AMERICAN UNIVERSITY OF ARMENIA

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LL.M. Program

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TITLE

Stock options and stock awards as a form of compensation for executives in joint stock companies

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INTRODUCTION

International experience has shown that compared to many other forms of companies, the joint stock corporation and its analogues worldwide have a unique feature, which gives opportunity to attract even small financial means from all groups of population.[1]Joint stock corporations unlike other forms of enterprises split their capital of the company into parts by issuing shares. The fact that these shares are transferable, and in particular may be publicly traded in the market differentiates the joint stock corporations from other privately held companies.[2] It creates opportunities for each shareholder involved to direct investments to the ultimate success of the common business at the same time it is easier to get out of the business by simply liquidating the stock. [3]

In the Republic of Armenia, the joint stock companies have started their work in quite difficult conditions. When the Soviet Union was dissolved the market economy of Armenia went through a strong depression and faced many hardships during the late 20th and early 21st century. The Soviet heritage and the economic transformation period that country passed since 1990-s were the main factors which were responsible for shaping key features of corporate governance and business practices that distinguish Armenian market. [4] Due to, inter alia, the legacy of privatization, the role of the State, poor awareness of securities markets and international corporate practices Armenia's corporate governance framework is characterized by a concentration of corporate control.[5]In addition to the aforementioned issues, Armenian companies in the current unfavorable economic conditions face hardship in maintaining the core workforce inside the company, since professionals and specialist, in particular in the sphere of high tech leave Armenia in order to improve their well being in other country which provides them greater career opportunities rather then their homeland does.[6]

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[1]Բաժնետիրական ընկերությունների արդի հիմնախնդիրները ՀՀ-ում -Արմինե Զախարյան, ՀԱՅԱՍՏԱՆ ֆինանսներ և էկոնոմիկա թերթ, մարտ-ապրիլ 2005, available at` http://www.fineco.am/?pg=view&vid=1275&sfx=_am

[2] 8 important characteristics of a joint stock company by Smriti Chand, YourArticleLibrary, available at http://www.yourarticlelibrary.com/joint-stock-company/8-important-characteristics-of-a-joint-stock-company/5214/

[3] 8 important characteristics of a joint stock company by Smriti Chand, YourArticleLibrary, available at http://www.yourarticlelibrary.com/joint-stock-company/8-important-characteristics-of-a-joint-stock-company/5214/

[4]The syndrome of post-soviet capitalism by Armand Sarian, AGBU Magazine, December 2011,available at` http://agbu.org/news-item/the-economy-the-syndrome-of-post-soviet-capitalism/

[5]Corporate Governance, Country assessment: Armenia, April 2005, Report on the observance of standards and codes(ROSC), p. 1, available at` http://www.worldbank.org/ifa/rosc_cg_arm.pdf

[6]How to reserve emigration? by Armen Yeghiazaryan 2003, available at` http://www.amerialegal.am/pdf/d5c0447534321fa8e3db55f97def1070.pdf

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However, in recent years Armenia has established outstanding achievements in the fast developing world of technologies as major inflow of foreign investors was established who opened their branches in Armenia to capitalize on the young and highly qualified workforce.[7] Hence, the Armenian government assessing the importance of the IT sphere started initiating some programs to promote the development of this sector. In the framework of this program the law on "State support on the field of the information technology" was adopted by the government which, inter alia mentions that "the state's purpose related to the field is the involvement of skilled professionals and continuous improvement of those skills through the provision of competitive salary (income)".[8]

It is obvious that the success of any business initiative depends primarily on the business idea, the skills and experience of people who are going to accomplish it. Investors are also acknowledging that much of the capital value of the company may dwell in the heads of the workers, not in the identifiable physical capital.[9] To preserve the company value, they need to attract the best professionals for the development of a new product or services and maintain the same workers, who developed the process.[10]

While targeting the programs to the development of high technologies, it should be acknowledged that some steps should be taken to cease the outflow of the "brains" from the country and incentive mechanisms are needed to keep the skilled professionals to be involved in the ongoing development process of the respective field.

One of the methods to solve this issue is to make intellectual workers into partners in their businesses by giving them stock.[11] Options to buy stock are an important tool in such a strategy because they provide important glue to stick the employee to the firm.[12]Stock options and the transfer of shares (stock award) are financial instruments that are widely used in foreign countries by employers as incentive mechanisms to encourage employees. However, the legislation for implementation of these mechanisms is very complicated and mostly does not

[7] ICT main indicators, publisher Union of Information Technology Enterprises, available at` http://uite.org/index.php?option=com_content&view=article&id=5&Itemid=171&lang=en

[8]Law on "State support on the information technology field" Article 4, Section 2, Part 2

[9]The Stock options controversy and the new economy by James V. DeLong June 2002, available at` https://cei.org/sites/default/files/James%20DeLong%20-%20The%20Stock%20Options%20Controversy%20And%20The%20New%20Economy.pdf

[10]The Stock options controversy and the new economy by James V. DeLong June 2002, available at` https://cei.org/sites/default/files/James%20DeLong%20-%

[11]

[12]

used in Armenia.[13] That is why with the initiative of the Central Bank of the Republic of Armenia the team of the "LegalLab" law firm joined the program with the willingness to develop a package of legislative reforms proposing solutions to simplify the current complicated procedure and make it, in particular useful for the IT startup companies and their employees. [14] The cofounder of the law firm strongly believes that “this is not only a change in the law, the aim of the amendments is the development of economy and the brand in Armenia, because IT may once serve as an ‘’ambassador’’ for Armenia.’’ [15]

In respect to the above mentioned the scope of research will be limited to studying the shortcomings of the Armenian legal framework which deprive or restrict the employees from the opportunity to receive stock options or shares to become shareholders in particular in joint stock companies since the limited liability company’s ownership is evidenced by membership interests which never can be publicly traded and LLCs cannot reward their employees with shares or rights to shares.[16]

In international practice many Western companies in order to increase profitability of the company partially compensate their managers with shares and stock options. Such incentives benefit both the shareholders and the managers.[17] When American capitalism was in the stage of transformation as a result of this process employee ownership expanded and affected ownership structure of public companies.[18] Employee-held stock is an option offered to restructure the main system of fixed wages and benefits. In US, which has the most developed stock market employee-ownership culture is considered an important investment which makes the company the top competitor in its business and the best organization for employees to work in.[19] Moreover, this culture emphasized active involvement of employees and demanded more responsibility in risk taking actions from them as owners. Hence US corporations use the employee-ownership as a tool to improve the company's economic future, because they believe that "employee ownership is a central part of the company's management plan to develop and motivate its

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[13] Փոփոխություն, որը ուղղված է Հայաստանի տնտեսության, հայկական բրենդի զարգացմանը, Իրատես թերթ, Փետրվար 2016 available at` http://www.irates.am/hy/1455895367

[14] Փոփոխություն, որը ուղղված է Հայաստանի տնտեսության, հայկական բրենդի զարգացմանը, Իրատես թերթ, Փետրվար 2016 available at` http://www.irates.am/hy/1455895367

[15] Փոփոխություն, որը ուղղված է Հայաստանի տնտեսության, հայկական բրենդի զարգացմանը, Իրատես թերթ, Փետրվար 2016 available at` http://www.irates.am/hy/1455895367

[16] Equity incentives in Limited liability companies, publisher National center for employee ownership, available at` http://www.nceo.org/articles/equity-incentives-limited-liability-company-llc

[17] Corporate governance manual (page 108), avalable at http://wwwwds.worldbank.org/external/default/WDSContentServer/WDSP/IB/2008/09/22/000334955_20080922062553/Rendered/PDF/452870WP0BOX327423B01PUBLIC1.pdf

[18] Joseph Raphael Blasi and Douglas Lynn Kruse."The new owners" (1991)see generally

[19] Joseph Raphael Blasi and Douglas Lynn Kruse."The new owners" (1991) see generally

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employees".[20]Accordingly, the paper studies international practice of the United States, as an example of the best legal framework and seasoned practice in regulating the rights and obligations both of the companies and employees during the stock awarding process. Likewise, this research is aimed at revealing the taxation specifics of that system. Afterward, the relevant Armenian legislation is analyzed. Based on this analysis Armenian legislation gaps are identified in order to prescribe the scope of reforms by which proper implementation of the employee rights may be ensured in the future. We cannot say for sure that employee[21]ownership culture in Armenia will grow and will have the same huge effect on the country's economy as it has in the US, because Armenian business culture and economic system strongly differs from the US and any comparison has significant limitations. However, this does not mean that the best practice of their legislation cannot be taken as a good example to follow and to make more incentives for that culture to be used in Armenian corporations as a tool to raise the success of the companies.
The employees will take more responsibility to collect information, identify problems and work with management to provide solutions if there are certain long-term incentive programs, including stock options, in particular, time–based restricted stocks and restricted stock units as means for employees to obtain equity in the company. And for such mechanisms to function effectively a favorable legislative framework is necessary. Finally, in the conclusion the paper advances to making recommendations grounded on the analysis of relevant Armenian legislation with reference to the discussed international practice.

