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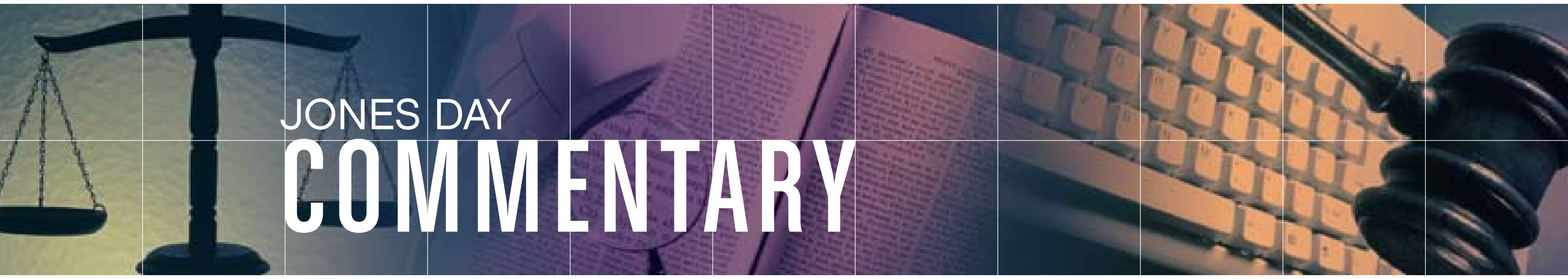

LOSS OF TAX EXEMPTION FOR ITALIAN STOCK OPTIONS HAS A SILVER LINING

A decree abolishing the "Fair Market Value" exemption for stock options[1] was issued and became law on August 6, 2008. Under the decree, any stock options exercised on or after June 25, 2008[2] will be subject to income tax on the spread at exercise (as defined under Italian law).[3] Due to a last-minute amendment in the text of the decree, local employers and employees will not be required to pay social insurance contributions on the spread at exercise for any options exercised on or after June 25, 2008.

While the loss of the Italian Fair Market Value ("FMV") exemption initially appeared to be a negative development, in practice few companies were using this exemption after additional conditions were added in 2006. The last-minute social insurance amendment was a major source of relief for employers and, for many companies, made the abolishment of the Italian FMV exemption a positive change.

BACKGROUND

Unless an exemption applied, employees in Italy were generally subject to income tax and social insurance on the spread at exercise of a stock option. Two exemptions were generally available. These exemptions led to significant income tax and social insurance savings from the top income tax rates of 43 percent and the top social insurance rates of approximately 35 percent for the employer and 9 percent for the employee.

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1. According to the Ministry of Finance, the "Fair Market Value" exemption only applied to nontransferable stock options and did not apply to transferable stock options.
2. The decree entered into force as of June 25, 2008.
3. Transferable stock options are subject to income tax and social insurance contributions at the time of grant (rather than at the time of the exercise). The new decree has not modified this treatment.

The first, the broad-based plan exemption, provided an exemption from income tax and social insurance on the spread at exercise (as determined under Italian law) up to a threshold of €2,065 per employee per year. This was the case, provided that the stock options were offered to all employees of the local subsidiary, the employer (or issuer) did not buy back the shares, and the employee did not sell the shares acquired under the option plan for three years after exercise. Due to the three-year holding requirement and the requirement to offer the stock options to all employees, very few companies chose to utilize the broad-based plan exemption.

The second exemption, the Italian FMV exemption, required that the exercise price of the stock option be set at or above the Italian FMV at the time of grant.[4] The following conditions were also required:

1) The employee's interests in the underlying shares could not exceed 10 percent of the voting rights or 10 percent of the outstanding shares;

2) The issuer's shares were required to be listed on a recognized stock exchange at the time of vesting.

Most companies found this exemption relatively easy to comply with by setting the exercise price of the stock options for their Italian employees at the higher of the Italian FMV and the grant price required under the plan. This led to very favorable tax treatment for Italian employees who were exempt from income tax and social insurance at exercise and were only required to pay capital gains tax on a later date, on the difference between the sale price and the exercise price, generally at a favorable 12.5 percent rate.

In 2006,[5] the following additional conditions were imposed to realize the benefit of the Italian FMV exemption for exercises on or after October 3, 2006:

1) The stock options were required to vest at least three years from the grant date;

2) The employee retained an investment in the shares for at least five years from the exercise date equal to or exceeding the difference between the Italian FMV and the exercise price.

With the additional two requirements, many companies chose not to grant awards that met the Italian FMV exemption. Most companies made this choice because the five-year holding requirement was seen as a condition that most employees would choose not to comply with and it would require the company to comply with the costly Italian financial intermediary rules if shares were issued to employees. By requiring employees to use a full cashless exercise, the company could rely on an exemption from the financial intermediary rules, since the employee ultimately received cash only upon exercise. This full cashless exercise requirement, however, ensured that the employees would not be able to hold the shares for the required five-year period under the Italian FMV exemption.

NEW LEGISLATION

A decree abolishing the FMV exemption was issued and became law on August 6, 2008. Under the decree, all stock options exercised on or after June 25, 2008, including stock options granted prior to the decree, are now subject to income tax. Under Italian law, once a decree is issued,

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4. Under guidelines issued by the Ministry of Finance, the Fair Market Value of a share traded on a stock exchange is equal to the average of the closing prices during the period ending on the grant date and starting on the same day of the preceding calendar month.

5. The requirements above applied to exercises on or after October 3, 2006. Interim requirements, for exercises on or after July 5, 2006, and through October 2, 2006, required, in addition to the original three requirements above, that the shares not be sold by the employee for at least five years from the exercise date, and that the fair market value of the shares acquired by the employee at exercise, combined with the value of all other shares acquired by the same employee pursuant to the exercise of the options in the calendar year, is not in excess of his or her annual gross compensation for the previous calendar year.

it must be converted into law by Parliament within 60 days. During this 60-day period, a last-minute amendment to the text was made. This amendment provided that social insurance will not be required on stock option exercises on or after June 25, 2008. This last-minute change significantly reduces the negative financial impact of the new decree for both employees and local employers. For many companies that were unwilling to impose a three-year vesting period or require the employee to hold at least a portion of the shares for five years, the new decree is a positive change because social insurance contributions are no longer required on stock option exercises.

NEXT STEPS

With the changes in the Italian FMV exemption, companies may want to consider the following next steps:

- Establish a process to ensure that proper income tax and withholding procedures are in place for stock option exercises.
- Inform the local payroll department that social insurance contributions are not required from either the employer or employee for stock option exercises on or after June 25, 2008.
- Revise employee tax summaries to reflect the changes in law.
- Revise grant procedures for new grants to Italian employees to eliminate the Italian FMV pricing and initial three-year vesting conditions.

LAWYER CONTACTS

For further information, please contact your principal Firm representative or one of the lawyers listed below. General email messages may be sent using our "Contact Us" form, which can be found at www.jonesday.com.

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