

# Global compensation update

The newsletter of the White & Case global equity-based compensation group

## Russia: Amendments to Securities Market Law

Impact of recent tax changes and reporting requirements in Australia

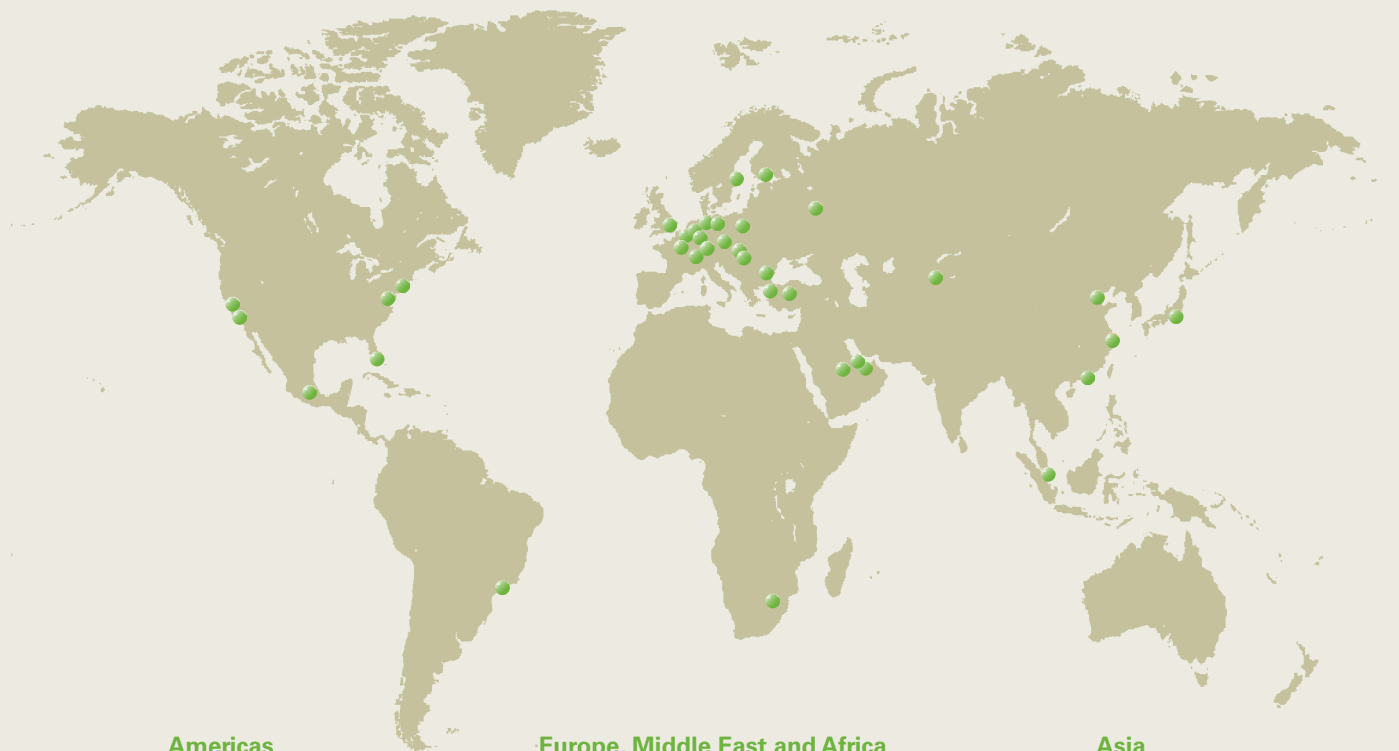
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## Russia: Amendments to Securities Market Law Add Complexity to Equity-Based Compensation

Equity-based compensation plans are becoming increasingly popular throughout Russia. The crisis years contributed to their development, as they enabled employers to motivate their employees without compounding cash-flow difficulties. As our Moscow office notes below, there are still some legal uncertainties concerning the operation of equity-based compensation plans in Russia.

