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## CONTENTS

EDITOR’S PREFACE .................................................................................................................. v

*Arthur Kohn*

Chapter 1   AUSTRALIA.............................................................................................................. 1

Sean Selleck, John Walker, Erica Kidston, Jonathan Kelt, Alexandra Stead and Sinan Alnajjar

Chapter 2   BRAZIL................................................................................................................. 20

Isabel Bueno, Dario Abrahão Rabay and Francisco A Coutinho

Chapter 3   DENMARK............................................................................................................... 29

Morten Skjønnemand, Lars Fogh and Ditte Grundvig Larsen

Chapter 4   EU OVERVIEW...................................................................................................... 39

Janet Cooper, Matthew Hunter and Stephen Penfold

Chapter 5   FINLAND............................................................................................................... 49

Johanna Haltia-Tapio, Lauri Lehmusuoja and Anniina Järvinen

Chapter 6   FRANCE.................................................................................................................. 63

Yoan Bessonat, Gabriel Flandin and Philippe Grude

Chapter 7   GERMANY.............................................................................................................. 76

Michael Brems and Jens Hafemann

Chapter 8   HONG KONG ........................................................................................................ 98

Rowan McKenzie, Steven Sieker and Karen Man

Chapter 9   HUNGARY............................................................................................................. 112

Barnabás Buzási, Melinda Pelikán, János Pásztor, Alexandra Tóth and Eszter Bohati

Chapter 10  INDIA................................................................................................................ 122

Avik Biswas, Namita Viswanath and Jaya Shruthi
<table>
<thead>
<tr>
<th>Chapter</th>
<th>Country</th>
<th>Authors</th>
</tr>
</thead>
<tbody>
<tr>
<td>Chapter 11</td>
<td>ISRAEL</td>
<td>Shachar Ponat, Orly Gerbi, Keren Assaf, Michal Lavi and Efrat Tzur</td>
</tr>
<tr>
<td>Chapter 12</td>
<td>ITALY</td>
<td>Gianluca Russo</td>
</tr>
<tr>
<td>Chapter 13</td>
<td>LUXEMBOURG</td>
<td>Annie Elfassi, Cédric Raffoul, Kheira Mebrek and Arnaud Barchman Wuytiers van Vliet</td>
</tr>
<tr>
<td>Chapter 14</td>
<td>MEXICO</td>
<td>Alejandro Santoyo and Francisco J Peniche Beguerisse</td>
</tr>
<tr>
<td>Chapter 15</td>
<td>NETHERLANDS</td>
<td>Suzanne Sikkink, Raoul Hagens, Marc Oostenbroek, Naomi Reijn, Dimitri Kolias and Olivier Valk</td>
</tr>
<tr>
<td>Chapter 16</td>
<td>PORTUGAL</td>
<td>Bernardo Abreu Mota, Martim Morgado, Pedro Furtado Martins and Ricardo Cunha Leal</td>
</tr>
<tr>
<td>Chapter 17</td>
<td>PUERTO RICO</td>
<td>Edwin J Seda-Fernández, Mariel Y Haack and Mariangely González-Tobaja</td>
</tr>
<tr>
<td>Chapter 18</td>
<td>RUSSIA</td>
<td>Elena Novikova and Olga Pimanova</td>
</tr>
<tr>
<td>Chapter 19</td>
<td>SPAIN</td>
<td>Eduardo Gómez de Salazar and Ana Ortiz García</td>
</tr>
<tr>
<td>Chapter 20</td>
<td>SWITZERLAND</td>
<td>Matthias Oertle, Franziska Stadtherr-Glättli and Patrick Schärli</td>
</tr>
<tr>
<td>Chapter 21</td>
<td>UNITED KINGDOM</td>
<td>Mahesh Varia</td>
</tr>
<tr>
<td>Chapter 22</td>
<td>UNITED STATES</td>
<td>Arthur Kohn and Julia Rozenblit</td>
</tr>
</tbody>
</table>

Appendix 1 ABOUT THE AUTHORS ......................................................... 307
Appendix 2 CONTRIBUTING LAW FIRMS’ CONTACT DETAILS ............................................................... 325
Executive remuneration encompasses a diverse range of practices and is consequently influenced by many different areas of the law, including tax, employment, securities and other aspects of corporate law. We have structured this book with the intention of providing readers with an overview of these areas of law as they relate to the field of executive remuneration. The intended readership of this book includes both in-house and outside counsel who are involved in either the structuring of employment and compensation arrangements, or more general corporate governance matters. We hope this book will be particularly useful in circumstances where a corporation is considering establishing a presence in a new jurisdiction and is seeking to understand the various rules and regulations that may govern executive employment (or the corporate governance rules relating thereto) with regard to newly hired (or transferring) executives in that jurisdiction.

The most fundamental considerations relating to executive remuneration are often tax-related. Executives will often request that compensation arrangements be structured in a manner that is most tax-efficient for them, and employers will frequently attempt to accommodate these requests. In order to do so, of course, it is critical that employers understand the tax rules that apply in a particular situation. To that end, this book attempts to highlight differences in taxation (both in terms of the taxes owed by employees, as well as the taxes owed – or tax deductions taken – by employers), which can be the result of:

\[ a \] the nationality or residency status of the executives;
\[ b \] the jurisdiction in which the executives render their services;
\[ c \] the form in which executives are paid (e.g., cash, equity (whether vested or unvested) or equity-based awards);
\[ d \] the time at which the executives are paid, particularly if they are not paid until after they have ‘earned’ the remuneration; and
\[ e \] the mechanisms by which executives are paid (e.g., outright payment, through funding of trusts or other similar vehicles or through personal services corporations).

In addition to matters relating to the taxation of executive remuneration, employment law frequently plays a critical role in governing executives’ employment relationships with their employers. There are a number of key employment law-related aspects that employers should consider in this context, including:

\[ a \] the legal enforceability of restrictive covenants;
\[ b \] the legal parameters relating to wrongful termination, constructive dismissal or other similar concepts affecting an employee’s entitlement to severance on termination of employment;
any special employment laws that apply in connection with a change in control or other type of corporate transaction (e.g., an executive’s entitlement to severance or the mechanism by which an executive’s employment may transfer to a corporate acquirer); and

other labour-related laws (such as laws related to unions or works councils) that may affect the employment relationship in a particular jurisdiction.

The contours of these types of employment laws tend to be highly jurisdiction-specific and therefore it is particularly important that corporations have a good understanding of these issues before entering into any employment relationships with executives in any particular country.

Beyond tax and employment-related laws, there are a number of other legal considerations that corporations should take into account when structuring employment and executive remuneration arrangements. Frequently, these additional considerations will relate to the tax or employment law issues already mentioned, but it is important they are still borne in mind. For example, when equity compensation is used, many jurisdictions require that the equity awards be registered (or qualify for certain registration exemptions) under applicable securities laws. These rules tend to apply regardless of whether a company is publicly or privately held. In addition to registration requirements, it is critical for both employers and employees to understand any legal requirements that apply in respect of executives’ holding, selling or buying equity in their employers.

Given the heightened focus in many jurisdictions on executive remuneration practices in recent decades – both in terms of public policy and public perception – the application of corporate governance principles to executive compensation decisions is crucial to many companies. Decisions about conforming to best practices in the field of executive remuneration may have substantial economic consequences for companies and their shareholders and executives. Corporate governance rules principally fall into two categories. The first concerns the approvals required for compensatory arrangements; a particular remuneration arrangement may require the approval of the company’s board of directors (or a committee thereof). Many jurisdictions have adopted either mandatory or advisory ‘say on pay’ regimes, in which shareholders are asked for their view on executive remuneration. The second concerns the public disclosure requirements applicable to executive remuneration arrangements; companies should be aware of any disclosure requirements that may become applicable as a result of establishing a new business within a particular jurisdiction, and in fact may wish to structure new remuneration arrangements with these disclosure regimes in mind. In recent years, there has also been increased legislative and shareholder focus in many jurisdictions on environmental and social governance issues, such as the gender pay gap, tying executive compensation to environmental and social goals, and diversity initiatives.

We hope that readers find the following discussion of the various tax, statutory, regulatory and supervisory rules and authorities instructive.

Arthur Kohn
Cleary Gottlieb Steen & Hamilton LLP
New York
September 2018
Chapter 1

AUSTRALIA

Sean Selleck, John Walker, Erica Kidston, Jonathan Kelt, Alexandra Stead and Sinan Alnajjar

I INTRODUCTION

Executive remuneration is a highly debated topic in Australia. Now, as much as ever, companies and executives need to remain aware of changes as they occur, as they will have structural implications for remuneration arrangements going forward.

The challenge for lawyers and other practitioners in this field is that it cuts across several areas of specialisation – tax, corporate and employment. This chapter is the combined work of a team of lawyers specialising in these areas who work together to provide corporate and individual clients with seamless advice that covers these specialty areas.

II TAXATION

i Income tax for employees

Determining residence of an employee

Under Australian domestic law, Australian-resident taxpayers are assessed on their worldwide income. An employee would usually include employment income in their assessable income in the income year in which it is received in cash (rather than when the entitlement to receive the amount accrues to the employee).

Non-resident individuals are generally only assessed on income derived directly or indirectly from sources in Australia (subject to certain exemptions). In particular, non-residents may be liable for withholding tax on dividends, interest, certain managed investment fund payments and royalties from Australian entities. Non-residents may have relief from double taxation under a double tax agreement if they are a resident in a country with which Australia has formed such an agreement.

A person may be a resident of Australia under Australian domestic law if he or she satisfies either a common law test or one of three statutory tests.

Individual taxpayers will be considered residents under the common law test if they ‘reside’ in Australia. The term ‘resides’ takes on its ordinary meaning as ‘to dwell permanently, or for a considerable time, to have one’s settled or usual abode to live in a particular place’. Whether a taxpayer resides in Australia will be a question of fact to be determined on an

---

1 Sean Selleck and John Walker are partners, Erica Kidston is special counsel, Jonathan Kelt a consultant, Alexandra Stead an associate and Sinan Alnajjar a senior associate at Baker McKenzie. The authors would like to acknowledge the contributions made to earlier versions of this chapter by former colleagues Ellen Thomas, Michael O’Neill and Maria Pawelek and to thank them for those contributions.
annual basis. The Australian Commissioner of Taxation (Commissioner) outlined some of the factors that should be taken into account in considering this question in Taxation Ruling 98/17, including:

\( a \) behavioural factors – including personal intentions or purpose of presence, family and business ties, maintenance and location of assets, place of abode, and social and living arrangements; and

\( b \) physical presence – where an individual displays behaviours consistent with them residing in Australia over a period of time (generally six months).

Where the common law test is not satisfied, each of the three statutory tests must be applied in the order set out below.

Under the domicile test, an individual whose ‘domicile’ is in Australia will be a resident of Australia unless the Commissioner is satisfied that the person’s permanent place of abode is outside Australia. An individual’s domicile generally refers to that person’s place of birth; however, this may change when a person moves indefinitely to another country. The question as to whether an individual’s ‘permanent place of abode’ is outside Australia is a question of fact, and includes considerations such as the intended and actual length of the individual’s stay in a foreign country. Generally, a period of two or more years outside Australia would indicate a taxpayer’s permanent place of abode is overseas.

Under the 183-day test, non-residents will be tax residents of Australia if they are physically present in Australia for more than 183 days during a year of income, either continuously or intermittently, unless the Commissioner is satisfied their ‘usual place of abode’ is outside Australia and the individual does not intend to take up residence in Australia. The discussion above in relation to ‘permanent place of abode’ is relevant to considering whether an individual’s usual place of abode is outside Australia.

Finally, an individual may be a resident of Australia if the person contributes to a superannuation fund for certain government officers.

‘Temporary residents’ who hold a temporary visa under the Migration Act 1958 (Cth) may be subject to different tax treatment to non-residents. Generally, foreign-sourced income (other than income related to employment) and capital gains derived by temporary residents would be treated as non-assessable and non-exempt income.

**Income tax rates**

The tax rates (known as marginal tax rates) for Australian residents for the income year ending 30 June 2019 are as follows:

<table>
<thead>
<tr>
<th>Taxable income</th>
<th>Tax on this income*</th>
</tr>
</thead>
<tbody>
<tr>
<td>A$0 to A$18,200</td>
<td>Nil</td>
</tr>
<tr>
<td>A$18,201 to A$37,000</td>
<td>19c for each A$1 over A$18,200</td>
</tr>
<tr>
<td>A$37,001 to A$90,000</td>
<td>A$3,572 plus 32.5c for each A$1 over A$37,000</td>
</tr>
<tr>
<td>A$90,001 to A$180,000</td>
<td>A$20,797 plus 37c for each A$1 over A$90,000</td>
</tr>
<tr>
<td>A$180,001 and over</td>
<td>A$54,097 plus 45c for each A$1 over A$180,000</td>
</tr>
</tbody>
</table>

* These rates do not include the Medicare levy of 2 per cent or the Medicare levy surcharge (between 1 per cent and 1.5 per cent if the taxpayer does not have a prescribed level of private hospital insurance).
The proposed increase in the Medicare levy from 2 per cent to 2.5 per cent, originally announced in the 2017–2018 Federal Budget, is no longer going ahead.

For non-residents, the marginal tax rates are currently as follows:

<table>
<thead>
<tr>
<th>Taxable income</th>
<th>Tax on this income*</th>
</tr>
</thead>
<tbody>
<tr>
<td>A$0 to A$90,000</td>
<td>32.5c for each A$1†</td>
</tr>
<tr>
<td>A$90,001 to A$180,000</td>
<td>A$29,250 plus 37c for each A$1 over A$90,000</td>
</tr>
<tr>
<td>A$180,001 and over</td>
<td>A$62,550 plus 45c for each A$1 over A$180,000</td>
</tr>
</tbody>
</table>

* Foreign residents are not required to pay the Medicare levy.
† Where an individual taxpayer is resident for only part of an income year, the tax-free threshold must be apportioned based on the number of months the individual is considered a resident of Australia.

The above tables include changes to the marginal tax rate thresholds announced by the Federal Government in the 2018–2019 Budget and implemented in legislation. The implemented measures will apply in their entirety from 1 July 2024, with gradual changes applying from 1 July 2018 as set out in the tables above. From 1 July 2022, the threshold at which the 19 per cent marginal rate will apply will increase from A$37,000 to A$41,000 and the threshold at which the 32.5 per cent marginal rate will apply will increase from A$90,000 to A$120,000. From 1 July 2024, the threshold at which the 32.5 per cent marginal rate will apply will increase from A$120,000 to A$200,000 and the highest marginal rate of 45 per cent will apply to taxable income exceeding A$200,000. The 37 per cent bracket will be removed entirely.

**Income tax treatment for employees of employee share scheme interests**

An employee will be subject to tax on any discount given in respect of shares or rights to acquire shares (including options or restricted stock units) when those interests are acquired. However, if the shares or rights are provided under a complying employee share scheme (ESS) then the employee may defer the tax payable in respect of acquiring the shares or rights.

Alternatively, an ESS may be structured so that an employee may be eligible for an exemption for the first A$1,000 worth of shares or rights if certain conditions are satisfied, including that the employee’s adjusted income is less than A$180,000.

