The New French Restricted Share Mechanism and German Considerations for Successful Plan Implementation

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Presentation

1. The New French Restricted Share Mechanism
2. German Considerations for Successful Plan Implementation

The New French Restricted Share Mechanism

1. Background
2. Description of the scheme
3. Tax and social security treatment
4. Comparison with other equity mechanisms
5. Implementation

Background

Until January 1, 2005 only stock-options (which have been existing in France since 1970) were eligible for a favourable tax and social security regime.

Over the years, this has led French companies to allocate a very large portion of executives' total compensation into options.

The recent lack of performance of financial markets has put pressure on French companies in terms of level of compensation for their senior executives in the international quest for talent.

The new international accounting standard IFRS 2 requesting the expenses of the fair value of equity vehicles has decreased the financial rationale behind the use of options.

Background

In addition, the taxation of the stock-options has been increased in the last few years reducing the gap with the taxation of ordinary compensation.

Overall, in an environment where corporate governance is getting stronger, French multinationals have requested over the last three years a new legal and tax regime applicable to a grant of free shares.

Description of the scheme

Principle

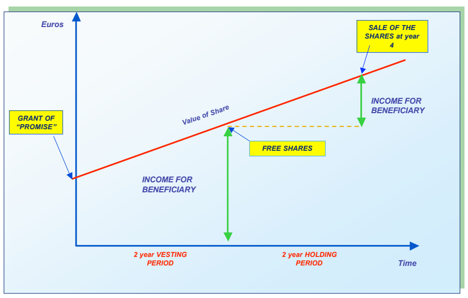
The French 2005 Finance Act has introduced into the French legal system a new mechanism of free share plans which entitles both listed and unlisted companies to grant, in favour of all or some of their employees and executives, free shares under a favourable tax and social security treatment

Description of the scheme

Main Characteristics

In practice, these shares are granted to their beneficiaries under certain conditions that, if fulfilled at the end of a minimum mandatory two years period called the *« période d'acquisition »* (vesting period) will allow the beneficiaries to become owners of the shares. These shares will then have to be held for another mandatory minimum two-year period called *« période de conservation »* (share retention period). Thus, the mechanism is over a 4 year period.

Description of the scheme



Description of the scheme

Legal Process

Under French law, the implementation of free share plans is subject to the prior authorization of the Extraordinary General Shareholders' Meeting which shall set:

- The maximum percentage of the share capital to be granted
- The minimum duration of the vesting period (2 years minimum)
- The minimum duration of the share retention period (2 years minimum)
- The period within which the board of directors may grant free shares, it being specified that such period cannot exceed thirty-eight months

In the framework of the Extraordinary General Shareholders' authorization, the board of directors shall determine the list of the beneficiaries and shall lay down the conditions upon which free shares may be granted

Description of the scheme

Application to a foreign issuer

As voted, this regime had not been expressly applicable to shares granted by foreign companies.

However, the Tax Instruction no. 5F-14-05, dated May 24, 2005, has now clarified the scope of this mechanism, acknowledging that the favourable tax and social security treatment also applies to grants made by companies whose registered office is located abroad to employees and corporate officers who perform their activity in France, **provided that this grant is made on the same conditions as those provided for by Articles L 225-197-1 to L 225-197-5 of the French Commercial Code, particularly with respect to the two above-mentioned time periods, each of which must be a minimum of two years.**

Description of the scheme

Application to a foreign issuer

The instruction further states that, if these conditions are met, the favourable tax and social security regime applies **for all grants made as from January 1, 2005, including those made pursuant to an authorization given by an Extraordinary Shareholders' Meeting prior to said date.**

Still, regarding the application of the favourable social security treatment to foreign companies, it would be useful if ACOSS (the Central French Social Security Administration) would confirm the position thus adopted by the Tax Authorities, so as to preclude any risk of a challenge by URSSAF (French Social Security Collection Agency).

