EQUITY COMPENSATION FOR U.S. MANAGERS: **AVOIDING U.S. TAX AND SECURITIES LAW PITFALLS**

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Equity compensation is usually an important component of the compensation packages offered by portfolio companies to their senior managers (whether under a free share plan, or pursuant to an actual investment made by the managers), aligning the managers' interests with a company's shareholders, as well as provide a financial incentive for superior performance. Many French portfolio companies operate globally, with key senior managers located all over the world. It is important for a portfolio company to take U.S. tax rules and securities laws into consideration in structuring its equity compensation for their U.S. managers. Failure to do so risks unexpected (and sometimes early) income tax bills for the U.S. managers. Failure to take U.S. tax and securities laws into consideration at the outset risks delaying a sale of the portfolio company down the road. The following is a discussion of issues to keep in mind when rolling out an equity compensation package for U.S. managers as well as French managers who could be transferred to the U.S. and become U.S. taxpayers.

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"Restricted" Stock Grant Election. If stock granted to a manager is subject to a call option with "bad leaver" penalties, it may be "subject to a risk of forfeiture" for U.S. federal income tax purposes. U.S. tax law allows the manager receiving or purchasing such "restricted stock" to elect to be taxed on the stock at grant (a "Section 83(b) election"). If made, upon a later sale of the stock, any appreciation from the time of grant will be taxed at the more favorable U.S. long-term capital gain rates if the stock has been held for more than one year. Also, no U.S. social security taxes will be due with a later sale (or if earlier, when the call option terminates). If no election is made, the manager will be taxable, at ordinary income tax rates and subject to social security taxes, on the stock's fair market value (less any amount paid by the manager) when the call option terminates. If the manager paid the fair market price for the stock when granted (so that no tax would be due at grant even if a Section 83(b) election is made), the failure to make a Section 83(b) election within 30 days of a stock grant can be costly. If a French manager not subject to U.S. tax is likely to be transferred to the U.S. in the future, it may make sense for the French manager to make a Section 83(b) election. Although U.S. federal tax law is not fully certain on this point, the prevailing view is that the French manager will owe no tax by making the election but will have the advantage of the election if the call option lapses while the manager is resident in the U.S. and subject to U.S. federal income tax.

Beware the ManCo. When the managers of French portfolio companies are required to make an actual investment to receive an equity package, it is common to establish a management company ("ManCo") to hold their shares. A ManCo may be treated as a passive foreign investment company ("PFIC") for U.S. federal income tax purposes. Such treatment can have harsh tax consequences to managers who are subject to US income tax, including late payment interest charges on tax deferral and denial of preferential capital gains rates or phantom income. It is often possible to structure a ManCo in a way that avoids the harsh effect of PFIC classification.

The Tip of the Iceberg. Section 83(b) elections and PFICs are just two of the issues confronting portfolio companies in designing equity compensation packages for their U.S. managers. Other tax traps include a possible 20% penalty imposed on U.S. managers and interest assessments if stock options are issued with a discounted exercise price or upon preferred stock; lost company tax deductions and a 20% excise tax assessed against the U.S. managers for amounts ("golden parachutes") paid upon a change in control (both of which a private company can avoid if shareholders approve the payment in a vote which complies with certain requirements), and tricky rules for deferred payments. Lastly, keep in mind that equity grants to U.S. executives may constitute stock offerings under U.S. federal and state securities laws. Exemptions from U.S. federal and state registration for the equity grants may be available but it is important that employers comply with their requirements.

The Bottom Line. Upfront tax planning is essential when granting French equity compensation packages to U.S. managers. Equity compensation that results in larger than expected income taxes – and risks possible U.S. tax penalties – risks unhappy managers. ■

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