The following table shows the taxation of options, restricted stock and restricted stock units. It has become popular to issue performance rights or similar interests in Australia and these should be taxed in a similar manner to restricted stock units. However, as a result of the recent changes, it is becoming popular once again to issue options.
**Australia**

<table>
<thead>
<tr>
<th>Tax treatment upon grant?</th>
<th>Tax treatment upon vesting?</th>
<th>Tax treatment upon exercise/delivery?</th>
<th>Tax treatment upon sale of underlying shares?</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Option</strong></td>
<td><strong>Restricted stock</strong></td>
<td><strong>Restricted stock unit</strong></td>
<td><strong>Further gain (in excess of market value at ESS deferred taxing point)</strong></td>
</tr>
<tr>
<td>No tax payable on grant, provided relevant conditions for deferral satisfied.</td>
<td>No tax payable on grant, provided relevant conditions for deferral satisfied.</td>
<td>No tax payable on grant, provided relevant conditions for deferral satisfied.</td>
<td>Further gain (in excess of market value at ESS deferred taxing point) subject to capital gains tax unless sold within 30 days of the ESS deferred taxing point.</td>
</tr>
<tr>
<td><strong>For options granted between 1 July 2009 and 30 June 2015:</strong> tax on market value less cost (if any) at ESS deferred taxing point* (generally vesting unless genuine restrictions on exercise or disposal).</td>
<td>Tax on market value of shares at ESS deferred taxing point† (generally vesting unless genuine restrictions on disposal).</td>
<td>No tax, unless ESS deferred taxing point has not yet happened.</td>
<td>Further gain (in excess of market value at ESS deferred taxing point) subject to capital gains tax unless sold within 30 days of the ESS deferred taxing point.</td>
</tr>
<tr>
<td><strong>For options granted on or after 1 July 2015:</strong> tax on market value less cost at ESS deferred taxing point** (generally exercise* unless genuine restrictions on disposal of resulting shares).</td>
<td></td>
<td>No tax, unless ESS deferred taxing point has not yet happened.</td>
<td>If shares held for at least 12 months after ESS deferred taxing point, a discount may be available on any capital gain.</td>
</tr>
<tr>
<td>Further gain (in excess of market value at ESS deferred taxing point plus exercise price) would be subject to capital gains tax, unless sold within 30 days of ESS deferred taxing point. If shares acquired upon exercise of options held for at least 12 months prior to sale, a discount may be available on any capital gain.</td>
<td>Further gain (in excess of market value at ESS deferred taxing point) subject to capital gains tax unless sold within 30 days of the ESS deferred taxing point. If shares held for at least 12 months after ESS deferred taxing point, a discount may be available on any capital gain.</td>
<td>Further gain (in excess of market value at ESS deferred taxing point) subject to capital gains tax unless sold within 30 days of the ESS deferred taxing point. If shares held for at least 12 months after ESS deferred taxing point, a discount may be available on any capital gain.</td>
<td>Further gain (in excess of market value at ESS deferred taxing point) subject to capital gains tax unless sold within 30 days of the ESS deferred taxing point.</td>
</tr>
</tbody>
</table>

* ESS deferred taxing point for rights (such as options or restricted stock units) granted between 1 July 2009 and 30 June 2015 is the earliest of:
  * seven years after the employee acquired the right;
  * when the employee ceases the employment in respect of which they acquired the right;
  * when there is no real risk of forfeiting the right and the scheme no longer genuinely restricts disposal of the right; or
  * when there is no real risk of forfeiting the right or underlying share and the scheme no longer genuinely restricts exercise of the right or disposal of the underlying share.

** ESS deferred taxing point for rights (such as options or restricted stock units) granted on or after 1 July 2015 is the earliest of:
  * 15 years after the employee acquired the right;
  * when the employee ceases the employment in respect of which they acquired the right;
  * when there is no real risk of forfeiting the right and the scheme no longer genuinely restricts disposal of the right; or
  * when the right is exercised and there is no real risk of forfeiting the resulting share and there is no genuine restriction on disposal of the resulting share.

However, regardless of when the right was acquired if the resulting share is disposed of within 30 days of the ESS deferred taxing point, the ESS deferred taxing point will be moved to the date of disposal.

† ESS deferred taxing point for shares (such as restricted stock) is the earliest of:
  * seven years or (for shares acquired on or after 1 July 2015) 15 years after the employee acquired the share;
  * when the employee ceases the employment in respect of which they acquired the share; or
  * when there is no real risk of forfeiture and the scheme no longer genuinely restricts disposal of the share.

** Social taxes for employees (foreign service income)**

Where a taxpayer is considered to be an Australian resident, foreign service income may be exempt from tax in Australia provided certain conditions are satisfied. Specifically, under Section 23AG of the Income Tax Assessment Act 1936 (Cth), the ‘foreign earnings’ of an individual taxpayer who is engaged in certain types of ‘foreign service’ for a continuous period of 91 days or more should be exempt from Australian tax. The categories of work that qualify for the exemption are very narrow – the exemption is generally limited to aid workers, charitable works and government employees. As of 1 July 2016, Australian government employees who earn foreign income while delivering Australian official development assistance have not been eligible for exemption from Australian income tax on their foreign employment income.

If an Australian resident’s employment income is taxed in another country, the employee may be entitled to a foreign income tax offset in respect of the tax paid in that other country.
iii  Tax deductibility for employers

*Remuneration (including bonuses)*

Generally, remuneration paid to employees will be deductible to an employer, provided the expenditure is incurred in gaining or producing assessable income and is not of a private or capital nature. Usually, a tax deduction is available in the year in which the employer incurs the liability to pay the salary or wages. However, in some circumstances, prepaid salary and wage expenses may not be deductible in the year the payment is incurred.

Expenses relating to annual leave, long-service leave, sick leave or other leave are only deductible when the relevant amount is actually paid to the individual to whom the leave relates.

Bonuses paid to an employee should be deductible when the expense is ‘incurred’. This generally requires that the bonus is capable of reasonable estimation and that a legal liability to pay the bonus has arisen.

*Other taxes*

Employers (including a foreign company that has employees who are liable for taxation in Australia) will need to register for and remit tax instalment deductions known as pay-as-you-go withholding tax in respect of the salary and wages of their employees.

Employers may also be required to pay payroll taxes to state authorities. Additionally, a ‘superannuation guarantee charge’ may be payable to the Australian Taxation Office if the employer does not make the minimum level of superannuation contributions (up to the maximum contribution base) for each employee (currently 9.5 per cent of the employee’s ordinary time earnings).

Fringe benefits tax may be payable by an employer on the value of certain fringe benefits (such as non-cash allowances, gratuities, compensation, benefits, bonuses and premiums) provided to employees (or associates of employees) in respect of the employment of the employee. Fringe benefits tax is a separate tax from income tax and is payable by the employer at the rate of 47 per cent.\(^2\) Where fringe benefits tax has been paid, the taxable value of the fringe benefit will generally be deductible to the employer. The value of the fringe benefit received is not assessable to the employee.

iv  Other special rules

Special rules may apply where a business is sold and the new employer takes on the existing long-service leave, annual leave, sick leave or other leave obligations of the former employer in respect of employees transferred to the new employer. The former employer would not be entitled to a deduction for that leave unless it makes an ‘accrued leave transfer payment’ to the new employer because an Australian law, award or industrial agreement requires the former employer to make the payment. The new employer would include the accrued leave transfer payment in their assessable income, and claim a deduction for providing the leave when the employer pays an amount to the individual to whom the leave relates.

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\(^2\) The rate is 47 per cent for the FBT year ending 31 March 2019.
III  TAX PLANNING AND OTHER CONSIDERATIONS

i  Alienation of personal services income

Income from personal exertion is usually taxed as ordinary income of the taxpayer. It is generally very difficult to structure an employment relationship to achieve a different tax treatment.

Various structures may be employed to seek to achieve income splitting. For example:

a  In the case of a taxpayer who carries on a business, it may be possible to equitably assign, for value, the interest in the business from which the income is derived. For example, in the Everett case, a partner in a partnership equitably assigned his interest in the partnership to another person. However, if an equitable assignment is not done effectively, the assignor will still be subject to tax in the full amount and will not be entitled to a deduction for payments to the purported assignee. Further, as of 14 December 2017, the Australian Taxation Office (ATO) suspended its previous guidance in relation to Everett assignments because of concerns that taxpayers’ arrangements were going beyond the original intent of the guidelines and other high-risk behaviour. The ATO intends to begin consulting with stakeholders in 2018 on replacement guidance that will apply prospectively. In the meantime, the ATO has asked individual taxpayers contemplating entering into new arrangements to engage with the ATO. Taxpayers who have entered into arrangements prior to 14 December 2017, which comply with the guidelines and do not exhibit high risk factors, can continue to rely on those guidelines.

b  Where a taxpayer provides personal services through a family trust or a corporation, the Australian Taxation Office would normally tax the individual providing the services, rather than the entity that has been engaged to procure the services of that individual. For example, if a taxpayer sought to arrange his or her affairs so that his or her salary was paid into a trust and then distributed to different family members, this may not be effective for tax purposes.

Similarly, there are statutory restrictions on the alienation of personal services income. In particular, Divisions 84 to 87 of the Income Tax Assessment Act 1997 (Cth) contain rules that effectively look through structures used by an individual who provides personal services through a vehicle. For example, if a taxpayer provides personal services through a company, the company would pay tax at marginal rates on that income (see Section II.i).

ii  Foreign executives moving to Australia

Foreign executives moving to Australia will need to plan their move very carefully. As discussed in Section II.i, the Commissioner will treat an executive as a tax resident of Australia if the executive commences residing in Australia (unless treaty relief is available).

Double tax agreements provide a tiebreaker where two countries would treat an individual as a resident in their country. Australia has entered into double tax agreements with many of its main trading partners (except Hong Kong). If the executive is treated as an Australian tax resident, he or she may be entitled to a foreign income tax offset for any tax paid in his or her home jurisdiction, subject to a cap.

4  Note there are other jurisdictions with which Australia does not have a double tax agreement in place.
A person who qualifies as a temporary resident in Australia is not taxed on his or her foreign-sourced income apart from personal services or employment income. A temporary resident is also not liable to capital gains tax unless the asset is taxable Australian property (broadly, a direct or indirect interest in land situated in Australia).

**IV EMPLOYMENT LAW**

i Non-competition covenants

Non-competition covenants are permitted and enforceable. However, there are some complexities.

The starting point is that post-employment restraints (whether in the nature of non-competition or non-solicitation covenants) are presumed to be invalid and unenforceable. This is because such restraints are considered to be contrary to public policy – the law does not like to see an individual prohibited from working in his or her lawful trade and generating an income.

The onus falls on the employer to demonstrate that, on the basis of its particular circumstances, the restraint is reasonable (having regard to the interests of the employer, the employee and the public) and is no wider than is reasonably necessary to protect the employer’s legitimate interests.

There is a large and constantly evolving body of case law that sheds light on when a post-employment restraint is reasonable. Courts will have regard to the nature and extent of the restraint, its geographical reach and its duration. Insofar as the nature of a restraint is concerned, Australian courts are far more reluctant to enforce non-competition covenants than non-solicitation covenants (as to which see below). Non-competition covenants are rarely enforced unless the former employer agrees to compensate the former employee for his or her inability to work during the restraint period. This usually involves the former employer paying the former employee a sum equivalent to the amount the former employee would have earned had he or she continued to be employed by the former employer during the relevant period.

Australian courts also retain a broad discretion to decline injunctive relief to enforce a restraint even if the former employer discharges the onus of proving that the restraint is reasonable. The existence and exercise of this discretion can make the task of enforcing post-employment restraints very difficult for employers.

**Monetary damages**

Non-competition covenants can be enforced by both injunctive relief (temporary and permanent injunctions) and by orders for monetary compensation. Most non-competition covenants spell this out. Sometimes they go further and provide for liquidated damages.

**Geographical or time limitations**

Two of the factors a court will take into account when considering the reasonableness of a post-employment restraint are its geographical reach and duration. It is important that both

---

5 Generally, a person holding a temporary visa, and neither he or she nor his or her spouse is an Australian resident for social security purposes (e.g., an Australian resident citizen).
go no further than is necessary to protect the employer’s legitimate interests. For example, if an employee has only ever worked in Australia, it is unlikely a restraint operating outside Australia would be found to be reasonable.

As far as duration is concerned, the key question is usually how long does the former employer need to replace the departed employee and give that replacement a reasonable opportunity to establish relationships with the former employer’s clients, thereby giving the former employer a reasonable opportunity to protect its business. Depending on the circumstances (such as the duties of the employee and the depth of his or her client relationships), this period might be somewhere between three and 12 months. It is rare for post-employment restraints to be upheld for longer periods.

Limitations on ‘competition’
Post-employment restraints can only be used to protect an employer’s legitimate interests. This requires careful identification of the employer’s business and its true competitors. If a restraint extends beyond these parameters, it is unlikely to be found to be reasonable.

Gardening leave provisions
In most cases a court will take into account a period of gardening leave when assessing the reasonableness of a post-employment restraint. An employer is not likely to be able to extend the duration of a reasonable post-employment restraint by also providing for gardening leave prior to termination of the employment relationship.

Enforceability
If the former employee was the owner (or part-owner) of a business that was acquired by the former employer and the restraint was entered into to protect the former employer’s investment in that business, a court will take a much more robust view about enforcing the restraint. This is because the character of the restraint is different. In this context, the restraint is part of a commercial arrangement, as opposed to a simple employment relationship. The commercial benefit derived by the former employee by virtue of the sale of the business to the former employer is a highly relevant factor taken into account in determining the reasonableness of the restraint.

ii Non-solicitation covenants

Enforceability against employees
Courts in Australia are more willing to enforce these types of restraints than pure non-compete restraints. This is because the enforcement of these more limited restraints does not usually deprive the employee of the ability to work and earn an income. However, these restraints must still be reasonable and go no further than is necessary to protect the former employer’s interests. For example, the covenant will usually need to be limited to the non-solicitation of clients with whom the former employee had some dealings before he or she left the former employer’s employment. A non-solicitation covenant that seeks to preclude solicitation of all the former employer’s clients or customers, even those with whom the former employee had no dealings or knowledge, is unlikely to be found to be reasonable.

Monetary damages
The position is the same as that set out above in relation to non-competition covenants.
**Limitations on scope**

As with non-compete covenants, non-solicitation covenants must also be limited in geographical reach and duration.

**iii Repudiation of contract and post-employment restraints**

Repudiation is ‘conduct which evinces an unwillingness or an inability to render substantial performance of the contract’. Some examples of repudiation in the employment context include where an employer unilaterally reduces an employee’s pay or significantly changes his or her responsibilities (for example, a demotion) without the contractual power to do so. The test for repudiation is an objective one. In the event of a repudiation, the innocent party has the option to either affirm the contract or to accept the repudiation and treat the contract as having come to an end.

If accepted by an employee, an employer’s repudiation of an employment contract invalidates post-termination restraints entirely. The principle that post-termination restraints do not survive the employer’s repudiatory breach goes back more than 100 years to a UK House of Lords case. It has been followed and applied in the Australian High Court and most recently in the Victorian Court of Appeal.

An employer should therefore take great care when terminating an employee’s employment not to do anything that might amount to a repudiation of the employment contract or it may not be able to rely on any post-employment restraints.

**iv Termination of executives**

**Employment law**

There are both contractual and statutory restrictions on an employer’s ability to dismiss an executive.

A termination must be carried out in compliance with the requirements of the executive’s employment contract. In Australia, most executive contracts provide for termination ‘without cause’ by the employer simply giving the executive a specified amount of notice or making a payment in lieu of that notice. Notice periods vary from the statutory minimum (which ranges from one to five weeks, depending on the length of service and the age of the employee) three, six, nine or, perhaps, up to 12 months.

Executive contracts also usually contain a provision for termination ‘summarily’ (i.e., without notice) where the executive has committed an act of ‘serious misconduct’. Serious misconduct is not just unsatisfactory performance, but misbehaviour to such an extent that it can be said the executive has demonstrated that he or she is no longer willing to be bound by his or her employment contract.

Under contract law, an employer can dismiss for any reason and does not need to articulate that reason. However, this position has been modified by a number of different statutes at both the state and federal levels. For example, a termination implemented because the executive possesses an attribute protected by one of Australia’s many anti-discrimination laws (which cover attributes such as gender, race, religion, sexual orientation, disability and

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7 *General Billposting Co Ltd v. Atkinson* [1909] AC 118.
8 *Kouffman v. McGillicuddy* [1914] HCA 63.
age) would be unlawful. If a discrimination claim is made and upheld, a range of remedies are available to the former employee, including reinstatement and awards of compensation for past and future economic loss, distress and hurt feelings.

There is also a body of federal law that prohibits employers taking ‘adverse action’ (meaning action that hurts or disadvantages an employee) because the employee possesses or has exercised a ‘workplace right’. Workplace rights include:

a benefits (such as minimum employment entitlements) and responsibilities (such as health and safety duties) under workplace laws;
b the ability to initiate or participate in a process or proceeding under a workplace law; and
c the ability to make a complaint or enquiry to a person having the capacity under a workplace law to seek compliance with that law (e.g., to a WorkSafe inspector or an inspector from the Office of the Fair Work Ombudsman).