Description of the scheme

Application to a foreign issuer

As with stock options, this extension of the favourable tax and social security regime for free shares enables foreign companies, as of now, to begin examining the possibility of setting up subplans for French beneficiaries.

Description of the scheme

Funding of the shares

The shares which will be granted in year 2 can either be :

Newly issued shares (capital increase)

Treasury shares (shares repurchased by issuing company prior to the date of vesting)

The corporate tax implications of the choice of funding of the shares should also be taken into account.

Tax and social security treatment

Tax treatment

This new mechanism benefits from a favourable tax and social security treatment

The capital gain will be taxed when the shares are sold according to the following rules:

- The acquisition gain corresponding to the value of the shares at the end of the vesting period *(plus-value d'acquisition)* is taxed at a rate of 41% (30%+11% of CSG, CRDS and social surtax)
- The capital gain on sale *(plus-value de cession)* corresponding to the difference between the share sale price and the share value at the end of the vesting period is taxed at the rate of 27% (16%+11% of CSG, CRDS and surtax)

Tax and social security treatment

Social security tax treatment

Free share grants are exempted from social security contributions insofar as conditions set by the board of directors are fulfilled

=> There will be no social security tax for the employee and the employer

Comparison with current mechanisms

Typical Equity Plans

The most usual vehicles are the following ones:
Restricted shares
Restricted Units
Cash Units
Stock Appreciation Rights (SARs)
Performance Shares
Stock-Options

With the exception of the stock-options, all equity mechanisms are deemed employee compensation subject to full French social security taxes (except for employees covered by a foreign social security regime) and ordinary progressive income taxes.

Comparison with current mechanisms

Typical Equity Plans

Therefore, all current plans (with the exception of qualified options please see after) are deemed employee compensation subject to taxation at the time the vehicle is deemed at disposition.

Tax rates in France:
The current marginal tax rate is 48.09%.
The social security rates decrease as the earnings increase and range from 23% to 8.5% for the employee to 45% to 26.5% for the employer.

Comparison with current mechanisms

The following table illustrates the point of taxation and the applicable tax treatment

Equity Vehicle	Point of taxation	Social tax Employee	Social tax Employer	Income taxes
Restricted Shares	Potentially at grant	Up to 23%	Up to 45%	Marginal rate
Restricted Units	Vesting	Up to 23%	Up to 45%	Marginal rate
Cash Units	Date of payment (vesting)	Up to 23%	Up to 45%	Marginal rate
SARs	Exercise	Up to 23%	Up to 45%	Marginal rate
Performance Shares	Vesting	Up to 23%	Up to 45%	Marginal rate
Stock-Options	Sale for qualified options – if not exercise	None if holding period respected	None if holding period respected	41%-51% or 27%-41%
Qualified Conditional Free shares	Sale	None if conditions respected	None if conditions respected	41%

Implementation

Plans eligible

Since under the French mechanism, the actual grant of the share occurs after a vesting period of 2 years, only equity vehicles which provide for a promise of a grant of shares in the future (vs. an immediate grant of shares with restrictions) could become eligible for the new qualified regime.

Therefore, only RSU and Performance Shares could qualify

Qualification of the plans

In order to qualify the RSUs and the Performance Shares, a subplan for France should be implemented which ensures that all legal conditions required under the new mechanism are respected AND especially that a 2 year holding period following the actual grant of the shares is implemented

The plans as currently drafted most likely do not qualify

Implementation

Process for qualification

As an initial step, it would be necessary to verify the shareholder authorization given to the board of directors in relation to grant of Performance shares and Restricted stock units, in order to ensure that the board would have authority to make the necessary modification to the plans by adding a subplan for France.

If board is authorized to do so, in the absence of the tax instructions at the moment, we would need to verify with the tax administration if an authorization given prior to January 1, 2005 is sufficient.

Provided the above two steps are fulfilled, a subplan would need to be drafted in order to "qualify" the plans. This subplan would then need to be approved by the board of directors.

