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WHITE & CASE

# Global compensation update

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

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Euan Fergusson (London), Bian Jiang and Liu Tian (Beijing) consider the SAFE filing requirements and tax treatment of employee incentives in China.

## Background

Hui Zong Fa [2007] "Circular 78" requires overseas companies to register with the State Administration of Foreign Exchange (SAFE) when implementing equity plans for their employees in China. SAFE registration can generate significant costs for companies when preparing and translating the required documents, going through the application procedure and renewing on an annual basis. It may, however, be possible for companies to avoid the SAFE obligations altogether when implementing award plans for their employees in China whilst still preserving a more favourable income tax position. This may be achieved by structuring the awards in such a way that individuals will not have any entitlement to shares but will receive a cash value representing either the value of a fixed number of shares at vesting (i.e. "phantom shares" or "cash-settled RSUs") or the increase in value of a fixed number of shares between grant and vesting/exercise (i.e. "stock appreciation rights" or "phantom options" ("SARS").

Either structure may be an attractive method for those companies who wish to reward their employees in China, as it will save both the time and expense of having to comply with the obligations under SAFE.

## Avoiding the need to file under SAFE

Companies can avoid the onerous filing requirements under the SAFE system if they can demonstrate that awards to their employees in China are not equity settled but take the form of SARS and/or phantom shares. Since no equity is issued, these plans are characterised in China as "bonus plans" and therefore fall outside the requirements to file under SAFE.

For companies to ensure that the awards fall outside the SAFE filing requirements, it is important to make clear in all documentation concerning the awards that participants will not be acquiring any shares or any rights to shares and shares must not be used to fund any payments made to participants under the awards.

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## The tax position of employee incentive plans

Cai Shui [2005] "Circular 35"; Cai Shui [2009] "Circular 5" and Guo Shai Han [2009] "Circular 461" provide for preferential tax treatment of the proceeds from stock options and other share based awards and allow these proceeds to be treated as employment income which can be taxed separately from an employee's monthly salary income. This means that a lower tax rate can be applied to that element of income derived from share based awards.

In order to benefit from this preferential treatment, locally listed companies or the local subsidiaries of overseas companies must register the relevant plans with the Local Tax Bureau ("LTB") and comply with certain other filing requirements on the exercise of the awards. The proceeds of awards under plans not registered with the LTB will be taxed together with the participant's salary, meaning a much higher tax rate will ordinarily apply.

To register with the LTB, companies must translate into Mandarin and submit a copy of the related documents, including the following (wherever applicable):

- the plan;
- standard form award agreement;
- grant notice; and
- exercise notice.

## Application of the favourable income tax treatment to cash awards

It is understood that local employing entities will still have to register their plans and documents outlined above with the LTB to take advantage of a lower tax rate for their employees. However, we consider that these requirements are far less demanding than those under the SAFE system and the tax advantages afforded to employees are expected to outweigh the additional costs and burdens associated with LTB filings.

Therefore, continued use of cash awards (linked to underlying share performance) to incentivise employees will have the benefit of attracting favourable tax treatment whilst still avoiding any requirement on the company to file these plans under SAFE.

# Guidelines for remuneration issued by Committee of European Banking Supervisors

**The Committee of European Banking Supervisors (CEBS) has issued final guidelines clarifying the position on remuneration practices and lessening the obligation on certain institutions to comply with some of the requirements outlined in the Third Capital Requirements Directive 2010/76/EU ("CRD III").**

CRD III requires that:

- at least 50% of variable remuneration should be paid in shares or other securities;
- 40% - 60% of variable remuneration is to be deferred for 3-5 years; and
- discretionary pension payments should be made in shares and will be subject to retention by the company for a 5 year period following the beneficiary's departure from the company or his or her retirement.

The principle of proportionality will apply to neutralise some of the CRD III requirements where this is appropriate given the risk profile and strategy of the institution. However, requirements cannot be partially neutralised (for example, by reducing the percentage of variable remuneration to be deferred from 40% to 30%). If an institution cannot justify complete neutralisation of a requirement, it must comply with the full requirement. Additionally, neutralisation is never automatic and institutions will need to explain their rationale for every potentially neutralised requirement.

Smaller or less complicated institutions may also have reduced obligations concerning disclosure of remuneration practices. Such institutions may only need to disclose some qualitative information and very basic quantitative information (however, if they do not provide all information required under CRD III they will still need to demonstrate how they have applied the proportionality principle to neutralise some of the requirements).

## News Update: Amendments to Prospectus Directive now in force

A Directive amending the Prospectus Directive (the "Amending Directive") was published in the Journal of the European Union on 11 December 2010 and came into force on 31 December 2010. Member states have until 1 July 2012 to implement the provisions set out in the Amending Directive.