Contraventions of these laws can attract prosecutions, fines, injunctions and orders for compensation.

Australia also has ‘unfair dismissal’ laws that prohibit a termination of employment where the termination is ‘harsh, unjust or unreasonable’. However, these laws rarely apply to executives.

**Release of claims from an executive**

Releases cannot be obtained if they in any way restrict the executive’s entitlement to make a claim under a statutory workers’ compensation scheme that applies to injuries and illnesses caused by work or that relates to the executive’s entitlement to the minimum amount of compulsory superannuation contributions.

The validity of a release agreement or deed (like any other agreement) can be challenged on grounds such as duress and unconscionability. For this reason, it would be prudent for an employer to give an employee an opportunity to obtain independent legal advice before asking him or her to sign a release agreement or deed.

**Limitations and guidelines**

As far as the common law is concerned, an employer and an executive can agree on whatever severance payments they believe are appropriate to their circumstances.

However, where executives are concerned, this position has been modified by provisions in the Corporations Act 2001 (Cth) (the Corporations Act). These provisions are complicated and contain numerous qualifications and exemptions, but broadly speaking, they restrict the payment of ‘termination benefits’ to directors and, in relation to entities listed on the Australian Stock Exchange (ASX), key management personnel to 12 months’ average base salary, unless that benefit has been approved by the company’s shareholders.

There are also some restrictions applying to public companies in relation to the giving of financial benefits (including termination payments) to ‘related parties’. Related parties include directors and spouses, and their parents and children.

Additionally, the ASX’s Listing Rules prohibit officers of listed entities from being entitled to termination benefits if the value of those benefits, when combined with the benefits payable to other officers of the entity, would exceed 5 per cent of the equity of the entity, unless shareholder approval is obtained.
There are also some provisions in the Fair Work Act 2009 (Cth) that entitle employees (including executives) to certain minimum benefits on termination of employment. These benefits are notice of termination (or payment in lieu) of between one and five weeks (depending on length of service and age of the departing employee); payment of certain accrued but untaken leave entitlements (limited to annual and long-service leave); and severance pay in the event of a redundancy (ranging between four and 16 weeks’ pay depending on length of service).

Terminations in connection with a change in control

If the employer is listed on the ASX, it must not allow an officer to receive any termination benefits (or any increase in them) simply because a change has occurred in the shareholding or control of that entity or any of its subsidiaries.

Involuntary termination for good cause

At an executive level, terminations of employment, whether involuntary or voluntary, and whether for good cause or without cause, are not restricted by legislation except to the extent that anti-discrimination and adverse action laws (discussed above) have an impact on this issue.

Leaving aside those statutes, the position in Australia is that executives can be terminated either with or without cause by the employer simply providing the executive with the appropriate period of notice (the amount of which is usually specified in the executive’s employment contract) or by making a payment in lieu of that notice. As noted earlier, an employee can also be dismissed summarily (without notice), if the dismissal is for serious misconduct.

Constructive termination

Australian law recognises that employers can behave in such a way that employees (including executives) can feel they have no alternative but to resign. This sort of ‘forced resignation’ is treated as a dismissal and is referred to as a ‘constructive dismissal’.

Severance compensation on transfer of employment connected with a corporate transaction

The statutory redundancy scheme is subject to provisions that can exempt an employer from the obligation to pay severance pay where an offer of suitable alternative employment has been secured.

As noted above, there is a rule applicable to entities listed on the ASX that prohibits payments on a change in control.

Leaving these rules aside, this question is one that is ordinarily dealt with in an executive’s contract of employment. That contract can specify when severance compensation is payable, including in circumstances of a change in control.

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10 Contained in the Fair Work Act 2009 (Cth).
v Personal liability

Workplace health and safety

Australian workplace health and safety laws are currently in a state of flux as we progress slowly towards the harmonisation of Australia’s state and federal safety laws.

The new federal laws (which now apply in the majority of Australian states) impose a positive obligation on directors; persons who make or participate in making decisions that affect the whole or a substantial part of a business; and persons who have the capacity to affect significantly a company’s financial standing to ensure that the employer complies with its obligations under work health and safety laws. This is known as the ‘due diligence’ requirement. Importantly, an officer who fails to comply with his or her due diligence obligations is exposed to the risk of prosecution and personal liability. This duty can be breached even if there has not been an accident or prosecution of the employer.

Employment laws

Under Australia’s federal employment laws (which apply to all corporations), a person who is involved in a contravention of a wide range of statutory provisions is deemed to have contravened those provisions him or herself. A person is ‘involved in’ a contravention if he or she has:

a. aided, abetted, counselled or procured the contravention;
b. induced the contravention;
c. been knowingly concerned in, or a party to, the contravention; or
d. conspired with others to effect the contravention.

In that event, the individual can be prosecuted just as if he or she had personally committed the contravention. These laws apply to executives.

The types of contraventions covered by these accessorial liability provisions are provisions that:

a. mandate minimum employment entitlements (such as wages, leave entitlements and termination entitlements);
b. require compliance with industrial instruments (such as awards and enterprise agreements);
c. prohibit adverse action (discussed in Section IV.iii); and
d. prohibit ‘sham contracting’ – the practice of treating employees as independent contractors.

Insolvency

Many duties are imposed on directors by statute (particularly the Corporations Act), the common law and the laws of equity. One that should be brought to the attention of foreign executives who become directors of Australian companies is the duty to prevent insolvent trading – failing to prevent the company from incurring a debt when there were reasonable grounds for suspecting the company was insolvent. Breach of this duty is, effectively, a criminal offence that can attract not only substantial fines but also imprisonment.

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11 Fair Work Act 2009 (Cth).
12 Corporations Act 2001 (Cth), Section 588G.
V SECURITIES LAW

i Introduction

Australian corporate and securities law focuses mostly on forms of executive remuneration that involve securities (such as options over unissued shares and shares) or financial products (such as ‘phantom equity’ or ‘replicator’ plans, or restricted share units (RSUs)).

ii Securities disclosure obligations when issuing ‘securities’

Disclosure generally

Remuneration plans that involve the issue of ‘securities’, including share plans and option plans are all subject to disclosure and fundraising regulation under Chapter 6D of the Corporations Act. At its most basic, that Chapter of the Corporations Act requires that any issue (and some sales) of securities must be made under a regulated form of disclosure document (such as a prospectus), unless an exemption applies.

A range of disclosure documents may be prepared under the Corporations Act with differing standards of disclosure, permitted uses and liability exposure. The most common form of disclosure document, a prospectus, must contain all the information that investors and their advisers would reasonably require to make an informed assessment of the rights and liabilities attaching to the securities and the assets and liabilities, financial position and performance, profits and losses and prospects of the issuer. Disclosure documents are lodged with the Australian Securities and Investments Commission (ASIC) and are subject to differing degrees of scrutiny depending on their nature. They are publicly available.

Any requirement to prepare a disclosure document is particularly onerous when seeking to implement a simple incentive plan.

Exemptions from disclosure

Fortunately, in most cases preparation of a disclosure document can be avoided by relying on one of the statutory exceptions to disclosure or on one of ASIC’s Class Order exemptions relating to employee share schemes.

Failing this, it is possible to apply to ASIC for specific relief, although the circumstances in which this will be granted can be quite limited.

Statutory exemptions

The statutory exemptions from disclosure are contained in Section 708 of the Corporations Act. The most relevant of these are:

a the senior manager exemption. An offer of securities does not need disclosure if the offer is made to (1) senior managers of the body or a related body or certain relatives of the senior manager, or (2) bodies corporate controlled by senior managers or their specified relatives. For these purposes, a ‘senior manager’ means a person who makes, or participates in making, decisions that will affect the whole, or a substantial part of the
business of the corporation or has the capacity to significantly affect the corporation’s financial standing (regardless of the person’s designation and whether or not the person is a director or secretary of the body);\textsuperscript{17} and

\textit{b} small-scale offerings.\textsuperscript{18} An offer of securities does not need disclosure if:

\begin{itemize}
  \item the offer is a ‘personal’ offer;
  \item the offer does not result in the number of people to whom securities have been issued exceeding 20 in any 12-month period; and
  \item the amount raised by the body does not exceed A$2 million in any 12-month period.\textsuperscript{19}
\end{itemize}

In calculating the 20-person and A$2 million limits, offers that qualify for another Section 708 exemption, offers made under a disclosure document under Chapter 6D, and offers made outside Australia are not included.

In practice, the senior manager exemption is likely to apply to most plans that are limited to the most senior employees and directors. The small-scale offerings exemption will provide some coverage for broader-based plans for others who do not qualify as senior managers.\textsuperscript{20}

\textbf{ASIC general relief from disclosure obligations}

\textit{Listed companies}

ASIC has provided general relief from disclosure for incentive plans under ASIC Class Order [14/1000], which assists listed companies issuing equity securities. The key conditions for this relief are as follows:

\textit{a} the offers must be made only to:

\begin{itemize}
  \item full-time or part-time employees, or directors of the issuer or of an associated body corporate of the issuer;
  \item contractors or casual employees of the issuer or an associated body corporate who work a number of hours equivalent to at least 40 per cent of a comparable full-time position; and
  \item persons who will, upon accepting the offers, become employees, directors or contractors;
\end{itemize}

\textit{b} the securities (or financial products) being offered must be ‘eligible products’ (as defined in the Class Order [14/000]), which include:

\begin{itemize}
  \item fully paid shares in an issuer in a class that has been continuously quoted on the ASX (or an approved foreign exchange) for the immediately preceding three months;
  \item options for the issue or transfer of such shares; or
\end{itemize}

\textsuperscript{17} ASIC Corporations (Disclosure Relief—Offers to Associates) Instrument 2017.

\textsuperscript{18} Corporations Act 2001 (Cth), Section 708(1).

\textsuperscript{19} For options and partly paid securities, any amount payable upon exercise or if a call is made is deemed to be included in the amount raised.

\textsuperscript{20} A ‘sophisticated investor’ exemption is also available that is more rarely useful given that most executives who would qualify for it would also qualify for senior manager exemption – broadly, where the amount invested by that person in the same class of securities is at least A$500,000 or an accountant verifies that the person has net assets of at least A$2.5 million or income of A$250,000 in the past two years: see Corporations Act 2001 (Cth), Section 708(8).
• ‘incentive rights’ (generally this term covers any right that is settled in or benchmarked against shares, such as RSUs and phantom shares); 

  c options and incentive rights referred to above must be granted for no more than nominal monetary consideration; and 

  d the total number of shares issued under the Class Order or similar relief in the past three years must be less than 5 per cent of the total number of shares on issue at the time of the offer.

There are a number of other requirements that must be satisfied in order for a listed company to be able to rely on the relief under Class Order [14/1000].

Unlisted companies

A similar exemption (Class Order [14/1001]) applies for offers of equity awards by unlisted companies. The exemption potentially covers fully paid voting ordinary shares, as well as incentive rights and options over such shares, but is subject to a number of restrictive conditions. In particular:

  a the total value of the awards being granted to any Australian-resident employee in any 12-month period must be no more than A$5,000;

  b options or incentive rights cannot be granted for more than nominal monetary consideration, and in addition cannot have a more-than-nominal exercise or vesting price unless:  

    • the underlying shares have been continuously quoted on an approved stock exchange for at least three months at the time of exercise or vesting; or

    • a ‘valuation document’, 21 which is dated no earlier than one month before it is given, is given to participating employees no later than 14 days prior to exercise or vesting; and

  c the grants must be accompanied by various disclosures, including a copy of the issuing company’s most recent annual financial statements.

Disclosure obligations when issuing ‘financial products’

It is also possible that the requirements of Chapter 7 of the Corporations Act will apply to executive incentive plans.

Chapter 7 contains a separate (and analogous) disclosure regime for ‘financial products’ (which are not securities). 22 This most frequently applies when a right that is not a share or an option over unissued shares is being offered as part of remuneration, or there is a component of the arrangement that constitutes a ‘derivative’ under the Corporations Act. A derivative is

21 For this purpose, a ‘valuation document’ is:

  • a current disclosure document (e.g., an Australian-compliant prospectus) for an offer of shares in the same class as the shares to which the options or incentive rights relate;

  • an independent expert’s report that contains an opinion on the value of a share in the same class as the shares to which the options or incentive rights relate; or

  • a copy of an executed agreement under which shares in the same class as shares to which the options or incentive rights relate are to be acquired on arm’s-length terms by a third party that is not an associate of the issuing company and that specifies a value of a share in that class.

22 See Corporations Act 2001 (Cth), Section 761A and Chapter 7, Part 7.1, Division 3 for a definition of financial products.
very broadly defined and essentially includes arrangements where, at a future point in time, a party will be obligated to provide consideration that is derived from the value of something else.\(^2\) This affects ‘phantom equity’ or ‘replicator’ plans, since, by their nature, these plans pay employees an amount of consideration that is derived by reference to the value of shares or other securities.

As noted above, ASIC Class Orders [14/1000] and [14/1001] provide disclosure exemptions for the financial products that are typically available under phantom equity plans and RSU plans.

**Licensing requirements**

Under the Australian Financial Service Licence (AFSL) regime, a series of licensing requirements can apply where a person is taken to carry on a ‘financial services business’ in Australia. ‘Financial services’ can include providing financial product advice (including advice in respect of securities), dealing in a financial product or providing custodial or depository services.\(^3\) Issuers may most commonly attract the application of this regime where:

\(a\) they provide advice or recommendations in respect of an incentive plan;

\(b\) they issue or sell securities or financial products (there are limited exceptions for self-dealing when issuing securities such as shares or options over unissued shares, but these do not apply to financial products, such as RSUs or phantom equity plans); or

\(c\) the plan structure involves the use of a trust to hold securities or financial products.

In some cases, it may be possible to seek case-by-case relief from ASIC. However, this is subject to ASIC policy and is often granted in only limited circumstances. As a result, entities generally structure their incentive arrangements to avoid the need to comply with the AFSL regime. In situations where, for example, a trust-holding arrangement is desirable for other reasons,\(^4\) listed entities at least tend to make use of a dedicated AFSL holder who is licensed to provide the relevant services.\(^5\)

**On-sale of securities**

The on-sale of securities or financial products by executives (e.g., the sale of shares acquired under an equity incentive plan) attracts a number of differing regulatory requirements. In brief, these include:

\(a\) insider trading: executives will need to be particularly mindful not to breach insider trading laws by selling securities or financial products when they have materially price-sensitive non-public information.\(^6\) Insider trading attracts serious penalties and is an area of particular focus for ASIC;

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23 Corporations Act 2001 (Cth), Section 761D.
24 Corporations Act 2001 (Cth), Section 911A.
25 Generally, this is implemented for taxation or accounting reasons, but also attracts some practical benefits for publicly listed companies.
26 Notably, the professional share registry and custodial service providers generally provide this service.
secondary sales disclosure: the on-sale of securities or financial products acquired under disclosure exemptions to a person or entity in Australia within 12 months of the issue of the securities may also be subject to disclosure and licensing requirements under the ‘secondary sale’ provisions of the Corporations Act;²⁸

share-trading policies: ASX-listed companies are required to have in place share-trading policies that regulate trading in its securities (including equity-based remuneration) by executives. Under share-trading policies, executives will be required to comply with fixed ‘trading windows’ during which executives can trade in securities, and ‘closed periods’ during which they cannot;²⁹ and

continuous disclosure requirements: ASX-listed entities (and directors) must comply with the continuous disclosure obligations in the Corporations Act and ASX Listing Rules.³⁰ These require disclosure of ‘notifiable interests’ held by directors and trades made by directors in the securities of their own entities within short prescribed time periods. The obligation for compliance is imposed on the entity by the ASX Listing Rules and the director under the Corporations Act.

Regulation of termination benefits

It is important to note that some equity plans can activate the restrictions on termination benefits³¹ mentioned in Section IV.iv. This can occur when the equity plan either accelerates vesting of equity benefits on cessation of employment or the employer exercises a discretion to allow the executive to retain an incentive (such as shares, options and bonus rights) when the executive ceases employment and would otherwise have forfeited those rights.

