FRENCH V. U.S. SHARE-BASED COMPENSATION PLANS: A COMPARATIVE ANALYSIS

Authors
Fanny Karaman
Stanley C. Ruchelman

Tags
Code §83
Code §409A
Cross-Border Tax Planning
France
Stock Options
U.S.

INTRODUCTION

While the terms of plans vary from country to country, share-based compensation incentives are commonly used by corporations worldwide. Employees defer income or realize income immediately at a low value and the employer accepts a deferred or reduced deduction for compensation expense. While the goals of these plans share common themes, the tax rules that make a particular plan attractive differ from country to country. Both sides to the arrangement are "invested" in operational success that leads to a liquidity event in the form of a public offering or a strategic sale.

FACTUAL CONTEXT

This article is drafted with the following situation in mind. A hypothetical French-resident employee participates in a French share-based compensation plan granted by a start-up operation. At the time of grant, neither the employer nor the employee envisions an expansion to the U.S. After several years pass, the employer forms a U.S. distribution subsidiary and sends the individual abroad to head the U.S. operation.

While the employer is concerned primarily with the success of the expansion, both the employer and the employee should be concerned with the U.S. tax treatment of the employee at the time of the liquidity event, which is the goal of the share-based scheme. The employee is concerned with avoiding excessive taxation on a global basis. The employer is concerned that the expense arising from the stock-based compensation scheme is fully deductible in the U.S. or France.

At this point, French and U.S. tax counsel are generally retained by the employer. The employee should make certain that the scope of the assistance encompasses a tax analysis of the employee's situation. If not, the employee should retain separate counsel to understand the tax consequences of his or her French share-based compensation plan for both French and U.S. tax purposes.

While a French share-based compensation plan qualifies for the relevant French beneficial income tax regime prior to moving to the U.S., it generally does not qualify for beneficial treatment on the U.S. side. Thus, French plans generally constitute nonqualified share-based compensation plans for U.S. tax purposes.

The balance of the article aims at highlighting the beneficial share-based compensation regimes for French tax purposes and providing an analysis of the U.S. tax treatment of nonqualifying share-based compensation plans.

THE MAJOR FRENCH SHARE-BASED COMPENSATION REGIMES

Three main share-based compensation regimes exist under French corporate and tax laws:

- Free share plans (“*plan d’attribution gratuite d’actions*”)
- B.S.P.C.E.’s (“*bons de souscription de parts de createurs d’entreprises*”)
- Stock option plans (“*options sur titres*”)

The first two regimes are commonly used in the start-up world, and so, those plans comprise the focus of this article.

Free Share Plans

Under current French law, free shares can be granted to certain employees and officers in a tax efficient way when the following requirements are met:[1]

- The issuing entity is formed as one of the following types of entities: a *Société Anonyme* (“S.A.”),[2] a *Société en commandite par actions* (“S.C.A.”),[3] or a *Société paactions simplifiée* (“S.A.S.”).[4]
- No free shares are distributed to employees or officers holding 10% or more of the share capital of the company.
- The distributed free shares do not exceed 10% of the share capital.
- The distribution of shares is authorized by the shareholders.
- The shares are issued to employees of the issuing entity or a related entity.

---

1 Article L.225-197-1 to L. 225-197-6 of the French Commercial Code.

2 An S.A. is a joint stock corporation that is the equivalent of a corporation in the U.S. The formation of an S.A. requires at least two shareholders. The minimum capital contribution upon formation is €37,000. At least 50% must be contributed upon formation, and the balance must be contributed within five years. Strict corporate governance rules apply (Articles L225 *et seq*. of the French Commercial Code).

3 An S.C.A. is formed by at least one general shareholder and three limited shareholders. The general shareholders are jointly and severally liable for the debts of the company, and their shares are not freely transferable. In comparison, the limited shareholders have the same status as shareholders in an S.A. Their liability is limited to the amount of their contributions, and their shares are transferable under the same conditions as those applicable to shareholders in an S.A. The minimum capital contribution for privately held S.C.A.’s is €37,000, of which 50% must be paid upon formation and the balance within five years. Despite these heavy regulations, S.C.A.’s can be attractive because they offer flexibility in defining the duties of corporate officers.

4 An S.A.S. can be formed by one or more shareholders. Every shareholder has limited liability. There is no minimum capital contribution requirement. This type of entity is attractive because of the absence of mandatory corporate governance rules. Shareholders can almost freely draft the bylaws (Articles L227-1 to L 227-20 and L244-1 to L244-4 of the French Commercial Code).

