

Insight

Global Equity-based Compensation

Indian FBT: Implications for awards of stock appreciation rights

Further to our previous report on Indian tax regulations making Employee Stock Options liable to Indian Fringe Benefit Tax ("FBT") (see Insight Autumn 2007 – NASPP Special Edition), the rising incidence of employers granting Stock Appreciation Rights ("SARs") to employees can raise notable issues in relation to FBT liabilities.

The essential characteristics of SARs involve an award of rights to the increase in value of a specified number of shares. The employee participating in the SARs is entitled either to cash in these rights after a vesting period and receive a cash amount equivalent to the appreciation in the shares, or alternatively, the awards can be settled with stock. In the former case, if SARs are cash-settled, then no FBT liability is expected to arise and the amount is simply taxed as income on Indian participants. However, a liability to FBT does arise where the SARs are equity-settled, and employers are liable to FBT directly.

To the extent that employers intend to pass the FBT liability on to participants, we recommend that existing plan rules are reviewed to check that this can be done. For awards granted in the future, this should not be problematic, although specific amendments to plan rules may be required. More significant issues may arise for any retrospective transfer of FBT liability.

Specifically, Section 115WKA of the Indian Income Tax Act 1961 enables the employer to recover the FBT from the participant in respect of specified shares. Related guidance clarifies that the employer can vary the agreement under which the awards have been granted. As such, employers seeking to transfer their FBT liability would be well-advised to ensure that, with regard to future awards, the withholding provisions of the plan rules and/or agreements are drafted broadly enough to cover this transfer, and make corrective amendments if necessary.



Our global equity-based compensation practice is a key part of the Global Executive Compensation Benefits and Employment Law group which numbers more than 100 lawyers worldwide. We offer extensive expertise in dealing with the key issues involved in operating international equity-based compensation plans. Our work includes:

- implementing global employee stock plans
- advising companies on the effects of major M&A transactions on their equity incentive plans
- implementing equity incentive plans for companies preparing for an IPO
- establishing offshore trusts for the benefit of employees
- implementing global re-pricing and exchange programs for underwater options
- implementing global stock appreciation rights plans
- implementing global profit-sharing plans.
- advising non-US companies on offering equity-based compensation in the US
- advising companies regarding equity-based plans with respect to the spin-off of divisions

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However, amending subsisting awards retrospectively to transfer FBT liabilities to participants is potentially more problematic than making the required amendments for awards granted in the future. This is because any unilateral change by employers to the terms of subsisting awards may not be legal or enforceable. Consequently, the express consent of Indian participants is likely to be required.

If retrospective amendments cannot be made unilaterally, an alternative may be to consider the extent to which plan documents provide for the exercise of equity-settled SARs to be satisfied in cash (in which case FBT would not apply).

Italian Decree abolishes tax breaks for options

Law Decree of 25 June 2008, no. 112 (the "Decree") has been published in the Official Gazette in Italy. Whilst it has yet to be converted into law, and is therefore subject to possible amendments, the thrust of the Decree is that the tax favourable treatment which currently exists for stock options, commonly called the fair market value grant program, will be abolished. Upon exercise of options, the "spread" (the difference between the average closing price of the shares during the month leading up to the option's exercise date and the purchase price paid by the employee) will now be treated as ordinary income whereas previously, provided certain conditions were satisfied, the spread was exempt from personal income tax and social security charges.

Importantly, however, the Decree as drafted does not amend the broad-based assignment of stock: a tax-favoured grant program under which an employee may generally defer tax on

up to € 2,065 of the spread annually, subject to a three year minimum holding period. This program therefore remains available.

If the Decree is confirmed by the Italian Parliament (and this needs to be done within 60 days), the provisions of the Decree will take effect from the day it was first published, i.e. 25 June 2008. There are not expected to be any "grandfathering" arrangements. Therefore all subsisting options, including those granted prior to 25 June 2008, will be affected.

Under current Italian legislation, a number of conditions have to be satisfied before a beneficiary can benefit from favourable tax treatment under the fair market value grant program. Tax on the spread is deferred until sale of the underlying shares or any other transfer for consideration. At such time, the gain is taxed at a flat rate of 12.5%.

Under the fair market value grant program, an employee can generally defer tax on the entire amount of the spread, subject to the following limits and conditions: (i) the option relates to no more than 10% of voting rights or share capital; (ii) the option price must be at least fair market value on the date of grant; (iii) the vesting period is at least three years; (iv) at the time the option vests, the issuer is listed on an official stock exchange; and (v) the beneficial owner of stock benefiting from the incentive is retained by the optionholder for at least five years after the exercise of the option.

