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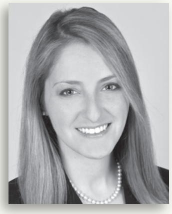
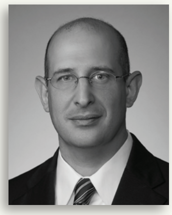
Bradd Williamson
Partner
New York Office
bradd.williamson@lw.com



Hayley Gladstone
Associate
New York Office
hayley.gladstone@lw.com



Kevin Kay
Associate
New York Office
kevin.kay@lw.com

EXECUTIVE COMPENSATION IN THE UNITED STATES: 2013 CURRENT ISSUES

By Bradd Williamson, Hayley Gladstone and Kevin Kay

A troika of developments include positive Say on Pay proxy voting trends, increased executive compensation related lawsuits and new Dodd-Frank rules in US stock markets

Continuing a recent trend, 2013 has been an eventful year for US executive compensation practices and disclosure. In particular, 2013 saw the continued evolution in proxy statement executive compensation disclosure and "Say on Pay" voting trends at US public companies and the continued influence of Institutional Shareholder Services (ISS) and other proxy-advisory firms on the Say on Pay voting results. Additionally, a wave of compensation-related lawsuits and plaintiff's law firm executive compensation "investigations" that began in late 2012 spilled into 2013. Finally, the New York Stock Exchange (NYSE) and NASDAQ Stock Market (Nasdaq) approved compensation committee and adviser independence rules under the Dodd-Frank Act. These rules will become effective in the second half of 2013.[1]

2013 Say on Pay

Since 2011, the Dodd-Frank Act has required large US public companies to conduct advisory "Say on Pay" shareholder votes and in 2013 the Say on Pay rules became applicable to many smaller US public companies for the first time.[2] Although a comprehensive year-over-year comparison of Say on Pay results will not be possible until after the 2013 proxy season, the consulting firm Semler Brossy's real-time reporting of shareholder votes offers insight as to how Say on Pay voting trends for 2013 compare with the overall voting patterns established in 2011 and 2012.[3]

General Positive Trend

To date, analysis indicates a trend toward slightly increased rates of shareholder approval for Say on Pay votes in 2013. In particular, companies that won shareholder approval of their Say on Pay packages in 2012 have generally seen continued shareholder approval in 2013 in even greater numbers, as the following statistics illustrate:

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- Companies that received 50-70 percent approval rates in 2012 are now receiving an average of 18 percent more support in 2013.
- 77 percent of companies have passed Say on Pay votes in 2013 with over 90 percent shareholder approval, up from 73 percent of companies in 2012 and 71 percent of companies in 2011.
- 92 percent of companies have passed their Say on Pay votes thus far in 2013 with over 70 percent shareholder approval, consistent with 91 percent of companies in 2012 and 93 percent of companies in 2011.
- 39 companies that received less than 50 percent approval on their Say on Pay votes in 2012 have passed their Say on Pay votes in 2013 (averaging more than 40 percent more support in 2013).

Failed Votes

Consistent with those positive voting trends, Semler Brossy's 2013 analysis also reflects a slight decline in the rate of Say on Pay votes receiving less than 50 percent support in 2013. Of the 2,214 companies that held an annual meeting in 2012, 57 received less than 50 percent support for their Say on Pay votes, resulting in a 2.6 percent overall Say on Pay vote failure rate. By contrast, 38 of the 1,675 companies that have held an annual meeting in calendar year 2013 have received less than 50 percent support on their Say on Pay vote, reflecting an overall vote failure rate of 2.3 percent to date. Thus far, all of the companies that received less than 50 percent support on their Say on Pay votes in 2013 received a negative recommendation from ISS.

Continued Influence of ISS

ISS continues to be the most influential US proxy advisor and continues to have significant impact on Say on Pay voting results in 2013. Specifically, shareholder support for company pay programs continues to be markedly lower at companies whose Say on Pay proposals received ISS' "against" recommendation. Thus far in 2013, shareholder support has been 30 percent lower for companies that received an "against" recommendation than for those that received a "for" recommendation, consistent with the 30 percent reduced shareholder support in 2012 and 25 percent reduced shareholder support in 2011. Glass, Lewis & Co., another important US proxy advisor, can also impact Say on Pay voting results, although for most companies its impact continues to be less significant than ISS.

ISS Positive and Negative Factors

The factor Semler Brossy most frequently cited as the likely cause for an ISS "against" vote recommendation is a pay-for-performance disconnect. ISS evaluates pay-for-performance alignment based on both quantitative and qualitative factors. With respect to its quantitative analysis, ISS seeks to gauge the alignment of a company's executive pay against company performance, evaluating the chief executive officer's (CEO's) pay against the company's total shareholder return on both a relative and absolute basis. With respect to its qualitative analysis, ISS may consider some or all of the following: ratio of performance-based equity awards to time-based equity awards; the company's peer group benchmarking practices; the rigor of performance goals (and the clarity of the related disclosure); and special circumstances, such as recruitment of a new CEO.

In an attempt to increase the likelihood of a successful Say on Pay vote, many companies continued to refine their compensation programs in 2013. Most notably, many companies adopted compensation recovery policies (*i.e.*, "clawback" policies) and instituted anti-hedging policies for their executives. Companies also continued to eliminate excise tax "gross-up" provisions and to increase senior executive stock ownership requirements. Perhaps most importantly, many companies continued to refine their compensation programs to increase the portion of senior executive compensation payable pursuant to performance-based equity awards.

Say on Pay and Other Executive Compensation Lawsuits

Since the enactment of the Dodd-Frank Act, compensation-related shareholder litigation has steadily increased. The first such lawsuits were shareholder derivative[4] actions alleging breaches of fiduciary duties against directors of companies that failed their advisory Say on Pay votes, but nevertheless approved the executive compensation subject to such failed Say on Pay votes. Of the 22 such lawsuits filed, approximately half were dismissed either for plaintiffs' failure to plead that they were excused from making a demand upon the defendant board of directors to bring the suit themselves (a threshold requirement in derivative actions) or due to the court's recognition of the non-binding nature of the Say on Pay vote. Approximately four of the cases settled, some resulting in significant attorneys' fees.

