


**Do's and Don'ts of
Implementing a Global
Recharge Program**

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The Estée Lauder Companies Inc.




What We Will Cover

- **Top Ten Do's**
- **Top Ten Don'ts**
- **Case Study Examples Throughout**
- **Newsworthy Countries**



1. Do Form a Team

- **Include HR, Tax, Legal, Accounting, and Finance**
- **Appoint a project manager at the company level to liaise between the company and consultant**



2. Do Perform Cost: Benefit Analysis

- Evidence of cost savings to the company
- Supports the time and cost involved
- Provides evidence of countries with most benefit
- Repatriation of cash from subsidiary to parent
 - Deemed dividend/withholding tax by foreign country issue
 - Payment in the nature of equity/tax-free in the parent country
- Net cash flow benefits result from reduced taxes in foreign jurisdictions



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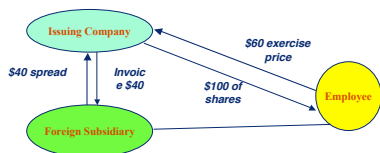
- Standard Recharge Arrangement: the basis for taking the income tax deduction
 - How does the deduction work?
 - General rule: with a properly executed chargeback agreement, the share plan costs can be deducted overseas
 - Most countries require the local employing company to ultimately bear the costs of the share plan evidenced by supporting documentation
 - Notable exceptions: United States, United Kingdom



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Standard Recharge Arrangement



Fair market value at exercise = \$100 Exercise Price = \$60 Spread = \$40
Income tax deduction = \$40



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Potential Corporate Tax Savings and Cash Repatriation

| Country | Price Per Share (a) | Exercise Price (b) | Options Outstanding | Spread Value | Corporate Tax Rate | Potential Corporate Tax Savings | Potential Cash Repatriation |
|----------------|---------------------|--------------------|---------------------|---------------------|--------------------|---------------------------------|-----------------------------|
| Canada | \$ 30.00 | \$ 13.00 | 200 | \$ 3,400 | 39% | \$ - (d) | \$ 3,400 |
| China | \$ 30.00 | \$ 13.00 | 4,500 | 76,500 | 33% | 25,245 | - (e) |
| France (c) | \$ 30.00 | \$ 13.00 | 14,500 | 246,500 | 33% | 81,345 | 246,500 |
| Germany | \$ 30.00 | \$ 12.00 | 149,000 | 2,882,000 | 39% | 1,045,980 | 2,682,000 |
| Hong Kong | \$ 30.00 | \$ 11.00 | 1,300 | 24,700 | 18% | 4,323 | 24,700 |
| Italy | \$ 30.00 | \$ 12.00 | 5,200 | 93,600 | 38% | 35,568 | 93,600 |
| Japan | \$ 30.00 | \$ 12.00 | 54,700 | 984,600 | 41% | 403,686 | 984,600 |
| Sweden | \$ 30.00 | \$ 11.00 | 13,000 | 247,000 | 28% | 69,160 | 247,000 |
| United Kingdom | \$ 30.00 | \$ 12.00 | 8,300 | 149,400 | 30% | 44,820 | 149,400 |
| | | | 250,700 | \$ 4,957,700 | | \$ 1,710,127 | \$ 4,431,200 |

Notes:

- (a) Current stock price
- (b) Computed as the weighted average of all in-the-money options
- (c) Some countries require the use of treasury shares in order to obtain a deduction
- (d) Canadian law does not permit income tax deduction for delivery of shares
- (e) China's foreign exchange controls may preclude the repatriation of funds



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3. Do Consider Accounting Pronouncements

- FASB and IASB requirement to expense stock options and other equity instruments for financial statement purposes
- FAS 109 prescribes the financial statement treatment for the income tax expense
- By taking the foreign income tax deduction, financial statement charges may be reduced
- IRFS/IAS

3. Do Consider Accounting Pronouncements

- How does the US accounting work?
 - At the time of grant, the tax benefit is estimated based on fair value of the equity award at the time of grant
 - At the same time, a Deferred Tax Asset is established equal to the tax benefit (of reduced income taxes overseas)
 - The Deferred Tax Asset reduces the expense for income taxes on the company's income statement

3. Do Consider Accounting Pronouncements

Example:

Fair Value using option pricing model = \$100,000

Foreign Tax Rate = 35%

Deferred Tax Asset = \$35,000

FAS 123R expense \$100,000

Deferred Tax Asset 35,000

Net expense \$65,000



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4. Do Practice Good Corporate Governance

•Required documentation vs. recommended

- Recharge agreement
- Intercompany invoice
- Board of directors' meetings and minutes
- Intercompany acknowledgement letters



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5. Do Review the Legal Basis

•Conduct a detailed feasibility study

•Will the foreign country withhold tax on reimbursement?

- If not otherwise deductible: Germany
- As a matter of course: Korea

•Will foreign exchange requirements present a challenge?

- China

•Can outstanding awards be deducted?

- Risk for deducting prior awards: Germany




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5. Do Review Legal Basis

•Which costs can be deducted?