Chapter I

Reviewing regulations for employee stock ownership system in the US as an example of international practice

<u>Introduction to the mechanisms of employee ownership</u>

Employee ownership occurs when the employee holds or purchases a stock of the company. Management experts believe that by allocation of the stock to employees they increase the employee's loyalty to the company since the expectation of the substantial financial reward motivates the employee to improve performance which in his turn promotes to the company's

[20]Joseph Raphael Blasi and Douglas Lynn Kruse."The new owners" (1991) see generally
[21]When the term employee is used in the paper workers below senior management, the executive directors and the management team will be viewed equally under the question raised in the report.

success.[22]Employee stock option plans known as ESOPs[23] have been boosted by the success of high tech firms such as Microsoft and Cisco Systems since the implementation of that mechanism in its turn led to great personal wealth for early employees of these companies.[24] However, these plans do not only serve as a scheme whereby employees of high tech companies can become rich off their stock options, but they also can represent a value for various stakeholder groups and individuals associated with the company and generate a benefit for the region where it is located.

From the perspective of a given firm an ESOP is used as a mean to create an ownership mentality among employees which has a result attracts and retains key or skilled employees. When the contribution of employees is evaluated by company it increases productivity and competitiveness among them. The potential productivity and employee retention benefits are typically greater than the dilutive effect of an option grant and therefore it is counterbalanced.[25] From the viewpoint of an employee, the benefits of an ESOP include job satisfaction which arises due to pride of ownership mentality and the capability to directly share in the success of the enterprise. Besides the ability to save taxes upon share disposal is a feature which makes ESOP more attractive. Finally, ESOPs have served as an alternative to government-sponsored/-retirement plans and have created a noticeable solution in tightening the ever increasing real wage gap. However, the implementation of an ESOP should not be inferred as an immediate guarantee of success.[26]

Stock option plans are broadly used particularly in the technology sphere at the beginning of their foundation. Previously, stock options were a merely given to top executives and outside directors, but in the 1990s, all employees started receiving stock options as fast-growing high-technology companies used it as a tool to attract and retain top talent. The dynamic atmosphere of the high-tech companies caught up with other industries as a result they also started using different kinds of stock option plans in their businesses. [27]

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[22]Employee Stock Options and ownership (ESOP), published by Encyclopedia of Business, available at https://www.referenceforbusiness.com/encyclopedia/Eco-Ent/Employee-Stock-Options-and-Ownership-ESOP.html#ixzz43MVPeOSf
[23] Employee stock options plans should not be confused with the term of employee stock ownership plans, which are retirement plans` https://www.sec.gov/answers/empopt.htm
[24]Employee Stock Options Guidelines available at http://nbif.ca/uploads/ESOP_Manual_Public.pdf
[25]Employee Stock Options Guidelines available at http://nbif.ca/uploads/ESOP_Manual_Public.pdf
[26]Employee Stock Options Guidelines available at http://nbif.ca/uploads/ESOP_Manual_Public.pdf
[27]Employee Stock Options and ownership (ESOP), published by Encyclopedia of Business, available at https://www.referenceforbusiness.com/encyclopedia/Eco-Ent/Employee-Stock-Options-and-Ownership-ESOP.html#ixzz43MVPeOSf

Generally *"an option is a right (but not an obligation) to purchase a quantity of a company's stock at a set price for a certain period of time."*[28]Stock options give employees the advantage to buy in a specific number of shares in the company at a fixed price in a determined period. [29] Usually the market value of the stock on the date that the options are given is the strike price which is the fixed price of purchases In most cases, employees must wait for four to five years before exercising their right to buy shares at the strike price till the options are vested. [30] The number of shares that are no longer subject to forfeiture when the employee leaves the company is referred to as vested. For stocks and options vesting works a little differently, since unlike options which employee become the owner when it vests for stock the entire amount of the stock issues to the employee and factually belongs to him, but the amount of shares which are unvested can be subject to forfeiture.[31]Under a typical stock option plan options are become vested after four or five years and employee for instance after two years might get the right to purchase 25% of shares, 50% after three, 75% after four, and in the last fifth year obtain 100% shares included in the plan. Shares generally should be exercised during seven or ten years term.[32] After this term options no longer has value and no longer exists, since it was already expired.[33]

Stock options grants are usually distributed either as a proportion of an employee's total compensation package which can be earned up as an annual bonus of 15% of the salary, or as a percentage of ownership which during 10 years cannot overcome 5% of the total shareholders' equity of the firm. [34] Mainly the shares which are granted under these plans are only saleable however either when an employee leaves the company or when management decides to liquidate the shares by selling the company to a third party or for eg. makes initial public offering (IPO). [35] Past and present employees were already thinking about their future plans of spmeding the anticipated income when Facebook, the world's No.1 online social network prepared for a blockbuster initial public offering. 'There's been discussions of sort of bucket list ideas that

[28]"Startup stock option plans overview and best practice'' slide 5
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[29]Employee Stock Options and ownership (ESOP), published by Encyclopedia of Business, available at https://www.referenceforbusiness.com/encyclopedia/Eco-Ent/Employee-Stock-Options-and-Ownership-ESOP.html#ixzz43MVPeOSf

[30]Employee Stock Options and ownership (ESOP), published by Encyclopedia of Business, available at https://www.referenceforbusiness.com/encyclopedia/Eco-Ent/Employee-Stock-Options-and-Ownership-ESOP.html#ixzz43MVPeOSf

[31]Employee equity vesting, published by MBA Mondays November available at` http://avc.com/2010/11/employee-equity-vesting/

[32]Employee Stock Options Guidelines http://nbif.ca/uploads/ESOP_Manual_Public.pdf

[33]‘'What is option'', published by OIC The Options Industry Council, available at: http://www.optionseducation.org/getting_started/options_overview/what_is_an_option.html

[34]Employee Stock Options Guidelines available at http://nbif.ca/uploads/ESOP_Manual_Public.pdf

[35]Employee Stock Options Guidelines available at http://nbif.ca/uploads/ESOP_Manual_Public.pdf

people are putting together of things they always wanted to do and now we'll be able to do it,' told to the interviewer one previous employee who had joined Facebook in 2005. His expectation of income was estimated to be worth some $50 million.[36]

While establishing the plan it must be taken into consideration that both corporate objectives and the needs of the employees are ensured.[37]

When founders and early investors of the startup company create an ESOP they set aside some percentage of shares in order to grant it to future employees. In reality, creating an ESOP requires a combination of top down and bottom up planning. By top down approach founders decide the total amount of equity which will be granted and these shares are allocated to employees over time while by bottom up plan the appropriate size of individual equity grants is decided by position and these shares are issued when employee is hired.[38]Generally a maximum number of shares must be reserved under the stock option plan to be issued in future. This total number is generally established by the board of directors, if it is appropriate, normally 5% to 20% of the company's outstanding stock will be used for the ESOP. [39] Although in most plans board of directors is appointed as the administrator, however some responsibilities the board must be able to delegate to a committee. The committee or the board should have wider powers while choosing the optionees and determining the types of options granted, and other terms. For securities law reasons shareholders of the company should generally be given an opportunity to approve the plan while providing the company an opportunity to offer tax-advantaged incentive stock options.[40]As the grant of stock options does not guarantee any employee a continued relationship with the company it should be clearly stated in the plan that it does not give employees an implied promise of employment. [41] Stock Option Agreement related to the plan