Implementation

BENEFITS FOR EMPLOYER

The RSUs and the Performance shares would not be any longer subject to social security taxes which would reduce the employment costs of the employees in France

BENEFITS FOR EMPLOYEES

The tax treatment of the RSUs / Performance Shares would be optimized. However, the minimum time frame between the grant of the award and the gain for the employee would be 4 years.

German Considerations for Successful Plan Implementation

1. Introduction to German Treatment of Equity Plans
2. German Participants in Non-German Plans
3. German Plans and International Implementation

Introduction to German Treatment of Equity Plans

Taxation

- Taxation occurs at the time the employee receives a benefit from his employer or a group company
- German tax law is similar to the constructive receipt doctrine in the US
- Economic ownership principle
  - entitlement to dividend and voting rights
- Payroll withholding – also for benefits provided by a third party
- Benefits are subject to social security (cap)

Introduction to German Treatment of Equity Plans

Taxation

	Taxation at			
	grant*	vesting*	exercise*	payment
Stock Options			P	
SAR			P	P
Restricted Stock	P			
RSU		P		P
Phantom Stock				P

*assuming that this is the point in time the participant has legal and / or economic ownership

Introduction to German Treatment of Equity Plans

Favourable tax rules

Section 19a para 1

- Tax-free benefit equal to 50% of the market value of the shares, subject to an overall maximum of EUR 135 p.a.
- Any excess benefit is subject to tax

Section 19a para 2

- Special valuation rule
- The taxable benefit is calculated based on the lowest share price quoted on a German, EU or EEA stock exchange at the time of taxable event
- If less than 9 months passed between the resolution to grant options / shares and the taxable event, the lowest share price quoted on the German or EU/EEA stock exchange on the day the resolution is passed is used

Introduction to German Treatment of Equity Plans

Favourable tax rules

Section 34

- Mitigation of progressive tax rates for income earned over several years like income from stock options
- Currently under discussion whether annual or regular grants exclude application of section 34

Note

⇨No approval is necessary for any of the tax favourable rules

Summary

⇨Very limited benefits

Introduction to German Treatment of Equity Plans

Valuation

Section 19a para 2

For companies not listed in EU /EEA

- Usually average share price quoted on the relevant stock exchange

Non-listed companies

- Valuation is complex
- Uncertain whether foreign valuation is accepted by German tax authorities
- Transaction with a third party within the last 12 months - this value is assumed to equal fair market value
- Otherwise valuation with generally accepted valuation methods

Introduction to German Treatment of Equity Plans

Capital Gains

Long term capital gains

- Holding period up to one year and interest in company below 1%

⇨Tax free

Short term capital gains or interest of 1% or more

- Holding period up to one year or interest in company equal to or exceeding 1%

⇨Only 50% of gain is taxed

Capital Gain

- Benefit in kind taxed at the time shares are acquired is part of the acquisition costs

Introduction to German Treatment of Equity Plans

Requirements under Corporate Law

- German corporate law is very restrictive
- Restrictions on:
  - Issue of new shares from conditional capital
  - Repurchase of shares
- Authorised capital legally complex for employee option plans
- De-minimus-limit for price payable by employees:
  - Difficult or impossible to implement restricted share or nil price option plans

German Participants in Non-German Plans

Considerations for Trusts

- Taxable receipt of shares in Germany if the employee is at least economic owner
  - Economic ownership – entitlement to dividend and voting rights
  - Shares held in trust or shares subject to selling restrictions usually lead to economic ownership by the employee

⇨ Attention: beneficial ownership pursuant to UK trust law is not necessarily the same as economic ownership pursuant to German income tax principles – can be beneficial or detrimental

- Section 19a para 1 (tax free amount of max. €135) may not apply in case a trust is involved due to lack of legal ownership (uncertainty)

German Participants in Non-German Plans

US ESPP (section 423(b) IRC)

