. This additional benefit results in additional expense for the company. The modification expense is based on two components:

- Incremental expense calculated on the date of the modification based on the excess of the fair value immediately after the modification when compared to the fair value immediately before the modification
- Additional shares that an employee will be able to purchase based on the decrease in stock price (i.e., new look-back FMV), as compared to the estimated shares calculated on the grant date

Any additional expense resulting from the modification will be amortized over the remaining purchase periods. These concepts are illustrated in Exhibits 11-8 and 11-9.

EXHIBIT 11-8: VALUATION OF TYPE D PLANS			
Plan Provisions:			
Offering period	Offering period of 24 months (January 1, 2012, to December 31, 2013) with purchases every six months (June 30, 2012; December 31, 2012; June 30,2013; and December 31, 2013)		
Dividends	None		
Interest paid on payroll deductions	No		
Contribution	$850 each purchase period		
Reset	Yes; triggered on June 30, 2012		
	12/31/2012	**6/30/2013**	**12/31/2013**
Grant date stock price	$10	$10	$10
Grant date exercise price	$8.50	$8.50	$8.50
Price on July 1, 2012	$8	$8	$8
Exercise price on July 1, 2012	$6.80	$6.80	$6.80
Expected life	0.50	1.00	1.50
Volatility	50%	55%	60%
Risk-free rate	0.25%	0.75%	1.25%
Dividend yield	0%	0%	0%
Pre-modification fair value:			
15% of stock price	$1.20	$1.20	$1.20
85% of a call option	$0.43	$0.95	$1.48
15% of a put option	$0.37	$0.46	$0.53
Present value of interest foregone	-$0.01	-$0.03	-$0.08
Total pre-modification fair value	$1.99	$2.58	$3.13
Post-modification fair value:			
15% of stock price	$1.20	$1.20	$1.20
85% of a call option	$0.96	$1.49	$2.00
15% of a put option	$0.17	$0.25	$0.33
Present value of interest foregone	-$0.00	-$0.03	-$0.06
Total post-modification fair value	$2.33	$2.91	$3.47

EXHIBIT 11-9: MODIFICATION EXPENSE RELATED TO TYPE D PLANS				
After the reset, the total expense for the offering period is calculated as follows and amortized over the remaining purchase periods.				
	6/30/2012	**12/31/2012**	**6/30/2013**	**12/31/2013**
Grant date stock price	$10	$10	$10	$10
Grant date share estimate (A=$850/$8.50)	100	100	100	100
Grant date fair value from Exhibit 11-6 (B)	$2.90	$3.66	$4.32	$4.87
Total grant date expense (C=A X B)	$290	$366	$432	$487
Modification expense:				
Pre-modification shares (D=$850/$8.50)	N/A	100	100	100
Pre-modification fair value from Exhibit 11-7 (E)	N/A	$1.99	$2.58	$3.13
Pre-modification expense (F=D X E)	N/A	$199	$258	$313
Post-modification shares (G=$850/$6.80)	N/A	125	125	125
Post-modification fair value from Exhibit 11-7 (H)	N/A	$2.33	$2.91	$3.47
Post-modification expense (J=G X H)	N/A	$291	$361	$434
Total modification expense (K=J - F)	N/A	$92	$103	$121
Total expense (C + K)	$290	$458	$535	$608

11.4.12. Type E – Multiple Purchase Periods with a Rollover

11.4.12.1. Type E (Multiple Purchase Periods with a Rollover) plans are similar to Type D plans, except that instead of a reset feature, they contain a rollover feature. A rollover occurs when the stock price on an exercise date is lower than the grant date stock price. At the rollover, the offering period is cancelled immediately after the purchase date and the employees are "rolled over" into a new offering period that uses the lower stock price as the base price.

11.4.12.2. If Exhibits 11-8 and 11-9 are applied to a Type E rollover plan, the incremental modification expense is similar. The expense for the first three purchase periods is the same. The expense associated with an additional purchase period must be added for plans with a rollover. No expense is associated with this additional purchase period from the previous offering period; therefore, there is no pre-modification expense and the fair value is the full amount of the post-modification fair value.

11.4.12.3. From administrative, accounting, and tax perspectives, reset and rollover features create complications. Tracking these changes is especially challenging because the features can be triggered multiple times within an offering. Ensuring that the $25,000 limit on qualified plans and plan share limits are applied appropriately when estimating expense (as well as when administering the actual purchase) is challenging since resets and rollovers allow for the purchase of additional shares each time they are triggered.

11.4.13. Type F – Multiple Purchase Periods with Semifixed Withholdings

11.4.13.1. Type F (Multiple Purchase Periods with Semifixed Withholdings) plans are similar to Type C plans (multiple purchase periods) except that an employee can increase or decrease his or her withholding amount immediately after a purchase period begins, to be effective for all future purchase periods in the offering. In practice, the employee authorizes a change for future purchase periods during the current period, but the change is not effective until the new purchase period.

11.4.13.2. Like Type D and Type E plans, Type F plans can trigger modification accounting under ASC 718. Any time an employee increases withholdings, modification accounting is triggered. For Type F plans, all increases are effective at the start of each new purchase period. Any decreases in withholding elections are ignored for expense purposes (i.e., the expense is not decreased to reflect this change because this is, in substance, a decision not to exercise). Decreases in withholdings, including decreases to 0%, are comparable to the cancellation (not to be confused with a "forfeiture") of vested employee stock options under ASC 718 in that there is no reversal of expense for these occurrences. The incremental modification is calculated based on the pre- and post-modification expense. The total modification expense will be equal to the modification fair value multiplied by the additional shares able to be purchased.

11.4.14. Type G – Single Purchase Periods with Variable Withholdings

11.4.14.1. Type G (Single Purchase Periods with Variable Withholdings) plans allow employees to change their withholdings at any time during the purchase period. The employee can increase or decrease the election for the purpose of all future withholdings. This type of plan can be combined with Type A or B plans, which are both single purchase period plans. A plan can allow unlimited contribution changes or place a limit on the number of changes permitted during the period.

11.4.14.2. Each time an employee increases his withholding election, modification accounting is triggered. The modification expense is calculated the same as for a Type F plan, where the additional cost is the number of incremental shares now able to be purchased multiplied by the modification date fair value. Variable withholdings add complexity to a plan because a modification valuation is required each time an employee increases withholdings, which could occur on numerous days during a purchase period. Thus, multiple fair values must be calculated, audited, and amortized over the remaining purchase period. Decreases in withholdings do not result in any modification accounting and any previously recorded expense for these "cancelled" shares is not reversed. These concepts are illustrated in Exhibit 11-10.

EXHIBIT 11-10: VALUATION OF TYPE G PLANS		
Plan Provisions: **Offering period** **Dividends** **Interest paid on payroll deductions** **Contribution**	 6 months, beginning January 1, 2012 None No $850 each purchase period	
Assumptions: **FMV on grant date** **Grant date fair value from Exhibit 11-4** **Employee increased contributions on April 1, 2012** **FMV of stock on April 1, 2012**	 $10 $2.90 $1,850 (a $1,000 increase per purchase period) $12	
The fair value for the modification is calculated as follows:	**Pre-Modification**	**Post-Modification**
Grant date stock price	$10	$10
Grant date exercise price	$8.50	$8.50
Price on 4/1/2012	$12	$12
Expected life	0.25	0.25
Volatility	45%	45%
Risk-free rate	0.15%	0.15%
Dividend yield	0%	0%
15% of stock price	$1.80	$1.80
85% of a call option	$1.95	$1.95
15% of a put option	$0.04	$0.04
Present value of interest foregone	-$0.00	-$0.00
Total modification fair value	$3.79	$3.79
Shares to be purchased	100	217.6471
Pre- and post-modification expense	$379	$825
Incremental expense (post-modification minus pre-modification)	$446	
The pre- and post-modification fair values are equal because the pre- and post-modification assumptions are the same. The only change is to the number of shares the employee will purchase. The modification expense is equal to the fair value multiplied by the incremental number of shares able to be purchased. In this case, the employee can purchase an additional 117.6471 shares ($1,000/$8.50), so the total modification expense is $446 (117.6471 shares X $3.79 fair value). The total expense for this employee is $936 ($290 grant date expense plus $446 modification expense).		

11.4.15. Type H – Multiple Purchase Periods with Variable Withholdings

11.4.15.1. Type H (Multiple Purchase Periods with Variable Withholdings) plans combine Type C (multiple purchase periods) and Type G plans (variable withholdings). As with Type G plans, modification accounting is triggered when employees increase withholding elections.

11.4.15.2. Perhaps the most complex type of plan seen in practice combines Type E (rollover), Type F (multiple purchase periods with semifixed withholdings), and Type H (variable withholdings). All three plan types can trigger modifications that must be tracked and accounted for separately. The complexities of multiple modifications include:

- Offering periods can roll over multiple times, and then incremental share calculations must be tracked separately.

- A rollover and an increase in contribution under a Type F plan (where the increase is effective for future purchase periods) can occur concurrently and trigger modification accounting on the same date. Issues arise regarding which incremental change is calculated first and which incremental shares are associated with which fair values.
- A rollover and increases under Type F and Type H plans (where contributions are increased during a current purchase period) can occur. Tracking the appropriate fair values and incremental shares able to be purchased due to each modification is difficult.

In addition for any type of modification, plan and IRS share limits cannot be exceeded.

11.4.16. Type I – Single Purchase Period with Variable Withholdings and Cash Infusions

11.4.16.1. Type I (Single Purchase Period with Variable Withholdings and Cash Infusions) plans are similar to Type G plans (single purchase period with variable withholdings) except that if an employee chooses to increase his withholdings, the "catch up" amounts can be paid at any point during the purchase period. The result is as if the employee chose to contribute at the higher contribution level for the entire purchase period.

11.4.16.2. Since there may not be a mutual understanding of the terms of the award, the grant date may not be determined until just before the exercise date. For example, assume an employee elected to withhold 1% of his compensation at the beginning of the offering period. One week before the purchase, the employee elects to make a catch-up contribution equal to contributing 15% of his compensation over the whole period. In this case, the grant date is the date the employee makes the catch-up contribution. There is no modification because the 15% election pertains to past services rendered. If the initial election is de minimis, the final measurement of the award may be deferred until the grant date is determined.

11.4.17. Plans can combine features of different types of plans. For example, a plan that combines Type E (rollover), Type F (multiple purchase periods with semifixed withholdings), and Type H (variable withholdings) is a very rich yet complex plan. It provides a great deal of flexibility for employees since they can change contributions throughout the offering (although some plans limit the number of changes) and the look-back and rollover feature protects them from stock price declines. From an administrative and financial reporting perspective, this type of plan can be burdensome to track and account for appropriately.

11.5 Other Considerations.

11.5.1 Foregone Interest.

11.5.1.1. The examples in ASC 718 do not consider the effect of interest foregone by the employee on the fair value of an award. Most ESPPs do not pay interest on the payroll withholdings collected from employees. The fair value should be reduced for the effect of foregone interest. Many companies exclude this component in the valuation as the difference is immaterial, but it is technically correct to include in the fair value calculation. Local law may require interest be paid on contributions by non-US employees. In certain cases contributions may be made by lump-sum payment rather than payroll deduction. The timing of the lump-sum payment could affect the calculation of foregone interest. Foregone interest is a product of the following components:

- FMV of the stock on the grant date
- Length of the purchase period
- Annualized risk-free rate of return
- 0.5 (assuming payroll withholdings are collected evenly over the purchase period and interest is paid at the midpoint of the period)
- Present value factor:

$$\left(\frac{1}{1 + Risk\ Free\ Rate}\right)^{Length\ of\ Time/2}$$

11.5.2 Present Value of Dividends.

11.5.2.1. For dividend-paying shares, the fair value must be adjusted if dividends are not paid on unvested shares of stock. Frequently dividends are not paid until the shares are purchased. The values of the unvested stock and the option components (and put, if applicable) are adjusted to account for the dividends employees do not receive during the purchase period.[5]

11.5.2.2. The components of the fair value for a Type B ESPP are as follows:

- Discount on a share of stock multiplied by the present value factor
- The present value factor assumes that dividend payments are reinvested in the stock and the present value of one share of stock that does not receive dividends is less than one:

$$\left(\frac{1}{1 + Annualized\ Dividend\ Yield}\right)^{Length\ of\ Time}$$

- Call option (with an annualized dividend yield assumption) multiplied by one minus the discount
- Put option (with an annualized dividend yield assumption) multiplied by the discount
- Present value of interest foregone

Exhibit 11-11 summarizes the impact of dividends on the valuation.

EXHIBIT 11-11: IMPACT OF DIVIDENDS ON THE VALUATION

Plan Provisions:		
Offering period	6 months	
Offering price	85% of fair market value on lower of FMV on grant date or purchase date	
Dividend payment	$0.25 per quarter, which is 2% annually	
Inclusion of look-back	Yes	
Interest paid on payroll deductions	No	
Assumptions:	**No Dividends Paid on Unvested Shares**	**Dividends Paid on Unvested Shares**
Grant date stock price	$10	$10
Expected life	0.50	0.50
Volatility	50%	50%
Risk-free rate	0.25%	0.25%
Dividend yield	2%	0%
Present value factor of 1 share of stock	99.01%	100%
15% of stock price X present value factor	$1.49	$1.50
85% of a call option	$1.15	$1.20
15% of a put option	$0.22	$0.21
Present value of interest foregone	-$0.01	-$0.01
Total fair value	$2.85	$2.90

11.5.3 Treatment of Compensation Increases.

11.5.3.1 Changes in withholdings due to compensation increases are not considered modifications to the awards. ASC 718 includes commissions and bonus payments in the definition of compensation increases. Additional compensation expense will be recorded based on the incremental number of shares purchased with the additional amounts withheld multiplied by the grant date fair value. The incremental number of shares is calculated based upon the exercise price on the grant date, as if the calculation were performed on the grant date. Some companies include expected compensation increases in the initial grant date estimates to minimize adjustments to the compensation expense at the end of the period.

11.5.4 Terminations versus Withdrawals.

11.5.4.1. ASC 718 makes a distinction between terminations and withdrawals from a plan. A termination is considered a pre-vesting forfeiture. Previously recognized expense for the purchase is reversed and no further expense is recognized, similar to a stock option that is forfeited prior to vesting. A withdrawal occurs when an employee decreases his or her contribution to $0 (or 0%) and obtains a refund of any amounts previously contributed during the purchase period. When a withdrawal occurs, the grant date expense associated with the shares is not reversed. The withdrawal is ignored for accounting purposes, which is similar to the accounting treatment of a cancellation of an employee stock option (i.e., the requisite service period has been satisfied and the employee is simply choosing not to "exercise" the "option" to purchase the shares).

11.5.4.2. The treatment of a withdrawal is further complicated when a plan contains a reset or rollover feature. If an employee withdraws prior to a reset or rollover occurring, then no incremental expense associated with the award is recorded since no additional benefit is realized by the employee.

11.5.5 Tax Accounting.

11.5.5.1. The value of equity compensation to be expensed should consider the potential tax benefit of a corporate tax deduction. The benefits of the corporate tax deduction are recognized currently for financial reporting purposes provided the cumulative amount of compensation cost recognized for equity compensation ordinarily would result in a future tax deduction under existing tax law.[6] Since tax deductions for qualified plans are limited to disqualifying dispositions, no corporate tax benefit can be anticipated. Corporate tax deductions can be estimated for nonqualified plans and offset the financial reporting cost of nonqualified plans. The potential tax benefits for nonqualified plans are tracked as a deferred tax asset (DTA) (i.e., a tax deduction will be claimed on the actual corporate tax return in the future). When actual tax benefits are claimed (normally when the purchase occurs for nonqualified plans), a tax deduction is permitted for the amount the employee reports as taxable income, assuming the compensation qualifies as a deduction. The actual benefit when the deduction is claimed on the corporate tax return most likely will not be equal to the estimated benefit initially recorded for financial reporting purposes. The difference between the estimated tax benefit and the actual tax benefit realized at the purchase is recorded as tax expense.

11.5.5.2 For qualified ESPPs, the potential tax benefit is not tracked as a DTA because no tax benefit can be anticipated. If the employee engages in a disqualifying disposition, the actual tax benefit of the disqualifying disposition is recorded as a reduction in tax expense.

11.5.6. Diluted EPS.

11.5.6.1. Shares issued under ESPPs are outstanding shares and are included in the calculation of basic and diluted earnings per share (EPS). The treatment of unvested ESPP shares in calculating EPS is unclear since Footnote 1 of FTB 97-1 states that they are treated as contingently issuable shares under ASC 260, but this footnote was not included in the codified standard.

11.5.6.2. If a company follows the contingently issuable approach, the contingency is the employees' payroll withholdings through the end of the period. The unvested shares that are expected to be purchased with these withholdings are calculated and one of two methods is applied:

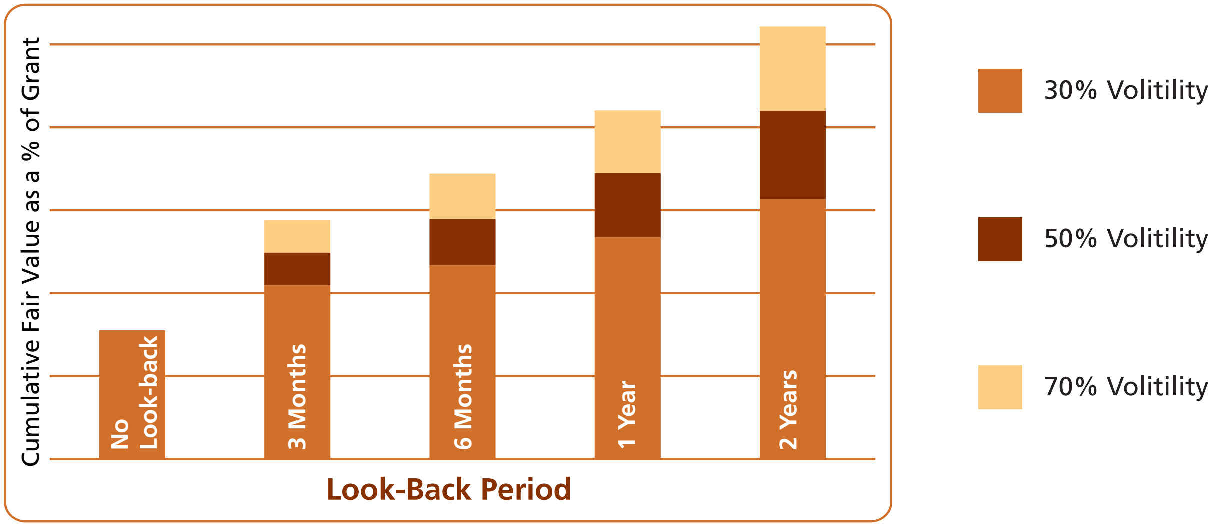
- If withholdings are refundable, the treasury stock method is applied to the unvested ESPP shares, just like unvested employee stock options and shares. This is the most common method used in practice.
- If withholdings are nonrefundable and a contingently issuable ESPP share is expected to vest, then the full amount of the ESPP share is included in the diluted EPS calculation.

11.5.6.3. Another approach applies the treasury stock method to the unvested shares for the entire purchase period, not just the portion for which withholdings have been collected through the end of the period. This method assumes that the unvested ESPP shares are not contingently issuable.

11.6 Sensitivity of Valuation Assumptions.

11.6.1. When designing a plan, the employee benefit must be weighed against the financial reporting impact. The financial impact of each design feature may not be intuitive and financial modeling may be appropriate as design features are considered. Exhibit 11-12 illustrates the fair value as a percentage of the grant price for ESPPs with various look-back periods and volatilities, assuming a 15% discount, no dividends, no interest paid on payroll deductions, and a risk-free rate of 1.5%. A more complicated plan has more variables and the ultimate cost is more difficult to forecast.

EXHIBIT 11-12: FINANCIAL REPORTING IMPACT OF ESPP FEATURES



11.7 Share Limitations and the Effect on the Valuation.

11.7.1. Share limits in a plan lower the fair value of the award. As the price of a stock declines, share limits are more likely to limit the number of shares an employee may purchase. The lower the share limit as compared to the price of the award, the more likely the share limit will be reached during a period.

11.7.2. In situations where employees are likely to reach the share limit during a period, a more sophisticated modeling technique like a Monte Carlo simulation may be necessary to value the put option component. This type of modeling is required to consider the various stock price thresholds where employees could reach the share limit. The put option fair value is reduced based on the probabilities of reaching those stock price thresholds. Although not technically correct, some companies in lieu of using a Monte Carlo simulation, continue to use a Black-Scholes valuation model and adjust estimated withholdings to reflect the effect of a potential decrease in share price on the share limit. The difference in values generated by each model may be immaterial.

Footnotes

[1] ASC 718-50-25-1
[2] ASC 718-50-55-25
[3] ASC 718-50-55-26.
[4] Glossary ASC Topic 718.
[5] ASC 718-50-55-18 and 718-50-55-19
[6] ASC 718-740-25-2

Appendix A: Acknowledgements

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The 2018 update to this publication was completed by Rachel Southorn of Stock & Option Solutions and Christine Zwerling of Twilio, Inc.

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Kathleen Wetzel, Morgan Stanley Smith Barney

The CEPI would like to acknowledge Carol Rutlen for her vision and significant contributions in making this project a reality. As a long-time supporter of the CEPI, previous Chair of the Advisory Board, former partner with PricewaterhouseCoopers, and adjunct professor at San Jose State, Carol's extensive industry experience equipped her well for this project. As Project Leader for this publication and previous GPS publications, Carol has been instrumental in researching and drafting this publication.

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Recognition is also due to Valerie Diamond, Partner, Baker & McKenzie, and Andrew Schwartz, CEP, Vice President, BNY Mellon. Valerie went well above and beyond in providing meaningful and relevant input on non-US issues. Andrew was instrumental in translating cost basis issues.

As an independent, academic organization the CEPI is proud to respond to the needs of the equity compensation industry by providing guidance on employee stock purchase plans.

Additionally, the CEPI is fortunate to have a dedicated and supportive Advisory Board. The Advisory Board initially recommended that the CEPI pursue independent research projects, and the Advisory Board has been actively involved throughout the project.

Appendix B: Glossary

ASC Topic 718	Accounting Standards Codification topic on stock compensation
Board	Board of Directors
Book Entry	Electronic recording of stock ownership where no physical certificate is given to securities broker
Broker	Brokerage firm; securities dealer; registered broker; stock broker
Closed trading window	Period of time during which designated individuals cannot trade securities of a corporation
Call Option	Used in valuing ESPP shares; an option that allows investors to buy a certain number of shares of stock at a specified price at a specified time
Common Stock	Capital stock; securities
Compensation Expense	Expense; compensation cost
Compensatory	An ESPP that must be expensed under ASC 718
Disqualifying Disposition	For purposes of stock purchased under an IRC §423 plan, a disposition made within two years from grant (offering date) or one year from exercise (purchase date)
Employee Trading Restrictions	Restrictions for employees on trading company stock
Enrollment Date	First date of the offering; Frequently the date the right to purchase the shares is granted
Enrollment Period	Period of time when the employee can enroll in the ESPP
Exchange Control	Restrictions on inbound and outbound transfer of local currency
Exercise	To execute the rights of an option to purchase shares at a predetermined price
Exercise Date	The date on which an option (purchase right) is exercised (purchased)
Fair Market Value	FMV
Fair Value	For accounting purposes, the value of an option (purchase right) determined in accordance with ASC 718
Form 3922	IRS form entitled "Transfer of Stock Acquired Through An Employee Stock Purchase Plan Under Section 423(c)"
Full-Service Brokerage Account	A brokerage account with stock plan and normal brokerage and investment functionality
Grant Date	Date of grant; under an IRC §423 plan, also known as offering date
Insider	A person with or eligible to have material, non-public information
Interest Foregone	Accounting term; interest is not paid on employee contributions to an ESPP, therefore the employee is considered to have foregone interest
IRC	Internal Revenue Code
Limited-Purpose Brokerage Account	A brokerage account that only holds shares received from equity compensation plans (e.g., stock option, ESPP, etc.); usually established by the company for the employees
Look-Back	A feature that bases the purchase price on the lower of the FMV on the grant (offering) date or the exercise (purchase) date
Modification	A change to the terms of the award; an accounting term
Noncompensatory	An ESPP that has no compensation expense associated with it; plan must meet requirements in ASC 718
Nonqualifed plan	An ESPP that is not qualified under IRC §423
Offering Date	Date of grant; under an IRC §423 plan, also known as grant date

Offering Period	The period starting with the grant (offering) date and ending with the exercise (purchase) date
Omnibus Account	A brokerage or transfer agent account in which the assets of more than one person are comingled; the account is managed by a custodian
Option	The right to purchase stock
Ordinary income	Compensation income; compensation
Participant	An employee participating in the employee stock purchase plan
Plan	Employee stock purchase plan
Purchase Date	For purposes of ESPPs, the date on which an option (purchase right) is exercised (purchased)
Purchase Discount	Difference between the FMV at purchase and the purchase price
Purchase Price	Price paid for shares; the exercise price
Put Option	Used in valuing ESPP; an option that allows investors to sell a certain number of shares of stock at a specified price at a specified time
Qualified Plan	An ESPP that meets the requirements of IRC §423
Quick Sale	Immediate sale of shares purchased; election to sell is made at the time of enrollment and sale requires no further instructions from the employee
Reset	For an offering with multiple purchase periods, if the stock price on a purchase date is less than the grant date price, the look-back for the remaining purchase periods will be based on the lower price
Rollover	For an offering with multiple purchase periods; if the stock price on a purchase date is less than the grant date price, the offering is terminated and a new offering begins
Sell-to-Cover	Shares sold from award to cover tax obligations
Share Reserves	The pool of shares that has been authorized for issuance under a stock plan; share pool
Shares	Stock
Stock Plan Brokerage Account	Brokerage account established specifically for company stock plan transactions; also known as a Limited-Purpose Brokerage Account
Tax Withholding	Withholding of income and social tax
Variable Withholdings	Accounting term; an employee can change the amount of contributions during an offering period
Withdrawal	An employee election to terminate participation before shares are purchased and accumulated contributions are refunded
Withhold-to-Cover	Shares withheld from award to cover tax obligation; net settlement
Withholding	Accounting term; employee contribution to an ESPP in the form of payroll deductions or lump-sum payments

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The Certified Equity Professional Institute (CEPI) at Santa Clara University is the only source of professional certification for equity compensation professionals. The CEPI is a nonprofit, academic organization with a mission of establishing, promoting, and providing certification and continuing education for the equity compensation industry.

Since its founding in 1989, the CEP Institute self-study curriculum has served as the industry's educational standard. Organizations and individuals use Institute exams as a measurement of basic (Equity Compensation Associate), intermediate (Level II), and advanced (Level III) knowledge, skills, and abilities related to equity compensation administration. The CEPI curriculum covers accounting, corporate and securities laws, taxation, and equity plan design, analysis, and administration, ensuring that CEP designees have achieved a required level of expertise in all of the relevant areas of equity compensation.

As the only source of professional certification in equity compensation, the CEPI recognizes and understands the critical need for impartial guidance in this area. The CEPI has undertaken a series of research projects titled *GPS: Guidance | Procedures | Systems.* Other GPS publications include:

- GPS | Performance Awards
- GPS | Global Stock Plans
- GPS | Restricted Stock and Restricted Stock Units
- GPS | Stock Options
- GPS | Participant Education and Communication: Case Studies

Previous GPS publications can be downloaded from www.scu.edu/business/cepi/.

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GPS

A research study of the Certified Equity Professional Institute

Guidance | Procedures | Systems

Restricted Stock and Restricted Stock Units

2022 Edition

SANTA CLARA UNIVERSITY

Risks and Controls:

- Restricted Stock
- Restricted Stock Units

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Previous Research

The CEPI recognized a need for unbiased guidance on equity compensation practices. In response to this need, in 2007 the CEPI expanded its mission to include industry related research and published the inaugural GPS research publication focusing on non-qualified stock options. Since that time, the CEPI has published six research documents, each addressing a different facet of equity compensation. Details of this research and the downloadable publications are available at www.scu.edu/business/cepi/.

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The CEPI was founded in 1989 to establish, promote, and provide certification and continuing education for the equity compensation industry. Since its founding, the CEPI's self-study curriculum has served as the industry's educational standard. The CEP curriculum focuses on the core disciplines of equity compensation: Accounting; Equity Plan Design, Analysis and Administration; Corporate and Securities Law; and Taxation. The CEP designation is granted to individuals who have passed all three exams and have demonstrated mastery of equity compensation related issues in all of the core disciplines. The Equity Compensation Associate (ECA) designation is granted to individuals who have passed the first exam. Visit www.scu.edu/business/cepi/ for details on certification.

Public Comment

The CEPI invited individuals and organizations to send written comments on all matters in the draft publication. All comments received were reviewed and incorporated as appropriate into this final document.

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Introduction

Equity compensation plans involve a broad range of financial, compliance, and operational risks. Even closer examination of these risks has been triggered by legislative and accounting changes. In response, there has been a renewed focus on internal controls to mitigate these risks. To achieve success in this area, it is essential that all parties understand the risks and the appropriate controls for these risks. The key parties responsible for this critical area include the professionals involved in the day-to-day administration of the equity plans, Finance, Human Resources, Payroll, Legal, Internal Audit, the external auditors, and, where appropriate, the third-party administrator and other third-party vendors.

RISKS

Even an apparently simple equity compensation program involves highly complex administration and coordination of many disparate internal and external parties. This complex administration, coupled with the regulatory requirements such as ASC Topic 718 and Sarbanes-Oxley has catapulted this function into a high risk area. Risks can be categorized into three predominate areas:

- Financial risk (e.g., an inaccurate grant date may have a significant financial statement impact)
- Compliance risk (e.g., failure to comply with SEC requirements regarding plan approval and compliance requirements can result in adverse publicity and shareholder and employee lawsuits)
- Operational risk (e.g., staff with inadequate skills or training can introduce risk into nearly every established process)

PURPOSE

This publication addresses the issues associated with **restricted stock** and **restricted stock units** awarded to US employees of publicly traded companies. For the purposes of this publication, the discussion of restricted stock units will be limited to awards settled in stock. Additionally, this publication assumes that the release of the underlying shares is not deferred, but occurs upon vest. Finally, all discussions assume time-based vesting, as opposed to performance-based vesting. (For a complete discussion of performance awards, refer to the Performance Awards GPS publication included in this volume.)

A separate publication specifically addresses stock options granted to US employees. For a copy of that publication, visit http://cepi.scu.edu.

This publication is designed to address the need to evaluate a company's equity compensation plans and related implications.

The following sections address critical processes in the Equity Compensation department and a detailed assessment of critical financial, compliance, and operational risks. Each section is composed of various questions and a discussion of the issues surrounding restricted stock and restricted stock units. Restricted stock is discussed first. Any differences with restricted stock units are discussed subsequently. For each process, illustrative controls and tests of controls to mitigate the risk have been identified. Each section of this publication will separately address the impact of outsourcing.

For purposes of this publication, the following terminology will be used:

TERMINOLOGY

Award	A grant of any type of equity compensation
Restricted Stock	Shares awarded for no cost with associated restrictions that lapse in the future
Restricted Stock Unit	A promise to award shares in the future
Vest	Award no longer subject to substantial risk of forfeiture
Release	Transfer of shares to the recipient

A more extensive glossary of terms can be found in Appendix B.

This publication contains some references to global issues and other types of equity awards. These references provide a high-level overview of some related key concepts, and are not intended to be comprehensive as they are outside the scope of this publication. Some of the controls in this publication can be applied to global issues, non-employees, and other types of equity arrangements. For a complete discussion of global issues, refer to the Global Equity Plans publication contained in this volume.

Restricted stock and restricted stock units and associated processes can be varied and complex. This publication is not intended to cover every possible contingency. The processes described represent standard practice, but each company's processes may differ based on their unique needs and resources. These recommendations should be considered general guidelines and applied as appropriate. Topics covered in this publication may need to be considered within the particular facts and circumstances of a company. For those reasons, clarifications such as "typically" and "generally" are not always included, but should be assumed. Please consult your own professional advisors with respect to the application of the information in this publication to company specific circumstances.

This document was last revised in late 2021.

Restricted Stock and Restricted Stock Unit Basics

The Restricted Stock and Restricted Stock Unit Basics section is a high-level overview and is intended for those who are new to the concepts of restricted stock and restricted stock units.

1.1. OVERVIEW OF RESTRICTED STOCK AND RESTRICTED STOCK UNIT BASICS

1.1.1. In the never ending quest to identify the ideal compensation structure to retain and motivate employees, companies have long embraced equity compensation as a component of long-term incentive compensation. The term "equity compensation" covers a broad range of equity awards, including stock options, restricted stock, restricted stock units, employee stock purchase plans, stock appreciation rights, performance awards, and innumerable variations on these equity awards. Stock options were the long-favored tool for delivering equity compensation due to relative simplicity, beneficial cash flow for the issuing company, and, historically, little or no related compensation expense in the financial statements. However, the introduction of ASC 718 coupled with growing shareholder concerns over dilution and burn rate, gave rise to a marked increase in the use of restricted stock and restricted stock units. Restricted stock and restricted stock units deliver the full value of the award rather than just the appreciation of a stock option. Additionally, restricted stock and restricted stock units deliver value even when the stock price declines. Therefore, these awards are generally smaller than corresponding awards of stock options.

1.1.2. Restricted stock and restricted stock units ultimately deliver similar economic benefits to an employee. However, the mechanics of the delivery are distinct. Exhibit 1 provides a basic comparison of restricted stock and restricted stock units.

1.1.3. Restricted stock is a grant of stock for which payment is not usually required. The stock is issued at the time of the grant, and the employee may be entitled to voting rights and dividends immediately. However, the stock is subject to vesting restrictions and held in an escrow account until the restrictions lapse. These vesting restrictions may be time-based and/or performance-based. As the restrictions lapse, the employee recognizes taxable income and the shares are delivered to the employee and can be freely sold.

1.1.4. Restricted stock units are a commitment from a company to issue stock in the future for which payment is not usually required. The stock is not issued at the time of the grant, so the employee is not entitled to voting rights and dividends, although dividend equivalents may be paid. The award is subject to vesting restrictions, which may be time-based and/or performance-based. As the vesting restrictions lapse, the shares issued are delivered to the employee. If provided in the Plan, an employee may defer the release of shares for restricted stock units under IRC Section 409A; without a valid deferral election, the employee recognizes taxable income at the time the shares are issued and released. Alternatively, under IRC Section 83(i), eligible employees participating in the broad-based equity plan of a privately held corporation may elect to defer the income taxation on shares released into an escrow account upon vesting of restricted stock units for up to five years, if permitted under such plan.

EXHIBIT 1. COMPARISON OF RESTRICTED STOCK AND RESTRICTED STOCK UNITS

	Restricted Stock	Restricted Stock Units
Issuance of shares	At grant	At release
Voting rights	Usually	No
Dividend rights	Usually	Dividend equivalents may be provided
Taxation point	At vest	At release, can be deferred*

Provided certain requirements are met.

1.1.5. Both restricted stock and restricted stock units deliver the full value of the underlying shares to the employee. When the risk of forfeiture lapses (normally at vest), the FMV (the value of the stock on that date) of the award is subject to tax. If the shares are vested, the employee can sell the underlying shares, assuming there are no trading or other restrictions.

1.1.6. Restricted stock and restricted stock units are distinctly different than stock options with respect to economic value. A stock option is a right to purchase a fixed number of shares of stock at a fixed price for a fixed period of time. Any value realized from a stock option is dependent on the current value of the stock being higher than the option price. Unlike stock options which have a cost to the employee (the option price), employees do not pay for restricted stock / restricted stock units, so the award always has value.

1.2. ADMINISTRATION

1.2.1. See Section 3, General Administration, for a full discussion of issues related to administration.

1.2.2. The "Administration" of restricted stock and restricted stock unit plans is bifurcated between the Board of Directors and the Equity Compensation department. The Board of Directors, or an appropriate subset of the Board or Compensation Committee, is named as "Plan Administrators" with responsibility for approving new awards and defining provisions that are not established in the Plan. The day-to-day administration of the Plan falls to the Equity Compensation department. This group may be part of Human Resources, Legal, or Finance.

1.2.3. A company may have a number of stock plans operating at any time. Multiple stock plans are the result of merger and acquisition activity where the stock plan is acquired or when the Company adds new stock plans to its total rewards structure. Employees may be granted awards from multiple plans. It is important that the plan requirements are followed for each specific plan. Awards that violate plan provisions may not be covered by the Plan and associated share registration. Compliance issues are abundant for awards that are not covered by an approved plan.

1.2.4. Administrative records may be maintained in a stock plan database, or, where the plans are simple and the population is limited, on a spreadsheet. For companies that maintain the data in-house, the stock plan database is generally a commercially-available database. The stock plan database is typically not integrated with the financial system or the human resource system. A company may keep all equity compensation records in-house, or the administrative and record-keeping function may be outsourced to a third-party provider, often a brokerage firm. Additional controls may be necessary where administration and record-keeping are outsourced.

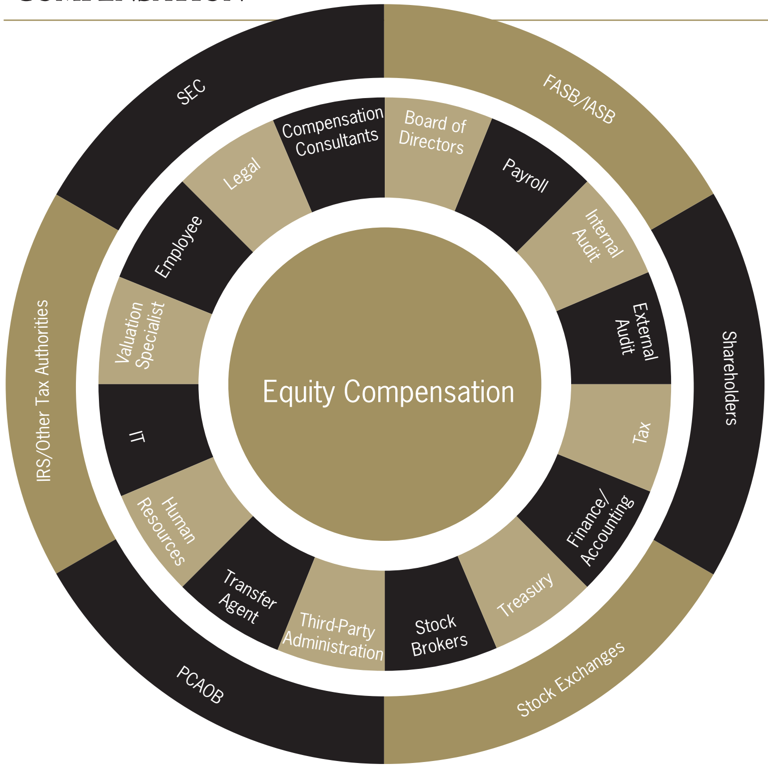
1.2.5. Overall, the administration of a company's stock plan is highly complex. The Equity Compensation department is truly at the intersection of many unrelated parties inside and outside the organization, requiring data input from and output to many groups. The major external parties involved include a stock broker or multiple brokers to facilitate transactions, a transfer agent to handle the record-keeping of all company share issuances, and possibly a third-party administrator to manage record-keeping and administration for equity compensation. Exhibit 2 illustrates parties involved in a company's stock program.

1.3. PLAN REQUIREMENTS

1.3.1. See Section 3, General Administration, for a full discussion of issues related to plan requirements.

1.3.2. The stock plan is developed by Human Resources and legal counsel, often with input from compensation consultants. Under state law, the issuance of stock requires approval of the Board of Directors. Therefore, Board approval of a stock-based plan is required. Also, the listing standards of most stock exchanges,

EXHIBIT 2. PARTIES INVOLVED IN EQUITY COMPENSATION



including the NYSE and NASDAQ, require that the Shareholders approve any plan under which stock can be granted to employees or Directors. After approval, the Plan must be filed with the SEC and the exchange where the shares are traded.

1.3.3. Each plan has unique attributes and administrative requirements that must be followed. Awards that are granted that do not meet the requirements specified in the Plan can have troublesome accounting, tax and securities law implications. Paragraph 3.3, Question 1, discusses the key plan features in more detail.

1.4. GRANT PROCESS

1.4.1. See Section 4, Grant Process, for a full discussion of issues related to grant processes.

1.4.2. Grant practices are critical to financial statement accuracy. The grant date establishes the fair value of the award based on the grant details. Thus, the grant practices are crucial in ensuring reliable data for financial statement purposes.

1.4.3. Award recommendations are developed by Human Resources, managers, Board of Directors, or executives. These recommendations are approved by the Board of Directors, or a committee/delegate designated by the Board. Upon approval, the Equity Compensation department verifies the award and employee information, records the award, and distributes the award notification to the employee.

1.4.4. The employee will receive an Award Agreement with details of the award and its terms. The agreement may be hard copy delivered via company channels, or it may be an electronic agreement delivered from the Equity Compensation department or by a third party.

1.4.5. Example. Human Resources recommends that Employee A receive an award of restricted stock of 1000 shares. The Board reviews and approves the award on April 1, 2017. The award vests in two equal annual increments on April 1, 2018, and April 1, 2019. As evidenced in Exhibit 3, the value of the award lies in the future value of the underlying stock.

EXHIBIT 3. GRANT OF RESTRICTED STOCK

Award Details

Award Date:	April 1, 2017
Shares:	1000
Price employee pays:	$0
FMV on April 1, 2017:	$10

Vest Details

Vest Date 1:	April 1, 2018
FMV on April 1, 2018:	$8
Vest Date 1 Gain:	$4,000 (500 vested shares x $8/share)
Vest Date 2:	April 1, 2019
FMV on April 1, 2019:	$12
Vest Date 2 Gain:	$6,000 (500 vested shares x $12/share)

1.4.6. Each process within the Equity Compensation department is cross functional. For example, the grant of a restricted stock unit can require input and participation from many disparate parties, and much data must be validated to ensure that the grant is proper. Appropriate grant processes are critical to ensure accurate financial reporting. Exhibit 4 illustrates a typical grant process administered internally by a company.

1.4.7. Where restricted stock units are granted, the process in Exhibit 4 is modified slightly. The Transfer Agent is not notified at the time of grant. The shares underlying a restricted stock unit are not issued until the restrictions have lapsed.

1.5. DIVIDEND PROCESS

1.5.1. See Section 5, Dividend Process, for a full discussion of issues related to dividend processes.

1.5.2. Dividends are payments a company may make to shareholders to distribute company profits. Not all companies pay dividends. If dividends are paid, they may or may not be paid on a regular basis. In addition, dividends can be paid in cash or stock.

1.5.3. Restricted stock is issued at the grant date; therefore employees holding unvested restricted stock are company shareholders. If a company pays dividends, the restricted stock plan usually provides dividends on unvested restricted stock even though dividends are not required to be paid on restricted stock.

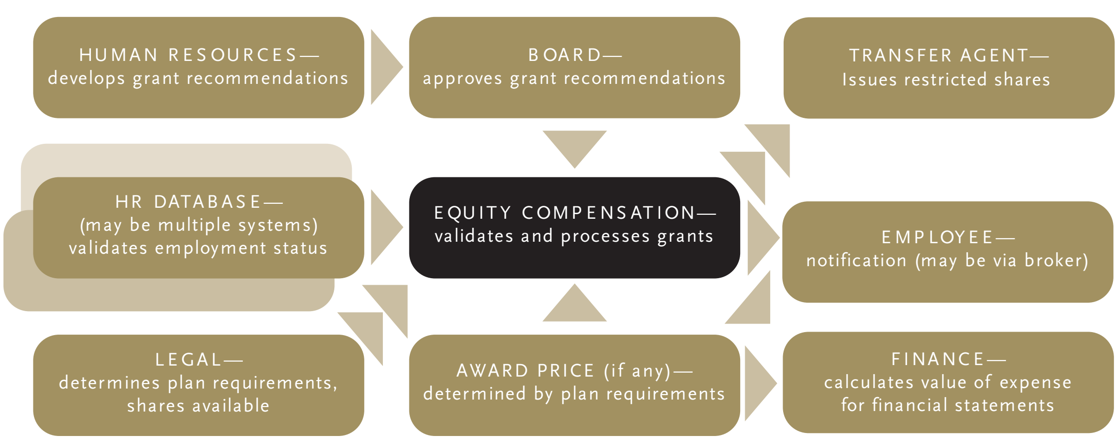
1.5.4. Restricted stock units are not issued until the applicable restrictions have lapsed. Therefore, employees with unvested restricted stock units are not shareholders of the company. Dividend equivalents paid on restricted stock units are not actual dividends, but the payments are structured to mirror dividends.

1.5.5. Dividends and dividend equivalents can be paid currently in cash or can be deferred until a future date and paid in cash or stock. Current payments are distributed to the employee at the time the regular dividend payment is distributed to the shareholders. Deferred payments are held until the award vests and paid at the time the shares are released to the employee. Administration of dividends, particularly dividend equivalents, is challenging, complex, and may exceed the benefit to the employee.

1.6. VEST/RELEASE PROCESS

1.6.1. See Section 6, Vest/Release Process, for a full discussion of issues related to vest/release.

EXHIBIT 4. GRANT PROCESS FOR RESTRICTED STOCK



1.6.2. Restricted stock and restricted stock units include a vesting schedule, requiring continued employment or the achievement of particular performance targets for the restrictions to lapse. An employee fully earns the award when the restrictions lapse, typically at vest date. For restricted stock, the shares are actually issued through the transfer agent at the grant date. Between the date of grant and the vest date, the shares may be held in an escrow account. The vest date triggers the lapse of the restrictions and the release of the shares from the escrow account. For restricted stock units, the vest date is the date the restrictions lapse and the shares are issued and released to the employee.

1.6.3. The vesting schedule is the time from the grant of the award to the time when the restrictions lapse. Awards may have cliff vesting, where the award vests in full at a specific date, or may have graded vesting, where the award vests incrementally over months or years. If the employee terminates employment before the award is fully vested, the vesting will cease as of the last day of employment. The terminating employee will forfeit awards that have not vested. Some plans may provide continued or accelerated vesting in particular cases, such as death, disability or retirement.

1.6.4. At vest, when the restrictions lapse and the shares are released, there is a taxable event and generally the underlying shares of stock are freely tradable. In this respect, restricted stock and restricted stock units are significantly different than stock options. With stock options, the employee decides to exercise the stock option which triggers the taxable event; with restricted stock and restricted stock units, the predetermined vest date triggers the taxable event. However, it should be noted that the release of restricted stock units may be deferred, affecting the timing of the tax event.

1.6.5. The vesting schedule also impacts the accrual of the expense. The fair value of restricted stock and restricted stock units is expensed over the service period. Usually, the service period is the vesting period. For example, if the award in Exhibit 3 has a fair value of $10,000, the Company will record an expense of $5,000 per year. (For simplification, this follows a straight line attribution method and forfeitures are not included.)

1.7. TAX AND PAYROLL ISSUES

1.7.1. See Section 7, Tax and Payroll Issues, for a full discussion of issues related to tax and payroll.

1.7.2. The taxation of restricted stock and restricted stock units is event driven. Restricted stock is taxable for social and income tax at vest, while restricted stock units are taxable for social tax at vest and income tax at release. For purposes of this publication, it is assumed that the vest date and release date occur on the same date. Therefore, the tax event of restricted stock and restricted stock units is at vest/release. At that point, the shares are no longer subject to forfeiture and the employee recognizes taxable income. Retirement eligibility may affect the timing of the tax event. See paragraph 7.3, Question 32, for details.

1.7.3. Before the shares can be released to the employee, the company must ensure the applicable taxes are paid. The FMV on the vest date is a taxable gain to the employee. Federal, state, local, and social taxes must be paid on any taxable gain recognized by the employee. The administrative processes and data transfers associated with the tax and payroll process are particularly challenging.

1.7.4. Employees can meet their tax withholding obligations using various methods (as permitted in the Plan and Agreement) discussed in Exhibit 5.

1.7.5. Withhold-to-cover and sell-to-cover are the preferred methods of tax payment. (Collecting cash for any but the smallest of plans is administratively burdensome and impractical.) Both have distinct advantages and disadvantages relating to corporate cash flow, managing trade volumes, and administrative processes. See paragraph 7.3, Exhibits 8 and 10 for full details on the steps of withhold-to-cover and sell-to-cover transactions.

1.7.6. The release of shares may also have financial statement implications for the Company since the Company is entitled to a tax deduction for the gain recognized by the employee. In addition, the payment of taxes through withhold-to-cover will be reflected in the Statement of Cash Flow as outgoing cash.

EXHIBIT 5. TAX PAYMENT METHODS

METHOD	DESCRIPTION	CASH FOR TAXES GENERATED BY	SHARES HELD AFTER TRANSACTION	BROKER REQUIRED?
Withhold-to-Cover	Company withholds necessary shares when shares are released. Shares to be withheld are calculated at current FMV to cover tax liability.	Company	Net	No
Sell-to-Cover	Open market sale of shares to generate adequate proceeds to cover tax liability.	Stock Sale	Net	Yes
Cash	The employee pays cash to cover the the tax liability.	Employee	All	No

Strategic and Tactical Design Issues

2.1. INTRODUCTION

When designing an equity compensation plan, strategic guidelines must be established. Additional decisions are required when converting the strategic guidelines into tactical policies and procedures. These decisions may impact the market price of the stock, the cash flow of the company, the investment community's perception of corporate governance, accounting for equity compensation, the scrutiny of internal/external auditors, the employees' perception of the benefit provided, and the cost of administering and communicating the plan. This section discusses some of the considerations when making strategic and tactical decisions.

2.2. OVERVIEW OF THE STRATEGIC AND TACTICAL DESIGN ISSUES

2.2.1. Collecting Tax on Awards. The most common methods of collecting tax are (1) withhold shares to cover the tax and (2) sell shares to cover the tax. When shares are withheld to cover the tax, the company withholds shares equal to the required payroll taxes and the company pays the payroll tax obligation from company funds. When selling shares to cover the tax, the sale proceeds are used to fund the payroll tax obligation. (Note – Selling shares can create problems if the vesting date occurs during a blackout period.) The ramifications of each method are amplified when a large number of restricted stock and restricted stock units vest on one day. This can result in a large number of shares being sold on one day to pay payroll tax (sell shares to cover the tax) or a significant cash outlay for the company (withhold shares to cover the tax). These issues are discussed in more detail in paragraph 7.3, Question 31.

2.2.2. Accelerated or Continued Vesting Upon Retirement. Restricted stock and restricted stock units that vest or continue vesting upon retirement are difficult to administer. Restricted stock is taxable for income and FICA tax purposes when the recipient is retirement-eligible even though the award has not vested. Restricted stock units are taxable for FICA tax purposes when the recipient is retirement-eligible. (Note – Restricted stock units are taxable for income tax purposes when the shares are released.) Because the tax event precedes the vesting event, reporting and collecting tax is burdensome and employee communication is challenging. Consider eliminating plan provisions that provide for vesting or continued vesting upon retirement.
If this provision can not be eliminated, minimize the administrative burden and the tax owed at retirement eligibility by issuing restricted stock units rather than restricted stock to employees that are retirement-eligible or will become retirement-eligible before the award vests. These issues are discussed in more detail in paragraph 7.3, Question 32.

2.2.3. Restricted Stock versus Restricted Stock Units. Restricted stock and restricted stock units provide a similar benefit to employees. However, restricted stock units offer several advantages that restricted stock does not. Restricted stock units are a more tax effective instrument for non-US employees. Restricted stock units also minimize coordination with the transfer agent, eliminate potential §83b elections, offer deferral features, and provide tax advantages for retirement eligibility. These issues are discussed in more detail in paragraph 4.2, paragraph 4.3, Question 17, paragraph 7.3, and Questions 31 and 32.

2.2.4. Dividends on Restricted Stock or Dividend Equivalents on Restricted Stock Units. Paying dividends and dividend equivalents requires significant administration and the administrative cost may exceed the benefit to the employee. These issues are discussed in more detail in paragraph 5.3, Question 21.

2.2.5. Grant Dates. Granting awards at pre-determined dates eliminates potential grant date selection issues and reinforces the appearance of good corporate governance to the investment community. When selecting grant/vest dates for restricted stock and restricted stock units many factors need to be considered including:

- Market implications if employees sell significant shares on the vest date
- Number of vest dates — each vest date requires additional administration
- Number of transactions processed on each vest date
- Vesting close to dividend dates can be problematic
- Month-end and year-end vesting will complicate the payroll reporting process
- Selling shares during a closed window may be difficult.

These issues are discussed in more detail in paragraph 4.3, Question 15.

2.2.6. Vesting Schedules. Restricted stock and restricted stock units have become more popular and frequently replace stock options as the preferred equity vehicle. As a result companies tend to grant such awards to a larger number of employees and the average size of the award is smaller, often based on the incremental difference in the Black-Scholes value. Monthly vesting of restricted stock and restricted stock units is administratively burdensome because each vest requires an administrative process to distribute the shares, triggers a taxable event, and requires the collection of tax from the employee. In addition, a monthly vest of a small award may result in an after tax distribution of just a few shares to the employee. This small distribution of shares may decrease the employees' perception of the value of the equity award. Consider limiting vesting to annual vesting or cliff vesting. These issues are discussed in more detail in paragraph 6.3, Question 26.

2.2.7. Grant Guidelines. Grant guidelines simplify the approval process and minimize the potential errors when processing the grant. These issues are discussed in more detail in paragraph 4.3, Question 14.

2.2.8. New-Hire Grants. Issue all new-hire grants in accordance with a written policy which provides for awards to be issued only at pre-determined regular grant dates incorporating standard language. This will simplify the approval process and minimize potential accounting issues. These issues are discussed in more detail in paragraph 4.3, Question 12.

2.2.9. Grant Terms. Standardized grant terms minimize the potential of human error when processing the grant and should be used whenever possible. These issues are discussed in more detail in paragraph 4.3, Question 11.

2.2.10. Definition of FMV. The definition of FMV on the date of vest will impact payroll tax administration. Defining FMV as the market close on the day prior to vest streamlines the payroll process. Taxable income and associated tax may be calculated on the day prior to vest after the market closes. (This is 24 hours earlier than using the market close on the day of vest to determine FMV.) This timing may be critical in meeting the requirement to deposit federal employment taxes of $100,000 or more on the next banking day. These issues are discussed in more detail in paragraph 7.3, Question 34.

2.2.11. Plan Provisions Regarding Dividends and Dividend Equivalents. Even if the company does not currently pay dividends, the Plan should always include language regarding the right to dividends and dividend equivalents. These issues are discussed in more detail in paragraph 5.3, Question 21.

General Administration

3.1. INTRODUCTION

Statement of Auditing Standards 78 (AU 319.06) defines internal control as a process effected by an entity's Board of Directors, management, and other personnel that is designed to provide reasonable assurance regarding the achievement of objectives in the following categories:

- Reliability of financial reporting
- Effectiveness and efficiency of operations
- Compliance with applicable laws and regulations

Internal controls applicable to equity compensation are addressed in the relevant sections in this publication (e.g., controls associated with the grant process are summarized in Section 4, Grant Process). Overall internal controls with broad applicability are discussed in this section.

3.2. OVERVIEW OF GENERAL AMINISTRATION

3.2.1. In most companies the stock plan database is not electronically integrated with other company systems, resulting in increased manual entry. Therefore, there is an increased potential for errors and need for additional controls to minimize such errors. As detailed in paragraph 1.2, Exhibit 2, administering a stock plan requires a multidisciplinary team. Close coordination is required among various internal and external groups and controls are required to ensure consistency.

3.2.2. Commercially-available systems used to record, process, and report equity compensation are also changing. Historically, commercially-available systems were flexible with limited controls and a limited audit trail. This flexibility was an advantage when dealing with numerous manual processes. Functionality has been added to systems to provide more controls and a more robust audit trail.

3.2.3. This section discusses the overall controls applicable to the Equity Compensation department when administering awards of restricted stock and restricted stock units. Many of the controls discussed are also applicable to other types of compensatory equity awards such as stock options.

3.3. CONTROLS ASSOCIATED WITH GENERAL ADMINISTRATION

Q1: *What Are the Unique Requirements of Each Plan?*

Restricted Stock:

A company may have numerous stock plans operating at any time. The life cycle of a plan includes the period of time that awards are granted from the Plan. It also includes the period awards are outstanding. Each plan is unique and has distinct attributes and administrative requirements that must be followed. It is not unusual to have multiple plans and some plans may be inherited from an acquired company. Complications are increased when operating multiple plans. Care must be exercised to ensure that grants made from each plan are appropriate.

Plans may have very broad terms (e.g., allow numerous types of equity instruments), or narrow terms (e.g., only allow restricted stock).

Key plan features may include—

- Total number of shares that may be granted
- Types of awards permitted

GLOBAL ISSUES

In the EU and other non-US jurisdictions, personal data (any data which identifies the individual) is subject to certain protections with respect to the collection, processing in a database, or transfer from one jurisdiction to another (if adequate data protection is not considered to exist in the jurisdiction). For example, the US is not considered by the EU to have adequate protections in place for personal data, so transfers of data from an affiliate in an EU jurisdiction to the US may violate data privacy laws unless certain measures are taken to protect the data. These protections may apply to the employee data that is collected, processed and transferred cross-border when initiating or processing equity grants and should be considered before offering an equity program outside the US. A complete discussion of this issue is outside the scope of this publication.

- Standard term of awards
- Standard vesting
- Permitted deviations from term and vesting
- Award eligibility requirements
- Share-counting convention
  - Impact of grant/award on the share reserve
  - Shares returned to pool upon expiration, cancellation, termination, or other changes of employment status
  - Surrender or withholding of shares to pay award price (if any) and/or tax obligations
- Accelerated vesting
- Retirement eligibility
- Dividends and dividend equivalents
- Change of control provisions
- Permitted methods of paying tax obligations
- Details on how shares are added to the plan reserve
- Plan expiration

The administration of a plan should be considered in the plan design phase. Some design features are extremely complex and very challenging to administer. Wherever possible, the Equity Compensation department should be consulted before the Plan is finalized to ensure that the plan design can be efficiently administered. Section 2, Strategic and Tactical Design Issues, discusses the key considerations when designing a plan.

Specific plan requirements must be properly reflected in the—

- Program administration manual
- System functionality
- Documentation provided to employee in hard-copy, electronically, or via the Web

Particular attention should be paid to new plans implemented or new plan requirements. Identify when system limitations may restrict the ability to deal with different plan requirements such as treatment of leaves of absence. In such cases, clearly document what manual process will be implemented to meet the plan requirements.

Restricted Stock Units:
Same as restricted stock.

	Illustrative Controls	Illustrative Test of Controls
1	For each Plan, develop a standard template to summarize key plan requirements. Use the standard template to document the plan requirements. Document how the requirements are incorporated in the administrative processes, system functionality, and documentation provided to employees.	Confirm documentation of all plans. Verify that details of new plans have been documented. Test that plan requirements have been properly implemented.

Q2: *Has Each Plan Been Properly Approved?*

Restricted Stock:

The Plan must receive proper corporate approvals to be a valid source for the grant of restricted stock and other stock-based awards. Under state law, the issuance of stock requires approval of the Board of Directors. Therefore, Board approval of a stock-based plan is required. As part of that process, the Board typically delegates authority to the Compensation Committee to approve individual grants under the Plan. Also, the listing standards of most stock exchanges, including the NYSE and NASDAQ, require that the Shareholders approve any plan under which stock can be granted to employees or Directors. Failure to receive stockholder approval can subject a company to being de-listed from the exchange. In the case of acquisitions, special care must be taken to determine if the Plan continues and if it is a valid plan.

Various legal requirements must be addressed such as—

- Was the Plan filed with the SEC as an exhibit to an appropriate periodic report filed under the Securities Exchange Act of 1934?
- Was a registration statement filed with the SEC to register the offer and sale of stock under the Plan under the Securities Act of 1933?
- Have appropriate state laws been met?
- Were prospectus delivery requirements met?

For a further discussion of these topics see paragraph 9.3, Question 41.

Restricted Stock Units:
Same as restricted stock.

GLOBAL ISSUES

A sub-plan may be established for certain non-US jurisdictions where tax benefits or regulatory requirements create the need for specialized terms or provisions.

	Illustrative Controls	Illustrative Test of Controls
1	Document the Plan approvals such as Board minutes, Annual Shareholders Meeting minutes, SEC filings, etc.	Verify that all plans (including plans of acquired companies) have been approved.

Q3: Are the Staff That Oversee the Administration of Equity Compensation Qualified?

Restricted Stock:

Qualified staff is a key component of good internal controls. Administering or auditing a stock plan requires expertise in the areas of—

- Grant/vest/release practices
- Tax law
- Securities law
- Accounting and financial reporting
- Payroll reporting
- Systems

The Equity Compensation department is the hub of a multidisciplinary function. Traditionally, the equity compensation function has been part of the Human Resources organization. However, some companies have moved this function into Finance or Legal in recognition of the financial and compliance requirements associated with equity compensation.

Qualified staff and adequate resources for ongoing education are necessary for stock plan compliance. The job description should specify the qualifications required, the number of years of experience, and specialized certifications such as the Certified Equity Professional (CEP) designation. Even when the day-to-day administration of equity compensation is outsourced, a company should maintain internal expertise in order to meet its financial and legal requirements.

The field of knowledge is constantly changing and personnel need access to and training on latest pronouncements. Personnel should receive continuing education annually. In addition, personnel need adequate product training to understand appropriate tools in the stock plan database and the functionality of those tools. This training is critical for every release of the system.

When companies outsource all or part of their administration, overall responsibility for internal controls cannot be outsourced. Companies that outsource the administration of equity compensation and companies who manage administration in-house need qualified staff.

Restricted Stock Units:
Same as restricted stock.

	Illustrative Controls	Illustrative Test of Controls
1	Hire qualified experienced staff.	Review job description and verify current staff have met the requirements.
2	Require all staff have continuing education annually.	Verify that continuing education requirements have been met.
3	Require all appropriate staff have adequate product training.	Verify that product training requirements have been met.

Q4: Are the IT Controls for the Stock Administration System Adequate?

Restricted Stock:

Companies use a wide variety of stock administration systems—electronic spreadsheets, stand-alone systems, and systems that are fully integrated with other financial systems. The most common approach is the use of a stand-alone system.

A stand-alone system may be linked to other company systems, such as human resources and payroll, with electronic imports and exports. If the Company uses multiple human resource and payroll systems (domestically and internationally), it is more difficult to maintain proper control of the import/export functions. The Company may also link to outside service providers such as—

- Brokers—to deliver electronic Award Agreements and process sales of stock acquired through a restricted stock award.
- Outsource service providers—to handle some or all of the administrative processes on behalf of the Company.

Coordination with outside vendors is discussed in more detail in paragraph 3.4.

Wherever possible, leverage the general IT controls within the Company. The unique nature of the stock plan database may require additional controls. These are discussed in more detail below. This list does not incorporate the standard IT controls that should be in place at a company.

System Access. System access should be coordinated with the overall company controls. The IT department should assign access to the stock plan database (e.g., set passwords and password expiration dates, limit access rights to appropriate personnel, etc.). The Equity Compensation department should not grant access to the stock plan database, but they will make recommendations to IT regarding access rights. Periodically, system access should be reviewed to ensure that only appropriate staff have access.

Audit Trail. Additional steps may be required to provide an audit trail for data entry and system changes since this functionality may be limited in the stock plan database. When an audit trail is not provided automatically by the system, transactions should be entered as a group, validated, and documented. The transactions should be reviewed by someone other than the individual who entered the information. Checklists should be developed and utilized where appropriate. Reports should be generated from the system verifying that the transaction has been recorded properly. If no report is available, use "print screen" before and after the entry to provide documentation.

Maintenance Controls. A stand-alone system may not be covered by a company's standard backup process. Additional backup procedures may be necessary to ensure proper backup. In addition to a daily backup, the database should be backed up prior to major transactions and system upgrades. Document system backups and obtain appropriate sign-off.

System Upgrades. Periodically the stock plan database will be upgraded. If necessary, involve IT staff in the upgrade process. Review upgrade documentation from software provider. After the upgrade, test the functionality and the output (e.g., standard reports) to ensure that plan requirements are properly reflected. Document the test results and obtain appropriate sign-off.

Revisions to Plans. New plans and new plan interpretations must be incorporated into the system functionality. Test the functionality and the output after the changes. Document the test results.

Restricted Stock Units:
Same as restricted stock.

	Illustrative Controls	Illustrative Test of Controls
1	IT department authorizes access to the stock plan database.	Verify that appropriate staff have received authorization for system access from the IT department.
2	Review access to stock plan database quarterly to verify that access is limited to appropriate staff.	Verify that the quarterly review has occurred.
3	Develop procedures to document data entry and system changes. Utilize appropriate checklists.	Select transactions (recurring and nonrecurring) and verify that the transactions have been properly entered into the system and appropriately documented.
4	Develop backup procedures and maintain a log to document when the system is backed up.	Review log to determine if backups are being done on a timely basis.
5	Develop a process to test the system upgrades. Document the steps taken to verify the system upgrade and obtain appropriate sign-off.	Determine when the system has been upgraded and the extent of the upgrades. Review the documentation related to the system upgrades. Verify that the process to test the system upgrades was followed.
6	Develop a process to incorporate new plans or new plan interpretations into the system functionality and obtain appropriate sign-off.	Test subsequent transactions to ensure that the system is properly handling new plans or new plan interpretations.

Q5: *Are the Data Capture Controls Adequate?*

Restricted Stock:

Data capture controls ensure that—

- All transactions are timely recorded in the stock plan database,
- Transactions are recorded only once
- Rejected transactions are identified, controlled, corrected, and reentered into the system

These controls focus on—

- Validity—Are these transactions valid?
- Completeness—Are all the transactions included?
- Valuation—Are the transactions properly valued?[1]

An example of these controls can be found in paragraph 4.3, Question 16.

Control Mechanisms. In general, there are two types of control mechanisms—batch processing and direct data entry. Batch processing describes the recording of numerous transactions of a similar type, such as annual grants or new-hire grants. Document batch processing by using a cover sheet that includes a reference to unique transaction details (e.g., annual grant of 6/30/XX; signatures of parties processing and reviewing the transaction; information on errors detected; and dispositions of the errors). Utilize totals such as the number of transactions and number of shares to verify that the entire batch has been processed. File batch documents in one folder for easy access and future reference.

Direct data entry is used for a one-off transaction or to correct an error. Post-dated transactions discussed in Question 8 typically require direct data entry. Direct data entries usually have limited source documents. Use a transaction log to record detailed information about the transaction such as reason for entry, date and time of entry, signature of the person processing the transaction, and signature of the individual authorizing the transaction.

Reporting. The flexibility of the stock plan database may generate inconsistencies between data entry and the associated reports. For example, the equity professional may mark an acquisition award as inactive to facilitate running a report on pre-acquisition restricted stock. If a grant is not re-activated, subsequent reports may be incorrect. To avoid this problem, identify reports generated from the stock plan database that should reconcile and then reconcile those reports monthly.

Reconciliations to Other Company Systems. Reconcile to other company systems as appropriate. Paragraph 4.3., Questions 12 and 13 discuss reconciliations that pertain to the grant process. Specific reconciliation processes are included in other sections of this publication.