The next type of compensation-related claim to arise took the form of class action lawsuits seeking to enjoin the company's annual meetings based upon allegations of inadequate executive compensation disclosure in the company's proxy statement. Of 22 such lawsuits filed, eight resulted in the denial of the sought preliminary injunction and 10 were either settled or withdrawn prior to the court's ruling. In a recent ruling dismissing such a claim, the US District Court for the Northern District of Illinois stated that the only required disclosures are those mandated under the Dodd-Frank Act and Regulation S-K of the US Securities Act of 1933, and afforded the directors' decisions deference under the business judgment rule.[5] Thus, the majority of such actions were unsuccessful in obtaining the preliminary injunction against the target company's Say on Pay vote and the number of such suits filed in the future may be expected to decrease. Indeed, although plaintiffs' firms publicly targeted over 70 companies for "investigation" of executive compensation issues during the 2013 proxy season, it appears that few if any of these sorts of Say on Pay injunction lawsuits will be filed in 2013.

However, the filing of similar actions attempting to enjoin a company's proposal to adopt or increase the number of shares reserved under equity compensations plans may persist. Although the merit of such cases is questionable and such lawsuits may be of little benefit to a company's shareholders, it appears that the plaintiffs' bar believes that such cases are more likely to result in a preliminary injunction (because the vote to increase the number of equity plan shares is not advisory) and thus to provide settlement leverage. Accordingly, cases seeking to enjoin a shareholder vote on an equity plan may be expected to continue, at least in the near future. Although no clear discernible pattern has emerged indicating which companies will be targeted, strong disclosures will put companies in a better position to defeat these actions. Companies would be well advised to continue to review all of their compensation plans and related securities law disclosure for compliance with applicable law and best practices.

Compensation Committee Independence Rules[6]

On January 11, 2013, the US Securities and Exchange Commission (SEC) approved the NYSE and Nasdaq proposed listing standards relating to independence requirements for compensation committee members and the selection of their advisers. These heightened independence standards became effective on July 1, 2013.

For those companies listed on the NYSE, compensation committee charters were required to be amended by July 1, 2013 to specify the additional responsibilities and authorities of the compensation committee as required in the final NYSE rules. For companies listed on Nasdaq, a compensation committee must be formed (such a separate committee was not required by Nasdaq before) but a revised compensation committee charter will not be required under the listing standards until 2014. Although Nasdaq-listed companies are not required to revise their compensation committee charters in 2013, such companies were obligated to clearly delegate similar responsibilities and authorities as those required under the NYSE rules to the compensation committee by July 1, 2013. Both NYSE and Nasdaq listing standards set forth guidance regarding the receipt of compensatory fees by compensation committee members. The NYSE requires its compensation committees to consider the source of the committee member's compensation, while Nasdaq implements a strict prohibition on any such receipt of fees by a compensation committee member.

Further, effective as of July 1, 2013, compensation committees are required to analyze the independence of any compensation consultants and advisers that advise the compensation committee using the six factor test outlined in Rule 10C-1 under the US Securities Exchange Act of 1934 (along with any other factors the committee deems relevant). Any such analysis must be done in advance of the retention of the particular adviser and the analysis is expected to be performed on an annual basis.

For further details regarding the specific compensation committee member and advisor independence requirements of the NYSE and Nasdaq listing standards, please see *July 1 Deadline for Implementing Compensation Committee and Adviser Independence Rules is Fast Approaching*, Latham and Watkins Corporate Governance Update, April 2013 and *What Companies and Boards of Directors Need to Know About the New Independence Rules for Compensation Committees and their Advisers*, Latham & Watkins Corporate Governance Commentary, October 2012. ■

Endnotes

[1] For purposes of this article, the "Dodd-Frank Act" refers to the Dodd-Frank Wall Street Reform and Consumer Protection Act and "Say on Pay" refers to the nonbinding advisory shareholder votes on executive compensation required under the Dodd-Frank Act.

[2] Say on Pay rules became effective for smaller reporting companies with annual meetings on or after January 21, 2013. Note, however, that foreign private issuers (FPIs) are exempt from conducting Say on Pay votes.

[3] The analysis and specific figures provided herein are based on Semler Brossy's Say on Pay report, dated June 12, 2013. To access this report, please visit http://www.semlerbrossy.com/wp-content/uploads/2013/06/SBCG-2013-Say-on-Pay-Report-2013-06-12.pdf.

[4] A shareholder derivative suit is a type of lawsuit brought by a shareholder on behalf of the corporation, often against the directors of the corporation. This contrasts to a direct claim where a shareholder (or group of shareholders in the case of a class action) asserts a claim on the shareholder's own behalf.

[5] *Noble v. AAR Corp.*, No. 12 C 7973, 2013 US Dist. LEXIS 48075 (N.D. Ill. Apr. 3, 2013).

[6] Under both NYSE and Nasdaq rules, FPIs are permitted to follow their home country practice relating to compensation committee rules in lieu of the NYSE or Nasdaq corporate governance listing standards. However, the FPI must then disclose in its annual report filed with the SEC each requirement that it does not follow and describe the home country practice followed in lieu thereof.

FRANCE'S NEW TAX DIMINISHES ADVANTAGES OF STOCK PLANS IN EMPLOYEE COMPENSATION

By Elie Boccara and Sophie Mouthon

Elie Boccara
Associate
Paris Office
elie.boccara@lw.com

Sophie Mouthon
Associate
Paris Office
sophie.mouthon@lw.com

Impact of France's 2013 finance law on qualifying stock option and restricted stock unit plans incites companies to examine remuneration alternatives

The French government has decided to increase taxation of the wealthiest taxpayers, and to align the tax treatment of income derived from employment and from capital. For example, capital gains previously taxed at a 19 percent flat rate[1] are now subject to individual income tax at progressive rates of up to 45 percent.[2] The government originally implemented more aggressive income tax increases of up to 75 percent for wealthy taxpayers. However, those rules were deemed contrary to the French Constitution[3] and are not currently in force.