The implementation of equity-based compensation plans with respect to employees of Russian companies is mainly regulated by Russian labour, securities, currency control and tax laws. Of these, it is the securities legislation that has been the subject of the most important recent developments. Amendments to the Federal Law No. 39-FZ "On Securities Market" dated 22 April 1996 (the "Securities Market Law") adopted on 28 April 2009 (the "Amendments") only allow foreign issuers to offer their securities to qualified investors if the securities are not admitted for placement or public circulation in Russia. As most employees are not qualified investors, this theoretically has the effect of preventing the grant of equity-based awards using foreign issuers' shares in Russia.

There may nevertheless be avenues available for foreign employers seeking to grant equity-based awards to employees in Russia, but uncertainty still remains and employers would be well advised to exercise caution and to seek appropriate legal advice.

### The Former Regime

Under the previous regime, there were only two ways in which foreign securities would be eligible for "placement" or "public circulation":

1. if there was a relevant international treaty between the Russian Federation and the country of incorporation of the foreign issuer; or
2. if a cooperation agreement existed between the Federal Service for Financial Markets (the "FSFM") and the relevant securities market regulatory authority of the country of incorporation of the foreign issuer.

The Securities Market Law therefore effectively prohibited placement (regardless of whether such placement was public or private) or public circulation of foreign issuers' securities in the absence of a relevant international treaty or cooperation agreement.

### The New Position

The Amendments have significantly changed the regime for the offering, placement and circulation of foreign securities in the Russian Federation. The Securities Market Law now states that foreign securities that have not been admitted to public placement and/or public circulation in Russia, as well as foreign financial instruments that have not been recognized as securities, may not be offered in Russia "in any form or by any means", including by way of advertising, to an unlimited number of persons or to persons who are not "qualified investors" under Russian law.

The term "offering" can be construed broadly to include, among other things, distribution of the plan materials, enrolment forms and other relevant materials in relation to the plan in Russia, as well as the holding of any presentations or other similar events in connection with the plan in Russia.

Furthermore, the procedure for securities to be admitted to public placement and/or public circulation involves a number of steps, including registration of a foreign securities prospectus with the FSFM, the Russian securities regulator. However, this procedure is not yet fully operational, as the full set of rules and regulations designed to implement the legislative amendments has yet to be developed. It should be noted that the wording of the new rules is rather vague and, in certain cases, allows for multiple interpretations.

We are also aware that the FSFM is currently working on a draft regulation that should allow "non-qualified investors", such as foreign individuals and Russian employees (acting under relevant provisions of their employment agreements), to acquire foreign securities that are not admitted for placement or public circulation in Russia. However, no formal declarations have been issued so far on this point by the FSFM, and employers should therefore continue to operate under the assumption that the law applies as stated in its written form.

*Continued overleaf*

## Implications for Employers

As explained above, and based on a literal reading of the prevailing rules and limitations, shares of a foreign issuer that are not admitted to public placement and/or public circulation in Russia may not be offered under equity-based compensation plans to “nonqualified investors” in Russia (either in connection with their initial placement or further resale). Since employees are unlikely to be recognised as qualified investors under Russian law, they will not be able to acquire shares under equity-based compensation plans in Russia. Hence, on the face of it, the implementation of such plans in Russia would likely be a violation of Russian securities law regulations.

Given the lack of clarity in the law and the fact that the changes are relatively recent, there are no guaranteed solutions to dealing with the issues raised by the Amendments. Specific advice would need to be obtained for each particular situation. There are, however, certain measures that employers can take to minimize the risk of breaching the above restrictions.

### Only Offer Foreign Shares Outside Russia

Employers should ensure that no offering of foreign shares to “non-qualified investors” in Russia is made within Russia. In practical terms, this means that ideally employees should be flown to a location outside Russia to review the plan documentation. It is potentially arguable that it may be acceptable for employees to view the plan documents via a website hosted on a foreign server; however, the risk of breaching the Securities Market Law would still exist in this scenario, as the documents would be accessed using Russian IP addresses. Execution of the award agreements (if necessary) should also be conducted outside Russia, either by the employees themselves or by an appropriately authorised individual with a power of attorney.

Employers should also keep in mind that the restrictions on distributing plan materials within Russia exist not only at the initial offering of the awards to employees, but also when subsequent or on-going distributions of information are made in relation to the plan. This will affect the way in which employers communicate with Russian employees on matters such as the vesting of their awards, or the making of amendments to the plan rules. Use of internet platforms which provide on-going plan information and are hosted on foreign servers may mitigate the risk of breaching the Securities Market Law, but again this risk is not eliminated given that employees will still be accessing the information using Russian IP addresses.