VI DISCLOSURE

i Annual reports

Companies, registered schemes and other disclosing entities must prepare annual financial reports and directors’ reports, unless exempted.³² Listed entities must include a remuneration report that sets out prescribed details regarding the company’s remuneration arrangements.³³ Particular emphasis is being placed on remuneration reports in the Australian market, with proxy advisers, institutional shareholders and shareholder associations all paying close attention to both the quality of disclosure and the settings of remuneration policies.

ii The ‘two strikes’ rule

The Corporations Act contains a ‘two strikes’ rule, which aims to provide shareholders of listed companies with greater control over high executive remuneration.

²⁸ Corporations Act 2001 (Cth) Sections 707(3)–(4) and 1012C(6)–(7).
²⁹ ASX Listing Rules 12.9 to 12.12.
³⁰ ASX Listing Rule 3.19A; Corporations Act 2001 (Cth), Section 205G.
³² Small proprietary companies are exempt from the requirement to prepare reports unless they are directed otherwise or have been controlled by a foreign company, and small companies limited by guarantee are exempt unless they are directed otherwise: Corporations Act 2001 (Cth), Section 292.
³³ Corporations Act 2001 (Cth), Section 300A.
Under the ‘two strikes’ rule, listed companies must put the remuneration report to their shareholders for a non-binding approval vote at the annual general meeting (AGM).\(^{34}\) If 25 per cent or more of eligible votes are cast against the remuneration report at two consecutive AGMs, the company must put a spill resolution to shareholders.\(^{35}\) If 50 per cent or more of the eligible votes are in favour of the spill resolution, the company must convene a spill meeting where all directors, except the managing director, may be dismissed by shareholder resolution and new directors appointed.\(^{36}\)

This rule continues to receive large amounts of media attention, with corresponding levels of criticism from some segments of the business community. It has undoubtedly increased the focus of listed companies on the adequacy of their remuneration reports and remains contentious.

VII CORPORATE GOVERNANCE

i ASX Listing Rule approval requirements

ASX-listed entities are subject to numerous shareholder approval requirements related to executive remuneration. Most notably, shareholder approval is required for the following:\(^{37}\)

\[a\] issuing of equity securities to directors and other related parties, other than in excepted situations;
\[b\] increasing the total amount of directors’ fees to its non-executive directors; and
\[c\] providing termination benefits to officers that in aggregate exceed 5 per cent of the value of the equity of the entity.

ii Corporate governance principles

In 2014, the ASX Corporate Governance Council published a revised set of non-binding principles and recommendations for good corporate governance. In relation to remuneration they contain recommendations regarding:

\[a\] remuneration committees, their composition and their operating processes;\(^{38}\)
\[b\] reporting separately on an entity's policies and practices regarding the remuneration of non-executive directors and the remuneration of executive directors and other senior executives;\(^{39}\) and
\[c\] the requirement that entities have a written policy with respect to hedging the risk of participating in equity-based remuneration schemes.\(^{40}\)

Although the principles and recommendations are non-binding, ASX-listed entities are required to report on their compliance with the ASX Corporate Governance Principles and explain the reason for any departures.\(^{41}\)

\(^{34}\) Corporations Act 2001 (Cth), Section 250R(2).
\(^{35}\) Corporations Act 2001 (Cth), Sections 250U to 250V.
\(^{36}\) Corporations Act 2001 (Cth), Sections 250V and 250W.
\(^{37}\) ASX Listing Rules 10.11 to 10.19.
\(^{39}\) Recommendation 8.2, ibid.
\(^{40}\) Recommendation 8.3, ibid.
\(^{41}\) ASX Listing Rule 4.10.
VIII SPECIALISED REGULATORY REGIMES

ASX-listed entities are subject to additional regulation that does not apply to unlisted companies. This occurs under the Corporations Act 2001 (Cth) and ASX Listing Rules, and is discussed in Sections V, VI and VII herein.

IX DEVELOPMENTS AND CONCLUSIONS

Executive remuneration continues to be an area of high scrutiny, for listed companies in particular. The Australian market is vigilant and aware of remuneration-related issues, and these are frequently matters of political intervention and public commentary. With the introduction of the ‘two strikes rule’, ASX-listed companies are more focused than ever on communicating with stakeholders on matters of executive remuneration.
I INTRODUCTION

Brazil’s employment law has been a matter of extensive debate in Congress in recent months. Brazil’s Labour Reform (Law No. 13,467) (the Labour Reform) came into effect on 11 November 2017. The Labour Reform is extensively changing the Brazilian Labour Code (CLT) and, as a result, companies are reviewing their employment relations in Brazil, especially with regard to executive remuneration.

The Labour Reform will have an impact on interpretation of social security taxes upon awards granted by the employer, which may encompass some share-based payments.

From an industry perspective, the financial industry remains the only one to have a regulation to guarantee a balance between long-term results and the sustainability of the business.

II TAXATION

i Income tax for executive employees and non-employees

Earnings that arise from compensation obtained in Brazil by executive employees and non-employees are subject to individual income tax in the form of withholding tax (WHT), at progressive rates up to 27.5 per cent, as indicated below (for calendar year 2017):

<table>
<thead>
<tr>
<th>Monthly earnings (reais)</th>
<th>Rate (%)</th>
<th>Deductible from income tax (reais)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Up to 1,903.98</td>
<td>–</td>
<td>–</td>
</tr>
<tr>
<td>From 1,903.98 to 2,826.65</td>
<td>7.5</td>
<td>142.80</td>
</tr>
<tr>
<td>From 2,826.65 to 3,751.05</td>
<td>15</td>
<td>354.80</td>
</tr>
<tr>
<td>From 3,751.05 to 4,664.68</td>
<td>22.5</td>
<td>636.13</td>
</tr>
<tr>
<td>Above 4,664.68</td>
<td>27.5</td>
<td>869.36</td>
</tr>
</tbody>
</table>

Some incentive share-based plans offered to executive employees and non-employees have the nature of compensation, and thus the individual taxation will follow the progressive rates mentioned above. However, if not, the gains obtained will be subject to income tax on capital gains according to the chart below:2

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1 Isabel Bueno and Dario Abrahão Rabay are partners and Francisco A Coutinho is an associate at Mattos Filho Advogados.
2 Rates applied from 1 January 2017, according to Law No. 13,259, enacted on 16 March 2016. Until 31 December 2016, the sole tax rate was 15 per cent.
Whether a long-term share-based incentive is part of the compensation depends upon the analysis of each case, verifying that three conditions are met:

- the participant accepts such granting as an investment opportunity, separate from his or her employment relationship;
- the participant has to contribute with his or her own financial assets to acquire shares, or exercise the options; and
- the corresponding investment must be subject to common market value fluctuations.

In principle, if the plan is characterised as compensation, the following tax treatment should apply:

<table>
<thead>
<tr>
<th>Capital gain (reais)</th>
<th>Tax rate (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Up to 5 million</td>
<td>15</td>
</tr>
<tr>
<td>From 5 million up to 10 million</td>
<td>17.5</td>
</tr>
<tr>
<td>From 10 million up to 30 million</td>
<td>20</td>
</tr>
<tr>
<td>Above 30 million</td>
<td>22.5</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th></th>
<th>Option</th>
<th>Restricted stock</th>
<th>Restricted stock unit (promise to deliver stock in the future)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tax treatment upon grant?</td>
<td>No taxation</td>
<td>No taxation</td>
<td>No taxation</td>
</tr>
<tr>
<td>Tax treatment upon vesting?</td>
<td>No taxation</td>
<td>No taxation</td>
<td>No taxation</td>
</tr>
<tr>
<td>Tax treatment upon delivery?</td>
<td>WHT and social taxes due by employee and company</td>
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</tr>
<tr>
<td>Tax treatment upon sale of underlying shares?</td>
<td>Income tax on capital gain</td>
<td>Income tax on capital gain</td>
<td>Income tax on capital gain</td>
</tr>
</tbody>
</table>

If, however, the long-term incentive does not qualify as compensation the tax treatment is as follows:

<table>
<thead>
<tr>
<th></th>
<th>Option</th>
<th>Restricted stock</th>
<th>Restricted stock unit (promise to deliver stock in the future)</th>
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<tbody>
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<td>No taxation</td>
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</tbody>
</table>

As mentioned before, the employment law reform may affect the taxation of share-based payments if they have the nature of an extraordinary award granted by the employer to the employee. In this case, a tax exemption of the social security tax may be applicable, considering that the employment law reform created a specific exemption in the tax law for this case.

Whether a share-based payment will qualify as an extraordinary award depends on a case-by-case analysis: not only the regulations of the specific shared-based payment but also the context in which this award was granted, the number and the qualification of the employee or group of employees that perceived it, and the amounts involved.

From our experience, we can assure that tax authorities will contest the social security tax exemption, to claim that this award had a compensatory nature and therefore is subject to
taxation. This is reason enough to be very cautious about what can be considered as an award in each company. Questions arise and are still a matter of discussion among employment and tax lawyers: can a retention bonus qualify as an extraordinary award? Does the company need to have a formal policy to regulate conditions for granting extraordinary awards to a single employee or a group of them? If yes, would they qualify, as something granted by the employers’ will or would they have the nature of a bonus for targets achieved by employees (case in which no exemption would apply)?

In the upcoming years jurisprudence will interpret this modification of the award payment in legislation and we will envision to what extent the employment law reform influenced executive compensation.

### ii Social taxes for employees

The two main sources of financing for social security and welfare systems are:

- **a** the contributions of the employer that are payable on the payroll and on other earnings from employment; and
- **b** the contributions of the employee or non-employee.

Foreign employees and any other persons that render services in Brazil to Brazilian companies, being duly compensated for these services, will also contribute to the social security or welfare system (as well as the respective companies to whom their services are rendered).

The average social tax rate payable by the company on compensation to employees is 20 per cent. In addition to this rate, percentages are added that are intended to cover the costs of occupational accident insurance and contributions to social security services that are specific to each activity carried out by the company. The average rate resulting from these additions is 28.8 per cent, a figure that may vary according to each company’s line of business.

In the case of executives (non-employee administrators, executive officers and board members), the social tax rate payable by the company is 20 per cent on the total compensation paid, with no additional contributions as above.

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3 Eventually, social security contributions could be due on gross income for specific economic sectors (according to Law No. 12,546/2011 and subsequent).

4 There may be variations in this rate depending upon certain factors, such as the business carried on by the company, the degree of risk of occupational accidents (according to the accident records of the company), and others.

5 The common management structures of Brazilian companies do not have exact equivalents in common law countries such as the United States. Taking the example of a Brazilian SA, which is the approximate equivalent of a classic US corporation, its management is divided between two different bodies: the board of administration and the executive management. The board of administration is the rough equivalent of a board of directors of a US company, whose members (‘administrators’) are chosen by the shareholders and appointed for fixed terms. The executive management is responsible for the day-to-day management of the company, whose members (‘executive officers’) are appointed by the board of administration, and no more than one-third of the board of administration may be executive officers. In addition to the foregoing, it is also common for companies to have additional executives that are employees not appointed by the board of administration, but who nonetheless exercise the typical duties of executive officers (‘non-statutory officers’). Some companies also feature boards of compliance.
The employee’s contribution is calculated by applying the corresponding rate to the monthly contribution salary, on a non-cumulative basis, according to the following table (in force as of 1 January 2018):

<table>
<thead>
<tr>
<th>Contribution salary (reais)</th>
<th>Rate (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Up to 1,693.72</td>
<td>8</td>
</tr>
<tr>
<td>From 1,693.73 to 2,822.90</td>
<td>9</td>
</tr>
<tr>
<td>From 2,822.91 to 5,645.80</td>
<td>11</td>
</tr>
</tbody>
</table>

The contribution of an administrator or an executive officer who is not an employee is calculated according to the following table:

<table>
<thead>
<tr>
<th>Contribution salary (reais)</th>
<th>Rate (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Up to 954.00</td>
<td>11</td>
</tr>
<tr>
<td>From 954.00 to 5,645.80</td>
<td>20</td>
</tr>
</tbody>
</table>

Legislation provides for numerous specific exemptions from social taxes, which include:

a. social security benefits, under the conditions and within the limits of the law, except for maternity leave salary payments;
b. one-off allowances received exclusively as a result of a change in the working location of an employee;
c. the amount of contributions actually paid by the legal entity in respect of a complementary pension programme, whether open or closed, provided that it is available to all its employees and managers; and
d. amounts relating to medical or dental care, whether in-house or contracted by the company, provided that cover is provided for all the employees and managers of the company.

Payments not specifically mentioned as being exempt, however, should be interpreted as being subject to social tax on a case-by-case basis.

### iii Tax deductibility for employers

The fixed monthly compensation of non-employees is a deductible expense for the employer, while variable compensation is not, except for the expenses of share-based plans.

According to Law No. 12,973/2014, the expenses related to share-based plans are deductible from the corporate income tax (CIT) calculation basis, and this includes the variable amount related to the non-employees by means of the provision of a specific regulation enacted by the Brazilian Internal Revenue Service (BIRS). Companies can deduct the respective expense at the moment of payment of the corresponding amount of the share-based incentive or at the moment the shares are delivered.

Compensation paid to employees, including variable amounts (paid according to profit-sharing plans and share-based incentives) are deductible from the CIT calculation basis.

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6 BIRS Normative Instruction No. 1,700/2017, Article 161.
iv Other special rules

There are no special tax rules affecting compensation or incentive plans applicable in cases of a change in control of a company.

In the specific case of social security tax, health plans or life insurance to all employees and managers, the expense of such benefits is not included in the base for calculating social contribution tax, as explained above.

For corporate tax purposes, the rules do not provide for special cases; if a benefit is granted to all employees and managers without distinction, the expense will be deductible for tax purposes.

III TAX PLANNING AND OTHER CONSIDERATIONS

The tax authorities oppose any type of tax planning that is intended to conceal an employment relationship or to minimise tax payments. In theory, Brazil is not an attractive location for an executive to change residence for tax purposes in an attempt to take advantage of tax planning based upon the application of treaties.

Although Brazil accepts the principle of taxation on a worldwide basis, compensation received by an executive before becoming resident in Brazil for tax purposes is not subject to Brazilian tax. Once the executive becomes resident for tax purposes, however, compensation received abroad is taxable in Brazil.

IV EMPLOYMENT LAW

Brazil’s Labour Reform (Law No. 13,467) came into effect on 11 November 2017. The Labour Reform is extensively changing the CLT, and, as result, companies are reviewing their employment relations in Brazil, especially with regard to executive remuneration. The Labour Reform will make the Brazilian labour framework more flexible in favouring negotiation between companies and their executives.

The Labour Reform set out a meaningful change in the CLT by amending or adding more than 100 sections. The employees’ fundamental rights guaranteed by Federal Constitution were maintained with no amendments, and some changes aim to favour negotiation between the parties, by means of collective bargaining agreements or through direct negotiation with the workforce.

One of the most important changes is the prevalence of collective bargaining agreements to prevail over the employment laws regarding several matters. Currently, the Labour Reform presents an exhaustive list of matters that cannot prevail over the laws, which, by the reverse, authorises the negotiation on any matter that is not on that list.

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7 The Labour Reform is changing the CLT to include Section 611-B. Section 661-B states that it is forbidden to suppress or reduce the following rights: (1) the rules for professional identification; (2) the unemployment insurance in case of involuntary dismissal; (3) the value of the monthly deposits and severance indemnity of the Severance Fund (FGTS); (4) minimum wage; (5) nominal value of the thirteenth salary; (6) remuneration of night work higher than that of daytime work; (7) protection of the salary (its wilful retention is a crime); (8) a social benefit called ‘family-salary’; (9) weekly paid rest; (10) remuneration of overtime at least 50 per cent higher than regular hours; (11) number of vacation days; (12) vacation bonus of one-third over the salary; (13) maternity leave with a minimum duration of 120 days; (14) paternity leave; (15) protection of the labour market for women, through specific
In addition, if an executive with a university degree and a monthly salary higher than double the ceiling for social security contributions purposes (around US$4,000 per month) enters into an agreement with an employer regarding labour and employment matters not prohibited by the exhaustive list of matters that cannot prevail over the laws mentioned above, this agreement shall prevail not only over the employment laws, but also over collective bargaining agreement.