In light of these changes, the 2013 French Finance Law has modified the existing favorable tax and social security regime for qualifying Restricted Stock Units (RSUs) and Stock Options (SOs) granted on or after 28 September 2012. As a result of the new rules, RSUs and SOs are significantly less attractive methods of remunerating employees and managers in France than before. Consequently, we anticipate French employers will look to other means of remunerating their key employees.

This article summarizes the impact of the new French tax rules on qualifying SO and RSU plans, *i.e.*, plans that comply with specific requirements set out in the French business code. Non-qualifying plans are already subject to the same tax and social security treatment as salary, and therefore are not affected by the new rules discussed below.

Impact of the New Rules on Qualifying Stock Options Plans

The table below compares the tax treatment of the "acquisition gain" and "sale gain" applicable to qualifying stock options under the new rules (applicable to all grants made as of 28 September 2012) with the old tax rules (which still apply to all grants made before 28 September 2012).

The "acquisition gain" is the difference between the fair market value of shares on the exercise date and the exercise price. The "sale gain" is the difference between the price of the shares upon their subsequent sale by the option holder and their fair market value on the exercise date.

For qualifying SOs, any acquisition gains and any sale gains are subject to tax in the year the shares are disposed of, not the year in which the options are exercised. This timing is also applicable for RSUs, *i.e.*, any acquisition gains and any sales gains are both taxed when the shares are disposed of, not when the RSUs vest.

	Old regime for stock options granted before 28 September 2012	New regime for stock options granted on or after 28 September 2012
Grant	30% employer-specific social security contribution calculated on (i) the fair value of the options or (ii) 25% of the fair market value of the underlying shares. This is an employer cost.	No change.
Exercise	Taxation if the employer allowed a discount exceeding 5% of the value of the underlying shares at the grant date; the excess discount will be subject to individual income tax bands (up to 45%) and social security contributions (approx. 45% for the employer and approx. 25% for the employee).	No change.
Sale	**Acquisition Gain**[4] • Proportionate flat rates between 18% and 41% depending on the holding period and the amount of the gain;[5] • Employee additional contribution (global rate of 15.5%); • Employee-specific social security contribution (10% rate). **Maximum rate between 43.5% and 66.5%**	**Acquisition Gain** • Individual income tax bands (up to 45%); • Employee additional contribution (global rate of 8%); • Employee-specific social security contribution (10% rate).[4] **Maximum rate: 64.5%**
	Sale Gain • Fixed rate of 24% for sales in 2012; • For sales after 1 January 2013: individual income tax bands (up to 45%) with increasing rebate on the sale gain depending on the length of the holding period;[7] • Employee additional contribution (global rate of 15.5%). **Maximum rate of 43.5% for FY 2012, expanding to 43.4% – 62% thereafter**	**Sale Gain** • Individual income tax bands (up to 45%) with increasing rebate on the sale gain depending on the length of the holding period;[7] • Employee additional contribution (global rate of 15.5%). **Maximum rate ranging from 43.4% – 62%**

Impact of the New Rules on Qualifying Restricted Stock Units

The table below compares the tax treatment of the "acquisition gain" and "sale gain" applicable to qualifying RSUs under the new rules (all grants made on or after 28 September 2012), and the old tax rules (which still apply to all grants made before 28 September 2012).

In the context of RSUs, the "acquisition gain" is the fair market value of the shares on the date they are delivered to the employee (generally when the RSUs vest). The "sale gain" is the difference between the price of the shares upon their subsequent sale by the RSU holder and their fair market value on the date they are delivered to the employee.

Under qualified RSU plans, the shares must not be transferred to the employee until a minimum of two years have passed from the RSU's grant date and, once transferred to the employee, the shares must not be sold before the expiration of an additional two-year holding period.[8]

Conclusion

France's new regime imposes higher tax and social security contributions for qualifying SO and RSU beneficiaries and may be further modified. We therefore anticipate that French corporations will turn their backs on these types of plans in favor of alternative types of remuneration such as deferred cash bonuses to incentivize their key employees. ■

	Old regime for restricted stock units granted before 28 September 2012	New regime for restricted stock units granted on or after 28 September 2012
Grant	30% rate of employer-specific social contribution of (i) the fair market value of the underlying shares or (ii) the fair value of the shares as stated in the IFRS consolidated accounts by the issuing company.	No change.
Acquisition	**Acquisition Gain** • Fixed 30% rate; • Employee additional contribution (global rate of 15.5%); • Employee-specific social security contribution (10% rate). **Maximum rate: 55.5%**	**Acquisition Gain** • Individual income tax bands (up to 45%); • Employee additional contribution (global rate of 8%); • Employee-specific social security contribution (10% rate).[6] **Maximum rate: 64.5%**
Sale	**Sale Gain** • Fixed rate of 24% for sales in 2012; • For sales as of 1 January 2013: individual income tax bands (up to 45%), with increasing rebate on the sale gain depending on the length of the holding period;[7] • Employee additional contribution (global rate of 15.5%). **Maximum rate of 43.5% for FY 2012, and spanning 43.4% – 62% thereafter**	**Sale Gain** • Individual income tax bands (up to 45%) with increasing rebate on the sale gain depending on the length of the holding period;[7] • Employee additional contribution (global rate of 15.5%). **Maximum rate ranging from 43.4% – 62%**