As previously reported in Issue 2 of the Global Compensation Update, the Amending Directive extends the provisions exempting directors and employees from the prospectus requirement. However, White & Case considers that it is unlikely that the extension of these provisions will have much practical effect due to the existence of other applicable exemptions already contained within the Prospectus Directive, aside from enabling non-EU corporations to offer employee stock purchase plans to large numbers of European employees.

## New case emphasises the importance of careful drafting for equity-based award plans in the US

**A decision on 16 November 2010 made by the United States appeals court for the Eleventh Circuit emphasises the importance of drafting stock-based compensation plan documents that clearly reflect the intent of the parties.**

In *Graphic Packaging Holding Co. v. Humphrey*, the employer sought repayment for amounts that it allegedly overpaid its executive in the cash settlement of his restricted stock unit (RSU) award. The employer originally paid the executive based on the value of the employer's stock on the executive's retirement date, but later claimed that it should have used the payment date instead as the valuation date. Because the executive was a "key employee" for purposes of Internal Revenue Code (IRC) Section 409A, the payment date was required to be delayed for six months following the executive's retirement date. Incidentally, the value of the employer's stock had dropped during the six-month delay. Both the applicable stock plan and the RSU award agreements were silent as to whether the valuation date should be the payment date or the retirement date. The employer's compensation committee, which had the authority under the terms of the plan to interpret the plan, determined that the proper valuation date was the payment date. Nevertheless, the court held that the employer did not produce evidence to show that the valuation date should be the payment date instead of the retirement date, and the executive was not required to repay any of the amounts he received.

In light of *Graphic Packaging*, employers should make sure to clarify in applicable plan documents the valuation date for stock-based compensation awards that are settled in cash, especially where IRC Section 409A may apply to delay payment.

## Finance bills significantly change taxation rates applying to equity awards in France

In France, the Finance Bills for 2011 have made a number of important changes to the way that stock options and free share plans are taxed both for the employer and employees. The key changes have been summarised in the tables below.

| Free Share Plans     | Income tax  | Capital gains tax   | Social security contributions  |
|----------------------|---|---|--|
| <b>Qualified</b>     | <b>Employee</b><br>Tax rate increased to 41% (from 40% in 2010), payable on market value of the award on vesting  | <b>Employee</b><br>Tax rate increased to 31.3% (from 30.1% in 2010)<br><br>Capital gains are now entirely taxable - threshold of €25,830 after which tax becomes payable is removed   |  |
| <b>Non-qualified</b> | <b>Employee</b><br>Income tax arising on any gain on acquisition<br><br>No taxation until the sale of the shares<br><br>Tax rate on gain from acquisition increased to 42.3% (against 42.1% in 2010)  | <b>Employee</b><br>Proceeds from the sale are now subject to tax at the rate of 31.3% (against 30.1% in 2010)<br><br>Capital gains are now entirely taxable - threshold of €25,830 after which tax becomes payable is removed | <b>Employee</b><br>Increased from 2.5% to 8%, assessed on the gain at acquisition where the market value of the shares per beneficiary exceeds €17,676<br><br><b>Employer</b><br>Increased contribution on the award date of the free share from 10% to 14% where the market value of the shares per beneficiary exceeds €17,676 |
| Stock Option Plans   | Income tax  | Capital gains tax   | Social security contributions  |
| <b>Qualified</b>     | <b>Employee</b><br>Tax rate increased to 41%, payable on market value of the award on vesting (from 40% in 2010)  | <b>Employee</b><br>Tax rate increased to 31.3% (against 30.1% in 2010)<br><br>Threshold of €25,830 after which capital gain became taxable is removed - capital gains are now entirely taxable                                |  |
| <b>Non-qualified</b> | <b>Employee</b><br>Acquisition gain taxed at the rate of 42.3% (against 42.1% in 2010) for the proceeds of the gain lower than €152,500 and at 52.3% (against 52.1% in 2010) on the proceeds of the gain in excess of €152,500<br><br>Where an additional two-year holding period is applied, the acquisition gain is taxed at 31.3% (against 30.1% in 2010) on the proceeds of the gain less than €152,500 and at the rate of 42.3% (against 42.1% in 2010) for proceeds above this figure | <b>Employee</b><br>Capital gain taxed at the rate of 31.3% (against 30.1% in 2010)<br><br>Capital gains are now entirely taxable - threshold of €25,830 after which tax becomes payable is removed                            | <b>Employee</b><br>Contribution assessed on the acquisition gain increased from 2.5% to 8%<br><br><b>Employer</b><br>Contribution on the award date of the shares of 10% is increased to 14% if the market value of the shares per beneficiary is higher than €17,676  |

# News in Brief

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

## Switzerland



The Swiss Parliament has adopted a new Federal Act providing that employee stock options will only be subject to tax on exercise, whereas restricted stock units will be taxable at grant (although at reduced levels to reflect the restrictions). The date on which the Act will come into force has not yet been announced, although this is currently being considered by the Swiss Federal Council.