### Apply for Admission of Foreign Shares to Public Placement or Circulation

Employers may wish to consider applying for admission of the shares to public placement and/or public circulation in Russia once all the necessary legal regulations implementing the provisions of the Securities Market Law come into force. Indeed, the Moscow Interbank Currency Exchange (“MICEX”) has recently registered its amended listing rules with the FSFM to allow technically for the admission of foreign securities. This means that the principal parts of the regulatory framework for the admission of foreign securities to a Russian stock exchange have essentially been set up; however, its practical implementation is still pending. Additionally, once implementation begins, certain

deficiencies may be revealed which could require further regulatory changes. As such, employers seeking to apply for admission of their shares may need to prepare themselves for any teething issues arising from the implementation of the Amendments.

In terms of the process for making an application for admission of foreign shares to public placement and/or circulation in Russia, we estimate that it would take roughly 1.5 to 2 months for registration of the foreign securities prospectus with the FSFM and admission of the foreign securities with MICEX to be completed. The potential costs involved are not yet clear; however, we anticipate that the primary costs would arise from preparation of the prospectus. Applying for admission of the shares would carry the advantage of ensuring that the Securities Market Law has been complied with when offering equity-based compensation plans in Russia. However, employers will then be subject to the costs and administrative burdens associated with on-going disclosure requirements.

However, given the possibility that regulations exempting equity-based compensation plans may be introduced in due course, applying for admission of the shares may be a somewhat drastic step. The wisest course of action for employers is perhaps to bide their time until the final status of equity-based compensation plans under the Securities Market Law becomes clear.

### Structure Awards to Provide for Cash-Settlement

Finally, it is also possible to structure plans so as to provide for cash settlement, without the actual placement or transfer of shares. However this would still require careful structuring to avoid violation of Russian securities law restrictions.

The main difficulty with cash-settlement arises from the absence of a definition of “foreign financial instrument” in the Securities Market Law. Even a cash-settled award would not be free from the residual risk of being viewed as an offering of a “foreign financial instrument”. However, it is arguable that the restrictions on the offering of “foreign financial instruments” are primarily targeted at the protection of the rights and lawful interests of Russian investors and are intended to capture securities, commodities, options and commercially similar instruments. Since cash-settled awards are very different in nature (i.e. offered on a private basis; cannot be resold on the secondary market) they do not bear the risks associated with market instruments. To get some comfort on this point from the regulator, an employer may wish to consider obtaining a transaction-specific clarification from the FSFM (such clarification, however, will not have force of law and will not create a binding precedent).

Equity-based compensation plans will continue to play an important role in the compensation of Russian-based employees. However, until further clarification is received as to whether equity-based compensation plans are subject to the Securities Market Law restrictions, employers will need to give careful thought and seek appropriate legal advice to ensure that the structuring and execution of their plans do not fall foul of the amended Securities Market Law.



## Important changes to Canadian employee stock options announced

**Draft legislation released in August 2010 by the Canadian Department of Finance proposes changes that are expected to cause companies that grant stock options to review carefully their current stock option plans and perhaps look to alternative methods to compensate their employees.**

The draft legislation follows the announcements made as part of the 2010 Canadian budget and incorporates changes which are expected to affect employee stock options in at least three ways. These are considered in turn below.

### Stock option benefits – tax deferral

#### Pre-budget position

Currently, Canadian employees may elect to defer (at least in part) the charge to income tax that would ordinarily arise on the exercise of their stock options until the earliest of (i) the year that the resulting shares are sold, (ii) the year the employee dies, or (iii) the year the employee ceases to be resident in Canada for Canadian tax purposes. One of the notable disadvantages of this arrangement is that the tax liability will always be assessed by reference to the market value of the stock under option at the time of exercise. Consequently, if an employee elects to defer recognition of the employment benefit and the value of the stock subsequently decreases, the employee may not have sufficient proceeds from the sale or other disposal of the securities to satisfy his or her tax obligation.

