global equity ORGANIZATION

Recharge, Get Set, Save!

(Everything you Always Wanted to Know About Charging Affiliates for Option Cost, but Were Afraid to Ask)

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Agenda

- What do we mean by cross-charging/ reimbursement?
- Why consider Cross-charging?
- Where are local tax deductions available?
- What is required to obtain deduction?
- Employer/Employee tax consequences
- Labor issues
- Other legal issues
- Conclusion – Matters to Consider

What Do We Mean by Cross-charging?

- When an option/equity grant is made, issuing company has tax or book expense at some point.
- Cross-charging or recharging is charging that cost to the affiliate of the issuer that employs the award recipient.

Why Are Companies Considering Cross-charging of Option/Equity Expense?

Three worlds to consider:

1. Tax return world
2. Financial statement world
3. Arm's length intercompany pricing world

Good old days -

Under APB25 and International Accounting Standards - No book expense for most options / ESPPs.

Although tax deduction allowed in many cases, this did <u>not</u> affect book profits (tax benefit booked to equity).

Under arm's length intercompany pricing, option expense was generally backed out or ignored (<u>Seagate</u>, <u>Xilinx</u> cases).

Today -

- FAS123R and IFRS2 require book expense for options/ ESPPs (FAS123R safe harbor for 5%, no lookback ESPP).
- FAS107 requires allocation of expense for book purposes.
- FAS109 requires that expense be tax-effected.
- OECD Study, U.S. Cost Sharing Regulations, Waterloo Case (UK) all require “cost” of options to be considered in intercompany pricing analysis.

One Additional Key Factor

- Under U.S. Tax Code (Section 1032) reimbursement of “spread” on options/ ESPP or value of restricted stock/RSU at taxable event is not treated as a dividend from non-U.S. affiliate.

- Permits tax-free repatriation of cash from non-U.S. affiliates in U.S. CFC tax deferral structures.

Is Local Tax Deduction Available?

- UK: Statutory deduction
- Most Countries (e.g., Australia/Belgium/Hong Kong/Spain/Taiwan): Yes
- Japan: Uncertain
- Italy: May be limited to “fair value”
- France/Germany/Sweden: Unlikely
- Canada: No

Reimbursement Agreements

- Required in most countries for local deductions (not required in Netherlands, U.S. or the UK.)
- Arm's length principle
- May need to be in place at time of grant
  - e.g., Australia

Employer Tax Consequences

- May trigger withholding/reporting
  - Korea (withholding and reporting)
  - Mexico (reporting)

- Employer social insurance contributions
  - Philippines

Employee Tax Consequences

Reimbursement may trigger

- Earlier taxable event for employee
- Taxation where otherwise none
- Employee social insurance contributions

Labor Issues

- Increased risk that awards included in “salary” for determination of severance payments, etc.
- May increase acquired rights risk
- May trigger consultation with works’ council (e.g., Germany)

Exchange Control Issues

- Exchange control restrictions may prevent reimbursement (e.g., Brazil)
  - Intercompany offset not permitted
- Exchange control approval may be required
- Reporting may be required

Before Implementing Cross-charging Program

- Evaluate impact on employee tax, employer social tax/withholding/exchange controls
- Evaluate labor law risks
- Evaluate availability of deductions and FAS109 impact
- Evaluate impact on intercompany pricing strategy
- Evaluate opportunities for cash repatriation
- Evaluate corporate impact of allocating cost by location

Questions?

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Thank you for your participation