## Netherlands



The Netherlands Participation Exchange is to expand its online trading platform after receiving approval for this move from the Dutch Supervisor (AFM). This will allow for employees working in companies not registered on a listed stock exchange to trade their stock amongst themselves, altering the way that stock is more customarily traded in Dutch companies.

## Czech Republic



Changes to Czech social security and labour laws have been approved by the Czech Parliament to come into effect from 1 January 2011. Social security and health insurance rates will not be lowered as originally considered, but will remain at their current rates. However, the yearly assessment cap will be raised from CZK 1,707,048 in 2010 to CZK 1,781,280 for 2011.

## Poland



Companies with Polish employees will need to consider the impact of new income tax regulations in force from 1 January 2011, governing the taxation of income from equity-based employee incentive awards. Under the new regulations, employees that receive shares from equity-based award plans that are issued by companies outside the EEA will no longer be eligible for exemptions from progressive tax rates and the deferral of tax rates until the time of sale of the shares. However, employers that offer employees treasury shares issued by companies within the EEA will now become eligible for the more favourable tax treatment.

## UK and Hong Kong



With effect from April 2011, the double taxation agreement made between the United Kingdom and Hong Kong will alter the treatment of corporation, income and capital gains taxes for individuals from either of these countries that are assigned to work in the other party's territory. Key points to note include the 0% rate of withholding on dividends (excluding Real Estate Investment Trusts) and a 0% withholding rate to apply to a resident of the other country living in the other party's territory. The treaty also allows short term residents from either area to qualify for tax exemptions on satisfying certain conditions.

## UK



In January, the experts who are to be involved in the Exchequer's study of a General Anti-Avoidance Rule ("GAAR") have been announced, along with the respective areas they will cover. Key areas to be looked into by this study will include (i) how the GAAR will approach the issue of tax avoidance in the UK, (ii) the operation of similar anti-avoidance rules and GAARs in other jurisdictions and (iii) how useful the operation of a GAAR would be.

## UK



In a recent consultation paper, the FSA are considering whether to adopt measures to require authorised firms, banks and insurers to provide one month's notice to the FSA, before issuing shares or any other equity awards that could be deemed regulatory capital. This obligation, if adopted, could in some cases extend to non-EEA group members who are issuing instruments of this nature.

## Ireland



New listing rules concerning corporate governance have been issued by the Irish Stock Exchange. The Irish Corporate Governance Annex requires listed companies to comply with the extra provisions contained in the Annex, along with the existing requirements under the UK Corporate Governance Code, or otherwise explain their failure for doing so. The new provisions focus predominantly on the composition and remuneration of the board and the work carried out by the audit committee.

# Upcoming Events

## South Africa



A ruling has confirmed the position on income tax for employees participating in share option and share appreciation rights plans of a holding company. The new ruling bases the calculation of an employee's taxable income on a set formula and distinguishes employees resident in South Africa, who are taxed on their income made worldwide, from non-resident employees, who are subject only to tax on income earned within South Africa.

## France



The French Administrative Supreme Court has held that compensation received by an employee by way of an indemnity for giving up their right to exercise employee stock options must be taxed as employee income and not as capital gains. The decision of this case has important implications, as it will mean that the rules governing income tax and social contributions will now apply to individuals in receipt of these payments.

## Russia



New Russian tax rules have been adopted governing the taxation of stock options, with the likelihood that such provisions under the rules will extend to ESPPs. The new rules and their interaction with the existing Russian Tax Code result in some uncertainty over how the awards should be taxed. It would seem that the awards are now subject to double taxation at grant and exercise, resulting in less favourable tax treatment and meaning further clarification will need to be provided.

## JSB International Employment Law Seminar

**30 March 2011, London**

White & Case lawyers from the London, Prague, Bratislava, Bucharest and Budapest offices will be chairing and presenting at the JSB International Employment Law Seminar for HR advisors on Employment Law in the Czech Republic, Slovakia, Romania and Hungary.

This one day interactive seminar led by White & Case will be held in London and will address important issues governing employment law within the relevant CEE jurisdictions, with a view to promoting an understanding of their cultural differences and work practices.

If you would like further information about this event, please contact Stephen Ravenscroft at [sravenscroft@whitecase.com](mailto:sravenscroft@whitecase.com).

## GEO's 12th Annual International Conference

**15-17 June 2011, Amsterdam**

Together with Lindsey Doud of Royal Bank of Canada and Simon Rogers of the Royal Bank of Scotland, Nicholas Greenacre will be making a presentation on the topic of the use of trusts and other similar vehicles in the executive compensation context as part of GEO's annual conference in Amsterdam.

If you would like further information on the event, please visit the GEO website: [www.globalequity.org/geo/2011](http://www.globalequity.org/geo/2011).



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