Endnotes

1. This rate was increased to 24 percent for capital gains realized in 2012. The temporary 24 percent rate was initiated to avoid additional complexity in calculating the tax due on gains realized in 2012.
2. In addition to the 45 percent marginal rate, an exceptional contribution is imposed on top income earners. That contribution takes the form of a levy equal to three percent of annual income (including income from capital) exceeding €250,000 for individuals or €500,000 for a couple filing a joint tax return, and four percent of annual income (including income from capital) exceeding €500,000 for individuals or €1,000,000 for a couple filing a joint tax return.
3. Pursuant to the Decision n°2012-662 DC dated 29 December 2012 rendered by the Constitutional Council (*Conseil Constitutionnel*). Note that the French government has already announced its determination to re-implement the 75 percent maximum rate—likely through an additional contribution from an employer paying remuneration exceeding €1,000,000 per year.
4. If a four-year holding period between the grant of the options and the sale of the shares is not satisfied, then the acquisition gain is treated as salary for tax purposes (subject to individual income tax rates and to regular social security contributions).
5. The acquisition gain is subject to a 30 percent rate on gains up to €152,500, and 41 percent on larger sums. Rates on acquisition gain decrease to 18 percent and 30 percent respectively if the employee holds the underlying shares for at least two years after the exercise of the options.
6. Note the original version of 2013 finance bill envisaged that this specific social security contribution would increase from 10 percent to 17.5 percent or 22.5 percent, depending on whether the four-year holding period was satisfied. However, pursuant to the previously mentioned decision of the Constitutional Council these floating rates have been declared "unconstitutional", and the 10 percent rate remains applicable. The French government could seek again to change these rules.
7. The percentage of the rebate will depend on the length of the holding period: (i) 20 percent for a holding period of two to four years; (ii) 30 percent for a holding period of four to six years; and (iii) 40 percent for a holding period exceeding six years. Note that the French Government has already announced this regime may be modified for gains realized as of 1 January 2013, with an increased rebate of up to (i) 50 percent if the shares are held for a period of between two and eight years, and (ii) 65 percent if the shares are held for a period exceeding eight years.
8. Note that if the acquisition period (the period starting on the grant date and ending on the date on which the shares are transferred to the employee) lasts for at least four years, then there is no holding period requirement with respect to the shares once delivered.

THE NEW UK SHARED PARENTAL LEAVE REGIME — WHO IS LEFT HOLDING THE BABY?

By Gretchen Lennon

Gretchen Lennon
Associate
London Office
gretchen.lennon@lw.com

A shake-up of UK regulation will allow couples to share 50 weeks' parental leave from 2015, but the business impact remains unclear

An administrative headache or the key to a competitive 21st century workforce? The UK Government consultation on the proposed new "shared parental leave" system has now closed. The system could see fathers taking as much as 50 weeks' parental leave. It could also radically change the career paths of mothers and return these skilled resources to the economy more quickly. But how will it work in practice? Some commentators question the impact on a society that sees childcare as a primarily female responsibility. Others have highlighted the real difficulties for employers managing cover under the proposed new system. The lack of provision for coordination between employers over couples' requests also seems problematic, potentially leaving employers open to fraud. In advance of the publication of the consultation results, some of these key issues are examined here.

The Current Statutory Maternity and Paternity Leave Regime

Maternity Leave: Currently, mothers are entitled to a maximum of 52 weeks' leave following the birth or adoption of a child. The first two weeks immediately following the birth or placement for adoption of the child are mandatory. An employee on maternity leave is entitled to be paid for the first 39 weeks of maternity leave, initially at a rate of 90 percent of their average weekly earnings for the first six weeks, and then the lower of 90 percent of their average weekly earnings or the statutory rate (which is currently £136.78 per week) for the next 33 weeks.

Paternity Leave: New fathers/partners of new mothers are entitled, as a minimum, to two weeks' statutory paternity leave to be taken within 56 days of a child's birth or placement for adoption. This is payable at the lower of 90 percent of their average weekly earnings or the statutory rate.

The "additional paternity leave" regime is effective for children due on or after 3 April 2011. Here, if a mother returns to work before the end of her 52-week statutory maternity leave period, the father/her partner is entitled to use the remaining unused portion of her maternity leave. If the mother has returned to work before the end of the 39-week paid statutory maternity leave period, the father/mother's partner is also entitled to the remaining portion of unclaimed statutory maternity pay.

The two main conditions attached to the existing additional paternity leave regime are that: (i) the father/mother's partner is only entitled to additional paternity leave if the mother has returned to work; and (ii) the period of additional paternity leave cannot begin any earlier than 20 weeks from the date of the child's birth or placement for adoption.

Proposed New Regime

The proposed shared parental leave regime will maintain the two-week compulsory maternity leave period for the mother immediately following the child's birth or placement for adoption. However, after this initial two-week period, both parents will be entitled to share the remaining 50 weeks' parental leave in any way they choose. This means both parents can take their joint parental leave entitlement either concurrently or consecutively, by alternating in periods of no less than one week at a time. The total number of weeks taken by both parents in aggregate must not exceed 52 (including the mother's compulsory two weeks). This new regime will therefore permit mothers to return to work immediately after the initial compulsory two-week period, allowing the father/mother's partner to take the whole of the remaining 50 weeks.

In accordance with the existing statutory maternity pay system, only the first 39 weeks of parental leave will be paid. The existing minimum two weeks' statutory paid paternity leave system will continue to operate as before. The current additional paternity leave regime will be abolished.

Unresolved Concerns for Businesses

The consultation period has raised a number of practical concerns set to test employers unless resolved.

Firstly, employees will not be required to provide their employers with full details of their plans regarding the whole parental leave period from the outset. They will be required to give employers eight weeks' notice of their intention to end the maternity leave and commence the shared parental leave, and the separate employers of both parents must then agree with their respective employees to the pattern of parental leave. However, there is no limit to the number of times parents can alternate between weeks of parental leave and work, which can result in their employers receiving notice of multiple proposed periods of leave in an ad hoc and piecemeal fashion. This aspect of the regime has the potential to be a real headache for employers.

The Department of Business Innovation and Skills (BIS) envisages that the new system will require a "light touch" administrative approach but employers have expressed disquiet about the anticipated managerial burden of implementing the new policy. For example, although BIS has stated it does not expect that each parent's respective employer will need to contact the other in order to verify their employees' leave entitlements, it is difficult to see how this can otherwise be achieved without risking errors or even employee fraud.

The increased flexibility for parents also means that employers may find themselves obliged to hire short-term replacements for these employees or share the burden of additional work amongst other employees.