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[36] I am rich, Facebook flotation to create 1.000 millioners among company's rank and file, published by Daily Mail Reporter, February 2012, available at: http://www.dailymail.co.uk/news/article-2072204/Facebook-IPO-create-1-000-millionaires-companys-rank-file.html

[37]Employee Stock Options Guidelines available at http://nbif.ca/uploads/ESOP_Manual_Public.pdf

[38]"Startup stock option plans overview and best practice" slide 14
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[39] "How Employee Stock Options Work In Startup Companies", by Richard Harroch, February 2016 available at;
http://www.forbes.com/sites/allbusiness/2016/02/27/how-employee-stock-options-work-in-startup-companies/#3c6dfe6a13ce

[40] "How Employee Stock Options Work In Startup Companies", by Richard Harroch, February 2016 available at;
http://www.forbes.com/sites/allbusiness/2016/02/27/how-employee-stock-options-work-in-startup-companies/#3c6dfe6a13ce

[41] "How Employee Stock Options Work In Startup Companies", by Richard Harroch, February 2016 available at;

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may also determine that shareholders should provide the company a right of first refusal on transfers of the underlying shares in order to keep share ownership in the company to a limited group of shareholders. [42]

The most common ways to issue employee equity are stock option plans (SOP), restricted stocks and restricted stock units (RSU) that are mostly used in startup companies. [43]

<u>Introduction to the types of ESOs and their tax treatment in US</u>

The most common believe of management experts is the main advantage of granting stock options to employees is that they increase employee loyalty and commitment to the organization.[44] But critics of stock options are sure that the disadvantages may sometimes outweigh the advantage. One of the justification is that many employees after exercising their option to buy cash out their shares immediately. These employees may whish to diversify their personal financial assets or lock in gains. In both cases, however, any motivational value of the options is lost since they do not remain shareholders very long. [45] Some employees as soon as they cash in their options disappear with their newfound wealth, trying to find another quick score with a new growth company. Hence, usually their loyalty lasts only until their options mature.[46]

There are different of alternatives on the general idea of an employee stock option. Generally there are no prohibitions for companies to issue ESOs, and therefore the main limitations arise

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http://www.forbes.com/sites/allbusiness/2016/02/27/how-employee-stock-options-work-in-startup-companies/#3c6dfe6a13ce

[42] "How Employee Stock Options Work In Startup Companies", by Richard Harroch, February 2016 available at; http://www.forbes.com/sites/allbusiness/2016/02/27/how-employee-stock-options-work-in-startup-companies/#3c6dfe6a13ce

[43]Employee Stock Options and ownership (ESOP), published by Encyclopedia of Business, available at https://www.referenceforbusiness.com/encyclopedia/Eco-Ent/Employee-Stock-Options-and-Ownership-ESOP.html#ixzz43MVPeOSf

[44] Employee stock options and ownership, by Laurie Collier Hillstrom, published Encyclopedia of Business http://www.referenceforbusiness.com/encyclopedia/Eco-Ent/Employee-Stock-Options-and-Ownership-ESOP.html#ixzz43MVPeOSf

[45] Employee stock options and ownership, by Laurie Collier Hillstrom, published Encyclopedia of Business http://www.referenceforbusiness.com/encyclopedia/Eco-Ent/Employee-Stock-Options-and-Ownership-ESOP.html#ixzz43MVPeOSf

[46] Employee stock options and ownership, by Laurie Collier Hillstrom, published Encyclopedia of Business http://www.referenceforbusiness.com/encyclopedia/Eco-Ent/Employee-Stock-Options-and-Ownership-ESOP.html#ixzz43MVPeOSf

from the tax implications.[47] Some variations arise due to the intended use of the options by the companies granting them. The Internal Revenue Code (IRC) identifies two essential types of options. One type of options is called "statutory" or "qualified" since if the Code's strict regulations are met then favorable tax treatment is applicable. The other is "nonqualified" options, where no special tax criteria is needed but for employees they are taxed as wage income and the employer recognizes them as expense and deducts when the employee includes them in income.[48]

Incentive stock options which are included in the "qualified" option plans must be approved by the shareholders and options must be allocated in accordance with a written plan. The plan must establish the classes of employees eligible to participate in the plan and determine the number of shares to be subject to the options.[49] At the time of the grant the option price must be adequate to the market value of the stock. Stock options under this plan must have 10 years exercise term started from the time it was granted.[50] Any individual who wants to liquidate its options must take into consideration the limitation of 100.000$ of the market value of the stock for any incentive stock options exercised in a year. The options for stock above 100.000$ in market value are considered as non-qualifying options, thus this limit is put on the amount that falls under favorable tax treatment not on the number of options which can be granted in general.[51]

As incentive stock options an employee stock purchase plan also requires the shareholders to approve the written plan, but under this plan all full-time employees with at least two years of service must commonly be included.[52] Employee who after exercising the options will own 5 or more percent of the company's stock must not be involved in the plan. When the option is granted or when it is exercised the price must be at least 85% of the fair market value of the stock. The options exercise term is more limited it should not exceed five years. The plan must not allow any employee to purchase more than $25,000 in stock in a year.[53]

Under current US law the above mentioned types of qualified stock options receive some tax benefit. When the options are granted or when they are exercised the employee recognizes no income as it is done for regular tax purposes. Taxes are imposed when the stock purchased by the employee is sold. The difference between the market price of the stock when the option was exercised and the price for which it was sold is taxed at long-term capital gains rates if sold after

[47] Employee Stock options: Tax treatment and tax issues by James M. Bickley (June 2012)see generally
[48] Employee Stock options: Tax treatment and tax issues by James M. Bickley (June 2012)see generally
[49] Employee Stock options: Tax treatment and tax issues by James M. Bickley (June 2012)see generally
[50] Employee Stock options: Tax treatment and tax issues by James M. Bickley (June 2012)see generally
[51]Internal Revenue Code Section 422
[52] Employee Stock options: Tax treatment and tax issues by James M. Bickley (June 2012)see generally
[53] Employee Stock options: Tax treatment and tax issues by James M. Bickley (June 2012)see generally

it has been held for at least two years from the date of the grant and was exercised in one year. [54] Hence, the tax advantage accrues to the employee since companies generally receive no deduction for qualified stock options. If the stock is not held for the required period then the employee is taxed at ordinary income tax rates instead of capital gains rates.[55] Besides it is stated that giving favorable tax treatment to a limited amount of compensation in the form of options helps extend the use of options to rank-and-file employees. [56]

However, employee options which do not offer tax-favored treatment are by far the most valuable ones since these options can be granted without any limitations on the amount.[57] Generally highly paid employees and corporate officers are compensated by this type of options. Nonqualified options are governed by the rules which regulate the transfer of property other than money in return for services.[58] Unlike qualified options, these options can be offered to anyone who provides services to the company and is not employee of the corporation. [59] Therefore, they can also be provided to an individual who is an independent contractor or serves on the company's board of directors. Mostly these options are granted to highly compensated individuals. [60] Basically, the rule is determines that when the person obtains an unrestricted right to the property and its fair market value can be reasonably ascertained then income equal to the fair market value was received by recipient. [61] IRS has ruled that the nonqualified options are not tradable which means that there is no ascertained market value. [62] Tax rules, because of the the uncertainty of option's actual value allow it to deffer the taxation until their value is realised, as in the case of capital gains. [63] Therefore, until they are exercised and any restrictions on the disposition of the stock are lifted it is difficult to establish the fair market value. At that time, the options are evaluated based on the difference between the exercise price and the stock's current market price. [64] The company's deduction of the compensation is also postponed and allowed in the same year when the recipient declares the income realised as a subject for taxation. [65]

