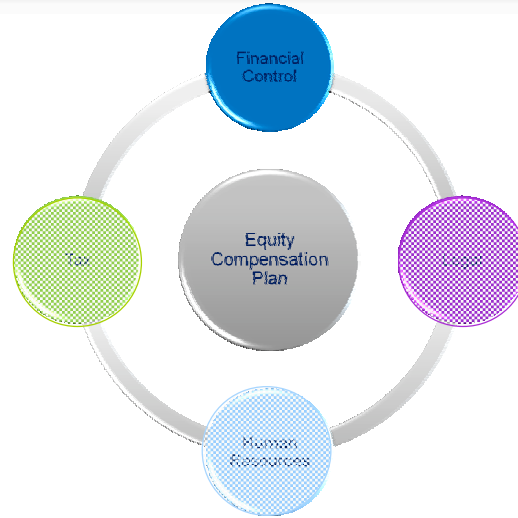


# Equity Compensation Plan Overview

GEO Hong Kong Chapter Meeting

March 17, 2008





## Financial Control

Presented by:

**Adie Leung**

**Citi**

**Regional Head of Equity Compensation &  
International Tax**

## Financial Control - Company's Financial Valuation

- Financial statements impact
  - How much can the Company afford to spend on Equity Comp awards?
  - Dividends payout
- Shareholders and Board of Directors' expectations and comments
- Stock price performance



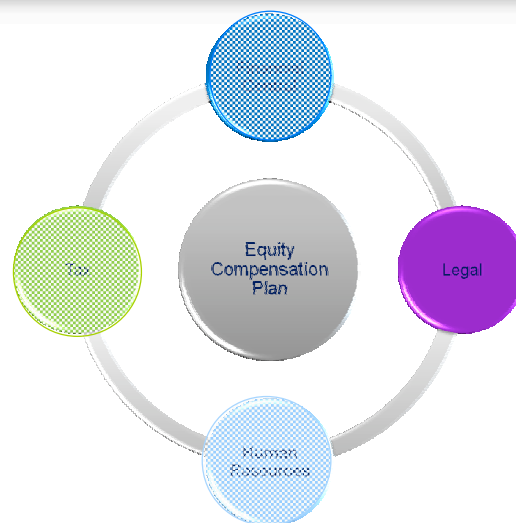
## Financial Control - Other considerations

- Accounting policy
  - Award
  - Vesting
  - Stock movement
  - Forfeitures
  - Charge back
  - Amortization
- Financial statements expense treatment



## Financial Control - Other considerations

- GAAP compliance
  - Head office country (US/UK)
  - Local country
  - IAS
- Award valuation
- Funding of stocks
- Type of award
- Financial Statement disclosure
  - IFRS requirement



## Employee share plans & the law


A brief overview of legal issues  
affecting share plans in Hong Kong

Rowan McKenzie  
Head of Employment and  
Employee Incentives – Asia  
Linklaters Hong Kong

17 March 2008



## Introduction

- Employee share plans are lightly regulated in Hong Kong
  - Less shareholder scrutiny than in other markets
  - Scope for creativity but:
    - quite strict rules for HK-listed companies
    - securities laws
    - tax considerations
- 

## What should your plan look like?

- Options
- Restricted Shares
- Other



## What should your plan look like?

- Options are traditional in Hong Kong
- But are they right for you?
  - a lot of shares to deliver relatively little benefit
  - benefit based on snapshot of share price so:
    - inefficient link to sustained performance
    - encourages timing of exercise
  - can demoralise in a bear market
  - larger accounting charge



## What should your plan look like?

- Free share plans deliver:
  - more benefit for fewer shares
  - better targeted incentivisation through performance conditions
  - some benefit whatever the share price does
- Options no longer standard in US and UK markets



## What should your plan look like?

- Should you extend to all employees or just senior executives?
- Should vesting be subject to performance conditions?
  - Earnings per share
  - Total shareholder return
- What should happen for leavers?
  - Vesting on leaving?
  - Continuation of options/awards?