#### Proposed position

The revised legislation introduces a special elective tax treatment for tax payers who have elected to defer tax, which will ensure that the tax liability on a deferred stock option benefit does not exceed the proceeds of sale of the underlying option securities following exercise, taking into account tax relief resulting from the use of capital losses on the option securities against capital gains from other sources.

Any year in which the tax payer is required to include in income a qualifying deferred stock option benefit, the tax payer may elect to pay a special tax for the year equal to the proceeds of the sale, or other disposal, of the option securities (in the case of residents of Quebec, the special tax will be two thirds of such proceeds). In applying these new rules it should be noted that only stock option benefits for which an election to defer taxation has already been made will qualify for the special elective tax treatment. It should also be noted that:

- (i) individuals who disposed of their stock before 2010 will have to make an election for the special treatment on or before 30 April 2011 i.e. the expected filing due date for the 2010 taxation year; and
- (ii) individuals who have not disposed of their stock before 2010 must do so before 2015, they will then have until their filing due date for the taxation year of disposition to make an election for the special treatment.

Finally, in relation to tax deferral, no deferral elections may be filed for publicly listed shares acquired after 4pm EST on 4 March 2010.

### Stock option benefits – cashed out options

#### Pre-Budget position

The tax rules currently ensure that when an employee acquires securities under a stock option agreement, only one deduction (at the employee level) is provided. This is because employers are, in this context, prevented from claiming a tax deduction for the issuance of a security. However, where employee stock option rights are not exercised but, instead, exchanged for a cash payment from the employer i.e. “cashed out,” the cash payment is fully deductible by the employer and, at the same time, the employment benefit received by the optionholder may still also be eligible for the existing stock option deduction (i.e. a deduction equal to one half of the employment benefit).

#### Proposed position

In line with the 2010 budget announcements, the revised legislation proposes to prevent employees and employers from both securing tax deductions for the same employment benefit. In addressing the situation, the stock option deduction will generally only be available to employees in situations where they exercise their options and acquire securities rather than giving up their rights in exchange for a cash equivalent. An employer may continue to allow employees to cash out their stock option rights without affecting their eligibility for the stock option deduction but, in these circumstances, the employer must make an election to forgo the deduction for the cash payment (and file copies of this election with the Canada Revenue Agency (CRA)).

As a consequence of these legislative proposals there are a number of actions which employers may wish to take to the extent that existing option plans have been, and may continue to be, operated on a cashed-out basis, including:

- carry out an assessment of the likely costs to the employer as a result of the foregone tax deduction if elections are to be made;
- consider the impact on share “headroom” if all options are now to be exercised in full rather than cashed-out;
- check that there are no contractual rights, or other policy restrictions, which would impact the employer if employees are prevented from a tax deduction if their options are cashed-out; and
- consider the impact that the loss of a deduction may have for financial reporting purposes. *Continued overleaf*

## Withholding obligations

### The pre-budget position

Employers have frequently utilised the “undue hardship” provision allowed for by the CRA and not withheld income tax at source on stock option benefits from other cash payments for those employees who would experience undue financial difficulty as a result. The CRA allowed a 50% reduction on any of the employee’s taxable income for employers to take account of when they decided to activate income tax withholding.

### The proposed position

“Undue hardship” will no longer apply where employers issue securities under an employee incentive plan. An employee will also not be allowed to apply to the CRA for “undue hardship” to reduce the liability for tax through withholding solely because the benefit was received as a non-cash bonus.

For securities issued on or after 1 January 2011, any withholding income tax will need to be treated as if the employee had received the benefit as a cash-paid bonus. It will be important for employers to consider the current measures they employ when withholding tax on options.

## Amendments to Prospectus Directive made by Council of European Union

**A directive amending the Prospectus Directive (PD) was adopted by the Council of the European Union on 11 October 2010 and will become law on the 20th day following its publication in the Official Journal of the EU. It is expected that this could occur later this month.**

Further to our article in Issue 1 of this newsletter, entitled “The effect on Employee Share Plans of the Amending Directive of the Prospectus Directive”, the amending directive will extend those provisions already exempting offers to employees and directors from the prospectus requirement to (i) all companies that are headquartered or registered in the European Union and (ii) companies with securities trading on markets outside of the EU, when that country is considered by the Commission to have the same regulatory and supervisory standards as a regulated market.