> *"If the beneficiary of the free share plan is not a French resident at the time the underlying shares are sold, French withholding tax applies to the Acquisition Gain at the highest marginal rate of 20%."*

- The shares are definitively attributed to the beneficiaries no earlier than one year after their grant (the "Definitive Attribution Period"), and the rights to the underlying shares are not disposed of prior to their definitive attribution.
- The Definitive Attribution Period and the "Mandatory Holding Period"[5] are at least two years in the aggregate.

While free shares must generally be attributed to an employee free of any payment, a symbolic purchase price can be attributed to shares granted under foreign plans.

Beneficiaries of newly issued plans[6] are subject to French income tax and social charges as follows:

- Compensation income is recognized in an amount that is equal to the difference between the fair market value at the time of definitive attribution and the amount paid for the shares (the "Acquisition Gain"). If no amount is paid, the fair market value is the measure of compensation.
- Once the amount of the Acquisition Gain is determined, tax is deferred until the shares are sold. If the shares are held for specified periods, generally applicable only for capital gains tax purposes, the taxable Acquisition Gain can be reduced by up to 65% generally and 85% in some instances. Social charges will be levied at a 15.5% rate on the full amount of the Acquisition Gain without the reductions in tax base allowed for income tax purposes.
- Capital gain realized upon sale is recognized up to the amount realized at the time of disposition, decreased by the fair market value at the time of definitive acquisition. Again, the tax base is reduced if certain holding period requirements are met. Social charges will be levied at a 15.5% rate on the full amount of the gain realized upon sale, of which 5.1% is tax deductible in the subsequent year.
- If the beneficiary of the free share plan is not a French resident at the time the underlying shares are sold, French withholding tax applies to the Acquisition Gain at the highest marginal rate of 20%.[7] No French withholding tax generally applies on the capital gain realized upon sale.

B.S.P.C.E.

Under current French law, B.S.P.C.E.'s grant their beneficiaries the right to subscribe to a certain amount of the issuing entity's shares at a strike price that is fixed at the time of grant. The B.S.P.C.E.'s constitute a sort of voucher, which gives the beneficiaries the rights to the underlying shares. The underlying shares are then issued upon the exercise and payment of the strike price by the beneficiary. The plan must stipulate a period within which the beneficiaries must exercise their rights.

---

[5] A plan may provide that the shares must be held by the beneficiary for a specific period after the shares have been definitively attributed to the beneficiary (the "Mandatory Holding Period"). A plan may also provide that, for certain employees or officers, the shares, or a certain amount of the shares, cannot be disposed of prior to the end of employment.

[6] *I.e.*, plans issued as of August 8, 2015.

[7] Article 182A *ter* of the French Tax Code.

Under article 163 *bis* G of the French Tax Code, an entity can issue B.S.P.C.E.'s if all the following conditions are met at the time of issuance:

- The entity is an S.A., S.C.A., S.A.S., or "European Corporation."[8]
- The entity is subject to French corporate income tax.
- The entity is either privately held or listed on an E.U., Norwegian, Icelandic, or Liechtenstein regulated market. If so listed, the entity's listed capital cannot exceed €150 million or its equivalent.
- The entity was officially formed within the preceding 15 years and is not the result of a corporate reorganization.At least 25% of the share capital is continuously and directly held by individuals, or by companies in which individuals directly hold at least 75% of the share capital.

B.S.P.C.E.'s can be attributed to employees and certain corporate officers. They are issued on a per name basis and are not transferrable.

French income tax is imposed at the time of a subsequent sale of the shares acquired upon exercise of the B.S.P.C.E. The taxable amount is the difference between the acquisition price and the sales proceeds. It is prudent to provide for an exercise price that equals at least the fair market value of the stock at the time of grant.

If these requirements are met, the taxable amount is subject to French income tax at a rate of 19% upon subsequent sale if the individual has been employed by the company for at least three years or 30% if the individual has been employed by the company for less than three years. If the requirements are not met, the gain realized upon a subsequent sale is subject to French income tax at ordinary rates. In addition, all employment-related social charges and contributions are imposed. Thus, the share-based compensation plan is effectively deprived of its benefits.

When the employee later departs France, the taxable amount is divided into the following categories:

- Acquisition Gain – which, for this purpose, equals the value of the shares on the date of exercise (the "Exercise Value") less the amount paid for the shares upon exercise – is treated as employment income for income tax treaty purposes.
- Sale Gain – which equals the proceeds received upon sale less the Exercise Value – is treated either as a capital gain or as "other income," depending on the applicable treaty.[9]

If the beneficiary is not a French resident at the time of subsequent sale, French withholding tax applies at the highest marginal rate of 20%.

---

[8] A European Corporation is a legal entity that can exercise activities in various E.U. Member States. It is governed by the European Council Regulation No. 2157/2001 of October 8, 2011 and by every Member State's internal legislation. In France, articles L229-1 to L229-15 apply to European Corporations. A European Corporation generally has the legal form of an S.A.