The draft proposals do not provide clarity on a number of potential issues. For example, it is not clear how to resolve a situation where one parent's employer agrees to a proposed pattern of leave, but the other employer does not. It is proposed that if an employee cannot agree on a pattern of leave with their employer, then the total amount of parental leave requested should be taken in one block. However, this may not be convenient for the other parent and their employer. Additionally, the UK Government has not provided guidance on what, if any, valid reasons an employer may be entitled to give for rejecting an employee's request for a particular pattern of shared parental leave.

Employers may face another potential burden if they are required to keep an employee's existing job open for them until their return from parental leave — the government consultation paper does not clarify whether or not this will be required. This right to return to the same job exists under the current regulations. However, it may be a lot more disruptive where an employee can return to work and leave a number of times in a year. In an effort to address this issue, the consultation paper proposes an additional 10 Keeping In Touch (KIT) days, in addition to the 10 KIT days which exist under the current regime. It is hoped that these additional KIT days may serve as a useful trial period for new working arrangements or will allow for a phased return to work.

Company-specific enhanced maternity pay policies represent a further complication. BIS has stated that employers may continue to offer enhanced maternity pay to female employees who are on maternity leave or shared parental leave but will not be obliged to offer the same enhanced pay to male employees on shared parental leave. However, it is difficult to see how a challenge to this approach on the grounds of sex discrimination could be successfully defended.

Looking Ahead

Consultation on these proposals and how they will work in practice closed on 17 May 2013 and we will publish an update once the results of the consultation are published. Much commentary has focused on the concerns and issues highlighted in this article.

Some sceptical commentators have doubted the impact this proposed regime will have in practice as it is argued that UK culture is too wedded to the idea that childcare is a female responsibility. Clearly cultural and social factors will have an impact on the level of uptake but likely the most important driver will be the family's financial position. For some families, relying on the mother's income, while the father receives just a statutory parental leave payment, simply may not be viable.

These proposals form part of a wider framework of regulations which the UK Government has published under an umbrella initiative aimed at creating a more flexible and family-friendly workplace culture and at encouraging fathers to be more involved in the traditionally female role of childcare. This, in turn, should encourage better retention of experienced and skilled women in the workplace. Hopefully the issues raised here will be resolved before the proposals are enacted into statute, and BIS' goal of a "light touch" administrative approach will be achievable. ■

Stefan Süß
Partner
Munich Office
stefan.suess@lw.com

Felicitas Mayer-Theobald
Associate
Munich Office
felicitas.mayer-theobald@lw.com

GERMAN COURT DECISION OPENS TAX PLANNING OPPORTUNITY FOR STOCK OPTIONS

By Stefan Süß and Felicitas Mayer-Theobald

German Federal Fiscal Court allows employee to steer timing of taxation to reduce tax burden on stock option gains

A recent German Federal Fiscal Court decision has opened the door to optimizing the tax treatment of stock options for employees. Applying the principles of the court decision, employees may steer the timing of taxation to significantly reduce any tax burden arising in respect of stock option gains.

Background

Generally, German employees are deemed to receive employment income upon the exercise or similar disposal of a stock option. Income tax at personal tax rates between 14 percent and 45 percent (plus solidarity surcharge and, if applicable, church tax) is payable on the difference between (i) the amount paid by the employee to exercise the option and (ii) the fair market value (FMV) of the underlying shares, calculated at the date the shares are booked into the account of the employee (the option gain). In addition, the employer and the employee must pay social security contributions on the option gain, up to certain ceilings specified by German social security laws. Therefore, as an example, the total income tax and social security burden of employment income in the amount of €40,000 is approximately 40 percent.

Facts of the Case

In the underlying case, the employee was granted 15,000 stock options in 2002. Shortly after the grant of the stock options, the employee sold the options to a German limited liability company (the Company) which he fully owned. The options were sold at a price well below the then current FMV. The Company was not incorporated in connection with the stock option grant and did not have as its sole purpose the holding of stock options. The Company exercised the options in 2004; at this time, the FMV of the options had increased by a factor of nine. The German tax authorities and the local tax court took the view that the employee was subject to wage tax and social security contributions in 2004 on the nine-fold increase in value.

Key Principles

The German Federal Fiscal Court rejected the view of the German tax authorities and the local tax court, deciding that the "disposal" which crystalized the employment income tax charge occurred at the time of the employee's transfer of the stock options to the Company in 2002. At that time, the FMV of the shares had only increased by a factor of two, which led to a significantly lower taxable amount.

The Company's exercise of the stock option did not lead to further employment income, nor did it constitute any other type of taxable event for the employee. In particular, the German Federal Fiscal Court declared that the sale of the options to the Company did not constitute an abuse of rights, as the Company was not incorporated in connection with the stock option grant and did not have as its sole purpose the holding of the stock options.

Implications

The judgment and reasoning by the German Federal Fiscal Court was consistent with the court's principles that a transfer of stock options is viewed as a disposal and therefore leads to employment income at the time of the transfer. Interestingly (and logically), even a transfer of options at well below the shares' FMV to a company fully owned by the employee (*i.e.*, a hidden contribution to the company) is regarded as a disposal and does not constitute an abuse of rights. The main practical implications are twofold:

- **Timing**: The German Federal Fiscal Court's decision grants flexibility to the employees with respect to the timing of the taxation of employment income. Through the sale of the stock options to a fully owned company, the employee may trigger wage tax at an early stage when the shares' FMV is low and therefore the "tax base" (*i.e.*, the margin between the share price upon exercise and the exercise price) is lower. A subsequent increase in value will not be subject to wage tax. Consequently, the greater the increase in the shares' value after the transfer of the options to the company, the higher the tax saving.
- **Overall tax rate**: In addition, by transferring the options to a fully owned company, employees may benefit from lower tax rates. Where an employee holds stock options, the option gain is taxed at the personal tax rate of the employee (*i.e.*, often 40 percent or more) and the subsequent sale of the shares is subject to a flat tax rate of 25 percent (plus solidarity surcharge and, if applicable, church tax). In contrast, holding the options via a corporation leads to a tax burden of only 30–35 percent, as (i) the capital gain resulting from a sale of the shares is subject to a 95 percent tax exemption for corporate income tax purposes and (ii) the employee benefits from the partial income taxation regime for dividends distributed by the corporation (*i.e.*, only 60 percent of the dividend is subject to tax).