The abolition of the fair market value grant program is expected to mean, effectively, that the spread on the exercise of the options will be taxed at progressive rates of personal income tax (presently up to 45.2%) and will be subject to social security charges when the options are exercised. Accordingly, this will create an obligation on employers to withhold taxes and pay social security contributions on the spread.

"Non-dom" incentive plan taxation reforms in the UK

Legislation introduced on 21 July 2008 has removed what the Government considers to be various loopholes and anomalies which have previously allowed remittance basis users to remit income and gains to the UK without paying tax on them.

The majority of the changes have been backdated to take effect on and after 6 April 2008.

(a) Prior Law

Under legislation applicable prior to this tax year, UK residents who are not domiciled in the UK can access the remittance basis of taxation without any UK tax being charged on the foreign income and gains they leave outside the UK. So the remittance basis means that income and gains arising overseas are only taxed in the UK when they are brought into the UK.

Conversely, if an individual pays tax on the arising basis then they pay tax on their worldwide income and gains. It is called the arising basis because tax is paid when the income and/or gains arise.

(b) What are the changes?

Provisions have been included in the Finance Act 2008 to ensure that non-domiciled individuals who have been in the UK more than seven out of the past ten years will have to pay an annual charge of £30,000, in order to be taxed on the remittance basis (unless their foreign income and gains are less than £2,000). If an individual decides not to elect to use the remittance basis, the individual will be taxed in the UK on his worldwide income and gains on an arising basis.

The £30,000 charge will be in addition to any tax due on UK income and gains or foreign income and gains remitted to the UK.

Changes have also been made to day counting, that is, days of arrival and departure will be counted in determining whether an individual is resident in the UK in any tax year.

HMRC also intends to remove perceived flaws and anomalies in the remittance basis which allowed non-domiciled individuals to avoid UK tax on foreign income and gains in circumstances where the Government now intends that tax should be payable.

Standardised treatment of equity awards for resident but not ordinarily resident employees

As part of the change to the residence and domicile rules announced in the UK 2008/2009 budget, individuals who are resident but not ordinarily resident will be taxed on restricted stock and stock option income in the same way as employees who are resident and ordinarily resident.

Prior to 6 April 2008, the charging provisions in Chapter 2 to 5 of Part 7 of ITEPA 2003 ("Part 7") did not apply to employees or office holders who were not ordinarily resident in the UK at the time the shares were awarded or options granted. However, other chapters of Part 7 (Chapters 3A to 3D) did apply to all employees resident in the UK, whether or not also ordinarily resident.

In this context, the most significant of these chapters was Chapter 3C (notional loans), under which securities acquired for less than market value were treated as creating a notional loan, and the employee was taxed on the benefit of the notional loan. It was Chapter 3C (notional loans) that HMRC applied when options were exercised by employees not ordinarily resident. This chapter will, however, continue to apply when options granted to those employees before 6 April 2008 are exercised after that date.

In contrast, Chapter 3C (notional loans) does not usually apply to option shares if a Chapter 5 (tax on option exercise) charge arises on the option exercise. Further, if there is a Chapter 5 charge, the amount charged to tax on exercise is credited in calculating any Chapter 3C liability, and is likely to be enough to wipe out any such liability.

As a result, Chapter 3C will generally no longer apply to option shares acquired by option holders who were not ordinarily resident at the time the option was granted (after 5 April 2008).

Consequently, the effect of the changes is to apply all charging provisions under Part 7 to employees who are resident but not ordinarily resident in the UK at the time the shares or securities options are acquired. The amendments apply only to securities or securities options which are acquired after 6 April 2008. This also means that resident but not ordinary resident employees will be able to make "s431" elections. This will afford a greater opportunity for tax planning.

Additionally, an apportionment mechanism is to be introduced for employees or officer holders who are taxed on the remittance basis.

Where gains on employment-related securities are partly derived from employment duties in the UK, and partly from duties outside the UK, they will be apportioned appropriately, with gains related to duties outside the UK being subject to UK Income Tax to the extent that they are remitted. A similar apportionment will be available to individuals who are not domiciled in the UK where the employment-related securities income relates to a foreign employment where the duties are performed wholly outside the UK.

This document is prepared for the general information of our clients and other interested persons. It is not, and does not attempt to be, comprehensive in nature. Due to the general nature of its content, it should not be regarded as legal advice.

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