Therefore, executives may enter into agreements directly with their employees in order to negotiate several employment matters, including to grant full release. Such matters, however, must be reviewed on a case-by-case basis.

Furthermore, there will be another important change in executives’ remuneration. According to the Labour Reform, the following items shall not be considered part of the executive’s compensation for tax and employment purposes, even if granted on the usual basis:

- any type of reimbursement;
- meal allowance, when granted in goods;
- travel allowances;
- awards (in goods or cash) discretionarily granted by the employer to the executive (or to a group of employees) as a result of an extraordinary performance; and
- medical and dental assistance even in the case of different plans and coverage for employees.

V SECURITIES LAW

Securities offered to employees generally do not need to be registered under Brazilian securities law, as this states that only public offerings must be previously registered with Brazil’s securities regulatory body, the CVM. In reviewing an inquiry submitted by a company wishing to offer shares to its employees, the CVM stated that an offer is deemed ‘public’ if it is directed to the general population; an offering made to a company’s employees would be not characterised as a public offering and is thus exempt from registration.\(^8\) Under regulations applicable to the securities market, executives and members of any other statutory bodies that have technical or advisory duties in a public company must inform the company of any beneficial ownership of shares issued by the company itself, its parent or its subsidiaries (in the latter two cases, this requirement is applicable only to public companies), or trades or dealings in such securities. Securities owned by a spouse, partner or any dependants included in their annual income tax incentives; (16) prior notice proportional to the length of service, being at least 30 days; (17) standards of health, hygiene and safety at work provided for by law or by regulatory standards of the Ministry of Labour; (18) additional remuneration for strenuous, unhealthy or dangerous activities; (19) retirement; (20) insurance against accidents at work, paid by the employer; (21) statute of limitation; (22) prohibition of any discrimination regarding salary and admission criteria for disabled workers; (23) prohibition of night work, dangerous or unhealthy to minors under 18 years and any work under the age of 16, except as an apprentice, from the age of 14; (24) measures for the legal protection of children and adolescents; (25) equality of rights between the worker with permanent employment relationship and the occasional worker; (26) freedom of association of the worker, including the right to previously approve any collection or salary discount established in a collective bargaining agreement; (27) right to strike; (28) legal definition on essential or urgent services in the event of a strike; (29) taxes and other credits of third parties; (30) the provisions regarding protection of women, pregnant and nursing.

\(^8\) Legal opinion/CVM/SJU/No. 81/82.
returns or by companies directly or indirectly controlled by the latter should also be included in this notification, which must be made within five days of each trade, on the first business day after taking up a position, and when submitting documentation to register a company as publicly traded.

The company must send the aforementioned information to the CVM, and to the stock exchanges or organised over-the-counter market entities in which the company’s shares are listed for trading (if applicable) within 10 days of the end of the month in which the alteration of the positions held occurs, or of the receipt of a notice delivered by the executives and members of any other statutory bodies aiming at updating the information previously provided to the company, or in the month in which the aforementioned persons take up their positions. This information should be delivered on an individual basis and consolidated by body (executive management, board of administration, compliance board and committees). Consolidated data will be available to the public, but individuals’ details will not be disclosed.

Executives must comply with the blackout periods prior to the disclosure of any material act or fact to the market or the company’s quarterly or annual financial statements, provided that a trading policy previously approved by the company may allow certain transactions within the banned period. Such blackout provisions do not apply for the transfer of treasury shares to executives or the subscription of new shares by executives under a stock-based plan approved by the general shareholders meeting. In addition, Brazil’s Corporate Law states that, upon signing the official document on taking office, an executive officer or administrator of a public company must declare his or her holdings and state the number of shares, warrants, stock options and convertible debentures issued by the company and subsidiaries or by the same group.

Further, at the request of shareholders representing 5 per cent or more of a company’s shares, an executive officer or administrator must disclose the following data, inter alia, at an annual general meeting:

- The number of securities issued by the company or its subsidiaries, or by the same group, or purchased or disposed of, directly or indirectly, in the previous year;
- Stock options that have been granted or exercised in the previous year;
- Benefits or advantages, indirect or supplementary, received or being received from the company and affiliated companies, subsidiaries or members of the same group; and
- The conditions of employment contracts that have been signed by the company with the directors and senior management employees.

VI DISCLOSURE

Public companies, regardless of their size, are required to supply certain information concerning executive compensation, including the highest, lowest and average individual compensation of directors, officers and members of the audit committee.

Insofar as general meetings decide overall or individual amounts paid to directors and officers, including benefits and representation allowances, closely held companies will also eventually disclose details of compensation paid to their executives; usually, the information in the minutes of the general meeting, which must be filed on public record and are therefore available to the public, includes the overall compensation paid to directors and officers.

Information that must be disclosed by public companies includes:

- A description of compensation policy or practices for executives, statutory committees and audit committees, and risk, financial and compensation committees;
fixed and variable compensation, post-employment benefits, benefits due to termination of mandate, and stock-based compensation recognised in income statements for the past three fiscal years and scheduled for the current fiscal year, for directors, officers and members of the audit committee, grouped by body;

c the number of shares or quotas held, directly or indirectly, in Brazil or other countries, and other securities convertible into shares or quotas issued by the company, or its directly or indirectly controlled subsidiaries or companies under common control, of members of the board of directors, the executive body, or the audit committee, grouped by body, as of the closing date of the latest fiscal year;

d the amount of the highest, lowest and average individual compensation of members of the board of directors, the executive body and the audit committee, for the past three fiscal years; and

e a description of contractual arrangements, insurance policies or other instruments containing mechanisms for compensation or indemnification for directors and officers in the event of dismissal or retirement, stating the financial consequences for the issuer company.

Information need only to be disclosed for executives on a group basis.

Public companies, as well as large private companies, 9 must follow international accounting standards, and thus the value of options must be calculated at their fair value as of the grant date.

If shareholders holding 5 per cent or more of the stock of a public company so request, directors and officers must disclose to the general meeting the conditions of employment contracts that have been signed by the company with executive officers and senior management employees.

Finally, a copy of the share-based compensation plan used by public companies shall be disclosed to CVM and the market, even if the compensation plan is based on the equity interest of their controlling shareholder, controlled companies or companies under common control.

VII CORPORATE GOVERNANCE

Compensation for directors and officers of any joint stock corporation, whether publicly or closely held, irrespective of its size, is decided at the general meeting, and compensation should take into account responsibilities, time devoted to duties, competence and professional reputation, and the value of their services in the market. As a rule, there is no need for additional approvals.

The overall or individual amount is decided at the general meeting, and stock option plans and restricted stock plans must be approved at the general meeting.

Typically, the general meeting also decides the aggregate amount of compensation for administrators and executive officers and the board of directors allocates payments individually.

9 Pursuant to Article 3, sole paragraph of Law No. 11,638 of 28 December 2007, a large company is one or a group of companies under common control whose total assets in the prior fiscal year exceeded 240 million reais in value or whose annual gross income exceeds 300 million reais in value.
There is no law requiring approvals from governmental authorities, labour unions or works councils, but if a rule exists in a collective labour agreement or collective bargaining agreement it will be considered mandatory, and approval will be required.

Compensation must be decided annually. If compensation paid to directors and officers exceeds the amount approved by the shareholders at a shareholders’ meeting, the company may hold to account the directors and officers who authorised payment to be made in amounts that exceeded the limit set.

VIII SPECIALISED REGULATORY REGIMES

Financial institutions and similar entities are subject to specific rules, which stipulate that at least 50 per cent of variable compensation must be paid in shares or share-based instruments, compatible with the creation of long-term targets and the acceptable time frame for risk. Financial institutions and similar entities may also be required to have a statutory compensation committee, comprising at least three members, at least one not being a member of the company’s management team, which should report to the board of directors.

These rules apply to financial institutions and other institutions authorised to operate by the Central Bank of Brazil, except for credit unions and entities lending to micro and small businesses, and managers of purchasing consortiums. They apply only to administrators and executive officers, and the Central Bank of Brazil is in charge of implementing or overseeing them.

IX DEVELOPMENTS AND CONCLUSIONS

Employment aspects

Brazil’s Labour Reform that came into effect on 11 November 2017 has extensively changed the Brazilian employment laws with a substantial impact on executives’ remuneration.

The Labour Reform has been helping the parties involved – companies and executives – to reach an equilibrium in their employment relations, both during the employment contract and after its termination. This surely brought more certainty to companies, also in respect to the appropriate taxation upon rights negotiated.

The Labour Reform allowed a more direct negotiation between the companies and their executives with a lower risk in case of the agreements are challenged before Labour Courts.

However, to the extent that the Labour Reform changed several employment dispositions of the Brazilian Labour Code and created new standards, Brazilian Labour Courts continue to construe the understanding around these changes, so new judicial precedents may be developed concerning these matters.
Chapter 3

DENMARK

Morten Skjønnemand, Lars Fogh and Ditte Grundtvig Larsen

I INTRODUCTION

Many aspects of the Danish regulatory regime and applicable restrictions will depend on and refer back to a basic distinction in Danish employment law, namely whether the executive in question is subject to the Danish Salaried Employees Act.

In general, only executives who hold an independent overall management position in respect of the day-to-day affairs of the company and in general those who are registered as part of the management branch of the two-tier management system generally applied by Danish companies (registered executive management) are exempt from the provisions of the Salaried Employees Act.

The distinction appears in many aspects of the regulation referenced below. Notably, executives who are subject to the Salaried Employees Act will also enjoy the protection afforded by the Danish Stock Options Act, restrictive covenants undertaken by them will be subject to the Danish Employment Clause Act, and their remuneration will not be subject to the approval requirements of the Danish Companies Act.

II TAXATION

i Income tax for employees

Employees, whether executives or registered executive management, resident in Denmark for tax purposes are taxed on their remuneration as personal income. Employees resident in Denmark are fully liable for taxes on their global income. Non-resident employees may be subject to limited tax liability if they perform services in Denmark.

Personal income tax is levied on a net-income principle, meaning that taxes are levied after deduction of relevant qualifying costs spent on obtaining and securing the income.

1 Morten Skjønnemand is a partner, and Lars Fogh and Ditte Grundtvig Larsen are associates at Gorrissen Federspiel.
3 Consolidation Act No. 309 of 5 May 2004.
4 Act No. 1565 of 15 December 2015.
5 Consolidation Act No. 1089 of 14 September 2015.
6 Consolidation Act No. 1140 of 26 September 2017.
Income is generally taxed when the employee obtains a final legal right to the income. However, if payment is delayed, the tax liability can be postponed for up to six months. At what point a legal right is obtained depends on the underlying agreement or applicable legislation. If the award of taxable income is subject to suspensory conditions, the time of taxation may be deferred.

Personal income is taxed at up to 56.5 per cent (2018) including a mandatory labour market contribution (8 per cent). All employees over 18 years have an annual personal allowance in their personal income of 46,000 kroner (2018), which is exempt from tax.

Capital gains on shares up to 52,900 kroner (2018) are taxed at a rate of 27 per cent, while sums exceeding this are taxed at 42 per cent. These rates are under continued political review with the intention of lowering the applicable rates.

Generally, personal income consists of cash remuneration including cash bonuses, benefits (e.g., company car, telephone, internet and newspaper), shares and options. Severance pay made as a result of termination of employment is, with a few modifications, taxed as personal income.

As a general rule, remuneration received in the form of shares, options, warrants, etc., is taxed as personal income at up to 56.5 per cent (2018). The remuneration is taxed when the employee obtains a final legal right to it. However, there are two different schemes in place to allow for deferral of taxation or a reduced tax rate.

One scheme, applicable to all employees and members of the board of directors, allows for remuneration in options and warrants to be subject to a deferred tax payment so that taxes are not levied until the options or warrants are exercised. The income is still taxed as personal income. The employer can deduct the costs of such remuneration, as described in Section III.

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<td>Tax treatment upon exercise?</td>
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<td>Tax treatment upon sale of underlying shares?</td>
<td>Personal income tax up to 56.5 per cent</td>
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Under certain conditions employee share programmes may qualify for another more favourable tax treatment, which is described in the table below. Under this scheme taxation is both deferred and reduced to the capital gains rate.

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<td>Capital gains tax up to 42 per cent</td>
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</tr>
</tbody>
</table>

Under certain conditions employee share programmes may qualify for another more favourable tax treatment, which is described in the table below. Under this scheme taxation is both deferred and reduced to the capital gains rate.
To qualify for this tax treatment a number of conditions must be met. These include the following:

a The tax scheme only applies to employees rendering personal services in an employment relationship. Members of the board of directors, consultants, etc., are not considered employees under the scheme.

b The remuneration must consist of shares, share options or share warrants and must be granted to the employee personally. Thus, the employee cannot receive the shares, etc., through a holding company.

c The awarded shares, etc., may not constitute a separate class of shares (i.e., the granting company cannot create a separate class of shares specifically for employees under the scheme).

d The discount value (benefit) of the shares, etc., may not exceed 10 per cent of the employee's annual total remuneration. However, if it is a general scheme for the employees, the discount value (benefit) of the shares, etc., cannot exceed 20 per cent of the employee's annual total remuneration.

The discount value (benefit) of shares, etc., is calculated differently depending on the type of remuneration and the terms of the share award plan. The discount value is assessed at the time when the actual exercise price or purchase price is known and at the latest when the employee obtains a final legal right to the shares, etc.

ii Social taxes for employees

Generally, all social contributions are included in taxpayers' income taxes. This includes the above-mentioned mandatory labour market contribution, which, unlike income taxes, is levied on the gross income. In addition, employees and employers pay a minor amount annually to a mandatory labour market pension scheme.

The employer is required to include the value of share and cash remuneration in the basis for payroll taxes.

iii Tax deductibility for employers

The general rule for deductibility of costs is that Danish companies can deduct costs incurred to acquire, secure and maintain the income. Costs related to remuneration that satisfy this criterion are consequently deductible. This includes bonuses and severance pay. No general distinction is made between ranks and titles regarding deductibility.

Dividends are not deductible. The employer can deduct an amount equal to the discount given to the employee in relation to shares, options and warrants. The deduction is made in the year in which the employer has incurred the costs (i.e., when the employee obtains a final legal right to the discounted value).

Costs related to employee share programmes under the most favourable tax scheme (see Section III) are specifically excluded from deduction by the employer.

iv Other special rules

Pension contributions made by the employer on behalf of the employee are under certain conditions tax free for the employee. Withdrawals from the pension scheme are taxed later on.

Benefits included in the employee's remuneration package are taxed as personal income. Generally, the value of these is set at the market value of the specific usage.

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Members of the board of directors are taxed personally on board fees and generally cannot allocate the fee to a company. Only in very special cases has allocation to a company been accepted by the Danish tax authorities.

III TRADE PLANNING AND OTHER CONSIDERATIONS

Under certain conditions, non-resident key employees can be recruited to work in Denmark, and become resident in Denmark for tax purposes and qualify for a preferential tax treatment. Employees who qualify for the scheme are taxed at an effective rate of 32.84 per cent including labour market contribution (2018). It is a gross tax and therefore no deductions are allowed in the income taxed under this scheme. The maximum period for taxation under the scheme is 84 months.

Only employees who have not been liable to pay taxes in Denmark for the past 10 years can qualify. The key employees are not allowed to have a controlling influence on the employer company and cannot hold more than 25 per cent of the share capital or 50 per cent of the votes in the employer company.

IV EMPLOYMENT LAW

i Severance terms

The Salaried Employees Act provides for statutory notice periods and a certain protection in case of termination of employment.

The notice to be given by the company can be up to six months to the end of a month depending on seniority. The executive may terminate the employment with one month’s notice to the end of a month, regardless of seniority. It may, however, be agreed in writing that a longer notice must apply, provided the notice to be given by the company is extended correspondingly. Such prolongation is commonly agreed for senior executives.

The Salaried Employees Act also provides for statutory severance pay. Accordingly, a salaried employee who has been continuously employed for 12 and 17 years is entitled to severance pay corresponding to one or three months’ salary, respectively, when the employment is terminated by the company.