[54] Employee Stock options: Tax treatment and tax issues by James M. Bickley (June 2012)see generally
[55]Internal Revenue Code Section 422
[56] Employee Stock options: Tax treatment and tax issues by James M. Bickley (June 2012)see generally
[57] Employee Stock options: Tax treatment and tax issues by James M. Bickley (June 2012)see generally
[58]Internal Revenue Code Section 83
[59] Employee Stock options: Tax treatment and tax issues by James M. Bickley (June 2012)see generally
[60] Employee Stock options: Tax treatment and tax issues by James M. Bickley (June 2012)see generally
[61] Employee Stock options: Tax treatment and tax issues by James M. Bickley (June 2012)see generally
[62] Employee Stock options: Tax treatment and tax issues by James M. Bickley (June 2012)see generally
[63] Employee Stock options: Tax treatment and tax issues by James M. Bickley (June 2012)see generally
[64] Employee Stock options: Tax treatment and tax issues by James M. Bickley (June 2012)see generally
[65] Employee Stock options: Tax treatment and tax issues by James M. Bickley (June 2012)see generally

Introduction to the types of stock awards and their tax treatment in US

Restricted stock and restricted stock units (RSUs) for many companies become a preferred mean which without the administrative complexity of traditional stock option plans gives opportunity to reward employees with a share of ownership in the company. [66] As it is not possible for the stock granted to become worthless restricted stock plans have shown themselves to be more preferable and valuable than their traditional counterparts. [67]Due to the lack of leverage these stocks carry less risk rather than a stock option, thus even if the stock price drops dramatically these stocks nearly always worth something. [68]Consequently, employers who provide restricted stock rather than stock options use fewer shares to provide the equal value to employees. One of the major driving forces in the growing popularity of restricted stock is the fact that restricted stock is less dilutive than stock options which is very attractive to some employers.[69]

"Restricted stock" and "restricted stock unit." sometimes are used interchangeably. Even though they are mainly similar there is one major difference which should be identified. With restricted stock, the employees receive and technically possess the stock itself which is subject to a vesting schedule. With restricted stock units, the stock is not factually transferred to the employee until the stock becomes vested since a restricted stock unit is a promise from the employer to transfer the stock in future on the vesting date. [70] The other difference that should be mentioned is that holders of the restricted stock unlike their RSU cousins receive the right to vote for the number of shares that they are given. Besides the recipient of the restricted stock regardless of the vesting conditions may be paid either direct dividends or a cash amount equal to them before they are vested and this privilege exists both before and after vesting.[71]

Hence, starting from the Restricted Stock Award it should be described that an employee who was offered the grant must give his agreement to accept the grant. The employer may require to pay a purchase price for the stock when the employee accepts the grant, however nowadays more

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[66]Mark Cussen, published by Money Crashes "What are restricted stocks and restricted stock units?" units?"http://www.moneycrashers.com/restricted-stock-units-rsu-taxation/

[67] Employee Stock options: Tax treatment and tax issues by James M. Bickley (June 2012)see generally

[68] RSUs: Essential Facts, by Matt Simon, published by Charles SHWAB available at: http://www.schwab.com/public/eac/resources/articles/rsu_facts.html

[69] Restricted stock: the tax impact on employers and employees, by G. Edgar Adkins, Jr., and Jeffrey A. Martin, published by Grant Thornton LLP http://www.grantthornton.com/staticfiles/GTCom/Tax/CBC%20files/Restricted_stock_tax_impact.pdf

[70] Restricted stock: the tax impact on employers and employees, by G. Edgar Adkins, Jr., and Jeffrey A. Martin, published by Grant Thornton LLP http://www.grantthornton.com/staticfiles/GTCom/Tax/CBC%20files/Restricted_stock_tax_impact.pdf

[71]Mark Cussen, published by Money Crashes "What are restricted stocks and restricted stock units?" units?"http://www.moneycrashers.com/restricted-stock-units-rsu-taxation/

often an employee is not required to pay for restricted stock. Thus, the shares preserve value when even on vesting the price declines between the grant date and the vesting date. [72]If the grant is accapted and the payment if neccessary was provided the employee must wait until the grant vests.[73]Some vesting schedules combine the following features: for instance, a four-year vesting schedule might be offered that will accelerate if the employee were to accomplish certain tasks or goals. [74] Either the "cliff" or "graded" vesting schedules for restricted stock may be chosen at the employer's discretion. The employee receives all of the shares at once after a certain period of time if an arrangement is Cliff vesting. [75] Graded vesting over a set period of time removes the restrictions on a portion of the shares – for instance, since the time of the grant during a five-year period 20% of the shares are removed once per year. [76] When a Restricted Stock Award vests, depending on the company's plan rules the employee may either receive the shares of company stock or the cash equivalent already without any restrictions. [77]

Under normal federal income tax rules, a Restricted Stock Award received by an employee is not taxed at the time of the grant since the employee is taxed when the restrictions lapse at the time of vesting. The amount of income which is the difference between the fair market value of the grant at the time of vesting minus the amount paid for the grant is subject for taxation. [78] When restricted stock is used as a compensation tool it results in income recognition for the employee and a deduction for the employer.[79] When the amount of the employee's income is declared then the timing and amount of the employer's deduction is determined. The taxation of the restricted stock is ruled by the Internal Revenue Code **Section 83**, which states that ''the value of property transferred in connection with the performance of services is included in gross income when the property is no longer subject to a substantial risk of forfeiture, or when the property becomes transferable."[80] The employee's tax holding period for grants that pay in actual shares, begins at

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[72]About Restricted Stock Awards, published by Fidelity
http://personal.fidelity.com/products/stockoptions/rstockawards.shtml
[73]About Restricted Stock Awards, published by Fidelity
http://personal.fidelity.com/products/stockoptions/rstockawards.shtml
[74]Mark Cussen, published by Money Crashes "What are restricted stocks and restricted stock units?" units?"http://www.moneycrashers.com/restricted-stock-units-rsu-taxation/
[75]Mark Cussen, published by Money Crashes "What are restricted stocks and restricted stock units?" units?"http://www.moneycrashers.com/restricted-stock-units-rsu-taxation/
[76]Mark Cussen, published by Money Crashes "What are restricted stocks and restricted stock units?" units?"http://www.moneycrashers.com/restricted-stock-units-rsu-taxation/
[77]About Restricted Stock Awards, published by Fidelity
http://personal.fidelity.com/products/stockoptions/rstockawards.shtml
[78]About Restricted Stock Awards, published by Fidelity
http://personal.fidelity.com/products/stockoptions/rstockawards.shtml
[79]About Restricted Stock Awards, published by Fidelity
http://personal.fidelity.com/products/stockoptions/rstockawards.shtml
[80] Internal Revenue Code Section 83 (a) part 2 available at` https://www.law.cornell.edu/uscode/text/26/83

the time of vesting, and the amount paid for the stock plus the amount included as ordinary compensation income is the basis for taxation. Assuming, the employee holds the shares as a capital asset then in that case the employee would recognize capital gain income or loss. Upon a later sale of the shares whether such capital gain would be a long-term or short-term gain would depend on the holding period of time between the date of the subsequent sale and the beginning at vesting[81]. However, employees can change the tax treatment of their Restricted Stock Awards under Section 83(b) of the Internal Revenue Code. Employees who receive restricted stock must make an important choice. They have the option to choose to pay the tax at the time of vesting, or they can immediately pay the tax on the stock at the time of grant. Section 83(b) of the Internal Revenue Code overall is a mean to pay possibly less tax since this election permits and allows employees to pay the tax before vesting.[82] By paying tax on the grant now, rather than on the day when shares vest, the current price of the stock will be established as the cost basis for the shares granted. Regardless of how much the shares may have changed in value at the time the shares do vest, no tax will be due until the shares are sold. However there are still are some risks that more taxes would be paid based on the fair market value if the stock price declined during the vesting period or if the restricted stock award is forfeited when the employee leaves the company before), since a loss cannot be claimed for tax purposes with respect to the restricted stock award. Hence, taxes are not recovered if already have been paid at grant date on Special Tax 83(b) election. [83]