1 Auditing & Assurance Services by William F. Messier, Jr.

The following are examples of ways to verify that information in the stock plan database reconciles to other company systems:

- Reconcile employees in the stock plan database to the human resource system or the payroll system to verify that the award recipient is an employee of the Company.
- Reconcile terminated employees from the human resource system to outstanding awards in the stock plan database to verify that awards held by terminated employees have been cancelled.

Error Checking. Periodically, test the stock plan database to ensure basic data integrity. Review grant records for—

- Missing tax rates
- Incomplete vesting schedules
- Employee demographic data

Compare year-to-date reports to quarterly reports to verify that the quarterly reports total to the year-to-date report. Re-run the previous quarter's reports to verify that nothing has changed. Post-dated transactions can impact reports in unexpected ways. For example, an employee terminates in June, but notification of the termination is not received until October. The restricted stock is cancelled at that time. The termination was not included in the June reports because the termination was not identified when the June reports were run. The termination may not be reported in the October reports because the termination occurred in June. This inconsistency could be identified by comparing the quarterly reports on terminations to the year-to-date reports. Changes made associated with post-dated transactions and error corrections may have accounting implications.

Restricted Stock Units:
Same as restricted stock.

	Illustrative Controls	Illustrative Test of Controls
1	Establish a process and associated checklist to document each type of transaction (e.g., annual grants, new-hire grants, etc.).	Review the documentation of batch processing to ensure that the written process was followed.
2	Develop and use transaction logs for direct data entry transactions. Include appropriate signoff for the preparer and reviewer.	Review transaction log. Compare date of data entry to when the transaction should have been entered. Investigate significant delays.
3	Reconcile database reports monthly.	Review reconciling items for reasonableness.
4	Reconcile database with human resource system and payroll system periodically.	Review reconciling items for reasonableness.
5	Quarterly compare year-to-date to quarterly reports. Reconcile any differences.	Review reconciling items for reasonableness.
6	Develop a basic data checklist. Verify data in the stock plan database periodically.	Review problems identified for trends.

Q6: *Is There an Appropriate Separation of Duties?*

Restricted Stock:

"Proper segregation of duties is one of the most important control procedures in any accounting system. Duties should be assigned to individuals in such a way that no one individual can control all phases of processing a transaction."[2] The following duties should be segregated:

- Initiating the grant
- Authorizing (i.e., approving) of the grant
- Recording of the grant in the stock plan database
- Processing the grant documentation

Frequently the Equity Compensation department is too small to provide for appropriate segregation of duties. If data privacy can be maintained, use people from other departments to oversee the stock transactions. For example, Human Resources can review grant approvals and database reports before Award Agreements are sent to employees.

Special care must be taken to monitor awards to personnel in the Equity Compensation department and anyone with access to the stock plan database. Develop a process to review grant records and vesting activity of such personnel quarterly.

Restricted Stock Units:
Same as restricted stock.

	Illustrative Controls	Illustrative Test of Controls
1	Structure responsibilities to separate the following duties: > Initiate the grant > Approve the grant > Record the grant > Advise the employees	Review responsibilities of Equity Compensation staff to ensure proper segregation of duties. Review stock records for employees with responsibility for administering stock plans. Trace activity for appropriate individuals to source documents.
2	Batch transactions and direct data entry should be reviewed by another employee.	Review checklists and transaction logs to verify sign-off by another employee.
3	Develop a process to review grant records and vesting activity for awards made to personnel in the Equity Compensation department and anyone with access to the stock plan database.	Quarterly review activity for appropriate personnel.

2 Ibid.

Q7: *Are the Shares Reconciled Periodically?*

Restricted Stock:

To maintain overall control of plans, it is critical to reconcile the activity in each plan periodically. The reconciliation should include—

- Shares outstanding
- Shares authorized
- Shares authorized and unissued
- Grants
- Cancellations—track to terminations
- Vested shares
- Shares released

Compare detailed records to total shares. In addition, this information should be reconciled on a monthly basis with the transfer agent (i.e., to confirm that the transfer agent has utilized the shares from the appropriate plan) and the broker (i.e., to confirm that all transactions are included).

Monitor plan requirements such as the maximum number of shares that can be granted in a single year or to a single person. In addition, it is prudent to project share needs for the next 12 months and take steps to ensure that the share pool is adequate to meet those needs.

Restricted Stock Units:

Shares are issued when restricted stock units vest. At the vest date, the transfer agent issues the shares and transfers the shares to the broker for deposit into the employee's account. In certain cases, the shares may remain in book entry position with the transfer agent and are moved at the employee's request in the future. Reconcile instructions to the transfer agent when the shares are issued and released on the vest date.

	Illustrative Controls	Illustrative Test of Controls
1	Reconcile shares monthly with the transfer agent and broker. Totals should reconcile to the batch transactions and the transaction log for the month.	Verify that the reconciliation is complete and timely.
2	Develop a process to handle transactions/corrections after each quarter.	Review all post-dated transactions to determine potential financial statement impact.
3	Monitor plan requirements regarding maximum grants in a single year or to a single person.	Verify that plan requirements have been met and documented.
4	Review each Plan quarterly to determine shares are available to meet the next 12 months' grant needs.	Verify that the projection is complete.

Q8: *Are the Controls for Post-Dated Transactions Adequate?*

Restricted Stock:

Post-dated transactions are a result of many causes including delay in the receipt of data and human error. The following are examples of post-dated transactions:

- A termination was not timely recorded in the human resource system; therefore, the termination was not recorded timely in the stock plan database. If an employee inadvertently receives a grant after termination, the grant may be invalid under the terms of the Plan. When the termination is recorded, the invalid grant is identified. Voiding the invalid grant is a post-dated transaction.
- Restricted stock was granted to Tony W. (William) Chun, but inadvertently recorded in the stock plan database as granted to Tony W. (Washington) Chun. When the problem is identified, the stock record is changed to the correct employee. Changing the grant details to correct an error is a post-dated transaction. *Note – Using unique employee ID numbers would eliminate this problem.*

It is important to monitor post-dated transactions, especially when the post-dated transactions may have financial statement implications. See paragraph 8.3, Exhibit 15, Accounting Implications for Post-Dated Transactions. Prepare a monthly report summarizing post-dated transactions and the reason for the transaction. Track trends and identify opportunities for process improvements. For example, the monthly report on post-dated transactions indicated numerous examples where a subsidiary did not record terminations on a timely basis. After additional training of appropriate subsidiary staff, the timeliness of reporting terminations improved.

Restricted Stock Units:
Same as restricted stock.

	Illustrative Controls	Illustrative Test of Controls
1	Develop a report to track all post-dated transactions.	Scan the report and note unusual items. Confirm that the transactions are properly reported in the stock plan database.
2	On a monthly basis, report the number of post-dated transactions and the reasons for the transactions. Compare the report to results from the previous months and previous year. Perform a root-cause analysis. Recommend action steps to minimize such problems in the future.	Review trends to identify areas where further intervention is required.

3.4. OUTSOURCING

3.4.1. Outsourcing Overview. Companies may utilize a third-party administrator to handle all or part of their stock plan administration. Some companies outsource the administration, recordkeeping, and execution of releases. Others maintain the administration and recordkeeping function and work with brokers to process releases.

3.4.2. SAS70. To ensure that the outsource vendors maintain appropriate controls, the vendor should have received a SAS70 certification. This certification signifies the "service organization has been through an in-depth audit of their control activities, which generally include controls over information technology and related processes."[3] There are two types of reports: Type I and Type II.

3.4.3. A Type I report describes the service organization's description of controls at a specific point in time. In a Type I report, the service auditor will express an opinion on (1) whether the service organization's description of its controls presents fairly, in all material respects, the relevant aspects of the service organization's controls that had been placed in operation as of a specific date, and (2) whether the controls were suitably designed to achieve specified control objectives.[4]

3.4.4. A Type II report not only includes the service organization's description of controls, but also includes detailed testing of the service organization's controls over a minimum six-month period. In a Type II report, the service auditor will express an opinion on the same items noted above in a Type I report, and (3) whether the controls that were tested were operating with sufficient effectiveness to provide reasonable, but not absolute, assurance that the control objectives were achieved during the period specified.[5] Neither a Type I nor a Type II report includes a review of the software or its calcuations utilized by the service organization.

3.4.5. The Company has overall responsibility for its internal controls and processes. When assessing the adequacy of these controls, a SAS70 certification of a "service organization" such as a third-party administrator should be considered. The Company must consider the SAS70 certification in light of its own internal controls and the scope of the SAS70 certification.

3.4.6. Working with a Third-Party Administrator. For an outsourcing arrangement to work effectively, the Company and the third-party administrator must work closely together. Processes, responsibilities, and specific handoffs must be clearly defined. The following information should be confirmed when the outsourcing arrangement is initialized and on a periodic basis:

- Plan details
- New plan interpretations
- All grant terms
- Employee demographic details

If the Company outsources all or part of the Human Resource department, additional steps may be required to coordinate these details.

3.4.7. Significant information is transmitted between the third-party administrator and the Company. A careful review of data security is required, including site security, data encryption, etc. To minimize problems, the transmittal of information should be a two-step process. The first step confirms that appropriate information has been properly sent and received. The second step identifies errors in the records transmitted.

- Step I—To facilitate this process, control totals should be used such as total records, total shares, total dollars, etc. The control totals can be sent as a separate file, as a header/trailer to the export/import file, or via e-mail. The recipient verifies the file matches the control totals. If the totals match, the recipient can move to Step II. If the totals don't match, the transmitter of the file must correct the file and retransmit it.
- Step II—When a file is imported into the system, it is also important to reconcile the information back to source documents. This can be accomplished by printing appropriate reports from the system after the import. The reports can be provided to the originating party who will reconcile the reports to the source documents.

3.4.8. When dealing with stock plans, it is important to ensure that the stock plan database has been properly tailored to handle the stock plan. Any limitations on configuration should be identified. Processes to work around software limitations should be closely scrutinized to ensure that appropriate controls are embedded into the work-around process.

3.4.9. Multiple Vendors. It should be noted that a company may also utilize a third party to value equity awards and/or to handle ASC 718 reporting, including expense accrual. Using multiple vendors for various parts of the process increases complications. Depending upon the services provided, these vendors may only need a subset of the information stored in the stock plan database. In all cases, it is imperative to provide control totals for all interface files. In cases where information is required to be shared by vendors (e.g., third-party administrator to third-party valuation provider) the data should be transferred through the Company. In this way, the Company can certify the timeliness, correctness, and completeness of the vendor-to-vendor transfers.

3 http://www.ethridgemiller.com/sas70.html.
4 Ibid.
5 Ibid.

Grant Process

4.1. INTRODUCTION

When an employee receives compensatory awards accounted for under the equity method provided in ASC 718, the grant date establishes the fair value of the award based upon the grant details. Confirmation of the grant details is critical to validate the expense and establish the proper accrual period. As noted by the SEC's Office of the Chief Accountant "qualitative factors… may cause misstatements of quantitatively small amounts to be material."[6]

4.2. OVERVIEW OF THE GRANT PROCESS

4.2.1. The key processes associated with granting restricted stock and restricted stock units, common areas of risk, and illustrative controls are discussed below.

4.2.2. Initiating the Grant. Human Resources, managers, Boards of Directors, or executives initiate the grant process by recommending the grant of an award to an employee. The recommendation includes the number of shares and, depending on the flexibility of the Plan, may also include the vesting period, vesting acceleration, and specific restrictions or limitations. The terms of the grant must be in accordance with the plan provisions and are specified in the Award Agreement. The terms generally include—

- The right to receive an established number of shares of company stock
- The type of grant (i.e., restricted stock or restricted stock unit)
- A vesting schedule
- A requirement of continued employment with limited exceptions for death, retirement, etc.
- Applicable dividends and voting rights
- The process of paying applicable taxes
- Termination provisions

4.2.3. Grants are discretionary by nature. They may be granted to all employees or limited to specific individuals. Grants may be given to all new employees (new-hire grants) and/or given to current employees periodically or annually. The terms of grants may also vary. The discretionary nature of the grant and flexibility in the terms of the award require additional controls to validate the grant. Sufficient shares must be available in the Plan. Employment status must be validated. The award terms must meet the plan requirements and be accurately reflected in the stock plan database. These controls are discussed in more detail in Questions 9 to 13.

6 Letter from Chief Accountant dated 9/19/06 to Lawrence Salva, Chairman, Committee on Corporate Reporting–Financial Executives International, and Sam Ranzilla, Chairman, Center for Public Company Audit Firms–AICPA.

In some circumstances stock must be issued for par value. (This requirement applies to companies incorporated in certain states.) In most cases par value is immaterial and the Company considers past services rendered as payment for the par value. A complete discussion of this issue is outside the scope of this publication.

IRC §83(b) Election — Normally restricted stock and restricted stock units are taxed at vest/release. An employee may make an IRC §83(b) election (commonly referred to as an 83(b) election) to have the restricted stock taxed at grant. Under §83(b) the employee elects to include in taxable income in the year of grant the FMV of the shares as determined on the date of grant. An 83(b) election is not available for restricted stock units. The election is not widely used and requires additional employee communication to make sure that the employee understands the tax consequences of making the election.

Companies frequently discourage employees from making 83(b) elections because of the potential adverse tax consequences to the employee in the event the award does not vest. Companies may prohibit the use of 83(b) elections by adding language in the Award Agreement restricting their use.

IRC §83(i) Election –Eligible employees participating in the broad-based equity plan of a privately held corporation may elect to defer the income taxation on shares released into an escrow account upon vesting of restricted stock units for up to five years by filing an IRC §83(i) election, if permitted under such plan. This election type was created by the Tax Cuts and Jobs Act of 2017.

For purposes of this publication we have assumed that neither an 83(b) election nor an 83(i) election has been made. A complete discussion of 83(b) and 83(i) elections is outside the scope of this publication.

4.2.4. Restricted awards granted to executive officers have additional tax and legal considerations. For example, a Form 4 must be filed with the SEC within two business days after a Section 16 executive officer is granted an equity award. IRC Section 162(m) denies a corporate tax deduction for compensation in excess of $1 million for certain executive officers. See Section 7, Tax and Payroll Issues, and Section 8, Legal Issues, for more details.

4.2.5. Authorizing the Grant. As required by the Plan, an appropriate party must approve a grant before it is considered a valid grant. Controls are required to validate that appropriate approval(s) have been received and the grant date is correct. These controls are discussed in more detail in Questions 14 and 15.

4.2.6. Recording the Grant. The system of record for equity awards is the stock plan database. In most cases, this database is not integrated with the other financial systems within the Company. Controls are required to ensure the grant has been recorded properly and the information in the stock plan database is accurate, valid, and complete. These controls were discussed in paragraphs 3.1–3.4 and are discussed in more detail in Question 16.

4.2.7. Processing the Grant. The Award Agreement is prepared and sent to the employee as notification of the grant. The Award Agreement includes the terms of the restricted award and provides documentation that the employee was timely notified. Many companies require an employee to accept the award. The transfer agent is notified of restricted stock grants and issues the shares. These controls are discussed in more detail in Questions 17, 18, 19, and 20.

4.2.8. Reporting the Grant. The stock plan database provides data input for valuing the award for financial statement purposes. Controls associated with the grant process support the accuracy, validity, and completeness of the data used in the valuation of the award. These controls are discussed in more detail in Section 8, Accounting Issues. The controls associated with SEC reporting are discussed in Section 9, Legal Issues, Question 42.

4.3. CONTROLS ASSOCIATED WITH THE GRANT PROCESS

Q9: *Does the Award Meet the Plan Requirements?*

Restricted Stock:

As discussed in paragraph 3.3., Question 1, each plan has specific provisions regarding the granting of awards to employees. Some plans are very restrictive, while others are broad and provide significant latitude in the type of equity instruments to be granted and their terms. Each plan is different and grants made under the Plan must adhere to the specific plan requirements in order to be deemed a valid grant.

Grants can be made only if shares are available under the Plan for the award and the Plan is still active. The Plan may specify the maximum number of shares to be awarded in a year for a plan or an individual. All grants must conform to these requirements.

When a Company operates multiple plans, adhering to the specific plan requirements can be challenging. The Company needs to ensure that the grant is made from the appropriate plan and reflects the appropriate terms. In addition, the stock plan database must be able to track grants under different plans with different terms. Using standard grant provisions provides inherent control. If the grant provisions are not standard, additional controls are necessary to ensure the grant conforms to the plan requirements and is a valid grant.

If the Plan provides flexibility as to the type of equity instruments to be granted and the terms of those instruments, legal counsel may need to interpret the Plan. For example, legal counsel may need to determine if the employee must accept the award for it to be a valid grant under the Plan. Such interpretations should be documented and a historic record of plan interpretations should be maintained. Additionally, such interpretations must be applied consistently on a prospective basis. New plan interpretations may require modification to the information maintained or the functionality incorporated in the stock plan database. Care should be taken to ensure that changes are only reflected on a prospective basis and historical data is maintained.

Restricted Stock Units:
Same as restricted stock.

GLOBAL ISSUES

Some tax jurisdictions provide beneficial treatment for restricted awards structured with particular terms (e.g., a restricted unit must vest over a minimum of two years and the shares received must be held for an additional two years before sale). Care needs to be taken to ensure that the terms of the Plan are legal or advisable in all countries and that particular provisions designed to be used in designated non-US jurisdictions are consistent with plan terms. In addition, specific terms need to be properly incorporated in the Award Agreement and other hard copy and electronic references. These particular non-US grant terms may impact the fair value or other accounting treatment of the awards.

	Illustrative Controls	Illustrative Test of Controls
1	Document that the grants meet the requirements as to the maximum number of shares to be awarded in a year and that sufficient shares exist in the plan pool.	Inspect documentation to ensure that requirements have been met.
2	Document new interpretations by authorized personnel and maintain a historic record of previous plan interpretations. Document how the interpretations are incorporated in the administrative processes, system functionality, and documentation provided to employees.	Inspect documentation of plan interpretations to ensure that the new interpretations have been properly documented. Test that the current interpretations have been implemented consistently. Review the database to ensure that changes do not impact historical data.
3	Document key provisions and plan interpretations (Plan Summary). Incorporate new provisions into the employee Award Agreement, plan prospectus, information distributed to employees (both hardcopy and electronic), and online plan references.	Inspect Plan and Plan Summary to validate plan provisions are properly reflected.
4	Modify the functionality in the stock plan database as appropriate.	Sample grants under new provisions to ensure that the terms are properly reflected in the stock plan database.

Q10: Are the Shares in the "Share Pool" Counted Accurately?

Restricted Stock:

The Plan provides for a number of shares authorized for issuance but not yet granted. (Shares authorized, but not yet granted, are frequently referred to as the "share reserves" or the "share pool.") Grants decrease the number of shares in the pool. The Plan may also provide that shares are added back to the pool when shares are withheld to cover tax or shares are cancelled when an employee terminates.

The number of shares in the pool may be increased by approval of shareholders and/or the Board of Directors.

The trend is to use omnibus share plans with a specified fungible share pool. The omnibus plan provides a company with flexibility to determine the type of awards to be offered. All awards count as a share in the fungible share pool, but different types of awards may be counted differently when determining the impact on the share pool. Exhibit 6 is an example of how shares may be counted in an omnibus share plan with a fungible share pool.

Tracking shares in the share pool has been subject to increased visibility as the authorization of additional shares in the share pool is subject to more scrutiny. Shareholder advisory groups provide recommendations for institutional investors on voting for proposed stock plans. Their analysis and opinions of share tracking can be critical for plan approval. For example, Institutional Shareholder Services (ISS), uses a model that compares the "shareholder value transfer" (SVT) against an ISS allowable cap. ISS assigns a higher SVT value to full-value awards (e.g., restricted stock and restricted stock units) than to appreciation only awards (e.g., stock options). ISS also assigns a considerably higher SVT to net-counted shares (those with shares "returned" to the plan for reuse, rather than retired). A company's allowable cap is calculated relative to its 4-digit GICS industry peers, with consideration of both market cap and industry-specific performance metrics (such that higher performing companies are assigned a higher allowable cap).

Stock plan database software may include functionality to manage the simpler calculations. More complicated calculations are usually managed on a spreadsheet by the Company. These calculations are reflected in footnote disclosures to the financial statements.

It is important to adhere to the methodology for counting shares as defined in the Plan. Document the methodology, the process of tracking different types of awards, and how shares would revert to the pool (e.g., for cancellations). Reconcile the share pool monthly. As appropriate, include grants, cancellations, and shares used for taxes. Calculations should be reviewed by another employee.

Restricted Stock Units:
Same as restricted stock.

EXHIBIT 6. COUNTING SHARES IN A FUNGIBLE SHARE POOL

> A plan has a total number of 2,000,000 shares of common stock available in the share pool for issuance and allows for the grant of stock options, restricted stock, and restricted stock units

> Any shares issued in connection with restricted stock and restricted stock units shall be counted against the share pool as 1.3 shares for each one (1) share issued

> Therefore, restricted stock and restricted stock units count against the Plan in larger share amounts

Under this plan, if only restricted stock and restricted stock units are granted, a total of 1,538,461 shares (1,538,461 x 1.3 = 2,000,000) can be issued.

If only options are granted, a total of 2,000,000 shares can be issued.

	Illustrative Controls	Illustrative Test of Controls
1	Document how the share pool is calculated for different types of equity awards and different types of transactions.	Inspect documentation to ensure that the Plan requirements have been met.
2	Monthly, document how shares were counted and the impact on the share pool. As appropriate, include grants, cancellations, and shares used for taxes. Calculations should be reviewed by another employee.	Verify calculation prepared and reviewed.

Q11: *Are the Terms of the Award Correct?*

Restricted Stock:

Standardized award terms minimize the potential of human error when processing the grant and should be used whenever possible. Flag grants with non-standard terms for special handling. Special approval should be required before granting awards with non-standard terms. Such awards may require direct data entry as discussed in paragraph 3.3, Question 5, and additional review to verify that the terms are permissible under the Plan and appropriately reflected in the stock plan database.

In certain circumstances, it may be appropriate to include other provisions in the Award Agreement such as the method of paying tax upon vest of the award or the impact of retirement. For a further discussion of these topics see paragraph 7.3, Question 31, for methods of paying tax and see paragraph 7.3, Question 32, for the impact of retirement.

Restricted Stock Units:
Same as restricted stock.

	Illustrative Controls	Illustrative Test of Controls
1	Document that the grants meet the requirements as to the maximum number of shares to be awarded in a year and that sufficient shares exist in the plan pool.	Inspect documentation to ensure that requirements have been met.
2	Document new interpretations by authorized personnel and maintain a historic record of previous plan interpretations. Document how the interpretations are incorporated in the administrative processes, system functionality, and documentation provided to employees.	Inspect documentation of plan interpretations to ensure that the new interpretations have been properly documented. Test that the current interpretations have been implemented consistently. Review the database to ensure that changes do not impact historical data.
3	Document key provisions and plan interpretations (Plan Summary). Incorporate new provisions into the employee Award Agreement, plan prospectus, information distributed to employees (both hardcopy and electronic), and online plan references.	Inspect Plan and Plan Summary to validate plan provisions are properly reflected.

Q12: *Are Grants Made to Current Employees who are Eligible to Participate in the Plan?*

Restricted Stock:

It is important to determine the employment status of an employee prior to granting an award. Close coordination is required between Human Resources and the Equity Compensation departments. Reconcile employees in the stock plan database with employees in the human resource database monthly. This update may be an automated or manual process. As discussed in Question 13, employee details should also be updated immediately prior to granting an award.

Changes of status such as terminations and leaves of absence require special handling. Identify employees ineligible to participate in the

STRATEGIC ISSUES

> Document who is authorized to approve grants and the limits of their authority. Utilize grant guidelines to simplify the approval process and minimize the potential errors when processing the grant.

> Standardized grant terms minimize the potential of human error when processing the award and calculating the fair value of the award. Standardized terms should be used whenever possible. Require special approval for awards with non-standard terms and process the awards separately.

> Issue all new-hire grants in accordance with a written policy which provides for awards to be issued only at pre-determined regular grant dates incorporating standard language. This will simplify the approval process and minimize potential accounting issues.

Plan (e.g., employees on leaves of absence). Incorporate appropriate restrictions in the database to prohibit grants to these employees. Document procedures for handling erroneous grants to employees who were not eligible to receive an award. See Section 10, Changes of Employment Status, for more details.

Employment status is particularly important when an employee receives an award as part of the employment offer. These grants are commonly referred to as "new-hire grants." If the Plan permits and the grant is made prior to becoming an employee, the effective date of the award may vary (i.e., the date of the employment offer, the date the offer was accepted, or the date employment commenced).

Some companies advise the employee of the grant in the offer letter, but the grant is effective on the date employment begins. New-hire grants may require daily approval and processing. This can result in an inefficient process and increased errors.

Best practice is to issue all new-hire grants in accordance with a written policy that provides for awards to be issued only on predetermined regular grant dates. New hires receive grants only on a regular grant date following the date of hire. The offer letter indicates the number of shares to be granted, the date the award will be granted, and the vesting schedule. Monthly, the Equity Compensation department should receive consolidated information from Human Resources for all new-hire grants including appropriate details such as employee name, date of hire, employee ID, address, Social Security number (or other tax ID), and number of shares.

Grouping grants will streamline the approval process and allow for batch processing of all new-hire grants. For example, all new hires in a particular month receive a grant on the third Tuesday of the month after employment begins. Any employee hired in January 2021 will be granted an award on February 16, 2021.

Restricted Stock Units:
Same as restricted stock.

	Illustrative Controls	Illustrative Test of Controls
1	Reconcile employees in the stock plan database with employees in the human resource system monthly and immediately prior to granting awards.	Review reconciling items for trends and unusual items.
2	Identify employees ineligible to participate in the Plan (e.g., employees on leaves of absence). Incorporate appropriate restrictions in the database to prohibit grants to these employees. Document procedures for handling erroneous grants to employees who were not eligible to receive an award.	Identify restrictions on employee eligibility for grants. Test that only eligible employees have received awards.
3	Establish a date for all new-hire grants in the month following the month of hire. The standard offer letter indicates the number of shares to be granted, the date the award will be granted, and the vesting schedule.	Review the standard offer letter to confirm that the terms of the grant are appropriate.
4	Establish a process to verify that Equity Compensation has received a consolidated report of all new-hire grants.	Sample offer letters with new-hire grants and verify the award has been issued.

Q13: *Is Employee Demographic Data Correct?*

Restricted Stock:

The fair value of restricted stock is based upon the grant details. The accuracy and completeness of the participant addresses, employment status, retirement eligibility, and personnel data must be maintained. "Participant addresses impact the taxes due on stock plan transactions. Participants' employment status (e.g., part-time, terminated, consultant, on leave) can impact their ability to conduct stock plan transactions or participate in company plans, their rate of vesting, the expense recorded for their grants, and the taxes due on stock plan transactions. Personnel data (e.g., department, cost center, location, division, salary grade, job code) can impact financial reports for company segments and eligibility for plan participation."[7]

7 National Association of Stock Plan Professional Internal Controls Portal: Practice Pointers–Internal Controls.

GLOBAL ISSUES

To avoid potential local issues, grants by a US-issuer to employees of a non-US affiliate should not be included in the standard offer letter from the employer. The award should be offered in a separate document from the US issuer reflecting appropriate language for that jurisdiction.

Unless the stock plan database is fully integrated with the human resource system, the employee demographic data must be imported from another source or manually entered. Either of these approaches increases the possibility of errors in employee data in the stock plan database. To minimize these errors, develop a standard process to update employee data. Update employee data from the human resource system on a periodic basis and immediately prior to granting an award. Audit this data monthly. Compare employee information in the stock plan database to the data stored in the human resource system and/or payroll system.

Restricted Stock Units:
Same as restricted stock.

	Illustrative Controls	Illustrative Test of Controls
1	Update employee data from the human resource system periodically and immediately prior to granting awards.	Sample employee data in the stock plan database and reconcile the information to the human resource system.
2	Periodically compare employee data in the stock plan database and the human resource system and/or payroll system. Document reconciling items, research performed, and resolution of the items.	Review reconciling items for trends and unusual items.

Q14: *Have the Grants Been Approved by the Appropriate Party and on a Timely Basis?*

Restricted Stock:

Corporate law, the Company's corporate governance provisions, and the Plan require the grant to be approved for it to be valid. Therefore, clearly defining the grant approval process and documenting approvals by appropriate parties is a key step in determining that a grant has occurred and the measurement date for accounting purposes is established.

Formalize and document the approval process. Establish and document requirements on who is authorized to approve grants and the limits of their authority. Note when multiple authorizations are required. Indicate who is required to approve grants to specific groups of employees (e.g., Compensation Committee, Board of Directors, or the CEO). Identify individuals with back-up approval authority where appropriate.

Utilize grant guidelines wherever possible. Grants in excess of the guidelines should require special handling and an additional approval process.

For purposes of internal control, the grant approval must be documented in writing. Documentation should include grant recipient, number of shares awarded, FMV, type of award, and the vesting schedule. Approval at committee or Board meetings should be documented in detail in the meeting minutes. When unanimous written consents are used, the date of receipt of the final consent determines the grant date.

Securing appropriate approvals by the grant date can be a challenge, especially when a company's practice is to grant awards daily. This is particularly difficult when multiple approvals are required and the approval date is the date the last approval is received. Best practice is to authorize grants at the Board or committee meetings rather than delegate to a committee of one or by unanimous written consents.

To minimize these issues, schedule and publish grant dates in advance. Depending on company needs, grant dates can be set annually, quarterly, monthly, or on some other periodic basis. Pre-selecting award dates avoids the appearance of favorable timing. Grants made off-schedule should require special approval.

Restricted Stock Units:
Same as restricted stock.

STRATEGIC ISSUES

> Granting awards at pre-determined dates has many benefits including:
- Improving transparency of the award process
- Avoiding the appearance of manipulating the grant dates
- Minimizing administration by limiting the number of vest dates during the year
- Avoiding restrictions when selling shares to cover the associated payroll taxes
- Minimizing errors when recording the awards in the database

> The high volume of trades may impact the price of the stock. In some cases the daily trading volume of the Company stock may not be sufficient to handle the sale of additional shares. Using pre-determined dates will also increase the number of transactions processed on a vest date. If the Company withholds shares to meet the employee's tax obligations, the Company is required to fund the tax obligations when the awards vest. This may result in a significant cash drain on the Company at the vest date. All of these factors must be considered when determining appropriate grant and vest dates.

	Illustrative Controls	Illustrative Test of Controls
1	Define the grant approval process and develop a matrix of authority. Include approvals that are required and any other individuals that must review and approve grant recommendations.	Verify the grant approval process is documented. Review the matrix of authority to ensure appropriate individuals are authorized to approve grants.
2	Document all grant approvals in writing.	Sample grants to confirm that the grant has been approved and the grant approval is within the limits of the approver's authority and conforms to the grant approval process.
3	Establish grant guidelines for groups of employees. Define the approval process for grants made outside the guidelines.	Sample grants to confirm that the grant is within the grant guidelines. For grants outside guidelines, verify that the plan requirements were met and appropriate approvals were received and documented.
4	Establish a schedule for issuing periodic grants to current employees.	Review grant dates in the stock plan database to verify that the grant schedule has been followed.
5	Coordinate the approval process to coincide with the established grant schedule.	Test grants to confirm that the date of grant is not prior to the approval.

Q15: Are The Grants Made on Appropriate Dates?

Restricted Stock:

Granting awards on pre-determined dates minimizes administration. The vest process requires a certain amount of administration regardless of the number of awards or the number of shares vesting on a specific day. Therefore, the more frequently a company grants awards and the more frequently awards vest, the greater the administrative burden. In addition, vested shares should be released into the employee's account the day after vest (T+1). This requirement is administratively challenging. Minimizing the number of vest dates during a year minimizes the administration regarding the release and delivery of shares. Using established grant dates will also minimize errors when recording awards in the stock plan database. For example, if the Company always grants on the 10th day of each month, the stock plan database records can be easily scanned to identify inappropriate grant dates.

Best practice is to limit the number of days awards are granted and vest during the year. Grant awards to employees annually. The awards should vest annually or be subject to cliff vesting.

Many factors should be considered when establishing the grant date and vest date. These factors include —

- Coordinate with scheduled board meetings to simplify the approval process.
- Grant during an open window to avoid questions about granting while in possession of material, nonpublic information.
- Match vest dates to periods when shares can be sold (i.e., an open window) to facilitate selling shares to cover required taxes. (See paragraph 7.3, Question 31 for more details.)
- Consider the implications over multiple years. (For example, an employee may have multiple awards vesting on consecutive dates. A February 4, 2019, grant with a two-year cliff vesting and a February 5, 2020, grant vesting in one year would vest on February 4, 2021, and February 5, 2021.) Consecutive vest dates can be very cumbersome to administer and difficult for employees to understand. An alternative would be to have vesting occur on a specific date each month (e.g., the second Tuesday).
- Avoid vest dates immediately prior to and during the dividend cycle. Coordination may be difficult when vesting occurs between the date of record and date of payment.
- Avoid vest dates close to quarter-end and year-end to simplify the payroll reporting process.
- Avoid vest dates that coincide with the Employee Stock Purchase Plan purchase date.

Restricted Stock Units:
Same as restricted stock.

GLOBAL ISSUES

Equity awards are typically granted to employees at the discretion of the issuer. In certain non-US jurisdictions, any benefit regularly offered by an employer is an "acquired right" which cannot easily be taken away or adjusted and is automatically included in the calculation of severance benefits on termination. If a company regularly grants awards or communicates their value as part of compensation paid by the employer (not the issuer), the award may be considered an acquired right of employment. In that instance, the award may no longer be deemed discretionary and the employee may acquire the right to receive such awards in the future. Publishing grant dates in advance may increase a company's exposure to "acquired rights."

	Illustrative Controls	Illustrative Test of Controls
1	Issue awards on pre-determined grant date.	Sample grants to test that the awards were made on pre-determined grant dates.
2	Require special approval to grant awards on dates other than pre-determined grant dates. Calendar non-standard grant/vest dates.	Review grants on dates other than pre-determined dates. Review items for trends and unusual items.

Q16: Do The Grants Agree to Source Documents on a Micro and Macro Basis?

Restricted Stock:

The details of the grant determine the compensation expense, the accrual of the compensation expense, and the fully-diluted earnings per share calculations. Because the grant recommendation system is usually not integrated with the stock plan database, the potential for errors is increased.

To minimize these errors and validate that the information is complete and accurate, specific data capture controls must be implemented when recording grants (either new-hire grants or periodic grants to current employees). As discussed previously, minimize errors by utilizing standard grant terms and only granting on scheduled dates. To simplify tracking grants, each grant should be assigned a unique identifying number.

Prior to entering grants into the stock plan database, confirm that all grant recipients are still employed by the Company as of the date of grant. Some employees may have terminated since the award was recommended, but before the award was approved. Whenever possible, import the details from the grant recommendation system into the stock plan database. Incorporate error-checking into the import process. Examples of standard error checks are testing for two grants for a person on the same day or ensuring all details (number of shares and vesting schedule) are included for each employee. Document the errors noted and disposition of the error.

The FMV of the underlying award is irrelevant when recording the grant, but is critical in determining the fair value of the award for accounting purposes. To simplify the valuation process, the FMV should be recorded when the grant is recorded. The Plan will specify how the FMV is determined, such as the price at market close on the date of grant, the high/low average on date of grant, or some other method. If the grant date is a non-trading day, extra care must be taken to verify the correct FMV is used. If the grant date is pre-specified and falls on a holiday or weekend (e.g., last day of the fiscal quarter), verify which date should be used in these occurrences, such as prior or next trading day. Regardless of how the FMV is determined, verify the price from multiple sources and document the calculation. Appropriate personnel should formally approve in writing the FMV that will be used.

After the grants have been recorded, reconcile total grants approved to grants recorded in the stock plan database on an aggregate basis. The reconciliation should include —

- Total number of shares
- Total number of employees receiving a grant

The reconciliation must be done for each plan within which awards are granted. Where non-standard vesting terms are used, an additional reconciliation must be done for aggregate shares vesting per vest date.

Verify that the stock plan database reflects a grant to the correct employee and the details of the award recorded in the stock plan database agree to the terms of the grant. Randomly select employees to verify that the terms as recorded in the stock plan database reconcile to the approved award. Identify grants with non-standard grant terms and verify that the grants have been properly recorded.

Utilize standard checklists to document the steps of recording the grant. Document the reconciliation process. Note discrepancies and the resolution of the discrepancy. Errors in the grant process may result from incorrect data entry or an error in the award details. Common errors are illustrated below —

- Employee A was approved to receive 10,000 shares of restricted stock, but an award of 1,000 shares was recorded in the stock plan database.
- Employee B was recommended to receive 5,000 shares of restricted stock, but the award was listed as 50,000 shares on the documentation submitted to the Compensation Committee for approval.

GLOBAL ISSUES

Many companies use a country-specific prefix when numbering grants to allow for easy identification of awards that require special handling in certain countries, (e.g., US123, FR456, or UK789). This numbering system may also be useful in identifying employees who move between the grant and vest date. At the taxation point, compare the current location of the employee to the country-specific prefix. If the current location and prefix do not match, investigate to determine the employee has moved and if the transaction requires special handling.

- Employee C was approved to receive 5,000 shares of restricted stock and Employee D was approved to receive 500 shares of restricted stock. The information was incorrectly entered into the stock plan database and Employee C received 500 shares and Employee D received 5,000 shares.

Identify types of errors. Establish and document guidelines how each type of error will be resolved. Consistently apply the guidelines. Identify situations where the award must be re-approved. In the example above, an incorrect award was approved for Employee B. The correction of the error would typically require re-approval by the Compensation Committee. These errors may also impact the employee acceptance process discussed in Question 19.

Restricted Stock Units:
Same as restricted stock.

	Illustrative Controls	Illustrative Test of Controls
1	Incorporate error checking as part of the import routine from the grant recommendation system.	Review error reports for unusual items.
2	Use standard grant terms and grant on scheduled grant dates. Require a special approval process for non-standard grants.	Sample grants to test that standard grant terms are used. Review non-standard grants. Note trends in use of non-standard grants. Verify that the stock plan database properly reflects non-standard terms.
3	Assign each award a unique identifying number.	Confirm that the process has been followed.
4	Establish a process to determine the FMV on the grant date. Verify the FMV with multiple sources. Document the calculation of the FMV and the approval of the FMV used.	Verify the FMV with an independent source. Verify the FMV was properly approved and reflected in the stock plan database.
5	Reconcile grants in the stock plan database to source documents (approvals and award details) on an aggregate and individual basis for each Plan.	Review documentation on batch processing of award on an aggregate basis. Test individual grants to verify that terms are properly reflected in the database.
6	Maintain a log of discrepancies and resolution of the discrepancies.	Review the discrepancy log to verify that all items were researched and resolved.

Q17: *Has the Transfer Agent Been Advised of the Award?*

Restricted Stock:

When restricted stock is granted, shares are issued. The shares are nontransferable and subject to restrictions that lapse at a future date. The Company directs the transfer agent to issue the restricted stock and provides the transfer agent with the number of shares to be issued and the name of the employee, if the stock will be held in the employee's name. (The issuance of the restricted stock usually occurs at the time of grant even though the employee acceptance of the award may occur at a later date. See Question 19 for more details on the acceptance process.) The transfer agent should be advised when restricted stock is issued whether dividends will be paid and the method of payment. The transfer agent holds the restricted stock as a book entry in an omnibus restricted account and/or an individual account until the restrictions lapse.

At the vest date, the transfer agent is advised to release the shares to the broker for deposit into the employee's account. In certain cases the shares may remain in book entry position with the transfer agent and moved at the employee's request in the future.

Reconcile instructions to the transfer agent when shares are issued on the grant date and released on the vest date. Utilize error-checking routines when exporting the file to the transfer agent. Document errors identified, research performed, and resolution of the issues. On a monthly basis, reconcile total unvested grants in the stock plan database to the shares issued by the transfer agent held in the custodial account or in book entry.

Restricted Stock Units:

Shares are issued when restricted stock units vest. At the vest date, the transfer agent issues the shares and transfers the shares to the broker for deposit into the employee's account. In certain cases, the shares may remain in book entry position with the transfer agent and are moved at the employee's request in the future.

Reconcile instructions to the transfer agent when the shares are issued and released on the vest date. Utilize error-checking routines when exporting the file to the transfer agent. Document errors identified, research performed, and resolution of the issues.

	Illustrative Controls	Illustrative Test of Controls
1	Establish and document the process to transfer data from the stock plan database to the transfer agent.	Review the documentation to ensure the process was followed.
2	Utilize error-checking routines when exporting the file to the transfer agent. Document errors identified, research performed, and resolution of the issues.	Review error reports for trends and unusual items.
3	On a monthly basis, reconcile total unvested grants in the stock plan database to the shares issued by the transfer agent held in the custodial account or in book entry.	Verify the reconciliation was completed. Note trends and unusual problems.

Q18: *Are Employees Notified of Their Awards on a Timely Basis?*

Restricted Stock:

- ASC 718 includes criteria for determining that a share-based payment award has been granted. Subtopic 10, Section 25, Paragraph 25-5 states that "a mutual understanding of the key terms and conditions of an award to an individual employee shall be presumed to exist at the date the award is approved in accordance with the relevant corporate governance requirements (that is, by the Board or management with the relevant authority) if both of the following conditions are met:
- "The award is a unilateral grant and, therefore, the recipient does not have the ability to negotiate the key terms and conditions of the award with the employer.
- "The key terms and conditions of the award are expected to be communicated to an individual recipient within a relatively short time period from the date of approval. A relatively short time period is that period in which an entity could reasonably complete all actions necessary to communicate the awards to the recipients in accordance with the entity's customary human resource practices."

Delayed communication to the employee may indicate the award was not fixed and unchangeable and may impact the date of grant. The number of employees to be notified and the geographical dispersion of employees can make timely notification challenging.

Formalize a process to notify employees of the grant and document that the employees were notified. The notification should occur as soon as possible after the grant date. Electronic notification tools may streamline this process. When paper copies of Award Agreements are used, documentation should include the mailing process.

Restricted Stock Units:
Same as restricted stock.

	Illustrative Controls	Illustrative Test of Controls
1	Establish procedures to notify the employee of the grant on a timely basis and document that the employees were notified.	Test notification process to ensure that the process is followed and conforms to FASB requirement for timely notification.

Q19: *Has the Process for Employee Acceptance of the Grant Been Followed?*

Restricted Stock:

Some companies require an employee accept a grant to document that the employee was notified of the grant. In addition, this acceptance may authorize selling shares to pay for the employee's tax withholding, document the employee's understanding of the tax consequences of the award, and/or establish documentation of a 10b5-1 trading plan. (See the paragraph 9.3, Question for more details about 10b5-1 trading plans.)

Companies may use a variety of methods to indicate acceptance. Some companies require affirmative acceptance (i.e., the employee must take a specific action to accept the award). The acceptance may be electronic or written. If a company requires affirmative acceptance of the grant, it is critical to define the consequences (including the tax consequences) if an employee does not accept the grant. If affirmative acceptance is required, the additional administration associated with the grant and release process may be significant.

Some companies require an employee take action only if they are not accepting the award. No response is deemed acceptance of the award. Other companies embed acceptance of the award into the Award Agreement. Different approaches may be used for awards to executives and non-executives.

Regardless of the approach used, document the process and the actions that will be taken if the employee does not follow the process. Validate that the software functionality supports the acceptance process. Communicate the acceptance process to employees receiving awards. Apply the process consistently.

Restricted Stock Units:
Same as restricted stock.

	Illustrative Controls	Illustrative Test of Controls
1	Establish and document a process to formalize employee acceptance of the award. Communicate the requirements to the employees.	Test the process to ensure it has been followed consistently.

GLOBAL ISSUES

The format for accepting an award may be specified or restricted in certain countries. Consult tax or legal counsel to determine permissible methods in each country.

Q20: Are the Disclosures to the Employee Appropriate?

Restricted Stock:

The Award Agreement is sent to the employee and includes details of the award and additional disclosures. As the Award Agreement changes over time, make sure the current Award Agreement is used. Mark each Award Agreement template with a version number and the date of update to maintain control over the Award Agreement template. Separate the Notice of Grant (incorporating the specific grant terms) and the Terms and Conditions (incorporating the overall grant terms) into two documents to simplify the change process. Each Plan may have a unique Award Agreement. When a company issues grants from multiple plans, verifying that the correct Award Agreement is used can be challenging.

Verify that the details included in the Award Agreement reflect the appropriate terms and match the information recorded in the stock plan database. Some commercially-available stock plan databases include functionality to customize and/or print Award Agreements. Utilizing this functionality will minimize inconsistencies between the Award Agreement and stock plan database.

Closely scrutinize grants with non-standard terms to determine the Award Agreement is appropriate. Archive electronic and hard copies of Award Agreements to maintain a historic record of the Award Agreements used.

Employee disclosures may also include information posted on a Web site. Make sure the Web site disclosures reflect the specific plan requirements. Consider using a hotline for employee inquiries during the grant and vest process.

Employees are less familiar with restricted stock as an equity vehicle than stock options and may be unaware of the associated tax consequences. Since the tax obligation occurs on the vest date without employee involvement, misunderstandings may occur. To avoid potential issues, enhance employee communications where necessary. Areas that require greater attention include grant acceptance, dividend payments, voting rights, the vesting process, and tax withholdings. Specific communication issues regarding the vesting process and tax withholdings are discussed in more detail in Section 6.3, Question 29.

Restricted Stock Units:
Same as restricted stock.

	Illustrative Controls	Illustrative Test of Controls
1	Utilize functionality in the stock plan database to customize and/or print the Award Agreement.	Sample Award Agreements to ensure that the current agreement was used, appropriate disclosures are included, and the details agree to the information in the stock plan database.
2	Limit grants with non-standard terms. Identify grants with non-standard terms in the stock plan database. Develop a checklist for processing employee disclosures for these grants.	Sample grants with non-standard terms to ensure that the grant terms were properly reflected in the disclosures to the employee.

4.4. OUTSOURCING

4.4.1. As discussed in paragraph 3.4, the Company may outsource certain aspects of plan administration. In the grant process, the Company retains responsibility for initiating and authorizing a grant. Recording, processing, and reporting the grant may be outsourced to a third-party administrator in whole or in part.

4.4.2. The controls discussed in this section will apply regardless of whether or not the Company outsources plan administration; however, the group responsible for implementing the control may differ. In general, the controls in Questions 9 to 15 are maintained by the Company. The controls in Questions 16 to 20 may reside partially with the Company and partially with the third-party administrator (depending on what functions are outsourced). In all cases, the Company retains overall responsibility for the internal control process.

4.4.3. Even when certain functions are outsourced, the Company is responsible for the accuracy of the data. This is particularly critical in the grant process since the Company is responsible for originating the grant file sent to the third-party administrator. To ensure data integrity after the grant file is imported, the Company must reconcile reports generated by the third-party administrator (such as the Grant Details and Outstanding Awards) to the source grant records maintained by the Company.

GLOBAL ISSUES

Award Agreements may be tailored for specific countries to incorporate requirements under local law. Consult legal counsel to determine what should be included for each country.

Dividend Process

Section 16 officers may be unable to participate in a dividend reinvestment program. The dividend reinvestment may be considered a new purchase for Section 16 reporting purposes, subject to short swing profit rules, and in conflict with the Company's Insider Trading Policy. A complete discussion of this topic is beyond the scope of this publication. Consult legal counsel to determine the potential impact of dividend reinvestment programs for Section 16 officers.

5.1. INTRODUCTION

Many companies pay dividends to shareholders. Employees holding equity awards from stock plans may be deemed a shareholder and have the right to receive dividends in certain circumstances.

5.2. OVERVIEW OF THE DIVIDEND PROCESS

5.2.1. When restricted stock is granted, shares are issued. Although subject to forfeiture during the vesting period, restricted stock is considered issued and outstanding stock of the Company. Employees holding unvested restricted stock are shareholders even though they do not take possession of the stock until a future date when the associated restrictions have lapsed. While the restrictions are applicable, the employee may have dividend rights, but these rights are not mandatory. If a company pays dividends, the Plan will usually provide that employees who hold restricted shares have the right to receive dividends. Dividends paid may be subject to forfeiture if the underlying award is forfeited. "Where dividends are paid on unvested awards and the dividends are not subject to forfeiture, the company is required to use the two-class method when reporting earnings per share."[8]

5.2.2. When restricted stock units are granted, the employee has received a promise to receive shares at some future date. Because the employee does not acquire "shares" and is not a shareholder, there are no dividend rights. The Company may choose to pay dividend equivalents to mirror the treatment of restricted stock. Dividend equivalents are not actual dividends, but the payments are structured to mirror dividends. Dividend equivalents may be subject to forfeiture if the underlying award is forfeited.

5.2.3. The different characteristics of restricted stock and restricted stock units require modification of the internal controls associated with paying dividends to shareholders. This publication does not cover the internal controls associated with the dividend process, but focuses on the special needs of paying dividends on restricted stock and dividend equivalents on restricted stock units.

5.2.4. The key dates for paying dividends are —

- Declaration date – the date the Board of Directors announces that a dividend will be paid
- Date of record – the date the Company identifies the shareholders based on company records
- Date of payment (dividend payable date) – the date the Company delivers the dividend to the shareholders identified on the date of record

The grant date and the vest date of the award are also critical in determining the employees' right to receive dividends or dividend equivalents.

5.2.5. Dividends can be paid currently in cash or can be deferred until a future date and paid in cash or stock. Dividends paid on restricted stock are taxed as ordinary income (i.e., as compensation income) when paid, rather than dividend income. Companies must withhold payroll tax on the income and may deduct the dividend paid on

8 Accounting for Equity Compensation, 14th edition, by Barbara A. Baksa, section 10.4.

STRATEGIC ISSUES

> Dividends and dividend equivalents should be addressed in the Plan, even if the Company does not currently pay dividends.

> Paying dividends on restricted stock or dividend equivalents on restricted stock units requires significant administration. The stock plan software must include specific functionality to administer the dividend process. In many cases the administrative cost exceeds the benefit to the employee. Dividends are not paid on options. If restricted awards are a replacement for nonqualified options, it may be inconsistent to pay dividends on restricted stock or restricted stock units. Consider all these issues when determining the appropriateness of paying dividends or dividend equivalents.

restricted stock (or dividend equivalents paid on restricted stock units) as a corporate tax deduction. The controls associated with the payment of dividends are discussed in Questions 21, 22, 23, and 24. The accounting issues associated with dividends and dividend equivalents are beyond the scope of this publication.

5.3. CONTROLS ASSOCIATED WITH THE DIVIDEND PROCESS

Q21: *Are Dividends Recorded Timely and Accurately?*

Restricted Stock:

Assuming the Plan provides for the payment of dividends on restricted stock, the calculation of the dividend mirrors the calculation of the dividend paid to shareholders. Dividends and dividend equivalents should be addressed in the Plan, even if the Company does not currently pay dividends. The dividends can be paid currently in cash or can be deferred until a future date and paid in cash or stock. The methods of paying dividends on restricted stock are —

- Cash dividends paid currently
- Dividends currently reinvested in company stock
- Deferred dividends paid in cash or stock

Each of these methods is discussed in more detail below.

Cash dividends paid currently are paid on or after the regular dividend date of payment. See Question 22 for more details on the mechanism for paying dividends. Accounting implications of cash dividends paid on restricted stock that is subsequently forfeited are beyond the scope of this publication.

Dividends that are reinvested in company stock are recorded currently and automatically reinvested in shares of company stock. The reinvested shares are usually subject to the same restrictions as the underlying award and are released to the employee when the award vests. The reinvested shares may be tracked in the stock plan database. The dividends may be compounded, (i.e., dividends are paid on previous stock dividends in addition to dividends paid on the unvested restricted stock).

When dividends are reinvested in company stock, the dividend will frequently be converted into fractional shares rather than whole shares because the dividend payment is not evenly divisible by the share price. Dealing with fractional shares is challenging. Fractional shares may occur at each dividend payable date. Clearly define the number of decimal places used to track fractional shares and specify the rules used to round shares. Consistently follow the specified process. Track dividend shares separately from the original award to avoid employee confusion. When shares are distributed on the vest date, round down to the next whole share and pay cash for the fractional shares based on the FMV of the stock on the vest date.

Dividends may be deferred until the vest date and paid in cash or in stock. When the deferred dividend is paid in stock, the deferred dividend is tracked as a cash dividend and paid in shares on the vest date. The conversion of cash to shares is based on the FMV of stock on the date of vest as defined by the Plan. If the conversion of cash to shares does not result in whole shares, the shares are rounded down to the next whole share and the balance is paid in cash at the vest date. Deferred dividends are usually subject to the same restrictions as the underlying award and are paid to the employee when the award vests.

Paying dividends on restricted stock, as compared to the payment of dividends to regular shareholders, requires additional administration and internal controls. For each Plan, determine if dividends will be paid and how they will be paid. Document the requirements and how they are incorporated into the administrative processes, system functionality, and documentation provided to the employees.

GLOBAL ISSUES

Paying dividend equivalents on a restricted stock unit may impact the taxability of the underlying award. Some non-U.S. jurisdictions consider the payment of dividend equivalents on restricted stock units as though the underlying award is converted to restricted stock. If the award is considered restricted stock, the tax consequences may be different (i.e., restricted stock may be taxed at grant, rather than taxable at vest).

Confirm employee status prior to processing the dividend. Terminated employees would generally not be entitled to receive dividends since the underlying award would have lapsed prior to the dividend date of record. For employees terminating during the dividend cycle, compare the date of record and the actual termination date to determine whether they are eligible to receive the dividend.

Confirm the dividend rate. When recording dividends, reconcile total dividends to dividends recorded in the stock plan database on an aggregate basis. Verify that the stock plan database reflects a dividend to the correct employee. Randomly select employees to verify the dividend recorded in the stock plan database agrees to the detailed records.

When converting a cash dividend to shares, verify the FMV used for conversion. Document the process for handling fractional shares. Confirm batch totals agree. Advise Corporate Tax of dividends attributed to restricted stock as this amount may be deductible for corporate tax purposes.

Restricted Stock Units:

When restricted stock units are granted, the employee has received a promise to receive shares at some future date. Because the employee does not acquire "shares" and is not a shareholder, there are no dividend rights. The Company can choose to pay dividend equivalents to mirror the payment of dividends on unvested restricted stock. Dividend equivalents are not actual dividends, but the payments are structured to mirror dividends. Dividend equivalents are usually treated as a deferred payment as if the dividend was reinvested in stock or deferred until vest rather than paid in cash. A complete discussion of dividend equivalents is beyond the scope of this publication.

	Illustrative Controls	Illustrative Test of Controls
1	For each Plan, determine if dividends will be paid and how they will be paid. Document the requirements and how they are incorporated into the administrative processes, system functionality, and documentation provided to the employees.	Confirm documentation of all plans. Sample awards that receive current dividends. Verify that appropriate dividends were paid or deferred in accordance with the plan requirements.
2	Reconcile employees in the stock plan database with employees in the human resource system immediately prior to the date the dividend is declared.	Review reconciling items for trends and unusual items.
3	Establish a process to verify the dividend rate. Document the calculation of the dividends to be paid currently or deferred.	Verify the calculation of the dividends.
4	Reconcile reinvested dividends and deferred dividends recorded in the stock plan database to source documents on an aggregate and individual basis for each Plan.	Review documentation on batch processing of deferred dividends on an aggregate basis. Test individual records to verify that the deferred dividends are properly reflected in the database.
5	If dividends are reinvested, establish and document a process to convert the dividend into stock, including the treatment of fractional shares. Verify the FMV used for the conversion. Reconcile reinvested dividends on an aggregate and individual basis for each Plan.	Review documentation of batch processing of reinvested dividends on an aggregate basis. Test individual records to verify that the reinvested dividends are properly reflected in the database.

GLOBAL ISSUES

Some countries tax dividend income as unearned income rather than compensation income. In those countries, dividend income on unvested restricted stock may not be subject to social tax.

Q22: Are Dividends Paid in an Accurate and Timely Manner?

Restricted Stock:

The calculation of dividends on restricted stock may mirror the calculation of dividends paid to shareholders, but the Company cannot use the standard dividend payment process for paying the dividend. The transfer agent should be advised when restricted stock is issued whether dividends will be paid and the method of payment. When dividends are paid, confirm instructions to the transfer agent and review the transfer agent's activity to verify the instructions were followed.

Cash dividends are the easiest to process. The transfer agent can pay the dividend to the employee or the Company can pay the dividend through payroll. In either case, the payment needs to be recorded as taxable income to the employee in the payroll system. If the transfer agent pays the dividends, establish and document how the transfer agent is notified, taxable income is recorded in the payroll system, tax is collected, and the process is verified. See Question 23 for more details on how dividends must be reported for tax purposes.

When dividends are reinvested in company stock, the Equity Compensation department advises the transfer agent of the dividend rate, date of record, and date of payment. The reinvested shares are issued on the dividend payable date and held by the transfer agent until the vest date when the reinvested shares are released to the employee. See Question 26 for a detailed discussion of releasing shares at the vest date.

When dividends are deferred, they are paid at vest in cash or stock. If the deferred dividends are paid in cash the transfer agent pays the dividend to the employee when the award vests or the Company pays the dividend through payroll. If the deferred dividend is paid in stock, the conversion of the dividend into shares is based on the FMV on the date of vest as defined by the Plan. If the conversion of cash to shares does not result in whole shares, the shares are rounded down to the next whole share and the balance is paid in cash at the vest date. The shares are released as part of vest/release process. See Question 26 for a detailed discussion of releasing shares at the vest date.

Regardless of the method used to pay the dividend, taxable income must be reported and tax must be collected. These issues are addressed in detail in Questions 23 and 24. If the vest date occurs immediately before the date of record or between date of record and date of payment, the payment of dividends must be closely monitored to ensure the proper amount of the dividend is paid and correctly reported for tax purposes. To eliminate this problem, do not grant awards with vest dates close to the dividend record date. Post-dated transactions must also be closely monitored to identify transactions that will impact the amount of dividends paid or reporting for tax purposes. Develop and document a process to handle dividends related to post-dated transactions where dividends may have been paid incorrectly.

Test the dividend process with the broker, transfer agent, and/or third-party administrator by transmitting a "pending" file of dividend recipients. Verify the information in the "pending" file for accuracy before making the actual dividend payments.

On each date stock dividends are released, reconcile the details in the stock plan database with the broker, transfer agent, and/or third-party administrator. The reconciliation should include the total number of shares to be released and the number of employees receiving dividends.

Restricted Stock Units:

A company may choose to pay dividend equivalents on restricted stock units to mirror the treatment of restricted stock. The payment of dividend equivalents is similar to the methods discussed above. A complete discussion of dividend equivalents is beyond the scope of this publication.

	Illustrative Controls	Illustrative Test of Controls
1	Develop and implement a procedure to pay dividends to employees holding unvested restricted stock. Provide detailed instructions to the transfer agent, as appropriate. For each dividend payment, pre-test the dividend payment process.	Review the documentation of the dividend payment process. Confirm the pre-test process was followed for each dividend payment. Sample employees with awards qualifying for dividends. If appropriate, include awards with dividends paid in cash and stock. Verify that dividends were paid timely and the calculation was accurate. Sample employees receiving cash dividends. Verify the cash dividends were calculated accurately and the payment was made to the employee on a timely basis.
2	If the transfer agent is paying a cash dividend, establish and document the process to transfer dividend information to the transfer agent. Reconcile the dividend paid by the transfer agent with the calculated dividend.	Review the documentation to ensure the process was followed.
3	On each date stock dividends are released, reconcile details in the stock plan database with the broker, transfer agent, and/or third-party administrator. The reconciliation should include the total number of shares to be released and the number of employees receiving dividends.	Select a number of release dates and confirm that the reconciliation was performed. Select several employees on a release date and verify the stock dividends were properly calculated and distributed.
4	Develop and document a process to handle dividends on post-dated transactions.	Confirm the process was followed.

Q23: *Are Dividends Properly Reported for Tax Purposes?*

Restricted Stock:

(*Note – The following discussion assumes a Section 83(b) election was not made.*) Dividends paid on unvested restricted stock are taxed as compensation income, rather than dividend income. This income is subject to income tax and FICA tax.

If the dividend is paid to the employee on the dividend payable date, the dividend is currently taxable and income tax and FICA must be paid. If the dividend is deferred (but not subject to the risk of forfeiture) and paid after the dividend payable date, the dividend is generally taxable for FICA tax on the dividend payable date assuming the employer has not elected to treat the dividend under the short-term deferral rule of Section 409A. The deferred dividend is taxable for income tax purposes when the dividend is actually paid. If a dividend is deferred and subject to the risk of forfeiture, the dividend is taxable for income tax and FICA tax purposes when the dividend is actually paid. The timing of the taxable event is summarized in Exhibit 7.

EXHIBIT 7. DIVIDENDS: TIMING OF THE TAXABLE EVENT

	Income Tax*	FICA (Social Security and Medicare)
Dividend paid on dividend payable date	Taxable on dividend payable date	Taxable on dividend payable date
Dividend deferred (but not subject to the risk of forfeiture) until award vests and the underlying shares are released	Taxable at vest/ release date	Taxable on dividend payable date**
Dividend deferred (and subject to the risk of forfeiture) until the award vests and the underlying shares are released	Taxable at vest/ release date	Taxable at vest/ release date
Release	Transfer of shares to the recipient	Transfer of shares to the recipient

*Taxed as compensation income, rather than dividend income.
**This assumes that the employer has elected not to treat the dividend under the short-term deferral rule which defers the FICA payment until no later than a brief period of time following the end of the calendar year of the dividend payable date.

If the dividend is paid in cash (on the dividend payable date or deferred until the award vests and paid in cash), taxable income is the gross dividend paid to the employee. No reduction in taxable income is permitted for any tax withheld. If the dividend is paid in stock (e.g., reinvested dividends or deferred dividends paid in stock), taxable income for income tax purposes is the FMV of stock as determined by the Plan on the vest/release date. Taxable income for FICA purposes is the FMV of stock on the date the dividend is taxed.

Establish and document the process to record the taxable income from dividends in the payroll system. Reconcile the dividend paid to the dividend income reported in the payroll system.

A corporate tax deduction is allowed for the amount of dividends paid on restricted stock that is reported as compensation income to the award recipient. Reporting for payroll tax purposes does not mean Corporate Tax has appropriate information for the corporate deduction. Establish and document a process to advise Corporate Tax of the amount of dividends paid on restricted stock awards for each quarter.

Restricted Stock Units:

The payment of dividend equivalents on restricted stock units is taxable as compensation income and may be subject to IRC §409A. A complete discussion of the taxation of dividend equivalents is beyond the scope of this publication.

	Illustrative Controls	Illustrative Test of Controls
1	Determine how the FMV of stock dividends are determined for each Plan. Document the calculation of the FMV.	Select several payment dates and review the calculation of FMV of stock dividends to confirm the established procedure was followed.
2	Establish and document the process to record the taxable income from dividends in the payroll system. Reconcile the dividend paid to the dividend income reported in the payroll system.	Sample dividend payments and verify that the income was reported in the payroll system on a timely basis and to the correct employee.
3	Establish and document a process to advise corporate tax of the amount of dividends paid on unvested equity compensation for each quarter.	Verify the process exists and is being followed.

Q24: *Is the Correct Tax Collected?*

Restricted Stock:

The Company is required to collect tax from the employee for dividends paid on unvested restricted stock. As discussed in Question 23, dividend income is taxed as compensation income and the employer is responsible for withholding payroll tax. The tax may be calculated using regular tax tables or supplemental tax rates.

If the dividend is paid in cash, the dividend may be paid through the payroll system or by the transfer agent. If the dividend is paid through the payroll system, the required tax can be essentially collected from the dividend distribution. If the dividend is paid by the transfer agent, tax is usually collected through the payroll system as an additional withholding from wages since the transfer agent does not have information to withhold the appropriate amount of tax.

If the dividend is paid in stock, the current FMV of the stock dividend is taxable to the employee. Tax is usually collected through the payroll system as additional withholding from wages.

Establish and document the process to calculate tax withholding. Clarify appropriate responsibilities between Payroll, Equity Compensation, and the transfer agent.

Restricted Stock Units:

Tax withholding is also required on dividend equivalents paid on restricted stock units. A complete discussion of the taxation of dividend equivalents is beyond the scope of this publication.

	Illustrative Controls	Illustrative Test of Controls
1	Establish and document the process to calculate tax withholding. Clarify appropriate responsibilities between Payroll, Equity Compensation, and the transfer agent.	Verify that the process is documented. Test that the established process was followed.

5.4. OUTSOURCING

5.4.1. The Company may outsource certain aspects of the dividend process. The transfer agent may pay cash dividends. A third-party administrator may reconcile deferred dividends. The Company retains responsibility for initiating/ authorizing a dividend and reporting taxable income/collecting tax. Recording and processing the dividend may be outsourced to a third-party administrator in whole or in part. Even though a third-party may be utilized to handle all or part of stock plan administration, the Company retains responsibility for the controls noted above.

Vest/Release Process

When restricted stock units vest, shares are issued, unlike restricted stock awards where the shares are issued at grant. In this section, the discussion and associated controls regarding restricted stock are applicable to restricted stock units as well. However, when release of shares is discussed for restricted stock, the corresponding process for restricted stock units includes an issuance of stock and a release of shares.

6.1. INTRODUCTION

When restricted stock is granted, shares are issued. The shares are nontransferable and subject to restrictions that lapse at a future date. When restricted stock units vest, shares are issued and released to the employee. The lapse of restrictions triggers a taxable event and the employee must pay the applicable payroll tax. This publication assumes that the release of the underlying shares is not deferred, but occurs upon vest, and that no Section 83(i) election has been made on RSUs—an option available only to employees of privately held corporations with broad-based equity plans that allow for such deferral.

6.2. OVERVIEW OF THE VEST/ RELEASE PROCESS

6.2.1. The key processes associated with the vest of an award, common areas of risk, and illustrative controls are discussed below. This publication only addresses restricted stock units settled in stock. Restricted stock units settled in cash are outside the scope of the publication.

6.2.2. Processing the vest/release. The vest process and subsequent release of shares to the grantee requires close coordination between the broker, third-party administrator, transfer agent, Human Resources, Payroll, and the Equity Compensation department. There are many acceptable methods of collecting tax on an award. The Company and the employee must comply with various legal requirements such as insider trading policies. Question 25 and 26 discuss controls that are required to ensure the employee is authorized to receive the shares and the shares are delivered in a timely and accurate manner. The controls associated with the applicable tax withholdings are discussed in Section 7, Tax and Payroll Issues. Controls associated with legal requirements are discussed in Section 9, Legal Issues.

6.2.3. Recording the vest/release. The Equity Compensation department tracks the awards that vest, the release of shares, and the collection of applicable taxes. When taxes are paid by selling shares, the broker is responsible for the sale of the shares to pay the tax. Controls associated with recording the vest/release and handling cash from the sale of shares are discussed in Question 27 and 28.

6.2.4. Reporting the vest/release. The employee is notified of the shares vesting and released by the Equity Compensation department, third-party administrator, or broker. In addition, the taxable income and applicable withholding must be reported by Payroll. The controls associated with employee communication are discussed in Question 29. The controls associated with the tax and payroll issues are discussed in Section 7, Tax and Payroll Issues. The controls associated with SEC reporting are discussed in Section 9, Legal Issues, Question 42.