A salaried employee who is dismissed without just cause, and who has been employed for at least one year at the time of dismissal, is entitled to compensation for unfair dismissal.

Provided the executive has reached the age of 30, the maximum compensation equals three months’ salary. The maximum compensation is increased to four and six months’ salary after 10 and 15 years’ seniority, respectively. Maximum compensation is seldom awarded.

Executives may also be entitled to certain severance terms provided by collective bargaining agreements, notably the managers’ agreement.

For registered executive management, both the length of the respective notice periods and the right to severance pay (if any) are based solely on agreement.

ii Right to bonus in connection with termination of employment

Under Danish employment law, variable remuneration is generally governed by two separate sets of rules: Section 17a of the Salaried Employees Act, and the Stock Options Act. Neither of these sets of rules applies to registered executive management.
Section 17a of the Salaried Employees Act applies to cash bonus schemes and provides that executives are entitled to pro rata bonuses for the bonus period in which termination becomes effective, irrespective of the fact that the employment ends during the bonus year or before the time of payment.

Bonus criteria presupposing that the executive is not under notice at the time of payment or employment during a full calendar year are generally not enforceable. Accordingly, an executive eligible for bonus whose employment ends during a financial year or before the time of payment is entitled to a pro rata share of the bonus he or she would have received if he or she had been employed at the end of the financial year or at the time when the bonus is paid – provided that applicable bonus targets are met.

The Supreme Court has confirmed, as assumed by practitioners, that the pro rata principle applies also to stay-on bonuses and the court has thereby resisted a possible tendency to materially modify such pro rata principle.

When calculating the length of employment, the entire notice period (including periods of garden leave) is included. The right to pro rata bonus applies irrespective of whether the employment is terminated by the company or the executive and irrespective of whether the termination is considered to be with just cause.

The Stock Options Act applies to stock option schemes where the time of the grant and the time of exercise are not identical. The act presupposes that the exercise of an option results in ownership of an actual share meaning that, for example, phantom shares are not governed by the Act.

Unlike Section 17a of the Salaried Employees Act, the Stock Options Act distinguishes between good-leaver and bad-leaver scenarios.

If the executive is considered a ‘bad leaver’, typically because the executive terminates his or her position to take up other employment or because the company dismisses or summarily dismisses the executive due to breach of employment, the executive will, as of expiry of the notice period, forfeit unexercised options and will have no right to be awarded further options.

If the executive is considered a ‘good leaver’, typically because the company terminates the employment for reasons other than the executive’s breach, the executive retains the options granted and the right to exercise these on applicable option terms. Further, the executive will, with certain modifications, be entitled to a pro rata share of the options to which the executive would have been entitled had the employment not been terminated.

iii Restrictive covenants

With the exception of clauses for registered executive management, the Employment Clause Act applies to all non-competition and non-solicitation clauses entered into on or after 1 January 2016. In order for the clauses to be valid and enforceable, they must comply with detailed information and compensation requirements.

Under the Employment Clause Act, only exceptionally trusted employees can be subject to non-competition clauses. Further, it is no longer possible to enter into non-poaching clauses in individual employment agreements. Non-competition and non-solicitation clauses entered into prior to 1 January 2016 in accordance with the previous rules will remain valid. Existing non-poaching clauses may be maintained until 1 January 2021, after which date they will become invalid.

The maximum periods allowed for non-competition and non-solicitation clauses are six to 12 months (after expiry of the notice period) and the executives are entitled to
compensation of 40 to 60 per cent of the remuneration during the period in which the clauses apply. Compensation for the first two months is fixed, however, as of the third month; the compensation will decrease to 16 or 24 per cent, respectively, if the executive commences other suitable employment.

For both registered executive management and executives, Danish law provides for a special rule on lapse of non-competition clauses. Accordingly, a non-competition clause becomes ineffective if the employment is terminated by the company without the executive having given just cause for such termination, or if the executive terminates the employment and the company’s failure to meet its obligations provides just cause for such termination. Non-competition clauses are therefore often combined with a non-solicitation clause, as such clause remains in force irrespective of the reason for the termination. Regardless of the lapse of the non-competition clause, an executive subject to the Employment Clause Act will be entitled to a minimum compensation.

V  SECURITIES LAW

After implementation of the Market Abuse Regulation, it is no longer a formal requirement for companies whose securities are listed on Nasdaq Copenhagen A/S (Nasdaq Copenhagen) to prepare internal rules for its members of the board of directors and employees trading in the company’s securities. The former requirements in this respect of the Danish Securities Trading Act and the Nasdaq Copenhagen Rules for Issuers have been repealed. The Nasdaq Copenhagen Rules for Issuers, however, still recommend that such internal rules are in place as a minimum, reflecting the Regulation rules on closed trading windows and considering whether further restrictions are relevant. It remains quite standard for Danish-listed companies to have such rules.

Members of the board of directors, registered executive management of listed Danish companies as well as higher-ranking executives, to be identified by the company based on their position, responsibilities and exposure to confidential information, are obliged to report their trading and that of their relatives in company securities. The transactions subject to reporting are those listed in Article 10 of Commission Delegated Regulation 2016/522. The methods for reporting are those set out in Commission Implementing Regulation 2016/523.

VI  DISCLOSURE

The Companies Act does not provide a general obligation on Danish companies to disclose executive remuneration. For listed companies (see below), a corporate governance recommendation applies to the effect that the company should disclose the individual remuneration of members of the board of directors and registered executive management. These rules are set to change when the implementation of Directive 2017/828 becomes effective.

For companies listed on Nasdaq Copenhagen, the rules applicable to issuers provide that the company must publicly disclose any decision to introduce a share-based remuneration programme for registered executive management and other employees, including the dilution effect of the programme. The disclosure is generally required to include specifics about:

a the types of share-based remuneration;

b the groups of persons encompassed by the programmes; and
timing, scope and total number of shares and the period within which the programmes can be exercised, along with strike price and information on conditions to be fulfilled under the programmes, and the aggregate market value of the share-based incentive programme.

The disclosure obligation relates to share-based and synthetic programmes and thereby also applies to cash or cashable programmes tied to the share price. The disclosure requirement is fulfilled by a company announcement. There is no requirement to publish plan rules or individual agreements or to summarise these in any greater detail.

The Danish Financial Statements Act provides that Danish companies encompassed by accounting class C and D must in their financial statement specify the aggregate remuneration, etc. for the financial year to current and former members of the board of directors and registered executive management, as well as any obligations to provide pensions for those groups.

If a separate incentive programme exists for members of the board of directors or the registered executive management, the category of members of the board of directors or executives encompassed, the type of remuneration and information necessary to determine the value thereof must be included.

Information shall be provided for the year of the financial statements and the previous year, but only on a functions level and not an individual level.

VII CORPORATE GOVERNANCE

The Companies Act contains the fundamental corporate rules for both private and public limited companies.

The Act states, inter alia, that the members of the board of directors or the supervisory committee, and registered executive management may receive either fixed or variable remuneration. Irrespective of form, the remuneration (1) cannot exceed an amount that is considered ‘ordinary’ with respect to the character and activity of the company, and (2) must be ‘financially reasonable’ with due regard to the company’s financial position. If the company is the parent company of a group, remuneration to registered executive management must be financially reasonable with due regard to the financial position of the group as a whole. These basic principles apply to all private and public limited companies.

When considering whether the remuneration is ‘ordinary’, reference can be made to what is being paid to registered executive management in comparable companies for similar management tasks. The requirement that any remuneration must be financially reasonable with due regard to the company’s financial position shall help ensure that the company has the resources to pay the specific remuneration, and that no payments to registered executive management are made to the detriment of the interests of the company’s stakeholders.

If a company is declared bankrupt, a statutory clawback provision entails that registered executive management must pay back any variable remuneration received up to five years prior to the date of declaration of bankruptcy, provided that the company was insolvent when the variable remuneration was determined. The clawback obligation applies even if variable remuneration was received in good faith.

7 Consolidation Act No. 1580 of 10 December 2015.
For public limited companies, additional requirements apply. Nasdaq Copenhagen has issued Rules for Issuers of Shares as last amended in January 2018. According to these rules, the company must specify the extent to which it complies with the Danish Recommendations on Corporate Governance or the recommendations on corporate governance that apply in the country where the company has its domicile. The Danish recommendations were issued by The Committee on Corporate Governance in 2013 and later amended in November 2014 and again in 2017. The recommendations are ‘soft law’. Companies may opt out of provisions in the recommendations according to a ‘comply-or-explain’ principle. The purpose of this principle is to ensure that all deviations from the recommendations are explained and made visible to the market, and to allow for flexibility in respect of the company’s specific circumstances. Accordingly, the recommendations are not directly enforceable, but for the companies listed on Nasdaq Copenhagen, the recommendations must be adhered to (unless the company has opted out). The comply-or-explain principle is also reflected in the Financial Statements Act.

The Recommendations on Corporate Governance contain ‘best practice’ recommendations for the board of directors and registered executive management of public listed companies; however, in practice the recommendations have a broader application as some non-listed companies choose to comply with some or all of these recommendations as well.

According to the recommendations, the company’s board of directors should appoint a remuneration committee to (1) recommend a policy on executive remuneration, including ‘General guidelines for incentive pay’ for all members of the board of directors and registered executive management, (2) make proposals for the remuneration of the board of directors and registered executive management and supervise compliance with the remuneration policy, (3) prepare the remuneration policy of the company, and (4) assist with preparation of the annual remuneration report.

If the company’s executive remuneration consists of variable remuneration in the form of incentive schemes it is a specific requirement according to the Companies Act that the company also adopts a provision in its articles of association stating that the company has adopted such policy on incentive schemes. The policy must be approved by the shareholders at the general meeting and made available on the company’s website stating the date of approval by the general meeting. Individual agreements to provide variable remuneration according to the policy cannot be entered into until the day after the approved policy has been made public on the company’s website. Otherwise such agreements will be deemed invalid. Amendments to existing agreements on executive remuneration that are not in accordance with the policy will also be deemed invalid.

With regard to the contents of the policy on executive remuneration with variable components, the Committee recommends, inter alia, that fixed limits are set on the variable components of the total remuneration, and that there is clarity about performance criteria and measurability for the variable components of the remuneration. Furthermore, it is recommended that it is ensured that variable remuneration shall not only consist of short-term remuneration components, and that long-term remuneration components must have a vesting or maturity period of at least three years. Variable remuneration should be based on realised results over an extended period so as to not incentivise short-term and risky behaviour. It is also recommended that variable remuneration is made subject to clawback in exceptional cases when payment has been made on the basis of information later shown to be inaccurate.
The Committee recommends that members of the board of directors are not paid with stock options or warrants. It is not contrary to the recommendations for members of the board of directors to receive shares in the company (at market value) as part of their executive remuneration.

If the company adopts a share-based executive remuneration programme, it is recommended by the Committee that rewards are granted periodically and should have a duration of at least three years from the date of grant before any subscription of shares or options can be exercised.

The recommendations also include a recommendation that the pay of each individual member of the board of directors and the registered executive management is specified in the company's financial statement.

Among Danish large and mid-cap companies, the level of compliance with the recommendations is above or around 90 per cent, while the recommendation concerning disclosure of individual remuneration is among the recommendations least complied with.

The recommendations also include a recommendation that the remuneration policy be revised and approved at the general meeting every four years and should be available on the company website. The information on remuneration of individual members of the board of directors and registered executive management is recommended to be formalised in a separate remuneration report, and it is recommended that such report also specify the key components of any retention and severance arrangements, see also Directive 2017/828.

VIII SPECIALISED REGULATORY REGIMES

Denmark has adopted rules to implement the EU Capital Requirements Directive IV. The rules are incorporated in the Financial Business Act. The rules are applicable to the financial sector broadly, including banks, insurance companies and securities businesses. The rules apply to the board of directors, registered executive management and employees deemed ‘risk-takers’ (MRT).8

The rules relate to financial businesses subject to Danish financial supervision. The key components of the limitations on remuneration are the following:

- Variable remuneration must not exceed 50 per cent of fixed remuneration (including pension) for the board of directors and registered executive management.
- Variable remuneration for MRTs must not exceed 100 per cent of fixed remuneration (including pension). The board of directors may under certain conditions apply an exemption and allow the variable remuneration to MRTs to amount to up to 200 per cent of fixed remuneration.
- No less than 50 per cent of variable remuneration must consist of a balanced mix of shares, share-based instruments, or other instruments (e.g., subordinated debt) reflective of the company's credit standing.
- Payment of not less than 40 per cent of variable remuneration (60 per cent if the amount is ‘substantial’) should be deferred over a three-year period commencing one

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8 Members of the broader executive group and employees in charge of key functions, including financial, legal, tax, HR and remuneration matters as well as employees who as a result of their function prepare or make decisions concerning the risk profile of the business.
year after the time of determination of the amount. For the board of directors and registered executive management, the deferral period is four years. The sequence of release of the payment may not be front-loaded.

c Clawback rules must apply if the company at the time of payment does not comply with capital or solvency requirements as applicable.

d For the board of directors and registered executive management, stock options and similar instruments must not account for more than 12.5 per cent of the fixed remuneration.

Appropriate lock-up provisions must apply to shares or instruments as successively released, and the recipient must not hedge the risk attached to such shares and instruments pending release.

The company must ensure that the criteria forming the basis for determination of the variable remuneration remain fulfilled at the time of payment, and that the recipients remain in good standing and have not been responsible for behaviour causing considerable losses for the company, and that the company’s financial situation has not materially deteriorated from the time of calculation of the variable remuneration.

IX DEVELOPMENTS AND CONCLUSIONS

The focus on remuneration for registered executive management of listed companies remains strong and the level of transparency is generally increasing also due to the Recommendations on Corporate Governance and the recent revisions thereto.

The Danish Ministry of Employment presented a bill to amend the Danish Stock Options Act on 27 June 2018. The stated purpose of the bill is to increase the freedom of contract when implementing option and warrant schemes. The suggested legislative changes entail, for example, abolishment of the current mandatory and non-mandatory rules governing good leaver and bad leaver regulation in case of termination of employment. It also includes provisions to ensure that, subject to certain conditions, the employer can buy back at market value shares that the employee has obtained through an option or warrant scheme. If the bill is passed in its current form, the changes will enter into force as of 1 January 2019. The bill is now in a phase of preparation and hearing of interested parties. It is expected that the bill will be subject to substantial debate and we currently consider it likely that material amendments will be made before the bill is passed.
EU OVERVIEW

Janet Cooper, Matthew Hunter and Stephen Penfold

I INTRODUCTION

The European Union (EU) has had its sights set on regulating executive pay for many years. Following the 2007–2008 global financial crisis, the Financial Stability Board (FSB) published ‘Principles for Sound Compensation Practices’ in April 2009 and ‘Principles for Sound Compensation Practices – Implementation Standards’ in September 2009. The EU, as a member of the FSB, quickly asserted that incentive arrangements were a significant factor motivating the excessive risk taking that allegedly led to the crisis, and introduced significant regulatory controls over pay in the financial services sector.

EU-wide regulation, as opposed to regulation on a national level, is intended to ensure a consistent approach throughout all Member States. The EU believes this is crucial due to competitive pressures in the financial services sector and the fact that many firms have cross-border operations. The initial focus of this regulation was on banks and investment firms. However, the EU has since expanded regulation to other subsectors, including asset managers and insurers.

Key developments regulating pay in the financial services sector include the:

1. Capital Requirements Directive (CRD) and Capital Requirements Regulation (CRR) (Section II);
2. Alternative Investment Fund Managers Directive (AIFMD) (Section III);
3. Undertakings for Collective Investment in Transferable Securities Directive (UCITS V) (Section III);
4. Solvency II Regulation (Section IV); and
5. Markets in Financial Instruments Directive (MiFID II) (Section V).

The EU has also published other requirements that impact on executive pay. These include share dealing rules under the Market Abuse Regulation (MAR) and corporate governance developments under the Shareholder Rights Directive (SRD) (Section VI).

EU requirements are highly detailed. This chapter is not intended to be comprehensive, but will instead alert you to relevant issues and trends that you should be aware of.