As it was mentioned above unlike the Restricted Stock Award, employers using Restricted Stock Units do not issue the respective number of shares until the vesting period. In that case the employee is just assigned an appropriate number of "units" that correspond to the amount of the promised stock, but the assignment of these units is merely a bookkeeping entry that has no tangible value of any kind, thus there is no actual funding until vesting is complete. [84] The system of taxation for restricted stock and restricted stock units, discussed above, is the very similar except where differences are specifically noted. [85] Employees who receive Restricted Stock Units

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[81]About Restricted Stock Awards, published by Fidelity http://personal.fidelity.com/products/stockoptions/rstockawards.shtml

[82]Mark Cussen, published by Money Crashes "What are restricted stocks and restricted stock units?" units?"http://www.moneycrashers.com/restricted-stock-units-rsu-taxation/

[83] Internal Revenue Code Section 83 (a) part 2 available at` https://www.law.cornell.edu/uscode/text/26/83

[84]Mark Cussen, published by Money Crashes "What are restricted stocks and restricted stock units?" units?"http://www.moneycrashers.com/restricted-stock-units-rsu-taxation/

[85] Restricted stock: the tax impact on employers and employees, by G. Edgar Adkins, Jr., and Jeffrey A. Martin, published by Grant Thornton LLP http://www.grantthornton.com/staticfiles/GTCom/Tax/CBC%20files/Restricted_stock_tax_impact.pdf

Tel: (37410) 51 27 55

have no option to choose The Section 83(b) for election of taxation period since no actual property is conferred to them as it is with shares of restricted stock and this provision only applies to tangible property of some kind. [86] However, until the vesting schedule is complete and the employee constructively receives the actual shares that were promised RSUs are not taxed. These two events generally take place at the same time, but in some cases employees are able to defer taxation by electing to be given the stock at a later date. [87]

Valuation regulation on companies issuing ESOs and RSUs in US

Employee stock options (ESOs) are not traded. In other words, unlike other "classic" options which are generally traded in the world's largest exchanges ESOs have no quoted value.[88] Standardized options are interchangeable and can be freely traded within the trading hours on any exchange that lists them while employee stock options generally are not transferable.[89]

It is difficult to "see" the value of ESOs without a market price reference point. As many ESOs are received with 10 years term, the employee does not have option to compare with other listed options trading with an equal amount of time. [90] This is because listed long-dated options' expiration dates are no longer then two years out in time, and this will only help in cases when ESOs also have two years or less in time remaining. In other words, the difference between two and 10 years is a big gap that leaves you without market price reference points. The employee stock option could have any strike price since the strike price is usually set by the market and the on the grant date it typically would be the market close price. Therefore reference prices may arise from theoretical pricing models.[91]

For public companies, it is easy to determine the fair market value of the underlying stock on the grant date. For private companies, fair market value is not available. Accordingly, for such companies, the Internal Revenue Code regulations provide that "fair market value may be determined through the reasonable application of a reasonable valuation method."[92] The private

[86]Mark Cussen, published by Money Crashes "What are restricted stocks and restricted stock units?" units?"http://www.moneycrashers.com/restricted-stock-units-rsu-taxation/
[87]Mark Cussen, published by Money Crashes "What are restricted stocks and restricted stock units?" units?"http://www.moneycrashers.com/restricted-stock-units-rsu-taxation/
[88]Employee Stock Options: Comparisons To Listed Options | Investopedia

[89] Standardized options vs. employee stock options, published by Options Guide http://www.theoptionsguide.com/standardized-options-vs-employee-stock-options.aspx
[90] Employee Stock Options: Comparisons To Listed Options | Investopedia
[91] Employee Stock Options: Comparisons To Listed Options | Investopedia
[92] Internal Revenue code section 409A available at https://www.law.cornell.edu/uscode/text/26/409A

company valuation requirement stems from the American Jobs Creation Act of 2004. Hence, section 409A of the Internal Revenue code applies to enterprises issuing its employees traditional or non-traditional deferred compensation such as stock options (most common), employment agreements, restricted stock units, etc..[93] This valuation is usually required to help companies set the strike price for any employee stock options they choose to issue Section 409A defines start-ups as companies that have been in business for less than ten years and haven't got publicly traded equity securities, and for which no transformation of control event or public offering is reasonably expected to occur in the next twelve months.[94] These valuations are usually done by any qualified third party and normally should be applied for up to 12 months. [95]

CHAPTER II

Analyzes of the current Armenian legal framework identifying gaps which restrict the issuance of the shares to employees

1. Concept of "Stock options" in current RA legislation

Studying the current stock market, relevant laws and legal acts of the Republic of Armenia regulating the process of activities implemented by the joint-stock companies, it becomes evident that the concept of "Stock Option" is not defined by any law including the RA Law on Joint Stock Companies or any other applicable legal act. Thus, may be for that reason, such transactions concluded directly by the joint-stock companies are not as common within the Armenian stock market.

However, even though the RA legislation does not define the concept of the "Stock Option", it does not necessarily exclude the possibility of concluding such a transaction if desired.

To implement the idea of the "Stock option" within the narrow range of the current legislation we should return firstly to its definition. Hence, it is defined, *"A stock option is a privilege, sold by one party to another that gives the buyer the right, but not the obligation, to buy (call) or sell (put) a stock at an agreed-upon price within a certain period or on a specific date"*[96]. Opening

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[93] Why do I need to get an IRC Section 409A Valuation, published by Simple409A available at http://simple409a.com/why-do-i-need-to-get-a-section-409a-valuation/

[94] "8 Things You Need to Know About Section 409A", by Travis W. Harms, published by Mercer Capital http://mercercapital.com/article/8-things-you-need-to-know-about-section-409a/

[95] "Section 409A Valuations and Stock Option Grants for Start-up Technology and Life Science Companies" by Tahir J. Naim, available at http://www.fenwick.com/FenwickDocuments/409_Valuations_Stock_Options.pdf

[96] "Startup employee stock option plans" slide 5 licensed under the Creative Commons Attribution-ShareAlike 4.0 International License

the definition brackets and explaining it we should note that the stock option is a contract between two sides, through which the person or the organization promises to sell a share to the other party which in his turn buys or receives the right, but not the obligation, to acquire a share within a pre-set time period and at an agreed-upon price.

The RA Civil Code enables to implement the concept of stock option within the framework of the current legislation; the article 445 of it defines that concluding a preliminary contract the parties can set certain conditions, which will make them undertake the duty to conclude in the future the basic contract on the transfer of property, doing work and rendering of services. The preliminary contract should contain such terms that make possible the establishment of a subject and also other substantial terms of the basic contract, including the time period in which the parties are obliged to conclude the basic contract. The preliminary contract could be the very guarantee that grants the option holder the right to acquire a share subsequently. Nevertheless, such a contract can be concluded in the RA only in case the party promising to sell a share in the future, at the moment of concluding the preliminary contract has the right to dispose of the shares in questions, or is certain to have such right when execution becomes due. Such a contract can be concluded in a secondary market with a party that is a stockholder in an open joint-stock company since according to the article 108 of the RA Civil Code the shares of a closed joint-stock company are distributed among its founders or other previously determined group of persons. Besides, as an obstacle for such kind of transactions in closed joint stock companies the right of first refusal should be outlined, since in closed corporations the owner of shares have no right to alienate the shares without "the consent of the other shareholders", as a closed company shareholder has the right of first refusal to obtain the shares which are sold and if none of the shareholders invokes their right then the Company itself can be a potential buyer of these shares[97]. Thus, this means that the promised shares eventually may not be accessible for the outsider.