STRATEGIC ISSUES

Restricted stock and restricted stock units have become more popular and frequently replace stock options as the preferred equity vehicle. As a result, companies tend to grant such awards to a larger number of employees and the average size of the award is smaller. Monthly vesting of restricted stock and restricted stock units is administratively burdensome because each vest requires the distribution of shares, triggers a taxable event, and requires the collection of tax from the employee. In addition, a monthly vest of a small award may result in an after-tax distribution of just a few shares to the employee. This small distribution of shares may decrease the employees' perception of the value of the equity award. Consider limiting vesting to annual vesting or cliff vesting to maximize the employee perception of the benefits of the award, maximize employee retention, and minimize administration.

6.3. CONTROLS ASSOCIATED WITH THE VEST/RELEASE PROCESS

Q25: *Is the Employee Eligible to Receive the Award at Vest?*

Restricted Stock:

Employee status is critical in determining if an employee is eligible to receive the award at vest. For example, an award is typically cancelled when an employee terminates. Leaves of absence may also impact the vesting schedule, as many companies suspend vesting of equity grants during certain types of leaves. The stock plan software includes functionality to automatically identify awards that vest based on data in the stock plan database. Therefore, it is critical that the stock plan database contain current employee status. This information should mirror the current employee status in the Human Resource system. (See Section 10, Changes of Employment Status, for additional details about change of status.) Close coordination is required between the Equity Compensation department, Human Resources and the third-party administrator, such as a company-designated broker, to ensure all parties have current information.

Validate employee status before releasing shares. Develop a process to handle post-dated terminations or leaves of absence where the stock was incorrectly released to the employee. Document the process and follow it consistently. The process should include contingency plans covering situations where stock incorrectly released is still in the employee's account and situations where the stock has been sold. Utilize a log to document when shares were released to a terminated employee. Document the resolution of the issues.

Restricted Stock Units:
Same as restricted stock.

	Illustrative Controls	Illustrative Test of Controls
1	Develop and document a procedure to update employee terminations and other changes of status. Utilize a log to document when shares were released to a terminated employee. Document the resolution of the issues.	Review the log for post-dated terminations. Note the number of transactions and the reasons for the issues.
2	Develop and document a process to handle post-dated terminations and leaves of absence where the stock was incorrectly released to the employee.	Review the log of shares released to terminated employees. Note the reasons for each issue and confirm the action taken was consistent with the established process.

Q26: *Are Controls in Place to Ensure Timely and Accurate Release of Shares?*

Restricted Stock:

Processing the vest/release and collecting the associated payroll taxes is administratively burdensome. The transaction is event-based and controlled by the Company rather than driven by the employee. To minimize the administrative burden, minimize the number of vest dates. The benefits of using pre-determined grant dates are discussed in paragraph 4.3, Question 15.

Releasing shares to the employee is complicated and requires pushing data to brokers, rather than responding to the action of the employee as in the case of stock options. Ideally, shares are released to the employee the day after the vest date. In practice, the release of shares may be slightly delayed. Develop and document a process to handle vest/release dates that fall on weekends or holidays.

Using multiple brokers creates extra work because coordination is required with each broker. Best practice is to use one company-designated broker. If multiple brokers are used, use the same process to interface with each broker. Deliver shares electronically directly into the employee's brokerage account rather than issuing stock certificates.

Since the shares are released into the employee's brokerage account, confirm the account is activated prior to the vest date. Implement a monthly process to identify which employees have not activated their account and follow-up with the employees. Develop a process to handle awards where the account has not been activated by the date of vest. This process may incorporate transferring the vested shares into a holding account for the employee or a company account as an interim step until the employee account is activated. The process needs to be closely monitored and the use of these accounts should be minimized. Using holding accounts creates additional administration when paying dividends and may be abused if not closely monitored.

Develop a vesting-event checklist for each type of award incorporating all the steps required to process the vest and release of the shares. Many companies require an employee accept the grant (see paragraph 4.3., Question 19) prior to the vest date. Employee acceptance is frequently required if the Company permits shares to be sold to pay the tax withholding. If employee acceptance is required, confirm the grant was accepted by the employee prior to the vest date. Pre-test the vest process, including -

- Withholding tax
- Rounding of fractional shares
- Processing the data file with payroll

Notify appropriate parties of upcoming vest dates. Advise transfer agent of the upcoming transactions and brokers that will be receiving shares. Managers and appropriate Human Resource personnel should have a general understanding of the tax consequences of an award and how the transaction will be processed. Payroll should be advised about the upcoming vest date, when the data file for taxable income and withholding will be transmitted and anticipated payroll tax deposit requirements. Advise appropriate parties of upcoming vests for Section 16 officers to facilitate the filing of Form 4. Treasury should be notified about the anticipated cash to be received for tax withheld on sell-to-cover transactions and cash requirements for tax due on withhold-to-cover transactions. (See Section 7, Tax and Payroll Issues, for a detailed discussion of sell-to-cover and withhold-to-cover transactions.) If a large number of awards are vesting on the same date and sell-to-cover transactions are permitted, advise Investor Relations of the vest date and estimated number of shares to be entering the market. Consult your broker to minimize the effect of a large number of shares offered for sale on a single day. See Question 29 regarding recommended employee communications.

Restricted Stock Units:
Same as restricted stock.

	Illustrative Controls	Illustrative Test of Controls
1	Use one company-designated broker.	Confirm the number of brokerage firms used. If multiple brokerage firms are used, review the controls regarding reconciliation of the transfer of shares to the brokerage firms.
2	Develop and implement a vesting-event checklist for each type of award.	Select several vest dates during the period. Confirm the appropriate checklist was utilized.
3	Require each employee to activate an account prior to the vest date.	Confirm that account activation is required for each employee.
4	Develop and monitor monthly reports identifying employees that haven't activated an account. Develop and document a procedure to follow up with employees who haven't activated an account.	Review monthly reports and documentation of follow-up procedures.
5	Develop and implement a process to transfer shares to a holding account when the vest occurs if the employee has not activated a personal account with the brokerage firm.	Monitor the monthly activity in the holding account.
6	Develop and implement a procedure to test the vesting process. Include withholding of tax, rounding of fractional shares, transmittal of information to payroll, and notification for Form 4 filings for Section 16 officers.	Confirm the process was followed.
7	Notify appropriate groups of upcoming vest date.	Confirm appropriate personnel were notified.

Q27: *Is the Vest/Release Recorded Timely and Accurately?*

Restricted Stock:

When the restrictions lapse (usually at the vest date), the award is deemed earned. In most cases, the transfer agent issued the shares at grant, often into a book entry account in the employee's name, but releases the stock to employee's brokerage account when the award vests. When the restrictions lapse, the award is taxable to the employee and payroll tax is required to be paid. See Section 7, Tax and Payroll Issues, for more detail on tax and payroll issues.

Recording the vest/release requires close coordination between the Company, third-party administrator, employee, broker, and transfer agent. If shares are sold to pay the applicable tax, the broker or third-party administrator is responsible for the sale of the shares. The Equity Compensation department or third-party administrator tracks the vest/release and applicable taxes. In addition, the taxable income and tax withheld must be reported to Payroll and included in the payroll reporting process.

Care should be taken to ensure the release is reported accurately and on a timely basis. On each vest date, reconcile details in the stock plan database with the broker and transfer agent. The reconciliation should include total number of shares vesting, number of awards vesting, number of employees, number of net shares released to employees, and number of shares withheld/sold for tax.

On a monthly basis (assuming some awards vest each month), reconcile the transfer of shares between the transfer agent and the broker by Plan. Compare to details in the stock plan database. Investigate and resolve any discrepancies.

Restricted Stock Units:
Same as restricted stock.

	Illustrative Controls	Illustrative Test of Controls
1	On each vest date, reconcile details in the stock plan database with the brokerage account and transfer agent. The reconciliation should include total number of shares vesting, number of awards vesting, number of employees, number of net shares released to employees, and number of shares withheld for tax.	Select a number of vest dates and confirm that the reconciliation was performed.
2	On a monthly basis, reconcile the transfer of shares between the transfer agent and the broker by Plan. Compare to details in the stock plan database. Investigate and resolve any discrepancies.	Review the monthly reconciliation, note any items investigated, and the resolution of the item.

Q28: *Are The Internal Controls for Handling Cash Adequate?*

Restricted Stock:

When a broker is involved in the sale of stock (e.g., sells stock to cover the applicable taxes), the broker collects the tax withholding from the proceeds of the sale of stock. The amounts are then transferred to the Company, usually via wire transfer, into a company-controlled bank account. Treasury transfers the funds from the company-controlled bank account daily. The Equity Compensation department advises Treasury of the amount due.

To ensure appropriate control over the collection of cash, separate the responsibilities for processing of the vest from the collection of cash. On a monthly basis, reconcile the total cash received to the stock plan database records.

Restricted Stock Units:
Same as restricted stock.

	Illustrative Controls	Illustrative Test of Controls
1	Segregate responsibilities for the processing of the release from the collection of cash.	Review the responsibilities of the equity compensation staff to confirm that the duties have been properly segregated
2	On a monthly basis, reconcile the total cash received to the stock plan database records.	Select several dates. For each date confirm that the proceeds as reported in the stock plan database were received by the Company on a timely basis and were applied to the correct account.

Q29: *Are the Disclosures to the Employee Regarding the Vesting Process Adequate?*

Restricted Stock:

As noted in Question 20, employees are less familiar with restricted stock than with stock options. Best practice is to communicate with employees prior to the vest date to remind them of the key aspects of the vest process, including —

- How the FMV is determined for tax purposes
- How the award will be taxed and how the tax will be collected
- The need for activating the employee's brokerage account
- When the employee can expect to receive the stock and where the shares will be deposited
- Potential market fluctuation between time shares are deposited into account and when the shares can be sold
- What types of communications the employee will receive for tax filing purposes
- Instructions to contact the broker to conduct further sales of shares after the vest date

After the vest process is complete, advise the employees of —

- Number of shares released
- Tax withheld
- Number of shares sold/withheld for tax
- FMV of the shares released
- When and where to locate the net shares deposited

This communication may be from the Company, third-party administrator, or broker.

Restricted Stock Units:
Same as restricted stock.

	Illustrative Controls	Illustrative Test of Controls
1	Establish procedures to notify employees of awards that will vest and that have vested.	Confirm process has been followed.

6.4. OUTSOURCING

6.4.1. The Company may outsource certain aspects of plan administration. In the vest/release process, the Company retains responsibility for authorizing the vest/release. Recording, processing, and reporting the vest/release may be fully or partially outsourced to a third-party administrator or a brokerage firm.

6.4.2. The controls discussed in this section will apply regardless of whether or not the Company outsources plan administration; however, the group responsible for implementing the control may differ. In general, the controls in Questions 25 and 28 are maintained by the Company. The controls in Questions 26, 27, and 29 may reside partially with the Company and partially with the third-party administrator (depending on what functions are outsourced). In all cases, the Company retains overall responsibility for the internal control process.

6.4.3. Some companies outsource the Human Resources and/or Payroll function. If these functions are outsourced, additional controls must be implemented to ensure the data transfers are accurate, timely, and complete.

Tax and Payroll Issues

7.1. INTRODUCTION

The tax withholding and reporting process requires close coordination between the Payroll department, the Equity Compensation department, and third-parties such as the company-designated broker or administrator. This coordination is particularly challenging when the Company uses multiple payroll systems.

7.2. OVERVIEW OF THE TAX AND PAYROLL ISSUES

7.2.1. Tax and payroll issues are among the most complex and challenging areas of administration. When the risk of forfeiture lapses for a restricted stock award (normally at vest), the employee recognizes taxable gain equal to the FMV of the shares on the lapse date (or the difference between the FMV and purchase price if the purchase price was not $0). The Company is required to withhold federal, state, local, and FICA taxes on the taxable income. In addition, the Company must include the taxable gain as income in the employee's Form W-2. When restricted stock units vest, the FMV of the award is only subject to FICA, and when the units are released, the FMV of the award is subject to federal, state, and local income taxes. For purposes of this publication, we have assumed that the vest date and release date occur simultaneously. Therefore, FICA and income tax will be withheld at the vest/release date for restricted stock units. However, it should be noted that in other circumstances, the taxation of restricted stock units may be bifurcated. Controls associated with the withholding and reporting process are discussed in Questions 30, 31, 32 and 34.

Caution –Restricted stock units will generally not be subject to IRC Section 409A provided the shares are released upon vest. The discussion of this topic is beyond the scope of this publication. Consult tax and/or legal counsel to determine the potential impact of IRC Section 409A.

7.2.2. Under ASC 718, tax withholding in excess of the maximum individual tax rate in the applicable jurisdiction may result in the award being accounted for as a liability rather than an equity instrument, thereby resulting in less favorable accounting treatment. If the transaction is part of a pattern, or if the terms of the Plan specifically allow employees to tender shares for payments in excess of the maximum tax rate, liability accounting may be required for the entire Plan. Controls associated with the maximum tax withholding requirements are discussed in Question 33.

7.2.3. A corporate tax deduction may be claimed for the ordinary income recognized by the employee associated with restricted stock and restricted stock units. *Note – IRC Section 162(m) places limitations on the corporate deduction for certain officers and highly-compensated employees.* The accounting expense for the fair value of the award under ASC 718, which is determined at the grant date, includes an offset for the corresponding estimated corporate tax benefit, calculated at the appropriate corporate tax rate. When the actual taxable event occurs, the Company claims the actual tax deduction on the corporate tax return. In all likelihood, the **actual** tax benefit will differ from the **previously recognized** tax benefit; thus additional accounting adjustments may be required. Controls associated with the corporate tax deduction are discussed in Questions 34 and 35.A detailed discussion of the accounting implications of the corporate tax benefit is outside the scope of the publication. Controls associated with the reports for providing underlying data for the cumulative effect of the corporate tax benefit are discussed in paragraph 8.3, Question 37.

7.3. CONTROLS ASSOCIATED WITH TAX AND PAYROLL ISSUES

Q30: *Is the FMV on the Date of Vest Properly Determined?*

Restricted Stock:

The Plan, the Award Agreement, or plan interpretations define how the FMV on the date of vest is determined. (For purposes of this publication we will refer to this as the FMV as defined by the Plan.) FMV may be determined in a variety of ways

GLOBAL ISSUES

Some non-US countries require that companies calculate the FMV of the shares on the vest date for purposes of calculating the taxable income using a local valuation methodology. For example, the valuation may be based on an average over the month prior to the vest date or a seven-day weighted average. Care should be taken to identify grants made in these jurisdictions to ensure that withholding and reporting is made on the appropriate FMV.

such as the market close on the day prior to vest, the market close on the vest date, or the average of the high/low on the vest date. (Defining FMV as anything other than the market close on the date of vest is permissible, but will require SEC disclosure.) The FMV, as defined by the Plan, is used to calculate taxable income for the employee.

Document the calculation of the FMV and source of the pricing data on the date of vest. If appropriate, the documentation should include the range of prices for that date. Special attention should be given in determining the market value for weekend dates and holidays.

Many companies calculate the FMV as the market close on the day prior to vest to simplify the calculation of applicable taxes (see Question 31 for more details) and to facilitate the timely payment of the payroll tax deposit (see Question 34 for more details). These considerations can be particularly important if shares are used to pay the applicable payroll tax.

Restricted Stock Units:

Restricted stock units differ from restricted stock awards in that the shares are not effectively issued until the vest date. For taxation purposes, the discussion above and associated controls regarding restricted stock are also applicable to restricted stock units. When the release of shares is discussed for restricted stock, the process for restricted stock units includes an issuance of stock *and* a release of shares.

	Illustrative Controls	Illustrative Test of Controls
1	Determine how the FMV is determined for each Plan.	Verify that the documentation exists.
2	Document the calculation of FMV and source of the pricing data. If appropriate the documentation should verify that the FMV used falls within a range of prices for that date.	Select several dates and review the calculation of FMV at vest to confirm that the established procedure was followed. Select a date and sample vests on that date. For the selected sample, trace each transaction to the stock plan database. Confirm that the FMV recorded was correct.

Q31: *Is the Correct Tax Collected?*

Restricted Stock:

Under IRC Section 83 an employee is subject to tax on property received in connection with the performance of services when the property is no longer subject to a substantial risk of forfeiture (i.e., substantially vested). Restricted stock qualifies as property under IRC Section 83. As such, it is subject to tax when the risk of forfeiture lapses.[9] Normally this is defined as the vest date. See Question 32 regarding the taxability of employees that are retirement-eligible.

9 Section 83 (c)(3) states: "So long as the sale of property at a profit could subject a person to suit under section 16(b) of the Securities Exchange Act of 1934, such person's rights in such property are subject to a substantial risk of forfeiture..."

Taxable income is the difference between the FMV of the restricted stock at the date of vest and the amount paid for the stock (usually $0). If FMV is defined as the average of high/low on the vest date or market close on the vest date, the calculation of taxable income and the applicable taxes can not occur until after the market closes on the vest date or the day after the vest date.

The amount of tax withholding is based on the rules of the appropriate tax jurisdiction and the employee's situation. This requirement reinforces the need for accurate employee demographic data as discussed in paragraph 4.3, Question 13. Collecting insufficient tax can result in the tax authorities assessing the Company significant penalties and interest. The Company may also be responsible for the tax that originally was required to be withheld from the employee.

The tax may be paid by the employee by withholding a portion of the vested restricted stock (withhold-to-cover), selling a portion of the shares to fund withholding (sell-to-cover), or remitting cash to the Company to cover the required withholding. The advantages and disadvantages of each method are discussed below.

Withhold-to-Cover. Withhold-to-cover is used frequently by companies that have sufficient cash to pay the payroll tax. The administrative steps in a withhold-to-cover transaction are summarized in Exhibit 8. Taxable income is calculated based on FMV as defined by the Plan. (See Question 30 for more details.) The payroll tax is calculated on the taxable income to be reported. The required tax will be paid by withholding newly vested shares equal to the amount of tax divided by the FMV of a share. The share value is based on FMV defined by the Plan. (This mirrors the FMV used in the calculation of taxable income.)

Most companies do not allow for the issuance of fractional shares. Therefore, the calculation of the number of shares that must be withheld is rounded to whole shares. If the fractional share is rounded up to the next whole share, the FMV of the partial share is added to withholding or refunded to the employee. (The accounting implications of rounding are discussed in Question 33.) If the fractional share is rounded down to the next whole share, the shortfall of tax is collected from the employee in the next payroll cycle or the employee remits cash to the Company to pay the shortfall. (Caution: The Sarbanes-Oxley Act of 2002 prohibits public companies from making loans to their executive officers. Collecting a tax shortfall in the next payroll cycle may be deemed a loan and prohibited under the Act. If an employer has an obligation to pay a bonus equal to the tax withheld on the award, the award may be considered a liability rather than an equity instrument.)

The Company is required to pay cash from company funds for the payroll tax deposit. Since no shares have been sold in a withhold-to-cover transaction, there are no sales proceeds to fund the payroll tax deposit. See Exhibit 8 for an example of withhold-to-cover.

EXHIBIT 8. RESTRICTED STOCK: WITHHOLD SHARES TO COVER TAX

The following describes the withhold-to-cover process. This chart assumes the Company administers the Plan internally and uses a company-designated broker. The FMV is the market close on the date prior to vest.

STEP	DATE	PARTY	ACTIVITY
1	T	Company	> Determines number of shares vesting > Determines FMV as defined by the Plan > Determines taxable income to be reported > Calculates applicable payroll tax
2	T	Company	> Calculates number of shares withheld to cover applicable payroll tax based on FMV > Processes release for net shares > Reports taxable income and associated withholding to payroll > Advises transfer agent to deliver net shares to broker and provides instructions for processing withheld shares > Sends file to broker with applicable issuance information for net shares for each employee > Confirms details of net release and associated shares withheld and taxes with employee
3	T+1	Transfer Agent	> Electronically transfers net shares to broker based on direction of Company > Processes withheld shares based on instructions from the Company
4	T+1	Broker	> Receives net shares from transfer agent > Records net shares in each employee's account
5	T+1	Company	> Payroll makes deposit with tax authorities if daily federal employment taxes exceed $100,000

Note – If FMV is determined based on the previous day, the Company may perform Step 1 after the market closes (on T-1, rather than T). In those cases, some aspects of Steps 2 to 5 may be accelerated by one day.

The advantages of withhold-to-cover are —

- Minimize dilution (In Exhibit 9, 310 shares rather then 450 shares are released; 140 shares may be returned to the plan reserves.) See Section 4, Grant Process, Question 10, for ISS implications.
- Easier to administer than the sell-to-cover or cash method
- Employee does not pay any commissions or fees on the shares withheld
- Minimizes involvement of Treasury since no cash is transferred to the Company

The primary disadvantage is that the Company must fund the employee's payroll tax by using company cash, rather than utilizing cash generated by the sale of stock. In addition, the rounding of fractional shares may create accounting issues. (See Question 33 for a detailed discussion of the accounting implications of rounding.)

Sell-to-Cover. The second method, sell-to-cover, is used frequently by companies that have insufficient cash to pay the payroll tax. The administrative steps in a sell-to-cover transaction are summarized in Exhibit 10. Taxable income is calculated based on FMV defined by the Plan. (See Question 30 for more details.) The payroll tax is calculated on the taxable income to be reported.

EXHIBIT 9. CALCULATION OF WITHHOLD-TO-COVER

- 450 shares vest
- FMV as defined by the Plan = $9.20 per share
- Applicable tax rate = 31%
- Fractional shares rounded up to whole shares with residual applied as additional withholding

Taxable income = $4,140 (450 x $9.20)

Tax withheld = $1,283.40 ($4,140 x 31%)

Shares withheld for tax = 140 ($1,283.40 / $9.20 = 139.5 shares rounded to 140)

Shares issued to employee = 310 (450 – 140)

Company makes payroll deposit of $1,288 ($1,283.40 + 4.60 residual from fractional share) from Company funds

The employee receives the full number of shares vesting and must sell a portion of the shares to generate cash to pay the required tax. The Company, broker, or third-party administrator estimates the number of shares required to be sold to deliver appropriate funds from the stock proceeds to pay the tax. The number of shares to be sold is rounded up to equal whole shares, not fractional shares, and to cover market fluctuation in the shares. (Market fluctuation is the difference in the estimate of the proceeds from the stock sale and the actual proceeds from the sale of stock.)

EXHIBIT 10. RESTRICTED STOCK: SELL SHARES TO COVER TAX

The following describes the sell-to-cover process. This chart assumes the Company administers the Plan internally and uses a company-designated broker. The FMV is the market close on the date prior to vest.

STEP	DATE	PARTY	ACTIVITY
1	T	Company	> Determines number of shares vesting > Determines FMV as defined by the Plan > Determines taxable income to be reported > Calculates applicable payroll tax
2	T	Company	> Processes release of total shares vested > Reports taxable income and associated withholding to payroll > Advises transfer agent to deliver shares to broker > Sends file to broker with details for number of shares to be delivered and associated taxes for each employee
3	T+1	Transfer Agent	> Electronically transfers shares to broker based on direction of Company
4	T+1	Broker	> Receives shares from transfer agent > Sells shares to cover tax > Confirms shares sold to cover taxes to the Company > Records in the employees' account sale of shares to cover tax and remaining shares
5	T+1	Company	> Confirms details of vest and associated taxes with employee (may be handled by broker) > Payroll makes deposit with tax authorities if daily federal employment taxes exceed $100,000
6	T+2	Broker	> Completes sale of shares > Distributes sales price of shares for applicable taxes to the Company
7	T+2	Company	> Receives cash distribution from broker to pay applicable tax

Note – Some companies perform Step 1 after the market closes (on T-1, rather than T). In those cases, some aspects of Steps 2 to 7 may be accelerated by one day.

STRATEGIC ISSUES

Equity awards are taxable income to the employee and the employee is required to pay payroll tax on the income. The payroll tax may be paid in a variety of ways. The most common methods of collecting the tax are (1) withhold shares to cover the tax and (2) sell shares to cover the tax. Each method has advantages and disadvantages that must be considered before making a decision about how to collect payroll tax from employees. For example, when shares are withheld to cover the tax, the company withholds shares equal to the required payroll taxes and the company pays the payroll tax obligation from company funds. When selling shares to cover the tax, the sales proceeds are used to fund the payroll tax obligation. The ramifications of each method are amplified when a large number of restricted stock and restricted stock units vest on one day. This can result in a significant cash outlay for the company (withhold shares to cover the tax) or a large number of shares being sold on one day to pay payroll tax (sell shares to cover the tax).

The sale usually occurs on the day after vest. In many cases, the broker executes a block sale of shares for all employees and the average sales price is applied to each employee. The reporting of the sale of the shares is usually handled by the broker. The sale proceeds equal the sales price per share multiplied by the number of shares sold. The sales price per share may not equal the taxable income per share initially calculated due to the market fluctuation between the vest date and the date the shares are sold. If sales proceeds exceed the amount of required tax withholding, the excess can be refunded to the employee by transferring the additional proceeds into the employee's brokerage account or by adding the additional proceeds to the tax withholding. See Exhibit 11 for an example of sell-to-cover.

The advantage of sell-to-cover is that the sales proceeds fund the payroll tax deposit, as opposed to the Company funding this in a withhold-to-cover transaction. The disadvantages are —

- Administrative complications.
  The challenge of estimating the number of shares to be sold to pay tax and the complications of handling proceeds that exceed or fall short of the required tax require significant time and effort.
- Securing employee authorization to sell shares.
  Authorization may be implied in the Award Agreement, incorporated as part of the formal acceptance of the grant, or required prior to the vest date.
- Ensuring the employees have activated their brokerage account.
  A brokerage account will facilitate the employee's sale of shares to pay the required tax.
- Selling shares during a closed window may be difficult or prohibited.

  Some companies utilize 10b5-1 trading plans for all recipients of restricted stock. Other companies incorporate language in the Award Agreement that require employees sell shares to pay payroll taxes, essentially embedding a 10b5-1 trading plan in the agreement. (See Section 9, Question 45, for a detailed discussion of 10b5-1 plans.) It may be necessary to utilize a different approach for Section 16 officers. A complete discussion of the issues of selling shares during a closed window is beyond the scope of this publication and legal counsel should be consulted.
- Potential impact on the market price if significant shares are sold on the same date.
  If the Company is thinly traded, the sale of a significant block of shares may impact the market price.
- Additional dilution.

  In Exhibit 11, 450 shares rather than 310 shares are released.

Cash. The third method is where the employee remits cash to the Company to cover withholding. The calculation of taxable income and associated tax is identical to the calculation in a withhold-to-cover or sell-to-cover transaction. Prompt collection of the payroll tax presents an administrative challenge. The calculation of the tax occurs on the vest date or the subsequent day. Payroll tax is due immediately, but it may be impractical to collect funds from the employee immediately. A wire transfer of funds may be difficult. Even if the employee delivers a check on the vest date, the Company should wait until the check clears before releasing the shares. Because of the administrative complications associated with this method, most companies do not allow their employees to pay their tax obligations in cash.

Best Practice. Best practice is to use one method to collect payroll tax, either withhold-to-cover or sell-to-cover, for all employees. However, if multiple methods of payment are offered and employees are allowed to elect which method to use, require the employee make the election at least 15 days prior to vest. If no election is received within 15 days prior to vest, provide a default method such as withhold-to-cover. Prohibit employees from changing their elections within 15 days of

EXHIBIT 11. CALCULATION OF SELL-TO-COVER

- 450 shares vest
- FMV as defined by the Plan = $9.20 per share
- Applicable tax rate = 31%
- Fractional shares rounded up to whole shares with residual applied as additional withholding
- Sales proceeds = $9.25 per share

Taxable income = $4,140 (450 x $9.20)

Tax withheld = $1,283.40 ($4,140 x 31%)

Shares issued = 450

Shares sold for tax = 140 ($1,283.40 / $9.20 = 139.5 shares rounded to 140)

Sales proceeds = $1,295
(140 shares X $9.25 per share)

Broker transfers $1,283.40 to the company

Company makes payroll deposit of $1,283.40 using sales proceeds to fund the payroll deposit

Net shares to employee = 310 (450 – 140 sold to pay tax) vest. The requirements related to the collection of payroll tax are usually incorporated into the Award Agreement. *Note – An Insider may only be able to make an election regarding the way payroll tax will be paid during an open window. See paragraph 9.3, Question 44, for more details on the trading restrictions during a blackout period.*

A number of ways exist to deal with a closed window on a vest date. Some companies use withhold-to-cover for Insiders and sell-to-cover for non-Insiders. (See paragraph 9.3, Question 43, for a definition of Insiders and a discussion of the restrictions on Insiders.) Some companies default to withhold-to-cover during blackout periods. Other companies delay the release of shares until an open window. *Caution – Deferring the release of shares may trigger Section 409A issues.*

Withholding Requirements. Year-to-date payroll information is required to calculate the tax. The Equity Compensation department collects the tax based on information provided from the payroll system. The calculation of tax required to be withheld may be the responsibility of (1) the Equity Compensation department with results transmitted to the brokerage firm, (2) the Payroll department with results transmitted to the Equity Compensation department, or (3) a third-party administrator/broker based on data provided by the Equity Compensation department.

Controls must be implemented to ensure withholding rates are correct as withholding rules and rates frequently change. Establish a process to regularly update tax rates and tax rules. Schedule the update process and document that the process has been followed.

Normally the income from vested awards is treated as supplemental wages and tax is withheld using supplemental tax rates rather than regular withholding rates. (In some states, the supplemental withholding rate applicable to equity compensation is different from the regular supplemental withholding rate.)

When year-to-date supplemental wage payments from all sources exceed $1 million for an individual in a calendar year, federal withholding must be increased to the maximum tax rate. Employers may treat either the entire supplemental payment, or just that which brings the total payment over $1 million, as subject to the mandatory withholding.[10] Establish a process to meet the withholding requirements for supplemental payments in excess of $1 million. Give special attention to reset the year-to-date information to zero at the beginning of each calendar year.

See Question 33 for further discussion on this point.

Year-to-date information is also important for social tax purposes. The Social Security portion of FICA is required to be paid on wages up to a certain limit within a calendar year. Social Security is not required to be withheld on wages that exceed this limit. The Medicare portion of FICA is required to be withheld on all wages with no maximum. An additional Medicare tax of 0.9% applies to all wages exceeding $200,000. An accurate record of year-to-date wages is important to ensure the proper FICA is withheld.

In some cases, the current location of an employee may not be used to determine which tax rates apply. The state of residency may have changed when an employee was terminated or retired. The employee may work in one location and live in another location. An employee may also be taxed in multiple jurisdictions if the employee moved between the date of grant and the date of vest. Special care must be taken in these cases to determine the tax requirements of each jurisdiction and how employee movement and work location should be tracked. A complete analysis of the issues associated with change of residency is beyond the scope of this publication.

Verify that every employee has tax withholding when the award vests. Investigate employees who have no withholding and document the

10 IRC Regulation Section 31.3402(g)-1(a)(4)(iv)).

GLOBAL ISSUES

> Many countries tax restricted stock when it is granted. In those countries, the tax withholding and reporting process may occur at the grant date. Some countries tax restricted stock units at grant if dividend equivalent payments are paid prior to vesting or if grants are made under certain tax beneficial programs.

> Acceptable methods of paying tax may be restricted and/or require employee consent in certain jurisdictions. Additional flexibility with respect to tax payment method may be required for non-US employees.

> If a U.S. company reports (or has subsidiaries that report) under IFRS2 in certain jurisdictions, allowing the employee to withhold shares to cover their tax liability will trigger liability treatment for the grant in question.

> Most jurisdictions do not apply flat withholding rates to supplemental payments such as equity compensation. Income from restricted stock and restricted stock units is subject to tax at regular payroll tax rates.

results of the investigation. This step will help prevent underwithholding and may detect the grant of awards to fictitious employees.

Restricted Stock Units:

Restricted stock units are not considered property and, therefore, are not subject to IRC Section 83. They are treated as cash compensation and subject to income tax upon release (issuance) of the shares. Restricted stock units are subject to FICA tax at vest under IRC Section 3121(v). This publication assumes vest and release are concurrent. *Note – The release of restricted stock units and income inclusion can be deferred under IRC Section 409A, or solely income inclusion may be deferred on the shares released into an escrow account under IRC Section 83(i). Either deferral may have tax consequences. A complete discussion of the deferral and associated tax consequences are outside the scope of this publication.* The calculation of taxable income and the associated tax is the same as restricted stock.

	Illustrative Controls	Illustrative Test of Controls
1	Establish and document the process to calculate tax withholding. Clarify appropriate responsibilities between Payroll, Equity Compensation, and third-party vendors such as a brokerage firm. Document details of the data transfer.	Verify that the process is documented. Test that the established process was followed.
2	Establish and document that the process to verify that the correct tax tables and tax rules are used. Develop a schedule to update the tax rates/rules.	Verify that the process is documented. Test that the tax rates/rules are updated according to the predetermined schedule. Confirm that year-to-date information was reset at the beginning of the year.
3	Establish and document the process to meet the withholding requirements for supplemental payments in excess of $1 million.	Sample employees whose supplemental payments exceed $1 million. Verify that the correct withholding rate was used for all transactions beyond the $1 million threshold.
4	Establish and document the process to meet the FICA withholding requirements.	Sample award vests. Verify that the correct year-to-date payroll information was used to calculate FICA.
5	Verify that tax is withheld for every vest. Note discrepancies and reasons for not withholding.	Review and document discrepancies and note unusual items.

Q32: *Are The Awards To Retirement-Eligible Employees Taxed Properly?*

Restricted Stock:

As discussed in Question 31 restricted stock is taxable under Section 83 when the property is no longer subject to a substantial risk of forfeiture. Normally the award is no longer subject to forfeiture when the restrictions lapse on date of vest; however, many plans include provisions that awards vest or continue vesting upon retirement. In these cases, retirement-eligible employees have no risk of forfeiture; therefore, the award would be taxed immediately for income tax and social tax purposes. For employees that are retirement-eligible at the date of grant, the award is taxed at grant. If the employee becomes retirement-eligible during the vesting period, the award is taxable when the employee becomes retirement-eligible. A corporate tax deduction may be claimed when the award is taxable for income tax purposes to the employee provided the employer has reported the income on Form W-2. The corporate deduction equals the amount of taxable income of the employee. (See Question 34 for further discussion on calculating the corporate tax deduction.)

Equity awards that vest or continue vesting upon retirement are difficult to administer and employee communications are challenging. The stock plan database may not include functionality to track the tax impact of retirement-eligibility. This may need to be tracked manually.

A retirement-eligible employee is taxed on the award even though the award has not vested. The employee cannot sell shares to pay the required tax nor can the Company withhold shares to pay the tax since the shares have not vested. If the employee pays tax out of other funds, there is no process to report the taxable income and tax withheld to payroll. When an award later vests, no taxable event occurs. Awards to retirement-eligible employees must be identified at the vest date and processed separately to ensure taxable income is not reported a second time and additional tax is not withheld. In addition, it is difficult to communicate these requirements to impacted employees.

Companies deal with the administrative complexities of reporting and collecting tax on awards to retirement-eligible employees in a variety of ways. To reduce administrative challenges, some companies eliminate Plan provisions that provide for vesting or continued vesting upon retirement. Other companies issue restricted stock units rather than restricted stock to employees that are retirement-eligible or will become retirement-eligible before the award vests.

GLOBAL ISSUES

Tax jurisdictions may have different rules. Withholding and reporting requirements may differ. Tax years may be different (e.g., the tax year end may be April 5 rather than December 31). A variety of civil and criminal penalties may be assessed for inadequate withholding. Care must be taken to determine the appropriate tax requirements of each jurisdiction.

As noted below, restricted stock units held by retirement-eligible employees are subject to less onerous tax requirements. See the following section on restricted stock units for further details.

Restricted Stock Units:

Restricted stock units are treated like cash compensation and subject to income tax upon release (issuance) of the shares. They are subject to FICA tax at vest under IRC Section 3121(v). If an employee becomes retirement-eligible and the Plan provides an award will vest or continues vesting upon retirement, the award is no longer subject to a risk of forfeiture and is subject to FICA tax. However, the employee is not liable for income taxes until the award is released. For employees that are retirement-eligible, the tax consequences of restricted stock units may be more beneficial than the consequences of restricted stock.

Though less burdensome than restricted stock, restricted stock units also have administrative challenges. Reporting of the award may be required under Section 409A when the employee becomes retirement-eligible. (Consult with Legal or Tax Counsel to determine the applicable reporting requirements.) A manual process may be required to track the tax impact of retirement-eligibility. Employee communication is still challenging. Some companies have employees pay the associated FICA through payroll. Other companies accelerate vesting to the date of retirement-eligibility and allow a partial release of the shares to provide funding for the FICA due upon vest. The remaining shares would be released at the original vest date. This approach can create complications, as all the shares in the award will be taxable for FICA purposes, and the shares with accelerated vesting will also be taxable for income tax.

IRC Section 31.3121(v)(2)-1(e)(5) includes a special provision for administrative convenience. An employer may delay reporting income for FICA tax purposes to any date within the same calendar year. In other words, an employer could report and collect FICA tax on December 31 for any award to employees that became retirement-eligible during the year. Assuming the employee had met the limit on the Social Security portion of FICA, only the Medicare portion of FICA would be required to be collected on the award.

	Illustrative Controls	Illustrative Test of Controls
1	Determine and document the retirement provisions for each Plan. Highlight provisions for accelerated or continued vesting at retirement.	Verify that documentation exists for all Plans.
2	Develop a process to identify and track retirement-eligible employees.	Select several retirement-eligible employees and verify that the employees were properly identified for stock plan purposes.
3	Establish and document the process to calculate and collect appropriate tax for awards to retirement-eligible employees.	Verify that the process is documented. Confirm that the process conforms to the appropriate tax requirements. Test that the established process was followed.
4	Establish and document the process to ensure previously reported taxable income is not reported at vest/release.	Select several retirement-eligible employees whose shares have vested/released and verify the appropriate tax was withheld at vest/release date.

Q33: *Have the Payroll Tax Withholding Requirements Under ASC 718 Been Met?*

Restricted Stock:

Some plans permit employees to pay the tax by relinquishing part of the award. (See Question 31 for full discussion of the process of withholding shares to cover the required payroll tax.) Withholding shares to cover the required payroll tax is commonly referred to as a "tender of shares." This "tender" of shares does not involve a sale; the Company credits the current value of the tendered shares to the amount owed. (The Company uses its own cash to pay the employee's withholding tax liability.) When shares

STRATEGIC ISSUES

> Review the Plan provisions regarding acceleration of vest upon retirement. Due to the administrative complexities with reporting and collecting tax on awards to retirement-eligible employees, consider eliminating this provision.

> Determining FMV on the date of vest will impact payroll tax administration. Defining FMV as the market close on the day prior to vest streamlines the payroll process. Taxable income and associated tax may be calculated on the day prior to vest after the market closes. (This is 24 hours earlier than using the market close on the day of vest to determine FMV.) This timing may be critical in meeting the requirement to deposit federal employment taxes of $100,000 or more on the next banking day.

> Vesting at month-end and year-end may create additional administration for the Payroll department. If possible avoid vesting at these key dates.

are tendered from those currently vesting, the tax withholding must be limited to the maximum individual tax rate as applicable for each jurisdiction. "Allowing employees to tender . . . shares for tax payments in excess of the maximum individual tax rate will trigger liability treatment for the grant in question. Moreover, if the transaction is part of a pattern, or if the terms of the plan specifically allow employees to tender shares for payments in excess of the maximum tax rate, liability accounting may be required for the entire plan."[11]

The payment of applicable tax may require the payment of fractional shares rather than whole shares because the tax payment is not evenly divisible by the share price. Since most companies do not issue fractional shares, the number of shares tendered must be rounded up or rounded down. The trend is to round up to the next whole share. The excess withholding may be refunded to the employee in the next payroll cycle or added to federal/state tax withholding. In most cases, the impact of rounding up is immaterial; however, multiple vests on the same day (resulting in numerous fractional shares — each being rounded up to the next whole share) or rounding up a high-value share could create problems. If the Company rounds down, the remaining withholding amount (that is equal to the fractional share) could be collected from the employee's next paycheck. Consult with the Company's external auditor to ensure the way fractional shares are handled does not affect the classification of the award as an equity instrument.

Note – The accounting issues discussed above do not generally apply to transactions where shares are sold in the open market to cover the required payroll tax.

Restricted Stock Units:
Same as restricted stock.

	Illustrative Controls	Illustrative Test of Controls
1	Establish and document the policy regarding tax payroll withholding requirements.	Sample vests and verify that the policy was followed.

11 Accounting for Equity Compensation, 14th edition, by Barbara A. Baksa, section 7.3.

Q34: *Is the Proper Income and Tax Withholding Reported to Payroll?*

Restricted Stock:

On the vest date, the Equity Compensation department transmits details regarding taxable income and corresponding withholding to Payroll. Payroll reflects the taxable income and corresponding withholding in the year-to-date information in the payroll system. Payroll also makes the required deposits of the payroll tax, often on the next day. To ensure this process works efficiently and effectively, all parties (Payroll, Equity Compensation, the third-party administrator, and the brokerage firm) must understand the process, which group is responsible for each specific activity, and the details of the data transfers. This can be particularly challenging when operating multiple payroll systems, domestically or on a global basis.

Payroll may not be able to simultaneously process the income from awards with regular payroll. Special input may be required into the payroll system. Include standard error-checking when importing the file into the payroll system. For example, verify that FICA was calculated accurately and federal/state withholding occurred for every employee. Implement a process to reconcile information from the stock plan database to the payroll records. On a monthly basis, reconcile total equity compensation reported in the payroll records to taxable income in the stock plan database. Investigate and resolve any discrepancies. Verify the tax withheld in the stock plan database agrees with the payroll records. Investigate and resolve any discrepancies.

Establish and document a policy on payroll tax deposits. Payroll deposits for stock transactions usually occur separately from other payroll tax deposits. The tax authorities have stringent requirements regarding timely deposit of payroll tax withholdings. Tax is required to be withheld when wages are constructively or actually paid. For restricted stock, wages are deemed paid and payroll tax must be withheld on the day the award vests. If on any day an employer has $100,000 or more of federal employment taxes accumulated, these taxes must be deposited by the close of the next banking day.[12] See Exhibit 12.

12 IRC Regulation Section 31.6302-1.

GLOBAL ISSUES

> Restricted stock units are taxed in most non-US tax jurisdictions when the shares are released. Restricted stock is taxed in most non-US jurisdictions at grant. This tax treatment makes restricted stock units the preferred equity vehicle in non-US countries. Consult tax and legal counsel to determine the taxability in appropriate countries.

> Use caution when including plan provisions that provide for vesting or continued vesting upon retirement. In the European Union such provisions may be deemed discriminatory.

EXHIBIT 12 . TIMELY DEPOSIT OF PAYROLL TAXES IN EXCESS OF $100,000

	Restricted Stock	Restricted Stock Units
Monday	Vest occurs (T) Payroll records the vest (T)	Vest occurs (T) Payment Initiated (T)
Tuesday	Payroll deposit occurs (T+1)	
Wednesday		Settlement occurs (T+2)
Thursday		Payroll deposit occurs (T+3)

Making the payroll tax deposits on a timely basis (i.e., on T+1) is challenging. If necessary, calculate the payroll tax deposit on T-1 using an estimated FMV of the shares scheduled to vest on T to project total taxable income and associated taxes. Deposit the projected tax on T+1. True up the amount when actual income and tax is determined.

Close coordination is also required at month-end and year-end. This can be particularly troublesome when the vest occurs after the last paycheck has been issued for the year. The Company must still record the taxable income and taxes paid in the payroll system for the correct year.

The Corporation may claim a tax deduction on the corporate tax return for the amount reported as tax able income by the employee for the year. If the corporation does not report on a calendar year basis, the Company may claim a deduction for the amount that relates to the calendar year end that falls within the Company's fiscal year. This treatment is different than the timing of the corporate deduction for nonqualified stock options and restricted stock units for tax purposes and for the treatment of corporate tax deductions for accounting purposes. See Exhibit 13.

Special care is required for year-end reporting of vesting events that require correction. Review the awards vested to determine if year-end reporting is impacted by any items.

Restricted Stock Units:

Restricted stock units are taxable for FICA at vest and taxable for income tax at release. For purposes of the payroll tax deposits and timing of the corporate tax deduction, restricted stock units may vary in treatment from restricted stock. If on any day an employer has $100,000 or more of federal employment taxes accumulated, these taxes must be deposited by the close of the next banking day after the restricted stock unit is settled (rather than the next business day after vesting, as in the case of restricted stock).[13] See Exhibit 12.

The Company may claim a corporate tax deduction for a restricted stock unit when the stock is released to the employee. The timing of the deduction is unclear, but many tax practitioners take the position that it is similar to the treatment of nonqualified stock options, rather than restricted stock. See Exhibit 14. Consult your tax advisor regarding this issue.

13. Internal Revenue Manual 20.1.4.26.2 (May 26, 2020).

GLOBAL ISSUES

> The laws in many countries do not include provisions for a minimum statutory rate. Selling shares in the open market to cover the required payroll tax will avoid this problem. Consult with the Company's external auditor to ensure the tax withholding process does not affect the classification of the award as an equity instrument.

> Making payroll tax deposits on a timely basis is no less critical in non-US jurisdictions. Companies should work with their advisors to determine the timing of withholding and payroll tax deposits on a country-by-country basis to ensure that deadlines are not missed.

> The non-US affiliate employing the grantee may be able to take a corporate tax deduction for the equity award. This may require that the non-US affiliate chargeback the cost and enter into a reimbursement agreement with the US issuer. The amount of the deduction may be limited by certain local tax restrictions. Taking the deduction may also trigger exchange control or other legal issues that the company needs to carefully consider. A complete discussion of this issue is outside the scope of this publication.

	Illustrative Controls	Illustrative Test of Controls
1	Establish and document the process to transfer data from the stock plan database into the payroll system.	Sample awards that vest from the stock plan database for several days and verify that the income was reported in the payroll system on a timely basis and to the correct employee.
2	Utilize error-checking routines when importing the file into payroll. Document errors identified, research performed, and resolution of the issues.	Review error reports for trends and unusual items.
3	On a monthly basis, reconcile total income from equity compensation in the payroll records to taxable income in the stock plan database. Investigate and resolve any discrepancies.	Verify that the reconciliation was completed. Note trends and unusual problems.
4	On a monthly basis, verify that taxes withheld in the stock plan database agree to the payroll records.	Verify that the reconciliation was completed. Note trends and unusual problems.
5	Establish and document a policy on payroll tax deposits.	Sample payroll deposits and verify that deposits were made on a timely basis.

Q35: *Has the IRC Section 162(m) Limit Been Observed?*

Restricted Stock:

A corporate tax deduction may be claimed for the ordinary income recognized by the employee upon vest of restricted stock. The corporate tax deduction is limited (IRC §162(m)) for "covered" employees whose compensation exceeds the $1 million cap for the year. Specifically, IRC §162(m) limits a publicly held corporation's deduction for compensation paid to each of its principal executive officer (PEO), principal financial officer (PFO), and its next three highest compensated officers, excluding the PEO and PFO, to $1 million per year. In addition, if an individual is considered to be a covered employee at any time during a tax year commencing after 2016, he or she will retain the covered employee status permanently. All future payments to such individuals (as well as their beneficiaries) will be subject to the $1 million deduction limit, even if the individual is no longer an officer or employee of the corporation at the time of payment unless the payment is covered by grandfathering rules discussed below. For many companies, this limitation may be a material item for financial statement purposes.

Under prior law, performance-based compensation was not subject to the $1 million cap. The definition of performance-based required that the compensation was contingent on the "attainment of one or more performance goals" and met numerous other requirements.

EXHIBIT 13. TIMING OF CORPORATE TAX DEDUCTION FOR RESTRICTED STOCK

Company reports on a year ending June 30.

Taxable income reported by employees for restricted stock that vested during calendar year 2020: $150,000

The Company can claim a tax deduction of $150,000 for the year ended June 30, 2021. December 31, 2020, falls within the Company's fiscal year ending June 30, 2021.

EXHIBIT 14. TIMING OF CORPORATE TAX DEDUCTION FOR RESTRICTED STOCK UNITS*

Company reports on a year ending June 30.

Taxable income reported by employees for restricted stock units that vested as follows:

$ 80,000	Vested January 1, 2007, to June 30, 2007
70,000	Vested July 1, 2007, to December 31, 2007
$150,000	Vested in calendar year 2007

The Company can claim a tax deduction of $80,000 for the year ended June 30, 2007. The deduction for the remaining $70,000 can be claimed in the year ending June 30, 2008.

** The timing of this deduction may be unclear; consult your tax advisor regarding this issue.*

The Tax Cuts and Jobs Act of 2017 (TCJA) eliminated this exception. As a result, generally all incentive compensation (e.g., performance shares) paid to covered employees after the 2017 tax year are subject to the $1 million deduction limit, unless it meets the IRC §162(m) grandfather rule.

The grandfather rule applies to compensation provided under a written binding contract that was in effect on November 2, 2017, and that has not been materially modified after such date. Under the grandfather rule, such compensation would be subject to the IRC §162(m) rules in effect prior to enactment of the TCJA, including being eligible for a deduction for performance-based compensation.

The Treasury Department and the IRS have provided detailed guidance on the application of the grandfather rule, explaining that a written binding contract is a payment obligation under applicable state law in which the employer does not have any discretion to unilaterally reduce or eliminate the covered employee's right to such award.

Many employers have existing plans and arrangements that were in effect on November 2, 2017, and were designed to meet the performance-based compensation exception. Such employers may still be able to take advantage of this exception and deduct the pay to the extent the employer cannot unilaterally reduce the amount. (Consult your tax advisor regarding this issue.) Similarly, many individuals who were not covered employees under prior law, but became covered employees following the enactment of the TCJA have incentive pay arrangements that existed on November 2, 2017, and were not designed to satisfy the performance-based compensation exception – namely, PFOs of listed corporations or all executive officers of unlisted corporations now treated as publicly held by virtue of having debt registered with the SEC. Employers may rely on the grandfather rule to fully deduct certain pay to such employees. A complete analysis of the issues associated with IRC §162(m) and a discussion of its grandfather rule are beyond the scope of this publication.

SEC proxy rules require that the Compensation Committee's report state its policy with respect to IRC § 162(m) (i.e., whether compensation paid to the corporation's officers is or is not intended to be fully deductible). This policy should be reviewed annually to determine that it accurately reflects the Committee's policy and the corporation's actual pay practices.

Restricted Stock Units:
Same as restricted stock.

	Illustrative Controls	Illustrative Test of Controls
1	Inventory all compensation plans and agreements that existed on November 2, 2017 (e.g., employment agreements, equity award agreements, severance plans).	Determine the extent to which each contract creates a legally binding obligation for the corporation to pay a specified amount (without unilateral employer discretion to reduce payment).
2	List all employees covered under any plan or agreement as of November 2, 2017.	Identify any participants who have become covered employees but were not covered employees under pre-TCJA rules. The grandfather protection may apply to the pay of officers who later become covered employees.
3	Identify grandfathered plans that were designed to satisfy the performance-based compensation exception under pre-TCJA rules.	Confirm the grandfathered plan satisfies the performance-based compensation exception.
4	Determine the duration of the grandfathered status.	Grandfathered protection ceases upon the first renewal of the plan or agreement after November 2, 2017 (automatic or otherwise), or earlier expiration.
5	Preserve §162(m) grandfather protection.	Confirm no actions have been taken that could result in a material modification of grandfathered plans (e.g., accelerating, deferring, supplementing, or increasing compensation payable beyond a reasonable cost-of-living adjustment).

7.4. OUTSOURCING

7.4.1. Even though a third party may be utilized to handle all or part of stock plan administration, the Company retains responsibility for the controls noted above. For example, a third-party administrator may facilitate the payment of tax, but the Company provides instructions about the amount of tax to be withheld based on appropriate tax rates and year-to-date earnings.

7.4.2. For an outsourcing arrangement to work effectively, the Company and the third-party administrator must work closely together. Processes, responsibilities, and specific handoffs must be clearly documented. In the tax and payroll area this includes, but is not limited to, —

- Identifying which party is responsible for calculating payroll tax on equity awards
- Ensuring year-to-date supplemental wages that exceed $1 million for an individual is properly accounted for when calculating payroll tax
- Updating payroll tax rates and limits

7.4.3. Timing of the data transfer is a critical component. If the Company outsources the payroll process, the requirements of the payroll vendor must also be included. For more information on maintaining data integrity when transferring information between vendor(s) and the Company, see paragraph 3.4.

Accounting Issues

8.1. INTRODUCTION

Calculating the fair value of restricted stock and restricted stock units with time-based vesting is easier than calculating the fair value of options. The fair value is the difference between the FMV at the measurement date (usually date of grant) and the amount paid for the stock (usually $0). The fair value must be decreased if dividends are paid on the underlying stock, but will not be paid on unvested awards. The fair value of the award is expensed over the service period. In many cases, the amount of the expense to be accrued should be reduced by the forfeiture rates in order to reflect grants that are not expected to vest during the accrual period. This publication focuses on controls necessary to assure the accuracy, completeness, and validity of the data used to calculate the fair value and the resulting compensation expense. A detailed discussion of the specific issues related to the equity-based compensation expense calculation is beyond the scope of this publication.

8.2. OVERVIEW OF THE ACCOUNTING ISSUES

8.2.1. The fair value of the award is established at the grant date. The controls associated with the reports providing underlying data for the valuation are discussed in Question 36. The controls associated with the grant process are discussed in detail in paragraph 4.3.

8.2.2. The fair value of the award is expensed over the service period. Usually the service period is the vesting period. Special accrual rules apply in certain circumstances such as employees who are retirement eligible (non-substantive vesting) or when a service period begins before the award is officially granted. Subsequent activities such as post-dated transactions, correction of errors, and modifications may also impact the amount and accrual of the expense. These items are discussed in more detail in Questions 38 and 39. Post-dated transactions are also discussed in paragraph 3.3, Question 8, and paragraph 6.3, Question 25.

8.2.3. The accrual of the fair value of the award over the service period may be reduced by anticipated forfeitures or trued up as forfeitures actually occur, if a company chooses to do so as part of a one-time election. Controls associated with the forfeiture rates and modifications to the forfeiture rates are discussed in Question 40.

8.3. CONTROLS ASSOCIATED WITH ACCOUNTING ISSUES

Q36: Is the Information Included in the Underlying ASC 718 Reports Accurate, Complete, and Valid?

Restricted Stock:

Data integrity of the stock plan database is critical to determining the proper fair value of the awards and accrual of the expense. Previous sections of this publication discussed the controls required to maintain integrity of the data associated with the grant process. Equally important is a detailed understanding of what data is required to determine the fair value of the award and how that data will be provided. (See Question 37 for a discussion of the potential corporate tax benefit.) Reports must extract the appropriate information from the stock plan database and users of the reports must understand the parameters of the data reported.

Earnings per Share – Restricted stock and restricted stock units are excluded in the weighted average number of common shares outstanding during the period (i.e., denominator) when calculating basic earnings per share. Since restricted stock has been issued and is outstanding, the number of shares outstanding in the basic earnings per share calculation must be reduced by unvested restricted stock. Restricted stock units are not issued until the vest/release date. Therefore, no adjustment is needed to the number of shares outstanding in the basic earnings per share calculation. Use care when recording grants to ensure restricted stock and restricted stock units are separately identified in the ASC 718 reports. A complete discussion of the calculation of earnings per share is outside the scope of this publication.

Prepare a detailed description of each report including —

- The purpose of the report,
- A description of each field and details of how each number is calculated, and
- Details of what is included and excluded (e.g., types of participants, grant details, transaction details, vesting period, and reporting period).

All appropriate parties should sign-off on the report format. The format should be reviewed and updated periodically, especially when awards are granted with new terms, mergers/acquisitions occur, and the stock plan database software is updated.

Develop and implement a procedure to validate the information included in each report. Test the calculations during implementation and when changes to the system or software occur. If the report incorporates data from a source other than the stock plan database (e.g., employees eligible for retirement), provide documentation of the data source.

Post-dated transactions may have accounting implications. (See paragraph 3.3, Question 5 – Error Checking, for review of year-to-date reports, and Question 8, for controls regarding post-dated transactions.) Review the monthly report summarizing post-dated transactions and summarize the accounting impact of these transactions. Verify that the post-dated transactions are reflected properly in the reports. See Exhibit 15. To minimize problems and provide an audit trail, reports should always include a date and time stamp.

Best practice incorporates preparing a quarterly audit narrative to document the process used to determine the fair value, including the assumptions used and the decisions made. See paragraph 4.3, Question 16, for controls related to determining FMV on the grant date.

Restricted Stock Units:
Same as restricted stock.

	Illustrative Controls	Illustrative Test of Controls
1	Summarize each report used for the ASC 718 valuation and accrual. Define the purposes of the report. Define each field and how each number is calculated. Enumerate what is included and excluded. All individuals that generate the report or use the report should sign off the report summary. Review and update the summary after each product release.	Confirm that there were no changes in the reports used for the period. If the report has changed, confirm that all appropriate people have signed off the revised report description.
2	Develop and implement a procedure to validate the information included in each report. Document that the validation procedure is followed prior to releasing the information to the group responsible for the ASC 718 valuation.	Confirm that the validation procedure is followed.
3	Prepare a quarterly audit narrative to document the process used to determine the fair value, including the assumptions used and the decisions made.	Review the audit narrative on a quarterly basis.
4	Review the report or log of post-dated transactions. Document that each transaction has been properly reflected in the ASC 718 reports.	Review the report of post-dated transactions to spot trends that may have a material accounting impact.

EXHIBIT 15. ACCOUNTING IMPLICATIONS OF POST-DATED TRANSACTIONS

Assume a transaction relates to January, but was posted in July. The appropriate expense was not taken for the period January to June. How is the transaction reflected in the reports?

> Have manual adjustments been made to the report for the post-dated transaction?

> Does the report for July assume the proper expense was claimed for January to June?

> Does the July report reflect a catch-up adjustment for the period January to June?

> Is the post-dated transaction ignored?

> Is the post-dated transaction valued with current period input or appropriate period input?

Q37: *Is the Corporate Tax Benefit Calculated Appropriately?*

Restricted Stock:

The value of equity compensation to be expensed should consider the potential tax benefits of a corporate tax deduction. The benefits of the corporate tax deduction are recognized currently for accounting purposes provided the cumulative amount of compensation cost recognized for equity compensation ordinarily would result in a future tax deduction under existing tax law.[14] The potential tax benefits are tracked as a deferred asset (i.e., a tax deduction will be claimed on the actual corporate tax deduction in the future). When the actual tax benefits are claimed (normally when the award vests, assuming the employee did not make a §83(b) election), a tax deduction is permitted for the amount the employee reports as taxable income assuming compensation qualifies as a deduction under §162(m). (See paragraph 7.3, Question 35, for more details on Section §162(m).) The actual benefit when the deduction is claimed on the corporate tax return most likely will not be equal to estimated benefit initially recorded for accounting purposes.

Prior to ASC 2016-09, the difference in the tax benefit was reported as Additional Paid in Capital (APIC), and the company had to take great care in assuring an appropriate APIC pool was established. ASC 2016-09 abolished the APIC pool.

Now, when the award is settled, any difference between the estimated deferred tax asset and the actual corporate tax deduction is recorded to tax expense. If the actual tax deduction exceeds the estimated deferred asset, the company records the difference as a reduction to tax expense. If the actual tax deduction is less than the estimated deferred tax asset, the company records the difference as an increase to tax expense.

Restricted Stock Units:
Same as restricted stock.

Q38: *Are the Controls for Modifications Adequate?*

Restricted Stock:

A modification is a change in any term of an award such as a change in quantity of shares subject to the award, transferability features, settlement provisions, or vesting conditions that is not incorporated in the Plan and/or the Award Agreement. Modifications can be intentional or unintentional (e.g. a termination is not timely recorded).

Types of modifications include, but are not limited to—

- Mergers and acquisitions where the equity compensation is assumed or converted
- Cashout of equity awards
- Cancellation and replacement of awards

A modification is typically not a correction of an error. Certain modifications may have negative income tax implications to the award recipient. Modifications often have accounting implications. For modifications that do not increase the likelihood that the award will ultimately vest, the fair value of the modified award less the fair value of the original award just prior to the modification represents an incremental accounting cost to the Company. In the case of a modification that increases the likelihood that the award will vest, such as an acceleration of vesting upon termination, the previously calculated expense is replaced with the expense calculated at the time of modification. See Exhibit 16 for an example of a Type III improbable-to-probable modification as covered in ASC 718-20-55-121.

A complete discussion of accounting for modifications is beyond the scope of this publication. Consult with the Company's external auditors to confirm the definition and classification of modification types.

Document detailed descriptions and educate appropriate personnel as to what action may trigger a modification. Develop a process to track each type of modification. As appropriate, incorporate details into the stock plan database. Document how the software tracks, reports, and calculates the impact on expense for modifications.

Utilize a standard form to document the following items:

- The reason for each modification
- The details of the modification
- Approval of the modification
- The associated accounting impact

If the modification is identified after the appropriate reporting period, particular attention must be given to the accounting implication of the modification. Mergers and acquisitions require special attention since the transaction may trigger a modification of the awards of the acquiring or acquired company, thereby triggering additional expense in subsequent years. Also, modifications may result in a change to the price of the merger or acquisition for

14 ASC 718-740-25-2.

GLOBAL ISSUES

Many countries do not allow a corporate tax deduction for equity compensation. Care must be taken to determine the estimated corporate tax benefit in each jurisdiction when calculating the tax offset.

accounting purposes. Closely scrutinize any assumed or converted awards to determine the potential accounting impact. Develop a checklist to highlight the steps required to convert the data relating to the outstanding awards. Verify data accuracy and completeness before importing the data into the stock plan database. Not all systems can accurately handle the adjustments required for modification accounting for an equity award. Thoroughly discuss the proper treatment of any modification with your software supplier or outsource provider to ensure the system properly records the adjustment to expense. A complete analysis of the issues associated with mergers and acquisitions is beyond the scope of this publication.

Restricted Stock Units:
Same as restricted stock.

	Illustrative Controls	Illustrative Test of Controls
1	Develop detailed descriptions for different types of modifications and educate appropriate personnel as to what action may trigger a modification.	Verify that appropriate documentation exists and training has occurred.
2	Develop a process to track modification types and details in the stock plan database.	Select several modifications and verify that the modifications were properly reflected in the stock plan database.
3	Develop a form to document the reason for the modification, details of the modification, approval of the modification, and accounting impact of the modification.	Select several modifications and verify that the supporting documentation is complete. Verify that the accounting impact was reflected properly.
4	Develop a standard checklist for mergers and acquisitions to highlight the key steps required to convert the data and to verify data accuracy and completeness.	Verify that the checklist was followed for any mergers and acquisitions.

Q39: *Does the Expense Properly Reflect Retirement-Eligible Employees?*

Restricted Stock:

The compensation cost of an award is recognized over the service period. Some plans provide for accelerated or continued vesting when an employee retires. Therefore, if an employee is retirement-eligible at the time of grant or may become so during the vesting period, it is not appropriate to recognize the cost over the standard vesting period. Grants made to employees who are or may become retirement-eligible will have a truncated service period and may require immediate expense recognition or the associated expense will be recognized during the abbreviated service period. The cost of an award granted to an employee who becomes retirement-eligible during the stated service period should be recognized over the truncated service period (i.e., grant date to retirement-eligible date).

This requirement presents various administrative challenges. Plans and Award Agreements may have different provisions regarding the impact of retirement-eligibility on vesting. If a company operates multiple plans, various methods may be required to handle retirement-eligible employees. Some grants may even have different terms. Review and document the retirement provisions for each Plan. Develop a process to identify and track retirement-eligible employees. Frequently, these records are maintained outside the stock plan database and may require manual handling (i.e., via spreadsheets). If the retirement-eligible date is entered after a grant is made, confirm that the expense accrual is adjusted appropriately.

Restricted Stock Units:
Same as restricted stock.

EXHIBIT 16. ACCOUNTING IMPLICATIONS OF A MODIFICATION*

> An award with a fair value of $200,000 at grant and cliff vesting at two years is one year into the vesting schedule. The Company has previously recognized $100,000 of expense associated with the award.

> The Company modifies the award by accelerating vesting of the award as part of a termination agreement. This acceleration was not provided for in the original terms of the award. The fair value at the time of the modification, based on current FMV of the stock, is $150,000.

> The Company reverses the previously recognized expense of $100,000 and does not recognize the remaining $100,000 in unamortized expense. At the time of modification, the company recognizes the full $150,000 of expense for the modified award.

**For simplification purposes, the above example does not address the tax impact of forfeitures.*

	Illustrative Controls	Illustrative Test of Controls
1	Determine and document the retirement provisions for each Plan with awards outstanding. Highlight provisions for accelerated or continued vesting at retirement.	Verify that documentation exists for all Plans.
2	Develop a process to identify and track retirement-eligible employees.	Select several retirement-eligible employees and verify that the employees were properly identified for stock plan purposes.

Q40: *Are Forfeitures Accounted for Properly?*

Restricted Stock:

Forfeitures (i.e., awards that were granted, but did not vest due to failure to meet service-based vesting requirements) impact the compensation expense recorded in the financial statements. In 2016, ASU 2016-09 removed the requirement to estimate and apply a forfeiture rate up front. Companies may now choose to either estimate forfeitures up front or true-up for forfeitures as they occur. The election must be applied to all awards granted by the company. See Exhibit 17.

Estimating Forfeitures:

Document how forfeitures are estimated and how the amounts are reflected in the reports summarizing the compensation costs associated with equity compensation. Include detailed descriptions of all quantitative and qualitative factors. When software is used to calculate the forfeiture rates, documentation should include a description of how the software calculates the forfeiture rates and any limitations in the software functionality. All relevant personnel generating or utilizing the relevant reports should sign off on the appropriate documentation, process to be utilized, and all associated accounting adjustments.

Clarify how often the forfeiture rates will be re-evaluated and potentially modified for future periods. Subsequent modifications to the forfeiture rates must be verifiable and replicable. Confirm that the report logic has not changed since the last reporting period. If the report has changed, verify that all appropriate people have signed off on the revised report description.

EXHIBIT 17. IMPACT OF FORFEITURES

Assume XYZ Company grants restricted stock to 20 employees with a 4-year cliff vesting service period. The company applies an estimated forfeiture rate when accounting for grants. Each employee receives an identical grant (i.e., the same number of shares, the same vesting schedule). Ignoring the impact of forfeitures, the pricing model determines the fair value of the awards is $10,000. The $10,000 compensation cost is expensed over the 4-year service period. Assuming a straight-line accrual, the expense reported in each year is $2,500 ($10,000/4 years).

Assume a 40% forfeiture rate. The compensation cost is adjusted to reflect the awards that will not vest.

$10,000	initial compensation cost
– 4,000	impact of forfeitures
$6,000	adjusted compensation cost

The $6,000 compensation cost is expensed over the 4-year service period. The expense reported in each year is $1,500 ($6,000/4 years).