Within the UK context, the government decided on 1 November 2010 to allow for early implementation of two of the PD amendments, namely:

- (i) the amendment exempting from the scope of the PD offers of securities for which the consideration is under EUR 5 million (formerly EUR 2.5 million), calculated over a 12 month period; and
- (ii) the amendment to the exemption from the requirement to file a prospectus for offers made to less than 150 persons per member state (formerly 100 persons per member state).

It is anticipated that these amendments will be introduced in the UK in early 2011, with a view to assisting small to medium-sized enterprises.

Although this exemption for companies outside the EU is apparently good news, many of these companies are still able to rely on the other exemptions from requiring a prospectus under the PD, meaning the effect of the amending directive may not be as significant as it seems.

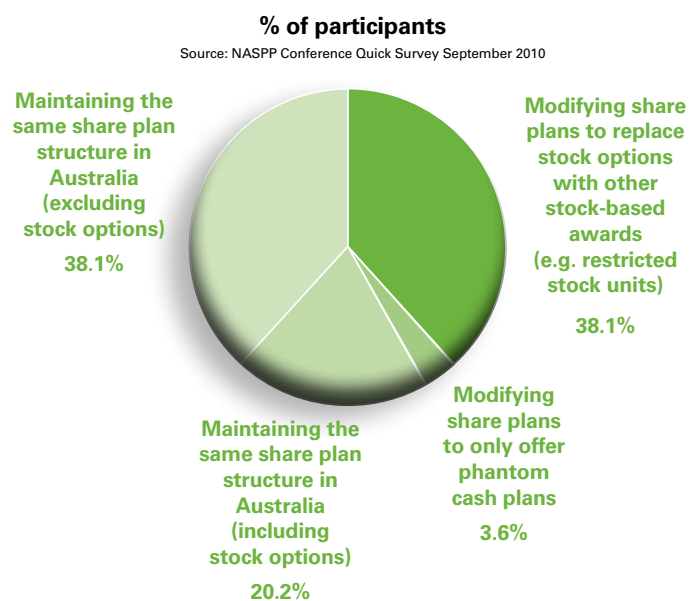
# Impact of recent tax changes and reporting requirements in Australia

As widely reported, the Australian tax regime relating to employee share schemes was overhauled and replaced with a completely new set of rules which came into effect on 1 July 2009.

Under the new Australian tax rules, employers must now pay payroll tax on employee share plans and issuers of shares or rights under these plans will be subject to reporting requirements to the Australian Tax Office and to employees using the approved forms.

As part of a recent survey prior to the NASPP Conference in Chicago (20-23 September 2010), a number of stock plan professionals working for issuers were asked how their companies would react in light of these recent tax changes and reporting requirements affecting their Australian share plans.

Over 40% of those professionals in the survey advised that they would be modifying their share plans in some way, clearly highlighting the repercussions that these tax changes and reporting requirements will have on companies with share plans in Australia.



# News in Brief

In this section, we highlight some recent legislative changes which may affect your equity plans around the world.

## Italy



On 13 September 2010, important guidelines were issued by the Italian tax authorities concerning the reporting of financial transfers totalling over EUR 10,000 in relation to assets held abroad or foreign income. These guidelines expand on the current requirements for a financial monitoring form to be attached to the tax returns of individuals making these transfers. Further obligations include ensuring that vested stock options are valued at their option price and assets held jointly or via separate legal and beneficial holders are reported by all individuals concerned. Tax residents who make such transfers should ensure they comply with these reporting requirements so that they do not face onerous financial penalties (which can be up to 50% of the value of the unrecorded transfer or asset).

## Turkey



Revised income tax brackets introduced by the Ministry of Finance have been implemented by Law No.6009. These new tax brackets will apply retroactively from 1 January 2010 and result in income levels of over TRY76,000 (previously TRY50,000) being taxed at the highest income tax bracket of 35%. It will be possible for employers to offset any overpaid tax under the previous tax brackets for the period of July to December 2010.