It is naturally assumed that the interest of acquiring a share with a preliminary contract is that it enables in a certain period of time to purchase a share which has a higher market price than defined in the preliminary contract. Otherwise if by the end of the time period in which the parties must conclude the basic contract it is not concluded or one of the parties does not send the other party a proposal to conclude this contract then the obligations provided by the preliminary contract shall be terminated.[98]

[97] The RA Law on Joint-Stock Companies, Article 8, Paragraph 3(2001)
[98]Civil Code of the Republic of Armenia, Article 445.6(1999)

The alleged possibility of granting stock option by the joint-stock companies may be implemented through another mechanism which is prescribed in the RA Law on Joint Stock Companies.

The RA Law on Joint-Stock Companies Article 40, Paragraph 3 is worth a special consideration; it defines the following: *"A company may issue convertible bonds and* ***other securities*** *that grant either the right to convert Company bonds and other securities into shares, or* ***the right to obtain shares on preferred terms****"*.[99]

Explaining the abovementioned article of the Law it turns out that the Company is eligible to issue *"another security"*, which owner receives the right to obtain shares declared by the Company on preferred terms. Moreover, the owners of Company securities with the right to acquire Shares exercise their **right prior to the shareholders**, in the time period stipulated by the Charter, even in case when the shareholders have the right of first refusal in relation to new shares commensurately with their existing share.[100]A company may issue bonds and other securities stipulated by law in accordance with its Charter; their allocation is carried out by a Board decision unless otherwise stipulated by the Charter.[101]

It turns out that even if the term *"option"* does not exist in our legislation, but the concept of option can be used through the defined article; like the stock option it grants the owner a privileged right to acquire a share, but the difference is, that the rights obtained through the stock option are restricted because they may be exercised in a certain time period and at a predetermined price, which is not regulated in the above mentioned Article. [102] In fact, at the first sight and only through literal interpretation of this very Article, the distribution and issuance of securities possibly stands near the concept of the stock option and it seems possible to use it for the employee option plans.

The discussed Article uses the concept of issuing another security as stipulated by the Law. A list of types of securities is established by the RA Civil Code, according to which the securities include: *"... a bond, check, simple bill of exchange, transfer bill of exchange, share of stock, bill of landing, bank record (bank book or bank certificate on deposit), double warehouse certificate, simple warehouse certificate, and other documents that the statutes on commercial paper and securities have classified as commercial paper and securities"* [103] .Hence, a complete list[104] is

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[99]RA Law on Joint-Stock Companies Article 40, Paragraph 3(2001)
[100]The RA Law on Joint-Stock Companies, Article 47, Paragraph 1(2001)
[101] The RA Law on Joint-Stock Companies, Article 40, Paragraph 1(2001)
[102]RA Law on Joint-Stock Companies Article 40, Paragraph 3(2001)
[103]Civil Code of the Republic of Armenia, Article 153 (1999)
[104] The Law of the Republic of Armenia on Securities Market, Article 3(2008)

determined by the RA Civil Code and the Law of the Republic of Armenia on Securities Market, which do describe the type of securities that would give a privilege to its owner to obtain in the future shares outstanding in the company. Accordingly, the Company may issue the securities that may be converted into shares.[105]

The RA Law on Joint-Stock Companies Article 40, Paragraph 3 is presumably may be applicable in practice, however the determined convertible securities are not favorable for awarding them as employee compensation, since the employee have to pay for receiving these securities before they are converted into shares. Hence, the current mechanism may be unattractive for the employees who lack extra money.

2. **Identifying main obstacles and restrictions for the implementation of employee stock distribution**

Important and partially crucial changes may take place in Armenia as discussions have recently started about the opportunities to implement the employee ownership system in Armenia. According to the news the Central Bank of the Republic of Armenia has interest and aim to develop the capital market through the implementation of that system. It seems that IT companies which operate in Armenian market in cooperation with the Central Bank of the Republic of Armenia want to cease the "outflow of brains" from Armenia. [106] They believe that if the system properly will be invested and implemented in the corporations then this new business culture will be one of the best ways to keep the workforce in Armenia taking into consideration the current market and economy situation in the country. [107] Even though there are already numerous IT companies in Armenia willing to distribute a stock through employee stock option plans or stock awards, Armenian legislation creates numerous restrictions and obstacles which make the investment process of the system more complicated and not applicable in practice. [108]

As a main restriction of this process the article 192.2 of Labor code of the Republic of Armenia should be mentioned, which prescribes that the payment of the wage by securities and

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[105] The Law of the Republic of Armenia on Securities Market, Article 3 paragraph 6 a) (2008)

[106]Հայաստանում ՏՏ մասնագետները քննարկում են աշխատողների բաժնետիրացման գործընթացի ներդրման հնարավորությունները,հրատարակված է ARMENPRESS-ի կողմից ,Փետրվար http://armenpress.am/arm/news/837599/hayastanum-tt-masnagetnery-qnnarkum-en-ashkhatoxneri-bazhnetiracman.html

[107]Հայաստանում ՏՏ մասնագետները քննարկում են աշխատողների բաժնետիրացման գործընթացի ներդրման հնարավորությունները,հրատարակված է ARMENPRESS-ի կողմից , Փետրվար 2016 available at` http://armenpress.am/arm/news/837599/hayastanum-tt-masnagetnery-qnnarkum-en-ashkhatoxneri-bazhnetiracman.html

[108]Հայաստանում ՏՏ մասնագետները քննարկում են աշխատողների բաժնետիրացման գործընթացի ներդրման հնարավորությունները,հրատարակված է ARMENPRESS-ի կողմից , Փետրվար 2016 available at` http://armenpress.am/arm/news/837599/hayastanum-tt-masnagetnery-qnnarkum-en-ashkhatoxneri-bazhnetiracman.html

commitments is prohibited, except for the cases established by the law.[109] This article excludes the possibility to include the stock option plans or stock awards as a part of the compensation package of the employee in return for provided services. One of the ways to raise the employee's substantial interest in the company, in particular, improve the productivity of the company, is to offer stock to them as a part of the employees' compensation package. Moreover, many firms find it easier to pay at least a portion of their employees' compensation in the form of stock. This type of compensation advantage is that it reduces the amount of cash compensation that employers must pay out for the first period of their activity. [110]

As an exception for the above mentioned article the law on Joint Stock Companies (LJSC) provides that there can be cases when a company may distribute shares among Company staff at preferred conditions if it is stipulated in the Charter, by means of the redeemed shares purchased at the cost of a special fund for staff shareholding.[111] The important thing that firstly should be noted in this point is that the company can distribute shares among staff members only in case if it is stipulated by the Charter. [112] This means that if there is no provision in the Charter which will set the terms for share distribution among the staff, respectively, then staff members will have no chances to obtain shares, as there is no article in the law which will stipulate implementation of such kind of rights directly. Secondly, the staff members can purchase shares of the Company only in case if there is a decision of the Board to redeem the outstanding shares from company's shareholders. If the profits and other funds of the Company are insufficient to buy back Company shares then the reserve fund shall be used to cover the costs.[113]Thus, it can be inferred that if there is no redeemed shares in the balance of Company then none of staff members can obtain shares and enjoy the rights as it is defined in the above mentioned article. Company itself has no other direct mechanisms established to sell/distribute shares among employees. This particular requirement may seem to be mostly unattractive for start up companies who are even if growth oriented but yet are financially unstable.

Generally staff shares are distributed among staff members with the consent of the employees. [114] Circulation of a staff share may be limited for a period of time stipulated by the Charter, but no

[109] RA Labor Code article 192.2(2005)
[110]Employee Stock Options and ownership (ESOP), published by Encyclopedia of Business, available at https://www.referenceforbusiness.com/encyclopedia/Eco-Ent/Employee-Stock-Options-and-Ownership-ESOP.html#ixzz43MVPeOSf
[111] RA Law on Joint Stock Companies –article 41.1(2001)
[112] RA Law on Joint Stock Companies –article 41.1(2001)
[113]RA Law on Joint Stock Companies –article 43(2001)
[114]RA Law on Joint Stock Companies –article 43(2001)

longer than for 3 years starting the date of its allocation.[115] This restriction may not correspond to the requirements of start ups, in particular when by the plan much longer period of time is needed to raise the value of the shares. Besides, more flexible system is needed to establish terms for such kind of share distribution plans, since each employee shares should be distributed with a term in regards with the goal that is already set out to reach in the framework of that plan.