This case therefore opens up opportunities for tax structuring of employee options that could give rise to significant tax savings and make the participation in stock option programs even more attractive to employees. ■

Sarah Gadd
Associate
London Office
sarah.gadd@lw.com

UK GOVERNMENT ENACTS NEW "EMPLOYEE SHAREHOLDER" RULES

By Sarah Gadd

As of August 2013 a new category of "employee shareholders" will gain company shares in exchange for certain employee rights

Following several weeks of wrangling between the two houses of the UK parliament, the government has now finalised the new "employee shareholder" reforms which are due to be implemented in Autumn 2013. The government has recently been championing employee share ownership as a good means of incentivising employees. However, the introduction of the new employee shareholder status was controversial as it was seen as a means for the government to attack protected employment rights.

The reforms will introduce a new category of employment status — an employee shareholder — with different rights to the existing categories of "employee" and "worker". Essentially an "employee shareholder" will give up or accept curtailment of the following statutory employment rights in return for shares in their employer company worth between £2,000 and £50,000:

- They will have no right to a statutory redundancy payment if they are made redundant;
- The right to claim unfair dismissal will not apply unless the dismissal is automatically unfair or discriminatory on one of the protected grounds (age, race, sex, disability, sexual orientation or religion or belief);
- They will only have the right to request flexible working when they return from parental leave and it will not be automatically unfair for an employer to dismiss an employee shareholder who requests flexible working in other circumstances. The government also proposes restricting the period of time in which a flexible working request could be made to within four weeks of return from parental leave; and
- They will have to give 16 weeks' notice of their intention to return early from maternity or adoption leave, instead of the current eight weeks.

The fact that employee shareholders will be required to forfeit these employment rights has sparked a lot of debate over the fairness of the new provisions. In order to pass the new rules, the government has had to make a number of concessions which protect the employee shareholder. In particular:

- An individual must receive independent legal advice prior to entering into any contract to become an employee shareholder (*e.g.*, from a lawyer or union representative). The employer must also pay the reasonable costs of this advice, whether or not the employee then accepts the role. If an individual does not receive independent advice before agreeing to become an employee shareholder, he or she will be an ordinary employee with all the associated statutory employment protections;
- There will be a seven day "cooling off" period, during which any acceptance of employee shareholder status will not be binding;
- Employers must provide a written statement with full details about the shares and associated rights to any individual who is considering becoming an employee shareholder;
- Any jobseeker who refuses an offer with employee shareholder status will not forfeit their social security benefits;
- The first £2,000 of shares will not attract income tax; and
- Existing workers will be protected from detriment if they refuse to switch to an employee shareholder contract.

Of these concessions, the most burdensome is likely to be the requirement that the employee obtains independent legal advice in relation to any offer of employment as an employee shareholder. Some employers may be deterred by the extra cost and administrative delay that this could cause.

However, we anticipate the bigger stumbling block for employers when considering hiring employee shareholders will be the administrative burden involved in granting shares to their employees, particularly for private companies. As with existing employee shareholding arrangements, non-listed companies will have to value the shares on acquisition and disposal. In addition, employers will need to ensure they have arrangements in place to buy back the shares from departing employee owners, which may require establishing an employee benefit trust. These can be costly and burdensome administrative processes. Employers will need to consider carefully whether the reduced risk of certain employment claims balances out these costs.

In terms of tax treatment, the first £2,000 of shares issued to an employee shareholder can be issued free of income tax and National Insurance Contributions (NICs). This tax incentive — not part of the government's initial proposal when it first introduced the employee shareholder concept in October last year — has since been included as an additional incentive for employers to adopt the employee-shareholder approach. Any increase in value of the shares between acquisition and disposal will be free of capital gains tax which will be attractive to employees (although will not save employers any money).

How popular the employee shareholder arrangements will be in light of the administrative considerations discussed above remains to be seen. Perhaps more importantly, the government has announced it intends to reform and "de-regulate" the UK Companies Act rules around share buy-backs to make it easier for employees to own shares and sell them back to their employer when their employment terminates. We anticipate these reforms may go further to promote employee share ownership than the introduction of the employee shareholder status. ■

Lyndon Tan
Associate
Singapore
lyndon.tan@lw.com

SINGAPORE: PROPOSED CHANGES TO THE EMPLOYMENT ACT

By Lyndon Tan

Several significant changes related to working hours, pay and benefits expected to take effect in 2014

Introduction

On 14 March 2013, the Singapore Ministry of Manpower (MOM) announced proposed changes to the Employment Act (Chapter 91) of Singapore (the Employment Act) to afford better protection to employees (including professionals, managers and executives) and to raise standards of employment.

The Employment Act is Singapore's main labour law, setting out the basic terms of employment, and shaping the responsibilities and relationships between employers and employees. The proposed changes are the outcome of Phase 1 of the first major Employment Act review since 2008. Due to the complexity of the issues involved, the review will be conducted in two phases. Phase 1, conducted from the second quarter of 2012 to the first quarter of 2013, focused on three main areas, namely:

- Extending the coverage of the Employment Act;
- Improving employment standards and benefits for employees; and
- Reducing rigidity and augmenting flexibility for employers.

Phase 2, expected to commence in the fourth quarter of 2013, will focus on two main areas, namely:

- Enhancing protection for employees in non-traditional work arrangements, such as contract work, self-employment and outsourcing; and
- Implementing better mechanisms to facilitate employment dispute resolution between employers and employees.

The MOM is expected to introduce an Employment Act Amendment Bill for the Phase 1 proposed changes in Parliament in the second half of 2013. If passed in Parliament, these changes will likely come into force in the first half of 2014. The key proposed changes for Phase 1 to the Employment Act are set out below.