EU requirements that impact on executive pay are amended and updated from time to time. Potential updates of particular note are CRD V and CRR II (which are currently under negotiation – please see Section II for more details), which contain proposals aimed at tackling unequal pay in the financial services sector by mandating a gender neutral

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39
remuneration policy. Financial services firms may well find themselves subject to EU gender pay regulations in the future, in addition to the voluntary codes that currently exist (such as the Women in Finance Charter, which applies in the United Kingdom) and any individual Member State legislative requirements that may apply.

II RULES FOR CREDIT INSTITUTIONS AND INVESTMENT FIRMS

In 2010, the EU adopted CRD III. This Directive created the bulk of the rules that regulate remuneration of executives and material risk-takers in credit institutions and certain investment firms. The rules were based on the FSB principles and significantly changed how those firms pay their staff.

Further rules were added in CRD IV. One significant addition was a cap on the variable pay of material risk-takers to 100 per cent or, with shareholder approval, 200 per cent of fixed remuneration, known as the ‘bonus cap’. When CRD IV was introduced, the EU also adopted CRR to harmonise remuneration disclosure by CRD-regulated firms.

CRD and CRR rules must be read in conjunction with the ‘Guidelines on Sound Remuneration Policies’ published by the European Banking Authority (EBA) in June 2016. These guidelines clarify expectations under CRD and CRR and also impose additional rules. The guidance was mandated by CRD IV and applied from 1 January 2017.

i Scope

CRD and CRR apply to credit institutions and certain investment firms at group, parent company and subsidiary level, including those outside the EU. This means that the rules cover non-EU subsidiaries and branches of regulated EU firms, as well as EU subsidiaries of non-EU institutions.

CRD and CRR also apply to employees ‘whose professional activities have a material impact on their employer’s risk profile’ (‘identified staff’ or ‘material risk-takers’), that is, senior management, other risk-takers, employees in control functions and employees in the same remuneration bracket as senior management and risk-takers. In 2014, the EU published regulatory technical standards to clarify the identification of ‘material risk-takers’ under CRD and CRR. The technical standards use qualitative and quantitative criteria to identify staff.

A key concept of CRD is the ‘proportionality principle’. It is recognised that firms may apply the rules differently according to their size, internal organisation and the nature, scope and complexity of their activities. There is currently a lack of clarity on the application of the proportionality principle. Some Member States interpret the proportionality principle as enabling the disapplication of certain principles. However, the EBA disagrees with this application under the current drafting.

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3 Directives ‘direct’ Member States to implement national law to give effect to objectives set out in the Directive within a set time frame. National implementation can give rise to inconsistent implementation around the EU.
5 Regulation (EU) No. 575/2013. Regulations directly apply to Member States and do not require transposition into the laws of each Member State.
The EU Commission has published proposed revisions to the CRR and CRD IV in the form of CRR II and CRD V. CRR II and CRD V are currently subject to discussions within the EU legislative bodies and should be finalised by the end of 2018 in order to come into force in early 2019 (subject to a transition period to mid 2020). It is anticipated that the CRR II and CRD V will restrict the application of the proportionality principle.

The EU Commission also published legislative proposals in December 2017 for the Investment Firms Regulation (IFR) and the Investment Firms Directive (IFD) introducing a revised EU prudential framework for investment firms. The proposed IFR and IFD would together make changes to CRR, CRD IV and MiFID II with the aim that the changes would dovetail with CRR II and CRD V. The proposed IFR and IFD divide investment firms authorised under MiFID II into three categories, referred to as Class 1, 2 and 3 firms (Class 1 being systemically important investment firms, Class 2 being non-systemically important investment firms and Class 3 being small and non-interconnected investment firms). The proposal is that the remuneration requirements of Class 1 firms will be subject to CRD V and CRR II in full, with Class 2 and Class 3 firms being subject to somewhat less restrictive remuneration requirements.

ii Rules

CRD seeks to encourage effective risk management and avoid short-term gain at the expense of long-term results. CRD includes requirements that:

a there is an appropriate ratio between fixed and variable remuneration. This includes the ‘bonus cap’, which limits material risk-taker variable pay to 100 per cent or, with shareholder approval, 200 per cent of fixed remuneration. The approval requires acceptance by at least 66 per cent of shareholders who own 50 per cent of shares, or 75 per cent of votes if 50 per cent of shares are not represented, and the resolution must be subject to a range of notification formalities. When calculating the bonus cap, a discount can be applied up to 25 per cent of total variable remuneration, enabling more remuneration to be awarded, provided it is paid in instruments with deferral of at least five years;

b variable remuneration must be subject to risk adjustment and be fully flexible. This means that firms must be able to reduce variable remuneration if negative performance occurs;

c under no circumstances may the total variable remuneration limit the ability of a firm to strengthen its capital base;

d performance assessment must be set in a multi-year framework, ensuring that short-term performance will not have a considerable impact on the amount to be paid out;

e between 40 and 60 per cent of variable remuneration must be deferred. The appropriate deferral period depends on the impact that a relevant staff member may have on the firm’s risk profile as well as the total variable remuneration. The higher the total variable remuneration, the higher the minimum deferred percentage must be. In any case, deferral must be for at least three to five years and must be in line with the nature of the business, its risks and the activities of the relevant member of staff;

f at least 50 per cent of all variable remuneration must be delivered in the shares or share-linked instruments, equivalent non-cash instruments in the case of a non-listed

firm or, if appropriate, in any other instruments reflecting the credit quality of the firm.\textsuperscript{9} The 50 per cent minimum threshold must apply equally to each of the non-deferred and the deferred parts;

\textit{g} institutions must establish a retention policy for their up front and deferred instruments that aligns the employee’s incentives with the institution’s long-term interests;

\textit{h} variable remuneration should only be paid or vested if it is sustainable according to the financial situation of the firm. Firms must set up adjustment mechanisms, including \textit{malus} (arrangements that permit the institution to reduce unvested or deferred remuneration) and clawback (arrangements that require repayment of vested variable remuneration) where certain triggers occur;\textsuperscript{10}

\textit{i} guaranteed bonuses must be limited to the first year of employment and in the context of hiring new staff;

\textit{j} severance payments must reflect performance achieved over time and not be designed to reward failure;

\textit{k} staff must not use personal hedging or insurance to undermine the risk alignment effects of the rules; and

\textit{l} if an employee leaves before retirement, discretionary pension benefits should be held by the firm for five years in instruments linked to long-term performance, such as shares and share-linked instruments. For retiring employees, discretionary pension benefits should be paid in those instruments and also be subject to five-year retention.

The rules also cover general remuneration governance. These include requirements concerning remuneration policy, such that it must be consistent with and promote sound and effective risk management and not encourage risk taking exceeding the firm’s tolerated risk level, and the policy and its implementation must be subject to annual independent review. There are also rules concerning the remuneration of control functions, and a requirement for certain firms to have an independent remuneration committee.

The EBA guidance also provides for additional requirements, including a prohibition on the payment of interest or dividends on instruments that have been awarded as variable remuneration under deferral arrangements to identified staff. This includes a prohibition on paying such interest or dividends when the deferral period ends. The payment should instead be treated as received and owned by the firm. This is understood to have implications for the valuation of awards when considering the value of variable remuneration for the purposes of the bonus cap.

\textbf{iii Disclosure}

Substantive remuneration disclosure requirements are found in CRR. Relevant firms must publicly disclose remuneration information at least annually. The disclosure may be a stand-alone report or be included in the firm’s annual report. The disclosures are qualitative and quantitative.

\textsuperscript{9} The European Commission has confirmed in a recent report (COM(2016) 510) that it deems it appropriate for listed institutions to use share-linked instruments instead of shares, and legislative proposals have been made for CRD V to make this permissible.

\textsuperscript{10} Minimum triggers include where the staff member (1) participated in or was responsible for conduct that resulted in significant losses to the firm, or (2) failed to meet appropriate standards of fitness and propriety.
Qualitative disclosures include information about the decision-making process for determining remuneration policy, information about the link between pay and performance, and the most important remuneration design characteristics, including information on criteria used for performance measurement and risk adjustment, as well as deferral policy and vesting criteria.

Quantitative information is broken down by business area and identified staff category and includes:

a. amounts of fixed and variable remuneration;
b. amounts and forms of variable remuneration, split into cash, shares, share-linked instruments and other types;
c. amounts of deferred remuneration awarded during the financial year; and 
d. amounts of sign-on and severance payments awarded.

Firms must disclose numbers of individuals remunerated €1 million or more per financial year, separated into bands of €500,000, and for remuneration of €5 million and above, separated into bands of €1 million. Firms must also submit data regarding high earners and remuneration benchmarking\(^{11}\) to national authorities, who then forward the data to the EBA. Firms that maintain a website must explain on it how they comply with the CRD rules.

The EBA guidance clarifies the disclosure requirements but there is also additional guidance available.\(^{12}\)

### III \ RULES FOR ASSET MANAGERS

#### i AIFMD

Firms authorised to conduct regulated activities under AIFMD\(^{13}\) will be subject to the applicable remuneration rules implemented in 2013. AIFMD has to be read in conjunction with the ‘Guidelines on sound remuneration policies’ published by the European Securities and Markets Authority (ESMA) in February 2013. A minor amendment to the Guidelines regarding the application of the rules where the manager forms part of group was published in March 2016.

The remuneration rules apply to all alternative investment fund managers (AIFMs) authorised under AIFMD, that is, to all EU AIFMs that manage or market alternative investment funds (AIFs) regardless of whether they are EU or non-EU AIFs. This includes managers of hedge, private equity, venture capital, commodity, infrastructure and real estate funds. Like CRD, AIFMD applies to the remuneration of those categories of staff whose professional activities have a material impact on the risk profiles of the AIFMs or of the AIFs they manage, including senior management, risk-takers, control functions and employees in the same remuneration bracket as senior management or risk-takers.

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\(^{11}\) Guidelines on high earners cover all EEA-based institutions (non-EEA branches or subsidiaries are exempt), but guidelines on remuneration benchmarking only apply to selected significant institutions chosen by national regulators.

\(^{12}\) Guidelines on remuneration benchmarking (EBA/GL/2014/08) and Guidelines on the data collection exercise regarding high earners (EBA/GL/2014/07).

\(^{13}\) Alternative Investment Fund Managers Directive 2011/61/EU.
As with CRD, AIFMD rules are based on the FSB principles and are broadly the same, and so align with the CRD III/IV requirements. There are, however, key exceptions. For example, for AIFMD firms:

- there is no bonus cap;
- the minimum non-cash instrument requirement must be paid in units or shares of the AIF concerned, equivalent ownership interests, or share-linked instruments or equivalent non-cash instruments; and
- the deferral period for deferred remuneration must be linked to the life cycle of the underlying AIF.

Also, as with CRD, certain AIFMs must establish a remuneration committee. In terms of disclosure, any AIFM seeking to obtain authorisation under AIFMD must disclose details of its remuneration policies and practices to its national regulator, and must also annually disclose specific remuneration information for each EU AIF it manages and each AIF it markets in the EU.

ii UCITS

Remuneration requirements under UCITS V\(^{14}\) mirror corresponding requirements under AIFMD. The UCITS rules were implemented by March 2016. UCITS V bridges the regulatory disparity between AIFs and undertakings for the collective investment in transferable securities (UCITS) in Europe. ESMA published their latest guidelines on ‘sound remuneration policies’ under the UCITS Directive in October 2016.

The UCITS Directive applies to undertakings for collective investment in transferable securities. Like CRD IV and AIFMD, the UCITS Directive applies to remuneration of those categories of staff whose professional activities have a material impact on the risk profiles of the UCITS management company or of the UCITS that they manage, including senior management, risk-takers, control functions and employees in the same remuneration bracket as senior management or risk-takers.

Like CRD IV and AIFMD, the UCITS Directive remuneration rules are based on the FSB principles and contain substantially the same principles as CRD IV, with the exception that, for UCITS firms:

- there is no bonus cap;
- the minimum non-cash instrument requirement must be paid in units of the UCITS concerned, equivalent ownership interests, or share-linked instruments or equivalent non-cash instruments; and
- the deferral period is at least three years (as opposed to three to five years).

As with CRD IV and AIFMD, certain UCITS management companies must establish a remuneration committee. The UCITS Directive also requires certain disclosures: (1) a UCITS prospectus detailing remuneration policy, methods of remuneration calculation and information about those responsible for remuneration; (2) an annual report containing information about total remuneration for the financial year and material changes to remuneration policy; and (3) key investor information.

\(^{14}\) Undertakings for the Collective Investment in Transferable Securities Directive 2009/65/EC, as amended, in particular by Directive 2014/91/EU (UCITS V). UCITS V is a revision to UCITS regime and it aims to enhance investor protection within the UCITS framework.
IV RULES FOR INSURERS AND REINSURERS

Remuneration rules for insurance and reinsurance businesses are found in the Solvency II Regulation,\(^\text{15}\) supplementing the Solvency II Directive.\(^\text{16}\) The relevant European supervisory authority for the insurance sector, the European Insurance and Occupational Pensions Authority has provided guidance on corporate governance under Solvency II, including on the scope of remuneration policy and composition of remuneration committees.

Under the Solvency II Regulation, an insurance or reinsurance undertaking must adopt a written remuneration policy. When establishing and applying that policy, the undertaking must ensure the policy promotes sound and effective risk management and not encourage risk taking that exceeds the risk tolerance limits of the undertaking. The policy must apply to the undertaking as a whole and contain specific arrangements that take into account the tasks and performance of the administrative, management and supervisory body, persons who effectively run the undertaking or have other key functions, and other categories of staff whose professional activities have a material impact on the undertaking’s risk profile.

The remuneration provisions are not as stringent as under other regulations. However, there are wide-ranging requirements, including, but not limited to, creation of an independent remuneration committee, the requirement for an appropriate balance of fixed and variable remuneration, the measurement of performance-related variable remuneration based on the performance of the individual, the relevant business unit and the overall results of the undertaking, and a minimum deferral period of three years.

The Insurance Distribution Directive\(^\text{17}\) (IDD) came into force in February 2016 with the requirement that Member States transpose the IDD into local law to take effect from 1 October 2018. From October 2018, insurance distributors must not be remunerated, or remunerate or assess the performance of their employees, in a way that conflicts with their customers’ best interests. In particular, remuneration arrangements or sales targets must not provide an incentive to recommend a particular insurance contract where a different insurance contract is available that could better meet a customer’s needs.

V RULES FOR SALES INCENTIVES

A recent focus of EU regulation is sales incentives. In December 2016, the EBA published guidelines on remuneration related to the sale and provision of retail banking products and services. Shortly after, in 2017, the EU published a regulation\(^\text{18}\) supplementing MiFID II.\(^\text{19}\)

The regulation provides remuneration rules in relation to all persons who could impact service provision or firm corporate behaviour within firms providing investment services, including front-office, sales or other staff indirectly involved in providing investment or ancillary services. The MiFID II provisions and EBA guidance cover similar trends.

When providing sales incentives, firms should ensure that they:

a  do not remunerate or assess performance in a way that conflicts duties to act in the clients’ best interests;

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\(^{15}\) Commission Delegated Regulation (EU) 2015/35.

\(^{16}\) Directive 2009/138/EC.

\(^{17}\) Directive (EU) 2016/97.


\(^{19}\) Directive (2014/65/EU).
do not use remuneration structures or sales targets, etc., that could provide incentives to recommend a particular financial instrument to a retail client when the firm could offer a different financial instrument that would better meet the clients' needs; 

design and implement remuneration policies that have appropriate criteria to be used to assess performance, including qualitative criteria encouraging acting in clients' best interests; 

define and implement remuneration policies and practices under internal procedures that take account of the interests of all clients of the firm, ensuring clients are treated fairly and their interests are not impaired by remuneration practices adopted in the short, medium or long term; 

do not create remuneration policies that create conflict of interests or incentives that may lead relevant persons to favour their own interests or the firm's interests to the potential detriment of any client; and 

ensure that remuneration and similar incentives are not solely or predominantly based on quantitative commercial criteria, and instead take into account appropriate qualitative criteria reflecting compliance with applicable regulations, fair treatment of clients, and quality of services provided to clients.