## What should your plan look like?

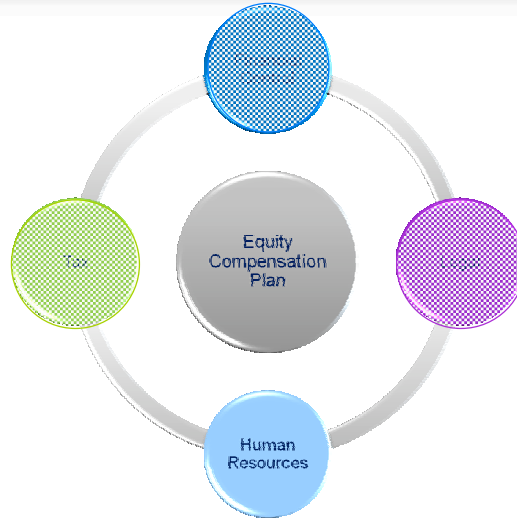
- What should happen on a takeover?
  - Full vesting is traditional but does it make sense?
  - Consider partial vesting (on performance and/or time pro-rating)
  - Consider exchange of options for options over buyer shares



## Regulation in Hong Kong

- Securities laws
- Listing Rules
- Other





## Human Resources

Presented by:

**Adie Leung**

**Citi**

**Regional Head of Equity Compensation &  
International Tax**



## Human Resources

- Compensation Philosophy & Structure
- Market Practice
- Administration Resources
- Due Diligence Review



## Compensation Philosophy & Structure

- Total compensation concept
- Encourage employees to think and act like owners
- To align employees' long term financial interest with Company's shareholders
- For retention
- For performance award



## Compensation Philosophy & Structure

- Sense of Ownership (grow with the Company)
- Incentive; Motivation
- Bonus structure (expense budgeting)
- Average work life expectancy



## Market Practice

- Industry/Competitors
- Types of awards offered
  - Stock awards
  - Phantom stocks
  - Stock Appreciation Rights
  - Stock Options
  - Stock Purchase Plan



## Market Practice

- How are they offered?
  - By seniority or compensation level
  - All employees
  - Countries
- One plan firm wide or multiple awards
  - % of incentive compensation
  - Defined threshold of compensation
  - Management nomination
  - With or without discount
  - Company performance
  - Sales performance



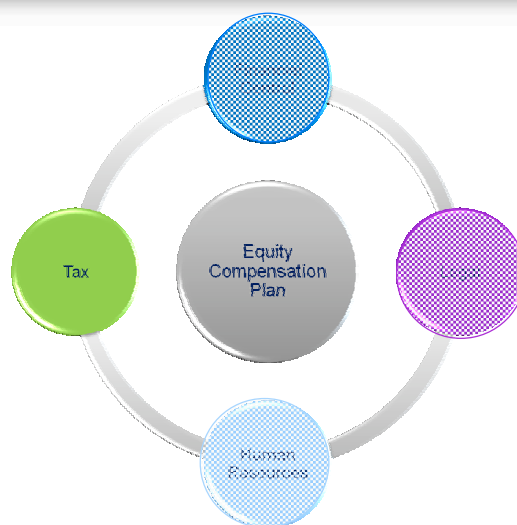
## Administration Resources

- In-house management or outsourcing
  - Award
  - Vesting
  - Exercising
  - Tracking of stock
  - Funding & Cash management
  - Income reporting / tax return filing
- Infra-structure support
  - Compensation
  - payroll



## Administration Resources

- Head-office centralized or decentralized processing to countries/subsidiaries
- IT and data base system sufficiency
  - Staff movements
  - Terminations
    - Accounting treatment
    - Forfeitures
    - Income reporting
- Supporting skill set
- Brokerage platform
- Communication



## Taxation of Equity Income

Presented by:

**Theresa Chan, PwC - Partner**

**Jenny Tsao, PwC - Director**



## Taxation - Equity Income

- Timing of taxation
  - At grant
  - At vest
  - At exercise
  - At disposal

## Taxation - Equity Income

- Tax withholding compliance
  - Tax withholding country
  - Expatriate vs. local
  - Mobile employee
- Correct withholding rate applied
- Social security tax
- Remittance and settlement



## Taxation – Equity Income

### Income reporting:

- Computation of income
  - Grant price
  - Vesting income (FMV on vesting day)
  - Exercise spread gain (FMV on exercise day – exercise price)
  - Disposal gain (capital gain)



## Taxation – Equity Income

Income reporting:

- Impact from corporate tax charge back policy
  - Corporate tax benefits may trigger personal tax
  