Besides provisions of Law on Joint Stock Companies also prescribe a number of administrative difficulties for issuing shares and that can be viewed as one of the major reasons why the Company distributes buyback shares among staff members rather than issues new shares from the declared but not yet allocated shares.

When a company is founded its shares must be distributed among the founders. Company equity is made up of the nominal value of shares acquired by shareholders.[116] Every time when company is intended to issue new shares it must made a decision of Charter amendments and modifications as prescribed in the article 15, which establishes that Charter amendments and modifications, as well as the approval of an edited Charter shall be carried out by a decision of the Meeting, which should be adopted by a 3/4s vote of the shareholders participating in it. [117]

Moreover when Charter amendments are approved by the shareholders the next mandatory step is the State registration of the edited Charter, because as it is established in the law "…amendments and modifications in the Charter, as well as an edited Charter of the Company are subject to state registration in the manner stipulated by Law on State Registration of Legal Entities".[118] Hence this means that each time when Company is going to issue and allocate shares to employees, it have to change the Charter and approve the amendments in the State Registrar. It is apparent the procedure is unreasonably complicated.

In addition there is a problem of determining fair market value in closely held corporation, which can be a practical consideration suggesting that stock options/awards are seldom appropriate in the closed joint stock company's context. Since it is always difficult to correctly estimate the fair market value of the share of the closely held company in the market, which leaves you without market price reference points to compare. Publicly held companies who have little number of shareholders or shares that are not regularly traded in the market may also have this kind of issue. It can be inferred that problems may arise in identifying the share's fair market price when employee of the closely held company may wish to sell the shares he owns. Since there is no clearly established requirement of company valuation, which at least may help to determine the

[115] RA Law on Joint Stock Companies article 41.2 and 41.3(2001)
[116] RA Law on Joint Stock Companies –article 30(2001)
[117] RA Law on Joint Stock Companies –article 17 (2001)
[118] Law on Joint Stock Companies article 17 (2001)

fair price the problem regarding the market price may arise for both the seller and the buyer when for instance an employee of the closed joint stock company decides to sell the possessed shares respectively, to the shareholder who has the right of refusal to buy them, the company or the outsider [119] Besides, in the case of termination of labor relationships with a staff member, except for retirement, a Company has the right of first refusal in terms of the purchasing the staff member's shares at a market price, but no less than at nominal value.[120] In this case also the employee can meet obstacles identifying current market price, in particular, when determination of the market price is compulsory only in cases when Company buy shares back.[121]Moreover, Company may use the services of an independent valuator to determine the market price of property only if so decided by the Board[122]. Hence if there is no decision of the Board to hire an expert it may raise additional obstacle for employee to realize its shares within the fair market value since the appraiser could be hired by initiative of employee, however it could be expensive and, therefore unfavorable. Unlike the current US legislation which requires, in particular non publicly held companies to evaluate the company to determine the strike price of shares issued as deferred compensation for their employees[123], in Armenia legislation has no mandatory requirement for Companies to make the valuation of the shares, in order to determine the strike price and regulate fair market value through the reasonable application of a relevant valuation method which may be held periodically at least once a year. At any case, the valuation of the stock of a closely held company is exceedingly difficult as expert appraisers are apt to differ widely in their conclusion.

Law on Joint Stock Companies does not foresee the possibility to issue several types of ordinary (plain) shares.[124] Hence this deprives Company of the opportunity to be more flexible while specifying certain classes of employee eligible for a certain stock distribution plan. Problems could appear in terms of the exercising the right of first refusal of the other employees, who have already receive staff shares outstanding by the Company. As it is prescribed in the law, all the holders of ordinary (plain) shares of a Company enjoy identical rights and have the right of first refusal for shares outstanding by the Company.[125] Hence, if Company distributes odinariry shares

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[119] Law on Joint Stock Companies article 8(2001)
[120] Law on Joint Stock Companies article 41.4(2001)
[121] Law on Joint Stock Companies article 58(2001)
[122] Law on Joint Stock Companies article 59(2001)
[123] Why do I need to get an IRC Section 409A Valuation, published by Simple409A available at http://simple409a.com/why-do-i-need-to-get-a-section-409a-valuation/

[124] Law on Joint Stock Companies article 32(2001)
[125] Law on Joint Stock Companies article 37.1 point d)(2001)

for other employees the rest who already possess the same ordinary shares factually have the right of first refusal to purchase the new distributed shares. [126]

3. **Issues related to the tax obligations**

In order to develop the IT industry in Armenia the "LegalLab" law firm has introduced an initiative to present the necessary reforms in Armenian legal framework which will make available the issuance of the shares to employees. [127] During one of his interviews, the cofounder of the law firm while identifying some of the issues mentioned above, also noted that at first for making the process possible the uncertainties existing in the tax field should be eliminated, since "…at this point it is unclear how the stock option will be taxed, at the moment when the option will be provided, or when the shares will be transferred, since the option itself is a promise to provide shares."[128]

Law on Income Tax of the Republic of Armenia stipulates that *“income shall constitute property receivable during the reporting period by the taxpayer under employment or civil legal agreements or on any other grounds.”*[129]If the definitions of stock options, restricted stocks and restricted stock units are included in the Armenian legislation, then the interpretation of the above mentioned article will be different for each of the systems and the implementation of each, respectively the period of the taxation liability could vary, which may raise some issues.

If the company may have a chance to provide stock option as compensation to employee, then in the framework of the Law on Income Tax the purchase of option should not entail any tax liability until the moment of actual transfer of shares. While exercising the option if the employee buys the determined stock then there is a risk that the substantial difference between the real market price of the stock and the purchase price determined by the option (the discount) may be viewed as a subject for taxation. Unlike the United States where employees recognize no income when the option is exercised but are taxed at capital gains rates on the difference between the market price of the stock when the option was exercised and the price for which it was sold[130] in Armenia there is no taxes can be imposed on the income received from the sale of the property, since capital gains are not taxable.

If the company decides to grant its employees restricted stocks, then the circumstances will differ because in that case the employee factually receives shares which come with restrictions and

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[126] Law on Joint Stock Companies article 37.1 point d)(2001)

[127] Վարկային միություն հանուն՝ ՏՏ զարգացման, published by Banks.am March 2016, available at http://www.banks.am/am/news/interviews/11867/

[128] Վարկային միություն հանուն՝ ՏՏ զարգացման, published by Banks.am March 2016, available at http://www.banks.am/am/news/interviews/11867/

[129] Income tax code, article 5.2 (2013)

[130] Employee Stock options: Tax treatment and tax issues by James M. Bickley (June 2012)see generally

many of them are not transferable for a period such as five years. In the framework of the relevant article, these shares will be included in the gross income as receivable property of the taxpayer and it should be declared as an income upon receipt. Even though the employee factually receives the shares it does not mean that the ownership of these shares already belongs to him as these shares are subject to forfeiture if the restricted stock holder leaves the company before the shares vest. It seems reasonable that the restricted stock must be taxable as ordinary income in the year it is granted. However, the restricted stock holder may face issues and the risk of taking the taxation upon receipt of share is that if the employee leaves the company before the shares vest, the shares are forfeited and taxes already paid are not refunded.

The distribution of shares to the employee can be treated in two ways as if it is a purchase of a property (security) or compensation in return for services therefore the tax liability of the company will very respectively. [131]

Generally the company while determining taxable profit should reduce from gross income the labor costs and other payments deemed equal thereto.[132] However, the distributed amount of shares cannot be considered as necessary expenses as the article 192.2 of RA Labor Code does not permit the payment of the wage by securities and commitments.[133] Normally the expences towards SOPs and ERSs should be deductible for company, but in the framework of the current legislation grant of the shares is included in the income for profit tax purposes.[134]Hence, if the tax sysytem puts tax liabilities on companies, that make anfavorable conditions for employee stock distribution plans, then Armenian corporations may have less incentives to use the system in practice.