In reality, it is impossible to accurately predict how many people will leave before their awards have vested. Assuming our estimate of 8 people is correct, the departures may not be equally dispersed over the 4-year period. For example, 3 people may leave in Year 1, 2 in Year 2, and 3 in Year 3. In all cases, the $6,000 compensation cost is expensed over the 4-year service period, but the amount of expense recognized in each year is dependent upon the adjustment of the forfeiture rate based on subsequent experience during the service period.

Note – The forfeiture rate is an estimate of awards that will not vest, not the number of employees terminating. For simplicity, this example refers to number of employees, rather than the valuation of each award that is forfeited and provides a simplified method of reflecting the true-up.

Using Actual Forfeitures:

A company can choose to account for the full expense up front and then account for forfeitures as they occur. As grants are forfeited, any previously recorded expense attributable to the forfeited portion of the grant is reversed.

Restricted Stock Units:
Same as restricted stock.

	Illustrative Controls	Illustrative Test of Controls
1	Determine methodology for accounting for forfeitures consistently across all award types, whether estimating or using actual forfeitures as they occur. Follow subsequent steps if applying a forfeiture estimate.	Confirm all awards are accounted for using the same methodology.
2	Document how forfeitures are estimated, how often the forfeiture rates will be re-evaluated and potentially modified, and how the amounts are reflected in the appropriate reports. All individuals that generate the report or use the report should sign off on the report summary.	Confirm that the appropriate parties have signed the documentation.
3	Review the forfeiture rates for subsequent periods and modify if appropriate. Document all calculations.	Confirm that the calculations are documented and approved by appropriate personnel.
4	Verify that the reporting format has not changed since the last reporting period. If the report has changed, require all appropriate people to sign off on the revised report description.	Confirm that the appropriate parties have signed off, as appropriate.

8.4. OUTSOURCING

8.4.1. The Company may outsource certain aspects of determining the accounting implications of equity compensation. Per paragraph 3.4.9, multiple vendors may be used for valuing the awards, or handling ASC 718 reporting. If certain functions are outsourced, it is imperative to clearly define responsibilities for maintaining and validating data. In addition, the parameters of all reports must be described in detail to minimize misunderstandings and inconsistencies.

8.4.2. As noted previously, even though the Company outsources certain functions, it continues to maintain responsibility for all calculations. Therefore, it is critical that company personnel understand and validate all calculations and underlying assumptions.

Legal Issues

9.1. INTRODUCTION

Companies and employees are subject to a variety of legal requirements relating to equity compensation. Some of the legal requirements have financial statement implications; others do not. Noncompliance with legal requirements may not have material financial statement implications, but can generate issues under Sarbanes-Oxley, raise concerns about company management and corporate governance policies, and identify weaknesses in internal controls.

9.2. OVERVIEW OF THE LEGAL ISSUES

9.2.1. When offering restricted stock and restricted stock units to employees, a company must adhere to a variety of legal requirements, including federal and state requirements and stock exchange requirements. A publicly-traded company must also adhere to SEC regulations. Plans require proper approval and awards must be properly granted for corporate law purposes. Publicly-traded corporations offering equity compensation are required to register the offering to comply with SEC rules and regulations. The registration of the offering is commonly referred to as the registration of shares. The Equity Compensation professional must have access to appropriate information to adhere to these legal requirements. Controls regarding plan approvals are discussed in paragraph 3.3, Question 2. Controls regarding granting practices are discussed in paragraph 4.3. Controls regarding registration requirements and access to appropriate information are discussed in Questions 41 and 46.

9.2.2. Certain employees are subject to additional legal requirements. Section 16 officers file SEC Forms 3, 4, and 5. Individuals with access to material, nonpublic information are considered "Insiders." Members of the Board of Directors, Section 16 officers, and other Insiders, are frequently subject to trading restrictions such as blackout periods. Rule 10b5-1 trading plans may be utilized by certain Insiders to allow selling of company stock at predetermined intervals to pay the tax on the award. The controls associated with these additional requirements are discussed in Questions 42, 43, 44, and 45.

Since Section 16 status also applies to members of the Board of Directors, the controls noted above will also apply to Directors and shareholders owning 10% or more of the stock of the Company

9.3. CONTROLS ASSOCIATED WITH LEGAL ISSUES

Q41: *Are The Underlying Shares Properly Registered?*

Restricted Stock:

Initial registration of the company's stock is part of the IPO (initial public offering). Registration of shares subject to stock plans is required when a new plan is established or when shares are added to an existing plan. Registration of shares can easily be overlooked when a company has received shareholder approval to extend the term of the Plan and/or to increase the authorized shares under the Plan.

Primary responsibility for registration of shares most commonly resides in the Legal department. Close coordination is required between Equity Compensation and Legal. To identify the need for additional shares, the Equity Compensation department should monitor shares available for grant quarterly. Additionally, the Equity Compensation department should calendar any Evergreen events so registration of the additional shares is not overlooked.

Registration of shares is also important in mergers and acquisitions. Mergers and acquisitions may affect pre-existing equity compensation plans (of both the acquiring company and the target), and those plans should be reviewed in the context of the corporate transaction. These requirements should be a standard part of due diligence process and incorporated in all merger and acquisition checklists.

In limited circumstances, shares may not need to be registered for private companies. Rule 144 provides exemptions from the SEC's registration requirement and allows the public resale of unregistered shares if certain conditions are met.

GLOBAL ISSUES

Each country has different legal requirements that govern equity compensation. It is important to understand and follow the requirements in each country where employees will be receiving awards under the Plan.

Rule 144 may also apply to public companies in the sale of registered shares by control persons (i.e., Section 16 officers, members of the Board of Directors, and shareholders owning more than 10% of the stock of the Company). If Rule 144 applies to shares issued from an equity compensation plan or to persons participating in a plan, appropriate restrictions should be noted in the stock plan database and the company's stock records and the broker(s) should be advised. A complete analysis of the issues associated with Rule 144 is beyond the scope of this publication.

Restricted Stock Units:
Same as restricted stock.

	Illustrative Controls	Illustrative Test of Controls
1	In coordination with the Legal department, establish a process to monitor the registration of plans. Quarterly monitor the availability of shares in each plan and review any Evergreen provisions.	Verify the process is documented. Test that the established process was followed.

Q42: *Are SEC Forms 3, 4, and 5 Filed Timely?*

Restricted Stock:

Section 16 officers are required to advise the SEC about ownership in the Company and changes in their stock ownership. The following forms are used to furnish ownership information:

- Form 3—Initial Statement of Beneficial Ownership of Securities
  - Filed once when an individual becomes subject to Section 16 reporting
  - Due within 10 days after the event making a person a Section 16 Insider
- Form 4—Statement of Changes in Beneficial Ownership of Securities
  - Filed upon events changing beneficial ownership
  - Due on or before the second business day after the ownership change has occurred
- Form 5—Annual Statement of Changes in Beneficial Ownership of Securities
  - If required, due 45 days after the end of the issuing company's fiscal year

EXHIBIT 18. FILING FORM 4

	Restricted Stock	Restricted Stock Units
At Grant	Yes	Yes
At Vest	No	Yes*
When shares are withheld to pay for tax	Yes	Yes
When shares are sold to pay for tax	Yes	Yes
Award forfeited during employment or at termination**	Yes	No***

** Not required if award is treated as a non-derivative security.*
***If forfeiture occurs after termination, reporting is not required.*
****If forfeiture occurs during employment or at termination, reporting is required if award is treated as a non-derivative security.*

Note – Very few transactions qualify for deferred reporting on Form 5. Best practice is to voluntarily accelerate reporting of these transactions on Form 4.

The requirements for filing Form 4 are summarized in Exhibit 18. To ensure timely filing, establish, document, and implement a pre-notification process for awards to Section 16 officers.

SEC Forms 3, 4, and 5 must be posted on or be accessible via the company website. The forms are usually filed by the Equity Compensation or Legal department on behalf of appropriate executive officers. In most companies, the Equity Compensation department monitors stock plan transactions and advises Legal of the transactions (i.e., grants and vests) to be reported.

To monitor adherence to appropriate restrictions, most companies prevent (commonly referred to as "block") certain individuals from selling stock without pre-clearance from Legal. Blocking individual accounts that are used in conjunction with awards from the stock plan requires coordination with the company-designated broker(s). The Board of Directors should pass a resolution annually to identify executive officers who are subject to Section 16 reporting requirements. This resolution should be cross-referenced to the stock plan database to ensure that the accounts of all appropriate individuals are blocked. Update this list frequently (at least quarterly) to capture changes in Section 16 officers.

It is also important to implement a process to handle new-hire grants to Section 16 officers. For example, assume a new Section 16 officer is hired effective June 1 and granted restricted stock. Form 3 is due June 10, but Form 4 for the new-hire grant is due June 3. To facilitate timely filing of Forms 3 and 4 implement a process to:

GLOBAL ISSUES

Countries have various registration requirements. Closely monitor the requirements in each country where employees will be receiving awards under the Plan.

- gather appropriate personal data
- receive CIK (Central Index Key)/CCC (CIK Confirmation Code)
- update Passwords and PMAC (Password Modification Access Code)

Where appropriate, obtain a power of attorney from a Section 16 officer to permit filings by appropriate personnel such as a designated corporate officer(s) on behalf of that Section 16 officer. Special attention should be given to changes resulting from mergers and acquisitions, such as cessation of Section 16 status or newly-appointed officer with Section 16 status.

Restricted Stock Units:
Same as restricted stock.

	Illustrative Controls	Illustrative Test of Controls
1	In coordination with the Legal department and company-designated broker, establish and document the process for filing Forms 3, 4, and 5.	Verify that the process is documented. Test that the established process was followed. Select grants to and vests of Section 16 officers and confirm that Forms 3, 4, and 5 were filed timely.
2	Block Section 16 officers from selling stock associated with equity awards. Require pre-clearance from Legal department before selling shares.	Select Section 16 officers and verify that the employees are blocked from selling shares without pre-clearance from Legal department.
3	Annually confirm list of Section 16 officers and that all Section 16 officers are blocked. Update the list frequently. Document the confirmation process.	Review the documentation and note unusual items.
4	Establish, document, and implement a pre-notification process for grants for Section 16 officers.	Verify that the process is documented. Test that the established process was followed.
5	Establish, document, and implement a process to handle new-hire grants to Section 16 officers.	Verify that the process is documented. Test that the established process was followed.

Q43: *Is the Insider List Accurate?*

Restricted Stock:

An “Insider” is any person with possession of material, nonpublic information about a company regardless of how they acquired that information. Examples of Insiders include, but are not limited to:

- Corporate officers, directors, and certain employees
- Friends, business associates, family members, and other “tippees” of such officers, directors, and employees
- Employees of law, banking, brokerage and printing firms who were given such information to provide services to the corporation
- Government employees who learned of such information because of their employment by the government
- Other persons who are in possession of confidential information[15]

It is illegal to buy or sell company stock while in possession of material, nonpublic information of that company. This restriction applies to anyone with access to material, nonpublic information, regardless of how the information was acquired.

A company should develop and maintain a formal “Insider Trading Policy.” The Insider Trading Policy is typically established by Legal and approved by the Board or the Compensation Committee as set forth in the company’s bylaws or corporate governance guidelines. The Policy should include the following topics:

- The responsibilities of the Compliance Officer
- Definition of an “Insider”
- How long individuals are considered Insiders
- What is considered “material, nonpublic” information
- When the trading window opens and how long the window remains open after an earnings release or other release of material, nonpublic information

The SEC reporting requirements of Section 16 officers are discussed in Question 42. Employees that are not Section 16 officers may also be Insiders. Non-Section 16 employees may be permanently classified as Insiders because of their ongoing job responsibilities such as financial reporting, access to the financial reporting system, or access to the revenue systems that report into the financial reporting systems. An employee may also temporarily qualify as an Insider because of temporary access to sensitive information such as corporate acquisitions, layoffs, or special projects (e.g., results of drug trials). Establish and document a process to identify and notify non-Section 16 employees who are permanently or temporarily classified as Insiders. Include details on how “temporary” Insiders will be identified and how long they will remain on the Insider list.

The Equity Compensation department plays an important role in overseeing and monitoring the trades of Insiders. All Equity Compensation professionals should understand the Insider Trading Policy and the impact of the blackout periods. Note that personnel in the Equity Compensation department may also qualify as “Insiders.” Establish and document a process to block stock plan transactions of all employees classified as Insiders. Develop a process to maintain the Insider list and notify employees of their status as an Insider.

The Legal department plays an important role in providing pre-clearance to an Insider to trade. Pre-clearance from Legal should specify a limited time period and a maximum number of shares to trade. Legal personnel may also qualify as Insiders.

15 *http://www.sec.gov/answers/insider.htm.*

Restricted Stock Units:
Same as restricted stock.

	Illustrative Controls	Illustrative Test of Controls
1	Establish, document, and implement an Insider Trading Policy.	Verify the policy is documented. Test that the established policy was followed.
2	Establish a process to identify permanent and temporary Insiders. Include a process to keep the list current and notify Insiders of their status as an Insider.	Verify the process is documented. Test that the established process was followed.
3	Establish and document a process to block stock plan transactions of all employees classified as Insiders. To monitor stock transactions associated with the payment of withholding tax, require pre-clearance from Legal before the vest date.	Select Insiders and verify that the employees' stock plan accounts are blocked without pre-clearance from Legal department.

Q44: *How are Blackout Periods Controlled?*

Restricted Stock:

A blackout period is a period during which the securities of a corporation cannot be traded by Section 16 Insiders and others who have access to material, nonpublic information about the Company and its affairs. Blackout periods are sometimes referred to as a "closed window." A blackout period is established by the Company and communicated to any affected parties in advance of, or concurrently with, the action triggering a blackout period. Blackout periods may be triggered by a wide range of events during which stock plan transactions may be prohibited. Many companies prohibit all trading by officers and directors outside of open trading windows, so that all other times are considered to be blackout periods by default.

Buying or selling stock during a blackout period may carry regulatory risk, negative company publicity, and the risk of market fluctuation. Even inadvertent trades during a blackout period can create problems. For example, an employee may have an outstanding limit order. (A limit order is an order to buy or sell a security at a specific price.) The order to buy or sell may be triggered during a blackout period. The execution of the trade generally qualifies as a prohibited transaction during the blackout period. Equity Compensation should work closely with the company-designated broker to ensure the broker does not process trades during a blackout period. When multiple brokers are used, additional controls must be implemented.

Primary responsibility for compliance with blackout periods resides with the employee, not the company. Employees need to understand when they qualify as an Insider. For example, many employees may not know to consider themselves Insiders after overhearing a conversation containing material, nonpublic information in the company cafeteria, and yet this would result in classification as an Insider. Employees also need to understand their personal responsibilities to comply with blackout periods and the consequences of not complying with the Insider Trading Policy. Develop and implement a program to educate appropriate employees of responsibilities regarding blackout periods. Educating employees is the cornerstone of compliance with the restrictions for Insiders and should not be underestimated.

Restricted Stock Units:
Same as restricted stock.

	Illustrative Controls	Illustrative Test of Controls
1	Establish and document a policy with company-designated broker(s) to comply with blackout period restrictions.	Verify the process is documented. Test that the established process was followed.
2	Develop and implement an ongoing program to educate Insiders and potential Insiders of responsibilities regarding blackout periods.	Confirm appropriate parties participated in the education program.

Q45: *Are Rule 10b5-1 Trading Plans Used?*

Restricted Stock:

A Rule 10b5-1 trading plan is a set of trading instructions with respect to company stock. In Rule 10b5-1, the SEC provided for a potential affirmative defense (in the nature of a "safe harbor") from Insider trading violations where a person has entered into a plan that gives pre-determined trading instructions (such as to buy or sell company stock at predetermined times and prices). The use of 10b5-1 trading plans varies. If restricted stock vests during a blackout period, an employee may be prohibited from selling shares to pay the tax that is due. 10b5-1 trading plans are frequently used to permit the sale of stock in these circumstances. If an Award Agreement includes language that requires stock to be sold to pay for the tax, a 10b5-1 plan may not be required. Some advisors also recommend a 10b5-1 trading plan when a company withholds shares to pay for the tax, since this is essentially a "sale" to the company.

The 10b5-1 trading plan is a predetermined process that allows trading during blackout periods. The original trading plan should be entered into outside a blackout period and during a time when the Insider does not possess any material, nonpublic information. The process should be clearly defined and include a written formula as to when transactions will occur and the shares that will be sold. The plan does not have to be all inclusive (i.e., some awards can be held outside the 10b5-1 trading plan). Once a 10b5-1 trading plan is in effect, the Insider should not influence when or whether the trades scheduled under the plan take place. The Insider may terminate the plan or make modifications to the plan during an open trading window provided they do not possess any material, nonpublic information at the time of the change. Form 4 is required to be filed for trades executed under a 10b5-1 trading plan.

For purposes of this publication, we have assumed that the 10b5-1 trading plan is limited to the sale of shares (or the shares withheld) to pay the tax. A general discussion of 10b5-1 trading plans is outside the scope of the current publication. Refer to the CEPI publication "GPS - Stock Options" section 9.7 for a detailed explanation of and best practices for 10b5-1 trading plans. This publication can be downloaded from http://cepi.scu.edu.

Restricted Stock Units:
Same as restricted stock.

	Illustrative Controls	Illustrative Test of Controls
1	Develop, document, and implement a program to support 10b5-1 trading plans for the sale of stock or withholding of shares to pay the required tax on awards. Advise General Counsel in the establishment of and approval of trading plans.	Verify that the process is documented. Test that the established process was followed.

Q46: Does the Equity Compensation Department Have Access to Appropriate Internal Personnel?

Restricted Stock:

Equity Compensation implements and administers stock plans based on information provided by other departments. To comply with legal requirements, Equity Compensation must be apprised timely of relevant decisions and have access to Legal, Board of Directors, Internal Audit, and external auditors.

Develop and document a process to handle requests to Equity Compensation that are inconsistent with standard procedures or that may seem inappropriate. Equity Compensation personnel should have access to raise such requests to appropriate personnel such as:

- Legal
- Compliance Officer
- Internal Audit/Financial Accounting
- Ethics Officer
- Whistleblower Hotline

Restricted Stock Units:
Same as restricted stock.

	Illustrative Controls	Illustrative Test of Controls
1	Identify key departments and appropriate personnel to comply with various legal requirements. Develop a process to keep updated on key decisions and other relevant matters.	Verify that the process is documented. Test that the established process was followed.
2	Develop and document a process to handle non-standard and inappropriate requests.	Request confirmation that all actions during the period were appropriate.

9.4. OUTSOURCING

9.4.1. Even though a third-party may be utilized to handle all or part of administrative and record-keeping functions, the Company retains ultimate responsibility for meeting its legal requirements. Close coordination is required with the brokerage firm(s) and/or third-party administrator regarding:

- Form 3, 4, and 5
- Rule 144 filings
- Insider list
- Blackout periods
- 10b5-1 trading plans

Special attention should be paid to understanding the stock plan system functionality as it pertains to legal requirements, especially blocking the trading activity of Insiders.

Changes of Employment Status

A full discussion of accounting treatment for changes in employment status falls outside the scope of this document.

10.1. INTRODUCTION

Equity awards are granted to employees as part of their compensation package. Subsequent changes of employment status may affect outstanding awards. Changes of employment status include resignations, regular or early retirements, for-cause terminations, layoffs, changes between part-time and full-time status, leaves of absence, disability, and death.

10.2. OVERVIEW OF CHANGES OF EMPLOYMENT STATUS

10.2.1. The Plan defines the impact of changes of employment status on outstanding awards (e.g., the vesting schedule for unvested restricted stock). Human Resources identifies changes of employment status and advises Equity Compensation. Equity Compensation or the third-party administrator records the impact of the change of status in the stock plan database. Frequently companies choose to advise the employees about the impact of the change of employment status on the outstanding awards. The change of employment status may have potential tax and accounting implications. These issues and associated controls are discussed in more detail in Questions 47 to 52.

10.3. CONTROLS ASSOCIATED WITH CHANGES OF EMPLOYMENT STATUS

Q47: *Have the Unique Requirements of Each Plan Been Followed?*

Restricted Stock:

As discussed in paragraph 3.3, Question 1, each Plan may have different requirements for handling changes of employment status. A change of employment status typically impacts the vesting schedule. See Exhibit 19 for examples of issues associated with changes of employment status. Particular attention should be paid to new plans implemented, new plan requirements, and plans assumed in a merger/acquisition.

Clearly define the administrative process for handling changes of employment status for each Plan. If the administrative process is not included in the Plan document, document the interpretation of the Plan and the administrative process that will be used. Include how exceptions to the Plan will be identified, approved, and processed. As discussed in paragraph 3.3, Question 11, using standard terms for awards simplifies the administrative process. If non-standard terms are used pertaining to changes of employment status, additional controls need to be implemented to ensure the terms of the award are being followed.

EXHIBIT 19. ISSUES ASSOCIATED WITH CHANGES OF EMPLOYMENT STATUS

> Terminations

When an employee terminates, unvested awards are cancelled.

> Leaves of Absence

Most plans define Leaves of Absence, but are silent regarding the process of administering a Leaves of Absence. The vesting schedule may be changed depending on the type of Leaves of Absence (e.g., short-term vs. long-term, maternity leave, military leave, etc.).

> Retirement

The Plan may provide for vesting of some or all awards when the recipient retires or becomes eligible to retire. In some cases, the exact definition of retirement eligibility is defined in the Award Agreement and may vary depending on the position of the recipient. Awards to retirement-eligible recipients may have additional accounting and tax implications.

Leaves of Absence are particularly difficult to track and may require different handling in certain jurisdictions. Many companies are not equipped to administer plan provisions to suspend vesting while an employee is on Leave of Absence. If the company does not follow the plan provisions, examine the facts and circumstances to determine the financial statement impact. If the company has a limited number of employees on Leave of Absence, the financial statement impact may be immaterial. In all cases, plan interpretation should be applied consistently.

Restricted Stock Units:
Same as restricted stock.

	Illustrative Controls	Illustrative Test of Controls
1	Develop a standard template to summarize the key requirements for changes of employment status. For each Plan, use the standard template to document the plan requirements and how the requirements are administered.	Confirm documentation of all plans. Verify that details of new plans have been documented. Test that the plan requirements have been properly implemented and reflected in the stock plan database.

Q48: *Is Equity Compensation Timely Advised About Changes of Employment?*

Restricted Stock:

The vesting of restricted stock occurs on a specified date as compared to the exercise of a stock option which occurs at the employee's discretion between the vest date and the date the option expires. Because the vest of the restricted stock requires no action on the employee's part, keeping an employee's status current is critical to ensure proper and timely withholding and to ensure that the vesting of an award does not automatically occur to an employee no longer eligible to receive the award.

General procedures regarding the update of employee demographic data are discussed in paragraph 4.3, Question 13, and paragraph 6.3, Question 25. Verify that the effective date of change of status in the stock plan database is consistent with the human resource system. Reconcile changes of employment status between the stock plan database and the human resource system on a monthly basis.

When Equity Compensation is not timely notified of an employee change of status such as a termination or a Leave of Absence, shares may be inappropriately released to the employee. Develop a process to handle the inappropriate release of shares. Involve Legal to ensure the Company's risks are considered appropriately when resolving these issues. Document the process. Late notification of changes of employment status constitutes a post-dated transaction which may result in an inadvertent modification and an accounting charge. Controls for post-dated transactions are discussed in more detail in paragraph 3.3., Question 8 and controls for modifications are addressed in paragraph 8.3, Question 38.

Restricted Stock Units:
Same as restricted stock.

	Illustrative Controls	Illustrative Test of Controls
1	Compare changes of employment status in the stock plan database with the human resource system monthly. Document reconciling items, research performed, and resolution of the items.	Review reconciling items for trends and unusual items.
2	Develop a process to handle late notifications of change of employment status. Include these transactions in the report on post-dated transactions and notify Finance as appropriate.	Review report of post-dated transactions. Note unusual items. Review trends to identify areas where further intervention is required.

GLOBAL ISSUES

Many countries have different legal definitions of what constitutes part-time employment, full-time employment, or Leave of Absence. Certain countries also provide legal protections when an employee changes employment status (e.g., a company may not be allowed to extend the vesting schedule for awards when an employee changes from full-time to part-time status).

Q49: *Has the Stock Plan Database Been Properly Updated for Changes of Employment Status?*

Restricted Stock:

General plan provisions and/or the Award Agreement may specify how a change of employment status affects an award (e.g., an award may lapse in the case of a termination or the vesting schedule may change in the case of a leave of absence). It is important to understand how the stock plan software will handle changes of employment status and identify potential systems limitations. The stock plan system may automatically process the termination based on parameters in the system. Defaults may be plan-based (i.e., reflecting the requirements of each Plan) or company-based (i.e., applicable to all plans regardless of the specific plan requirements). Develop procedures to handle manual processing of changes of employment status or overrides of system defaults.

In some circumstances, changes may be made in the terms of the award that were not provided for in the general plan provisions and/or the Award Agreement. For example, the severance package of a terminated employee may include accelerating the vesting of unvested restricted stock. If changes are made in the terms of the award, controls must be implemented to ensure the changes:

- are permitted under the provisions of the Plan
- were properly approved and the approval was documented
- are correctly recorded in the stock plan database

Changes in the terms of the award may have potential accounting and tax implications. Understand the software functionality as it pertains to accounting for equity compensation. Verify that changes in the stock plan database are properly reflected in reports used for accounting for equity compensation. Modifications of an award are considered an exchange of the original award for a new award and may trigger incremental accounting expense. See paragraph 8.3, Question 38, Exhibit 16, for a brief discussion of the accounting implications of modifications.

In certain circumstances, IRC Section 409A may determine the tax consequences of the award by treating the award as deferred compensation. A complete analysis of the issues associated with IRC Section 409A is beyond the scope of this publication.

Restricted Stock Units:
Same as restricted stock.

	Illustrative Controls	Illustrative Test of Controls
1	Document how the software handles changes of employment status, including the impact on reports used in accounting for equity compensation.	Confirm the process has been documented. Sample changes of employment status and confirm the change was properly recorded in the stock plan database.
2	Identify situations that require manual processing and document the required procedures.	Confirm the process has been documented. Sample changes of employment status requiring manual processing and confirm the change was properly recorded in the stock plan database.
3	Establish a process to handle changes in the terms of the award. Notify the group responsible for the ASC 718 calculations of the changes. Verify that such changes are allowed under the Plan. Include documentation of the approval process and the recording of the changing in the stock plan database.	Review changes of employment status that resulted in changes in the terms of the award. Confirm that the changes were properly approved and recorded in the stock plan database.

Q50: *Has the Transfer Agent Been Advised of Forfeited Shares?*

Restricted Stock:

When restricted stock is granted, shares are issued. The transfer agent holds the restricted stock as a book entry in an omnibus restricted account and/or an individual account until the restrictions lapse. If the employee terminates prior to vest, the shares may be forfeited. The transfer agent is notified of the forfeiture and cancels the shares. The forfeited shares may be returned to the share pool and available for future allocation in the plan records. Establish and document the process to advise the transfer agent of cancellations as a result of employee terminations.

Restricted Stock Units:

Because shares are issued when restricted stock units vest, there is no requirement to notify the transfer agent when the award is forfeited.

	Illustrative Controls	Illustrative Test of Controls
1	Establish and document the process to advise the transfer agent of cancellations as a result of employee terminations.	Review the documentation to ensure the process was followed.

Q51: *Do the Employees Receive Proper Notification About Changes in Their Awards?*

Restricted Stock:

Establish and document a policy regarding notification of employees who have changed employment status. The employee is advised of the impact of changes of employment status on outstanding awards in the Award Agreement, Plan, and Plan Prospectus. Although there is no legal requirement for the employer to notify the employee of the impact on the award when employment status changes, best practice is to notify employees who have changed employment status about changes in the award terms.

In most cases the grantee is notified by letter. The letter reflects the changes in the award term(s) in accordance with the plan requirements and the Award Agreement provisions. Many software packages include such letters as part of their standard reports. When a company establishes a process to notify employees about changes in the terms of the award, the process must be consistently followed. Timing is critical. In many cases, the work e-mail is no longer accessible and the employee may be difficult to reach. In addition, special access may be needed to process the award since the employee may no longer have system access through the Company or be receiving paychecks.

Restricted Stock Units:
Same as restricted stock.

	Illustrative Controls	Illustrative Test of Controls
1	Establish and document a policy regarding notification of employees who have changed employment status about changes in the award terms.	Sample changes of employment status and confirm the policy was followed regarding notification about changes to the awards.

Q52: *Are Transferred Employees Handled Properly?*

Restricted Stock:

A transferred employee may change employers within a corporate group. For example, an employee may be terminated from one corporate entity and hired by another corporate entity. Assuming the new entity also qualifies as an "employer" under the Plan, the change of employer does not constitute a change of employment status to the employee even though the employee may be treated as a new hire for payroll and human resource purposes. Develop a process to handle employees that transfer between related entities. The process should address the potential accounting and corporate tax impact. Coordinate with Payroll and Human Resources to identify and consistently treat appropriate employees.

Restricted Stock Units:
Same as restricted stock.

	Illustrative Controls	Illustrative Test of Controls
1	Develop a process to handle employees that transfer within the corporate group.	Confirm the established process was followed.

10.4. OUTSOURCING

10.1.1 Even though a company may outsource certain aspects of administering changes of employment status, the Company continues to retain primary control over the process. When utilizing a third-party to handle all or part of stock plan administration, the processes and responsibilities must be clearly defined as discussed in paragraph 3.4. If the Human Resources function is outsourced, additional challenges regarding vendor-to-vendor data transfer are introduced. Additional controls are required to ensure data transfers are accurate and timely.

GLOBAL ISSUES

International transfers typically change employers within the corporate group. Companies frequently use different Human Resource and Payroll systems in different countries.

Appendix A: Acknowledgements

The Certified Equity Professional Institute (CEPI) at Santa Clara University would like to acknowledge the significant contributions that made this publication possible. Fidelity Investments, Merrill Lynch, Charles Schwab, Smith Barney, Computershare Plans Software (formerly Transcentive), and E*TRADE Corporate Services have generously underwritten the CEPI costs associated with this project. By sponsoring this research project, these industry leaders have made it possible for all issuers and service providers to benefit from comprehensive standardized industry guidelines.

It is not possible to complete a project of this magnitude alone. Such an undertaking requires the perspectives and inputs of a diverse group of industry experts. This publication is the culmination of extensive interviews, in-depth analysis and a widespread technical review. The guidance and inputs of members of the Board of Review and Technical Oversight Board provided invaluable expertise throughout the project to ensure that the publication captures an industry-wide perspective.

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The 2022 update to this publication was completed by Carlisle Toppin of Kilpatrick Townsend & Stockton LLP. He advises clients in connection with all compensation and employee benefits related aspects of corporate transactions, reorganizations, financing arrangements, and public offerings.

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Additionally, the CEPI is fortunate to have a dedicated and supportive Advisory Board. The Advisory Board initially recommended that the CEPI pursue this project, and the Advisory Board has been actively involved throughout the project.

Additionally, the CEPI would like to acknowledge the hundreds of equity professionals who contributed to this project through in-depth interviews, research participation, or thoughtful comments. Without the involvement of these professionals, this publication could not exist.

Finally, the CEPI would like to acknowledge Carol Rutlen for her significant contributions in making this project a reality. As a long-time supporter of the CEPI, previous Chair of the Advisory Board, former partner with PricewaterhouseCoopers responsible for the global stock practice, and adjunct professor at San Jose State, Carol's 20+ years of extensive industry experience equipped her well for this CEPI project. As Project Leader, Carol was instrumental in researching and drafting this publication.

Appendix B: Common Equity Compensation Terms

Accepted Terminology	Equivalent
ASC 718	FASB Accounting Standards Codification Topic 718; ASC 718 replaced FAS 123(R)
Award Agreement	Employee Stock Agreement; Grant Agreement; Agreement
Black-Scholes Model	Black-Scholes Option Pricing Model; Black-Scholes
Board	Board of Directors
Book Entry	Electronic recording of stock ownership where no certificate is given to securities holders
Broker	Brokerage Firm; Securities Dealer; Registered Broker; Stock Broker
Cliff Vest	Entire award vests in full on a single date
Common Stock	Capital Stock; Securities
Compensation Expense	Expense; Compensation Cost
Compensation Income	Income; Compensation
Director	Member of the Board of Directors; Board member
Dividend	A payment to holders of unvested restricted stock that mirrors dividends paid to shareholders
Dividend Equivalent	A payment to holders of unvested restricted stock units that mirrors dividends paid to shareholders
Evergreen Provision	Annual replenishment of shares in a Plan
Fair Market Value	FMV
Fair Value	Accounting term for ASC 718(R)
FASB	Financial Accounting Standards Board
Forfeiture	Loss of award; cancellation
Full Value Awards	Awards that deliver the total underlying value of the shares (rather than appreciation only), including restricted stock, restricted stock units, and performance awards
Grant	Award
Grant Date	Date of Grant; Option Date
IASB	International Accounting Standards Board
Insider	Affiliate
IRC	Internal Revenue Code
Leave of Absence	Leave; LOA
Modification	Change; edit
Omnibus Account	Brokerage or transfer agent account where transactions of multiple individual account holders are combined
Plan	Employee Stock Plan; including the Plan document, the Terms and Conditions, and related documents
Release	Transfer of shares to the recipient
SEC	Commission; Securities and Exchange Commission
Sell-to-Cover	Shares sold from award to cover tax obligation
Shares	Stock
Tax Withholding	Withholding
TCJA	Tax Cuts and Jobs Act of 2017, Public Law 115-97.
Trading Window	Blackout Period; Window Period
Vest	Award no longer subject to substantial risk of forfeiture
Withhold-to-Cover	Shares withheld from award to cover tax obligation; Trade for taxes

Appendix C: About Our Sponsors

The Certified Equity Professional Institute (CEPI) at Santa Clara University would like to acknowledge Fidelity Investments, Merrill Lynch, Charles Schwab, Smith Barney, Computershare Plans Software (formerly Transcentive), and E*TRADE Corporate Services, for their significant contributions that made this publication possible. By sponsoring this research project, these industry leaders have made it possible for all issuers and third party service providers to benefit from comprehensive standardized industry guidelines.

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As the only source of professional certification in equity compensation, the CEPI recognizes and understands the critical need for impartial guidance in this area. The CEPI has undertaken a series of research projects titled *GPS: Guidance | Procedures | Systems*. Other GPS publications include:

- GPS | Performance Awards
- GPS | Global Stock Plans
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CERTIFIED EQUITY PROFESSIONAL INSTITUTE

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PERFORMANCE AWARDS

2021 Edition

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Performance Awards

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Exhibits

Introduction

1.1. Overview.

1.1.1. In the never-ending quest to identify the ideal compensation structure to retain and motivate employees, companies have long embraced equity compensation as a component of long-term incentive compensation. The term "equity compensation" covers a broad range of equity awards, including stock options, restricted stock, restricted stock units, employee stock purchase plans, stock appreciation rights, performance awards, and innumerable variations on these equity awards. Stock options were the long-favored tool for delivering equity compensation due to relative simplicity, beneficial cash flow for the issuing company, and, historically, little or no related compensation expense in the financial statements. ASC Topic 718, coupled with growing concerns over dilution, burn rate, and pay for performance, gave rise to a marked increase in the use of restricted stock units and restricted stock, and, ultimately, the addition of performance goals to these awards. While performance awards have existed for decades, the combination of the following factors converged to create an increased use of performance awards as a supplement to, or even a replacement for, time-based grants for executives.

- Stock options can deliver greater compensation in a bull market due to the larger number of options often granted. Even though a bull market has existed for the last several years, this latest rise was preceded by the market volatility of 2008 and 2009, when the use of performance awards increased. Restricted stock and restricted stock units, with or without performance goals, may better deliver compensation in a bear market, but performance awards can deliver great compensation regardless of the type of market environment.
- The ability to specify corporate, business unit, team, and/or individual objectives opens opportunities to strengthen the line of sight and resulting behavioral impact while responding to the continued evolution of corporate governance standards.
- In some cases, the use of time-based restricted stock and units resulted in considerable compensation to executives at a time when shareholders had experienced significant losses. Certain proxy advisors that advocate for shareholder interests have since encouraged the use of performance awards to create better align pay for performance with shareholder interests. This particular factor is probably the greatest driver in the increased use of performance awards, and is the most significant reason performance awards are so common today.
- Increased market volatility has resulted in option grants where the grant date is a more important factor in the value of the award than the actual company performance. As a result, grant timing could be a more important factor than company performance in compensation outcomes, creating employee inequities.
- Accounting rule changes "leveled the playing field." The financial statement expense for performance awards had been unpredictable and often prohibitively expensive compared to stock options. Under ASC Topic 718, all types of equity awards result in an income statement expense.

Although performance awards were initially limited to top executives, companies have extended performance awards to broader groups of employees; however, the majority of companies issue performance awards to a relatively small number of recipients.

This publication addresses the unique issues associated with performance awards, particularly with respect to the administrative requirements and the necessary cross-functional support of Human Resources and Financial Reporting.

1.1.2. The increase in the use of performance awards has been accompanied by a proliferation of terminology, design concepts, plan features, and the associated administrative and communication challenges. When managing an equity compensation program that includes performance awards, all parties must understand the unique aspects of the performance awards. The key parties responsible for this critical area include the professionals involved in the day-to-day administration of the equity plans, Finance, Human Resources, Payroll, Tax, Legal, and, where applicable, the third-party administrator and other third-party vendors. This publication addresses the unique issues associated with performance awards, particularly with respect to the administrative requirements and the necessary cross-functional support of Human Resources and Financial Reporting.

1.1.3. Any equity vehicle may have a performance goal attached and be construed as a "performance award." When attaching performance goals to any equity award, the underlying fundamentals of that award are largely unchanged. The most commonly used performance award type is a performance stock unit – a full-value award defined in share units with a performance goal determining when, if, and/or how much of the contingent award will vest and be paid to the employee. The types of compensation arrangements that fall under the term "performance awards" can include any equity award type (stock options, stock appreciation rights, restricted stock units, or restricted stock awards) with one or more explicit performance goals. These awards may be structured to grant upon the achievement of a specific goal, or the achievement of the goal may determine the amount and/or timing of compensation to be received.

1.1.4. Performance stock units and performance stock awards are full-value awards. The employee receives the full value of the underlying stock when the award is paid out. Performance stock units, which are restricted stock units with associated performance goals, are more common than performance stock awards, which are restricted stock awards with associated performance goals. Both ultimately deliver similar economic benefits. The mechanics of the delivery and taxation are substantially different, however, and performance stock units offer clear advantages in flexibility and administrative ease.

1.1.5. A performance stock option delivers the economic value of the appreciation in the underlying stock when the option is exercised. A performance stock option is treated in a similar manner as a performance stock unit and a performance stock award in terms of granting an award, tracking performance goals, and change of employment status. A performance stock option is treated differently at the vest date, for tax/payroll purposes, and in valuing the award for financial reporting purposes. These differences are highlighted in the appropriate paragraphs of this publication.

1.2. Scope of Publication.

1.2.1. Terminology associated with performance awards can vary widely. Care should be taken to understand the specifics of the underlying award, regardless of company-assigned terminology. For purposes of this publication, "performance awards" are restricted stock units, restricted stock awards, or stock options with attached performance goals. This publication is focused on awards granted to US employees of US-headquartered, publicly-traded companies and awards settled in stock. Cash-settled performance awards are outside the scope of this publication. Performance granted stock options, restricted stock awards (RSAs), and restricted stock units (RSUs) are treated the same as regular stock options, RSAs, and RSUs following grant and are not covered by this publication.

GLOBAL ISSUE

Performance awards have been a significant component of compensation for companies headquartered in Europe and Australia. The taxation and regulatory considerations of performance awards may mirror those of the underlying vehicle (restricted stock units, restricted stock, or stock options). In any particular jurisdiction, plan design features may be more or less favorable due to local law and practice. This publication contains some references to global issues and other types of performance awards. These references provide a high-level overview of some related key concepts and are not intended to be comprehensive as global issues are outside the scope of this publication.

1.2.2. For purposes of this publication, the following terminology will be used:

TERMINOLOGY	
Performance Award	A stock-settled performance stock unit, performance stock award, or performance stock option.
Performance Stock Unit (PSU)	A restricted stock unit with performance goals attached; A promise to award shares for no cost in the future contingent on achieving associated performance goals and meeting the requisite service period.
Performance Stock Award (PSA)	A restricted stock award with performance goals attached; Shares awarded at grant for no cost contingent upon achieving associated performance goals and meeting the requisite service period. When the performance goals and service period are met, shares are released to the employee.
Performance Stock Option (PSO)	A stock option granted with vesting or price contingent on achieving associated performance goals and service requirements.

A more extensive glossary of terms can be found in Appendix B.

1.2.3. Performance awards and associated processes can be varied and complex. This publication is not intended to cover every possible contingency. The processes described represent standard practice, but each company's processes may differ to reflect their unique needs and resources. These recommendations should be considered general guidelines and applied as appropriate.

1.2.4. Topics covered in this publication may need to be considered within the particular facts and circumstances of a company. For example, many of the financial reporting processes in this publication are specified as quarterly. Some companies may undertake these tasks on a monthly basis or on a different schedule. For those reasons, clarifications such as "typically" and "generally" are not always included, but should be assumed. Please consult your own professional advisors with respect to the application of the information in this publication to company-specific circumstances.

1.2.5. Other GPS publications specifically address issues of stock options, restricted stock, and restricted stock units without performance goals attached. Much of the guidance in those publications is applicable to performance awards. GPS|Restricted Stock and Restricted Stock Units is included in this volume. For a copy of GPS|Stock Options, visit www.scu.edu/business/cepi/.

1.3. Basics of Performance Awards.

1.3.1. The basic lifecycle of PSUs and PSAs is outlined in Exhibit 1-1 and of PSOs is outlined in Exhibit 1-2. As discussed in paragraphs 3.2.7 and 5.2.2, the determination of goals and the grant date are interrelated. In certain scenarios parts of the lifecycle may occur simultaneously.

1.3.2. Each element of performance award design, from the determination of performance goals to the performance period definition and the ultimate vesting determination, has potentially significant implications for the ultimate complexity, total cost, and total value of the award. The structure of the performance goals creates the greatest diversity of award design of any form of equity compensation.

1.4. Public Comment.

1.4.1. The CEPI invited individuals and organizations to send written comments on all matters in a draft version of this publication. All comments received were reviewed and incorporated as appropriate into this final document.

Note: Each paragraph is numbered and cross-referenced. The document should be used in its entirety. Users of one section will need to reference other sections for a comprehensive understanding.

EXHIBIT 1-1 – BASIC LIFECYCLE OF A PERFORMANCE AWARD – PSU or PSA

Performance goals determined → Grant → Performance period ends → Performance is certified → Service period ends → Award vests → Award paid out

EXHIBIT 1-2 – BASIC LIFECYCLE OF A PERFORMANCE AWARD - PSO

Performance goals determined → Grant → Performance period ends → Performance is certified → Service period ends → Option vests and is exercisable → Option exercised

Strategic Issues

2.1. Overview.

2.1.1. Performance awards are frequently an important component of a total rewards package for executives. Much has been written about selecting the correct performance goals to align the interests of employees with those of shareholders and to reward employee behavior. Less attention has been given to the financial reporting implications of performance awards or the processes that must be implemented to support these awards. This publication highlights the design decisions that affect the perception of corporate governance, financial reporting for the awards, the employees' understanding and perception of the benefit provided, and the cost of administering and communicating the plan. The key strategic issues are discussed in this section.

This publication highlights the design decisions that affect the perception of corporate governance, financial reporting for the awards, the employees' understanding and perception of the benefit provided, and the cost of administering and communicating the plan.

2.2. Selecting the Appropriate Equity Vehicle.

2.2.1. Selecting the appropriate equity vehicle to meet a company's needs is critical. Exhibit 2-1 identifies the most appropriate award(s) in certain circumstances. In many cases, other award types may be used, but would generate ancillary issues, including administrative complications, financial reporting issues, tax consequences, and employee communication challenges. In most cases a PSU offers advantages that are not available with a PSA.

2.3. Establishing the Vest Date.

2.3.1. The vest date is the date on which the employee has the unrestricted right to receive the underlying stock. When establishing the vest date many factors should be considered including:

- Adequate time to certify the performance results
- Tax consequences
- Impact on financial reporting
- Time required to process the award
- Trading restrictions

These issues are discussed in Section 3, Design; Section 6, Performance and Service Period; Section 7, Tax/Payroll Issues; Section 8, Legal Issues; and Section 10, Financial Reporting.

2.3.2. A change of employment status may occur before the vest date. The design should anticipate changes in status and address the impact of the change in status on the vest date and when the underlying shares will be released to the employee. Although the practice is not uncommon, implementing a design that provides for full or partial vesting where the underlying shares are released before the end of the performance period may result in unforeseen consequences. These issues are discussed in more detail in subsection 3.4 and paragraph 7.5.5.

EXHIBIT 2-1 – SELECTING THE APPROPRIATE PERFORMANCE AWARD			
	Performance Stock Unit	Performance Stock Award	Performance Stock Option
Number of shares to be paid out varies with level of achievement of performance goals	●	●	●
Number of shares to be paid out is fixed, but vesting is accelerated on achievement of performance goals	●	●	●
Payout of award may be deferred	●		
Accelerate or continued vesting upon retirement may occur	●		●
Payment of dividend/dividend equivalent on unvested award	●	●	
Voting rights on unvested award		●	
Transfer agent involvement not required at time of grant	●		●
Vesting schedule or payout rate may be modified as a result of changes of employment status	●		●
Timing of taxation controlled by employee			●
Underlying shares are available when the shares are taxable for income tax purposes	●		●
Facilitates trading shares in an open window			●
Award may count toward stock ownership guidelines	●	●	
83(b) election permissible		●	

2.4. Treatment of Dividends.

2.4.1. Dividends or dividend equivalents may be paid on performance awards to allow the employee to receive the equivalent value of dividends during the vesting period. Dividends may be paid currently or deferred to a future date. Because performance awards may never vest, paying dividends currently introduces administrative and accounting complexities and may be inappropriate. In addition, the treatment of dividends should be addressed in the design even though the Company is not currently paying dividends. These issues are addressed in more detail in Section 3, Design, and Section 6, Performance and Service Period.

2.5. Implications of Design Decisions.

2.5.1. Performance awards vary greatly. Design decisions affect employee behavior, shareholder perception, financial reporting, proxy disclosure, employee communication, and administrative processes. Minor adjustments to the design of a plan can have a dramatic impact on the financial reporting and administrative processes. Although administration and financial reporting should not determine design, design decisions should be made with a full understanding of the administrative and financial reporting consequences. There is a direct correlation between the complexity of a performance award's design and the additional resources (e.g. increased budget and headcount) required. This publication discusses those consequences in detail.

Design

3.1. Overview.

3.1.1. The flexibility in the design of performance awards creates considerable opportunities and considerable challenges. The implications of design decisions are significant to the ultimate behavioral impact, shareholder perception, financial and reporting impact, proxy disclosure, employee communication, and administrative requirements of the plan. The complexity and the expense of performance awards can be better managed with a clear understanding of the design issues and implications.

3.1.2. Any type of equity vehicle can have performance goals attached, converting it into a "performance award," as discussed in paragraph 1.1.3. In practice, PSUs are the most common type of performance award. Both units and awards deliver similar economic benefits. The mechanics of the delivery are distinct and PSUs offer clear advantages in flexibility and administrative ease, while PSAs have inherent challenges. Exhibit 2-1, paragraph 2.1.2, summarizes the issues that should be considered when selecting the type of performance award to be used. **In most situations PSUs, rather than PSAs, will be better suited to achieve the Company's goals.**

GLOBAL ISSUE
Labor law and tax regulations may restrict or inhibit the use of certain design features of performance awards granted to employees in specific countries. The complexity of this issue is beyond the scope of this publication but it should not be assumed that extending the concept of performance awards to employee groups outside the US will parallel the extension of stock options or RSUs to those jurisdictions.

Administration and financial reporting should not determine design, but design decisions should be made with an understanding of the administrative and financial reporting consequences.

3.1.3. The nature of performance awards leads to a potentially infinite number of plan designs. The four core design aspects of performance awards include –

- Performance measures - the measures that are the basis for the assessment of performance. These measures may be relative, absolute, or a combination of both
- Performance period - the period over which performance is measured
- Vesting provisions - when the employee has the unrestricted right to the underlying shares
- Payout provisions - how those variations in deemed performance level adjust the compensation earned from the award

This section outlines the possible design features related to these four aspects of performance awards. A detailed discussion of designing performance awards is outside the scope of this publication.

3.2. Performance Measures.

3.2.1. Performance measures are the basis for the assessment of performance. Designing a performance award incorporates decisions about what specifically will be measured and how it will be measured. These factors are summarized as one or more performance goals and incorporated into the terms of the Award.

3.2.2. The types and number of performance measures used vary widely. In addition, the plans vary in how performance is defined. For example, revenue may be defined as gross revenue, backlog, revenue from contracts signed, revenue from invoices billed, "adjusted" revenue, or collections. This highlights the criticality of thorough definitions and the associated financial modeling. For accounting purposes, performance awards are broadly grouped into awards that have either "market conditions" that are stock price related or "performance conditions" that are not related to stock price but are still based on company performance. See Exhibit 3-1 for examples of performance measures.

EXHIBIT 3-1 – EXAMPLES OF PERFORMANCE MEASURES	
MARKET CONDITIONS	
Stock Price Measures	
Absolute Price Growth (%) Stock Price Target ($) Ratio of stock price at grant vs. stock price at vest date Total Shareholder Return (TSR)	
PERFORMANCE CONDITIONS	
GAAP Measures	**Non-GAAP Variations**
Revenue Gross revenue Net revenue	Backlog Contract revenue
Profit Net income (after tax) Net income (pretax) Operating income Earnings per share (EPS) EPS growth	EBIT (Earnings before interest and taxes) EBITDA (EBIT and before depreciation, amortization, and impairment) Adjusted net income Adjusted operating income Adjusted EPS
Cash Flow Operating cash flow Cash flow	Cash flow excluding items
Balance Sheet Net asset value per share Working capital	
Financial (not accounting) Measures: GAAP	**Financial (not accounting) Measures: Non-GAAP Variations**
Return on Equity (ROE) Return on Assets (ROA) Return on Sales (ROS) Return on Invested Capital (ROIC)	Economic profit Adjusted ROE/ROA/ROS/ROIC
Operational Measures	
Unit volume Market share Customer satisfaction index Employee attitude survey results Safety rating (number of incidents) Product quality index (warranty incidents)	
Milestone Measures	
Product release or shipment Launch of beta version Opening of new retail locations Completion of phase of clinical trials Filing of new drug application	

3.2.3. Once the measure has been clearly defined, the next step is to set a standard against which the performance is measured. This decision affects the behavioral impact of the plan, valuation, and financial reporting. The first step is to determine if internal or external measures will be used.

EXHIBIT 3-2 – EXTERNAL REFERENCE MEASURES

Peer group	Most publicly traded companies have a group of peer companies used as a reference point for executive compensation benchmarking purposes. This may also be the group against which performance on a particular measure is determined for a performance award. The peer group may be based on financial or operating characteristics, global industry classification, size within an industry, or other factors.
Multiple Peer Groups	A peer group for executive compensation may not always be appropriate for performance comparisons. Separate performance peer groups may be used for performance comparisons and may have overlapping membership with the compensation peer group.
Indexes	As an alternative, an index (e.g., S&P 500 or NASDAQ 100) may be used for performance comparisons. An index is helpful when a limited number of public companies are available as useful peer comparisons. An index may be an industry index or broad market index. An index may automatically incorporate changes to the group as a result of delisting, merger, acquisitions, or other eligibility changes.

- Externally-referenced measures – Performance is assessed against an external reference point. Exhibit 3-2 includes examples of external reference measures.
- Internal goals – Performance is assessed against internally determined targets (e.g., a specific dollar target, percentage growth over previous year(s), or a ratio relative to other measures).

A goal is a particular level of attainment on a measure. For example, "EPS of $3.50" represents EPS as the measure and $3.50 as the goal.

3.2.4. The next step is to specify an absolute/target-based or relative performance goal.

- Absolute/target-based – Internal or external points establish a simple absolute target, with associated variations (e.g., EPS = $3.50).
- Relative – Performance is assessed relative to an external reference points (e.g., stock price performance exceeds the median of the group of peer companies).

It can be difficult to determine appropriate targets and range of performance over a multi-year period in a complex business and economic environment. This may lead a company to prefer assessing performance relative to an external reference point specifically based on stock price performance. Relative plans can mitigate the impact of certain macroeconomic events that may negatively affect the company's stock price despite excellent performance. Alternatively, current goals can be relative to prior period results (e.g., 20% revenue growth year-over-year). Both absolute/target-based performance goals and relative performance may be used as secondary measures. For example, a company may establish performance goals that include TSR exceeding the 50th percentile of the TSR of a peer group and requiring that absolute TSR must be greater than zero. It should be noted that proxy advisors have placed more emphasis on relative performance recently, helping to influence the design of these equity programs.

3.2.5. Where performance awards have a single performance measure, the award may be designed to provide for variable payout depending on performance against that single measure. Exhibit 3-3 provides an example of a performance award with a single performance measure.

EXHIBIT 3-3 - SINGLE MEASURE

	Return on Equity (ROE)					
	Less than 9%	9% - 9.99%	10% - 11.99%	12% - 12.99%	13% - 14.99%	15% and higher
Percent of Target Shares Earned	0%	50%	80%	100%	120%	150%

EXHIBIT 3-4 – MULTIPLE MEASURES WITH WEIGHTED OBJECTIVES

		Relative Weight	Threshold Level	Target Level	Above Expectation
Revenue	Performance	40%	75%	100%	125%
	Payout		50%	100%	150%
Operating Margin	Performance	40%	90%	100%	110%
	Payout		50%	100%	200%
ROIC	Performance	20%	80%	100%	120%
	Payout		75%	100%	150%

3.2.6. Where performance awards have multiple performance measures, these measures must be combined to determine the appropriate payout. The most common ways to handle multiple measures are –

- Weighted objectives – This approach assigns a relative weight to two or more performance objectives which are used in the payout calculation. Exhibit 3-4 shows an example of a weighted objective approach.
- Matrix – Independent objectives are combined in a matrix. Each cell of the matrix represents a combination of performance levels of the measures that creates a performance outcome translated into a number of shares vesting. Exhibit 3-5 shows an example of a matrix approach.

EXHIBIT 3-5 - MULTIPLE MEASURES WITH MATRIX

		Total Shareholder Return		
		Below 50th Percentile	Between 50th and 59th Percentile	60th Percentile and Higher
Return on Equity	Greater than 15%	75%	150%	200%
	10% to 15%	50%	100%	150%
	Less than 10%	0%	50%	75%

- Modifiers - Two or more performance measures interact using a modifier, a factor that adjusts the payout from one or more measures based on the performance on another measure. For example, revenue is 60% and profit is 40%, but a safety score can increase or decrease the revenue and profit-based preliminary payout by plus or minus 25%. Exhibit 3-6 shows an example of a modifer.

EXHIBIT 3-6 - MODIFIERS

	Calculated Result from Objectives ↓	
	Assessment	Payout Modifier
Safety Score	Exceeds	125%
	Meets	100%
	Below	75%
	↓ Final Amount of Payout	

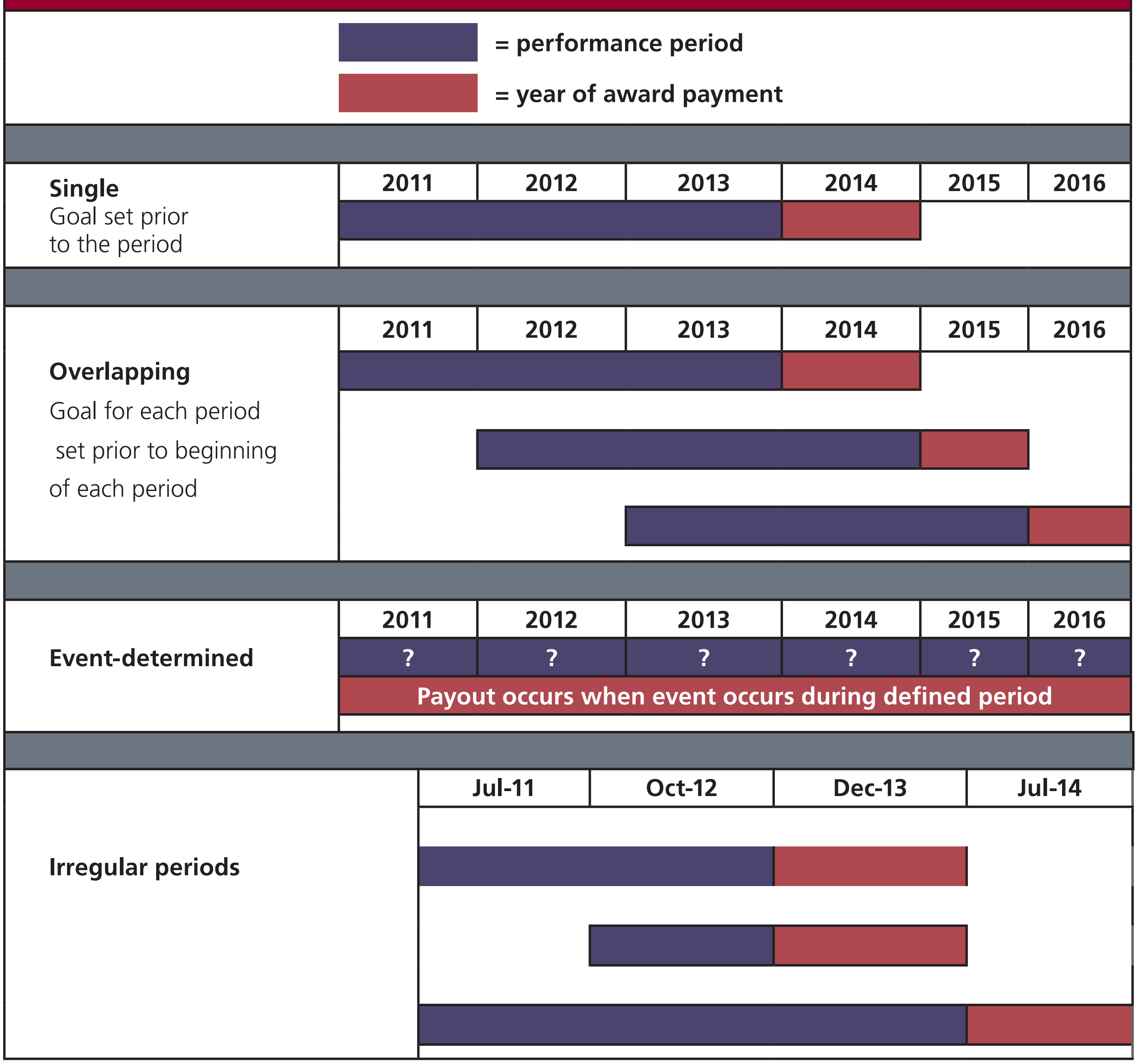
3.2.7. Performance goals must be established no later than the grant date in order to establish a grant date for the award and to determine a fixed value per share for the award. The fair value of the award for financial reporting purposes is determined on the grant date. As discussed in paragraph 5.2.2 the grant date is established when there is a mutual understanding by the employer and employee of the key terms of the award. If the Board has merely determined a performance award will be granted, but has not defined the specific performance goals, the grant date has not occurred.

3.2.8. The performance measures associated with an award can have a significant impact on how an award is treated for financial reporting purposes. Small changes in plan design may have large financial consequences. For example, for accounting purposes performance awards are grouped as those with performance conditions and those with market conditions. (Exhibit 3-1, paragraph 3.2.2, summarizes what measures are considered performance conditions and market conditions.) In general the quarterly expense of awards with market conditions is less volatile than the quarterly expense of awards with performance conditions. If financial statement volatility is a concern, performance goals with market conditions will yield a more stable expense when ignoring the effect of forfeitures. See Section 10, Financial Reporting, for a more detailed discussion of the financial implications of design decisions.

The selection of performance measures can directly impact the volatility of the quarterly expense accruals for financial reporting purposes.

3.2.9. Performance awards are designed to drive desired employee behavior. While more intricate performance measures may be conceptually preferred in terms of shareholder value creation and underlying business strategy, an overly complex set of measures is likely to inhibit employee understanding and motivation. As noted in paragraph 3.2.8, the employee must understand the key terms of an award to establish the grant date. While having complicated,

EXHIBIT 3-7 - TYPES OF PERFORMANCE PERIODS



difficult to understand goals does not preclude the establishment of a grant date, best practice is to fully communicate the terms of the award to maximize employee understanding. An overly complicated design may not be understood by the employee and may not drive desired employee behavior. Key elements of employee communication are discussed in paragraphs 5.7.1 and 5.7.2.

Best practice is to carefully consider employee understanding in the design process. The implementation and communication of more complex plans will be easier for companies that have an established culture of frequent employee education and communications.

3.3. Performance Period.

3.3.1. The period of time over which performance will be measured must be determined as an element of the grant design. The performance period may be –

- A single period
- Overlapping cycles
- Event-determined
- Irregular non-fiscal year periods

Exhibit 3-7 shows an example of these types of performance periods.

3.3.2. The performance period as incorporated in the terms of the award impacts financial reporting by determining the service inception date discussed in subsection 10.7 and the requisite service period discussed in subsection 10.8. Small changes may have a significant impact on the expense associated with an award.

3.3.3. Generally an award also incorporates a service period that requires the employee to provide employment services during a requisite time period. The service period may coincide with the performance period or extend beyond the performance period. Normally the service period is not less than the performance period.

3.4. Vesting Provisions.

3.4.1. The vesting date is the date on which the employee earns the unrestricted right to receive the underlying stock. The vest date for performance awards is after the performance goals and service period have been met. The payout may be delayed to a future date, but the employee has the right to receive the underlying stock. An award may vest at a specific point in time (i.e., cliff vesting) or a percentage of an award may vest at designated points in time (i.e., graded vesting). In the case of graded vesting, each tranche (i.e., the portion of an award that vests) may be treated as a separate unit for financial reporting purposes. See subsection 10.4 for a discussion of accounting treatment of performance awards with graded vesting.

3.4.2. The vest date is defined by the terms in the Plan/Award Agreement. The vest date also impacts the point of taxation for a PSU/PSA, as discussed in subsection 7.2, and the requisite service period for financial reporting, as discussed in subsection 10.8. In defining the vest date of an award, these factors must be balanced. For example, a PSU may vest immediately when the performance goals and service period are met. In many cases the vesting occurs after the performance has been certified to provide confirmation that the performance goals were met and the service period has been met. Another approach would be to define the vest to coincide with the payout of the award at the next open trading window so as to ensure the employees are able to generate funds to meet the employee's tax withholding obligations. The vest date may be structured to verify the performance goals are met, simplify tax withholding, allow sufficient time to process the award, or coincide with an open trading window. Best practice is to specify a vest date no earlier than the certification date. In all cases, if the employee terminates before the vest date (even if the termination occurs after the performance goals and service period have been met), the employee would forfeit the shares.

3.4.3. Most equity plans have change of status provisions defined in the Plan. These terms determine what happens to outstanding unvested awards in the event of an employee's voluntary or involuntary termination of employment, death, disability, retirement, or a company's change in control. Alternatively, plans may reference the provisions in individual award agreements, affording the Company more flexibility to vary these among different grant types and situations. The Plan/Award Agreement will determine what will be paid out and when it will be paid. The most common treatment for any type of status changes include –

- Forfeiture of unvested awards – This is administratively the simplest, and is likely to be considered the most equitable to the Company in the event of a voluntary termination by the employee or an involuntary termination for cause.
- Pro rata vesting with payout determined at the end of the performance period – The payout amount is determined after the performance period is met. The payout is a pro rata allocation based on the proportion of the period completed to the actual results under the terms of the performance award. This is common in the event of retirement.
- Vesting based on assumed performance at target – This is often used for change in control situations, in which the performance awards must be terminated due to the change and it is deemed punitive to require full forfeiture and overly generous to assume that maximum performance would be achieved.
- Pro rata vesting based on portion of period completed – This method calculates the proportion of the period completed and also requires an assumed performance level. This is often used for death, disability, and retirement situations
- Vesting based on estimate of performance period-to-date – This method calculates the payout based on performance–to-date.
- Full payment of unvested awards at the minimum, target, or maximum levels – This provision is often used for change in control, retirement, and disability situations to provide a benefit to the employee for a change in status that is outside of their control.
- Payout determined at end of performance period based on actual performance– The payout amount is determined after the performance period is met. The payout is based on actual results under the terms of the performance award. This is common in the event of retirement.

3.4.4. Implementing a design that provides for full or partial vesting where the underlying shares are released before the end of the performance period may result in unforeseen consequences and negative shareholder reaction. For example, an employee who terminates and receives payout of a pro rata portion of the award prior to the end of the performance period may be the only one who receives a payout if the performance goals are never met. In the case of awards whose payout varies (e.g., the award is paid at 100% of target if the EPS is $4 or less and is paid at 125% of target if the EPS exceeds $4 per share), calculating the appropriate payout required for employees who change status can be difficult and result in inequities among employees.

3.4.5. Unforeseen labor, tax and financial reporting consequences may also occur if the Plan/Award Agreement provides for full or partial vesting upon retirement. Further discussion on the tax consequences is discussed in paragraph 7.5.5. Review retirement provisions carefully to minimize unexpected situations.

KEY TERMS

For purposes of this publication, the following terms are used:

Vest: Award no longer subject to substantial risk of forfeiture

Payout: The process of determining the amount to be paid on the award; sometimes refers to the release of shares, as well as the payout of the award

Release: Transfer of shares to the employee

*For example, a PSU is granted on 1/1/2010. On 3/1/2012, the performance goals are certified, the service period is met, and the award **vests**. The **payout process** determines the number of shares earned. On 3/15/2012, the **payout** occurs and the shares are **released** to the employee's account.*

DIVIDENDS AND DIVIDEND EQUIVALENTS

Dividend or dividend equivalent rights may be attached to a PSU or a PSA to allow the employee to receive the value of dividends paid to shareholders during the vesting period. Usually dividends are not paid on PSOs. Providing for dividends/dividend equivalents is not required, but is common practice. For awards with a fixed payout, the calculation of the dividend is straightforward. For awards with a payout that varies depending upon the level of performance, the final dividend calculation typically is not performed until the number of units earned is known at the end of the performance period.

Shareholders and proxy advisors have criticized PSUs and PSAs that pay dividends before the ultimate vesting of the shares, thus providing another reason to delay the payment of the dividend until the award vests. It should be noted that paying dividends before the ultimate vesting of shares can also trigger unintended financial reporting consequences. These issues should not be ignored simply because a company is not currently paying dividends. Awards should specifically address the payment of dividends in anticipation that the Company may change its dividend policy during the performance period(s).

For purposes of this publication we will refer to dividends and dividend equivalents under the term "dividends."

3.5. Payout Provisions.

3.5.1. Central to the performance award concept is the determination of compensation earned as a function of performance. This is accomplished by defining the number of units, awards, or options that vest based on the defined performance measures, performance period, and vesting provisions. The payout can be determined in a variety of ways including –

- Formula-based – The most common approach to determine payout based on performance is a direct formulaic scale between performance level and payout. This type of variable payout typically includes a minimum (threshold) level of performance required below which there is no payout, and a maximum level of performance above which no additional payout occurs.
- Discretion – The Compensation Committee has the ability to vary the formula-based outcome by some amount (e.g., plus or minus 20%), or the determination of the number of shares has two or more performance factors, one of which is a discretionary assessment of performance. Discretion may be a vague judgment that cannot be clearly articulated.
- Subjective Assessment – Subjective assessment structures discretion into clearly articulated performance conditions that may not be able to be quantitatively measured.