Extending General Protection to Junior Managers and Executives

In general, the Employment Act protects rank-and-file employees[1] in Singapore, that is, the non-executive and non-managerial employees, who are viewed as more vulnerable and in need of protection by the law. The Employment Act currently also offers limited protection, in respect of salary payments,[2] to managers and executives who earn up to S$4,500 a month (Junior Executives). The proposed changes to the Employment Act will extend the scope of protection to Junior Executives, to offer general protection such as prohibitions against unfair dismissal, as well as paid public holiday and sick leave benefits, in addition to the existing limited salary protection. MOM expects that about 300,000 Junior Executives will benefit from these changes.

While the proposed changes to the Employment Act seek to extend the scope of protection to Junior Executives, they will also require Junior Executives to serve at least one year with their employers before they are eligible to seek redress against unfair dismissal. This qualifying service period is intended to provide employers with reasonable time to assess the employee's suitability to the job.

The proposed changes to the Employment Act will also allow employers to grant time-off in-lieu to Junior Executives who are required to work on public holidays, subject to mutual agreement. The rationale behind these changes is to account for the nature of professional, managerial and executive work, which is generally more outcomes-based and which often includes in-built flexibility arrangements. In the absence of such mutual agreement between employers and employees, the employers are required to grant their employees at least half a day off in-lieu.

Extending Working Hours Protection to More Non-Workmen

Part IV of the Employment Act, which provides for working hours related protection (that is, protection against excessive working hours, the right to rest days and the right to overtime payment), currently applies to non-workmen[3] who earn up to S$2,000 a month, and to workmen who earn up to S$4,500 a month. The proposed changes to the Employment Act will increase the salary threshold for non-workmen to S$2,500 a month, in line with a general increase in salary levels, to provide working hours related protection to a larger pool of eligible non-workmen. MOM anticipates these changes will benefit an additional 150,000 employees in Singapore.

However, the salary threshold for non-workmen will remain constant at S$4,500 a month and the proposed changes will simultaneously cap the amount of overtime payable to non-workmen at the salary level of S$2,250 a month. MOM introduced this cap to help employers manage labour costs.

Issuance of Payslips and Maintenance of Salary Records

At present, the Employment Act requires employers to keep the salary records of workmen only, not for all employees. The proposed changes to the Employment Act will require employers to provide written itemised payslips to, and maintain detailed salary (and other employment) records for, all employees who fall within the scope of the Employment Act. The MOM views these measures as not only protecting employees, but also helping employers in the event of a salary dispute.

Cap on Deductions from Employees' Salaries

Employees' salaries are currently protected from any deductions by employers other than those authorised under the Employment Act. The authorised deductions under the Employment Act include deductions for absence from work and for accommodation, amenities and services supplied by the employer. The authorised deductions (other than authorised deductions for absence from work, recovery of advances, loans or overpayments, income tax payable by employee or agreed payments to co-operative societies) are also subject to a cap of 50 percent of an employee's salary for the applicable salary period.

The proposed changes to the Employment Act seek to impose a new 25 percent sub-cap for authorised deductions for accommodation, amenity and services supplied by the employer (within the existing 50 percent total cap), so as to prevent excessive deductions from employees' salaries.

Payment of Retrenchment Benefits

Under the current Employment Act regime, an employee who has been employed in a company for at least three years may request retrenchment benefits if he or she is retrenched. An employee who has worked for less than three years in a company is not entitled to retrenchment benefits under the Employment Act. However, this does not prohibit a company from paying an ex-gratia payment at its discretion.

The proposed changes to the Employment Act will reduce the service requirement for retrenchment benefits from three years to two years, in line with shorter employment tenures.

Protection of Unionised Employees Upon Restructuring

Currently, when employees are transferred from one company to another under a restructuring exercise, the collective agreement protects the employment terms of affected unionised employees until it expires. To provide greater certainty for these affected employees, the proposed changes to the Employment Act will require protecting the employment terms of the affected employees' existing collective agreement for at least 18 months after the transfer, even if the collective agreement is expected to expire before that.

Limiting Employers' Liability for Sick Leave and Medical Examination Expenses

The Employment Act currently obliges employers to provide paid sick leave and medical examination expenses for their employees. The proposed changes to the Employment Act will specifically exempt employers from having to grant paid sick leave and bear the medical examination expenses of employees for cosmetic consultations and procedures which are not medically necessary. These changes are aimed at maintaining the balance of responsibilities between employers and employees.

Conclusion

The proposed changes to the Employment Act are significant, and we recommend employers take the changes into consideration as they plan their human resources strategies and procedures for 2014, when the changes are expected to come into effect. ■

Endnotes

[1] The Employment Act covers "employees", which are defined in Section 2(1) of the Employment Act as:

"a person who has entered into or works under a contract of service with an employer and includes a workman, and any officer or employee of the Government included in a category, class or description of such officers or employees declared by the President to be employees for the purposes of this Act or any provision thereof, but does not include —
(a) any seaman;
(b) any domestic worker;
(c) subject to subsection (2), any person employed in a managerial or an executive position; and
(d) any person belonging to any other class of persons whom the Minister may, from time to time by notification in the Gazette, declare not to be employees for the purposes of this Act".

Section 2(2) of the Employment Act applies certain provisions of the Employment Act to managers and executives whose monthly salaries fall within the specified threshold by regarding them as "employees":

"(2) Any person employed in a managerial or an executive position who is in receipt of a salary not exceeding $4,500 a month (excluding overtime payments, bonus payments, annual wage supplements, productivity incentive payments and any allowance however described), or such other amount as may be prescribed by the Minister, shall be regarded as an employee for the purposes of —
(a) sections 20, 20A, 21, 22, 23 (read with section 10 or 11, as the case may be), 24, 25 and 34 and Parts XII to XVI (read with the Second and Third Schedules); and
(b) such other provisions of this Act as the Minister may, by regulations, specify, and those provisions shall apply in relation to that person subject to such modification as may be prescribed."

[2] This includes the determination of salary periods, computation of salary, time of payment, and payment on dismissal or termination.