[9] BOI-RSA-ES-20-4- no 470 and 480.

U.S. STOCK OPTION AND STOCK PURCHASE REGIMES

U.S. tax law provides three separate tax regimes for share-based compensation:

- Nonqualified stock option ("N.S.O.")[10]
- Incentive stock option ("I.S.O.")[11]
- Employee stock purchase plan ("E.S.P.P.")[12]

I.S.O.'s and E.S.P.P.'s provide for favorable tax treatment. N.S.O.'s are treated as a form of deferred compensation and, by and large, do not provide for favorable tax treatment. The French share-based compensation plans described above generally fail one or more requirements to qualify for favorable U.S. tax treatment. Thus, only N.S.O.'s are analyzed in this article.

Application of Code §83 to N.S.O.'s and Restricted Property

Code §83 deals with property transferred in connection with the performance of services (see below regarding potential application of Code §409A). Absent a substantial risk of forfeiture or non-transferability, Code §83 will apply to N.S.O.'s either at grant or upon exercise, as follows:[13]

- If the option has a readily ascertainable fair market value at the time of grant, Code §83 applies to the grant of the N.S.O. As a result, that readily ascertainable value, less any amount paid by the N.S.O. recipient, is taxed as compensation income in the year of grant.
- Absent a readily ascertainable market value at the time of grant, Code §83 applies upon exercise of the option. In this case, the taxable amount equals the fair market value at the date of exercise less the price paid by the recipient for the option and the shares. In addition, if the strike price is below fair market value on the date of issuance, Code §409A may provide for taxation prior to the date of exercise (see below). Any tax paid under Code § 409A will increase the cost basis in the shares.

For the purpose of Code §83, options have a readily ascertainable value when they are publicly traded. Otherwise, the value must be measurable with reasonable accuracy.[14] In any event, an option will not be considered as having a readily ascertainable value unless all the following requirements are met:[15]

- The option is transferable by the beneficiary.
- The option is exercisable immediately in full.

---

10 Internal Revenue Code of 1986, as amended, (the "Code") §§409A, 457A and 83. For purposes of this article, the provisions of Code §457A are not discussed.

11 Code §§421 and 422.

12 Code §§421 and 423.

13 Code §83(e)(3).

14 Treas. Reg. §1.83-(7)(b)(2).

15 *Id.*

- The option or the underlying shares are not subject to any restrictions or conditions that have a significant effect on the option's fair market value, other than a lien or other condition to secure the purchase price.
- The fair market value of the option privilege is readily ascertainable.

If the stock increases in value after the shares have been acquired, the sale will be treated as a capital gain. Should the shares be held for longer than 12 months, favorable tax rates for long-term capital gains (up to 20%) will apply, and possibly net investment income tax (3.8%). State and local tax in the place of residence will be imposed, as well.

As a result, if the N.S.O. is taxed upon grant, any subsequent increase in value can benefit from long-term capital gains tax rates upon subsequent sale if the holding period requirement is met. The compensation aspect is limited to the date of grant. If, however, the N.S.O. is taxed upon exercise, the potential increase in value of the underlying stock, from the date of grant until the date of exercise, is subject to income tax at ordinary rates. Only the increase in value from the date of exercise can potentially benefit from long-term capital gains tax treatment upon subsequent sale.

However, if a substantial risk of forfeiture exists upon grant or exercise, or if the option is not transferable, the taxable event will be deferred until the earlier of the following two events: the lapse of the substantial risk of forfeiture or the date of sale. Any tax computed under Code §409A is deferred until the date on which the substantial risk of forfeiture is terminated.

"Should the shares be held for longer than 12 months, favorable tax rates for long-term capital gains (up to 20%) will apply, and possibly net investment income tax (3.8%)."

Discounted Stock Options and the Code §409A Anti-Deferral Regime

Code §409A accelerates the time when the holder of an N.S.O. must recognize income. Its breadth is wide. In general, it applies to N.S.O.'s if the exercise price is lower than the fair market value of the stock at the time of grant.[16] For this purpose, restrictions that will lapse over time are ignored in measuring value. The delta is immediately taxable when the options vest. This may be on the date of issuance or on the date when a substantial risk of forfeiture lapses. A substantial risk of forfeiture exists when a person's right to compensation is conditioned upon the future performance of substantial services by any individual or the occurrence of a condition related to a purpose of the compensation, and the possibility of forfeiture is substantial.[17]

In addition to income tax on the deferred compensation amount, the taxpayer must also pay (i) interest, at the underpayment rate plus 1%, on the tax due as of the first day compensation should have been included in income and (ii) 20% of the deferred compensation amount.