Incorporating discretionary or subjective elements into plan design has important implications for financial reporting. In some cases, when discretion or subjectivity is involved, the conditions of the award may not be known and the grant date may not be established, resulting in liability treatment for accounting purposes. Monitor the share reserves to ensure sufficient shares are available in the Plan to pay out the maximum number of shares under the payout provisions.

3.5.2. The payout schedule may include provisions that impact the number of shares that vest. The schedule may incorporate the following provisions –

- Minimum (Threshold) – Minimum level of performance required for payout
- Target – Expected level of performance
- Maximum – The maximum payout paid for performance
- Floor – A guaranteed minimum payout
- Ceiling – A downside-only scale used when there is no upside to the performance goal or the Company does not want to or should not incent performance above the target due to capacity constraints or burn rate considerations
- All-or-nothing – The payout is calculated for the achievement of the performance target with no provision for exceeding or falling short; best suited to event-based goals that are sensitive to timing

In addition the payout schedule may include provisions that affect when an award vests. For example, if the original target is missed, there is a secondary opportunity to vest in the award (typically at a reduced rate). This may be referred to as "second-chance" shares or as a "catch-up" provision.

3.5.3. The payout provisions may determine the type of equity vehicle best suited for use as a performance award and influence the structure of the performance provisions. For example, an award that provides for changes in the number of shares that vest upon achieving certain performance goals may be unsuitable for a PSA. Shares are issued to the employee at the time of grant. If the actual number of shares earned upon payout is different from the shares issued at the grant date, additional shares must be issued or excess shares must be cancelled. Both alternatives create complications that could be avoided by using a PSU rather than a PSA. A performance-accelerated award may be structured as a PSU or PSA. A PSA would allow additional flexibility for employees to file an 83(b) election, as discussed in Section 7, Tax/Payroll Issues.

3.5.4. Some awards may provide for a delayed payout. This deferral may be elected by the employee receiving the award or may be a requirement under the terms of the Award Agreement. The deferral of the payout date may create tax issues. See subsection 7.6 for a discussion of the tax impact of deferral provisions.

3.6. Issues Associated with Implementation.

3.6.1. Because performance awards are more complex than equity awards with service-based vesting only, it is more important to broaden the team involved in the design process. Effective design incorporates input of all relevant parties, including Human Resources, the CEO, CFO, Board of Directors, Compensation Committee, and Investor Relations. In addition the complexities require the involvement of Financial Reporting, Legal, Tax, and Equity Compensation during the design phase.

3.6.2. Performance awards frequently require special handling. The stock plan system may require some level of workarounds due to limited functionality to support performance awards. Valuation of the awards may be more complex and require external resources. Employee communication should be more robust to maximize the employees' perception of the value of the awards and to obtain the desired effect. This special handling may require additional resources, including increased budget and headcount. There is a direct correlation between complexity in the design of a performance award and additional resources required.

3.6.3. As discussed in this section, many design features complicate the administrative process and financial reporting. Exhibit 3-8 summarizes some these key design features impacting administration and financial reporting.

EXHIBIT 3-8 – SUMMARY OF KEY DESIGN FEATURES THAT IMPACT ADMINISTRATION AND FINANCIAL REPORTING

- Performance goals must be established prior to the grant date in order to finalize the fair value of the award.
- Performance measures can directly impact the volatility of the quarterly expense for financial reporting purposes. Market conditions provide less quarterly volatility than performance conditions.
- Vest date must be clearly defined to provide for –
    - Certification of the performance results
    - Meeting tax withholding requirements
    - Transactions during an open trading window
    - Administrative processing
- Continued or accelerated vesting upon retirement may create financial and administrative challenges.
- Discretion by the Board of Directors or Compensation Committee to increase the payout may have tax consequences.
- Small changes in plan design may have large financial reporting and taxation consequences.
- Balance design complexities with employee understanding.

General Administration

4.1. Overview.

4.1.1. Performance awards can be challenging to administer. The complexity of the administrative process is closely tied to the design details of the Plan and the number of employees receiving performance awards. If performance awards are limited to the executive population, the number of grants is limited and a manual process may be acceptable. If the awards are broad-based, the higher volume of grants requires a more automated administrative process.

4.1.2. Because of the flexibility in the design of performance awards, automated solutions frequently do not address all of the administrative requirements and some level of manual workarounds may be required. When developing an administrative process for performance awards, close communication with Financial Reporting is required to ensure the solution considers the financial reporting implications. In addition, special attention must be given to appropriate internal controls any time a manual workaround is utilized.

4.2. Plan Details.

4.2.1. A company may have numerous plans operating at any time – each with unique attributes and administrative requirements that must be followed. An omnibus plan may allow for the grant of performance awards or the Company may have a separate performance plan. The Plan may specify the parameters of performance awards, and the details of a specific performance award must meet the requirements of the Plan. Plan design has evolved in recent years as proxy advisory services such as ISS and Glass Lewis have focused on how they believe performance plans should be structured. Key plan features relating to performance awards may include –

- Types of performance awards that may be granted
- Total number of shares that may be granted as performance awards
- Standard performance period
- Permitted deviations from term and performance period
- Award eligibility requirements
- Share counting conventions
  - Impact of grant/award on the share reserve
  - Impact of shares returned to pool upon expiration, forfeitures, cancellation, termination, or other changes of employment status
  - Surrender or withholding of shares to pay award price (if any) and/or tax obligations
- Vesting provisions including accelerated vesting
- Impact of change in status, including retirement, terminations, death, and disability
- Dividends and dividend equivalents
- Change of control provisions
- Permitted methods of paying tax obligations

In some circumstances stock must be issued for par value. (This requirement applies to companies incorporated in certain states.) In most cases par value is immaterial and the Company considers past services rendered as payment for the par value. A complete discussion of this issue is outside the scope of this publication.

Develop a standard template to document the plan requirements. Document how the requirements are incorporated into the administrative processes, system functionality as discussed in paragraphs 4.4.1 and 4.4.2, and documentation provided to employees. Particular attention should be paid to new plans implemented or new plan requirements. See Exhibit 4-1 for internal controls associated with plan details.

4.2.2. The Plan must receive proper corporate approvals to be a valid source for the grant of performance awards. Under state law, the issuance of stock requires approval of the Board of Directors. Therefore, Board approval of a stock-based performance plan is required. As part of that process, the Board typically delegates authority to the Compensation Committee or other parties to approve individual grants under the Plan. Also, the listing standards of most stock exchanges, including the NYSE and NASDAQ, require that the Shareholders approve any plan under which stock can be granted to employees or Directors. Failure to receive stockholder approval can subject a company to being de-listed from the exchange. In the case of acquisitions, special care must be taken to determine if the Plan continues and if it is a valid plan.

4.2.3. Various legal requirements must be addressed such as –

- Was the Plan filed with the SEC as an exhibit to an appropriate periodic report filed under the Securities Exchange Act of 1934?
- Was a registration statement filed with the SEC to register the offer and sale of stock under the Plan under the Securities Act of 1933?
- Have appropriate state laws been met?
- Were prospectus delivery requirements met?

See Section 8, Legal Issues, for a more detailed discussion.

4.3. Award Details.

4.3.1. The terms of an award may be detailed in the Award Agreement or incorporated by reference to the Plan as discussed in paragraph 4.2.1. The Award Agreement should incorporate the design features discussed in paragraph 3.1.3. Administrative challenges do not drive the design of performance awards, but small tweaks in the design may ease the administrative burden. As noted in subsection 3.6. and Exhibit 3-8, paragraph 3.6.3, specific design features may generate administrative challenges.

4.4. Stock Plan System Functionality.

4.4.1. The flexibility of performance awards allows each company to customize the design of the award and the performance goals. This flexibility creates challenges in developing systems to handle these awards. The stock plan system may incorporate various software products including the stock plan database, an employee portal, and a financial reporting package. The system may be used internally by the Company or by a third-party outsourcer. Some systems have some level of limitations in recording, tracking, and processing performance awards. Review the system functionality to identify the capabilities to handle each stage in the lifecycle of a performance award, as discussed in Exhibits 1-1 and 1-2 and paragraph 1.3.1. Some common questions regarding the administrative functionality of the stock plan system are summarized in Exhibit 4-2.

4.4.2. Understand the functionality of the stock plan system and how it provides data to Financial Reporting. Establish and document a process to provide required information to value performance awards. See Section 10, Financial Reporting, for a more detailed discussion.

EXHIBIT 4-1 - INTERNAL CONTROLS ASSOCIATED WITH PLAN DETAILS

	Illustrative Controls	Illustrative Test of Controls
1	Develop a standard template to summarize key plan requirements for each Plan. Use the standard template to document the plan requirements. Document how the requirements are incorporated in the administrative processes, system functionality, and documentation provided to employees.	Confirm documentation of all plans. Verify that details of new plans have been documented. Test that plan requirements have been properly implemented.
2	Document the Plan approvals such as Board minutes, Annual Shareholders' Meeting minutes, SEC filings, etc.	Verify that all plans (including plans of acquired companies) have been approved.

EXHIBIT 4-2 – COMMON QUESTIONS REGARDING THE ADMINISTRATIVE FUNCTIONALITY OF THE STOCK PLAN SYSTEM

Performance goals determined
- How will the employee communications from the stock plan system reflect the performance goals?
- Can the employee access updated information about the progress toward achieving the performance goals?

Grant
- How is a performance award recorded?
- What type of performance awards (e.g., stock-settled PSU, PSA, and PSO) are supported in the stock plan system?
- How does the system record and track awards with variable payouts?
- Is the employee notification of the grant from the stock plan system adequate to support a clear understanding of the terms of the Award, including the performance goals and service period?
- For share reserve purposes, is the award tracked at the maximum payout?
- What share amount is used in the Award Agreement?
- Does the system support the tracking and payment of dividends, if required under the terms of the award?
- Is the award recorded in sufficient detail to support the proper financial reporting of the award?

Performance period ends
- Does the system highlight when a performance period ends?
- Does the system handle an extension of the performance period that is considered a modification to the award?
- How does the system handle changes to awards when all or a portion of the award is cancelled because the performance goals have not been met?
- How does the system handle changes of employment status before the performance period ends?
- Does the system support multiple vesting periods and secondary opportunities to vest in awards (i.e., overlapping cycles or second-chance shares as discussed in paragraph 3.5.2.)?

Performance is certified
- How does the system record that the performance goals have been met and the results have been certified?
- In the case of variable payouts, how does the system handle changes in the number of shares to be received?
- Does the system notify employees that the performance goals have been met and the results certified?

Service period ends
- Does the system automatically vest the shares at the end of the service period, when the service period ends after the end of the performance period?
- How does the stock plan system handle changes of employment status before the service period ends?
- Can awards be prorated for changes of employment status?
- Does the system track retirement-eligible employees for the awards granted to facilitate appropriate taxation?
- Does the system allow prorated payouts for leaves of absence?

Award vests
- Is the vest of an award automatic or is a manual process required to record the vest?
- In the case of accelerated vesting, how is the acceleration recorded and reflected in appropriate reports?

Payout Process
- How are deferred dividends or dividend equivalents processed?
- How are deferred PSUs handled?
- Is the payout of a PSU/PSA processed automatically or does it require manual processing?
- How is rounding of shares handled if the award does not pay out at 100%?
- In the stock plan system is the payout of a PSU/PSA handled differently than an award without performance goals?
- Is the exercise of a PSO handled differently than the exercise of a stock option?

4.5. Outsourcing.

4.5.1. The Company may outsource certain aspects of the administration of performance awards. Because vesting is dependent on meeting specific performance goals and performance awards may be tracked outside the stock plan system, companies that outsource the administration of performance awards need to have a higher level of involvement in coordinating the entire process with the outsourcer. Clear communication between the Company and the third-party administrator is critical.

4.5.2. The processes discussed in this publication will apply regardless of whether the Company outsources plan administration; however, the group responsible for implementing the process may differ. In all cases, the Company retains overall responsibility for the internal control process. In general, the Company typically –

- Defines the performance goals
- Tracks the performance goals
- Ensure assessments of the probability of payout for financial reporting purposes are accurate (determination of the probability may be outsourced)
- Determines if the performance goals have been met and certifies the vesting of the award

The Company may outsource –

- Recording the grant
- Recording and processing the vest
- Processing the payout of a PSU/PSA and the exercise of a PSO
- Valuing the award and calculating period expense based on inputs provided by the Company

Grant

5.1. Overview.

5.1.1. When an employee receives a performance award accounted for under ASC Topic 718, the grant date generally establishes the fair value of the award based upon the grant details. Note that the grant date of an award can have different relevance for financial reporting, Section 16 reporting, and proxy disclosure.

5.1.2. The key processes associated with granting performance awards are similar to the processes associated with other types of equity awards. The following discussion focuses on the unique requirements of performance awards. The grant processes associated with other types of equity awards are included in GPS research publications on restricted stock/restricted stock units, which is included in this volume, and on stock options, which can be downloaded from www.scu.edu/business/cepi/.

5.2. Terms of the Award.

5.2.1. As noted in paragraph 4.2.1., the Award Agreement must conform to the terms of the Plan. Award Agreement for performance awards should include –

- The performance goals
- The performance period
- The service period
- The vesting provisions
- The impact of a change of employment status
- A payout schedule upon meeting performance goals

In addition, the standard terms that should be included in any Award Agreement include –

- The right to receive an established number of shares of company stock
- The type of grant (i.e., stock option, restricted stock, restricted stock units, PSUs, and PSAs)
- An established exercise price (for stock options)
- A vesting schedule
- A description of how performance will be calculated
- A requirement of continued employment with limited exceptions for death, retirement, etc.
- Applicable dividends/dividend equivalents and voting rights (for restricted stock, restricted stock units, and performance awards)
- The acceptable methods of paying applicable tax
- Termination provisions

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If a company regularly grants awards or communicates their value as part of compensation paid by the employer, the award may be considered an acquired right of employment. In that instance, the award may no longer be deemed discretionary and the employee may acquire the right to receive such awards in the future. Performance awards are more likely to be considered an entitlement of employment and the employee may have the right to receive such awards in the future.

5.2.2. The grant date is established when there is a mutual understanding by the employer and employee of the key terms of the award. The employer must determine the performance goals and the employee must understand the key terms of the award. If the Board has merely determined a performance award will be granted, but has not defined the specific performance goals, the grant date has not been established, resulting in accounting consequences. See paragraph 10.6.1 for more details.

5.3. Approving the Award.

5.3.1. Corporate law, the Company's corporate governance provisions, and the Plan require the grant to be approved for it to be valid. Therefore, clearly defining the grant approval process and documenting approvals by appropriate parties is a key step in determining that a grant has occurred and the grant date for accounting purposes is established. As noted in paragraph 5.2.2 when dealing with performance awards, the performance goals must also be established prior to approving the award in order to establish the grant date for accounting purposes.

5.3.2. Formalize and document the approval process. Establish and document requirements on who is authorized to approve grants and the limits of their authority. Note when multiple authorizations are required. Indicate who is required to approve grants to specific groups of employees (e.g., Compensation Committee, Board of Directors, or the CEO). Identify individuals with back-up approval authority where appropriate.

5.3.3. For purposes of internal control, the grant approval must be documented in writing. Documentation should include grant employee, number of shares/units awarded, performance goals, performance period, service period, vesting provisions, the impact of a change of employment status, and the payout schedule. Approval at Committee or Board meetings should be documented in detail in the meeting minutes. When unanimous written consents are used, the date of receipt of the final consent determines the grant date. See Exhibit 5-1 for key internal controls associated with approving the award.

EXHIBIT 5-1 - INTERNAL CONTROLS ASSOCIATED WITH APPROVING THE AWARD

	Illustrative Controls	Illustrative Test of Controls
1	Define the grant approval process and develop a matrix of authority. Include approvals that are required and any other individuals that must review and approve grant recommendations.	Verify the grant approval process is documented. Review the matrix of authority to ensure appropriate individuals are authorized to approval grants.
2	Document all grant approvals in writing. Documentation should include grant employee, number of shares/units awarded, performance goals, performance period, service period, vesting provisions, the impact of a change in status, and the payout schedule.	Sample grants to confirm that the grant has been approved and the grant approval is within the limits of the approver's authority and conforms to the grant approval process.

5.4. Recording the Award.

5.4.1. Develop a consistent process to record the grant of the award. As noted previously there are numerous complications when administering performance awards and frequently manual workarounds are required. The grant may be recorded in the stock plan system or tracked separately. Many companies record awards in the stock plan system as of the grant date. The interrelation of an award with both performance conditions and market conditions, as discussed in paragraphs 10.2.2 and 10.2.3, can be challenging, and it may be necessary to record the award as two separate grants – one grant with performance conditions and one grant with market conditions. Other companies track grants of performance awards outside the stock plan system and only record the grant in the stock plan system when the performance goals have been met and the shares vest. If this approach is taken, special care must be taken to ensure that plan reserves are accurately adjusted to avoid unexpectedly running out of shares.

5.4.2. If a company tracks performance awards outside the stock plan system, reconcile activity monthly including –

- Awards granted
- Awards cancelled because the performance goals are not met
- Awards forfeited because of changes of employment status
- Awards expiring
- Awards outstanding, but unvested
- Awards vested (i.e., performance goals and service period met)
- Awards paid out
- Number of employees
- Number of awards
- Maximum number of shares to be paid on outstanding awards

5.4.3. Establish and document a process to provide required information for financial reporting for performance awards. The process will be dependent upon the extent the stock plan system is used to calculate the fair value of the awards and the period expense. The three most common approaches are –

- The stock plan system is used to calculate the fair value of the awards and the period expense
- The stock plan system is used to maintain data for financial reporting purposes but the fair value of the awards is calculated outside the stock plan system
- Performance awards are tracked, valued, and the period expense managed outside the stock plan system

5.4.4. If the stock plan system is used to calculate the fair value and the period expense of the awards, review the stock plan system functionality to ensure the grant is properly recorded. As discussed in Section 10, Financial Reporting, certain types of awards (those with market conditions as opposed to performance conditions) require more sophisticated valuation techniques such as Monte Carlo simulation or binomial models. Understand the functionality of the current version of the stock plan system and whether the stock plan system can meet the financial reporting needs. Special attention may be required when a new release of the stock plan system is installed.

5.4.5. If the stock plan system is used to maintain data for financial reporting purposes, but the fair value of the awards is calculated outside the stock plan system, reports will extract the appropriate information from the stock plan system. Prepare a detailed description of each report to ensure the users of the report understand the parameters of the data reported. The report should include—

- The purpose of the report
- A description of each field and details of how each number is calculated
- Details of what is included and excluded (e.g., types of employees, grant details, transaction details, vesting period, and reporting period)

All appropriate parties should sign-off on the report format. The format should be reviewed and updated periodically, especially when awards are granted with new terms, mergers/acquisitions occur, and the stock plan system is updated. Even though the valuation is calculated outside the stock plan system, the fair value may be stored in the stock plan system for ease of reporting or allocations.

5.4.6. If the Performance awards are tracked, valued, and the period expense managed outside the stock plan system, establish a standard report to provide information to the group responsible for financial reporting. Details about the content, documentation, and update of the report are discussed in paragraph 5.4.5.

EXHIBIT 5-2 - INTERNAL CONTROLS ASSOCIATED WITH SHARE RESERVE MANAGEMENT		
	Illustrative Controls	**Illustrative Test of Controls**
1	Document how the share pool is calculated for different types of equity awards and different types of transactions.	Inspect documentation to ensure that the Plan requirements have been met.
2	Document each reporting period how shares were counted and the impact on the share pool. Performance awards with a variable payout should be included at the maximum payout rate. Verify sufficient shares exist in the share pool.	Verify calculation prepared and reviewed.

5.5. Share Reserve Management.

5.5.1. The Plan provides for a number of shares authorized for issuance but not yet granted. Shares authorized, but not yet granted, are frequently referred to as the "share reserves" or the "share pool." Grants decrease the number of shares in the pool. The Plan may provide that shares are added back to the pool when shares are forfeited, expired, or cancelled because the performance goals are not met. The number of shares in the pool may be increased by approval of shareholders and/or the Board of Directors.

5.5.2. One approach is to use omnibus share plans with a specified fungible share pool. The omnibus plan provides a company with flexibility to determine the type of awards to be offered. All awards count as a share in the fungible share pool, but different types of awards may be counted differently when determining the impact on the share pool.

5.5.3. Because performance awards may incorporate a variable payout feature, share reserve management is critical to ensure the share reserve has sufficient shares to meet the maximum payout requirements. Stock plan software may include functionality to manage the simpler calculations. In some cases calculations must be managed on a spreadsheet by the Company. These calculations are reflected in the financial statements. See Exhibit 5-2 for internal controls as sociated with share reserve management.

EXHIBIT 5-3 - INTERNAL CONTROLS ASSOCIATED WITH NOTIFYING THE EMPLOYEE		
	Illustrative Controls	**Illustrative Test of Controls**
1	Establish procedures to notify the employee of the grant on a timely basis and document that the employees were notified.	Test notification process to ensure that the process is followed and conforms to FASB requirement for timely notification.

5.6. Notifying the Employees.

5.6.1. ASC 718-10-25-5 provides guidance on determining the grant date of an award.

Assuming all other criteria in the grant date definition have been met a mutual understanding of the key terms and conditions of an award to an individual employee shall be presumed to exist at the date the award is approved in accordance with the relevant corporate governance requirements (that is, by the Board or management with the relevant authority) if both of the following conditions are met:

a. The award is a unilateral grant and, therefore, the recipient does not have the ability to negotiate the key terms and conditions of the award with the employer.

b. The key terms and conditions of the award are expected to be communicated to an individual recipient within a relatively short time period from the date of approval. "A relatively short time period is that period in which an entity could reasonably complete all actions necessary to communicate the awards to the recipients in accordance with the entity's customary human resource practices."[1]

5.6.2. Delayed communication to the employee may indicate the award was not fixed and unchangeable and may impact the date of grant, even when all the other requirements for establishing a grant date have been met, as noted in paragraph 10.6.2. The number of employees to be notified and the geographical dispersion of employees can make timely notification challenging.

5.6.3. Formalize a process to notify employees of the grant and document that the employees were notified. The notification should occur as soon as possible after the grant date. Electronic notification tools may streamline this process, but may have limited functionality related to performance awards. When paper copies of Award Agreements are used, documentation should include the mailing process. See Exhibit 5-3 for internal controls associated with notifying the employee.

5.7. Employee Communication.

5.7.1. The Award Agreement is sent to the employee and includes details of the award. Verify that the details included in the Award Agreement reflect the appropriate terms as specified by the Board. A discussion of the strategy of using performance awards may be appropriate upon the grant of the first performance award to each employee.

5.7.2. Employee disclosures may also include information posted on a stock plan website. Make sure the website disclosures reflect the specific plan/award provisions. Care should be taken to monitor consistency of information in all communications. Performance awards are often shown separately from other types of awards to highlight the payout of the performance awards is dependent upon meeting the goals set for the award. The website should include the following information on performance awards –

- Performance period
- Number of target shares
- Target dividends, if applicable
- The performance goals and what is required for the award to vest
- How frequently the performance goal will be measured
- Payout provisions, such as a payout matrix reflecting variable payouts upon achieving specific performance goals

If an award with performance and market conditions was recorded as two separate grants, special care is required to avoid miscommunication with employees.

1 ASC 718-10-25-5

5.8. Performance Stock Units vs. Performance Stock Awards.

5.8.1. When PSUs are granted, the Company promises to issue stock to the employee when the performance and service conditions are met. The stock is issued when the award is paid out. When PSAs are granted, shares are issued as of the grant date. Issuing shares as of the grant date creates numerous complexities when the award provides for changes in the quantity of awards that vest. For example, if a PSA grants 1,000 shares if revenue equals 100% of targeted revenue and 1,250 shares if revenue exceeds target, how many shares are issued as of the grant date? Does the Company issue 1,000 shares on the grant date and later issue an additional 250 shares if revenue exceeds target? Does the Company issue 1,250 shares on the grant date and later cancel 250 shares if revenue equals target? Either approach requires additional administration and potential employee misunderstandings. **Best practice in these cases is to use PSUs rather than PSAs for grants with variable payouts.**

5.8.2. If PSAs are used, special handling will be required. The issued shares are nontransferable and subject to performance and service restrictions. If the stock will be held in the employee's name, the Company directs the transfer agent to issue stock with restrictive provisions, and provides the transfer agent with the number of shares to be issued and the name of the employee. The transfer agent should be advised when restricted stock is issued whether or not dividends will be paid and, if so, the method of payment. Typically, the transfer agent holds the restricted stock as a book entry in an omnibus restricted account and/or an individual account until the restrictions lapse.

5.8.3. When the performance and service conditions are met, the restrictions lapse and the shares vest. On the vest date, the transfer agent is advised to release the shares to the employee. Whenever possible, best practice is to have the transfer agent release the shares to the employee's broker for deposit into the employee's account. In certain cases the shares may remain in book entry position with the transfer agent and moved at the employee's request in the future.

5.8.4. Reconcile instructions to the transfer agent when shares are issued on the grant date and released on the vest date. Utilize error-checking routines when exporting the file to the transfer agent. Document errors identified, research performed, and resolution of the issues. On a monthly basis, reconcile total unvested grants in the stock plan system to the shares issued by the transfer agent held in the custodial account or in book entry. See Exhibit 5-4 for internal controls associated with PSAs.

EXHIBIT 5-4 - INTERNAL CONTROLS ASSOCIATED WITH PERFORMANCE STOCK AWARDS

	Illustrative Controls	Illustrative Test of Controls
1	Establish and document the process to transfer data from the stock plan system to the transfer agent.	Review the documentation to ensure the process was followed.
2	Utilize error-checking routines when exporting the file to the transfer agent. Document errors identified, research performed, and resolution of the issues.	Review error reports for trends and unusual items.
3	On a monthly basis, reconcile total unvested grants in the stock plan system to the shares issued by the transfer agent held in the custodial account or in book entry.	Verify the reconciliation was completed. Note trends and unusual problems.

Performance and Service Period

6.1. Overview.

6.1.1. After a performance award is granted, the performance conditions and market conditions must be tracked. In addition the requisite service period must be monitored. Frequent employee communication during the performance and service period reinforces the potential benefits of the award. At the end of the performance and service period, the performance results are certified and the award vests (to the extent the performance conditions, market conditions, and service period are met). In the case of a PSU, the payout of shares may be immediate or deferred. In the case of a PSA, the payout of shares is usually immediate. In the case of PSOs, the vested award may be exercised at the discretion of the employee and subject to the terms of the award.

6.1.2. As noted previously most stock plan systems, including commercially-available software and outsourcing systems, may have some level of limitations in tracking and processing performance awards. The process of tracking goals and triggering the payout of shares may require manual interface, workarounds, or a secondary service provider. Clear communication and strong internal controls are critical to ensure the terms of the awards have been followed.

6.2. Tracking Performance Goals.

6.2.1. After an award has been granted, the performance goals must be tracked. Exhibit 6-1 summarizes the key activities associated with tracking performance goals. Different individuals may be responsible for each tracking activity. Assessing the probability the award will be earned is discussed in Section 10, Financial Reporting. Tracking the change of employment status is discussed in Section 9, Change of Status. Determining if the performance goals have been met is discussed in this section.

The terms of the performance award will determine how frequently the performance goals must be reviewed to determine if the goals have been met.

EXHIBIT 6-1 – TRACKING PERFORMANCE GOALS
Activities Required
• Quarterly review probability the award will be earned and adjust the expense and diluted EPS calculation accordingly.
• Quarterly track changes of employment status and adjust as necessary for terminations, leave of absence, etc.
• Determine if the performance goals have been met at each measurement date. (Frequency of the review is based on the terms of an award.)

EXHIBIT 6-2 - INTERNAL CONTROLS ASSOCIATED WITH TRACKING PERFORMANCE GOALS

	Illustrative Controls	Illustrative Test of Controls
1	Establish and document the process to track performance goals.	Review the documentation to ensure the process was followed.
2	For each date the performance goals are measured, document the performance goals and whether or not the goals were met.	Sample documentation for dates performance goals are measured. Verify the calculations are correct.

6.2.2. The terms of the performance award will determine how frequently the performance goals must be reviewed to determine if the goals have been met. For example, an award with a performance condition based on annual revenue will need to be monitored annually, but may need to be assessed monthly or quarterly for financial reporting purposes. An award with a market condition tied to stock price may need to be monitored each day the stock market is open.

6.2.3. Develop and implement a procedure to monitor performance goals. Identify the individual(s) responsible for the process. Document that the process is followed on the appropriate timetable for the award, even if the tracking calculation is outsourced. Special care is required if the terms of the award provides for a partial cancellation of the award if the performance goals have not been met. In certain circumstances the vesting date may be extended to provide a second-chance for the employee to earn the shares in a subsequent period. These provisions must be incorporated in the process used to track performance goals. See Exhibit 6-2 for internal controls associated with tracking performance goals.

6.3. Employee Communication.

6.3.1. Best practice is to provide employees with detailed education at the time of grant and frequent updates on progress toward achieving the performance goals. At a minimum, these updates should be quarterly. This communication will enhance the employee's understanding of the performance award, drive desired employee behavior, reinforce the link between the payout and the performance goals, and tie employees to shareholders. This communication can be in the form of a quarterly email to the employee or an update to the stock plan website. Complicated performance goals may be difficult to track and present challenges in communicating interim progress to employees, which is another reason employee comprehension should be considered during the design phase.

6.3.2. There are many values that are associated with performance awards, including the threshold/target/maximum (as reported in the Grants of Plan-Based Awards Table), expected payout, and the probability of achievement for financial reporting purposes. Companies may use a more conservative value for reporting the expected payout to the employees than that used for financial reporting purposes. The more conservative value sets employee expectations regarding ultimate payout without impacting the expected value used for the financial reporting. For companies using a more conservative value for employee communications, the Company should be prepared to explain the difference upon employee inquiry.

6.4. Certification of Performance Results.

6.4.1. Once the performance goals have been met, the performance results should be certified prior to the vesting of the award. Develop and implement a procedure to certify performance results and to ensure the timely communication of the certification to the appropriate parties within the organization. Identify the individual(s) responsible for the process, and document that the process is followed, even if the certification calculation is outsourced. In most cases the performance results are certified by the Board of Directors or the Compensation Committee of the Board. See Exhibit 6-3 for internal controls associated with certification of performance results.

6.4.2. Awards that have a variable payout or allow for discretion in the level of payout by the Board or Compensation Committee require special handling. Document the payout and clearly communicate the decision to the employee, the Equity Compensation group, and Financial Reporting.

6.5. Vest Process.

6.5.1. The vest date is defined in the Plan/Award Agreement and is the date the employee has earned the award and has acquired an unrestricted right to receive the underlying shares. At the vest date the award is no longer subject to forfeiture by the employee. The vest date may be –

- The end of the performance period
- When the performance results are certified
- The end of an additional service period after goal certification
- The date a PSU or PSA is paid out
- Some other date as defined by the Plan/Award Agreement

The vest date may also be defined to coincide with an open trading window. The vest date is always the first date the award is no longer subject to forfeiture. If an award is no longer subject to forfeiture upon retirement and the terms of the award provide for a guaranteed payout, the vest date would be the date the employee becomes retirement-eligible.

6.5.2. Once a PSO vests, the employee may exercise the award. For PSUs and PSAs, the vest date also controls when the PSU or PSA is taxable for social tax and/or income tax purposes. See subsection 7.2 for a discussion of the tax issues related to vest dates. The expense of the award is recorded over the period of the grant date to vest date. See Section 10, Financial Reporting, for a discussion of the financial reporting issues associated with the vest date. The vest date is defined in the Award Agreement and should be consistently applied to determine when the employee has earned the award, when a PSO can be exercised, the point of taxation of a PSU/PSA, and the period for amortizing the expense.

6.5.3. The vest of a performance award is typically triggered by a manual process because vesting is tied to performance goals, rather than the passage of time. To facilitate the vesting process, review awards prior to the measurement date to identify awards that may vest. Leverage the functionality of the stock plan system to process the vest. For example, if the awards were recorded at grant, the stock plan system may require the vest to be recorded manually. If the awards were tracked outside the stock plan system, the grant and the vest of the awards may be recorded at vest.

6.5.4. Processing variable payouts can be challenging. Determination of the payout percentage is typically done outside the stock plan system and the payout percentage is manually recorded in the system. The stock plan system applies the payout percentage to the appropriate awards and calculates the award to be paid out (i.e., number of shares vesting). Calculating variable payouts may result in fractional shares rather than whole shares. Since most companies do not issue fractional shares, the number of shares must be rounded up or rounded down. Establish a protocol for handling fractional shares.

6.5.5. Allow for a period of time between the measurement of the performance goals and the payout of shares to process the award. This time is necessary to handle various administrative requirements including certification of the performance results, as discussed in subsection 6.4, processing tax withholding, as discussed in Section 7, Tax/Payroll Issues, considering legal implications, as discussed in Section 8, Legal Issues, tracking changes of employment status, as discussed in Section 9, Change of Status, and providing instructions to the transfer agent, as discussed in paragraph 6.6.1.

EXHIBIT 6-3 - INTERNAL CONTROLS ASSOCIATED WITH CERTIFICATION OF PERFORMANCE RESULTS

	Illustrative Controls	Illustrative Test of Controls
1	Establish, document, and implement the process to certify performance goals.	Review the documentation to ensure the process was followed.

6.5.6. Develop a vest event checklist for handling each type of performance awards. Leverage the process and internal controls for processing service-based awards (i.e., awards without performance and market conditions) to ensure a timely and accurate payout of shares. See Exhibit 6-4 for internal controls associated with the vest process.

6.5.7. Employees may be less familiar with performance awards than other types of equity compensation. Best practice is to communicate with employees upon the vest of the award to emphasize the key aspects of the vest process. Communication of the vest of a PSU/PSA may include –

- How the payout is calculated
- How and when the award will be taxed
- How the tax will be collected and reported
- When the employee can expect to receive the stock and where the shares will be deposited
- Potential for market fluctuation between the vest date and when shares get into account and can be sold
- Explanation of the types of communications the employee will receive for tax filing purposes
- Instructions to contact the broker to conduct a sale of shares after the vest date

When PSU/PSA shares are paid out, advise the employees of –

- Number of shares vested
- Number of shares released
- Tax withheld and/or reported
- Number of shares sold/withheld for tax
- FMV of the shares released
- When and where to locate the shares to be deposited

This communication may be from the Company, third-party administrator, or broker.

6.6. Payout.

6.6.1. The payout process for a PSU/PSA is similar to that of awards with no performance conditions or market conditions. No shares are issued when a PSU is granted. The underlying shares are issued at the payout date. At payout the transfer agent issues the shares and releases them to the employee's account or as a book entry. When a PSA is granted, shares are issued. The shares are nontransferable and subject to restrictions. At payout, these restrictions lapse. The transfer agent is advised to release the shares to the broker for deposit into the employee's account or as a book entry. As discussed in paragraph 5.8.1, a PSA subject to a variable payout may require special handling. If the actual number of shares earned is different from the shares issued at the grant date, additional shares must be issued or unearned shares must be cancelled. Subsection 6.8 addresses the exercise of PSOs.

A PSU/PSA is vested when the award is no longer subject to forfeiture and the payout of a PSU/PSA occurs when the underlying shares are delivered to the employee.

6.6.2. Performance awards typically include a service requirement; however in certain cases, the award may provide for a pro rata payment to employees whose status has changed. See paragraph 3.4.3 and Section 9, Change of Status, for more detail.

EXHIBIT 6-4 - INTERNAL CONTROLS ASSOCIATED WITH VEST PROCESS

	Illustrative Controls	Illustrative Test of Controls
1	Establish and document a process to record the vest of performance awards.	Inspect documentation to ensure that requirements have been met.
2	Establish and document a process to handle fractional shares resulting from awards with a variable payout.	Verify the established process was followed.
3	Establish procedures to notify employees of awards that will vest and awards that have vested.	Confirm process has been followed.

6.6.3. Accounting for the payout of shares in fungible and/or omnibus plans can be challenging. Instructions to the transfer agent must be explicit. For example, when paying out a PSU/PSA the following details should be included:

- Number of shares to be issued and/or released
- Number of shares to be removed from the plan reserves for shares withheld for taxes, if applicable
- Name of the brokerage firm and employee account number where the shares should be deposited

The transfer agent should also receive detailed instructions for handling unique share counting methodologies such as those required by variable payouts or certain types of awards (e.g., each PSU share counts as 1.5 shares in the share pool). If the administration of performance awards is outsourced to a third-party, the share counting methodology and responsibilities for communications with the transfer agent must be clearly defined. On a monthly basis to minimize problems, reconcile total unvested grants in the stock plan system to the shares issued by the transfer agent held in the custodial account or in book entry.

6.7. Deferral Provisions.

6.7.1. PSUs may provide for a delayed payout. This deferral may be elected by the employee receiving the award or may be a requirement under the terms of the Award Agreement. The deferral of the payout date may create tax issues. See subsection 7.6 for a discussion of the tax impact of deferral provisions.

6.7.2. If an award has a deferral provision, the award must be tracked between the vest date and the date shares are released. Develop a process to track these awards. Leverage the functionality of the stock plan system where possible. Reconcile the vested shares periodically. Exercise care to ensure that the vested shares are properly reflected for financial reporting purposes.

6.7.3. Employee disclosures should reflect awards that have been earned but are not yet paid out. These awards should be shown separately in recognition of their special treatment. Disclosure should include when the shares will be paid out.

6.7.4 ASC 718 also allows for a fair value discount for certain deferral periods where employees have earned shares but the shares are not yet released. Work with the Financial Reporting team to understand whether your provisions comply with this allowance.

6.8. Exercise of Performance Stock Options.

6.8.1. Once PSOs vest, their treatment is similar to that of options with no performance goals. An employee who holds an option may exercise the option and purchase the underlying shares of stock any time after the option is vested and before the term of the option expires. To exercise the options (purchase the shares at the price specified in the Award Agreement), the employee must pay the exercise price that is specified in the Award Agreement. Any increase in the FMV of the stock between the price specified in the Award Agreement and the FMV on the exercise date is taxable income to the employee.

6.8.2. The key processes associated with the exercise of PSOs are similar to the processes associated with options without performance goals.

6.9. Dividends.

6.9.1. An employee receives restricted stock when a PSA is granted. The restricted stock may have dividend rights, but these rights are not mandatory. When a PSU is granted, the employee has received a promise to receive shares at some future date if the performance goals are met. Because the employee does not acquire "shares" and is not a shareholder, there are no dividend rights. The Company may choose to pay dividend equivalents to mirror the treatment of dividends paid on a PSA. Dividends are not typically paid on PSOs. For purposes of this publication we will refer to dividends and dividend equivalents under the term "dividends."

6.9.2. The Plan/Award Agreement specifies the right of the employee to receive dividends. Dividends may be –

- Paid currently in cash or stock
- Paid currently and reinvested in company stock
- Deferred and paid out at a future date in cash or stock

It is more common to pay dividends on PSAs rather than PSUs. The transfer agent should be advised when a PSA is issued whether or not dividends will be paid and the method of payment. Dividends paid on PSUs are typically deferred and paid when the shares are released to the employee. Deferred dividends are usually subject to the same restrictions as the underlying performance award. Even if the Company does not currently pay dividends, dividends should be addressed in the Plan.

6.9.3. Paying dividends on PSUs and PSAs, as compared to the payment of dividends to regular shareholders, requires additional administration and internal controls. For each award, determine if dividends will be paid and how they will be paid. Document the requirements and how they are incorporated into the administrative processes, system functionality, and documentation provided to the employee.

6.9.4. Dividends paid on a PSU or PSA are taxed as compensation income, rather than dividend income and are included on the employee's W-2. This income is subject to income tax and FICA tax. The timing of the taxable event is summarized in Exhibit 6-5.

6.9.5. If the dividend is paid in cash (on the dividend payable date or deferred until a future date and paid in cash), taxable income is the gross dividend paid to the employee. No reduction in taxable income is permitted for any tax withheld. If the dividend is paid in stock (e.g., reinvested dividends or deferred dividends paid in stock), taxable income for income tax purposes is the FMV of stock as determined by the Plan on the vest/release date. Taxable income for FICA purposes is the FMV of stock on the date the dividend is taxed.

EXHIBIT 6-5 – DIVIDENDS: TIMING OF THE TAXABLE EVENT

	Income Tax*	**FICA** (Social Security and Medicare)
Dividend Equivalents Paid on PSUs		
Dividend equivalents paid on dividend payable date	Taxable on dividend payable date	Taxable on dividend payable date
Dividend equivalent deferred (but not subject to the risk of forfeiture) until the underlying shares are paid out	Taxable on release date	Taxable on dividend payable date
Dividend equivalent deferred (and subject to the risk of forfeiture) until the underlying shares are paid out	Taxable on release date	Taxable on release date
Dividend Paid on PSAs		
Dividend paid on dividend payable date	Taxable on dividend payable date	Taxable on dividend payable date
Dividend deferred (but not subject to the risk of forfeiture) until the award vests	Taxable on vest date	Taxable on dividend payable date
Dividend deferred (and subject to the risk of forfeiture) until the award vests	Taxable on vest date	Taxable on vest date

* Taxed as compensation income, rather than dividend income.

6.9.6. The process and controls for paying dividends on performance awards is highly dependent on the capabilities of the stock plan system. The stock plan system may include the following functionality:

- Tracking, recording, and reporting the taxable income from dividends in the payroll system
- Tracking dividends earned, but deferred for future payout
- Processing fractional shares in a dividend reinvestment program
- Prorating dividends when an underlying award is partially forfeited due to termination

Develop and document a process to handle dividend payments. Identify system limitations that require manual workarounds and implement appropriate internal controls.

6.9.7. A corporate tax deduction is allowed for the amount of dividends paid on performance awards that are reported as compensation income to the employee. Reporting for payroll tax purposes does not mean Corporate Tax has appropriate information to claim the corporate deduction. Establish and document a process to advise Corporate Tax of the amount of dividends paid on performance awards each quarter.

6.9.8. See Exhibit 6-6 for internal controls associated with dividends. A more complete discussion of the processes and internal controls associated with paying dividends is included in the GPS research publication on restricted stock/restricted stock units, which is included in this volume.

EXHIBIT 6-6 – INTERNAL CONTROLS ASSOCIATED WITH DIVIDENDS

	Illustrative Controls	Illustrative Test of Controls
1	For each Plan, determine if dividends will be paid and how they will be paid. Document the requirements and how they are incorporated into the administrative processes, system functionality, and documentation provided to the employees.	Confirm documentation of all plans. Sample awards that receive current dividends. Verify that appropriate dividends were paid or deferred in accordance with the plan requirements.
2	Determine how the FMV of stock dividends are determined for each Award. Document the calculation of the FMV.	Select several payment dates and review the calculation of the FMV of stock dividends to confirm the established procedure was followed.
3	Develop and implement a procedure to pay dividends to employees holding unvested PSUs and PSAs. Provide detailed instructions to the transfer agent, as appropriate.	Review the documentation of the dividend payment process.
4	Establish and document the process to record the taxable income from dividends in the payroll system. Reconcile the dividend paid to the dividend income reported in the payroll system.	Sample dividend payments and verify that the income was reported in the payroll system on a timely basis and to the correct employee.
5	Establish and document a process to advise Corporate Tax of the amount of dividends paid on unvested equity compensation for each quarter.	Verify the process exists and is being followed.

Tax/Payroll Issues

7.1. Overview.

7.1.1. Tax and payroll issues are among the most complex and challenging areas of administration. The point of taxation for performance awards is generally the same as the taxation of awards without performance or market conditions.

7.1.2. At the point of taxation the employee recognizes taxable gain equal to the difference between the FMV of the shares and the purchase price of the shares (for a PSU and PSA the purchase price is normally $0 and so the taxable gain equals the FMV of the shares). The Company is required to withhold federal, state, local, and FICA taxes on the taxable income. In addition, the Company must include the taxable gain as income on the employee's Form W-2.

7.2. Point of Taxation.

7.2.1. PSUs are treated like cash compensation and generally considered deferred compensation under IRC §3121(v). As such, they are taxable for social tax purposes at vest under IRC §3121(v) and for income tax purposes upon release (issuance) of the shares. The Internal Revenue Code provides several methods of delaying the collection of FICA tax from the vest date to a later point in time; however, in no case can the reporting of income for social tax purposes be later than the reporting for income tax purposes. For example, if a PSU vests on December 1 and shares are released on the following January 15, a company could elect to have the PSU treated as a short-term deferral. In this case the PSU is taxed for social tax and income tax on January 15 based on the FMV of the award on January 15. Another commonly used provision is IRC §31.3121(v)(2)-1(e)(5) that permits an employer to delay reporting income for FICA tax purposes to any subsequent date within the same calendar year for "administrative convenience." In other words, an employer could report and collect FICA tax on December 31 for a PSU that vested during the year. Assuming the employee had met the limit on the Social Security portion of FICA by the end of the year, only the Medicare portion of FICA would be required to be collected on the award. When using the rule of "administrative convenience," FICA withholding is based on the FMV of the award on the date FICA is collected from the employee. Taxation of a PSU to retirement-eligible employees is discussed in Paragraph 7.5.5. A corporate tax deduction may be claimed when the award is taxable for income tax purposes to the employee provided the employer has reported the income on Form W-2. The corporate deduction equals the amount of taxable income of the employee. A discussion of a potential limit on the corporate deduction under IRC§162(m) is discussed in subsection 7.7.

7.2.2. PSAs are taxable under IRC §83 for income and social tax purposes when the property is no longer subject to a substantial risk of forfeiture. Normally the award is no longer subject to forfeiture when the restrictions lapse on date of vest. Paragraph 7.5.5 discusses taxation of retirement-eligible employees. A corporate tax deduction is permitted as noted in paragraph 7.2.1.

GLOBAL ISSUE
Some non-US countries require that companies calculate the FMV of the shares on the vest date for purposes of calculating the taxable income using a local valuation methodology. For example, the valuation may be based on an average over the month prior to the vest date or a seven-day weighted average. Care should be taken to identify grants made in these jurisdictions to ensure that withholding and reporting is based on the appropriate local FMV.

GLOBAL ISSUE

The point of taxation of performance awards may vary in each country. Consult tax and legal counsel to determine the taxation in appropriate countries. The timing of income tax may differ from the timing of social tax in some countries.

7.2.3. PSOs are taxable for income and social tax purposes when the employee exercises the option. Paragraph 7.5.5 discusses taxation of retirement-eligible employees. The Company may claim a tax deduction for the amount reported as income by the employee.

7.2.4. The Plan, the Award Agreement, or plan interpretations may define how the FMV is calculated at the point of taxation. (For purposes of this publication it is assumed FMV is defined by the Plan.) FMV may be determined in a variety of ways such as the market close on the day prior to vest/exercise, the market close on the vest/exercise date, or the average of the high/low on the vest/exercise date. The FMV, as defined by the Plan, is used to calculate taxable income for the employee.

7.2.5. If the vest and release dates are simultaneous, both a PSU and a PSA are taxed for income and social taxes on the vest/release date. As discussed in paragraphs 6.5.1 and 6.5.2, the vest date is defined in the Plan/Award Agreement and will determine if the vest and release dates are simultaneous.

7.2.6. The tax treatment differs for a PSU and PSA if the release of the underlying shares is delayed for any reason such as a delay due to a blackout period, an administrative period to process the award, a post-vesting holding period, or an integral part of the award design to encourage employee retention. If the release of the award will be delayed to a point after the vest date, a PSU is the preferred performance vehicle due to its favorable tax treatment. Since PSUs are taxable for income tax purposes upon the release of the shares, the payout of a PSU may be deferred with minimal tax consequences (i.e., only social tax is due upon vest, rather than income tax). If the payout of a PSU is deferred for more than 2 ½ months beyond the year of vesting, IRC §409A may apply. See subsection 7.6 for a more detailed discussion about the consequences of deferral provisions under §409A.

7.3. Tax Withholding – Performance Stock Units/ Performance Stock Awards.

7.3.1. The tax due may be paid by the employee by withholding a portion of the performance award shares (withhold-to-cover), selling a portion of the shares to fund withholding (sell-to-cover), or having the employee remit cash to the Company to cover the required withholding. The advantages and disadvantages of each method are discussed below.

7.3.2. Withhold-to-cover is used frequently by companies that have sufficient cash to pay the payroll tax. The payroll tax is calculated on the taxable income to be reported. The required tax will be paid to the Company by the employee as shares where the Company withholds shares from the award equal to the amount of tax divided by the FMV of a share. The share value is based on FMV defined by the Plan. (This mirrors the FMV used in the calculation of taxable income.)

IRC §83(b) Election - Normally a PSA is taxed when the award vests. An employee may make an IRC §83(b) election (commonly referred to as an 83(b) election) to have a PSA taxed at grant. Under IRC §83(b) the employee elects to include in taxable income in the year of grant the FMV of the shares as determined on the date of grant. In most cases an 83(b) election would only be appropriate for a PSA if the award provides for a minimum payout. An 83(b) election is not available for a PSU or a PSO. An 83(b) election is not widely used and requires additional employee communication to make sure that the employee understands the tax consequences of making the election. Similar elections to be taxed on a PSA at grant exist in other countries as well.

7.3.3. Most companies do not allow for the issuance of fractional shares. Therefore, the calculation of the number of shares that must be withheld is rounded to whole shares. If the fractional share is rounded up to next whole share, the FMV of the partial share is added to withholding or refunded to the employee. ASC 718 now requires liability accounting if shares are withheld for tax in excess of the maximum individual statutory requirements. In some cases, rounding up may be interpreted as exceeding the maximum individual statutory requirements. Consult with the Company's external auditor to ensure the way fractional shares are handled does not affect the classification of the award as an equity instrument. Further, please consult all tax obligations and policies from the Internal Revenue Service when determining the amount to withhold. The Internal Revenue Service determines taxation requirements on equity awards. The policy under ASC 718 as created by the FASB is focused on the accounting of share-based payments and does not consider other tax consequences should a company withhold at the maximum individual statutory requirements. If the Company chooses to withhold at the minimum individual statutory requirements and the fractional share is rounded down to the next whole share, the shortfall of tax is collected from the employee's earnings in the next payroll cycle or the employee remits cash to the Company to pay the shortfall. (Caution: The Sarbanes-Oxley Act of 2002 prohibits public companies from making loans to their executive officers. Collecting a tax shortfall in the next payroll cycle may be deemed a loan and prohibited under the Act.)

7.3.4. The Company is required to pay cash from company funds for the payroll tax deposit. Since no shares have been sold in a withhold-to-cover transaction, there are no sales proceeds to fund the payroll tax deposit. See Exhibit 7-1 for examples of withhold-to-cover and sell-to-cover.

7.3.5. The advantages of withhold-to-cover are –

- Minimize dilution (In Exhibit 7-1, 310 shares rather than 450 shares are released; 140 shares may be held as Treasury Shares or returned to the plan reserves, if permitted by the Plan. Note that returning shares to the plan may raise concerns from shareholders and proxy advisory firms.)
- Easier to administer than the sell-to-cover or cash method

EXHIBIT 7-1 – COMPARISON OF WITHHOLD-TO-COVER AND SELL-TO-COVER

Facts:

450 shares vest

FMV as defined by the Plan = $9.20 per share

Applicable tax rate = 31%

Fractional shares rounded up to whole shares with residual applied as additional withholding

Sales proceeds = $9.20 per share

Shares withheld or sold are rounded up to the nearest whole share

	Withhold-to-Cover	Sell-to-Cover
Taxable Income	$4,140 (450 x $9.20)	$4,140 (450 x $9.20)
Tax Withheld	$1,283.40 ($4,140 x 31%)	$1,283.40 ($4,140 x 31%)
Shares Withheld for Tax	140 ($1,283.40/$9.20 = 139.5 shares rounded to 140)	None
Shares Issued to Employee	310 (450 – 140)	450
Shares Sold for Tax	None	140 ($1,283.40/$9.20 = 139.5 shares rounded to 140)
Funding of Tax Withholding	From company funds	From sales proceeds

- Employee does not pay any commissions or fees on the shares withheld
- Minimizes involvement of Treasury since no cash is transferred to the Company

The disadvantages of withhold-to-cover are –

- Company must fund the employee's payroll tax by using company cash, rather than using cash generated by the sale of stock
- Rounding up of fractional shares when withholding at the maximum individual statutory rate as discussed in 7.3.3 may create accounting issues

7.3.6. The second method, sell-to-cover, is used frequently by companies that have insufficient cash to pay the payroll tax. Taxable income is calculated based on FMV defined by the Plan. The payroll tax is calculated on the taxable income to be reported. The employee receives the full number of shares and must sell a portion of the shares to generate cash to pay the required tax. The Company, broker, or third-party administrator estimates the number of shares required to be sold to deliver appropriate funds from the stock proceeds to pay the tax and the broker's commissions and fees. The number of shares to be sold may be rounded up to equal whole shares, not fractional shares, and to cover market fluctuation in the shares. (Market fluctuation is the difference in the estimate of the proceeds from the stock sale and the actual proceeds from the sale of stock.)

7.3.7. The sale usually occurs on the day after the shares are released. In many cases, the broker executes a block sale of shares for all employees and the average sales price is applied to each employee. The reporting of the sale of the shares is usually handled by the broker. The sale proceeds equal the sales price per share multiplied by the number of shares sold. The sales price per share may not equal the taxable income per share initially calculated due to the market fluctuation between the vest date and the date the shares are sold. If sales proceeds exceed the amount of required tax withholding, the excess can be refunded to the employee by transferring the additional proceeds into the employee's brokerage account or by adding the additional proceeds to the tax withholding. See Exhibit 7-1, paragraph 7.3.4, for an example of sell-to-cover.

7.3.8. The advantage of sell-to-cover is –

- Sales proceeds fund the payroll tax deposit, rather than using company cash

The disadvantages of sell-to-cover are –

- The challenge of estimating the number of shares to be sold to pay tax and the complications of handling proceeds that exceed or fall short of the required tax
- Significant time and effort is required
- Securing employee authorization to sell shares
- Ensuring the employees have activated their brokerage account
- Selling shares during a closed window may be difficult or prohibited, as discussed in subsection 8.1
- Potential impact on the market price if a significant number of shares are sold on the same date
- Additional dilution (In Exhibit 7-1, paragraph 7.3.4, 450 shares rather than 310 shares are released)

7.3.9. In the third method the employee remits cash to the Company to cover withholding. The calculation of taxable income and associated tax is identical to the calculation in a withhold-to-cover or sell-to-cover transaction. Prompt collection of the payroll tax presents an administrative challenge. The calculation of the tax occurs on the vest date or the subsequent day. Payroll tax is due immediately, but it may be impractical to collect funds from the employee immediately. A wire transfer of funds may be difficult. Even if the employee delivers a check on the vest date, the Company should wait until the check clears before releasing the shares. Companies need to consider the administrative complications associated with this method when allowing employees to pay their tax obligations in cash.

GLOBAL ISSUE

Non-US tax jurisdictions may have different rules. Withholding and reporting requirements may differ. Tax years may be different (e.g., the tax year end may be April 5 rather than December 31). A variety of civil and criminal penalties may be assessed for inadequate withholding. Care must be taken to determine the appropriate tax requirements of each jurisdiction.

7.3.10. Best practice is to use one method to collect payroll tax, either withhold-to-cover or sell-to-cover, for all employees. If multiple methods of payment are offered and employees are allowed to elect which method to use, require the employee to make the election at least 15 days prior to vest. If no election is received within 15 days prior to vest, provide a default method (that does not require employee action) such as withhold-to-cover. Prohibit employees from changing their elections within 15 days of vest. The requirements related to the collection of payroll tax are usually incorporated into the Award Agreement. Note – An Insider may only be able to make an election regarding the way payroll tax will be paid during an open window.

7.4. Tax Withholding – Performance Stock Options.

7.4.1. Tax is due when a PSO is exercised. The employee may pay the tax in a variety of ways including:

- From the proceeds of the sale of stock acquired in the option exercise (same-day-sale or sell-to-cover)
- By withholding a portion of the shares to fund withholding
- Remitting cash to the Company to cover the withholding

7.4.2. In a same-day-sale the employee exercises the option, sells the stock acquired, and uses the proceeds from the sale of stock to pay both the exercise price and tax withholding. The employee pays no out-of-pocket cash to exercise the option and retains no ownership in company stock after the transaction. A sell-to-cover exercise is similar to a same-day-sale. Only a portion of the acquired shares are sold and the employee retains ownership of the balance. See paragraphs 7.3.2 to 7.3.5 for a discussion on withhold-to-cover. See paragraph 7.3.9 for a discussion of the challenges of the remittance of cash to cover the required withholding.

GLOBAL ISSUE

Acceptable methods of paying tax may be restricted and/or require employee consent in certain jurisdictions. Additional flexibility with respect to tax payment methods may be required for non-US employees. Many countries do not have a minimum statutory withholding rate. As a result, companies may require sell-to-cover for non-US employees to avoid adverse accounting consequences.

7.5. Challenging Design Features of a Performance Stock Unit/Performance Stock Award.

7.5.1. The relationship between the vest date and the point of taxation may result in unforeseen consequences when administering the Plan. Certain design features may make compliance with payroll tax requirements difficult. Some of the more common design features that can create tax challenges are –

- Automatic vesting upon achievement of performance goals
- Vesting prior to certification of performance results
- Vesting on the date performance results certified
- Discretion of Board to increase variable payout
- Continued or accelerated vesting upon retirement
- Post-vest holding periods if the grant is not in the form of units

7.5.2. Consider a market condition that provides for the vesting of a PSA when the stock price reaches $60. If the stock price is based on the market high for the day, the award may vest with little or no warning. A PSA would be taxable for income and social tax purposes when the award vests. As noted in previous GPS publications, the tax authorities have stringent requirements regarding timely deposit of payroll taxes. Tax is required to be withheld when the award is taxable (i.e., the day the award vests). If on any day an employer has $100,000 or more of federal employment taxes accumulated, these taxes must be deposited by the close of the next banking day. Tracking the performance goals, administering the vest process, and withholding appropriate taxes within a 24-hour period is difficult to coordinate when there is insufficient time or advance warning of the event. This problem could be avoided with minor modifications to the Plan to delay the vest date to allow for time to administer the payout of the award. An alternative would be to utilize PSUs rather than PSAs.

7.5.3. Certification of the performance results must be considered when establishing the vest date. Assume an employee has an unrestricted right to receive the underlying shares on the date the performance goals are met. A PSA would be taxable for income and social tax on the date the performance goals are met. A PSU would be taxable for social tax on the date the performance goals are met. If the Plan provides that the performance goals must be certified before the shares are released to the employee, the award would be taxable, but no shares would be available to meet the tax withholding requirements. This problem could be avoided by establishing a vest date that is dependent on the certification of the performance results.

7.5.4. Such problems can be exacerbated if the Board has discretion in determining the amount of the award. If the vest date of a PSA is defined in the Plan as the date the performance goals have been met, the award will be taxable on that date. The taxable amount cannot be determined until the Board determines the amount of the award. Establishing a vest date that is dependent on the certification of the performance results and calculation of the award earned would eliminate this problem.

7.5.5. Some plans include provisions that awards immediately vest or continue vesting upon retirement. If an award provides for a minimum payout regardless of whether or not the performance goals have been met, the award will be taxable to the extent of the minimum payout when an employee is retirement-eligible. The acceleration of tax occurs because the retirement-eligible employee no longer has a risk of forfeiture. A PSA would be taxed immediately for income tax and social tax purposes. A PSU would be taxable immediately for social tax and taxed for income tax purposes when the shares are released. Tax would not be accelerated if the award does not guarantee a minimum payout since the award would still be subject to achieving the performance goals. (Plan provisions regarding retirement-eligibility do not impact the taxation of PSOs.) Awards with accelerated/continued vesting on retirement and minimum payouts should be closely examined to minimize any unforeseen tax consequences.

GLOBAL ISSUE

Non-US employees may also be subject to tax at the time the employee is retirement eligible. Further, if the retirement benefits are based on an employee reaching a specific age, the provisions may violate certain age discrimination provisions in some countries.

7.6. Tax Impact of Deferral Provisions.

7.6.1. As discussed in paragraph 6.7.1, some Plans/Award Agreements may provide for a delayed payout for all awards or at the election of the employee. In some circumstances a deferral of an award may create additional tax, penalties, and interest under IRC §409A. A PSU is taxed for social tax purposes at vest and income tax purposes when shares are released. A PSU may be subject to the provisions of IRC §409A if the shares are released more than 2 ½ months after the end of the year in which the vest date occurs. IRC §409A does not apply to a PSA. A vested PSO is exercised at the employee's discretion prior to the expiration of the option. Normally PSOs do not have deferral provisions beyond the exercise date (a PSO with deferral provisions may be subject to IRC §409A).

7.6.2. IRC §409A addresses the taxation of nonqualified deferred compensation (NQDC). A PSU may be considered NQDC, depending on the terms of the award. A PSA and a PSO are generally not treated as NQDC. If an award is NQDC, it must meet the requirements of IRC §409A to avoid immediate taxation and substantial penalties. Unless the IRC §409A requirements are satisfied, amounts deferred under a NQDC plan for all tax years are currently includible in gross income, to the extent the amounts were not previously taxed and not subject to a substantial risk of forfeiture.[2] Compensation is subject to a substantial risk of forfeiture if the employee's rights to such compensation are conditioned upon the future performance of substantial services.[3] If tax is due under IRC §409A, then the deferred compensation is taxable for income tax purposes and the income tax imposed is increased by 20%, plus interest at a penalty rate. There is no deferral of compensation if payment is made no later than 2 ½ months after the end of the year in which the vest date occurs (commonly referred to as a "short-term deferral"). Therefore, if a PSU is paid within the applicable 2 ½ month period, it will not be NQDC and the provisions of IRC §409A will not apply.

7.6.3. A complete discussion of IRC §409A is beyond the scope of this publication. Consult tax and/or legal counsel to determine whether the deferral of the release of shares for a PSU qualifies as a short-term deferral or, if not, whether the deferral meets the requirements of IRC §409A.

7.7. Limits on Corporate Tax Deductions.

7.7.1. A corporate tax deduction may be claimed for the ordinary income recognized by the employee when an equity award is taxed. The deduction may be limited (IRC §162(m)) for "covered" employees whose compensation exceeds the $1 million cap for the year. Specifically, IRC §162(m) limits a publicly held corporation's deduction for compensation paid to its CEO, CFO, and its next three highest-compensated officers to $1 million per year.[4] Further, any "covered" employee from a prior year still receiving compensation from the company will remain a covered employee.

2 Conf Rept No. 108-755 (PL 108-357), p. 715

3 IRC §409(D)

4 Notice 2018-68. The limit may be higher if the award is eligible for grandfathering under pre-2018 Section 162(m) rules.

7.7.2. The Tax Cuts and Jobs Act of 2017 eliminated an IRC §162(m) provision that exempted "performance-based compensation" from the $1 million limit. Some awards granted before the law's passage on November 2, 2017, are still deductible up to a specified limit as long as the compensation is contingent on the attainment of performance goals and certain conditions are met with the Compensation Committee and shareholders. A historical summary of the issues of associated with IRC §162(m) is not included in this publication. Performance-based compensation is now treated similarly to other forms of compensation when determining the deduction allowable to the company.

EXHIBIT 7-2 - INTERNAL CONTROLS ASSOCIATED WITH CORPORATE TAX DEDUCTIONS

	Illustrative Controls	Illustrative Test of Controls
1	Incorporate appropriate provisions in the Plan to meet IRC §162(m) requirements.	Confirm that provisions are included in the Plan.
3	Identify the top three highest-compensated officers other than the CEO and CFO as well as any prior covered employees still receiving compensation from the company. For each grant to one of these individuals, document that appropriate IRC §162(m) requirements have been met.	Review documentation to confirm that the appropriate individuals have been selected and the IRC §162(m) requirements have been met.
4	Document the policy with respect to IRC §162(m) in the Compensation Committee's report. Update the policy annually.	Confirm that the policy has been updated and documented in the Compensation Committee's report.

Legal

8.1. Overview.

8.1.1. Companies and employees are subject to a variety of legal requirements relating to equity compensation. Noncompliance with legal requirements may not have material financial statement implications, but can generate issues under Sarbanes-Oxley, raise concerns about company management and corporate governance policies, and identify weaknesses in internal controls.

8.1.2. When offering performance awards to employees, a company must adhere to a variety of legal requirements, including federal and state securities laws. A publicly-traded company must also adhere to SEC regulations and stock exchange requirements. This section discusses the unique legal issues associated with Section 16 reporting, proxy disclosures, and blackout periods for performance awards. The grant date of a performance award can have different ramifications for purposes of financial reporting, Section 16 reporting, and proxy disclosure. Highlights of such reporting are included as a high-level discussion. A complete discussion of the legal issues associated with performance awards is outside the scope of this publication.

The SEC disclosure and reporting rules use specialized terminology that is not always consistent with commonly-used terms in equity compensation. For purposes of this publication, terminology in this section is consistent with terminology in the rest of the publication and may not align with SEC terminology.

8.2. Section 16 Reporting – General.

8.2.1. The Section 16 reporting of performance awards on Form 4 can vary, depending on whether the award constitutes a "derivative security," whether it is settled in cash or stock, and whether or not the grant and/or payout of the award is exempt from the short-swing profits recovery rules of Section 16(b). The primary determinant in how such awards are reportable under Section 16 is whether or not they constitute "derivative securities."

8.2.2. "Derivative securities" are awards that have a value derived from the value of an equity security.[5] A performance award that may be settled only in cash still may be a derivative security that is subject to Section 16 so long as the award "derives its value" from an equity security of the Issuer. Performance awards are not derivative securities unless their value is tied solely to the market price of an equity security of the Issuer. Form 4 reporting format depends on whether the award qualifies as a derivative security.

5 Rule 16a-1(c)

GLOBAL ISSUE

If the performance awards are granted to employees outside the U.S., the Company must also adhere to local securities law, exchange controls requirements, and other legal requirements.

Because performance awards can be structured with a wide variety of designs and vesting conditions, they require individual analysis under Section 16 of the Securities Exchange Act of 1934. This discussion focuses on Form 4 reporting. The information provided for Form 4 can also apply to the preparation of Forms 3 and 5.

8.2.3. The majority of performance awards are not derivative securities, because the value of the award is not tied solely to the value of an equity security. Examples of awards that are not derivative securities are awards whose value is based on –

- Return on Equity
- Earnings per Share
- Product quality
- Customer acceptance
- Job performance
- Increases in the Company's book value over time
- Stock price compared to a peer group
- Achievement of personal performance goals
- Attainment by the Issuer of earnings targets

Additionally, when the plan administrator (including the Compensation Committee or the Board) has discretion to adjust the performance goals, the award is not considered a derivative security.