[3] The expression "workman" is defined in Section 2(1) of the Employment Act as:

"(a) any person, skilled or unskilled, who has entered into a contract of service with an employer in pursuance of which he is engaged in manual labour, including any artisan or apprentice, but excluding any seaman or domestic worker;
(b) any person, other than clerical staff, employed in the operation or maintenance of mechanically propelled vehicles used for the transport of passengers for hire or for commercial purposes;
(c) any person employed partly for manual labour and partly for the purpose of supervising in person any workman in and throughout the performance of his work:
Provided that when any person is employed by any one employer partly as a workman and partly in some other capacity or capacities, that person shall be deemed to be a workman unless it can be established that the time during which that workman has been required to work as a workman in any one salary period as defined in Part III has on no occasion amounted to or exceeded one-half of the total time during which that person has been required to work in such salary period;
(d) any person specified in the First Schedule; and
(e) any person whom the Minister may, by notification in the Gazette, declare to be a workman for the purposes of this Act."

HONG KONG: GOVERNMENT CONSIDERS STANDARD WORKING HOURS AND OVERTIME

*By Jane Ng**

Changes could burden the economy, but may bring Hong Kong working hours in line with those of other countries

The Hong Kong Labour and Welfare Bureau formed a Special Committee (the Committee) on 9 April 2013 to consider whether standard working hours (SWH) should be introduced in Hong Kong.

The Committee is examining issues set out in the Hong Kong Labour Department's November 2012 Report of the Policy Study on Standard Working Hours (the Report), including:

(i) The existing working hours in Hong Kong
(ii) The potential impact of introducing SWH
(iii) The framework which might govern SWH
(iv) The nature of SWH policies established in other regions

Amongst other things, the Report assesses the probable impact of imposing SWH in Hong Kong if the SWH policy were to have the following characteristics:

(i) Weekly SWH of 40–48 hours
(ii) Overtime pay rate for working beyond SWH of between 100–150 percent of SWH rate
(iii) No exemption from the SWH policy for "higher-skilled" employees.

The Report estimates that in such circumstances, the annual wages paid to the Hong Kong workforce would increase between 1.7 percent and 11.4 percent beyond the wages paid in 2011 — an increase of between HK$8.0 billion and HK$55.2 billion. The additional financial burden that such overtime payments would impose upon the economy is one of the issues to be examined by the Committee in assessing whether SWH should be introduced.

The Committee is also considering the fundamental issue of whether maximum working hours (typically defined as an upper threshold of working hours not to be exceeded whatsoever, or to be exceeded only in extremely limited circumstances) should be imposed in addition, or as an alternative, to SWH (generally defined as a number of working hours which may be exceeded but only when overtime pay is offered in compensation). The question of whether a SWH policy should be introduced by legislation, as opposed to using industry-specific guidelines, is also under scrutiny by the Committee.

The Report's proposed SWH regime does not significantly deviate from those imposed in other countries, both within the Asia-Pacific region and worldwide. An International Labour Organization study found that 101 of 107 countries surveyed have introduced a SWH regime in some form, of which 41 percent adopted a 40 hour week and approximately 59 percent a 40–48 hour week.

Should the SWH be introduced, the economic security offered by overtime pay would supplement the financial protection granted to Hong Kong's workforce by the recent introduction of a minimum wage pursuant to the entry into force of the Minimum Wage Ordinance (Cap. 608) on 1 May 2011. ■

Jane Ng
Partner
Hong Kong Office
jane.ng@lw.com

*This article was prepared with assistance of **Scarlett Jennings**, trainee solicitor in the Hong Kong office of Latham & Watkins.

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This issue of *The Working World* was edited by Catherine Drinnan. If you have any questions about this issue of *The Working World*, please contact any of the authors or editors, or any of the lawyers listed below.

Contact Latham & Watkins

Abu Dhabi
Villiers Terblanche
Stephen M. Brown
+971.02.813.4800

Barcelona
Jordi Domínguez
+34.93.545.5000

Beijing
Allen C. Wang
+86.10.5965.7000

Boston
David O. Kahn
+1.617.948.6000

Brussels
Jean Paul Poitras
+32.2.788.6000

Chicago
Robin L. Struve
Sandhya P. Chandrasekhar
+1.312.876.7700

Doha
Villiers Terblanche
Stephen M. Brown
+974.4406.7700

Dubai
Villiers Terblanche
Stephen M. Brown
+971.4.704.6300

Düsseldorf
Thomas Fox
+49.211.8828.4600

Frankfurt
Dirk Oberbracht
+49.69.6062.6000

Hamburg
Stefan Lunk
Norma Studt
+49.40.4140.30

Hong Kong
Simon Berry
Jane M. S. Ng
+852.2912.2500

Houston
C. Timothy Fenn
+1.713.546.5400

London
Stephen M. Brown
Catherine Drinnan
+44.20.7710.1000

Los Angeles
James D. C. Barrall
David M. Taub
Laurence Seymour
Joseph B. Farrell
+1.213.485.1234

Madrid
Jordi Domínguez
+34.91.791.5000

Milan
Fabio Coppola
+39.02.3046.2000

Moscow
Christopher J. Allen
+7.495.785.1234

Munich
Claudia Heins
+49.89.2080.3.8000

New Yorik
New Jersey
Jed W. Brickner
John D. Shyer
Bradd L. Williamson
+1.212.906.1200

Orange County
James D. C. Barrall
+1.714.540.1235

Paris
Agnès Cloarec-Mérendon
Matthias Rubner
+33.1.40.62.2000

Riyadh*
Salman M. Al-Sudairi
Stephen M. Brown
+966.1.207.2500

Rome
Fabio Coppola
+39.06.98.95.6700

San Diego
Holly M. Bauer
+1.858.523.5400

San Francisco
Linda M. Inscoe
Scott D. Thompson
+1.415.391.0600

Shanghai
Rowland Cheng
+86.21.6101.6000

Silicon Valley
James A. Metz
Alice M. Chung
+1.650.328.4600

Singapore
Chei Liang Sin
+65.6536.1161

Tokyo
Michael J. Yoshii
Hiroki Kobayashi
+81.3.6212.7800

Washington, D.C.
David T. Della Rocca
+1.202.637.2200

* In association with the Law office of Salman M. Al-Sudairi