Chapter IV

Recommendations and conclusion

Quite recently during the ICT leaders forum-meeting, which was mainly devoted to the legal regulations for the implementation of employee stock distribution mechanisms by Armenian

[131] Employee Stock options: Tax treatment and tax issues by James M. Bickley (June 2012)see generally
[132] RA Law on Profit Tax 10 paragraph 2 point b) (1997)
[133] RA Labor Code article 192.2(2005)
[134]RA Law on Profit Tax 7 paragraph 2 point g) (1997)

joint stock companies the "Legallab" law firm while introducing the specifics of the stock distribution process offered solutions to the problems of the system associated with the Armenian legal framework.[135]

It was proposed to start from the experience of stock awards since as long as there is no well developed capital market in Armenia the opportunity to grant stock options is less attractive.[136]

Given what has been explored and outlined from the US practice, it can be assumed that among described employee stock ownership models as effective models for provision of employee stock Restricted Stock Award and Restricted Stock Units may easily be adopted taking into consideration the respective strategic objectives of the startups. There are number of privileges can be outlined to prioritize these plans. One of the major advantages is the accepted fact that these stocks nearly always worth something even if their value drops significantly[137], since in most cases in the given practice employees are not required to pay for restricted stocks. Taking into consideration that there is a lack of developed secondary market in Armenia restricted stock awards (when the stock is factually provided) may become most favorable for employees, since they may provide opportunity to receive dividends from the granted shares before and after vesting. Thus, stemming from the sense of ownership more employees will be interested in the development and prosperity of the company. In their turn restricted stock units can be preferable choice for the company who are lacking extra money and have no means to issue shares, since there is no requirement of actual funding until the end of the vesting schedule. Thus, it is a mean for growth oriented companies to gain time until the financial stability.

However before choosing the respective plan for the employee's future wealth and company's success the main restrictions in the legal framework should be removed in order to facilitate and make the process more applicable. [138]

During the forum-meeting the "LegalLab" firm outlined the amendments that are most needed. *"...three main steps should be taken and at first companies should have means to issue several*

[135] ՏՏ լիդերները քննարկել են ՏՏ վարկային կազմակերպության ստեղծման տեսլակերը, հրատարակված՝Հետք-ի կողմից, available at:
http://hetq.am/arm/news/66102/tht-lidernery-qnnarkel-en-tt-varkayin-kazmakerputyan-stextsman-teslakany%E2%80%8B.html

[136] Հայաստանում ՏՏ մասնագետները քննարկում են աշխատողների բաժնետիրացման գործընթացի ներդրման հնրավորությունները,հրատարակված է ARMENPRESS-ի կողմից ,Փետրվար
http://armenpress.am/arm/news/837599/hayastanum-tt-masnagetnery-qnnarkum-en-ashkhatoxneri-bazhnetiracman.html

[137] Employee Stock options: Tax treatment and tax issues by James M. Bickley (June 2012)see generally

[138] Հայաստանում ՏՏ մասնագետները քննարկում են աշխատողների բաժնետիրացման գործընթացի ներդրման հնրավորությունները,հրատարակված է ARMENPRESS-ի կողմից ,Փետրվար
http://armenpress.am/arm/news/837599/hayastanum-tt-masnagetnery-qnnarkum-en-ashkhatoxneri-bazhnetiracman.html

classes of ordinary shares, secondly the entrepreneurs should have more flexibility while determining certain employee rights which inferrs flexibility of the right of first refusal and third the obligatory condition of payment should be eliminated, namely not to force employee to make some payement to become the owner of the share."[139]

Hence, if the legislation foresees possibility to issue several classes of ordinary stock the company will be given opportunity to define specific rights and obligations with each provided stock, based on company's strategic policies and employee's distinctiveness. [140]

In order to ensure flexibility of the right of first refusal this right should not be accessible to everyone and should be realized only if it is directly provided by the stock certificate. It follows that differentiation will exist and the employer may provide stock to the particular employee since the rest of employees will not automatically obtain the right of refusal towards these shares.

It is known that prices of stock may vary a lot and in case when the stock has high price for the ordinary worker it may be difficult to pay even 25% of the stock price. If the obligatory requirement of certain payment is eliminated[141] from our legislation then companies may award stocks to employees in return for provided services without any requirement of property compensation in the future.

In addition to the aforementioned obstacles Article 41 of JSCL provides for other restriction that is the limitation on the circulation of staff shares, which cannot be longer than 3 years. [142] Generally in US vesting period may last up to four or five years and during that period restriction is put on the transferability of shares. [143] However, considering the Armenian market economy specifics more flexible terms are needed, since the company should not be bound by any limitation of time and must be able to define its own terms and limitations in regard with each determined stock plan.

At any case before all the above mentioned obstacles the major problem that firstly should be noted is that company cannot distribute shares among staff members if there are no redeemed shares in the balance of the capital. [144] At that situation company should issue shares then buy

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139 ՏՀՏ զարգացման ֆինանսական գործիքներ, published by armef.news March 2016, available at` http://armef.com/hy/news/verlutsutyun/tht-zargacman-finansakan-gorciqner/

140 Աշխատակցից սեփականատեր, Ստեփան Խզրթյան դեկտեմբեր 2015, available at http://www.slideshare.net/StepanSKhzrtian/from-employee-to-shareholder

141 Աշխատակցից սեփականատեր, Ստեփան Խզրթյան դեկտեմբեր 2015, available at http://www.slideshare.net/StepanSKhzrtian/from-employee-to-shareholder

142 RA Law on joint Stock Companies article 41 (2001)

143 Mark Cussen, published by Money Crashes "What are restricted stocks and restricted stock units?" units?"http://www.moneycrashers.com/restricted-stock-units-rsu-taxation/

144 RA Law on joint Stock Companies article 41 (2001)

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back them by the means of the special fund and only then distribute the shares among employees. Moreover, the existing administrative complexity of the system is one another reason not to issue new shares to the staff members. Since as it was noted the Charter should be amended and approved by the State Registrar every time when company issues shares. [145] In order to avoid additional complexities and make the system more practical certain percentage of shares from the total of the company's equity can be set aside for future employee share distribution plans by the decision of founders and early investors. If it is determined that for instance 20% percent of the declared shares should be granted to employees as a compensation then the rest of the shareholders would be beforehand informed that certain percentage of shares will belong to employees and it will help them to better imagine the possible dilutive risks(which will be less). Besides, the decision of employee stock distribution may be delegated to the powers of the board, in order to avoid administrative complexities in regard with the Charter amendment.

However, making amendments only in the Law on Joint stock companies is not enough and amendments in tax law are also necessary.

Employee stock distribution plans may become more attractive when the tax legislation will be more ascertained and concrete terms would be adopted which will correspond to the requirements of that system. Thus, two main things should be taken into consideration; at first if the restriction of Labor code would be removed then securities may be distributed as a part of the employee's compensation package and therefore ESOPs and ERSs should be construed as expenses for deduction of company's taxable profit. Moreover, at this point the legislation does not provide any means to defer the taxation of the staff shares at the moment when they are granted. In the US receiving compensation in this form postpones the payment of taxes from when they would have been due on an equivalent amount of cash wages or at least tax liabilities accrue at the day of vesting.[146] Deferring tax obligations would permit employees to avoid taking additional costs of taxation in case if shares are forfeited.

If our legislation defines certain long-term incentive programs, including stock options, in particular, time–based restricted stocks and performance based programs employees will take more responsibility to collect information, identify problems and work with management to provide solutions. However only well structured mechanisms which will be operating through

[145] RA Law on Joint Stock Companies article 17 (2001)
[146]About Restricted Stock Awards, published by Fidelity http://personal.fidelity.com/products/stockoptions/rstockawards.shtml

revised legal framework will let companies to create structures to grant the employees stocks as a long term incentives and let the latter to use their rights fully and with more confidence.

Employee activism will affect business, the relationships of shareholders and management, workers and managers at all levels, board directors and senior executive teams. Moreover, it may promote the development of the capital market in Armenia; attract more foreign investors and therefore have significant effect on the economy of our country.

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