8.2.4. Generally, PSAs that are non-derivatives are deemed acquired when the performance criteria have been satisfied, not as of the grant date. The SEC staff once expressed the view that PSAs carrying voting and dividends rights should be considered acquired on the date of grant, even though subject to forfeiture if the performance criteria are not satisfied. That view is not consistent with beneficial ownership standards, and for purposes of this publication PSAs are considered the same as PSUs for Section 16 reporting purposes. Involvement of Legal Counsel in this interpretation is necessary.

8.3. Section 16 Reporting – Non-Derivative Securities.

8.3.1. Performance awards that are classified as non-derivative securities are reported as follows:

- Grant — Not a reportable transaction
- Vest — Not a reportable transaction, unless vesting triggers payout
- Forfeiture or cancellation — Not a reportable transaction
- Payout — Constitutes a "grant or award" and, therefore, is eligible for exemption from Section 16(b) if the conditions of Rule 16b-3(d) are met; reported on Form 4 by the end of the second business day after the date shares are released, regardless of whether exempt from Section 16(b)

8.3.2. If a non-derivative performance award is settled in stock at the time of vesting, the award itself is never reported, but the Insider's receipt of stock upon payout of the award must be reported in Table I of Form 4. The payout of shares does not involve the disposition of a derivative security and, therefore, does not require reporting of the disposition of the performance awards in Table II of Form 4. Instead, only the acquisition of the underlying shares should be reported in Table I.

8.3.3. Cash settlement of performance awards that are non-derivative securities can be interpreted in two ways. These awards can be viewed as a cash bonus that is not reportable under Section 16. This position is most defensible where the award can be settled only for cash or the holder elects, prior to vesting, to receive cash upon payout of the award. Alternatively, cash settlement of the award can be interpreted as the simultaneous acquisition of stock and disposition of that stock back to the Issuer (both of which are reportable in Table I of Form 4). If the original award was exempt from Section 16(b) under Rule 16b-3(d), the payout would also be exempt from short-swing profit recovery under Section 16(b), but not exempt from reporting under Section 16(a). Involvement of Legal Counsel in this interpretation is necessary.

8.4. Section 16 Reporting – Derivative Securities.

8.4.1. Performance awards that are classified as derivative securities (except as noted below for awards settleable solely in common stock on a one-for-one basis) are reported as follows:

- Grant — Reported on Form 4 within two business days after the grant date, whether or not it is exempt from Section 16(b); report on Table II as the acquisition of a derivative security
- Vest — Not a reportable transaction, unless vesting triggers payout
- Forfeiture or cancellation— Not a reportable transaction, unless for consideration
- Payout — Deemed to involve both the disposition of the derivative security (reported in Table II of Form 4) and the acquisition of the underlying stock (reported in Table I)

Alternatively, derivative securities settled solely in common stock on a one-for-one basis may be reported as follows:

- Grant — Reported on Form 4 within two business days after the grant date, whether or not it is exempt from Section 16(b); may report on Table I
- Vest — Not a reportable transaction, unless vesting triggers payout
- Forfeiture or cancellation— Not a reportable transaction, unless for consideration
- Payout —Nothing to reported on Table II at payout, but report on Table I any additional shares earned over the originally reported target shares

See Exhibit 8-1 for a summary of Section 16 reporting requirements for performance awards.

8.4.2. The cash settlement of derivative securities involves, first, a conversion of the derivative security into the underlying stock, and then a disposition of the stock to the Issuer.[6] The disposition of the derivative security is reportable in Table II of Form 4. The simultaneous acquisition and disposition of the underlying stock is reportable on two lines in Table I.

8.4.3. If the original grant of the award was approved in accordance with Rule 16b-3(d), then (i) the disposition of the performance award and the deemed acquisition of the underlying stock would be reportable using transaction code "M" ("Exercise or conversion of derivative security exempted pursuant to Rule 16b-3"), and (ii) the deemed disposition of the stock to the Issuer (in the case of a cash-settled performance award) would be exempt from Section 16(b) by virtue of Rule 16b-3(e) and reported using transaction code "D" ("Disposition to the issuer of issuer equity securities pursuant to Rule 16b-3(e)").

8.4.4. If the original grant of the award was NOT approved in accordance with Rule 16b-3(d), then the disposition of the performance award and the deemed acquisition of the underlying stock may be exempt under Rule 16b-6(b), but the deemed disposition of stock back to the Issuer (in the case of a cash-settled performance award) would not be exempt, and would be reportable using transaction code "S" ("Open market or private sale of non-derivative or derivative security").

6 American Bar Association (December 20, 1996) (Q.4(b)(4)

EXHIBIT 8-1 – SECTION 16 REPORTING FOR PERFORMANCE AWARDS[1]			
Performance Award Description[2]	**Derivative Security?**	**Form 4 Filing on Grant**	**Form 4 Filing on Settlement**
PSU/PSAs earned if (i) stock price reaches $30 by December 31, 20XX, **and** (ii) EPS exceeds $2.50 for FY 20XX. Award settles in **stock** upon vesting.	No	N/A	Within 2 days after vesting. Table I shows exempt acquisition of stock (Code A).
PSU/PSAs earned if (i) stock price reaches $30 by December 31, 20XX, **and** (ii) EPS exceeds $2.50 for FY 20XX. Award settles in **cash** upon vesting.	No	N/A	Within 2 days after vesting. Table I shows exempt acquisition of stock (Code A) and simultaneous exempt disposition of stock to the Issuer for cash (Code D).
PSU/PSAs earned if (i) stock price reaches $30 by December 31, 20XX, **or** (ii) EPS exceeds $2.50 for FY 20XX. Award settles in **stock** upon vesting.	No	N/A	Within 2 days after vesting. Table I shows exempt acquisition of stock (Code A).
PSU/PSAs earned if stock price reaches $30 by December 31, 20XX, **unless** Committee determines a lower payout based on individual performance. Award settles in **stock** upon vesting.	No	N/A	Within 2 days after vesting. Table I shows exempt acquisition of stock (Code A).
PSU/PSAs earned if Issuer's TSR over FY 20X1 – 20X3 ranks in the top 1/3 of a specified peer group over the same period. Award settles in **stock** upon vesting	No	N/A	Within 2 days after vesting. Table I shows exempt acquisition of stock (Code A).
PSU/PSAs earned if Issuer's TSR[3] over FY 20X1 – 20X3 exceeds Y%. Award settles in **stock** upon vesting.	In some cases[4]	Yes, if derivative security. N/A, if not.	Within 2 days after vesting. Table I shows exempt acquisition of stock (Code A). Table II shows exempt disposition of derivative security, if applicable (Code M).[5]
PSU/PSAs earned if stock price reaches $30 by December 31, 20XX. Award settles in **stock** upon vesting.	Yes	Within 2 days after grant date. Report on Table II as a derivative security (Code A).[5]	Within 2 days after vesting. Table II shows exempt disposition of derivative security (Code M). Table I shows exempt acquisition of stock (Code M).[5]
PSU/PSAs earned if stock price reaches $30 by December 31, 20XX. Award settles in **cash** upon vesting.	Yes	Within 2 days after grant date. Report on Table II as a derivative security (Code A).	Within 2 days after vesting. Table II shows exempt disposition of derivative security (Code M). Table I shows exempt acquisition of stock (Code M) and simultaneous exempt disposition of stock to the Issuer for cash (Code D).

1 This table only reflects reporting for shares released. Reporting for shares sold or withheld for taxes is not addressed.

2 Assume in each case the award was pre-approved by two non-employee directors and is, therefore, exempt from Section 16(b) under Rule 16b-3(d).

3 TSR (stock price appreciation plus dividends).

4 Not a derivative security for companies that pay substantial regular dividends. According to the SEC staff, this may be a derivative security if the Company pays no dividends or only de minimis dividends, such that value is derived almost entirely on appreciation is stock price. See ABA Joint Committee on Employee Benefits, SEC Q&A 9, May 6, 2008.

5 Chart shows normal reporting for grant and settlement of derivative securities. If the award may be settled solely in common stock on a one-for-one basis and may not be settled for cash, may alternatively report the grant on Table I as an acquisition of stock. In that case, upon settlement, no reporting on Table II, but Table I would report the acquisition of any additional shares earned over the originally reported target shares.

8.5. Proxy Statement Disclosure – Compensation Discussion and Analysis (CD&A).

8.5.1. US public companies are required to include in their annual proxy statements a CD&A which is a narrative description and analysis of the Company's compensation objectives, policies, and pay decisions with respect to its top five executive officers. Among the many topics required to be addressed are the Company's incentive compensation arrangements, including the reasons for the selection of specific performance measures, specific goals with respect to each measure, and the resulting performance outcomes.

8.5.2. Performance goals are required to be disclosed if they are material to the compensation decision; however, companies are not required to disclose details that would result in competitive harm. The SEC Staff has been generally skeptical of competitive harm arguments in the context of CD&A disclosure of performance goals. To the extent that a performance target level or other factor or criteria otherwise has been disclosed publicly, a company cannot rely on a competitive harm position to withhold the information. If a company does withhold information on performance goals, the CD&A must discuss the significance of the undisclosed goal, so that an investor could understand the relative degree of difficulty in achieving the goal.

8.5.3. The CD&A must also discuss whether discretion can be or has been exercised – either to award compensation absent attainment of the relevant performance goals or to reduce/increase the size of any award or payout. Companies are required to identify any particular exercise of discretion, and state whether it applied to one or more specified officers or to all compensation subject to the relevant performance goals.

8.5.4. Modification of performance goals can be a sensitive area for shareholders. To minimize the risk of a negative say-on-pay vote, be prepared to provide a thorough and compelling explanation for any such modifications or exercises of discretion.

8.6. Proxy Statement Disclosure – Summary Compensation Table.

8.6.1. The reporting of performance awards in the Summary Compensation Table is determined by whether the award is an "equity incentive plan award" covered by ASC Topic 718, which would include PSUs, PSAs, and PSOs settled in cash or stock, or a "non-equity incentive plan award" that is not covered by ASC Topic 718, such as a performance award payable in cash where the value is not determined in whole or in part on the Company's stock price. This distinction can create timing differences in the reporting.

8.6.2. Equity incentive plan awards are reported as follows:

- Reported in the Option or Stock column of the Summary Compensation Table, the same as if they were time-based awards, using the grant date fair value based on the probable outcome, excluding the effect of estimated forfeitures. The probable payout at the time of grant is always used, even if subsequent assessments change the probable outcome. If the probable outcome at the grant date is less than the maximum payout, disclose the maximum payout in a footnote to the table.
- Reported in the Summary Compensation Table for the year in which they were granted.

8.6.3. Non-equity incentive plan awards are reported as follows:

- Reported in the Non-Equity Incentive Plan Compensation column of the Summary Compensation Table. If, in the exercise of discretion, an amount is paid over and above the amount earned by meeting the performance goals, that excess should be reported in the Bonus column.[7]
- Reported for the year in which the relevant specified performance criteria are satisfied and the compensation is earned, whether or not payment is actually made in that year. In the case of separate performance periods, the disclosure is made on a tranche basis, as earned.
- Also reported in the Grants of Plan-Based Awards Table in the year of grant.
- Once the grant of the award has been disclosed in the Grants of Plan-Based Awards Table and the vesting of the award has been disclosed in the Summary Compensation table, no further disclosure is required when the award is paid.

7 Question 119.02 of the SEC Staff's Compliance and Disclosure Interpretations of Regulation S-K

8.7. Proxy Statement Disclosure – Grants of Plan-Based Awards Table.

8.7.1. When reporting performance awards (equity or non-equity incentive plan awards) in the Grants of Plan-Based Awards Table, the estimated payout based on threshold, target, and maximum performance, or the applicable range of estimated payouts, is required to be reported. For this purpose, the terms are defined as –

- Threshold – The minimum amount payable if specified threshold performance (if any) is achieved. This does not mean "zero."
- Target – The amount payable if the specified target performance level is achieved.
- Maximum – The maximum payout possible under the award.

If the award provides only for a single estimated payout, that amount should be reported as the "target" level. Provide a representative amount based on the previous fiscal year's performance if the target amount is not determinable, and provide an explanation in a footnote or in the narrative following the table.

8.7.2. This table also calls for the grant date fair value of equity awards. In the case of performance awards, report grant date fair value based upon the probable outcome of the performance conditions (which is not always the target amount), consistent with the estimate of aggregate compensation cost to be recognized over the service period determined as of the grant date under ASC Topic 718, excluding the effect of estimated forfeitures. This concept is consistent with the approach used for the Summary Compensation Table disclosure, as discussed in paragraph 8.6.2.

8.7.3. Each award should be disclosed on a separate line, identifying the plan under which it was made. Any consideration paid by the executive officer for the award should be disclosed in a footnote.

8.7.4. The narrative discussion following this table should also cover the material terms of any performance award reported in the table, including a general description of the formula or criteria to be applied in determining the amounts payable and the vesting schedule. Any performance-based conditions or other material conditions that are applicable to the award should be described, unless they would result in competitive harm as discussed in paragraph 8.5.2.

8.8. Proxy Statement Disclosure – Outstanding Equity Awards at Fiscal Year End Table.

8.8.1. Only equity-based awards are reported in the Outstanding Equity Awards at Fiscal Year End Table. These awards should be reported as follows:

- For full-value performance awards (such as PSUs and PSAs), report the number and the payout value of shares underlying the unvested awards as of the last day of the fiscal year. The market value is determined by multiplying the year end stock price by the number of shares that would be earned based on achieving threshold performance goals. If the previous fiscal year's performance has exceeded the threshold, the disclosure must be based on the next higher performance measure (i.e., target or maximum) that exceeds the previous fiscal year's performance. If the award provides only for a single estimated payout, that amount should be reported.
- For PSOs or stock appreciation rights, report the number of shares underlying unvested awards as of the last day of the fiscal year.

8.9. Proxy Statement Disclosure – Options Exercises and Stock Vested Table.

8.9.1. Report the number of shares and amount realized upon the vesting of PSUs and PSAs or the exercise of PSOs. For any amount realized upon exercise or vesting for which receipt has been deferred, a footnote quantifying the amount and disclosing the terms of the deferral must be provided.

8.10. Blackout Period.

8.10.1. A blackout period is a period during which the securities of a corporation cannot be traded by Section 16 Insiders and others who have access to material, nonpublic information about the Company and its affairs. Blackout periods are sometimes referred to as a "closed window." A blackout period is established by the Company and communicated to any affected parties in advance of or concurrently with the action triggering a blackout period. Many companies prohibit all trading by officers and directors outside of open trading window, so that all other times are considered a blackout period by default. The precise reasons for establishing a blackout period and the laws controlling it are outside the scope of this publication. A more complete discussion of blackout periods and internal controls associated with blackout periods is included in a separate GPS research publication on stock options. Details of this research and the downloadable publication are available at www.scu.edu/business/cepi/.

8.10.2. Buying or selling stock during a blackout period may carry regulatory risk, negative company publicity, and the risk of market fluctuation. The execution of any market transaction (such as a sale of shares to cover tax withholding) generally qualifies as a prohibited transaction during the blackout period. Equity Compensation should work closely with the company-designated broker to ensure the broker does not process trades during a blackout period.

Change of Employment Status

9.1. Overview.

9.1.1. Performance awards are granted to employees as part of the compensation package. Subsequent changes of employment status may delay the vesting or result in forfeiture of outstanding awards. Changes of employment status include voluntary terminations, involuntary terminations (e.g., for cause or layoffs), regular or early retirements, changes between part-time and full-time status, leaves of absence, disability, death, and change of control. The implications of a change in status on a performance award may vary depending upon the reason for the change in status (e.g., termination for cause vs. disability). In some cases a performance award will not be forfeited upon a change in status, but the potential payout will be reduced to reflect the shortening of the service period.

9.2. Impact on Financial Reporting.

9.2.1. An award may not vest due to a change of employment status or because performance goals were not met. A forfeiture of an award as a result of a change of employment status may have different accounting implications than a cancellation due to the nonattainment of performance goals.

9.2.2. To ensure proper financial reporting, understand the functionality of the stock plan system and record the forfeiture or cancellation of an award appropriately. For example, the forfeiture due to termination may be recorded differently in the stock plan system than the cancellation because performance goals were not met. A forfeiture due to termination will impact the estimated forfeiture rates and accruals of compensation expense. A cancellation because a market condition was not met will have no financial reporting impact, as discussed in paragraph 10.2.3.

9.3. Timely Notification of Changes in Status.

9.3.1. Keeping an employee's status current is critical to ensure the proper and timely withholding of payroll tax on a performance award. In addition this process will ensure that an award does not automatically vest for an employee who is no longer eligible to receive the shares.

9.3.2. Update employee data from the human resource system on a periodic basis. Verify that the effective date of change of status in the stock plan system is consistent with the human resource system. Reconcile changes of employment status between the stock plan system and the human resource system on a monthly basis and before any major stock event.

GLOBAL ISSUE

The implication of a change of employment status may differ for US employees and non-US employees. Frequently changes of employment status between the grant of a performance award and the end of the performance period or between the attainment of the performance goals and the release of the shares have dissimilar legal and tax consequences in different countries

EXHIBIT 9-1 - INTERNAL CONTROLS ASSOCIATED WITH CHANGE OF STATUS

	Illustrative Controls	Illustrative Test of Controls
1	Compare changes of employment status in the stock plan database with the human resource system monthly. Document reconciling items, research performed, and resolution of the items.	Review reconciling items for trends and unusual items.
2	Develop a process to handle late notifications of change of employment status. Include these transactions in the report on post-dated transactions and notify Finance as appropriate.	Review report of post-dated transactions. Note unusual items. Review trends to identify areas where further intervention is required.

9.3.3. When Equity Compensation is not notified in a timely manner about the change of status (such as a termination or leave of absence) for an employee, shares may be incorrectly released to the employee. Develop a process to handle the inappropriate release of shares. Involve Legal to ensure the Company's risks are considered appropriately when resolving these issues. Document the process. Late notification of changes of employment status constitutes a post-dated transaction which may result in an inadvertent modification and an accounting charge. See Exhibit 9-1 for internal controls associated with change of status.

A change of control may trigger the immediate vest of an award. This acceleration may be deemed a golden parachute as defined by IRC §280G and subject to the golden parachute excise tax. A complete discussion of IRC §280G is outside the scope of this publication.

9.4. Adjusting the Potential Payout.

9.4.1. As discussed in paragraph 3.4.3, upon a change in status the performance award may be forfeited or the potential payout may be adjusted to reflect the shortening of the service period. The award may vest immediately upon the employee's change in status or it may be delayed until the performance goals have been met under the Award Agreement.

9.4.2. The administrative requirements of adjusting the payout rate or vest date vary depending on what type of performance vehicle was used and the Award provisions. Some of the key administrative requirements when adjusting the payout rate or vest date include –

- Recalculate the adjusted payout or the number of options that vest
- Process an accelerated vesting
- Communicate changes to the employee
- Advise Financial Reporting of changes in the payout rate or vest date
- Advise transfer agent to cancel shares if necessary to reflect the adjusted payout of a PSA

Financial Reporting

10.1. Overview.

10.1.1. Calculating the financial statement impact of performance awards requires special knowledge and the Company may find it helpful to use outside resources to assist with the process. The equity compensation department may be an integral driver of the detailed accounting calculations or focused on providing data on performance awards to Financial Reporting. Equity Compensation may also be critically engaged in forecasting/budgeting exercises related to the redesign of awards or the expense impact of existing awards on future reporting periods. Regardless of the scope of responsibilities, the equity compensation professional must understand the impact of the underlying data on the valuation of the award, the allocation of the expense to the appropriate period, the calculation of EPS, roll-forward of the deferred tax asset, and compilation of the financial statement disclosures.

10.1.2. This section provides an overview of the key concepts regarding the financial reporting of performance awards. A thorough discussion of the financial reporting requirements of performance awards is outside the scope of this publication.

ASC Topic 718 broadly categorizes performance awards into two types - those with performance conditions and those with market conditions.

10.2. Accounting Classifications of Performance Goals.

10.2.1. Generally, Accounting Standards Codification (ASC) Topic 718 broadly categorizes performance awards into two types - those with performance conditions and those with market conditions. Awards that do not meet either classification would be called "other conditions." The accounting distinctions between awards with performance conditions and market conditions are significant. These distinctions are not mutually exclusive, as some awards may have a combination of performance, market, and service conditions.

10.2.2. As discussed in paragraph 3.2.2, a performance condition is a goal that is based on the internal operations or activities of the employer or the activities of peer companies, and requires that the employee provide services for a specified period of time. The goal may relate to the performance of the entire company, a division, or an individual employee. Similar to a service condition, performance conditions are not incorporated into the grant date fair value of an award; but, instead, affect the quantity of awards for which expense is accrued. Therefore, performance conditions require the Company to "true up" the compensation expense to reflect for the number likely to be paid out based on trending performance and ultimately to the number of awards earned. See Exhibit 10-1 for an example of a performance condition.

Equity compensation professionals must understand the impact of the underlying data on the valuation of the award, the allocation of the expense to the appropriate period, the calculation of EPS, roll-forward of the deferred tax asset, and compilation of the financial statement disclosures.

EXHIBIT 10-1 – EXAMPLES OF AWARDS WITH PERFORMANCE AND MARKET CONDITIONS	
Facts	A company grants 100 PSUs when the stock price is $10. The number of awards that ultimately vest will range between 0 and 200% depending on a performance goal at the end of 3 years.
Performance Condition	If the performance goal incorporates Earnings per Share (EPS), then the goal would be considered a performance condition. If 200% of target is paid out, then the Company will recognize $2,000 of expense (200% x 100 shares x $10 Fair Value). If 0% of target is ultimately paid out, then the Company will recognize $0 of compensation expense (0% x 100 shares x $10 fair value).
Market Condition	If the performance goal incorporates TSR, then the goal would be considered a market condition. Using a valuation model, the Company determines that the fair value of the award is $13.00. Regardless of the final payout amount, between 0% and 200%, the Company will ultimately recognize $1,300 of expense (100 shares x $13 Fair Value).

Further examples of Performance Conditions and Market Conditions can be found in Exhibit 3-1, paragraph 3.2.2.

10.2.3. A market condition is a goal that is tied to a stock price, either on an absolute basis or on a relative basis against comparable companies. Awards with market conditions reflect the probability of achieving the performance targets within a valuation model. Compensation cost is recognized for an award with a market condition provided the requisite service period is completed, as discussed in subsection 10.8, regardless of the ultimate payout of the performance award. See Exhibit 10-1 for an example of a market condition.

10.2.4. In general the expense of awards with market conditions is less volatile than the expense of awards with performance conditions. Some companies may prefer the "truing up" aspect of performance conditions, because it permits a reversal of compensation expense if the goal is not met. If the performance condition is met, however, the total compensation expense could be higher than it would otherwise have been with a market condition, because a market condition essentially discounts the fair value based on the probability that a market condition may not pay out.

10.2.5. An "other condition" is rare, but represents any goal not classified as a performance, market, or service condition. An example of an "other condition" would be awards that are indexed to the price of gold. An award with an "other condition" is treated as a liability award.

10.3. Vest and Payout Provisions.

10.3.1. Performance awards may have fixed vesting and payout provisions. Other performance awards may have performance goals that affect the vesting, exercisability, exercise price, or other pertinent factors as discussed in subsection 10.10 that are used in determining the fair value of an award. Broadly, the most prevalent categories of these awards are –

- Changes in the quantity of awards that vest
- Changes in the timing of vesting
- Changes in the value of awards

The categories above are not mutually exclusive. Some performance awards can fall into multiple categories, and require careful consideration in preparing the financial reporting.

10.3.2. The first category is awards with changes in the quantity of awards that vest. A performance award can be designed so that the number of awards earned ranges from a downside threshold percentage (typically 0%) to some upside outperform percentage (typically 200%) based on the degree of satisfaction of the performance goal. The goal can be based on a performance condition, a market condition or both. See Exhibit 10-2 for an example of an award where the quantity of award changes.

EXHIBIT 10-2 – EXAMPLES OF AWARD VARIATIONS	
Changes in the quantity of awards that vest	• A Company grants 100 PSUs for which: • 0% will vest if the Company's TSR is below the 25th percentile of the peer group • 100% will vest if the Company's TSR equals the median TSR of their peer group • 200% will vest if the Company's TSR equals or exceeds the 75th percentile of the peer group. The Company will interpolate payouts between those percentiles based on performance over a three-year period. *Note: This is a market condition, since vesting is contingent on stock prices. See paragraph 10.10.2 for details on how the Company will value the award.*
Changes in the timing of vesting	A Company grants 100 PSUs. The vesting will occur when the Company receives regulatory approval to market a new product offering. *Note: This is a performance condition, since vesting is contingent on an internal goal (i.e., regulatory approval). Each reporting period, the Company will need to assess the expectation for achieving the condition.*
Changes in the value of awards	A Company grants 100 PSOs when the stock price is $10 with an exercise price of $20 (a premium option). If market share increases to a pre-defined percentage, then the exercise price will be reduced to $10 (an at-the-money option). *Note: This is a performance condition, since the value of the award is contingent on an internal goal (i.e., market share). Effectively, the Company has issued 2 awards that are mutually exclusive (i.e. an individual cannot earn both the option with the $20 exercise price and the option with the $10 exercise price). Each possible payout will have a distinct grant date fair value. Each reporting period, the Company will assess their expectation for achieving the goal. Further, the Company will need to record compensation accruals based on the fair value of the outcome that is assumed, and ultimately realized.*

10.3.3. The second category is awards with changes in the timing of vesting. A performance award can be designed with vesting contingent on when a goal is satisfied. The performance goal can be based on a performance condition or a market condition. Performance awards in this category will generally either require an assessment to determine an implicit service period or a calculation on the grant date to determine a derived service period, as discussed in paragraph 10.8.2. See Exhibit 10-2 for an example of an award where the timing of vesting changes. Some awards are structured such that a performance goal is evaluated for vesting at the end of a preliminary performance period. In the event that vesting does not occur at the initial completion of the performance period, the awards will have a "second-chance" for vesting at the end of another performance period. This form of secondary testing is another example of an award where the timing of vesting changes.

10.3.4. The third category is awards with changes in the value of awards. A performance award can be designed with internal goals that affect the terms of the award in the future. This type of award is not common. See Exhibit 10-2 for an example of an award where the value of an award changes.

10.4. Performance Awards with Graded Vesting.

10.4.5. For performance awards with graded vesting, each vesting tranche requires its own distinct valuation and requisite service period. For most performance awards, this will create expense recognition patterns where more compensation expense is recognized earlier in the performance period (sometimes described as "FIN 28 accounting"). For some performance awards with independent performance conditions where the service inception date has not occurred yet, expense recognition patterns can appear similar to straight-line accounting.

EXHIBIT 10-3 – INDEPENDENT/DEPENDENT GOALS

Vesting	Graded Vesting with Independent Goals	Graded Vesting with Dependent Goals
Tranche 1 – 25%	Year 1 revenue equal to $10M	Vests when stock price = or > $10
Tranche 2 – 25%	Year 2 revenue equal to $11M	Vests when stock price = or > $11
Tranche 3 – 25%	Year 3 revenue equal to $12M	Vests when stock price = or > $12
Tranche 4 – 25%	Year 4 revenue equal to $13M	Vests when stock price = or > $13
	The goals of each vesting tranche are independent (i.e., Tranche 2, 3, or 4 can vest without any prior tranches vesting).	*The goals of each vesting tranche are dependent (i.e., Tranche 2 cannot vest unless Tranche 1 has vested).*

10.5. Independent / Dependent Goals.

10.5.1. Performance awards with graded vesting can be designed with goals for vesting tranches that are dependent on the vesting of prior tranches or are independent of the vesting of the prior tranches. The distinction is critical with respect to the service inception date, as discussed in subsection 10.7, and the requisite service period, as discussed in subsection 10.8. The applicable details are included in the terms of the Award Agreement as noted in paragraph 5.2.1. Exhibit 10-3 shows examples of independent and dependent goals.

10.6. Defining the Accounting Grant Date.

10.6.1. A grant date will generally not be established until the performance goals have been defined and a mutual understanding of the terms has been reached, assuming all other approvals have been achieved. A grant date has not occurred until all shareholder and Board approvals are obtained, unless such approval is essentially a foregone conclusion. For example, if management and Board members control enough votes to approve the plan, the vote would be considered a formality.

10.6.2. A mutual understanding of the key terms requires that the goals be communicated to an individual employee within a relatively short time period from the date of approval. A relatively short time period should consider all the facts and circumstances, but generally should be measured in days or weeks, not months.

10.7. Defining the Service Inception Date.

10.7.1. The service inception date is the date at which the requisite service period begins or when the employee begins rendering service to achieve a particular target. Usually, the service inception date is the grant date. However, the service inception date may differ from the grant date for certain performance awards.

10.7.2. Some awards have a service inception date prior to the grant date. This generally occurs in graded vesting awards when a company defines performance goals for later vesting tranches at a later time. In some circumstances, the service inception date can occur after the initial accounting grant date. This occurs when all terms are defined upon grant, the performance goals of each vesting tranche are independent, and the period of measurement has not begun.

10.7.3. Exhibit 10-4 summarizes alternative expense recognition patterns for awards with different possibilities of grant dates and service inception dates, with both dependent and independent vesting tranches. Note: Each of these performance awards has similar targets; however, they differ in the timing and method of communicating the goals. The accounting treatment is dramatically different in each situation.

10.8. Defining the Requisite Service Period.

10.8.1. The requisite service period is the period during which an employee is required to provide service in exchange for stock-based compensation. It defines the period of time that the expense of an award will be amortized. Generally, it should consider explicit, implicit, and derived service periods, depending on all of the terms of an award. Further, the requisite service period will define the period of time that compensation expense can be reversed, in the event of employee termination, as discussed in subsection 10.11.

EXHIBIT 10-4 - PERFORMANCE AWARDS WITH ALTERNATE EXPENSE RECOGNITION PATTERNS

	Dependent Conditions	Independent Conditions
Grant Date **Equal** to Service Inception Date	FIN 28 expense recognition **Example:** Tranche 1: Year 1 revenue of $10M (target determined on Year 1 grant date) Tranche 2: Year 1 vests and Year 2 revenue of $11M (target determined on Year 1 grant date) Tranche 3: Year 2 vests and Year 3 revenue of $12M (target determined on Year 1 grant date) Tranche 4: Year 3 vests and Year 4 revenue of $13M (target determined on Year 1 grant date)	FIN 28 expense recognition **Example:*** Tranche 1: Year 1 revenue of $10M (target determined on Year 1 grant date) Tranche 2: Two-Year cumulative revenue of $21M (target determined on Year 1 grant date) Tranche 3: Three-Year cumulative revenue of $33M (target determined on Year 1 grant date) Tranche 4: Four-Year cumulative revenue of $46M (target determined on Year 1 grant date)
Grant Date **Prior** to Service Inception Date	Not Possible	Effectively straight-line expense recognition **Example:** Tranche 1: Year 1 revenue of $10M (target determined on Year 1 grant date) Tranche 2: Year 2 revenue of $11M (target determined on Year 1 grant date) Tranche 3: Year 3 revenue of $12M (target determined on Year 1 grant date) Tranche 4: Year 4 revenue of $13M (target determined on Year 1 grant date)
Grant Date **After** Service Inception Date	FIN 28 (subsequent vesting tranches are re-measured until grant date for tranche is fixed) **Example:** Tranche 1: Year 1 revenue of $10M (target determined on Year 1 grant date) Tranche 2: Year 1 Vests and Year 2 revenue of $11M (target determined immediately before Year 2) Tranche 3: Year 2 Vests and Year 3 revenue TBD (target determined immediately before Year 3) Tranche 4: Year 3 Vests and Year 4 revenue TBD (target determined immediately before Year 4) Since the performance targets have not been defined for Tranches 2-4 on the initial grant date, then the accounting grant date has not been established until the performance targets are set.	FIN 28 (subsequent vesting tranches are re-measured until grant date for tranche is fixed) **Example:** Tranche 1: Year 1 revenue of $10M (target determined on Year 1 grant date) Tranche 2: Two-Year cumulative revenue of $21M (target determined immediately before Year 2) Tranche 3: Three-Year cumulative revenue of $33M (target determined immediately before Year 3) Tranche 4: Four-Year cumulative revenue of $46M (target determined immediately before Year 4) Since the performance targets have not been defined for Tranches 2-4 on the initial grant date, then the accounting grant date has not been established until the performance targets are set.

*For grants with multiple tranches, each tranche may have a different grant date.

10.8.2. The explicit service period is stated in the terms of the award. The implicit service period is inferred from the terms of a performance award and can generally be seen in performance awards with performance conditions that affect the timing of vesting. The derived service period is calculated from the same valuation techniques used to determine fair value, as discussed in paragraph 10.10.2 and can generally be seen in performance awards with market conditions that affect the timing of vesting. From the valuation model, the derived service period represents the duration of the median of the distribution of share price paths on which the market condition is satisfied.

10.9. Multiple Conditions.

10.9.1. Awards with multiple market, performance, or service conditions may have terms that specify multiple service periods. Multiple conditions may be referred to as "And/Or conditions." For accounting purposes, an award can only have one requisite service period (per vesting tranche).

10.9.2. An award that requires all conditions be satisfied prior to vesting is classified as an "And" condition award. It is critical to thoroughly understand the interrelation of multiple conditions as it directly impacts the amortization of the compensation expense. Generally, the requisite service period for an "And" condition equals the longest of possible service periods. An award that requires only a single condition be satisfied prior to vesting is classified as an "Or" condition. Generally, the requisite service period for an "Or" condition equals the shortest of possible service periods.

10.10. Valuation of Performance Awards.

10.10.1. The effect of a performance condition is not reflected in the grant date fair value. For awards with performance conditions, generally the fair value will be equal to the stock price on the grant date (absent any reductions for the lack of dividends or dividend equivalents).

10.10.2. The effect of a market condition is reflected in the grant date fair value. Awards with market conditions frequently have path-dependent features (such as an averaging period on the calculation of TSR), as well as complex features (such as vesting contingent relative to the TSR of peers). As a result, more advanced valuation techniques, such as Monte Carlo simulations, are the most common approach for valuing these awards. The fair value determined using a Monte Carlo simulation will represent the present value of all potential stock price outcomes.

10.10.3. Many performance awards today have holding periods after vesting that allow the company to reduce the fair value of the award, regardless of whether it has a performance condition or a market condition. The fair value reduction must be calculated separately using a different technique than was used to determine grant date fair value, and may require the use of an external expert.

10.11. Treatment of Forfeitures.

10.11.1. A pre-vesting forfeiture describes when an award is forfeited due to a change of employment status prior to the completion of the requisite service period. If an award is forfeited prior to the requisite service period, then any prior accruals of compensation expense will be reversed. If an individual terminates after the requisite service period, then no compensation expense will be reversed.

10.11.2. Consider an example of a termination prior to the requisite service period. A company grants 100 PSUs when the stock price is $10. Vesting occurs at the earlier of achieving a stock price of $20 or on the 4th anniversary of the grant date. Through a valuation model, the Company determines that the award has a derived service period from the stock price performance goal of three years. Further, the award has an explicit service period of four years. Since the award would vest at the earlier of the service condition or market condition, then the requisite service period would represent the minimum of the service periods, or three years. If termination occurs prior to three years and the award is forfeited, then all prior accruals of associated compensation expense would be reversed, without regard to the satisfaction of the market condition. If termination occurs after three years, then all compensation expense would be recorded for the award, regardless of the satisfaction of the market condition.

10.12. Interim Changes in Expense Amortization.

10.12.1. Estimating the change in expense may be challenging, depending on the interrelationships of different performance goals. When changes in the quantity, timing, or the value of performance awards occur, different expense recognition patterns result.

10.12.2. The impact of changes in the quantity, timing, or value of performance conditions is summarized in Exhibit 10-5. The impact of changes in market conditions is summarized in Exhibit 10-6.

EXHIBIT 10-5 – EXPENSE RECOGNITION PATTERNS FOR PERFORMANCE CONDITIONS

	Impact on Expense	Example
Changes in Quantity	Cumulative Effect	A company grants 100 PSUs with a three-year cliff performance period. The payout can range from 0-200% of target based on EBITDA targets. Initially, the Company expects to pay out at 100% and amortizes the expense over the three-year period. At the end of Year 2, the Company revises the assessment to 150%. The Company takes a cumulative charge to reflect for the additional shares expected to vest.
Changes in Timing	Prospective Change	A company grants 100 PSUs such that vesting will occur when the Company receives regulatory approval to market a new product offering. Initially, the Company assumes that regulatory approval will occur in 3 years. At the end of Year 1, the Company revises the assumption to assume that regulatory approval occurs in 5 years. The Company will prospectively amortize any unrecognized compensation cost over the new requisite service period of 5 years (no adjustment for the cumulative effect).
Changes in Fair Value	Cumulative Effect	A company grants 100 PSOs with a four-year explicit service period when the stock price is $10 with an exercise price of $20 (with a fair value of $2). If product market share increases to a certain percentage, then the exercise price will be reduced to $10 (with a fair value of $5). Initially, the Company assesses that the performance goal will not be met, and the Company amortizes $2 over the four-year service period. At Year 2, the Company assesses that the performance goal will be met. The Company takes a cumulative charge to reflect for the additional value based on the new exercise price.

EXHIBIT 10-6 – EXPENSE RECOGNITION PATTERNS FOR MARKET CONDITIONS

	Impact on Expense	Example
Changes in Quantity	None	A company grants 100 PSUs such that 0%-200% will vest dependent on the TSR over a three-year period relative to a peer group. Using a valuation model, the Company determines on the grant date the fair value of the awards is $13. The Company initially amortizes $1,300 (100 x $13) over three years. At the end of Year 1, the Company determines that it is most likely that 200% will be paid out. Despite the assessment that 200% will be paid out, there will be no changes in prior, current, or future expense recognition because the fair value incorporates the probability of all potential performance outcomes.
Changes in Timing	None; acceleration of unrecognized expense if vesting occurs	A company grants 100 PSUs when the stock price is $10. Vesting occurs at the earlier of achieving a stock price of $20 or on the 4th anniversary of the grant date. Through a valuation model, the Company determines that the award has a derived service period from the stock price performance goal of three years. The Company initially amortizes over the three-year requisite service period. If the Company achieves a stock price of $20 during Year 1, the Company will immediately accelerate any unrecognized compensation expense.
Changes in Fair Value	None	A company grants 100 PSOs with a four-year explicit service period when the stock price is $10 with a strike price of $20 (with a fair value of $2 per). If Company TSR increases to a certain percentage, then the exercise price will be reduced to $10. The economic impact of this market condition is considered in the valuation model. The single fair value produced by the model is then expensed over the requisite service period.

10.13. Earnings per Share Requirements.

10.13.1. Performance awards are often considered a contingency in applying the guidance in ASC Topic 260 – Earnings per Share. At the end of each reporting period, the Company is required to measure the quantity of awards that would have been paid out if the performance period had ended during the reporting period. The Company applies the Treasury Stock method to the shares considered issuable based on that measurement as long as the awards are not participating securities.

10.13.2. A company may need to calculate a different quantity of awards expected to vest under ASC Topic 260 than what is used for recognition of compensation expense under ASC Topic 718. For example, a company issues 100 PSUs that vest when annual revenues exceed $10,000,000. Even though the Company is recognizing compensation expense at target for ASC Topic 718 (which represents what the Company ultimately expects to vest), under the contingent share provisions of Topic 260, the incremental awards would not be included until the Company revenue exceeds $10,000,000 (which represents what would vest if the performance period ended today).

10.14. Plan Design Challenges.

10.14.1. Small changes in plan design or communication can sometimes yield large changes in financial reporting. Exhibit 10-4, paragraph 10.7.3, summarizes examples of expense recognition for performance awards with only minimal changes in the goals and the timing of communication. In those examples the accounting ramifications were dramatically different. Exhibit 10-4 underscores the importance of a close integration between Financial Reporting and plan design.

10.14.2. As a result of ASC Topic 718, it is increasingly important that companies expand the role of Legal and Finance on the plan design team and encourage a greater degree of participation and coordination among team members. Many of these same personnel will also be involved in documentation and testing the Company's internal controls over stock-based compensation.

10.15. Quarter-End Checklist.

10.15.1. At the end of each fiscal reporting period, several steps need to occur for the financial reporting process. Close coordination is required between Equity Compensation, Human Resources, Finance, Corporate Tax, and third-party providers. The financial reporting process at many companies involves many disparate internal and external systems, the involvement of many departments, and significant manual intervention. Robust internal controls are necessary to ensure the validity of the financial reporting process. Some of the required steps for quarterly financial reporting include –

- Reconcile awards forfeited and cancelled prior to the end of the requisite service period to the expense amortization schedule
- Assess the probability of payout for awards with vesting contingencies
- Assess the timing of vesting for all performance awards
- Determine the appropriate payout multiplier for purposes of determining "contingently issuable shares" under ASC Topic 260
- Compute the cumulative effect adjustment (or prospective adjustment, if appropriate) of any changes in payout multiplier and/or vesting timing assumptions
- Interface with the Corporate Tax department to ensure the roll-forward of the deferred tax asset matches changes in the expense amortization schedule
- Ensure a multi-layer review occurs, with a particular focus on any manual spreadsheets driving the calculations
- Reconcile final current period expense to forecasted expense of prior reporting periods

See Exhibit 10-7 for internal controls associated with financial reporting.

EXHIBIT 10-7 - INTERNAL CONTROLS ASSOCIATED WITH FINANCIAL REPORTING		
	Illustrative Controls	**Illustrative Test of Controls**
1	Summarize each report used for the valuation and accrual. Define the purposes of the report. Define each field and how each number is calculated. Enumerate what is included and excluded. All individuals that generate the report or use the report should sign off the report summary. Review and update the summary after each update of the stock plan system.	Confirm that there were no changes in the reports used for the period. If the report has changed, confirm that all appropriate people have signed off the revised report description.
2	Develop and implement a procedure to assess the probability of the attainment of the goal and communicate the probability and any changes in the probability to appropriate parties as necessary.	Confirm that the process is followed.
3	Develop and implement a procedure to validate the information included in each report. Document that the validation procedure is followed prior to releasing the information to the group responsible for the valuation.	Confirm that the validation procedure is followed.
4	Prepare a quarterly audit narrative to document the process used for financial reporting, including the assumptions used and the decisions made.	Review the audit narrative on quarterly basis.

10.16. Outsourcing.

10.16.1. The Company may outsource certain aspects of performance awards for financial reporting purposes such as valuing the award, calculating the period expense, and tracking performance for diluted EPS purposes. Multiple vendors may be used for valuing the awards and handling ASC 718 reporting. If these functions are outsourced, clearly define responsibilities for maintaining and validating data. Close coordination is required between the Company and a third-party to ensure a clear understanding of responsibilities of each party and the source of required data. In addition, the parameters of all reports must be described in detail to minimize misunderstandings and inconsistencies.

10.16.2. Many administrative and software platforms have the capability to effectively meet the requirements of ASC Topic 718 for some types of performance awards. Given the complexity of accounting guidelines and the significant potential for unique design features in performance awards, standard capabilities should be carefully evaluated to determine suitability.

10.16.3. The valuation of performance awards with market conditions under ASC Topic 718 generally requires a Monte Carlo simulation to determine fair value. Further, many performance awards today (regardless of the type of condition) also contain post-vesting holding periods, which allows the company to reduce the fair value of the award for this forced period of illiquidity. Many companies require the use of an outside specialist for the Monte Carlo simulation or assessment of the holding period's effect on the fair value.

10.16.4. The tracking of performance is handled differently across companies, typically based on the complexity of plans. Absolute awards with performance conditions are usually already tracked by the Finance team, but tracking of performance for relative awards or awards based on market conditions may be outsourced to ensure accuracy and transparency.

Appendix A: Acknowledgements

The Certified Equity Professional Institute (CEPI) at Santa Clara University would like to acknowledge the substantial contributions that made this publication possible. Significant support was provided by our Title sponsors, Bank of America Merrill Lynch, E*TRADE Corporate Services, Fidelity Stock Plan Services, Morgan Stanley Smith Barney, Transcentive, Hay Group, and Radford, an Aon Hewitt Company. These leading firms have generously underwritten the major costs associated with this project. Additional support was provided by our Contributing sponsors, Alston + Bird LLP, Baker & McKenzie LLP, Ernst & Young LLP, and Equity Methods. By sponsoring this research project, these industry leaders have made it possible for all Issuers and service providers to benefit from comprehensive standardized industry guidelines. It is not possible to complete a project of this magnitude alone. Such an undertaking requires the perspectives and inputs of a diverse group of industry experts. This publication is the culmination of extensive interviews, in-depth analysis and a widespread technical review. The guidance and inputs of members of the Technical Oversight Board provided invaluable expertise throughout the project to ensure that the publication captures an industry-wide perspective.

The 2020 update to this publication was completed by Dan Kapinos, CEP, and Amanda Benincasa, CEP.

Dan is a Partner and the East Coast Practice Leader for Aon's Equity Services Team, providing expertise, service and advice surrounding equity compensation to more than 600 companies, including plan design considerations, performance metric selection and goal setting, reporting requirements under ASC Topics 718 and 805 and IRC 280G, corporate governance analytics, performance tracking and more. Dan has a degree in statistics from the Pennsylvania State University. Dan also maintains the Certified Executive Compensation Professional (CECP) designation through World@Work. He is a frequent national and international speaker and writer on a variety of equity compensation topics. Dan has also served as the President of the NASPP Philadelphia Chapter, and currently sits on the Executive Advisory Committee for the NASPP.

Amanda Benincasa is a Director and the East Coast Practice Leader with Aon Equity Services, the equity valuation and accounting group within Aon Rewards Solutions. Her background consists of valuation and technical accounting for equity, handling topics including employee stock options, restricted stock units, performance share awards, restricted stock awards, repurchases, IPOs, and an array of SEC reporting responsibilities (10Q/K, Proxy, Forms 4/5, etc.). She is an industry speaker, addressing topics related to equity valuation and accounting, and has written several articles surrounding the same topics. She serves on the Board of Directors of the NASPP Boston Chapter.

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The CEPI would also like to acknowledge the substantial contributions of Terry Adamson, CEP, of Radford, an Aon Hewitt Company, and Fred Whittlesey, CEP, from Hay Group. As National Practice Leader for Radford Valuation Services, Terry's extensive experience with financial reporting and valuation enabled him to translate the complex and confusing components of financial reporting into detailed examples and illustrations to provide a practical "how-to-guide" in the Financial Reporting section. As Senior Consultant with Hay Group, Fred's many years in the compensation consulting field have contributed to his vast knowledge of every type of plan design. Fred's knowledge, experience, and passion for design were instrumental in drafting the Design section.

Laura Thatcher, Partner, Alston + Bird LLP, also went well above and beyond in providing meaningful and relevant input on Section 16 and proxy reporting.

As an independent, academic organization the CEPI is proud to respond to the needs of the equity compensation industry by providing guidance on performance awards.

Additionally, the CEPI is fortunate to have a dedicated and supportive Advisory Board. The Advisory Board initially recommended that the CEPI pursue independent research projects, and the Advisory Board has been actively involved throughout the project.

Appendix B: Common Equity Compensation Terms

Accepted Terminology	Equivalent
ASC Topic 718	Accounting Standards Codification topic covering stock compensation
Award Agreement	Employee stock agreement; Grant Agreement; Agreement
Blackout Period	Period of time in which designated individuals cannot trade securities of a corporation
Board	Board of Directors
Book Entry	Electronic recording of stock ownership where no certificate is given to securities broker
Broker	Brokerage Firm; Securities Dealer; Registered Broker; Stock Broker
Cancellation	The annulment of a performance award as a result of nonattainment of a performance goal; An accounting term
Cash- Settled	An award which pays out in cash rather than in stock
Ceiling	A maximum payout regardless of additional, incremental performance
Certification	Validation of achievement of performance goals, typically by the Board of Directors or a sub-committee of the Board
Clawback	Contractual right to recover gains from equity compensation in certain circumstances
Cliff Vest	Entire award vests in full on a single date
Common Stock	Capital stock; Securities
Compensation Expense	Expense; Compensation cost
Compensation Income	Income; Compensation
Deferral	An optional or mandatory election to delay payout of an award beyond vest date to a later date

Accepted Terminology	Equivalent
Derivative Security	For Section 16 reporting, awards that have a value derived solely from the value of an equity security
Director	Member of the Board of Directors; Board member
Dividend	A distribution of profits paid to owners of company stock
Dividend Equivalent	A payment to holders of unvested stock units that mimics a dividend paid stockholders
Employee Trading Restrictions	Restrictions for employees on trading company stock
Exchange Control	Restrictions on inbound and outbound transfer of local currency
Exercise	To implement the rights of an option to purchase shares at a predetermined price
Fair Market Value	FMV
Floor	A minimum payout on a performance award, regardless of the level of performance achieved
Forfeiture	The annulment of a performance award which never vests as a result of a change of employment status; An accounting term
Fungible Share Pool	A reserve of shares in a plan used to settle different types of awards granted under the plan; Different types of awards may be counted differently against the reserve
Graded Vesting	Incremental schedule over which vesting requirements are met
Grant	Award
Grant Date	Date of grant; Option date
Insider	Affiliate
IRC	Internal Revenue Code
IRC Section 83(b) Election	US tax election to include the FMV of property received (less any amount paid for the property) in the year of transfer
Issuer	Company that "issues" stock, may be privately held or publicly traded

Accepted Terminology	Equivalent
Market Condition	A performance goal that is related to company stock price
Modification	A change to the terms of the award; An accounting term
Net Exercise	An exercise of an option where the Company withholds some of the underlying shares to cover the option price
Non-Derivative Security	For Section 16 reporting, awards that have a value NOT derived solely from the value of an equity security
Payout	The process of determining the amount to be paid on the award; Sometimes refers to the release of shares, as well as the payout of the award
Peer Group	An identified list of companies to be used as a reference point for compensation and performance
Performance Award	Performance stock unit; Performance stock award; Performance stock option
Performance Condition	A performance goal that is NOT related to company stock price
Performance Goal	A particular level of attainment on a performance measure
Performance Measure	The basis for the assessment of a performance goal
Performance Stock Award	Shares awarded for no cost contingent upon achieving associated performance goals and meeting the requisite service period
Performance Stock Option	A stock option granted with vesting or price contingent on achieving associated performance goals and service requirements
Performance Stock Unit	A promise to award shares for no cost in the future contingent on achieving associated performance goals and meeting the requisite service period
Plan	Employee stock option plan
Release	Transfer of shares to the employee
Restricted Stock Award	RSA; Equity award in which stock is issued, usually at no cost, subject to vesting restrictions
Restricted Stock Unit	RSU; Equity award in which a promise is made to issue stock, usually at no cost, when vesting restrictions have been met.
Same-Day-Sale	SDS; Exercise of an option and simultaneous sale of shares through a broker

Accepted Terminology	Equivalent
SEC	Commission; Securities and Exchange Commission
Second-Chance Shares	Awards that have a secondary chance to vest when the original goal was not achieved
Sell-to-Cover	Shares sold from award to cover tax obligation
Service Period	The time over which an employee earns the award
Settlement	Transfer of unrestricted ownership of an award through payment of cash or stock
Shares	Stock
Share Reserves	The pool of shares that has been authorized for issuance under a stock plan; Share pool
Stock-Settled	An award which pays out in stock rather than in cash
Stock Option	Equity award in which the right to purchase stock at a fixed price for a fixed period of time is granted, may be subject to vesting restrictions.
Stock Plan Brokerage Account	Brokerage account established specifically for company stock plan transactions
Target	Expected level of performance
Tax Withholding	Withholding
Threshold	Minimum level of performance required for any payout
Total Shareholder Return	Return on investment of stock in a company, including stock appreciation and dividends; TSR
Variable Payout	A sliding scale of payout that is adjusted for varying levels of performance
Vest	Award no longer subject to substantial risk of forfeiture
Withhold-to-Cover	Shares withheld from award to cover tax obligation

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The Certified Equity Professional Institute (CEPI) at Santa Clara University is the only source of professional certification for equity compensation professionals. The CEPI is a non-profit, academic organization with a mission of establishing, promoting, and providing certification and continuing education for the equity compensation industry.

Since its founding in 1989, the CEP Institute self-study curriculum has served as the industry's educational standard. Organizations and individuals use Institute exams as a measurement of knowledge, skills, and abilities related to equity compensation administration. The three levels are:

Level 1 (basic). Those who pass this exam become Equity Compensation Associates (ECAs).

Level 2 (intermediate)

Level 3 (advanced). Those who pass this exam become Certified Equity Professionals (CEPs).

The CEPI curriculum covers accounting, corporate and securities laws, taxation, and equity plan design, analysis, and administration, ensuring that CEP designees have achieved a required level of expertise in all of the relevant areas of equity compensation. More than 65 percent of the Fortune 1000 have CEPs supporting their stock plans.

As the only source of professional certification in equity compensation, the CEPI recognizes and understands the critical need for impartial guidance in this area. The CEPI has undertaken a series of research projects titled *GPS: Guidance | Procedures | Systems*. The other GPS publications include:

- GPS | Global Equity Plans
- GPS | Restricted Stock and Restricted Stock Units
- GPS | Stock Options
- GPS | Employee Stock Purchase Plans
- GPS | Participant Education and Communication: Case Studies

The GPS publications can be accessed at www.scu.edu/business/cepi/.

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Global Equity Plans

A Research Study of the
Certified Equity Professional Institute

GPS

guidance | procedures | systems

2024 Edition

SANTA CLARA UNIVERSITY

Index

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Introduction

In 2007, the CEPI launched an initiative to provide unbiased, university-based research to address risk assessment and identify best practices for the equity compensation community. The project was titled GPS – or Guidance, Procedures and Systems. Since that time, the CEPI has published six research documents, each addressing a different facet of equity compensation. This publication – previously titled "Global Stock Plans" – was originally released in 2009. Since that time, the use of global equity plans has become much more common, as companies are operating in multiple countries. Emphasis has been given to areas of risk that are independent of a specific country. Country-specific information is provided through links to information available on the internet, ensuring the information is up to date. The title has also been updated to reflect the use of all types of equity awards (not just stock plans).

The original publication was authored by Carol Rutlen (see bio) and updated by Valerie Diamond of Baker McKenzie LLP. This current release was updated and edited by Marlene Zobayan of Rutlen Associates LLC, with assistance from Denise Glagau of Baker McKenzie LLP and Elizabeth Dodge, CEP, of Equity Plan Solutions, LLC.

Bank of America Merrill Lynch, Fidelity, Computershare (Transcentive), Alston+Bird, Baker McKenzie LLP, EY, Global Tax Network, James F. Reda & Associates LLP and PwC sponsored the original publication. The updated version was sponsored by: Baker McKenzie LLP, Bank of America Merrill Lynch, Charles Schwab, E*TRADE Corporate Services, Fidelity Stock Plan Services, Morgan Stanley, Solium, and UBS Equity Plan Advisory Services.

1.1. Overview.

Special attention must be paid when implementing and maintaining equity plans for non-US employees. Although most companies administer grants and other equity award transactions from corporate headquarters, company actions must conform to local requirements. Local country tax/legal requirements may be different. Local country resources (e.g., Human Resources, Payroll, system functionality, etc.) may be different. While corporate processes may be replicated in each country, local country adjustments may be required which can be costly and time-consuming.

1.2. Scope.

1.2.1. This publication addresses the key concepts and challenges associated with awarding equity compensation to non-US employees of US-headquartered, publicly traded companies. For purposes of this publication, non-US employees are employees working in a country other than the US. They are employed by a subsidiary or other affiliate of the US issuing company in that country and on a non-US payroll. Issues related to granting equity awards to employees of a professional employer organization (PEO) or an employer of record (EOR) as well as independent contractors are not within the scope of this publication. A non-US employee may be a citizen of his or her work country, a citizen of the US or a citizen of a non-work, non-US country. Other GPS publications address the administrative requirements and internal controls for awards granted to US employees working in the US. (Note – All GPS publications can be accessed at www.scu.edu/business/cepi/.)

1.2.2. This publication focuses on awards with time-based vesting such as nonqualified stock options, restricted stock, and restricted stock units. Where appropriate, administrative complexities and local country requirements are noted for employee stock purchase plans. A discussion of performance awards is outside the scope of this publication. See Appendix B for a glossary of common equity compensation terms used in this publication.

1.2.3. While the administrative processes associated with grants, equity award related transactions, and tax/payroll issues are discussed in detail, no country-specific information is provided. In addition, the design of plans for non-US employees, legal issues, accounting issues, and other related items are summarized at a high level. Thus, these sections do not provide comprehensive information and some Key Considerations noted at the end of the section are not covered in the narrative. Where appropriate, internal controls are identified, alternative approaches discussed, and best practices summarized. At the end of each section Key Considerations are summarized for subsequent review with a company's service provider(s). The final section provides guidance when converting the concepts addressed in this publication into an action plan.

1.2.4. Effective for interim and annual periods ending after September 15, 2009, the FASB Accounting Standards Codification (ASC) is the single source of authoritative reference for nongovernmental US generally accepted accounting principles (US GAAP) for financial statements. As a result, existing references to US GAAP standards are replaced by new references to ASC Topics. In general, the codification retains the existing rules of US GAAP. Stock compensation as addressed in FAS 123R is included in ASC Topic 718.

Equity awards and associated processes can be varied and complex. This publication is not intended to cover every possible contingency. The processes described represent standard practice, but each company's processes may differ to reflect their unique needs and resources. These recommendations should be considered general guidelines and applied as appropriate. Topics covered in this publication may need to be considered within the particular facts and circumstances of a company. Consult tax and/or legal counsel to determine applicable requirements in specific countries. Refer to the other GPS publications for equity compensation basics and general administration. All GPS publications are available on the CEPI website at cepi.scu.edu.

1.3. Public Comment.

1.3.1. The CEPI invited individuals and organizations to send written comments on all matters in the draft publication. All comments received were reviewed and incorporated as appropriate into this final document.

Design of Plans

2.1. Overview.

In certain cases equity awards may not be a suitable reward vehicle for non-US employees.

2.1.1. Designing a total rewards package that includes equity compensation for non-US employees can be very challenging. The use of US-based equity plans for non-US employees may seem to be a simple solution, but in certain cases the results are inefficient and ineffective for such employees. Alternatively, the use of country-specific plans may recognize the unique needs of each employee group or the local culture, but these plans are frequently time consuming and costly to administer. This section discusses factors to consider when designing a total rewards package that includes equity compensation for non-US employees.

2.1.2. The design of equity plans for non-US employees is usually the responsibility of Corporate Human Resources with input from the local Human Resources department and others. (See paragraph 2.5 for a discussion of the team approach.) The first step in choosing the right equity vehicle is to define the role of equity compensation in the total rewards package. The purpose(s) may be to attract and retain employees, to provide long-term incentive compensation, to provide similar benefits to all employees, to align employees' interests with those of the shareholders, etc.

2.1.3. The next step is to analyze the demographics of the non-US employees. Factors to consider include –

- Country of eligible employees
- Number and level of employees in each country
- Average salary by country
- Anticipated employee growth by country (e.g., the Company is building a new facility in a country)
- Anticipated employee attrition by country (e.g., the Company plans to sell a portion of the business in a country)
- Employee perception of the "value" of equity compensation
- Company culture

2.1.4. In certain cases, equity awards may not be a suitable reward vehicle for non-US employees. The employee demographics or the tax consequences of equity vehicles may be different in non-US countries. US tax-advantaged plans such as Incentive Stock Options (ISOs) and Section 423 plans do not carry the same tax benefits outside the US. For example, some countries tax restricted stock at the grant date rather than the vest date. The country-specific labor laws may have a significant impact on how an award is treated when an employee terminates or takes a leave of absence. In addition, administrative costs such as compliance with securities registration requirements may be substantially greater in other countries. In countries with such limitations a cash bonus may be a more suitable incentive than an equity award.

2.2. US vs. Non-US Employee Characteristics.

2.2.1. Non-US companies may grant different types of equity awards or equity awards with different terms and conditions than those granted by US companies and, as a result, equity awards granted by US companies may be less familiar to non-US employees. Communication with non-US employees regarding equity awards may need to be tailored for key countries and in many countries more basic education regarding equity programs may be required. In some countries written communication, which can include legal plan documents and award agreements in addition to employee communication, may be legally required to be translated into the local language.

2.2.2. Frequently the size of awards to non-US employees may be less because total competitive compensation is less. In addition, when equity is directly linked to base salary, awards in low-base-salary countries may result in very small awards that are costly to administer when compared to the value delivered to the employee. For example, a non-US employee may participate in a Section 423 plan, but only be able to acquire 20 shares of company stock in each purchase period because the contributions are limited to a percentage of base salary. When the employee sells the shares, the transaction fees associated with a sale of 20 shares may be significant. The net proceeds and the perceived benefit received by the employee may be significantly less than that of an average US employee. In such cases, a company may balance the benefit to the employee against the cost of administering such a plan and decide not to offer the same benefit to employees in certain countries.

2.3. Due Diligence.

Prior to designing an equity compensation plan or extending current equity awards to non-US employees, a company should have a high-level understanding of the impact on employees and the cost to administer a plan. By undertaking country-specific due diligence and estimating the cost of the Plan before making final design decisions, future problems and costs can be avoided.

2.4. Design Flexibility.

Any equity plan should incorporate flexibility to accommodate the needs of non-US locations.
For example –

- The definition of fair market value, for purposes of taxable value calculations may vary under local law (e.g., see Section 4.5.3 for further details)
- The local country may specify how a company must withhold tax and forbid certain withholding tax methods
- Currency restrictions may impact the employees' ability to remit funds to exercise options or purchase ESPP shares or impose other requirements on the company and/or the employees
- Certain types of equity awards may have tax advantages in some countries similar to ISOs or Section 423 plans in the US
- Employment termination benefits under local law may conflict with vesting and post-termination provisions (e.g., retirement, death) in the Plan
- Beneficiary designations may be ineffective in some countries
- Payment of dividends and dividend equivalents may create tax or securities issues
- Forfeiture and clawback provisions may be illegal or unenforceable in certain countries
- Retirement provisions that accelerate vesting or continue vesting may be discriminatory (e.g., in the European Union)
- Excluding part-time employees, employees on a leave of absence, or temporary employees from participating in equity plans may violate local law
- Local labor law may override Plan provisions (e.g., extend the vesting schedule beyond that in the grant terms) resulting in a modification under ASC 718

Wherever possible, design the Plan to provide maximum flexibility to incorporate country-specific requirements. In some cases, it may be necessary to modify a Plan for certain countries where tax benefits or regulatory requirements create the need for specialized terms or provisions. This can be done by an addendum to the Plan or by the use of country-specific plans, subplans or award agreements, with proper considerations to address employee transfers into or out of such locations. Occasionally countries require that the Plan be approved by the local tax or regulatory authority prior to making any grants. The Plan may give the company's board of directors or compensation committee, rather than its shareholders, authority to adopt the addendum or subplan. However, if the addendum or subplan modifies the terms of the Plan in a material respect, shareholder approval may be required. Consult legal counsel to determine if shareholder approval is required to adopt the addendum or subplan.

2.5. Team Approach.

Designing an efficient and effective Plan for non-US employees requires a team approach. Most companies utilize outside legal or tax counsel to determine the local country legal and tax requirements. Country-specific administrative requirements should be reviewed by the stock broker(s) and/or third-party administrator. As the chart below illustrates, team members and appropriate responsibilities typically include, but are not limited to:

Group	Responsible For
Human Resources	Purpose of the Plan, specific award types, size of awards and the employee's perception of the benefit
Equity Compensation	Issues associated with administering the Plan
Local Payroll	Processing withholding and reporting through the local country payroll system
Corporate and Local Finance	Financial reporting, valuation and the recognition of the expense associated with the award
Legal	Country-specific legal requirements, including plan filings, and litigation
Local Country Representation	Needs of the local entity, including Human Resources, to administer the Plan and facilitate employee communications
Treasury	Cash flow issues and reconciliation
Tax	Impact on the Company's tax provision/agreements to charge the equity costs to the local company and identification of appropriate tax rulings

KEY CONSIDERATIONS

- What are the goals of using equity compensation as part of the total rewards package for non-US employees?
- In which countries are the eligible employees located and how many are in each country?
- Is the intent to mirror current Plan provisions on paying dividends (or dividend equivalents), accelerating or continuing vesting upon retirement, methods of paying applicable tax, and achieving specific tax advantages?
- In which countries will the number of employees increase in the future?
- In which countries will the number of employees decrease in the future?
- Are there certain countries where the current employee population does not warrant the cost associated with implementing an equity compensation plan?
- Is it a priority to minimize the tax costs of equity benefits to non-US employees?
- Is it a priority to maximize corporate or subsidiary tax benefits from equity plans?
- Is the goal to provide the same equity benefits to all employees or will the benefits be modified to incorporate country-specific benefits?
- What are the important cultural differences regarding compensation?
- Has preliminary due diligence been completed to determine the major tax and legal consequences (including a review of pending regulatory or tax law changes), impact on employees, and the cost to administer the Plan?
- Are country-specific administrative requirements supported by the stock brokers(s) and/or third party administrator?
- What Plan provisions need to be modified to address the needs and requirements of non-US employees?
- What Plan provisions can be added without shareholder approval?
- What Plan provisions require additional shareholder approval?
- If different types of awards (e.g., stock options, restricted stock, or cash) are considered, what are the accounting implications?
- Can the existing administration system handle the proposed Plan design, including the timing of taxable events?

Legal Issues

3.1. Overview.

3.1.1. Companies and employees are subject to a variety of legal requirements relating to equity awards. Each country has different legal requirements that govern equity compensation. It is important to understand and follow the requirements in each country where employees will be receiving awards under the Plan. In many cases the legal issues must be addressed and resolved before the first award is granted.

3.1.2. The responsibility for addressing the legal requirements usually resides with General Counsel and the corporate legal group. The Equity Compensation department may assume responsibility for certain legal requirements and may be responsible for administering filing requirements. The local entity also may be involved in meeting the legal requirements.

3.1.3. This section reviews the most common legal issues and discusses various requirements. Determining the legal requirements in each country can be challenging. Most companies use outside legal counsel to determine the local country requirements. Since each country may have different requirements, best practice is to develop a country-specific administration guide summarizing the key requirements and update this guide on a regular basis or as legal requirements change. See Appendix C for an example of a country-specific administration guide.

3.2. Securities Law.

3.2.1. Securities law requirements may exist in each country or jurisdiction (e.g., EU) where employees receive equity compensation. Equity compensation (e.g., transferable and non-transferable options, restricted stock/restricted stock units for no cash consideration, ESPP rights/options, and various plan structures/trust arrangements) may be considered a security under local law. An Issuer (i.e., Company) offering a plan or rights under a plan may need to comply with a variety of securities law requirements. These requirements include registering the Plan and/or the shares, preparing a prospectus, including an exemption notice in a sub-plan or grant agreement and/or filing for exemption from registration/prospectus requirements. (For a link to a current list of countries that may require local country securities filings or other requirements, see Appendix D.) The Issuer also may need to be licensed as a broker/dealer in the jurisdiction or use a licensed broker to place shares in the local jurisdiction. Employees may be subject to resale restrictions or a requirement to obtain an exemption to sell shares. Directors of Issuers' foreign subsidiaries may be subject to special reporting requirements when they acquire rights to shares or sell shares.