A limited exception applies to the application of the Code §409A anti-deferral provisions. If an N.S.O. complies with the requirements of this exception, it is deemed not to provide for the deferral of compensation. For this purpose, all the following requirements must be met:

- The N.S.O. is an option to purchase "Service Recipient Stock" (defined below)

[16] Treas. Reg. §1.409A-1(b)((5)(i)(A).

[17] Code §409A(d)((4); Treas. Reg. §1.409A-1(d).

from an eligible issuer.[18] An eligible issuer is the corporation for which services are performed at the date of grant or a corporation in the same group.[19]

- The exercise price is not less than the fair market value of the underlying stock on the date the option is granted.[20]
- The number of shares subject to the option is fixed on the original date of grant.[21]
- The transfer or exercise of the option is subject to tax pursuant to Code §83 and Treas. Reg. §1.83-7.[22]
- The option does not include any feature for the deferral of compensation other than the deferral of recognition of income until the later of the following:
    - The exercise or disposition of the option
    - The time the stock acquired pursuant to the exercise of the option first becomes substantially vested[23]

Service Recipient Stock is stock that constitutes common stock as of the date of grant. Excluded from this treatment are shares of stock that meet one of the following conditions:

- The stock contains a preference as to distributions other than distributions of Service Recipient Stock and distributions in liquidation of the issuer.
- The stock is subject to a mandatory repurchase obligation other than a right of first refusal, and the repurchase price is based on a measure other than the fair market value, disregarding lapsed

The regulations under Code §409A provide for several exceptions in the case of non-U.S. plans. One of these exceptions applies to individuals that were not U.S. residents at the time of grant but later became U.S. residents. If, in this scenario, the deferred compensation was not U.S.-source income and was earned and vested prior to the individual becoming a U.S. resident, that deferred compensation is exempt from the application of Code §409A.[24]

CONCLUSION – APPLICATION OF TAX RULES TO THE TRANSFERRED EMPLOYEE

Employing the foregoing analysis, three or four key moments in the life of a stock-based compensation plan can be identified as taxable events under both the French

---

18 Treas. Reg. §1.409A-1(b)(5)(i)(A); Treas. Reg. §1.409A-1(b)(5)(iii)(A); Treas. Reg. §1.409A-1(b)(5)(iii)(E).

19 Treas. Reg. §1.409A-1(b)(5)(iii)(E)(1).

20 Treas. Reg. §1.409A-1(b)(5)(i)(A)(1).

21 *Id.*

22 Treas. Reg. §1.409A-1(b)(5)(i)(A)(2).

23 As defined in Code §1.83-3(b).

24 Treas. Reg. §10409A-1(b)(8)(ii).

qualified plan and U.S. nonqualified plan approaches:

- The grant of share-based compensation
- The exercise of an option
- The "vesting" of the underlying shares
- Subsequent sale of the underlying shares

On both sides of the Atlantic, the nature of the taxable income can vary. It may constitute ordinary income or fall within a more favorable tax regime with beneficial tax rates such as those for long-term capital gains. Generally, B.S.P.C.E.'s comply with the requirements of Code §409A or fall within the exception provided for foreign plans under the regulations and are thus subject to Code §83, only. Since free shares are not options *per se* and constitute restricted property, they are generally subject to the provisions of Code §83, only.

In addition, while French tax laws allow for beneficial tax base reductions for free shares, the benefit depends upon the holding period of the underlying shares and is not available once in the U.S. Thus, having anticipated a beneficial tax regime at grant, the beneficiary of the plan can see his or her tax burden increase unexpectedly upon a move to the U.S.

The table below summarizes the main characteristics of the applicable regimes on both sides of the ocean.

	FRANCE		**U.S. (As Relevant)**	
	Free Shares	**B.S.P.C.E.**	**Code §83**	**Code §409A**
Taxable Events	1. Vesting of Underlying Shares (date of definitive attribution of ownership to beneficiary) 2. Sale of Shares	Sale of Underlying Shares	1. Grant, Exercise of Option, or Lapse of Substantial Risk of Forfeiture 2. Sale of Shares	1. Grant or Lapse of Substantial Risk of Forfeiture 2. Subsequent Sale of Underlying Shares
Date Tax is Due	Year of Sale of Underlying Shares	Date of Taxable Event	Date of Taxable Event	Date of Taxable Event
General Tax Regime	1. Compensation Income (benefitting from holding period reductions) 2. Capital Gains Treatment (benefitting from holding period reductions)	Income Subject to 19% or 30% Tax Rate (19% if beneficiary has been employed for at least 3 years or 30% if employed for a shorter period)	1. Compensation Income 2. Long-Term Capital Gains Treatment (if held as a capital asset for a sufficient period)	1. Ordinary Income Tax Rates (20% surcharge and interest on deferred compensation amount may apply) 2. 20% Long-Term Capital Gains Tax (if held as a capital asset for a sufficient period)