- Proper income reporting
  - Timing
  - Form
  - Exit employees



## Taxation – Equity Income

- Mobile employee:
  - Tracking of movement
  - Income sourcing
  - Corporate tax chargeback
  - Filing obligation – possible double taxation



## Taxation – Hong Kong

### Share options

- Guidelines in DIPN 38
- Timing of taxation: “exercise, assignment or release”
- Amount of taxable income: FMV – consideration paid (exercise price usually)
- Sourcing of taxable income: depends on the vesting period
- Deemed exercise election upon departure (“all or none” election)
- “Lock-up” on shares after exercise: 5% discount per year of lock-up



## Taxation – Hong Kong

### Restricted share awards

- Tangible shares awarded to employees upfront
- Employees are “real” shareholders and entitled to respective rights
- Restrictions to sell during “lock-up” period
- IRD’s view: taxed upfront (discount may be available)
- Subsequent dividend distributions / lapse of “lock-up” period: non-taxable



## Taxation – Hong Kong

### Conditional share awards

- Intangible “phantom” share units awarded to employees upfront
- Employees do not have the rights as shareholders during vesting period
- Tangible shares delivered upon lapse of vesting period
- IRD’s view: taxed at vesting
- Dividend equivalent during vesting period: taxable
- Sourcing rules? (vesting period / year of distribution)



## Taxation – Hong Kong

### “Hybrid” cases

- Restricted share awards with forfeiture provisions – taxed at grant or vesting?
- Conditional share awards “vested” to the employees but shares delivered later – timing of taxation?



## **Section 16(1) of the Inland Revenue Ordinance (“IRO”)**

General deduction is allowed for all outgoings and expenses incurred in the production of assessable profits in the relevant year of assessment.



## **“Incurred” Test**

“Outgoings” refers to sums actually paid out. An expense is “incurred” when it is paid out or when a liability to pay arises.



## **Accounting v Tax treatment**

In view of the decision in a tax case, Commissioner of Inland Revenue v Secan Ltd. & Ranon Ltd. [5 HKTC 266], the Inland Revenue Department (“IRD”) is likely to follow the accounting treatment of the expenses for tax purposes. Provided such treatment is in accordance with ordinary principles of commercial accounting and is not inconsistent with any provision in the IRO.



## **Frequently Asked Questions (“FAQ”) published by the IRD**

- Equity-settled Share-based Payments accounted for under HKFRS 2
- Cash-settled Share-based Payments accounted for under HKFRS 2



## **FAQ for Equity-settled Share-based Payments**

1. Initial recognition of expenses in relation to the shares/options granted is not deductible as it is merely an accounting entry and not an “outgoing or expense incurred” for the purpose of Section 16 of the IRO



## **FAQ for Equity-settled Share-based Payments (cont'd)**

2. Any subsequent adjustments are neither deductible nor taxable based on the same principle in (1) above.
3. Prior period adjustments are not allowable for deduction.
4. Other expenses associated with the grant or issue of equity instruments to employees should be deductible if the normal rules in Section 16 of the IRO are satisfied.



## **FAQ for Cash-settled Share-based Payments**

1. A contingent liability recognized under a cash-settled share-based payment transaction is not deductible until the recipient becomes unconditionally entitled to the payment (e.g. when the shares/options granted become fully vested).



## **FAQ for Cash-settled Share-based Payments (cont'd)**

2. Prior period adjustments with respect to liabilities arising from the adoption of HKFRS 2 are deductible in the year of first adoption provided that the recipient's rights have become fully vested.



**FAQ for a recharge from the parent company for stock options or share awards granted by the parent company**

- The entity concerned will debit the P&L Account and credit the “equity-reserve” account. Upon recharging, the entity will debit the “equity-reserve” account and credit the “payable to parent” account.



**FAQ for a recharge from the parent company for stock options or share awards granted by the parent company (cont'd)**

- A recharge is deductible when the entity has become unconditionally liable to pay the recharge which is considered as an expense incurred for the purpose of Section 16(1) of IRO.



**FAQ for a recharge from the parent company  
for stock options or share awards granted by  
the parent company (cont'd)**

- Any provision for recharge claimed by the entity for deduction in the basis period in which the parent company has not issued the shares should be disallowed.



**Q & A**



## QUESTIONS?

**Thank you  
for your interest in GEO**

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