3.2.2. The filings may be dependent on a variety of factors including number of employees receiving a grant, type of award (e.g., options vs. RSUs), total value of the grants, type of shares offered (i.e., treasury vs. newly issued), or the qualification for specific-country exemptions. Registration fees may be assessed on the initial filing. In addition, the Company may be required to make appropriate disclosures to employees. Subsequent filing and employee disclosures may be mandated and the associated fees may be significant. Special care must be taken to monitor changes in corporate structure since certain changes, such as new entities as a result of reorganizations or mergers and acquisitions, may trigger or modify filing requirements.

Caution – This section is an overview of the legal issues associated with global equity plans and is not intended to address country-specific requirements. Noncompliance with local law may result in civil and criminal penalties. Consult with legal counsel to determine the country-specific requirements and the risks of noncompliance.

3.2.3. Securities requirements and the penalties for noncompliance vary by country. It is imperative to understand the securities requirements and the cost of complying with the requirements. In many countries securities filings must be completed prior to granting awards to employees. Develop a process to monitor the securities laws in each country in order to timely identify what impact a change will have on the Company.

3.3. Employee Trading Restrictions.

3.3.1. Certain employees are subject to additional legal requirements when trading shares. A non-US employee may be a Section 16 officer and required to file SEC Forms 3, 4, and 5 in the US. Individuals (US and non-US) are not permitted to buy or sell company stock while in possession of material, nonpublic information of that company regardless of how the information was acquired. Trading restrictions may also exist in non-US countries and impact the timing of when a non-US employee can receive grants, acquire shares or sell shares.

3.3.2. Employees need to understand their personal responsibilities (under local law and US law) to comply with the appropriate requirements. Develop and implement a program to educate US and non-US employees of their responsibilities. Educating employees is the cornerstone of compliance and should not be underestimated.

3.4. Labor Law.

3.4.1. Equity awards are typically granted to employees at the discretion of the Issuer. In certain countries, any benefit made as part of the employment agreement or regularly offered by an employer may be an "entitlement" or may become an "acquired right" which cannot easily be taken away or adjusted. The value of that benefit could be automatically included in the calculation of severance benefits on termination. If a company regularly grants awards or communicates their value as part of compensation paid by the employer (not the Issuer), the award may be considered an entitlement of employment. In that instance, the award may no longer be deemed discretionary and the employee may have the right to receive such awards in the future. Publishing grant dates in advance may increase a company's exposure to having equity awards become an "acquired right." Charging the cost of the equity program to the local entity as discussed in paragraph 8.2 may also increase exposure.

3.4.2. Proper structuring of equity awards, appropriate wording of the Award Agreement, and closely monitoring other employee communications discussing equity awards (e.g., the local employee handbook) can minimize the risk of the award becoming an acquired right. Appropriate action will vary by country but may include specifying that the award is not part of compensation or is not a reward for past service. In some countries it may be appropriate to specify the equity award is specifically excluded from severance or to terminate vesting when the active employment period ends. When hiring a new employee, do not reference the equity award in the offer of employment. Communicate the award in a separate letter on Issuer (usually the parent company) letterhead.

3.4.3. Discrimination rules differ in each country and equity awards may be structured differently in response to local country rules. For example, some Plans include provisions that awards vest or continue vesting upon retirement. If the retirement provisions are age-based, local law may consider the provisions discriminatory against younger workers. The retirement provisions in equity awards may need to be revised to reflect local country discrimination rules. Some countries regulate the exclusion of part-time and fixed-term employees. Participation in an ESPP may be restricted to employees working 20 hours or more a week, or five months or more a year. Such restrictions may not be acceptable under local law, thereby requiring a revision in restrictions on plan participation.

3.4.4. Many countries have different legal definitions of what constitutes part-time employment, full-time employment, or Leave of Absence. Certain countries also provide legal protections when an employee changes employment status (e.g., a company may not be allowed to revise the award or extend the vesting schedule for an award when an employee changes from full-time to part-time status). Review the local country requirements carefully and incorporate the requirements into the procedures in that country.

3.4.5. Other labor issues that should be addressed under local law, if necessary, include –

- Consulting with or notifying labor unions or works councils regarding implementing, changing, or terminating an equity plan
- Continued vesting or extended exercise periods for terminated employees
- Restrictions on changes to or termination of an equity plan
- Reporting requirements for pay equity purposes
- Translation requirements for equity-related documentation

3.5. Exchange Control and Foreign Ownership Limitations.

Some countries monitor or restrict the flow of money and securities in and out of the country. The conversion of local currency to/from another currency or the purchase/sale of stock may require prior approval or reporting of the transaction after it has occurred. Approval may be required for each transaction or may be secured once and apply to all similar transactions of the local entity and/or the employee. The employee may be required to repatriate funds immediately to the home country. All funds may need to be transferred through a designated bank account. In some countries exchange control and foreign ownership limitations may effectively eliminate the use of equity awards as part of the total rewards package. In some countries, foreign currency restrictions can be avoided through the use of cash-settled awards paid by the local employer.

3.6. Data Privacy.

In the EU and an increasing number of other countries, personal data (i.e., any data that identifies the individual) is subject to certain protections. The collection and processing of personal data and the transfer of personal data from an employee or affiliate in such country to the US (or other country) and onward to third-party service providers may violate data privacy laws unless there is a valid basis on which the company can rely to collect, process and transfer the data and/or certain safeguards are in place to protect the data being transferred to another country. These protections may apply to the employee data that is collected, processed and transferred across borders when initiating or processing equity awards and should be considered before offering an equity program outside the US.

3.7. Employee Communications.

3.7.1. A country may specify what employee disclosures are required regarding equity awards. Each country may mandate what information must be included, if the information must be translated into local language, and the communication medium (e.g., electronic vs. hard copy).

3.7.2. The documents supporting change of life events such as divorce and death will vary country to country. The process that requires the submission of appropriate documentation to substantiate the event should be flexible to accommodate country differences.

3.8. Employee Stock Purchase Plans.

3.8.1. Certain legal restrictions may apply when administering an ESPP for non-US employees because a stock purchase plan involves collecting funds from the employees to pay for the purchase of stock. Usually, employees pay for the stock through a payroll deduction. In some countries, the Company must seek the approval of the local union or works councils or a government agency to take a payroll deduction from the employee. In other countries a payroll deduction is not permitted, but the employee can make a cash payment to the employer (or the issuing company) to purchase the stock. Local law may require the Company maintain a separate bank account to hold the funds collected from the employee or pay interest on the funds held for the employee. Local labor law may also require the Plan be open to all employees, rather than restrict participation of part-time and fixed-term employees. Review the Plan to determine if these actions are permitted under the Plan. If appropriate, a subplan or separate offering may be used for non-US participants in the ESPP to accommodate local requirements. The subplan may not need to meet the technical requirements (e.g., $25,000 annual limit) under IRC Section 423 if the offering is to foreign subsidiaries outside of the 423 offering restrictions.

> An employee stock purchase plan (ESPP) is a plan that allows an employee to buy stock in the employer company. Employees who are US taxpayers participating in an ESPP will have preferential US tax treatment if the Plan meets the requirements of IRC Section 423. Such plans are typically referred to as Section 423 plans. The US tax advantages provided by Section 423 plans do not apply in other countries. In some cases companies may implement an ESPP plan that will not qualify as a Section 423 plan for US and non-US employees. Care should be taken to include specific requirements needed to address international issues and country-mandated processes in ESPP plan documents.

3.8.2. Currency conversions can also impact how the Plan is administered. For example, funds will be withheld from the employee in local currency, while the payment for the shares will occur in US dollars. Determine when the local currency will be converted to US dollars and what exchange rate will be used for the conversion. Common practice is to convert the funds contributed during the applicable purchase period to US dollars at or around the date of purchase and use the exchange rate on the day of conversion.

3.8.3. If the Plan has a US dollar limit on the number of shares that can be purchased, determine how the limit will be applied to non-US employees. Fluctuation in exchange rates during the period may have a significant impact on calculating the US dollar limit.

3.8.4. The definition of compensation that is eligible for payroll deductions may not anticipate the types of compensation received by non-US employees (e.g., 13th month salary) so the plan definition should include flexibility for such differences to be addressed in a way that does not run afoul of any local rules or any Section 423 requirements in the case of a Section 423 ESPP.

3.9. Implementation Strategy.

Understanding and meeting the various legal requirements under local law is difficult and costly. Closely monitor legislative and regulatory changes in each country. Carefully assess the risks associated with noncompliance. Enforcement of the requirements may change in the future and result in retroactive assessment of penalties. In some countries it may be cost effective to avoid certain types of equity awards or use cash plans or bonuses in lieu of equity.

KEY CONSIDERATIONS

- Are securities or exchange control filings or notifications required?
- Have the required filings been made and approvals received before granting awards?
- What are the costs of the appropriate filings?
- Does the calendar of important dates include requirements for all countries?
- Are employee/award recipient headcounts being tracked in each country?
- Are employees advised about applicable trading restrictions?
- Does the grant of equity compensation become an acquired right and entitle the employee to future grants?
- What action can be taken to minimize the likelihood of equity awards being treated as an acquired right?
- Does equity compensation require special consideration to be excluded from the calculation of severance payments or retirement benefits?
- Are equity awards to new hires excluded from the offer of employment?
- Do discrimination laws permit the exclusion of part-time employees from participating in certain equity plans?
- Do the vesting schedules or exercise periods extend beyond termination?
- Are there any restrictions on changes to the Plan (including terminating the Plan)?
- To what extent are labor unions or works councils required to be involved in the use of equity compensation?
- Can/must the employee convert funds into local currency from the sale of stock?
- Is a local financial institution required to be an intermediary for cash flows in or out of the country?
- Can the employee continue to hold company shares after exercising an option or the vesting of restricted stock/restricted stock units?
- Are there any restrictions on the transfer of funds from the local entity to the issuer?
- Do data privacy laws restrict the flow of information related to the administration of the equity plan?
- Have the appropriate releases been received from employees to allow for the required flow of data to administer the equity plans?
- What documents are required to be supplied to the employees?
- What documents are required to be translated into local language?
- Can employee communications be electronic?
- Does the Company need permission of the labor authorities or other regulatory body to take payroll deductions for ESPPs?
- Are there any restrictions on withholding payroll deductions from employees for ESPPs?
- Are the employee contributions to the ESPP required to be held in a separate bank account?
- Is interest required to be paid on employee contributions to the ESPP?
- Are employees allowed to hold company shares after an ESPP purchase?
- What are the risks for noncompliance with legal requirements?
- How will changes in local tax laws and regulatory requirements be monitored for ongoing compliance?
- Do other types of equity compensation (or cash awards) have the same legal requirements?

Grant Process

4.1. Overview.

When an employee receives compensatory equity awards accounted for under the equity method as provided in ASC 718, the fair value of the award is determined at the grant date. Confirmation of the details of the grant term is critical to validate the expense and establish the proper accrual period. The general grant process for US employees, including common areas of risk and illustrative controls, is discussed in other GPS publications, but may be equally applied to non-US employees. This section discusses additional issues applicable specifically to non-US employees. The grant process for non-US employees is usually controlled at the corporate level with input from the local entity.

4.2. Grant Size.

The size of the grants to non-US employees may be determined by –

- Adapting the US standard to a local application (e.g., a percentage of the US standard)
- Applying a global standard (i.e., the same job gets the same award regardless of the location of the employee)
- Using a local standard (e.g., a percentage of salary)

When applying the grant guidelines, the actual work country of the employee is normally used to determine the appropriate grant size.

4.3. Administration.

4.3.1. Although the majority of the grant administrative process is at the corporate level, the local entity may be involved in initiating the grant (i.e., recommending employees for the award), and reporting the award (i.e., reporting the grant to the local tax or other regulatory authorities). Exhibit 1 summarizes the key grant processes and responsibilities. Note, however, that the involvement of the local entity in the plan administration may impact the taxation or employer tax responsibilities, and/or may have labor implications in some countries.

EXHIBIT 1 - GRANT PROCESS AND RESPONSIBILITIES

Grant Process	Responsibility of	
	Corporate	Local Entity
Initiating the Grant – Recommending the equity award for an employee	X	X
Authorizing the Grant – Approving the award by the appropriate party	X	
Recording the Grant – System of recording awards in the equity plan database	X	
Processing the Grant – Finalizing the Award Agreement, notifying the employee, and processing appropriate disclosures	X	
Managing compliance for the Grant – Completing compliance filings and obtaining securities, exchange control and other approvals	X	X
Reporting the Grant – Providing information for financial statement purposes and to local tax authorities	X	X

Since each country may have different requirements, best practice is to develop a country-specific administration guide summarizing the key requirements of each location.

4.3.2. Internal controls implemented for the grant process to US employees generally apply to non-US employees since the plans are administered in the US. When certain responsibilities for administering aspects of the Plan are handled by the local entity, appropriate internal controls must be implemented by the local entity. For example, updating employee status and demographic data is frequently handled by the local entity. Keeping this information up to date requires close coordination between the local and corporate Human Resource groups. To minimize errors, develop a standard process to update employee data and, where possible, automate updates from the human resource system to the equity plan database. Use unique global identification numbers for all employees. Communicate the importance of updated data to the local entity and establish critical dates for data to be updated. Personnel in the local entity should work with the Equity Compensation department to periodically compare employee data in the equity plan database to the local country human resource system and/or payroll system. See paragraph 6.10 for the unique requirements of mobile employees.

4.3.3. Administrative processes will vary by country. Some countries may require the grant of an award be reported to the tax authorities. Some countries may tax the award at the grant date. Since each country may have different requirements, best practice is to develop a country-specific administration guide summarizing the key requirements of each location. Some of the items to be addressed in the guide are –

- Definition of FMV for tax purposes
- Grant price restrictions for tax-favored awards
- Restrictions on timing of the grant
- Restrictions on the sale of the underlying shares
- Required tax and legal filings
- Considerations on available or mandated tax withholding settlement methods
- Corporate tax deduction position
- Taxability of awards, including favorable tax treatment
- Reporting the grant to the tax, securities or exchange control authorities
- Required income and/or social tax withholding
- Required communications and legal disclosures (and any applicable translations)
- Trustee requirements
- Holding periods
- Letters of Authorization
- Special documents and communications provided to employees at the time of grant such as applicable exchange rates, trustee agreements, country-specific tax documents, or Frequently Asked Questions (FAQ) approved by the local tax authorities.

See Appendix C for an example of a country-specific administration guide.

4.3.4. Awards that are taxable at grant are problematic. In most cases the award is subject to restrictions that preclude the sale of some or all of the underlying shares to pay the associated tax. An employee is required to pay the tax from other personal assets. Such awards may not be viewed as desirable by employees. Best practice is to avoid awards that are taxable on grant and use awards with a more favorable tax treatment.

4.3.5. Some companies use country-specific coding when recording grants in the equity plan database to allow for easy identification of awards that require special handling in certain countries. For example, to identify employees who move between the grant, vest, and/or exercise date the process may include using a country-specific prefix when numbering grants (e.g., FR456 for an award to a French employee or UK789 for an award to a UK employee) or a country-specific code recorded at the grant level. At the taxation point, compare the current location of the employee to the country-specific coding of the grant. If the current location and code do not match, investigate locations where the employee has moved between grant to taxation point and determine if the transaction requires special handling.

4.3.6. Companies may utilize a third-party administrator to handle all or part of their equity plan administration. For an outsourcing arrangement to work effectively, the Company and the third-party administrator must work closely together. Processes, responsibilities, and specific handoffs must be clearly defined. Any special requirements for handling non-US employees and country-specific requirements must be highlighted.

4.4. Legal Issues.

4.4.1. Certain legal issues discussed in Section 3 must be considered when granting an award. For example, avoid granting awards that vest during a period when employees may be restricted from trading shares. Data privacy requirements may impact what information can be transmitted from the local entity to the parent or third-party administrator. (See paragraph 3.6.) A company may wish to limit the involvement of the local entity in the grant process to minimize exposure to labor law issues. (See paragraph 3.4.) Minimizing the involvement of the local employer may also impact tax withholding and reporting requirements in addition to the payment of employer social tax.

(See paragraph 6.4.2.) Some companies require Board approval for country-specific terms in the Award Agreement.

4.4.2. To minimize labor law issues, the Issuer should advise non-US employees of equity awards instead of relying on the local entity or management. The written communication of the award may include appropriate local country language; however, it should be prepared by the Issuer. In addition, when hiring non-US employees, grants by a US Issuer to employees of a non-US affiliate should not be included in the standard offer letter from the local employer. The award should be offered in a separate document from the US Issuer reflecting appropriate language for the local country.

4.4.3. If any exchange control, securities, and/or other filing/approvals are necessary, the Issuer should plan for this in advance of the grant. Filings and approvals normally must be completed before grant documents are prepared and distributed to employees and the timing/disclosure requirements should be incorporated into the grant process.

4.5. Terms of the Award.

4.5.1. Any award made to non-US employees must meet the Plan requirements. As noted in paragraph 2.4, the Plan should be flexible to accommodate the tax and legal needs of non-US countries. For example, a one-year cliff vest may be utilized to meet the requirements for a tax-favored plan in a specific country even though the standard vesting schedule is quarterly over four years without a cliff. In some cases, a local subplan may be required. Wherever possible, standardize award terms to minimize the potential of human error when processing the grant.

4.5.2. Some countries may require the use of a trustee to administer the Plan or hold the shares that have been granted in order to secure specific tax benefits. In countries where a trustee is utilized, review all country-specific requirements. Highlight additional administrative requirements such as the drafting of Letters of Authorization in the country-specific administration guide.

4.5.3. It is important to note the distinction between the definition of FMV in the Plan and for local tax purposes as the definitions may differ and the application of each must be understood for proper equity plan administration. For example, the Plan definition of FMV may be the price at market close and the Plan may limit an option grant price to a price no greater than FMV using the Plan definition. A local country definition of FMV may be different (e.g., the average stock price over the month preceding the grant) and it may be applicable to determine whether an award receives tax-favored treatment. The Plan also may use a definition of FMV for purposes of determining the value of shares withheld to cover tax withholding and that definition may differ from a local country definition of FMV used for tax valuation calculations. Both FMV definitions must be understood to operate withholding properly. As discussed in paragraph 2.4 the design of an equity plan should incorporate flexibility to accommodate the country-specific definition of FMV where necessary to grant tax-favored awards or to manage tax withholding or settlement.

4.5.4. Prior to establishing the grant price of a stock option, review the definition of FMV under local law and the provisions of the applicable Plan. If the country-specific definition of FMV is not permitted under the Plan, investigate alternatives. If the FMV under local law is less than the FMV for US purposes, additional steps may be required to avoid accounting issues associated with granting options at a discount, as well as tax issues for US taxpayers. Many companies set the grant price as the higher of FMV on the date of grant or FMV as defined under local law.

4.5.5. Some countries also may require a certain period of time during which options are not to be exercised or shares are not to be sold to obtain a tax benefit. These holding periods should be carefully considered when determining the timing of a grant and built into the Award Agreement and/or the subplan.

4.6. Award Agreements.

4.6.1. The Award Agreements for non-US employees must be tailored to incorporate country-specific requirements. Companies use a variety of approaches in developing Award Agreements including –

- One Agreement for all US employees and one Agreement for all non-US employees
- A standard Award Agreement for all employees with an appendix for country-specific terms
- Specific Award Agreements for each country

In deciding which approach to use, balance administrative ease with country-specific requirements. Ensuring the correct version of the Agreement is utilized is critical since Award Agreements change periodically. More companies are using standardized Agreements with an appendix for country-specific terms to minimize the need to maintain various Award Agreements and to manage mobile employee compliance.

4.6.2. Some provisions that should be incorporated in Award Agreements for non-US employees are –

- International date format (or clarification on date format used)
- Clarification of currency used (many countries use the term "dollar" to denote their currency)
- Appropriate provisions regarding the collection, processing and transfer of employee personal data in accordance with data privacy regulations
- Different grant dates, vesting schedules or exercise restrictions to reflect country-specific blackout periods
- Different expiration dates to reflect country-specific requirements
- Flexibility to withhold taxes or pay purchase price in a variety of ways (e.g., selling shares or withholding shares to pay required tax)
- Flexibility to change or add tax withholding or shift employer social tax liability to the employee
- Flexibility to implement different terms for grants to non-US employees (e.g., cash settled restricted stock units)
- Restrictions on the issuance or sale of shares in compliance with non-US securities and exchange control rules
- Deletion of or clarification regarding references or statements applicable only to US taxpayers (e.g., 83(b) elections and ISOs)
- Appropriate disclaimer language for "acquired rights" and other labor law issues
- Identification of appropriate governing law and venue for legal disputes (note that these may not always be enforceable but may be at least a deterrent to legal claims being brought in non-US jurisdictions and being governed by non-US law)
- Validity of electronic delivery of Plan information
- Validity of electronic acceptance of an award
- For any translated Plan documents, a notation that the English version supersedes the local language version (unless otherwise required by law)
- Impact of change of status of employee (e.g., leave of absence)
- Impact of part-time status on vesting schedule
- Clarification of the termination date and notice period for purposes of determining the grace period under the Plan (i.e., the termination date may be defined differently under local law)
- Definition of "eligible compensation" for contributions to an ESPP
- Flexibility to segregate contributions and hold in bank account until purchase of ESPP shares

Consult legal and/or tax counsel to determine what provisions should be included for each country. Note – Certain grant terms may affect the value of the award for accounting purposes or the accrual period.

4.7. Employee Communication.

4.7.1. ASC 718 requires that the key terms and conditions of an award be mutually understood by the employer and employee at the grant date. The key terms and conditions of the award are expected to be communicated to an employee within a relatively short time after the date the award was approved. Notifying employees on a timely basis takes into consideration the location of the employee, the complexity of the company, global use of equity, etc.

4.7.2. Some companies require an employee accept a grant to document that the employee was notified of the award and to agree to tax withholding and other grant terms. Companies use a variety of methods to indicate acceptance. The format for accepting an award may be specified or restricted in certain countries. Many companies require non-US employees to accept an award, even though US employees may not be required to accept awards. Requiring acceptance may be helpful to provide support for the Company's position with regard to labor law issues discussed in paragraph 3.4. Formal acceptance may also avoid potential problems under local law. Electronic signatures may not result in an enforceable award agreement if there is uncertainty as to the employee's identity or consent. There also may be some terms in the award agreement (e.g., data privacy consent) that are not legally binding if electronic acceptance is used. Many companies still use electronic signatures for simplicity and consistency even though electronic signatures may be problematic as they may not carry the same weight as formal signatures under local law. It may be difficult to obtain employee acceptance for grants that do not involve voluntary participation or exercise (e.g,. restricted stock units). Some companies have turned to relying on "deemed acceptance" whereby an award that is not accepted or rejected by the employee by a certain date will be deemed to have been accepted. Depending on the country and the types of terms and conditions attached to the award, this may or may not be considered an effective acceptance. Consult legal counsel to determine the requirements for each country and the risks of noncompliance.

4.7.3. Employee communication is critical to ensuring the non-US employees understand their award, the potential benefits of the award, how to participate in elective programs (e.g., ESPP), the way the award will be administered, and employee tax treatment of the awards and filing requirements. Many countries have implemented specific regulations on what information must be distributed to employees and what documents must be translated into local language. Employee communications may need to be tailored for each country.

4.7.4. Date and time differences can be problematic for employees working outside the US. Communication regarding expiration dates should clearly indicate how the date and time will be administered (e.g., local date/time vs. headquarters date/time). Common practice is to use headquarters date/time for all employees.

4.7.5. Some companies limit employee communication to that required under local law. Additional communication is viewed as an expense that can be avoided. The attractiveness of reducing current administrative costs should be balanced against the benefits of a strong communication program and the long-term cost of employee misunderstandings. A country-specific communication strategy recognizing cultural differences can increase employees' perception of the benefit provided and understanding of the process. Best practice is to develop a communication strategy incorporating local input for all key countries and translate documents into local language when English is not widely understood. Headquarters should drive the process to ensure the local input is appropriately incorporated and local translations properly reflect Company policy and procedures.

4.7.6. US regulations may require the key terms of the awards, including any non-US terms, be communicated to non-US employees in a prospectus document. There are differing views as to whether companies must include the tax consequences for non-US employees in the prospectus. Best practice is to include the following general information for each non-US country as a prospectus supplement –

- A description of the taxable event
- Income and social tax consequences
- How the taxable amount is calculated
- The timing of tax payments
- How tax will be collected
- What information will be reported to the tax authorities
- Exchange control and foreign account or shareholding reporting requirements
- A statement that employees should consult their own tax advisors

4.7.7. Effective employee communication must balance the needs of the employee against the cost and benefits to the employer. It is not appropriate for the employer to provide tax advice to employees. At the same time providing employees with general information of their responsibility regarding their associated tax liabilities could reduce the employer's responsibility regarding non-compliant employees and reduce the number of questions directed to the Issuer or local employer about the plan.

KEY CONSIDERATIONS

- Have the grant practices for awards to non-US employees been clearly defined?
- Have country-specific administration guides been developed to summarize all key requirements for each country with employees participating in equity plans?
- Have additional controls been implemented to reflect the responsibilities of the local entity?
- Have the specific data privacy requirements been met?
- Are equity awards made to non-US employees excluded from the offer of employment and addressed in a separate document?
- If necessary, are country-specific grant terms included in grant resolutions?
- Are country-specific requirements permitted under the Plan?
- Are country-specific requirements incorporated into the Award Agreement?
- Is the most current version of the Award Agreement used?
- Is a local country trustee required for the Plan?
- Does the country define FMV the same as the US?
- Does the Plan allow for different FMVs in different countries?
- If FMV is determined differently under local law, have the accounting implications been considered?
- Is the employee notified of the award on a timely basis?
- Is the employee required to formally accept an award?
- Is the Company required to furnish the employee with specific Plan information and documents?
- Is electronic distribution of Plan documents acceptable under local law?
- Do employee communications need to be translated into the local language?
- Are electronic signatures acceptable locally?

Transactions

5.1. Overview.

5.1.1. The economic benefit of an equity award becomes available to the employee when restrictions on the award lapse (i.e., the award vests). The timing and mechanics vary according to the type of award. The most common types of equity awards are discussed below –

- Stock option – An employee who holds an option may exercise the option and purchase the underlying shares of stock any time after the option is vested and before the term of the option expires, provided there are no legal restrictions prohibiting the exercise. To exercise the option (purchase the shares at the price specified in the Award Agreement), the employee must pay the grant price that is specified in the Award Agreement. The employee receives the underlying shares and can hold or sell the shares.
- Restricted stock – When restricted stock is granted, shares are issued. The shares are non-transferable and subject to restrictions that lapse at a future date.
- Restricted stock units – Restricted stock units are a commitment from a company to issue stock in the future. The stock is not issued at the time of grant. When restricted stock units vest, shares are issued and released to the employee.

Note – This publication assumes that for restricted stock and restricted stock units the release of the underlying shares occurs at vest and is not deferred to a later date.

5.1.2. The processes associated with these awards, common areas of risk, and illustrative controls for US employees are discussed in other GPS publications. The processes and associated internal controls from the other GPS publications are also appropriate for non-US employees. This section discusses additional issues applicable specifically to non-US employees. The associated legal issues are discussed in Section 3. The associated tax and payroll issues are discussed in Section 6.

The majority of non-US employees elect to exercise their stock options using a "cashless" or "same-day-sale" exercise

5.2. Stock Options – Administration.

5.2.1. Generally, a stock option vests over time and requires continued employment during the vesting period. After the options vest, they can be exercised. Although not mandatory in most countries, the majority of non-US employees elect to exercise their stock options using a "cashless" or "same-day-sale" exercise if permitted under local law. This means that the employee exercises the option to purchase the shares and immediately sells the shares received by exercising the option. The proceeds of the sale are used to pay the grant price specified in the Award Agreement and taxes, if any. Some countries or companies may impose a holding period for the shares and a same-day-sale may not be appropriate. (See the GPS | Stock Options for a discussion of other methods of exercising stock options.) The steps in the same-day-sale process are –

- Step 1 – Employee exercises the option by purchasing the shares at the grant price
- Step 2 – Employee simultaneously sells the shares acquired in Step 1 with the assistance of a broker
- Step 3 – The proceeds are distributed as follows:
  - o Grant price of the option is distributed to the US company

- Required tax withholding, if any, is distributed to the local entity or the US company that subsequently distributes the funds to the local entity for remittance to the appropriate tax authorities
- Net proceeds (less any transaction fees) are distributed to the employee

Exhibit 2 summarizes the steps in a same-day-sale. Paragraph 5.5 discusses the processes and issues associated with opening a US stock plan brokerage account for a non-US employee.

EXHIBIT 2 – SAME-DAY-SALE

Facts	Option granted to acquire 100 shares of stock at $10/share. FMV on the date the option is exercised = $50/share. Non-US employee is required to have tax withheld at a 30% rate on the difference between the FMV on the date of exercise and the grant price. The amount withheld for tax is distributed to the local entity and the local entity remits the tax to the local tax authorities. No transactional fees are paid on sale of shares.
Step 1	Employee exercises the option Option to acquire 100 shares of stock for $10/share = $1,000
Step 2	Shares acquired are sold 100 shares sold for $50/share = $5,000
Step 3	Proceeds distributed $1,000 US company (grant price of the option) $1,200 Local entity [tax withheld ($5,000 – 1,000) x 30%] $2,800 To non-US employee $5,000 Total proceeds

5.2.2. The same-day-sale process is similar for US and non-US employees. The mechanism for collecting the tax and distributing the proceeds may vary. For example, the method of distributing the sales proceeds may differ in each country. The funds may be distributed directly to the non-US employee, to the local (non-US) entity, to a trustee administering the Plan, or to a special bank account in the country as part of the currency control requirements. Paragraph 6.5 discusses the most common methods of collecting the tax on the award and distributing the proceeds. Paragraph 5.4.5 discusses the impact of converting the proceeds into local currency.

5.2.3. Some countries provide an opportunity to qualify for tax advantages, such as lowering social taxes or delaying the taxable event. To qualify for these tax advantages the Plan may require that certain conditions need to be met, e.g. a certain amount of time between the award of a grant and the exercise of a grant or between the exercise of the grant and the sale of the shares. Employees in certain countries may also be required to sell the shares immediately due to tax and legal requirements. These restrictions may be included in the country-specific subplan or addendum discussed in paragraph 2.4.

5.2.4. The administration of the vesting and exercising of the awards is at the corporate level. When the option vests, the equity plan database indicates the award is vested. The company-designated broker(s) is updated on the award status either through a manual or automated process. The local entity may be involved in the distribution of the sale proceeds or in reporting the award (i.e., reporting the vest or exercise to the local tax authorities). Exhibit 3 summarizes the key processes and responsibilities.

EXHIBIT 3 - OPTION EXERCISE PROCESS AND RESPONSIBILITIES

Exercise Process	Responsibility of		
	Employee	Corporate	Local Entity
Initiating the Exercise – Employee initiates the exercise	X		
Authorizing the Exercise – Verifying that the option is available for exercise (i.e., the option has not expired, there is no blackout period in place, and the employee status is current)		X	X
Recording the Exercise – Recording the exercise and sale in the equity plan database		X	
Processing the Exercise – Processing the exercise, sale, and distribution of the sales proceeds		X	X
Reporting the Exercise – Providing information to the employee, the local entity, and the local tax authorities	X	X	X

5.2.5. The exercise of the option is initiated by the employee. Date and time differences can be problematic if an option is exercised on the expiration date of the award. For example, an employee in Taiwan may hold an award that expires on 30 June at 11:59 p.m. Pacific Time. 30 June 11:59 p.m. Pacific Time is the same as 1 July at 2:59 p.m. in Taiwan. Communication regarding expiration dates should clearly indicate how the date and time will be administered (e.g., local date/time vs. headquarters date/time).

5.2.6. Non-US employees also may have restrictions on when their options may be exercised. For example, the employee may be subject to legal restrictions (e.g., country-specific insider trading rules) or contractual limits (e.g., restrictions imposed on country-specific plans). See Section 3, Legal Issues, for a discussion of legal issues associated with equity awards.

5.2.7. Companies take different approaches as to advising employees about options that are nearing expiration. In many cases companies are reluctant to assume responsibility for notifying employees because this process may make the Company responsible should the employees not exercise the option prior to expiration. Notifying employees of expiring options may be more important for non-US employees since the employees may be unclear as to their responsibilities in order to exercise an option. Best practice is to adopt a policy regarding notification of employees of expiring options and consistently follow the policy. Some companies have implemented automatic exercise programs whereby an option that is going to expire is automatically exercised (e.g., by a net exercise that does not require the employee to take any action to pay for the shares); this can be problematic for tax or legal reasons in some non-US countries so advice should be sought from the Company's advisor(s) before extending such a program outside the US.

5.3. Restricted Stock and Restricted Stock Units – Administration.

5.3.1. The vest process and subsequent release of shares to the employee requires minimal employee involvement. Close coordination is required between the broker, third-party administrator, transfer agent, Human Resources, Payroll, and the Equity Compensation department. For purposes of this publication, we have assumed that the vest of the shares and release of the shares occur at the same time.

5.3.2. The administration of the vest is at the corporate level. Tax withholding may be required. See Section 6, Tax and Payroll Issues, for more details. Shares released to an employee may be subject to local country legal restrictions. See Section 3, Legal Issues, for more details. The local entity may be involved in reporting the award (i.e., reporting the vest to the local tax authorities). Exhibit 4 summarizes the key processes and responsibilities.

Best practice is to develop a country-specific administrative guide that incorporates country-specific vesting requirements.

5.3.3. The vesting process may vary in each country. Best practice is to develop a country-specific administrative guide that incorporates country-specific vesting requirements including –

- Determination of FMV for tax purposes
- Withholding and reporting requirements
- Special instructions to the broker
- Restrictions on distribution of shares or proceeds of the sale of shares

EXHIBIT 4 - RESTRICTED STOCK AND RESTRICTED STOCK UNITS VEST PROCESS AND RESPONSIBILITIES

Vesting Process	Responsibility of		
	Employee	Corporate	Local Entity
Processing the Vest/Release – Processing the vest and release of the shares		X	
Recording the Vest/Release – Recording the vest, release of shares, and collection of applicable tax in the equity plan database		X	
Reporting the Vest/Release – Providing information to the employee, the local entity, and the local tax authorities	X	X	X

5.4. Internal Controls.

5.4.1. Internal controls associated with the exercise of options and vest/release of restricted stock or restricted stock units to non-US employees are similar to those used for US employees. The transactions are normally administered in the US. The corporate Equity Compensation department generally –

- Verifies the award is valid
- Confirms all securities and exchange control requirements have been met
- Records the transaction
- Determines the FMV of the shares on the transaction date
- Calculates the tax withholding
- Facilitates the disbursement of cash from the sales proceeds, if any
- Facilitates the issuance of shares to the company-designated broker

In addition, Equity Compensation works with the company-designated broker to implement procedures to ensure the employee trading restrictions discussed in paragraph 3.3 are followed.

"Termination" as defined by the Plan may be different than termination of employment defined under local law.

5.4.2. When certain responsibilities for administering aspects of the Plan are handled by the local entity, appropriate internal controls must be implemented at the local level. For example, the local payroll group may be responsible for reporting the transaction to the tax or exchange control authorities. Controls regarding payroll reporting are discussed in Section 6.

5.4.3. The determination of employee status requires special attention when an employee terminates. "Termination" as defined by the Plan may be different than termination for employment defined under local law. In certain countries, a "notice period" may be required even if the employee is not required to work during that time. The termination date under the Plan may be when the notice period ends or when the employee ceases work. Consult tax or legal counsel to determine what constitutes termination in accordance with the Plan in specific countries.

5.4.4. Supporting employees in multiple countries frequently means dealing with a separate payroll system with different system requirements and capabilities in each country. Additional controls are required to maintain data integrity. Document all payroll requirements in the country guide, including format of the data and key dates.

5.4.5. Administration of equity awards for non-US employees frequently requires currency conversion. The underlying stock is valued in US dollars. The sales proceeds and/or tax withholding may be in US dollars and subsequently converted into local currency. Taxable income and associated tax withholding are reported in payroll and to the local tax authorities in local currency. See Exhibit 5 for an example of the impact of currency fluctuations on the exercise of an option.

EXHIBIT 5 – CURRENCY FLUCTUATION	
Facts	Proceeds of the sale of shares = US $100
	Award is taxable when exercised
	Sales proceeds wire transferred to the employee
	Rate of exchange on date of exercise and same-day-sale is US $1 = 28 local currency
	Rate of exchange on date of wire transfer is US$1 = 25 local currency
2,800 local currency = taxable income (using exchange rate on the date of sale)	
2,500 local currency = proceeds wire transferred to employee (using exchange rate on date of wire transfer)	

To accommodate the required conversion to/from US dollars and local currency, work with Treasury and Finance to formalize a currency exchange policy summarizing the methodology used to determine the exchange rate for various activities including, but not limited to –

- Reporting the income and withholding
- Transfer of sales proceeds, if any, to the employee trustee or local bank account
- Transfer of tax withholding to the local entity
- Internal financial reporting

In some countries, there is a prescribed exchange rate that must be used for purposes of calculating the taxable amount for tax withholding and/or reporting purposes.

Identify which party (e.g., the Company or the employee) bears the risk of any currency fluctuation.

5.4.6. Additional controls regarding the handling of cash may be necessary. When a broker is involved in the transaction (e.g., same-day-sale), the broker collects the grant price and the tax withholding, if any, from the proceeds of the sale of stock. The grant price and the tax withholding are transferred to the Company (either the corporate headquarters or the local entity). The transfers of funds, including wire transfers directly from the broker to corporate or the local entity, should be reconciled monthly at a minimum.

5.4.7. The Company may outsource certain aspects of Plan administration. The controls discussed above will apply regardless of whether or not the Company outsources Plan administration; however, the group responsible for implementing the controls may differ. In all cases, the Company maintains ultimate responsibility over the activities. Some companies outsource Human Resources and/or Payroll. If these functions are outsourced, additional controls must be implemented to ensure the data transfers are accurate, timely, and complete.

5.5. US Stock Plan Brokerage Account for Non-US Employees.

5.5.1. Establishing a US stock plan brokerage account for non-US individuals can be challenging. A US stock plan brokerage account may be used to hold shares received from an equity award, hold dividends paid on shares, facilitate the sale of shares, and receive the proceeds of sales. When a non-US person opens a US stock plan brokerage account, a Form W-8BEN and appropriate documentation must be completed by the non-US individual and provided to the broker. The Form W-8BEN remains in effect for a period starting on the date the form is signed and ending on the last day of the third succeeding calendar year, unless a change in circumstances makes any information on the form incorrect. (Note – US citizens and residents should complete Form W-9 and not Form W-8BEN regardless of where they reside.)

5.5.2. Generally a stock plan brokerage account must be established for an employee prior to the exercise of an option or the vest of restricted stock/restricted stock units since the shares from the award will be transferred into the account. An account may also be necessary for employees participating in an ESPP. Implement a monthly process to identify which employees have not activated a stock plan brokerage account and follow-up with employees. Develop a process to handle awards where the account has not been activated. This is especially important for restricted stock and restricted stock units as the Company, rather than the employee, initiates the transaction.

5.5.3. Some brokerage firms require 24 hours to open a stock plan brokerage account. This can be problematic if an employee waits until the expiration date to exercise an option and has not previously established an account with the brokerage firm. It may not be possible to establish the account prior to the option expiring. Identify such timing requirements and communicate the requirements to all employees.

Generally a stock plan brokerage account must be established for an employee prior to the exercise of an option or the vest of restricted stock/restricted stock units.

5.5.4. The proceeds of the sale of shares received from an equity award are typically deposited in the US stock plan brokerage account. Frequently the non-US employee transfers the funds from the US stock plan brokerage account into an account (e.g., bank account) in their country of residence. Brokerage firms may support different methods of transferring funds. The most common ways to transfer funds are by wire or check. The transfer can be denominated in US dollars or local currency. A fee may be charged to send and/or receive a wire transfer. Common practice is for the employee to bear the cost of the wire transfer. If the amount is denominated in local currency, the employee usually bears the risk of any currency fluctuation.

5.5.5. In some cases a company account is used to facilitate the sale of shares received from an equity award. With a company account, employees do not open individual accounts with the broker. Instead, the company holds an account which is used to aggregate employee transactions. A company account may be used in various situations, including brokerage limitations on non-US individuals, country limitations on US brokerage accounts, or the reduction of brokerage fees and commissions on equity awards when the number of shares issued to each employee is small. The shares are deposited in the company account and subsequently sold as a block of shares. The sales proceeds are deposited in the company account. The Company (either the corporate entity or the local employer) distributes the sales proceeds to appropriate parties (e.g., employee and local entity) on a prorata basis. The Company may absorb the transaction costs or allocate them to the employees. If a company account is used, additional controls are necessary to document the process and reconcile the distribution of the sales proceeds to the employee. Trades from a company account may be limited to trades at the current market price. Limit orders, orders to sell at a designated price, etc. may not be permitted.

5.5.6. Participants may be required to obtain approval for opening a US stock brokerage account or report such an account and/or their awards to the local tax or other authority.

5.5.7. In certain situations, a non-US participant may not be able to establish a US stock plan account because of restrictions under local law. In this case other types of accounts, such as participant trusts, may be established to facilitate stock plan transactions. In the unlikely event that the participant is in a country that is on the Office of Foreign Assets Control (OFAC) list of prohibited countries, the participant will be barred from opening any financial services account in the US. Local laws may require the participant to use a local (non-US) broker to sell shares. The Company may need to establish special procedures to enable compliance with this requirement.

KEY CONSIDERATIONS

- Do the internal controls support the administrative activities handled by the local entity?
- Have procedures been established to update employee status and demographic data for non-US employees?
- How are international date and time differences handled for non-US employees?
- Have restrictions under local law regarding the timing of option exercises been identified?
- Has a policy been adopted and consistently followed regarding the notification of employees with expiring options?
- Does the country-specific administrative guide include required steps in the vesting process?
- How is FMV of the award determined under local law?
- How is the employee's "termination date" determined?
- Has a currency exchange policy been formalized?
- Who will bear the cost of currency fluctuation?
- Who will bear the costs associated with sending and receiving a wire transfer?
- How will the withholding be transferred to the local entity?
- Do the controls surrounding the handling of cash include the intercorporate transfers of funds to the local entity and transfer of funds in other currencies?
- Have controls been established to ensure the US stock plan brokerage account is activated prior to exercise or vest?
- Are there any restrictions on the non-US employee establishing a US stock plan brokerage account or selling shares through such account?
- How will the net proceeds be transferred to the employee, trustee or local bank account?
- If a company account is used in lieu of individual employee accounts, are internal controls adequate?
- If a company account is used to sell employee shares, have local country reporting requirements been considered?

Caution – This section is an overview of the issues associated with tax and payroll for global equity plans and is not intended to address country-specific requirements. Noncompliance with local law may result in civil and criminal penalties. Consult with legal and/or tax counsel to determine the country-specific requirements and the risks of noncompliance.

Tax and Payroll Issues

6.1. Overview.

6.1.1. Equity awards are considered compensatory and, therefore, taxable in virtually all countries. The type of tax payable, amount subject to tax, timing of the taxable event, tax withholding requirements, tax rates, and the requirement to report the income to the tax authorities vary by country. For example, some countries require withholding and reporting, others require reporting but not withholding, and others require no withholding or reporting.

6.1.2. Countries use different tax years. Reporting the taxable event is typically done on a tax year basis rather than a company's fiscal year. In most cases the tax year is the calendar year (e.g., US). Other countries use different tax years, such as a tax year beginning on April 1 and ending on March 31.

6.1.3. The special US tax advantages of plans such as ISO and Section 423 plans are not recognized in other countries. Outside the US, an ISO is treated the same as any other stock option. Stock purchases under a Section 423 plan are generally treated as a purchase of stock at a discount. Tax is usually due on the difference between the FMV of the stock on the purchase date and the price paid for the stock. These differences in tax timing can create significant issues for mobile employees, particularly where withholding tax is required in the non-US country at the time of exercise or purchase.

6.1.4. Other countries may provide for equity plans qualified under local law that provide tax advantages. It may be necessary or desirable to modify a plan for non-US countries to incorporate country-specific terms or provisions. This can be done by an addendum to the current Plan or by using country-specific plans, subplans, or agreements. (See paragraph 2.4.) Some countries require that the Plan be approved by the local tax authority before making any grants.

6.1.5. The tax advantages received by such plans can take many forms dependent on the country. Some countries offer a tax exemption for some or all of the otherwise taxable amount. Other countries or plans may defer the point of taxation to the sale of the underlying shares and may then tax some or all of the sale proceeds as capital gains instead of compensation income. Typically, capital gains are not subject to social tax and may be taxed at lower tax rates than compensation. For the employer, a tax advantaged plan may result in reduced or no employer social taxes.

6.1.6. A tax-advantaged plan may also have additional or different employer compliance requirements such as additional reporting to the tax authorities. Some tax-advantaged plans require the use of an in-country trustee to administer the plan in coordination with the stock plan administrator.

6.1.7. Complications can arise when an employee receives an equity award under a tax-advantaged plan and relocates to another country before the award is vested, exercised, or released. It is likely that the award will only receive tax advantages in the country in which it was granted and will be subject to tax in the new country without any preferential treatment. Using shares acquired from the award to pay for taxes in the new country may create a taxable event in the grant country.

6.1.8. Using country-specific tax-advantaged plans may require additional tracking of transactions and employees. For example, a country-specific tax-advantaged plan may require tracking and reporting of dispositions of stock after the employee has terminated employment with the Company. This publication does not discuss country-specific requirements, but addresses how the withholding process works, alternative approaches, determining the appropriate withholding rate, common practices, and considerations in determining how to meet the withholding and reporting requirements. Since each country may have different requirements, best practice is to develop a country-specific administrative guide summarizing the key requirements. See Appendix C for an example of a country-specific administrative guide.

6.1.9. The processes associated with these awards, common areas of risk, and illustrative controls for US employees are discussed in other GPS publications. The processes and associated internal controls from the other GPS publications are also appropriate for non-US employees. This section discusses additional issues applicable specifically to non-US employees. The associated legal issues are discussed in Section 3. Corporate tax deductions are discussed in paragraph 8.2.

6.2. Point of Taxability.

6.2.1. The point of taxability may be at grant, vest, release, exercise, when the restrictions (if any) on shares acquired are lifted or when the acquired stock is sold. The point of taxability of the most common equity awards is discussed in Exhibit 6. Consult tax or legal counsel regarding the tax treatment of equity awards in specific countries. See Section 6.10 regarding the tax treatment of mobile employees.

6.2.2. In some cases certain types of awards may be taxed at grant. Since the employee has merely been granted the award and does not have access to the underlying shares, meeting the tax withholding requirements is difficult. Frequently an employee would be required to pay the tax associated with the equity award with funds from another source. This requirement makes these types of awards unattractive to employees. To avoid these issues, understand the tax consequences of an award prior to granting the award. Minimize awards that are taxable at the grant date.

6.2.3. As noted above, some countries tax an employee participating in an ESPP on the difference between the FMV of the stock and the price paid for the stock on the purchase date.

EXHIBIT 6 – POINT OF TAXABILITY[1]	
Stock Options	Stock options are usually taxed at exercise in most countries, including the US (nonqualified stock options). In some countries, options may be taxed at grant, vest, or when the acquired stock is sold.
ISOs	The US tax advantages of ISOs are not recognized in other countries. When ISOs are granted to non-US employees working outside the US, the award is treated as a nonqualifying stock option in the local country.
Restricted Stock Awards	Restricted stock is taxed in the US at vest unless an IRC Section 83(b) election is made to tax the restricted stock at grant. Taxation is delayed from grant to vest (assuming no Section 83(b) election is made) because forfeiture restrictions have been placed on the award. Many countries consider ownership of restricted stock to have transferred at the grant date and, therefore, tax the restricted stock award at the grant date. Possible taxation at grant typically makes restricted stock an unattractive equity vehicle from a tax perspective for non-US employees.
Restricted Stock Units	Assuming they comply with 409A, restricted stock units are taxed in the US for social tax purposes (FICA - Social Security and Medicare) in the year there is no longer a substantial risk of forfeiture (i.e., at vest) and are taxed for income tax purposes when the shares are released. In most non-US countries, restricted stock units are taxed at vest/release and restricted stock is taxed at grant. Therefore, restricted stock units are typically the preferred equity vehicle for non-US employees.
ESPP	The tax advantages of a Section 423 plan are not recognized in other countries. When a non-US employee participates in a Section 423 plan and purchases stock at a discount, the employee is usually taxed at the purchase date on the difference between the FMV of the stock on the purchase date and the price paid. Taxation upon purchase makes Section 423 plans less attractive from a tax perspective for non-US employees. (Note – Some countries have tax-advantaged plans similar to Section 423 plans that may be implemented in lieu of Section 423 plans.)
Locally Tax-Advantaged Plans	A locally tax-advantaged plan may be exempt from income and social taxes on all or part of the income or the point of taxation may be deferred until the sale of the underlying shares. The tax advantages are usually specific to the country of grant.

1 Note: This section addresses tax withholding associated with a company's responsibility. Employees may owe additional taxes if shares are held and then later sold.

Collecting tax on this difference can be challenging because the transaction does not generate any funds to pay the tax. An employee may be required to pay the tax with funds from another source or immediately sell the stock acquired. Common practice is to collect the required tax from the employee's next paycheck or to collect the tax directly from the employee.

6.2.4. Some countries delay the tax event to the date of sale of the underlying shares. In these countries, it may be necessary to track the award until the date of sale. Identify the countries that delay the tax event to the date of sale. Develop country-specific processes to meet the tax reporting and withholding requirements. Such tracking is administratively difficult, especially for terminated employees, and may require the use of a trustee or separate administrator to hold the shares after vest/exercise until the date of sale by the employee.

6.3. Administration.

6.3.1. Tax and payroll issues are among the most complex and challenging areas of administration. Close coordination is required between the Equity Compensation department, the local country Payroll, and third-parties such as the company-designated broker or administrator. This coordination is particularly challenging when the Company uses different payroll systems in different countries or outsources the payroll process.

6.3.2. Leverage the procedures and internal controls for the tax withholding process used for US employees. Some of the internal controls that should be implemented for each country are –

- Determine whether there is a payroll reporting and/or tax withholding requirement in the country
- Determine how the FMV is determined for tax purposes in each country
- Establish and document the process to calculate tax withholding and reporting
- Establish and document the process to verify that the correct tax tables and tax rules are being used.
- Develop a schedule to update the tax rates/rules. Audit the tax withholding rates periodically to verify that the current rates are being used
- Clarify appropriate responsibilities between local Payroll, Equity Compensation, and third-party vendors such as a brokerage firm. Establish and document the process to transfer data from the equity plan database into the payroll system
- Verify that tax is withheld for each employee in appropriate countries
- On a monthly basis, verify that tax withheld in the equity plan database for a country agrees with the local country payroll records
- Establish and document a policy on payroll tax deposits relating to equity compensation for each country
- At year end, verify that tax reporting for equity plan income has been completed with local country payroll

6.3.3. Special attention is required when the FMV for tax purposes in the country is not defined as the current market price of the stock. See Exhibit 7. Care should be taken to identify grants made in these countries to ensure that withholding and reporting is made using the appropriate FMV.

6.3.4. Keep the withholding process as simple as possible. Summarize all country-specific requirements in the country guide and update the information regularly.

6.4. Tax Withholding.

6.4.1. Tax withholding is frequently required at the point of taxability. As noted previously, the point of taxability may be at grant, vest, exercise, release of shares, lifting of restrictions (if any) on shares acquired, or sale of shares. Appropriate withholding rates must be determined for each country and potentially for each employee based on the work location of the employee. A variety of civil/criminal penalties, fines, and interest may be assessed for inadequate or untimely withholding. Tax withholding on equity compensation is under increased scrutiny by tax authorities and in many countries this is a high-priority audit

EXHIBIT 7 – IMPACT OF COUNTRY-SPECIFIC DEFINITION OF FMV
1,000 shares of restricted stock vest
Tax withholding is required at a 40% tax rate
Shares are sold to pay the required tax
Local law defines FMV as the average of the market price over the previous month
\$10.00 = FMV determined under local law
\$8.00 = current market price on the date shares vest and are sold to pay the tax
\$10,000 = taxable income reported (1,000 x \$10)
\$4,000 = required withholding (\$10,000 x 40%)
500 shares required to be sold (500 x \$8 = \$4,000) to meet the required taxes

initiative. Care must be taken to determine the appropriate tax and employer withholding requirements of each country. See section 6.10 for a discussion of the treatment of mobile employees.

6.4.2. The withholding requirements for income tax and social tax may differ. For example, withholding may be required for social tax but not for income tax. Alternatively, withholding may be required for income tax but not for social tax. Income tax withholding may be required for terminated employees. Some countries require the income be reported to the tax authorities by the employer, but no withholding is required. See paragraph 8.2 for a discussion of chargebacks of equity awards from the parent to the local entity.

Note – For purposes of this publication, the term "payroll taxes" will refer to income taxes and employer/employee social taxes.

6.4.3. Most countries do not have flat withholding rates on supplemental income. Instead tax is required to be withheld at the individual employee's marginal tax rates. Tax withholding rates may be provided by tax or legal service providers or by local country Payroll. Tax withholding may be impacted by the following:

- Company structure
- Grantee employment status
- Local employer involvement
- Award type and terms
- Recharge of equity costs to local entity and claiming a corporate tax deduction
- Transfer of the employer's social tax to the employee
- Whether equity is granted under a tax-favored plan
- Employee mobility during the life of the award
- In some countries, the tax withholding may be limited by law to the individual employee's cash salary amount, which may be significantly less than the value of an equity award.

6.4.4. Many companies use maximum tax withholding rates or average withholding rates since individual rates are difficult to determine and implement on a timely basis. If a maximum tax rate is used, internal processes and controls at the local payroll level will need to be implemented to ensure that any over-withholding is refunded to the employee via a "true-up" process, as obtaining a tax refund for income tax may be difficult, and refunds of over-paid social tax are generally not possible. See paragraph 6.6 for a discussion of withholding rates.

6.4.5. In certain countries the employee may reimburse or contractually assume the liability of the employer's portion of the social tax. (If the employee reimburses the liability, the liability remains the responsibility of the employer even though the employee will ultimately bear the cost of the social tax. If the employee assumes the liability, the liability is no longer the responsibility of the employer.) This is accomplished through a written agreement between the employer and employee, which may involve the assumption of liability as a term of the award and the arrangement may need to be approved by the local tax authorities. Prior to the release of ASU 2016-09, share withholding up to a minimum statutory rate did not trigger liability accounting. With the release of ASU 2016-09*, the maximum individual tax rate is now allowed for withholding shares without triggering liability accounting under ASC 718. This may allow greater flexibility within jurisdictions in which no flat tax rate is available for supplemental income but withholding is required. You should discuss potential changes to your processes with your audit firm.

6.4.6. Tax may be collected from the individual in a variety of ways as summarized in Exhibit 8. Sell-to-cover and withhold-to-cover are the most commonly used methods of collecting tax from non-US employees and are discussed in more detail in Section 6.5.

6.5. Withholding Methods

6.5.1. Not all methods of withholding tax may be legally allowed in each country and certain methods may not be practical if the award is taxed at grant. Additional flexibility with respect to tax payment method may be required for non-US employees. Labor law may restrict the way a company collects tax from the employee. For example, an employee may be required to specifically authorize the sale of shares to pay the required tax or the employer may be required to distribute 100% of the sales proceeds to the employee. A blackout period may restrict the withholding method to withhold-to-cover or sell-to-cover tax withholding. In some countries an employee may have restrictions on holding shares thereby requiring immediate sale of all stock received from an award. Some methods may be prohibited to certain employees (e.g., a deduction from 13-month pay may be construed as a prohibited loan to a Section 16 officer). All of these items need to be considered in determining how to collect the required tax from the employee. Exhibit 8 compares the common methods of withholding taxes.

* ASU 2016-09 - Accounting Standards Update 2016-09: Compensation - Stock Compensation (Topic 718) - Improvements to Employee Share-Based Payment Accounting

6.5.2 Companies can use different methods for different award types, or even, where required by law, for different countries. Two of these methods, sell-to-cover and withhold-to-cover, are discussed in more detail below. For both of these methods, the payment of applicable tax may require the payment of fractional shares rather than whole shares because the tax payment is not evenly divisible by the share price. Since most companies do not issue fractional shares, the number of shares tendered must be rounded up (resulting in slightly more than the minimum amount required to be withheld) or rounded down (resulting in a shortfall in withholding). The trend is to round up to the next whole share. The excess withholding may be refunded to the employee in the next payroll cycle or added to tax withholding.

6.5.3. When using sell-to-cover, shares are sold from the award transaction (e.g., stock option exercise, restricted stock or restricted stock unit release) to pay the required tax. The sales proceeds fund the tax payment. In some cases, all the shares may be sold either because the individual does a same-day-sale stock option exercise or due to country-specific restrictions, in which case the taxes are withheld from the sale proceeds, and the net proceeds (net of any price the employee has to pay and tax withholding) is typically deposited in the employee's brokerage account. In other circumstances, only the number of shares required to cover the tax withholding (and the purchase price if applicable) may be sold.

6.5.4. When using withhold-to-cover, shares are withheld from an award transaction (e.g., stock option exercise, restricted stock or restricted stock unit release) to pay the required tax. Withholding shares to cover the required payroll tax is commonly referred to as net share withholding. Share withholding does not involve a sale; the Company credits the current value of the withheld shares to the amount owed for payroll tax. If the Company withholds shares and uses its own cash to pay the employee's tax liability, the Company is effectively repurchasing its own stock from the employee at FMV. Consult legal counsel and accounting/audit advisors to determine if this activity is permitted under relevant local and corporate laws and to determine what impact it may have to the financial reporting requirements.

6.5.5. Until very recently, under US GAAP when shares were tendered from the shares to be

EXHIBIT 8 – TAX WITHHOLDING METHODS

METHOD	DESCRIPTION
Sell-to-Cover*	Shares are sold from an award to pay the required tax. The sales proceeds fund the tax payment. The process-related advantages and disadvantages associated with sell-to-cover are discussed in other sections of this combined GPS volume.
Withhold-to-Cover	Shares are withheld from an award to pay the required tax. The Company makes the required tax payment with company funds. The process-related advantages and disadvantages associated with sell-to-cover are discussed in other GPS publications. The accounting treatment of collecting tax using the withhold-to-cover method under US GAAP and IFRS differ. See Section 7, Accounting Issues, for further discussion.
Cash	The grantee pays cash (through personal check, certified check, or wire transfer) to the Company for the required tax. Collecting cash from non-US employees is difficult administratively, introduces currency and exchange issues, and is not common practice.
Deduction from Salary	Tax is withheld from current salary or withheld on a pro rata basis through the rest of the year. This is not practical if the required tax will exceed the employee's salary or where the tax payment is due to the authorities before it can be fully recovered from the employee. Withholding tax from salary also increases the risk of "acquired rights" issues discussed in paragraph 3.4.1. In addition, some countries impose limits on the percentage of tax that can be withheld from each paycheck and/or the total deduction from each paycheck.
Deduction from Bonus	Tax is withheld from a bonus. This method has the same disadvantages as a deduction from salary and is not widely used except where the bonus payment is made at the same time as the equity award is paid out.
Deduction from 13-Month Pay	Some countries mandate an additional month pay. Tax is withheld from the 13-month pay. This method has the same disadvantages as a deduction from salary and is not widely used.

* When using the sell-to-cover method for stock option exercises, non-US employees frequently use a same-day-sale. The employee exercises the award, sells all the shares received, and does not hold any shares after exercising the award.

distributed to the employee, the tax withholding was required to be limited to the minimum required statutory payment to avoid liability accounting.[2] However, under ASU 2016-09, as long as no more than the maximum allowable amount is withheld, liability accounting will not be triggered. Allowing employees to tender shares for tax payments in excess of the maximum individual tax rate will trigger liability treatment for the grant in question. If the transaction is part of a pattern, or if the terms of the Plan specifically allow employees to tender shares for payments in excess of the maximum tax rate, liability accounting may be required for the entire Plan.[3] The accounting treatment under US GAAP and IFRS 2 differ. This section assumes that financial results are reported under US GAAP. See Section 7, Accounting Issues, for a further discussion of the differences in accounting for equity compensation under US GAAP and IFRS 2.

Allowing employees to tender shares for tax payments in excess of the maximum individual tax rate will trigger liability treatment for the grant in question.

6.6 Withholding Tax Rates

6.6.1. In the US, determining the tax rate at which to withhold is relatively simple since the US provides for a flat withholding rate on supplemental income. (In 2023 the supplemental withholding rate for US federal tax was 22% on year-to-date supplemental wages of $1 million or less and 37% on year-to-date supplemental wages of more than $1 million). Most countries do not apply flat withholding tax rates to supplemental income such as equity compensation, and income from equity awards is generally subject to tax at regular payroll tax rates. These rates may vary by individual based on personal circumstances. In some countries, the tax authorities will determine the appropriate withholding rate for each individual and inform the employer.

6.6.2. Determining the proper amount of tax to be withheld requires additional effort since a separate calculation is frequently required for each individual, unless a flat tax withholding rate is used for each country or for groups of individuals within each country. A variety of methods can be used to determine the amount of tax to be withheld and collect the appropriate tax from the employee. The most common methods are discussed below. Some methods may require employee consent, which is usually achieved through appropriate language in the plan and award agreement.

6.6.3. The processes described represent standard practice, but each company's processes may differ to reflect their unique needs and resources. A comparison of the advantages and disadvantages of the methods is summarized in Exhibit 9. Exhibit 10 compares the methods assuming the exercise of a stock option with a same-day-sale of the acquired shares. Exhibits 11 and 12 compare the methods assuming the grant of restricted stock units.

- **Method 1** – Withhold tax at a designated tax rate and adjust in the next payroll.

  The designated tax rate is typically either the maximum tax rate for the country or an average tax rate of the employees receiving awards in that country. The employee receives the net proceeds, whether in shares or in cash, from the broker after the withholding of tax and the payment (if any) to the Company for the shares. The income and the tax withheld from the award are included in local country payroll the next pay period. The payroll system calculates the actual tax due on the award. If insufficient tax was collected from the employee, additional tax is collected through payroll from the employee's paycheck. If excess tax was collected from the employee, the excess tax is refunded through payroll and added to the employee's paycheck.

  This method is simple to administer at the corporate level because one tax rate is used for all employees in a country; however, the employee may be required to sell or tender more shares than necessary to meet his tax obligations so the employee should consent to this withholding method. The temporary cash shortfall will be settled through the payroll system when the employee receives his next paycheck. This method may not be available for a terminated employee because the employee is no longer receiving a paycheck. Significant coordination is required with local country payroll to implement this method and limited functionality in the local country payroll system may prohibit its use. The employee receives the net income from the equity award in two parts – part from the broker and the balance as an

2 ASC 718-10-25-18.

3 Accounting for Equity Compensation, by Barbara A. Baksa, CEP, and Advanced Topics in Equity Compensation Accounting, by Takis Makridis, CEP.

adjustment through payroll. Communicating the mechanics of this method to employees can be difficult.

- **Method 2** – Withhold tax at a designated tax rate and adjust the tax when the individual's tax return is filed.

  This methodology is similar to Method 1 except the local payroll does not do a reconciliation and remits the taxes withheld for each individual. This method is simple to administer because one tax rate is used for all employees in a country. Because the employee may be required to sell or tender more shares than necessary to meet his tax obligations, the employee should consent to this withholding method. The temporary cash shortfall will be settled when the employee files her/his tax return. If tax is not withheld at the maximum tax rate, insufficient tax may be collected. Penalties and interest may be assessed to the employee and employer for paying the tax with the return rather than at the point of taxability. This method will require the employee to file an annual tax return. Filing a tax return may be a burden on employees in countries where an annual tax return is not required for regular compensation that is subject to employer withholding. Note, however, that obtaining a tax refund for income tax may be difficult in some countries and refunds of over-paid social tax are not possible in many countries. Therefore, best practice is to perform a "true-up" in the next payroll cycle, as discussed in Method 1 above.

EXHIBIT 9 – SELL-TO-COVER: COMPARISON OF METHODS TO CALCULATE TAX WITHHOLDING AND DISTRIBUTE PROCEEDS

Method	Advantages	Disadvantages
Method 1 – Withhold tax at a designated tax rate and adjust in the next payroll	• Easiest to calculate designated tax rate • Can utilize maximum tax rate • Transfer of proceeds to employee facilitated by broker	• Coordination required with Payroll • May result in over withholding until next payroll • Employee may have temporary cash shortfall • Employee may liquidate more shares than necessary • Employee consent should be obtained • Employee receives proceeds in two installments (i.e., from the sale of shares and through payroll) • More difficult to explain to employees • Difficult to process through payroll for terminated employees
Method 2 – Withhold tax at a designated tax rate and adjust the tax when the individual's tax return is filed	• Simplest to administer • Easiest to calculate designated tax rate • Can utilize maximum tax rate • Transfer of proceeds to employee facilitated by broker	• May result in over or under withholding • Receipt of appropriate proceeds may be delayed until tax return filed • Employee may have temporary cash shortfall • Employee may liquidate more shares than necessary • Penalties and interest may be assessed on underpayments • Non-US employees may not be able to obtain refund of over-remitted tax • Employee consent may need to be obtained (since the method may result in overwithholding and employee may liquidate more shares than necessary)
Method 3 – Withhold at the actual withholding rate for each individual employee	• Transfer of proceeds to employee facilitated by broker • No delay in the receipt of sales proceeds by the employee • Employee maximizes the shares held	• Significant coordination required with payroll • Detailed calculations using current data required for each employee • More complicated to administer and obtain timely information • Process may not be scalable for a large number of employees
Method 4 – Distribute sales proceeds through payroll	• Leverage payroll system to calculate actual withholding required	• More coordination required with Payroll • Distribution of proceeds to the employee will be delayed until the next pay cycle • More difficult to explain to employees • Difficult to process through payroll for terminated employees • May require additional tax reporting and withholding obligations • Does not facilitate share ownership by employees

EXHIBIT 10 - COMPARISON OF METHODS TO ADMINISTER SELL-TO-COVER

Facts:	• Employee A receives an option to acquire 1,000 shares of stock for $5 per share • On the date the option is exercised, FMV of the stock is $15 per share • The employee recognizes $10,000 [($15 x 1,000 shares) – ($5 x 1,000 shares)] of taxable income from the exercise of the award • Employee A sells 1,000 shares immediately • Employee A's actual tax rate is 30% and tax is withheld at the maximum tax rate of 45%
$15,000	Proceeds from the sale of 1,000 shares ($15 x 1,000 shares)
- 5,000	Grant price ($5 x 1,000 per share)
$10,000	Taxable income
Method 1 – Withhold tax at a designated tax rate and adjust in the next payroll.	
$10,000	Taxable income
- 4,500	Tax withholding ($10,000 x 45%)
$5,500	Initial cash distributed to Employee A from the broker
$1,500	Refund received in the next pay cycle [($4,500 – ($10,000 x 30%)]
$7,000	Net proceeds received by Employee A ($5,500 when the shares are sold and $1,500 in the next pay cycle)
Method 2 – Withhold tax at a designated tax rate and adjust the tax when the individual's tax return is filed	
$10,000	Taxable income
- 4,500	Tax withholding ($10,000 x 45%)
$5,500	Initial cash distributed to Employee A from the broker
$1,500	Refund received when Employee A files the annual tax return [$4,500 – ($10,000 x 30%)]
$7,000	Net proceeds received by Employee A ($5,500 when the shares are sold and $1,500 when Employee A files the annual tax return)
Method 3 – Withhold at the actual withholding rate.	
$10,000	Taxable income
- 3,000	Tax withholding ($10,000 x 30%)
$7,000	Net proceeds received by Employee A from broker
Method 4 – Distribute sales proceeds through payroll.	
$10,000	Taxable income
- 3,000	Tax withholding ($10,000 x 30%)
$7,000	Net proceeds received by Employee A in the next pay cycle

- **Method 3** – Withhold at the actual withholding rate for each individual employee.