## France



Companies are advised to review their current equity-based compensation plans in light of pension reform legislation due to be voted on by the French Parliament by the end of 2010. This legislation is set to increase employer and employee social tax rates on qualified share plan income, with employee rates due in the year of sale rising from 2.5% to 8% and employer rates at grant rising from 10% to 14%. The legislation also proposes to increase marginal income tax rates by 1% from 40% to 41% and is likely to contain provisions increasing withholding tax rates on dividends and from fixed investments. Other measures may result in the elimination of tax credits on dividends along with the removal of the current capital gains tax exemption on gains below the EUR 25,830 threshold.

## Brazil



Brazil's Federal Revenue Department has stated that, when a tax payer is granted options at no cost, there is no taxable income to report at the time of grant. The ruling helps shed some welcome light on the taxation of employee stock options.

## India



In the recent case of Accenture Services Pvt. Ltd (Taxpayer) and others, the Mumbai Income Tax Appellate Tribunal confirmed that costs relating to the establishment and operation of an employee stock purchase plan are considered as wholly and exclusively incurred for carrying out the business purposes of the taxpayer and, as such, are corporation tax deductible. This ruling helps to clarify the position of deductible expenditure for employers operating employee share purchase plans.

## India



In a recent judgement concerning Vodafone International Holding BV (a Dutch based member of the Vodafone Group Plc), the Indian Supreme Court held that the company's acquisition of the majority stake in an Indian company, Hutchison Essar Ltd, had a sufficient financial connection for the Indian tax authorities to have jurisdiction to examine the transaction and, consequently, impose tax on Vodafone.

This case illustrated a move by Indian tax authorities to increase their focus on examining offshore transactions to determine whether they have a fiscal nexus in India and are therefore eligible to be taxed by the Indian authorities. This will undoubtedly have important implications on how cross-border transactions may be carried out in order to mitigate the risk of such tax liability arising.

## Russia



As of 2011, the rate of Russian social contributions will increase from 26% to 34%. Once this occurs, any in-kind and monetary benefits received by employees (including free shares or share-based bonuses received under restricted stock, restricted stock units and share appreciation rights plans) will be subject to social contributions at the increased rate.

However, the assessment base for social contributions will still remain capped at RUB 415,000 annually (approximately USD 14,000 or EUR 10,000, subject to annual indexing which should soon be established for 2011). This implies that benefits received under equity-based compensation plans should not be subject to additional social contributions with respect to employees whose annual remuneration exceeds the above threshold.

# Upcoming Events

## **JSB International Employment Law Seminar**

**12 November 2010, London**

White & Case lawyers from the London and Istanbul offices will be chairing and presenting at the JSB International Employment Law Seminar for HR advisors on Employment Law in Turkey.

This one day interactive seminar led by White & Case will be held in London and will be addressing important issues governing employment law within Turkey with a view to promoting an understanding of its cultural differences and work practices.

## **Global Equity Organisation Regional UK Conference**

**18 November 2010, London**

White & Case will be hosting the Global Equity Organisation Regional UK Conference to be held at White & Case's London office on 18 November 2010. The agenda will include a number of plenary sessions and break out groups covering a number of issues currently affecting the operation of equity based incentives. In particular, Nicholas Greenacre will present the latest issues relating to equity compensation in Russia, China and the United States.

If you would like further information about this event please contact Nicholas Greenacre at [ngreenacre@whitecase.com](mailto:ngreenacre@whitecase.com).

## **Benefits after the Budget**

**23 November 2010, London**

This session will analyse the impact that the successive 2010 Budget changes have had on the structure and operation of equity based incentive plans. An update will also be provided on (i) measures likely to be taken by HM Revenue & Customs to tackle tax avoidance arrangements through the use of employee benefit trusts, and (ii) recent notable changes to overseas legislation which may impact the implementation and operation of global share plans. The session will also consider the impact of the 2010 Budget on pensions. This includes the proposed scrapping of the "special annual allowance" in favour of a simplified (but lower) annual allowance to curtail tax relief available to high earners, and the move to scrap compulsory annuity purchase at age 75 for defined contribution scheme members.

This seminar will be held at our White & Case London office at 5 Old Broad Street, London EC2N 1DW. To reserve your place at one or all of the seminars, please reply to [rsvp@whitecase.com](mailto:rsvp@whitecase.com).

### November 2010

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