- ESPP regarded as option plan in Germany
- Saving contributions in Germany out of net salary (like US ESPP)
- Taxable event is acquisition of shares after each 6-month purchase period
- Taxable benefit-in-kind equals spread at exercise / acquisition
  - 15% discount to the market value at grant is part of spread
  - German tax free amount of € 135 p.a. generally available
  - Section 34 relief not applicable
- Holding requirements in respect of shares imposed by section 423, have no impact on the point of taxation or for the valuation in Germany.
- Meeting holding requirements under German law (more than 1 year) might lead to a tax free capital gain

German Participants in Non-German Plans

UK SAYE

- Option plan
- Saving contributions in Germany out of net salary (like UK SAYE)
- Taxable event is exercise of the option
- Taxable benefit-in-kind equals spread at exercise
  - 20% discount to the market value at grant is part of the spread
  - German tax free amount of € 135 p.a. (attention if trust used)
  - Section 34 relief
- Bonus / interest from savings account is taxable in Germany pro rata
- Use of a German bank possible

German Participants in Non-German Plans

US ISO & UK CSOP or EMI

- Option plans
- Taxable event is exercise of options and acquisition of shares
- Taxable benefit-in-kind equals spread at exercise
  - German tax free amount of € 135 p.a. (attention if trust used)
  - Section 34 relief
- Holding requirements in respect of the shares imposed by local foreign law, e.g. in case of ISO, have no impact on the point of taxation or for the valuation in Germany
- Meeting holding requirements under German law for the shares (more than 1 year) might lead to a tax free capital gain

German Participants in Non-German Plans

UK SIP

- Partnership Shares can only be acquired from net salary
- Receipt of Matching Shares, Free Shares or Dividend Shares is a taxable benefit-in-kind equal to market value of shares
  - Taxation up front even if shares are held in trust and selling restrictions apply
  - German tax free amount of € 135 p.a. (attention as trust used)
  - Section 34 relief not available
- Selling restrictions / holding requirements in respect of the shares imposed by UK law have no impact on the point of taxation or for the valuation in Germany
- Meeting holding requirements under German law for the shares (more than 1 year) might lead to a tax free capital gain

German Participants in Non-German Plans

(US) Restricted Shares

- Employee is legal or at least economic owner of shares after award (voting and dividend rights)
- Award of shares is taxable in Germany
  - Taxation up front even if shares are held in trust and selling restrictions apply
  - German tax free amount of € 135 p.a. (attention if trust used)
  - Section 34 relief not available
- Selling restrictions / holding requirements in respect of the shares imposed by US law have no impact on the point of taxation or for the valuation in Germany
- Meeting holding requirements under German law for the shares (more than 1 year) might lead to a tax free capital gain

German Participants in Non-German Plans

UK share plans of non-listed companies

The following issues may arise:

- Complex valuation
- Taxable event uncertain
- Economic ownership
- Use of special classes of shares increases uncertainty regarding valuation and economic ownership

German Participants in Non-German Plans

Summary

- Different tax treatments
- Different benefits
- Different taxable events
- German participants have less knowledge of share or option plans

⇨ **Country specific analysis and good communication are key!**

German Plans and International Implementation

German broad based share plans

- Usually share purchase plans with a discount or free shares
- German design offers only small benefits

German stock option plans

- Performance hurdles required under German corporate law
  - In the past premium priced options for US GAAP purposes
- Minimum exercise price required under German corporate law
- Corporate Governance considerations
- American Job Creation Act 2004

International Aspects

- To achieve beneficial tax or social security treatment and increase take-up rates
  - ⇨ Implementation of local sub-plan

German Plans and International Implementation

Trends

- Continued use of option and broad based share plans
- Equity settled RSUs under discussion:
  - De-minimus-limit for price payable by employees to be considered
- More challenging and complex performance hurdles after new accounting rules (IFRS and US GAAP) – not only premium priced options
- Transfer pricing rules emphasize need to implement recharge structures
- Expatriates and options – more awareness for risk of not complying with local law and complexity of tax treatment

Questions?

Thank you for your participation