  The required withholding is calculated for each individual employee using the appropriate withholding rates in the country and year-to-date income for each individual employee. These calculations are typically performed outside the payroll system in the equity plan database or by a third party. The employee receives the net proceeds, whether in shares or cash, from the broker after the withholding of tax and the payment (if any) to the Company for the shares. The income and the tax withheld from the award are included in local country payroll the next pay period. Withholding is not required to be adjusted since the initial calculation was based on actual income, withholding rates, and employee payroll data. However, small adjustments (up or down) to withholding will generally still be needed, due to payroll-specific considerations that may fluctuate (e.g., benefits or taxable expenses) and, where shares are sold or withheld to cover taxes, due to the fact that generally only whole shares will be sold or withheld.

  This method minimizes overwithholding/underwithholding of required tax from employees. The employee does not sell or tender more shares than necessary to fund the required tax. Significant coordination is required to calculate actual withholding for each employee. This method may be administratively burdensome. More coordination is required with local payroll. Most companies do not have the resources to provide current data and calculate withholding for each employee prior to the close of the transaction. Even where significant resources are dedicated to the process, obtaining a "perfect" tax rate for an employee which results in no payroll adjustment at the local level is often not possible.

- **Method 4** – Distribute sales proceeds through payroll.

  This method is applicable **only** when the employees execute a same-day-sale of the acquired shares. All shares are sold in the open market. The broker facilitates the sale of shares. The gross proceeds less transaction costs and the payment (if any) to the Company for the shares are distributed to the Company. The employee receives the net proceeds through local country payroll. The taxable income is recorded in the local payroll system (similar to a cash bonus) and the payroll system calculates the required withholding. The net amount is paid to the employee. This method may not be available for a terminated employee since the employee is no longer receiving a paycheck.

This method minimizes overwithholding/underwithholding of required tax from employees. Utilizing functionality in the payroll system ensures the appropriate tax is withheld. This method requires significant coordination with local country Payroll and the broker. Distribution of the proceeds to the employee is tied to the pay cycle. Many countries pay salaries monthly. In those countries, the employee may not receive the sales proceeds for a month or more.

Since the amounts are processed by local payroll, this method may change the payroll obligations in some of the countries. This is particularly troublesome in countries that do not typically have payroll reporting or withholding obligations on equity income. Consult tax counsel to determine applicable requirements in specific countries.

6.7. Coordination with Payroll.

6.7.1. At the point of taxability, the Equity Compensation department transmits details regarding taxable income and corresponding withholding to local Payroll. Payroll imports the taxable income and withholding in the payroll system. Payroll also makes the required deposits of the payroll tax. To ensure this process works efficiently and effectively, all parties (Payroll, Equity Compensation, the third-party administrator, and the brokerage firm) must understand the process, which group is responsible for each specific activity, and the details of the data transfer. This can be particularly challenging when operating multiple payroll systems or using different payroll vendors in different countries each with different requirements.

6.7.2. In many countries payroll is processed once a month. This can result in a significant delay when a transaction occurs at the beginning of the month and the payroll is not processed until the end of the month. For example, assume a stock option is exercised on March 1, but the payroll does not process the transaction until March 31. The transaction will not be settled or recorded for

EXHIBIT 11 – WITHHOLD-TO-COVER: COMPARISON OF METHODS TO CALCULATE TAX WITHHOLDING AND DISTRIBUTE PROCEEDS

Method	Advantages	Disadvantages
Method 1 – Withhold tax at a designated tax rate and adjust in the next payroll	• Easiest to calculate the designated tax rate • Minimizes exposure to assessed penalties and interest	• More coordination required with Payroll • Withholding additional tax or refunding excess tax from the employee’s paycheck may create cash flow issues for the employee • More difficult to explain to employees • Difficult to process through payroll for terminated employees
Method 2 – Withhold shares at the minimum tax rate and adjust the tax when the individual’s tax return is filed	• Simplest to administer • Easiest to calculate the minimum tax rate	• May result in under withholding • Exposes the employee and the Company to potential assessment of penalties and interest for underwithholding of tax • Employees may not manage their cash flow properly and may not retain sufficient funds to pay the tax when the annual tax return is filed
Method 3 – Withhold at the actual withholding rate for each individual employee	• Minimizes exposure to assessed penalties and interest	• Detailed calculations using current data required for each employee • More coordination required with Payroll • More complicated to administer and obtain timely information

approximately one month if the employee uses a same-day-sale, tax is collected through payroll, and the sales proceeds are distributed through payroll. This delay may create several issues. The payroll tax deposit may not be made on a timely basis. If the employer funds the payroll tax deposit from Company funds and later collects the tax from the employee though payroll, the Company is essentially making a loan to the employee. In many countries there are tax consequences of making loans to employees. If the employee is a Section 16 officer (which can include non-US officers) for US regulatory requirements, the Company is prohibited from making loans to such employees. In addition, the employee will not receive the sales proceeds until the payroll is processed. Special procedures may be required to be implemented in countries with monthly payroll.

6.7.3. The calculation of taxable income and the determination of the corresponding withholding are usually done in US dollars. The reporting of the income and withholding in local payroll is in local currency. Determine how the exchange rate from US dollars to local currency will be calculated and apply the methodology consistently. Some companies utilize a calculated average monthly exchange rate that is used for other corporate financial transactions. This exchange rate is typically provided by the Treasury department. Some countries require a particular exchange rate be used for tax purposes.

6.7.4. Payroll may not be able to simultaneously process the income from awards with regular payroll. Special input may be required into the payroll system. Include standard error-checking when importing the file into the payroll system. For example, verify that social tax was calculated accurately and withholding occurred for every employee where required. Implement a process to reconcile information from the equity

EXHIBIT 12 - COMPARISON OF METHODS TO ADMINISTER WITHHOLD-TO-COVER

Facts:	• Employee A receives an award of 1,000 shares of restricted stock units • On the date the award vests and the shares are released the FMV of stock is $15 per share • Employee recognizes $15,000 ($15 x 1,000 shares) of taxable income from the vest/release of the award • Employee A's actual tax rate is 30% and the designated tax rate is 20%
Method 1 – Withhold shares at the designated tax rate and adjust in the next payroll.	
1,000	Restricted stock units awarded
- 200	Restricted stock units withheld for tax [(1,000 shares x 20%(designated tax rate))]
800	Net shares distributed
$15,000	Taxable income ($15 x 1,000 shares)
30%	Employee A's actual tax rate
$ 4,500	Actual tax due on award
- 3,000	Value of shares withheld for tax from distributed shares (200 shares x $15 per share)
$1,500	Tax due from Employee A's next paycheck
Method 2 – Withhold shares at the designated tax rate and adjust the tax when the individual's tax return is filed.	
1,000	Restricted stock units awarded
- 200	Restricted stock units withheld for tax [(1,000 shares x 20%(minimum tax rate))]
800	Net shares distributed
$15,000	Taxable income ($15 x 1,000 shares)
30%	Employee A's actual tax rate
$ 4,500	Actual tax due on award
- 3,000	Value of shares withheld for tax from distributed shares (200 shares x $15 per share)
$1,500	Tax due with Employee A's annual tax return
Method 3 – Withhold at the actual withholding rate for each individual.	
1,000	Restricted stock units awarded
- 300	Restricted stock units withheld for tax [(1,000 shares x 30%(actual tax rate))]
700	Net shares distributed
$15,000	Taxable income ($15 x 1,000 shares)
30%	Employee A's actual tax rate
$ 4,500	Actual tax due on award
$ 4,500	Value of shares withheld for tax from distributed shares (300 shares x $15 per share)

plan database to the local payroll records. On a monthly basis, reconcile total equity compensation reported in the local payroll to taxable income in the equity plan database. Investigate and resolve any discrepancies. Verify the tax withheld in the equity plan database agrees with the local payroll records. Investigate and resolve any discrepancies.

6.7.5. Establish and document a policy on payroll tax deposits. Payroll deposits for stock transactions usually occur separately from other payroll tax deposits. Each country may have different requirements regarding the timely deposit of payroll tax withholdings. For example, payroll tax deposits may be required the next day, in the next pay cycle, or by the end of the following month. Consult with legal and tax counsel to determine the timing of payroll tax deposits on a country-by-country basis to ensure that deadlines are not missed.

6.7.6. Close coordination is also required at month-end and year-end. This can be particularly troublesome when the point of taxability occurs after the last paycheck has been issued for the year or when the tax year varies from a calendar year. For example, many companies have a mid-December payroll cut-off for the final paycheck of the calendar year. The Company must still record the taxable income and taxes for equity transactions occurring after the payroll cut-off and prior to December 31 in the payroll system for the correct year.

6.7.7. Special attention must be given to countries that have annual employer reporting, especially those that only have annual reporting and no monthly reporting or withholding. The Company should coordinate with the local country Payroll to confirm that all the detailed information necessary to comply with the annual employer reporting has been received and to verify that the employer reporting has been completed. In some countries, special annual tax reporting is required for equity award income, separate from payroll annual reporting, so coordination with other departments (such as legal or tax) may also be required to ensure these reporting requirements are met.

6.8. Implementation Strategy.

6.8.1. Understanding and meeting compliance requirements in every country where employees receive equity compensation is difficult. Plan administrators must keep current with legislative and regulatory changes in each country. Monitor significant corporate changes that may impact the withholding and reporting requirements such as a modification of a recharge agreement (see paragraph 8.2) or changes in corporate structure. Best practice is to reevaluate withholding and reporting requirements quarterly.

6.8.2. In some countries there may be a gap between the compliance requirements and common business practice. Local entity personnel may not have the same approach to compliance or may not be familiar with the compliance requirements of US stock plans. A company's decentralized structure may lead to looser or no controls globally. Inadequate and ad hoc procedures can lead to compliance failures and result in significant fines, penalties, and interest. Best practice is for the corporate headquarters to make decisions regarding local country compliance. Audit local country practice periodically to confirm compliance is consistent with corporate instructions.

6.8.3. Many factors need to be considered in determining how a company should collect tax on an equity award. Some of the factors to be considered include:

- Number of employees with equity awards in each country
- Employee demographics
- Availability of company cash
- Company risk profile
- Impact of noncompliance on employee
- Equity plan database functionality
- Payroll system functionality
- Requirements of external auditors regarding withholding rates and practices
- Acceptable withholding methods under local law
- Withholding methods allowed under the plan and in the employee's stock award agreement

Balance the cost of compliance with the benefits and risks of noncompliance. Companies with a large number of employees with equity awards or large equity grants may be more closely scrutinized by the tax authorities than companies with one or two employees with equity awards. Determine the capabilities of the local country payroll system. Frequently the local payroll system will be unable to process additional tax payments or tax adjustments on equity awards.

6.8.4. Companies frequently desire to give employees a choice as to how to pay the required tax on equity awards. When determining how to collect tax on equity awards, allowing choice requires extra administration. Best practice is to mandate an appropriate method of collecting payroll tax in each country. If multiple methods of payment are offered in a country and employees are allowed to elect which method to use, require the employee make the election at least 15 days prior to the exercise of an option or the vest of restricted stock/restricted stock units. If no election is received within the 15 day period, provide a default method such as sell-to-cover. Section 16 officers' ability to choose withholding methods may be limited to avoid short-swing profits.

6.8.5. As noted above, using withhold-to-cover for non-US employees has many challenges and may only be applicable in specific countries. Withholding tax in excess of the maximum individual rate may trigger liability accounting. If withhold-to-cover is used for non-US employees, consult with the Company's external auditor to ensure the tax withholding process is not in excess of the maximum tax rate and therefore does not affect the classification of the award as an equity instrument. To ensure the appropriate compliance requirements are met, develop country-specific checklists that highlight appropriate steps in the process.

6.8.6. Payroll reporting and withholding in multiple countries requires coordination of many groups including Equity Compensation, local Payroll, the company-designated broker, and in many cases a third-party administrator. Best practice is to test the process in each country by submitting sample information prior to major transactions such as a vesting of restricted stock units. The test will highlight potential problems before the actual transactions occur and will allow time to modify the process to avoid problems with the actual data.

6.9. Dividends and Dividend Equivalents.

6.9.1. When restricted stock is granted, shares are issued and the employee becomes the shareholder of record. Although subject to forfeiture during the vesting period, restricted stock is considered issued and outstanding stock of the Company. Employees holding unvested restricted stock are shareholders even though they do not take possession of the stock until a future date when the associated restrictions have lapsed. While the restrictions are applicable, the employee may have dividend rights, but these rights are not mandatory. The majority of US-headquartered companies that pay dividends to shareholders pay dividends on restricted stock. Dividends paid to US employees prior to vest are considered employment income and taxed appropriately. The tax impact of dividends paid to non-US employees is discussed in paragraph 6.9.4.

6.9.2. When restricted stock units are granted, the employee has received a promise to receive shares at some future date. Since the employee does not acquire "shares" and is not a shareholder before vesting, there are no dividend rights. The Company may choose to pay dividend equivalents to mirror the treatment of restricted stock. Dividend equivalents are not actual dividends, but the payments are structured to mirror dividends. Frequently US-headquartered companies that pay dividends to shareholders pay dividend equivalents on restricted stock units. Dividend equivalents paid to US employees are considered employment income and taxed appropriately. The dividend equivalents may be paid in cash when dividends are issued or they may be paid in cash or shares when the restricted stock units vest and shares are issued. The tax impact of dividends paid to non-US employees is discussed in paragraph 6.9.4.

6.9.3. There also may be US tax withholding on the payment of dividends and dividend equivalents from a US-headquartered to a non-US employee. Dividends paid to non-US persons may be subject to US withholding at source by the payor of the dividend (i.e., generally the transfer agent or broker distributing the payment). The amount of withholding may be reduced if the non-US person completes a Form W-8 BEN and if there is a treaty in place with the respective country. In general US tax withholding is not required for payment of dividend equivalents. Section 3401(a)(6) defines wages as all remuneration for services performed by an employee for his employer, except payments for services performed by a nonresident alien individual.[4]

6.9.4. The tax treatment of dividends paid on restricted stock and dividend equivalents paid on restricted stock units varies by country. In some countries the income is considered earned from employment and subject to social tax. In other countries income may be considered unearned income (i.e., not related to employment) and social tax is not required. A stock dividend may be treated as a new grant and require separate tracking. The withholding rules for dividends and dividend equivalents may be different from the withholding requirements on restricted stock and restricted stock units. Consult tax or legal counsel

4 IRC 3401(a)(6).

regarding the withholding and reporting requirements in specific countries. The tax treatment should be summarized on the country-specific administrative guide. (See Appendix C.)

6.9.5. The payment of dividend equivalents on restricted stock units may impact the taxability of the underlying award and facilitate tax withholding. As noted in paragraph 6.2.1 countries may deem that significant ownership rights are transferred when restricted stock is granted. These ownership rights relate to dividends and voting rights. In those countries, restricted stock may be taxed at grant, rather than at vest/release. On the other hand, restricted stock units are usually taxed at release. The award is viewed as a promise to distribute stock in the future, but no ownership rights are conferred at grant. The payment of dividend equivalents on restricted stock units may be interpreted as acquiring ownership rights at grant. Under local law these ownership rights may trigger taxation of a restricted stock unit at grant similar to the treatment of restricted stock. Dividend equivalents paid in cash may be used to offset tax withholding when simultaneously paid with the issuance of shares at vesting of restricted stock units. It may also be necessary to treat the dividend equivalent as a new grant in order to avoid triggering similar tax withholding on the restricted stock unit grant, especially when the tax withholding requirements are different or the restricted stock unit falls under a tax advantaged plan.

6.9.6. It is not common to pay dividends or dividend equivalents on stock option awards.

6.10. Mobile Employees.

6.10.1. Mobile employees are employees who work in one or more countries or states between the grant of an equity award and when the equity award is taxable under local law. Since the employee works in various tax jurisdictions, each jurisdiction may tax some or all of the income associated with an equity award. Mobile employees include –

- Employees who permanently move from one location to another location
- Employees who move from their home location to another location for some time period and then return to their home location
- Employees who work in more than one location during a short period of time, e.g., sales
- Business travelers

6.10.2 Rules in countries regarding the taxation of equity compensation vary. Equity compensation may be taxable to an employee at grant, vest, exercise, lapse on restrictions on shares, sale, or at the point when an employee permanently leaves a country. When an employee moves from one country to another, each country may want to tax the employee on the income from the equity compensation, and the employee may pay tax in more than one country. The tax may be owed at the time of the taxable event or at the time the employee departs the country on a "deemed" basis. The mobile employee may even be subject to tax in a country or state where the employee no longer works. This is frequently referred to as a "trailing liability." Exhibit 13 includes an example of how equity awards may be taxed for mobile employees. Exhibit 14 summarizes some of the information needed to properly determine withholding and reporting requirements in a country.

6.10.3. Local law controls how equity compensation is taxed. The local law may provide that equity compensation is fully taxed or only a percentage is taxed. The US Federal income rules are quite clear with respect to the taxation of equity compensation for mobile employees. A US tax resident (including citizens, permanent residents (green card holders), and individuals satisfying the "substantial presence" test) is taxed on worldwide income regardless of where the individual is working. (Worldwide income includes all income regardless of where it is earned or paid.) Therefore, a US tax resident will always be taxable in the US on 100% of the equity compensation even though the person is working in another country. (Exemptions, exclusions, and tax credits may apply to reduce the amount of US tax payable.) Note that Double Tax Treaties can override local taxation.

6.10.4. A non-US citizen or permanent resident who moves to the US will generally become a US tax resident within 183 days of moving to the US (on the basis that he or she satisfies the requirements of the "substantial presence" test). (Note – The determination of US tax residency is very complicated and beyond the scope of this publication. An individual's facts and circumstances should be reviewed in detail to determine if the individual qualifies as a US tax resident.) Once an individual is a US tax resident, the individual is taxed on worldwide income. Therefore, a US tax resident is subject to US tax on 100% of equity compensation even if the award was fully vested prior to establishing US residency.

6.10.5. When a US tax resident (who is not a US citizen or green card holder) leaves the US, the individual may still hold equity compensation that has not been taxed. US law provides that when the taxable event occurs, the employee is subject to US tax on the portion of the income earned in the US. For example, an employee may hold unvested restricted stock when US residency is terminated. When the restricted stock vests, the portion of the income attributed to US services will be subject to US tax.

6.10.6. US states do not always follow US federal taxation, and many do not conform to federal taxation under a double tax treaty.

EXHIBIT 13 - TAXATION OF MOBILE EMPLOYEES
1 January 2019 John works in Country A. John receives a stock option from his employer that vests in 3 years. 1 January 2020 John moves to Country B. John's option vests 1 January 2022. 1 January 2023 John exercises his option. Country A and Country B tax stock options when the option is exercised. Country A and Country B have the right to tax John's options.
To determine how John is taxed, look to the tax laws in Country A and Country B. Many countries tax John even though he is no longer a tax resident of that country on the theory that John worked in the country after he was granted the option. Therefore, a portion of the option earnings relates to the period John was working in that country.
Assume Country A taxes a prorata portion of the income at exercise and Country B residents are taxed on their worldwide income. When John exercises the option, Country A taxes 1/3 of the income because John worked in Country A for 1-year during the 3-year vesting period. Country B taxes 100% of the income because John is a tax resident of Country B.

6.10.7. Each country has the right to tax the income, which can result in double taxation. However, there may be ways to avoid double taxation. Some countries tax only a portion of the income. Some tax 100% of the income but allow a tax credit for tax paid to another country (i.e., foreign tax credits). Tax credits provide an offset for income that is double taxed by reducing actual tax by tax paid in another country. See Exhibit 15 for an example of a foreign tax credit. Some countries have entered into bilateral agreements that provide special handling of double-taxed income. Tax treaties are agreements between two countries that address how each country will tax certain types of income and include provisions to avoid double taxation.

6.10.8. Common methods of allocating equity compensation are –

- Allocating income based on work location/ work days between date of grant to date of vest as compared to total work days from date of grant to date of vest, for each tranche.
- Allocating income based on work location/ work days between date of grant to date of exercise as compared to total work days from date of grant to date of exercise

See Exhibit 16 for a comparison of methods of allocating equity compensation. The US Internal Revenue Service has issued regulations regarding the allocation of income for purposes of where income is deemed earned. The regulations address multi-year compensation arrangements including stock plans, transfers of restricted property, and other deferred compensation

EXHIBIT 14 - INFORMATION NEEDED TO DETERMINE TAXATION OF MOBILE EMPLOYEES

- Work country
- Country of residence
- Nationality
- Visa
- US green card status (lawful permanent resident)
- Total time spent in country and in local jurisdictions (e.g., State, Province, Canton)
- Tax residency in country at grant/hire (e.g., resident, nonresident, resident but not ordinarily resident, etc.)
- Tax residency during vesting and at vest (e.g., resident, nonresident, resident but not ordinarily resident, etc.)
- Employer in home country (e.g., US corporation, branch of US corporation, non-US corporation, branch of non-US corporation, etc.)
- Employer in work country (e.g., US corporation, branch of US corporation, non-US corporation, branch of non-US corporation, etc.)
- Special tax treatment
- Date of transfer
- Intended duration of stay
- Applicability of income tax treaty
- Conditions of grant (e.g., grant made on the transfer to the new country)
- Tax equalization policy (if applicable, an arrangement between the employee and the employer as to which taxes the employee will be responsible for bearing the cost of, at the new or temporary location; tax equalization arrangements used to be popular through the 1990s, but their popularity has waned over time).
- Previous international travel for work
- Certificate of coverage
- Taxable income for income tax purposes
- Taxable income for social tax purposes
- Exit taxes

arrangements that generally relate to services performed over a period of more than one year. The allocation is based on time apportionment and the applicable facts and circumstances. In the case of stock options, income is generally allocated based on the work location between the date of grant and the date of vest.

6.10.9. Some countries assess an exit tax when the employee leaves the country. To avoid future compliance and collection problems, the individual is taxed as though the equity compensation was taxable when the employee moves. An exit tax can create problems for the employee. Tax may be due even though the equity award has not vested. The exit tax may not be adjusted to reflect subsequent decreases in the value of the award. An exit tax may also complicate the foreign tax credit calculation.

6.10.10. The rules surrounding mobile employees are very complicated and it is challenging to comply with the tax withholding and reporting requirements in multiple countries and in multiple payroll systems. Tax authorities take an interest in equity compensation of mobile employees and some countries are targeting mobile employees for audits. Employees and companies that are not compliant may be subject to interest, monetary and civil penalties, and in some cases criminal penalties, i.e., jail time.

EXHIBIT 15 - FOREIGN TAX CREDIT

$1,000	Salary income taxed in Country A
$ 100	Stock option income
100%	Stock option income taxed in Country A
30%	Stock option income taxed in Country B
40%	Tax rate in Country A and Country B

Tax paid in Country B is a foreign tax credit in Country A

	Tax Calculation		
	Country A	Country B	Total Tax
Salary income	$1,000		$1,000
Stock option income	100	$ 30	100
Total income	$1,100	$ 30	$1,100
Tax rates	40%	40%	40%
Tax before credits	$ 440	$ 12	
Foreign tax credit*	-12	n/a	
Tax after credits	$ 428	$ 12	$ 440

* Certain limitations may apply

EXHIBIT 16 - METHODS OF ALLOCATING EQUITY COMPENSATION

Mary works in Country A

1/1/20X1	Mary receives a stock option from her employer that vests in two equal annual installments
1/1/20X2	50% of Mary's stock options vest
1/1/20X2	Mary moves to Country B
1/1/20X3	The remaining 50% of Mary's options vest
1/1/20X5	Mary exercises her option

Total gain on the option is $10,000

Method	Calculation of Income Allocated to Country A
Allocating income based on work days between date of grant to date of vest as compared to total work days from date of grant to date of vest	Tranche 1: 1 year / 1 year x 50% $10,000 = $5,000 Tranche 2: 1 year / 2 years x 50% $10,000 = $2,500 Total allocated to Country A: $7,500
Allocating income based on work days between date of grant to date of exercise as compared total work days from date of grant to date of exercise	1 year / 4 years x $10,000 = $2,500

K E Y   C O N S I D E R A T I O N S

- What are the income tax consequences at the grant of an equity award?
- What are the income tax consequences at the vest of an equity award?
- What are the income tax consequences at the exercise of an equity award?
- What are the income tax consequences at the lifting of any restrictions on the shares acquired pursuant to the equity award?
- What are the income tax consequences at the sale of shares of stock?
- How is FMV defined under local law?
- Is the equity award subject to social tax?
- Can the employer's portion of social tax be transferred to the employee?
- What are the income and social tax withholding and reporting obligations?
- What is the tax year for reporting the income?
- What is the appropriate rate of income and social tax withholding?
- What is the employer's portion of the social tax?
- Can the employer's portion of the social tax be reimbursed by the employee?
- How will the employee's portion of the tax be collected?
- Is the method used to collect tax permissible under local law?
- Does the withholding method affect the classification of the award of accounting purposes?
- Does the withholding process meet the requirements under local law?
- How will the taxable income and withholding be reported to Payroll?
- Does the parent company have any obligations (e.g. financial reporting, withholding) under local law?
- Are the responsibilities of the various constituents (e.g., Payroll, Equity Compensation, third-party administrator, broker) clearly defined?
- Is the tax withheld in the equity plan database reconciled to the local payroll records monthly?
- Are there any tax-advantaged equity plans under local law?
- Does charge of the cost of the award from the parent to the local entity have any impact on the taxation to the employee?
- Should cashless exercises be required to avoid exchange control restrictions?
- How are dividends and dividend equivalents taxed under local law?
- Does the payment of a dividend equivalent affect when restricted stock units are taxable?
- How is taxable income for each country determined for mobile employees?
- Does the country assess an exit tax when individuals leave the country?
- Is the cost of compliance balanced against the risk of noncompliance?

Accounting

7.1. Overview.

7.1.1. This section focuses on the key issues associated with accounting for equity awards to non-US service providers. Paragraphs 7.2 to 7.5 consider the reporting issues under US GAAP. Paragraph 7.6 considers the reporting issues under IFRS. A detailed discussion of the specific issues related to the equity-based compensation expense calculation is beyond the scope of this publication.

> Generally accepted accounting principles (US GAAP) are normally used for preparing financial statements of US-headquartered companies. The Financial Accounting Standards Board (FASB) establishes standards for financial accounting and reporting. The statements and interpretations issued by the FASB (e.g.,ASC 718) are recognized as US GAAP. The International Accounting Standards Board (IASB) establishes International Financial Reporting Standards (IFRS) that are required or permitted in over 100 countries.
>
> ASC 718 addresses the treatment of share-based payments under US GAAP. IFRS 2 addresses the treatment of share-based payments under the international accounting standards. Accounting for share-based payment under US GAAP ASC 718 and IFRS 2 are similar, but not identical. This section assumes that financial results are reported under US GAAP/ASC 718. Where appropriate, differences between ASC 718 and IFRS 2 are noted.

7.1.2. ASC 718 addresses the treatment of share-based payments under US GAAP. IFRS 2 addresses the treatment of share-based payments under the international accounting standards. Unless a US company elects to adopt IFRS, US GAAP is normally used for preparing financial statements of US-headquartered companies.

ASC 718 addresses the treatment of share-based payments under US GAAP. IFRS 2 addresses the treatment of share-based payments under the international accounting standards. Unless a US company elects to adopt IFRS, US GAAP is normally used for preparing financial statements of US-headquartered companies.

7.1.3. In general, ASC 718 requires public companies to measure the cost of awards based on the grant date fair value of the award, with limited exceptions. The cost of the awards is recognized over the requisite service period, usually the vesting period.

7.1.4. Denominating an equity award in a currency other than the one in which the employer company conducts its daily business does not affect the method of determining expense under ASC 718 so long as a substantial portion of the company's stock trades in that currency. So, for example, a US-based company whose stock is traded on the NASDAQ could recognize the expense for U.S.-dollar denominated options granted to Canadian employees the same way it accounts for similar options granted to US-based employees.

7.1.5. Assuming the equity awards are not readily marketable and will be delivered in stock of the Issuer, the fair value of stock options is estimated and fixed at the grant date using an option-pricing model. At a minimum the option-pricing model must include the following inputs –

- Grant price
- Market value of the underlying stock
- Expected term
- Expected volatility of the underlying stock
- Expected dividend rate
- Risk-free interest rate

7.1.6. Calculating the fair value of restricted stock and restricted stock units with time-based vesting is easier than calculating the fair value of options. The fair value is the difference between the FMV of the stock at the measurement date (usually the date of grant) and the amount paid for the stock (usually $0). The fair value must be decreased if dividends are paid on the underlying stock, but will not be paid on unvested awards. Any type of equity award may include performance criteria in addition to the requirement of continued service (i.e., the individual remains an employee of the Company). Awards with performance criteria are referred to as performance awards. Performance awards with market conditions generally require the use of a "sophisticated" option-pricing model to calculate their fair value.

7.1.7. Additional information on determining the fair value of the various equity award types can be found in the corresponding GPS publication (e.g. see GPS|Stock Options for more details on the determining the fair value of options, and GPS|Restricted Stock and Restricted Stock Units for details on determining the fair value of restricted stock and restricted stock units).

7.2. Option-Pricing Model.

For determining the fair value of options, the option-pricing model applies to US and non-US service providers. Consider the demographic information of non-US plan participants to determine whether stratification is necessary for purposes of determining the expected term of awards to non-US employees. When valuing options that have non-standardized terms to accommodate local country requirements, such as cliff vesting, review the pricing model being used to value the option as well as the underlying assumptions to ensure the model/assumptions are appropriate.

7.3. Forfeiture Rate.

The recognition of the cost (i.e., fair value) of the award over the service period may be reduced by estimated forfeitures during the service period of the award. For time-based awards, only grants that never vest because service conditions are not met are considered forfeited. Expiration of a vested but unexercised option or SAR is not a forfeiture. Study the demographic information of non-US plan participants to determine if the forfeiture rate differs. Document how forfeitures are estimated and how the amounts are reflected in the reports summarizing the compensation costs associated with equity compensation. ASU 2016-09 removed the requirement to estimate and apply an estimated forfeiture rate. Companies may now choose, as part of a one-time policy election, to true up for forfeitures as they occur.

7.4. Modifications.

With the release of ASU 2017-09, the scope of modifications was limited to changes in the terms of an award that result in a change to the fair value of the award, its vesting, or its classification (liability vs. equity). These modifications may include changes in the quantity of shares subject to the award, or repricing or vesting conditions that are not included in the original Plan and/or the Award Agreement. Modifications to awards may result in additional compensation expense. Document detailed descriptions of various types of modifications and educate local country Human Resource personnel as to what action may trigger a modification to avoid any unintentional modifications. Use a standard form to document the following items:

- The reason for each modification
- The details of the modification
- Approval of the modification
- The associated accounting impact, if any

7.5. Tax Accounting.

7.5.1. The accounting charge for equity compensation must consider the potential tax benefits of a future corporate tax deduction. The benefits of the anticipated future corporate tax deduction are recognized currently for accounting purposes provided the equity award ordinarily will result in a future tax deduction under existing tax law.[5] A deferred tax asset (DTA) is recorded for the future corporate tax deduction of each grant. This is the amount of expense for the grant multiplied by the applicable corporate tax rate. It is recorded as the expense is recognized. At the time of settlement (i.e., exercise of an option, delivery of shares, or expiration of a non-qualified option), the DTA is adjusted to the actual tax benefit received by the Company. If the actual tax benefit exceeds the DTA, an additional tax benefit is recorded. If the actual tax benefit is less than the DTA, then a tax deficiency is recorded. Excess tax benefits reduce tax expense in the income statement, while tax deficiencies increase tax expense. No DTA is recorded for tax-qualified awards such as incentive stock options and Section 423-qualified ESPPs. If the shares are disposed of in a disqualifying disposition, the resulting tax deduction creates a reduction to tax expense.

5 ASC 718-740-25-2.

7.5.2. The estimated corporate tax benefit and the deduction on the corporate tax return must be tracked on a grant-by-grant basis. As discussed in paragraph 8.2, some countries do not allow a corporate tax deduction for equity compensation. In addition, countries outside of the US may have different tax rates. Therefore if a deduction is allowed in the foreign country, the DTA would typically reflect the tax deduction at the local corporate tax rate, not the US corporate tax rate. Care must be taken to determine the estimated corporate tax benefit in each country when setting up (if appropriate) a DTA and when calculating the excess or deficiency at vesting of full value shares/exercise of options/expiration of awards.

7.6. IFRS 2.

7.6.1. In February 2004, the International Accounting Standards Board (IASB), whose standards are followed by entities in many countries, issued International Financial Reporting Standard (IFRS) 2, Share-based Payment. IFRS 2 requires that all entities recognize an expense for all services received in share-based payment transactions, using a fair-value-based method that is similar in most respects to ASC 718. The major differences between ASC 718 and IFRS 2 are summarized in Exhibit 17.

7.6.2. Although IFRS 2 is not currently applicable to financial statements issued under US GAAP, reporting under IFRS 2 may be required for financial statements issued in certain countries. Given the tranche-by-tranche requirement of IFRS 2, companies may also want to rethink issuing awards with monthly or quarterly vesting. IFRS 2 requires the fair value of each tranche to be determined separately and expensed using the graded method. For awards with graded vesting (e.g., vesting monthly), each vesting tranche is valued separately, and each tranche is expensed over its vesting period. In contrast, US GAAP allows a company to expense on either a tranche-by-tranche basis or on a straight-line basis. Changing the vesting from monthly to quarterly will reduce the significant administrative burden of calculating fair values for all tranches (four values per year for quarterly vesting tranches versus twelve values per year for monthly vesting tranches).

EXHIBIT 17 – MAJOR DIFFERENCES BETWEEN ASC 718 AND IFRS 2

Area	US GAAP	IFRS 2
Grant-Date Fair Value	Same fair value for different vesting tranches acceptable	Different fair value for each vesting tranche may be required
Attribution Method	Straight-line or tranche-by-tranche for time based awards (the latter is also referred to as the "Graded" method)	Tranche-by-tranche (aka graded or accelerated) only
Valuation Assumptions	Country-specific stratification may be required, if material	Country-specific stratification required
Share Withholding	Maximum individual rate can be used without triggering liability accounting	Minimum statutory rate must not be exceeded to avoid liability accounting
Tax Accounting	DTA (Deferred Tax Asset) accrued based on grant-date fair value, trued up at settlement	DTA accrued based on intrinsic value at end of each reporting period (not to exceed fair value)
Accrual of Payroll Tax Liability	At time of taxable event (exercise, vest, release, etc.)	Accrued as award vests based on intrinsic value of grant at end of each reporting period
Non-Compensatory Section 423 plan	5% discount only (no lookback)	No safe harbor, all plans (including US Section 423 plans) considered compensatory

KEY CONSIDERATIONS

- Are valuation assumptions and forfeiture rates (if applicable) developed and applied on a country-by-country basis?
- Are controls in place to assess the accounting impact prior to potential modifications?
- Is a DTA only recorded for grants to employees in countries where a tax deduction is anticipated?
- Is the DTA set up and reversed based on the country-specific tax rate?
- If there are significant awards for mobile employees, is the DTA based on the country in which the tax deduction is expected?
- Are statutory financial statements required in any country that is not under US GAAP?
- Which non-US subsidiaries are reporting under IFRS?
- Is expense currently recognized on a straight-line or graded basis?
- Are employees permitted to tender shares to cover taxes and/or the option price?
- Is an ESPP offered?

Other Issues

8.1. Overview.

The detailed information provided in Sections 1-7 addresses the major areas of concern when administering equity plans for non-US employees. There are a variety of other issues that may arise. This section provides a brief overview of some of the ancillary issues and relevant factors to be considered. The issues vary by country and new legislation may generate additional requirements. Therefore, the information provided should not be treated as comprehensive.

8.2. Corporate Tax Deductions.

8.2.1. The non-US entity employing the grantee may be able to take a corporate tax deduction for the cost or intrinsic value of an equity award. The availability and the amount of the deduction are determined under local law. Securing a corporate tax deduction for the equity award may reduce the actual corporate tax that the Company pays in that country and the expense reported for financial statement purposes. A corporate deduction will also affect the calculation of the deferred tax asset under ASC 718.

8.2.2. The exact amount of the deduction varies by country but is typically the amount recognized as income by the employee. Some countries allow a deduction for the fair value of an award at grant. Other countries limit the deduction to the actual "cost" incurred by the parent. A corporate tax deduction is usually limited to employees working for the benefit of the local affiliate. For example, Corporation A in Country Z gets a deduction for equity compensation reported by Corporation A employees in Country Z. Corporation A doesn't get a deduction for equity compensation reported by employees of Corporation B in Country X. Corporate tax deductions for mobile employees must be reviewed carefully.

8.2.3. A corporate tax deduction may be available automatically or a formal agreement (i.e., chargeback or a recharge agreement) may be required between the US issuer and the non-US entity whereby the non-US entity agrees to reimburse the US issuer for the cost of equity awards. The availability of the deduction may be impacted by the type of documentation of the charge, the approval of the board or shareholders of the employing entity and the type of shares used to settle the awards (e.g., treasury shares). Confirm that the state of incorporation of the issuer permits treasury shares since some states require repurchased shares be canceled rather than held as treasury shares. The reimbursement payment to the US may require exchange control approval from local authorities.

8.2.4. A chargeback of equity awards will generally have a positive impact on cash flow of the US issuer. The chargeback of costs to a local entity means the repatriation of cash from the local entity to the US on a dividend-free basis. (Note – The payment of the grant price of an option increases cash to the US issuer whether or not the cost of the award is charged to the local entity.) Care should be taken to ensure that the arrangements comply with US requirements for tax-free repatriation.

8.2.5. In many countries a chargeback agreement must be formalized before the award is granted. Claiming a corporate tax deduction for

The non-US entity employing the grantee may be able to take a corporate tax deduction for the cost or intrinsic value of an equity award. The availability and the amount of the deduction are determined under local law.

equity awards may trigger social tax (at a rate that may be higher than the corporate tax rate) or withholding and reporting obligations. Taking the deduction may also trigger exchange control or other legal issues. Carefully consider all consequences before implementing a chargeback of equity awards. Review chargeback agreements periodically, especially when plans are modified or added.

8.2.6. The impact of a chargeback may be mitigated by transfer pricing agreements that the Company has in place between related entities in the corporate group. Chargeback agreements may also create additional transfer pricing issues for the Company. The involvement of the corporate tax department is critical when implementing a chargeback of equity compensation.

8.2.7. For US tax purposes dividends paid on unvested restricted stock and dividend equivalents paid on unvested restricted stock units are deductible as compensation expense if paid through local payroll. A corporate tax deduction may be allowed in other countries for dividends and dividend equivalents paid to local employees if paid through local payroll.

8.3. Changes to the Equity Plan.

Changes to the Plan may have unforeseen non-US implications, especially regarding tax and legal issues (e.g., re-registration of the Plan under local law or Works Council consultation). Always consider non-US implications when making changes to a plan. Build flexibility into the Plan to minimize the need for further changes. Additional employee communications may be necessary to advise non-US employees of changes in the Plan.

8.4. Mergers and Acquisitions.

Equity plans require special attention during a merger, acquisition, internal reorganization, spinoff, or other corporate transaction. The following are some of the key areas to be addressed during the due diligence or the transition process –

- Identify areas of noncompliance
- Determine how equity plans will be consolidated
- Summarize tax and legal ramifications for settlement/conversion program
- Identify impact on tax-preferred non-US plans
- Identify new areas of compliance post-acquisition (e.g., increased size of employee base in a country, participants in new countries, new entities in a country)

KEY CONSIDERATIONS

- Are corporate deductions available in each country?
- What steps must be taken to secure a corporate deduction for equity compensation?
- Is the repatriation of cash to the US advantageous and consistent with business needs?
- Has a deduction for dividends/dividend equivalents paid been claimed?
- Have changes to the Plan been reviewed for global implications?
- Have all corporate transactions been reviewed to determine the impact on equity plans?

Next Steps

9.1. Overview.

Implementing and administering global equity plans is complicated. The number of processes that must be reviewed and compliance issues that must be addressed for each country is significant. It is difficult to know where to begin and where to focus. This section will provide guidance when converting the concepts addressed in this publication into an action plan.

Successfully implementing a global equity plan requires clearly defined objectives and a focused implementation strategy.

9.2. Implementing a Plan.

9.2.1. Successfully implementing a global equity plan requires clearly defined objectives and a focused implementation strategy. Establish Company objectives, including the actual/perceived benefits to the employee and anticipated costs of the Plan, prior to designing the Plan. Consider phasing implementation outside the US and delaying implementation in countries until there is a critical number of participants in that country. Section 2 discusses factors to consider when designing a total rewards package that includes equity compensation for non-US employees. Utilize a team approach in the decision-making process to ensure all critical issues are addressed at the design stage. Incorporate due diligence in the design process to identify items that may affect plan design such as troublesome tax and legal issues or appropriate planning opportunities. (Appendix D identifies countries that may require tax reporting and withholding for equity awards and countries that may require local country registration. Appendix E identifies significant countries that may have tax-favored equity opportunities.)

9.2.2. The implementation process converts the Plan into reality. Update the due diligence from the design phase and, where appropriate, conduct additional research. In some cases, the cost of complying with various legal and tax requirements may exceed the benefit to the Company or the employees. Involve appropriate tax and legal personnel in making risk management decisions to ensure all factors are considered.

9.2.3. Coordinate with local Human Resources and Payroll to identify what data is required and when it is required. Payroll system functionality may impact how the Plan will be administered in a specific country. Document the process in a country-specific administrative guide. See Appendix C for an example of a country-specific administrative guide. Highlight administrative processes that are inefficient or costly. In certain countries it may be necessary to reconsider the granting of equity awards or restructure the type of equity award granted to accommodate local-country requirements.

9.2.4. Companies grapple with how to meet the compliance requirements in every country. It may not be possible or practical to be in full compliance. Best practice is to prioritize compliance in key locations. Factors used when prioritizing compliance requirements include, but are not limited to –

- Number of employees impacted
- Anticipated growth in a country
- Level of public scrutiny of business activities
- Exposure to penalties and interest
- Enforcement by local authorities

9.2.5. Develop a strategy to communicate the Plan details and benefits to the employees. The strategy may incorporate written materials, local meetings, and web-based learning. The communication strategy should fit the corporate culture and reflect country-specific requirements.

9.2.6. Equity plan database software, brokers, and third-party administrators have enhanced their service offering and functionality to support global equity plans. When selecting a vendor for a global equity plan, the request for proposal should gather information for the unique needs of global plans. Appendix F is a sample of additional information that may be requested from vendors supporting global plans. Identify areas that may require workarounds in response to system limitations. Review the contract for services closely to ensure the contract incorporates all requirements for global employees.

9.3. Maintaining a Plan.

9.3.1. Frequently a company implements an equity plan for non-US employees before understanding all the legal and tax requirements in a country. In those cases, plan maintenance includes many of the steps noted in paragraph 9.2 regarding implementing a plan. Highlight compliance gaps and develop an action plan to ensure compliance. As noted previously, in some cases the cost of complying with various legal and tax requirements may exceed the benefit to the Company or the employees.

9.3.2. Companies may use a centralized or a decentralized approach to plan administration. A centralized approach means most administrative processes are handled at corporate. The local entity involvement is limited to serving the needs of the local employees and meeting the country-specific compliance requirements such as tax withholding and reporting. Centralizing administration usually is most efficient and effective. In addition, centralization allows for more control over the administrative process. If the equity plan administration is decentralized, additional internal controls must be implemented. Best practice is to audit local country activities regarding tax and legal requirements to ensure the process implemented by corporate is understood and followed.

9.3.3. Maintaining current tax rates is important to meet the country-specific tax withholding requirements. At a minimum, tax rates should be confirmed on a regular basis (e.g., quarterly) or prior to significant events such as the vesting of restricted stock units. Tax rates are usually not provided by third-party administrators such as brokers. Tax service providers, such as international accounting/law firms, or local country Payroll usually provide this information.

9.3.4. Keeping up with detailed compliance requirements can be difficult. Companies with operations in a large number of countries may have multiple changes in the tax and legal requirements every year. A company must be aware of legislative changes, changes in the enforcement or interpretation of current legislation, and judicial decisions. Develop a plan to keep current and budget for outside counsel to be involved in periodic review. Best practice is to review the key countries quarterly and to develop a relationship with a service provider to periodically review the risk management decisions and evaluate/resolve troublesome issues. Many service providers provide timely updates on significant law changes. See the "About Our Sponsors" section for helpful websites.

9.3.5. To ensure the administration of the Plan is efficient and effective, review the administrative processes regularly and reexamine the decisions made when implementing the Plan. Involve the appropriate personnel (see paragraph 2.5 regarding the team approach) and the third-party administrator/broker. Identify processes that are inefficient. Review the country-specific administrative guide annually to ensure the details in the guide reflect current practice.

9.3.6. When using a third-party administrator to handle all or part of equity plan administration, implement an annual process to review processes, responsibilities, and specific handoffs. The annual review should include –

- New releases of the equity plan database
- Changes in the Plan
- New country-specific requirements
- Changes in corporate structure
- Significant change in the number of participants in any one country

9.3.7. On a periodic basis review the Plan to determine if the plan objectives are being met. Equity plans are part of the total rewards package for an employee. As changes are made in the total rewards package for competitive reasons or to meet statutory requirements in a country, the role of equity compensation may change. A periodic review of the plan benefits as perceived by the employees can identify opportunities to create a more appropriate rewards package.

To ensure the administration of the Plan is efficient and effective, review the administrative processes regularly and reexamine the decisions made when implementing the Plan.

Appendix A: Acknowledgements

The Certified Equity Professional Institute (CEPI) at Santa Clara University would like to acknowledge the substantial contributions that made this publication possible. The original publication was funded by support from our Title sponsors, Bank of America Merrill Lynch, Fidelity Stock Plan Services, and Transcentive, a Computershare company. Additional support was provided by our Contributing sponsors, Alston + Bird LLP, Baker & McKenzie LLP, Ernst & Young LLP, Global Tax Network US, LLC, James F. Reda & Associates LLC and PricewaterhouseCoopers LLP. As much of this publication leverages that prior work, their contribution was critical to this updated version.

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It is not possible to complete a project of this magnitude alone. Such an undertaking requires the perspectives and inputs of a diverse group of industry experts. The publication was the culmination of extensive interviews, in-depth analysis and a widespread technical review. This publication was able to build from that research and review, coupled with additional input and review from four additional authors. The guidance and inputs of members of the Technical Oversight Board provided invaluable expertise throughout the project to ensure that the publication captures an industry-wide perspective.

2017 Technical Oversight Board

Merav Brown, CEP	UBS
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Renee Trotta, CEP	Charles Schwab
Marlene Zobayan, CEP	Rutlen & Associates LLC

Additionally, the CEPI is fortunate to have a dedicated and supportive Advisory Board. The Advisory Board initially recommended that the CEPI pursue independent research projects, and the Advisory Board has been actively involved throughout the project.

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Marlene is a regular speaker and author on global stock plan and rewards issues. Prior to joining Rutlen Associates, Marlene was the practice leader on the west coast for Deloitte Tax's Global Rewards group. In November 2009, Marlene was awarded the Individual Achievement Award by the National Association of Stock Plan Professionals.

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Denise is a partner in the Baker McKenzie Employment & Compensation Group and focuses her practice on global equity services. She advises multinational companies on the issues related to offering equity and other incentive compensation programs to service providers in their home countries and on a global basis. Denise works with public and private companies to design plans, draft award documentation, review and deal with tax considerations, comply with securities registration, exchange control and other regulatory requirements, minimize labor law exposure, and address data privacy concerns and other compliance issues associated with offering equity and other incentive plans around the world. She also advises companies on the implications of corporate transactions on equity plans and awards. Denise previously served on the CEPI Advisory Board and is a member of the National Association of Stock Plan Professionals and the Global Equity Organization. She is a frequent speaker on topics of interest for professionals dealing with global equity plan issues.

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Elizabeth served as the final technical authority on Accounting matters for this publication.

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Stacy served as the coordinator for the 2017 update to this publication. She reviewed and collected the comments from the Technical Review Board and incorporated their comments into the publication. Stacy was instrumental in keeping the project on track.

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Additional Acknowledgements

The CEPI thanks Baker McKenzie LLP for the use of their Global Equity Matrix (referenced in Appendix D). The Matrix is updated on an ongoing basis, ensuring that anyone using the GPS publication has access to the latest information regarding reporting, legal compliance and regulatory registration requirements for most countries in the world.

The CEPI thanks PwC for the use of their data on countries with tax favored equity plan opportunities (included in this publication as Appendix E). In the future, their website will have a link with this same information, again providing GPS users with access to the latest information.

The CEPI acknowledges Carol Rutlen for her vision and significant contributions in making the original version of this publication. Although Carol was not active in this GPS release, much of the vision of the layout and scope of all of the GPS publications and much of the content in this publication must be credited to Carol.

The CEPI acknowledges Dee Crosby, the former Executive Director of the CEP Institute, for her commitment to the CEP program and her dedication to the GPS research projects. Dee acted as the overall project manager for the publications between 2012 and 2017. Without her support, these projects would not exist. Pam Chernoff, the former Curriculum Coordinator for the CEPI Institute, has served as the project manager since the 2019 update.

Additionally, the CEPI recognizes the hundreds of equity professionals who contributed to this project through in-depth interviews, research participation, or thoughtful comments. Without the involvement of these professionals, this publication could not exist.

Appendix B: Common Equity Compensation Terms

Accepted Terminology	Equivalent
409A	US Internal Revenue Code 409A
Acquired Rights	Regularly offered benefit that is deemed non-discretionary and cannot be taken away
Approved Plan	A plan that receives favorable tax treatment in a specific country
ASC Topic 718	Accounting Standards Codification on stock compensation incorporating FAS 123(R)
Award Agreement	Employee Equity Agreement; Grant Agreement; Agreement
Black-Scholes Model	Black-Scholes Option Pricing Model; Black-Scholes
Blackout Period	Period of time in which designated individuals cannot trade securities of a corporation
Board	Board of Directors
Broker	Brokerage Firm; Securities Dealer; Registered Broker; Stock Broker
Chargeback Agreement	Arrangement between an Issuer and its subsidiary where the subsidiary reimburses the parent for the cost of an equity program
Clawback	Contractual right to recover gains from equity compensation in certain circumstances
Cliff Vest	Entire award vests in full on a single date
Common Stock	Capital Stock; Securities
Compensation Expense	Expense; Compensation Cost
Compensation Income	Income; Compensation
Data Privacy Laws	Laws regarding how personal information is collected, processed in a database, and transferred from one country to another
Deferred Tax Asset	DTA; an asset representing anticipated tax benefits to be received in the future
Director	Member of the Board of Directors; Board member
Employee Stock Purchase Plan	ESPP; a plan which permits employees to purchase stock in the employer through regular contributions, often with favorable terms; may be US tax-qualified under IRC Section 423
Employee Trading Restrictions	Restrictions for employees on trading company stock
Exercise	To implement the rights of an option to purchase shares at a predetermined price
Exchange Control	Restrictions on inbound and outbound transfer of local currency
Exit Tax	A tax on equity imposed when an individual terminates residency or leaves a country
FMV	Fair Market Value
Fair Value	Accounting term for SFAS 123(R)
FASB	Financial Accounting Standards Board
Forfeiture	An accounting term for awards which never vest due to a failure to satisfy the requisite service period
Graded Vesting	Incremental schedule over which vesting requirements are met
Grant	Award
Grant Date	Date of Grant; Option Date
Grant Price	Exercise price; cost to acquire the underlying shares of an equity award
Home Country	The country of origin for a mobile employee
IASB	International Accounting Standards Board
IFRS	International Financial Reporting Standards; guidelines and rules for preparing financial statements

ISO	Incentive Stock Option; a US tax-qualified option
Insider	Affiliate
IRC	US Internal Revenue Code
IRC Section 423 Plan	ESPP; Employee stock purchase plan that complies with the statutory rules of IRC Section 423
IRC Section 83(b) Election	US tax election to include the FMV of property received (less any amount paid for the property) in the year of transfer
Issuer	Company that "issues" stock; may be privately held or publicly traded
Leave of Absence	Leave; LOA
Mobile Employee	Employees that work in one or more countries between the time they are granted equity compensation and when the equity compensation is taxable under local law
Modification	Change; edit related to a Plan, award or grant of equity
Non-US Affiliate	A corporate subsidiary or affiliate organization in the same group, owned or controlled by the US Issuer
Non-US Employee	Employees working in a country other than the US; may be a citizen of the work country, a citizen of the US, or a citizen of another country
Notice Period	Advance notice required prior to the formal termination of employment; may include a period when the employee is not providing service to the company
Plan	Legal document or rules under which employee equity awards are granted, including employee stock option plan, employee stock purchase plan
Recharge Agreement	Chargeback; agreement where a foreign subsidiary reimburses the issuer for the costs of equity awards
Release	Transfer of shares to the recipient
Restricted Stock Award	RSA; Equity award in which stock is issued, usually at no cost, subject to vesting restrictions
Restricted Stock Unit	RSU; Equity award in which a promise is made to issue stock, usually at no cost, when vesting restrictions have been met
Same-Day-Sale	SDS; exercise of an option and simultaneous sale of shares through a broker
SEC	Commission; Securities and Exchange Commission
Sell-to-Cover	Shares sold from award to cover tax obligation
Shares	Stock
Stock Option	Equity award in which the right to purchase stock at a fixed price for a fixed period of time is granted; may be subject to vesting or other restrictions
Stock Plan Brokerage Account	Brokerage account established specifically for company stock plan transactions
Subplan	Partitioned section of an equity plan to serve particular jurisdictions
Tax Treaty	Bilateral agreements between countries that provide how items are treated for tax purposes
Tax Withholding	Withholding
Termination	Conclusion of an employment arrangement
Transfer Agent	Agent responsible for issuing and transferring shares of a corporation
US GAAP	Generally accepted accounting principles normally used for preparing financial statements of US-headquartered companies
Vest	Award no longer subject to substantial risk of forfeiture
W-8BEN	US Internal Revenue Service form to certify ownership of assets by a non-US taxpayer
Withhold-to-Cover	Shares withheld from award to cover tax obligation; net settlement
Works Council	A group representing employees in discussions with employer on working conditions, etc.

Appendix C:
Country-Specific Administration Guide

Country:		
Local Human Resource Contact:		
Local Payroll Contact:		
Topic:	Standard Practice	Country-Specific Requirements (Designate Responsible Party if Applicable)
Plan Design		
Types of awards issued		
Subplan or country specific terms used	YES/NO	
Legal Requirements		
Securities filings required		
Employee trading restrictions		
Labor law issues		
Data privacy		
Exchange control requirements		
Foreign ownership limitations		
Mandated employee communications		
Other		
Grant Process		
Employees covered		
Treatment of part-time employees		
Treatment of employees on leaves of absence		
Update of employee status – timing and process		
Standardized grant terms used	YES/NO	
Special vesting and post-termination provisions		
Special forfeiture provisions		
Special retirement provisions		
Definition of FMV		
Restrictions on timing of the grant/grant dates		
Reporting of grant to tax authorities		
Award agreement format		
Grant package documentation		
Grant acceptance required	YES/NO	
Translation requirements		
Other		
Transactions		
Establishing a stock plan brokerage account		
Require same-day-sale	YES/NO	
Special instructions to broker		
Restrictions on distribution of shares		
Methods of distributing proceeds		
Requirements for handling terminated employees		
Currency conversion		
Other		

Appendix C: Country-Specific Administration Guide *(continued)*

Tax and Payroll Issues		
Tax treatment of award		
Withholding method		
Determination of withholding amount		
Key dates - Transmission of income and withholding data to Payroll - Due date of payroll tax deposits		
Format of data		
Rounding of shares		
Taxation of dividends/dividend equivalents		
Provide rates to broker		
Import withholding and reporting into payroll system		
Make tax deposit for tax withheld for equity awards		
Other		
Other Issues		
Corporate deduction available	YES/NO	
Documents required to secure corporate deduction		
Other		

Appendix D: Country Tax Withholding and Reporting, Legal Compliance and Regulatory Registration Requirements

Baker McKenzie's Global Equity Services practice publishes a complimentary Matrix summarizing local country employee tax treatment, employer tax withholding and reporting obligations and registration requirements for US public companies offering stock options, ESPP, restricted stock/restricted stock units and cash awards in 50 countries.

Topics covered in the Matrix for each of the 50 countries and the various awards include:

- Data Privacy Considerations
- Exchange Controls Requirements
- Plan Entitlement
- Securities Restrictions and Filings
- Subsidiary Tax Deduction
- Taxation of Employee
- Tax Withholding and Reporting

The Matrix is available as an interactive tool at https://resourcehub.bakermckenzie.com/en/resources/global-equity-matrix.

DISCLAIMER

The information in the Matrix should not be relied upon for tax/legal advice and is not a substitute for obtaining such advice before a Company offers equity awards to employees outside the US. Although every effort has been made to ensure that the Matrix provides an accurate and up to-date summary based on grants to employees under a public company's plan, the laws applicable to stock plans change frequently and are often unclear in their application to awards offered by a company in another country. Also, specific plan features, structure of legal entities, industry of issuer, types of shares used, specific tax rulings obtained, etc. may affect legal and tax results. Specifically, depending on the terms of the plan/grant, the tax/legal consequences can vary greatly. Accordingly, reliance on information in the Matrix for answering specific tax/legal questions is not advised. Instead, the information in the Matrix should be used only as a guide to potential tax/legal issues/consequences, and readers should seek appropriate legal and/or tax advice before making grants.

Appendix E : Significant Countries with Tax-Favored Equity Plan Opportunities

(Effective 15 September 2023)

The following information has been provided by PwC LLP. www.pwcequityplanner.com

Country Name:	Stock Options	Employee Stock Purchase Plan	Restricted Stock Units
Argentina	-	-	-
Australia	-	-	-
Austria	✓	✓	✓
Belgium	✓	✓	✓
Brazil	-	-	-
Canada	✓	-	-
China	✓	✓	✓
Denmark	✓	✓	✓
Finland	-	✓	-
France	✓	✓	✓
Germany	✓	✓	✓
Hong Kong	-	-	-
India	-	-	-
Ireland	✓	✓	-
Israel	✓	✓	✓
Italy	✓	✓	✓
Japan	✓	-	-
Korea	-	-	-
Mexico	-	-	-
Netherlands	-	-	-
Norway	✓	✓	✓
Philippines	-	-	-
Singapore	-	-	-
Spain	✓	✓	✓
Sweden	-	-	-
Switzerland	-	-	-
Thailand	-	-	-
United Kingdom	✓	✓	-
United States	✓	✓	-
Venezuela	-	-	-

Although we have noted countries that have special tax preferences and tax advantages for equity awards that comply with certain requirements, this does not necessarily mean that a better tax result will be available nor that typical US award types/ terms can/will qualify for such preferential tax treatment.

Appendix F: Vendor Selection for Global Equity Plans

When selecting a vendor to support administration of equity plans, special attention needs to be paid to the needs of non-US participants and the special requirements for plan administration in all jurisdictions. This appendix identifies topics that may be appropriate to include in a Request for Proposal (RFP) for administering a global equity plan.

General Capabilities

- Describe support/services model for non-US participants
  - Locations and hours of operation for call centers
  - Web materials and capabilities
  - Live chat or email support
  - Real-time trading
  - Brokerage and other participant services
  - Funds disbursement/foreign exchange/remittance
    - Methods of delivering sales proceeds
    - Delivery charges (i.e., mailed check, wire transfer, overnight delivery)
    - Currency conversion and fees
- Describe language and translation capabilities, including telephone support and web materials
- Ability to customize participant communications
- Flexibility to customize support to meet country-specific requirements
- Describe data security and privacy to ensure enterprise security
  - Compliance/certification with European or other non-US data privacy standards
  - Data security procedures and protections
  - Data storage
  - Management of access to participant info
- Describe processing of shares and money (contributions, proceeds)
  - Ability to accept/send data to/from multiple payroll systems
  - Processes for managing funds and shares
- Other
  - Describe the abilities related to Insiders/Executive Services
  - Describe process for staying abreast of changes in non-US regulatory and compliance framework
  - Describe process for communicating changes in non-US regulatory and compliance framework to clients
  - Provide information as to the number of CEPs on staff

Equity Plan Database Functionality

- Describe the scope of the system's abilities for tracking and administering non-US plans, including
  - Plan participant data and naming restrictions
  - Requirements for unique global ID
  - Special processing or limitations for certain countries (i.e., only allowing same-day-sale of options in a particular jurisdiction)
  - Country-specific definition of FMV supported
  - Decimal place requirements
  - Grant expiration dates (midnight of day prior or 11:59 p.m. day of, and time zone used)
  - Information required for country-specific tax advantaged plans
  - Mobility tracking and income allocation for tax withholding purposes
  - Dividend reinvestment calculation functionality

Equity Plan Database Functionality *(continued)*

- Describe the capabilities for generating and tracking grant/award agreements and packages, including
  - ✦ Types of agreements that can be generated
  - ✦ Ability to restrict transactions pending receipt of signed agreement
  - ✦ Ability to post different grant/enrollment agreements on website and ensure participant accesses correct agreement for his/her grant terms & conditions
  - ✦ Ability to track the grant agreement associated with each grant
  - ✦ Whether award agreements are generic or customized by group or participant
  - ✦ Whether participant grant information is included
  - ✦ Number of agreements/documents that can be posted per grant
  - ✦ Ability for participants to accept or reject awards online
  - ✦ Indicate if there are any countries where this functionality is not available
- Describe the system's ability to track multiple exercise types, including cash, cashless (same-day-sale and sell-to-cover), SARs, and stock swap (settlement in cash, stock, or combination of both)
  - ✦ Describe the method for processing each type of exercise, including
    - ❍ Ability to limit exercise types by demographic region (i.e., specific country location)
    - ❍ Calculation of tax withholding (domestic and non-US)
  - ✦ Describe the communications process for notifying Company when changes or corrections are required
  - ✦ Describe the ability to remit option grant price (and tax withholdings) to Company via multiple wire transfers to varying corporate bank accounts based on corporate entity
- Restricted Stock Awards/Units
  - ✦ Describe the system's ability to track Restricted Stock Awards/Units, including
    - ❍ Vesting dates
    - ❍ Releases/issuances
    - ❍ Tax elections
    - ❍ Calculation and tracking of tax payments due
    - ❍ Variances in definition of taxable event (grant or vest) based on country
  - ✦ Indicate the allowable methods of tax payment that can be supported, i.e., cash funding of account, check received directly from participant, net share issuance, etc.
  - ✦ Describe the process for gathering and tracking tax elections directly from participants and transmitting them to the administration system. Indicate whether online and/or manual election forms are available.
- Terminations
  - ✦ Describe the system's ability to track termination terms by plan and termination type, including the process for tracking non-standard termination terms
  - ✦ Describe the system's ability to implement different rules for various employment termination situations, such as retirement, death, or disability
- Describe the ability to track non-US insiders and executives
- Specifically address administering equity awards in the following list of countries and list any related issues or special services provided for participants in these countries:
  - ✦ Country X
  - ✦ Country Y
- List any countries not supported or for which there is limited support and the associated limitations.

Participant Information and Transactions

- Describe the process for participants to set-up and activate accounts
  - ✦ Availability of on-line account set-up and activation. Indicate any countries where this feature is not available.
  - ✦ Process for W-9 and W-8BEN certification
  - ✦ Turnaround time for account activation
  - ✦ User security requirements
  - ✦ Any special requirements for non-US participants
- Transaction Processing
  - ✦ Describe the delivery methods and typical delivery times available for non-US participants. Indicate if any particular delivery methods are not available in all countries.
  - ✦ Describe company's ability to deliver proceeds in foreign currencies. Indicate which currencies are available.

Tax and Reporting

- Tax
  - ✦ Describe the source for tax rates; third party supplied, plan sponsor supplied
  - ✦ Describe the system's ability to capture and apply different tax withholding rates and caps for domestic and non-US participants. Indicate whether multiple tax rates are stored on an individual basis or whether they can be specified as a flat rate for a particular location.
  - ✦ Describe the ability to withhold tax at different taxable events as specified by local law in all countries in which the Company grants equity
  - ✦ Describe the system's capability to track holding periods as required in certain countries and notify the Company if holding periods are not met
  - ✦ Describe the company's process to deliver tax withholdings to the Company
  - ✦ Describe the ability to remit tax amounts to the Company through either a "Pay through Payroll" method or through a special bank account specified by the Company for countries with local income tax withholding and special exchange control requirements
  - ✦ Indicate the turnaround time for loading and processing updated tax withholding data
  - ✦ Describe the tracking and reporting of tax obligations for the various entities
- Reporting/Financial Reporting
  - ✦ Describe support for compensation expense reporting under IFRS2 and ASC 718
  - ✦ Describe support for compensation expense reporting by entity-level or user-specified element
  - ✦ Describe ability to provide data to the Company for expense or other financial reporting via feedback files
  - ✦ Describe ability to track data required for expense chargeback program
  - ✦ Describe audit and controls environment for financial reporting
  - ✦ Describe the system's ability to limit access for reporting purposes based on location and/or function
  - ✦ Describe the system's ability to track country or location code for reporting/tax purposes
- Describe capabilities for tracking mobile participants
  - ✦ Historical data and "As Of" dates
  - ✦ Status changes
  - ✦ Reporting on mobility changes
  - ✦ Support for third party/external services for taxation of mobile participants or expatriates

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[1] According to full administration plan sponsors surveyed in the 2011, 2012, 2013, 2014, 2015, and 2016 Group Five Stock Plan Administration Benchmark Studies. Group Five LLC is a business-to-business research and consulting firm in San Anselmo, CA. Group Five LLC and Fidelity Investments are not affiliated.

[2] Source: Certified Equity Professional Institute, January 2017.

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The Certified Equity Professional Institute (CEPI) at Santa Clara University is the only source of professional certification for equity compensation professionals. The CEPI is a nonprofit, academic organization with a mission of establishing, promoting, and providing certification and continuing education for the equity compensation industry.

Since the CEP Institute was founded in 1989, thousands of individuals have benefited from its self-study certification program. More than 2,000 people have achieved the Certified Equity Professional designation. Organizations and individuals use the CEP exams as a measurement of knowledge, skills, and abilities related to equity compensation tax, corporate and securities law, accounting, and equity plan design, analysis, and administration. The three levels are:

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Additionally, in 2020 the CEPI introduced the Advanced Equity Compensation Accounting Certificate program. As the only source of professional certification in equity compensation, the CEPI recognizes and understands the critical need for impartial guidance in this area. The CEPI has undertaken a series of research projects titled *GPS: Guidance | Procedures | Systems.*

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