- Spread
- Start-up costs
- Ongoing administration costs
- Employer's social tax



5. Do Review Legal Basis

•Legal basis for income tax deduction


- Recharge for reimbursement of costs
 - The norm
- Contractual/Fee
 - Italy
- Agency agreement
 - Australia – role of parent company in awarding the benefit
- Statutory
 - United Kingdom – for shares provided in accounting periods beginning after 2002
- Common law employment relationship
 - United States



6. Do Include All Equity Programs

•More efficient

- No need to go back to conduct feasibility study
- No need to re-draft documents required to support the recharge

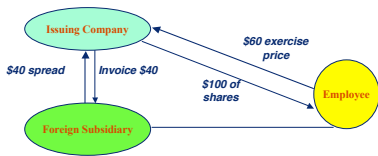


7. Do Consider Alternatives

- Consider that repatriating cash may be beneficial even where full deduction unavailable
 - Canada
- Consider alternative structures
 - China

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Standard Recharge Arrangement

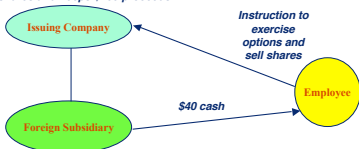


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7. Do Consider Alternatives

Local Payment Arrangement

Sells shares and keeps \$100 proceeds



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Income tax deduction = \$40

8. Do Review Transfer Pricing

- Transfer pricing: concerns the reallocation of income and deductions among related taxpayers
- U.S. IRS authority to compel reallocation based on arm's length standard to determine the true value as if parties were unrelated
- Arm's length standard entrenched in US negotiated tax treaties and OECD treaties
- U.S. Treasury Regulations regarding intangibles ignored previous standards for cost sharing
- Xilinx – U.S. case on cost sharing
- Review your company's transfer pricing and cost sharing agreements for any impact on recharge



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9. Do Plan to Account for Expatriates

- Consider local rules regarding deductions for expatriates
 - Singapore
- If no guidance, reasonable approach may be necessary
 - Track expatriate foreign income and match with a foreign deduction



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10. Make the Reimbursement a Condition of Participation

- Methods:
 - Approval of invoice by subsidiary or
 - Intercompany agreement to bear costs
 - 100% ownership of subsidiary is not a "slam dunk"
- Cash rich vs. cash poor subsidiary



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1. Don't Mandate Without Enlightenment


- **Achieve buy-in with early communications with subsidiary country manager, finance, and accounting**
 - Explanation of program and benefits to the company as a whole
- **Pre-implementation meetings**
 - Assignment of responsibilities
 - Tracking expatriates
 - Tracking shares where required, e.g. France
 - Acceptance and payment of invoice
- **There will be increased administrative burden at corporate HQ and subsidiary level**



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2. Don't Implement Without Considering Exposure


- **Existing payroll practices**
 - Don't assume that equity income is being reported through payroll as required
- **Exposure to government payroll audit**
- **Expands to audit for other areas**
 - Corporate income taxes
 - Regulatory: securities, data privacy, labor



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3. Don't Forget Social & Payroll Tax Implications

- **Employer social tax liability**
 - Argentina
- **Income and social tax liability**
 - Chile
- **Payroll withholding responsibility**
 - Mexico
- **May need to institute new payroll procedures at foreign subsidiary level**



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4. Don't Forget NOLs

- Foreign subsidiaries with Net Operating Losses or marginal profit
- May be no benefit to recharge
 - Consider whether NOL may be carried forward and if it is expected to reverse soon



5. Don't Forget Cash Flow

- Don't force the reimbursement when the subsidiary lacks cash flow
 - Consider the impact of subsidiary performance on grant leveling practice



6. Don't Assume One Recharge Agreement Fits All

- Some countries will need to be tailored
 - Australia
 - France
 - United Kingdom
- Additional documents required
 - Germany
 - Spain
 - Italy
 - Ireland
 - France



7. Don't Fund With Wrong Type of Shares

- **Newly issued shares**
 - Newly authorized and unissued until provided to participant at exercise
 - Basis for denial of deduction by some countries: no economic cost to issuer
- **Shares purchased on the market**
 - "Treasury shares" if held in treasury (typical US style)
 - Deduction allowed by most countries



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8. Don't Ignore French Requirements

- **Must use treasury shares**
- **Recharge must be calculated differently**
 - Calculation example:
 - January 2005 issuer/parent company grants "at the money" options at \$30/share
 - January 2007 issuer/parent company buys shares on the market at \$45/share
 - January 2008 options first become exercisable and employee exercises when the price is \$55/share
 - French subsidiary gets income tax deduction of \$15/share for capital loss (\$30 - \$45)
 - Parent company invoices subsidiary for \$15/share



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8. Don't Ignore French Requirements


- **Shares must be tracked**
 - Procedure:
 - Each share's cost,
 - Acquisition date, and
 - Specifically linked to an exercise



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9. Don't Double Dip

- **The income tax deduction cannot be taken by the issuing company for non-employees**
 - U.S. common law employment rule governs
 - Other countries may not allow on statutory basis
- **Reduce exposure on income tax return as many companies are inadvertently deducting compensation costs of non-employees**
- **Bottom line: if not deducting at foreign subsidiary level, the deduction is lost**



10. Don't Assume the U.K. is a "No Brainer"

- **U.K. now has relaxed requirements**
 - Statutory deduction applies only to shares
 - No formal reimburse agreement
 - Still need documents to support the expense
 - General trading principles apply to other costs
 - Still need reimbursement agreement
- **Uncertainty surrounding interaction between statutory deduction and transfer pricing rules**
 - Clarification from HMRC expected



Some Other Newsworthy Countries

- **Ireland**
 - Finance Bill 2005
- **Brazil**
 - Exchange Controls
- **Canada**
 - Will cash-based plans become more popular?



Questions?

Thank you for your participation