The MiFID II rules also require that the management body approves the firm's remuneration policy, and that senior management takes responsibility for day-to-day policy implementation and for monitoring compliance risks.

VI  MARKET ABUSE REGULATION, CORPORATE GOVERNANCE AND DATA PROTECTION

i  MAR

MAR\(^{20}\) expands and develops the EU market abuse regime. The rules came into effect on 3 July 2016. Much of MAR focuses on general market abuse provisions, such as insider dealing or market manipulation. However, the rules also impact the operation of incentive plans. MAR includes notification and disclosure requirements for ‘persons discharging managerial responsibilities’ (PDMRs) working within issuers linked to EU regulated markets, and for ‘persons closely associated’ (PCAs) with a PDMR.

The rules include requirements for PDMRs and PCAs to notify the issuer and relevant competent authority within three days of every transaction conducted on their own account relating to shares or debt instruments, or linked derivatives, of that issuer. The issuer must notify the market within the same time period. The rules also provide for ‘closed periods’ during which PDMRs cannot deal in securities of the issuer, subject to limited exemptions.

ii  Corporate governance

The EU also has a strong focus on corporate governance. In 2007, the EU published the Shareholder Rights Directive (SRD).\(^{21}\) The SRD aims to improve corporate governance

\(^{20}\) Regulation 596/2014.  
\(^{21}\) Directive 2007/36/EC.
in EU companies traded on regulated markets by enabling shareholders to better exercise voting rights across borders. The rules cover a wide range of formalities for general meetings, including minimum notice periods, information requirements and voting rules.

The SDR was amended in June 2017, 22 requiring Member States to transpose the amendment into national law by 10 June 2019 (SDR II). SRD II establishes a range of corporate governance rules, including an obligation for companies to publish a directors’ remuneration policy subject to a shareholders’ vote. Member States may determine whether this vote is binding or advisory, but a vote must be held whenever the policy is amended and at least every four years. Companies must also publish a ‘clear and understandable’ directors’ remuneration report annually that is subject to an advisory shareholders’ vote.

### iii Pay equality

The EU remains interested in equal pay and gender equality. A report commissioned by the EU published in April 2017 23 shows initiatives taken by Member States to promote pay equality. Many Member States have started to introduce gender pay gap reporting, which (broadly speaking) places a requirement on firms caught by the reporting regulations to periodically publish data relating to the differences in the levels of pay between male and female employees. These Member States include Belgium, Denmark, France, Germany, Iceland, Sweden and the United Kingdom.

### iv GDPR

The EU General Data Protection Regulation 24 (GDPR) came into force on 25 May 2018. The GDPR gives individuals greater rights in relation to the processing of their ‘personal data’, and has widespread application wherever personal data processing takes place. Executive remuneration structures, particularly where trusts and nominee arrangements exist, or the structures are managed on behalf of employers by professional share plan administration companies, will be caught by the GDPR. Companies based in the EEA, or with employees in the EEA, should review their remuneration structures to ensure all personal data processing is compliant with the GDPR.

### VII CONCLUSION AND OUTLOOK

EU regulation of executive remuneration and corporate governance is evolving rapidly. Even though financial services has been the primary target, executive remuneration in all sectors is a sensitive and politically charged issue, as evidenced by the expansion of the rules and the proposed corporate governance requirements.

Good governance and robust pay structures can improve accountability, transparency and encourage more dialogue with shareholders. However, there can be unintended consequences, certainly as regards prescriptive regulation on financial services pay. Less regulated sectors, such as technology firms, have flexibility around how they pay their staff, enabling them to attract the most talented staff. To compete with these sectors, many

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24 (EU) 2016/679.
EU Overview

banks have significantly increased fixed pay to continue to offer competitive remuneration packages. In addition, some firms have supplemented salaries and bonuses with new forms of remuneration, including ‘role-based’ or ‘fixed-pay’ allowances, which the EU has acted to regulate.

The EU has probably the most prescriptive financial services remuneration rules in the world. Time will tell whether this has the EU’s intended impact of reducing risk in the sector, or whether it, along with other regulations affecting the sector, has the impact of significantly reducing jobs in the EU in this sector as they are redeployed elsewhere.

2018 and 2019 will see the introduction of CRD V, CRR II, IFR and IFD, which will have an effect on executive remuneration in the financial services sector. The final details of these pieces of legislation will soon become apparent.
Chapter 5

FINLAND

Johanna Haltia-Tapio, Lauri Lehmusoja and Anniina Järvinen

I INTRODUCTION

Remuneration of companies’ senior executives and the appropriateness of such remuneration has, over the past few years, been increasingly discussed in Finland. No important legislative amendments have been introduced, but tax authorities appear interested in reviewing tax-optimised incentive plans.

II TAXATION

i Income tax for employees

Residents and non-residents are treated differently for tax purposes. The worldwide income of persons resident in Finland is subject to taxation in Finland. Non-residents are taxed only on Finnish-sourced income. The applicable tax rates are also different.

Income from employment is considered to be Finnish-sourced income if the employer is a Finnish entity, and if the employment has been physically carried out in Finland completely or for the most part. Employment income is not Finnish-sourced (and hence not subject to tax if received by a non-resident) if the employer is a foreign entity. The same applies even in the case of a Finnish employer, if the work has mainly been carried out abroad. Remuneration paid to members in the board of executives of a Finnish company is taxable in Finland irrespective of whether the meetings have been held in Finland or overseas. It should be noted that Finland does not generally apply the economic employer approach, and the starting point is that foreign group companies of a Finnish company qualify as foreign employers under the aforementioned rules.

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1 Johanna Haltia-Tapio is a specialist partner, Lauri Lehmusoja is a counsel and Anniina Järvinen is a senior associate at Hannes Snellman.
2 An individual is deemed a resident of Finland if the permanent home and abode of such a person is in Finland or if such person stays in Finland for a continuous period of more than six months. A Finnish citizen who has moved abroad is considered to be a resident of Finland until three years have passed from the end of the year of departure, unless it is proven that no substantial ties to Finland existed during the relevant tax year.
3 A Finnish permanent establishment of a foreign entity is treated similarly to a Finnish entity in this respect. Specific rules apply with respect to the taxation of individuals employed by the Finnish government or other Finnish entities of public administration.
4 The assessment of whether the majority of the work has been carried out in Finland is made separately for each salary payment period (typically monthly).
The earned income of a tax-resident individual is taxed at progressive tax rates of up to approximately 55 per cent, while salaries paid to a non-resident are subject to a flat withholding tax of 35 per cent, if subject to tax in Finland. The capital gains and other capital income of a Finnish tax resident are taxed at rates of 30 per cent for capital income up to €30,000 and 34 per cent for capital income exceeding €30,000. Capital gains received by non-residents are in many cases exempt from Finnish taxation.

Generally, there is a broadly applicable substance-over-form principle in the Finnish taxation system, and progressive employment income taxation covers any payments regarded as compensation for employment. It is therefore difficult to structure a compensation plan in such a way that the compensation would qualify for taxation as capital income. Capital income taxation should be applicable only in genuine arm’s-length investments (e.g., in the employer company’s shares) by the employee.

Qualification of the executive share ownership under the capital income taxation regime has sometimes been sought through arrangements involving heavily leveraged holding companies. Such a holding company would be owned by the executives, often receiving loan funding from the employer company and investing in the employer company’s shares. Such management holding company arrangement by a listed company was, however, considered tax avoidance in a rather recent Supreme Administrative Court ruling leading to earned income taxation of the benefits received from the arrangement.

Taxable income is, as a main rule, triggered in the taxation of individuals when the income is paid to the individual or when the individual gains control over the income in question. Employees gain control over deferred income items, for example, when they have the opportunity to choose, upon salary payment, whether certain items are paid directly to them as cash payments or into deferred account arrangements. If there is no possibility to opt for a cash payment or otherwise dispose of the funds, a tax-effective deferral of the income item may be accepted, if properly structured and taxable income is triggered only at the point when the deferred income is paid to the employee.

<table>
<thead>
<tr>
<th>Option</th>
<th>Restricted stock</th>
<th>Restricted stock unit (promise to deliver stock in the future)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tax treatment upon grant</td>
<td>None</td>
<td>Fair market value at grant taxable as earned income at progressive rates*</td>
</tr>
<tr>
<td>Tax treatment upon vesting</td>
<td>None</td>
<td>None</td>
</tr>
<tr>
<td>Tax treatment upon delivery</td>
<td>Spread taxable as earned income at progressive rates</td>
<td>None</td>
</tr>
<tr>
<td>Tax treatment upon sale of underlying shares</td>
<td>Capital gains taxation at rates of 30–34%. Amount taxed as earned income deductible as acquisition cost</td>
<td>Capital gains taxation at rates of 30–34%. Amount taxed as earned income deductible as acquisition cost</td>
</tr>
</tbody>
</table>

* Typically, no possibility for downward adjustment, if the share price decreases.

5 However, it is possible under certain conditions for non-residents to request their earned income to be taxed at progressive tax rates instead of the 35 per cent flat tax at source.

6 It remains to be seen whether similar disputes will arise even in companies related to private equity funds, where similar co-investment arrangements have also been used. Carried interest paid in private equity fund context has in recent case law been considered to not constitute salary income – there were, however, some specific circumstances in the said cases and the outcome could hence be different in future cases if the circumstances differ.
ii Social taxes for employees

Persons covered by Finnish social security are generally subject to Finnish social security contribution obligations. Employees covered by the social insurance system of another state and seconded to Finland may be exempt from Finnish social security contributions. The contributions applicable to employment in Finland are uncapped. The currently applicable payment percentages are as follows (2018 figures):

<table>
<thead>
<tr>
<th>Employer</th>
<th>Healthcare charge</th>
<th>0.86%</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Pension insurance contribution in the average</td>
<td>17.75%</td>
</tr>
<tr>
<td></td>
<td>Accident insurance contribution in the average</td>
<td>0.80%</td>
</tr>
<tr>
<td></td>
<td>Unemployment insurance contribution</td>
<td>0.65–2.60%</td>
</tr>
<tr>
<td>Employee</td>
<td>Group life insurance contribution in the average</td>
<td>0.07%</td>
</tr>
<tr>
<td></td>
<td>Pension insurance contribution</td>
<td>6.35% (for employees who are 17–52 years of age or 63–67 years of age); 7.85% (for employees who are 53–62 years of age)</td>
</tr>
<tr>
<td></td>
<td>Unemployment insurance contribution</td>
<td>1.90%</td>
</tr>
<tr>
<td></td>
<td>Employee’s healthcare charge (included in tax withholding percentage)</td>
<td>0.00–1.53%</td>
</tr>
<tr>
<td></td>
<td>Employee’s daily allowance contribution (included in tax withholding percentage)</td>
<td>1.53%</td>
</tr>
</tbody>
</table>

Benefits from share-based incentive plans may in many cases be exempt from most social security contributions in Finland. This exemption may apply to benefits from an employment stock option plan or a phantom option plan. It may be applicable also to shares granted to employees, provided that the shares granted are listed on a stock exchange and there is a vesting period of at least one year between the promise of the award and the actual award of the shares to the employee.

iii Tax deductibility for employers

Costs accrued because of employment are generally fully deductible for the employer, even in cases where costs are a result of employment of the senior management of the company. The employment cost item is deductible in the corporate income taxation of the employer company in the tax year during which the work in question was carried out. The year of payment of the compensation item does not determine the tax year applicable to the deduction in the employer’s corporate income taxation.

Special rules govern deductibility of costs for shares used to settle share-based incentive plans, considerably limiting the employer’s right to deduct such costs. The issue of new shares to settle an incentive plan does not give rise to a deductible cost in the corporate income taxation of the Finnish employer company issuing the shares. If existing shares of the company are used to settle the benefits under the plan, a deduction may be available if the shares used have been obtained from the stock exchange. However, a recharge of costs of a

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7 The employee’s healthcare charge of 0.00–1.53 per cent is, however, always payable.
8 The social security exemption rules concerning a grant of shares to employees are somewhat less strict if shares have been granted to the majority of the company’s employees.
9 In cases where a deduction is available, there are, furthermore, specific rules limiting the maximum deductible amount.
share-based incentive plan paid by a Finnish employer company to a group company abroad operating the plan should, as a starting point, be fully deductible, regardless of whether new or existing shares of the foreign group company have been used.

iv Other special rules
There is a specific 35 per cent flat rate tax regime applicable to expert-level expatriates moving to Finland that may apply during the first 48 months of their stay in the country. The applicability of the regime has to be carefully planned, as a non-fulfilment of the technical requirements\(^\text{10}\) for qualifying may easily prevent the applicability. It should be noted that in contrast to the normal progressive taxation of employment income, no deductions are allowed under this regime.

Pension benefits of executives that exceed the mandatory pension cover are normally arranged by means of a collective pension scheme, which generally allows fairly flexible insurance terms and full deductibility of the pension insurance payments by the employer in calculating its corporate income taxation, while not triggering any taxable income to the executives prior to the payment of the pension benefits to them upon retirement. At least two persons must be covered by the pension insurance for this tax treatment to be applicable.\(^\text{11}\)

A voluntary health insurance taken by the employer for the benefit of employees generally gives rise to taxable income to insured employees unless the insurance covers all employees and offers all employees benefits at a similar, reasonable, level. Life insurance payments paid by the employer for the benefit of employees do not generally trigger taxable income for the employees if the insurance is purely risk insurance. Insurance payments made to a unit-linked life insurance policy constitute taxable income for the insured employee.

III TAX PLANNING AND OTHER CONSIDERATIONS
Personal service company arrangements and other similar structures are used to some extent in Finland in the tax-planning of remuneration paid to senior executives. There is, however, a quite well-established practice in Finland to pierce through minor consultancy firms and to tax the consultancy proceeds as the salary (or board fee, as the case may be) of the person carrying out the consultancy tasks in practice, if the arrangement is considered as de facto employment of the consultant by the client company. This may be the case especially if the person carrying out the consultancy tasks has previously been employed by the company purchasing the consultancy services, if the consultancy firm has no other clients of importance, or if the consultancy firm is very small. According to Supreme Administrative Court case law and tax

\(^{10}\) The requirements to qualify for the regime include a monthly cash salary of at least €5,800, a non-Finnish nationality of the employee in question and a specific application that has to be filed within 90 days of the beginning of employment in Finland. The actual paid cash salary has to meet the €5,800 threshold each month, which has to be taken into account, for example, when planning unpaid leave.

\(^{11}\) It should be noted that the tax benefits discussed above may be denied in case the arrangement has characteristics of tax avoidance or substituting taxable salary payments by means of pension insurance contributions, e.g., if the amount of the insurance payments made by the company is disproportionately high in comparison to the taxable salary paid to the executive. Granting additional pension benefits to executives may in some circumstances also include a negative publicity risk, as such arrangements have been scrutinised and viewed very critically in the Finnish press recently. The Finnish government has also issued a general guideline that no new additional pension benefit arrangements should be made to executives in state-owned enterprises.
authorities’ guidelines, remuneration for services as a CEO or a board member may not be accepted as income of a consultancy company, but it is personal earned income of the CEO or board member.

There may also be planning possibilities when determining the timing of the entry into Finland and the departure from Finland. According to the Finnish rules, the foreign income referring to the part of the year prior to the commencement of tax residence or after the cessation of tax residence enjoys full exemption and is not taken into account when determining the progressive tax rate applicable to the income taxable in Finland. A well-planned timing of arrival and departure may hence significantly cut the progressive tax rate applicable to the part of income taxable in Finland in the year of arrival or the year of departure. In addition, various split salary arrangements may offer planning opportunities if executives are working only a part of their working days in Finland and the other part, for example, in another Scandinavian country.

IV EMPLOYMENT LAW

i General

The Finnish Employment Contracts Act (ECA)\(^\text{12}\) is applicable to most employment relationships in Finland. Managing directors of limited liability companies are, however, excluded from the scope of the ECA. The terms of assignment for managing directors are determined by the service contract between the director and the company. In addition, the Companies Act regulates the managing directors’ position as an organ of the company. In practice, most of the agreed terms of assignment of managing directors do not, however, differ to a large extent from those of other executive directors.

The ECA provides for a loyalty obligation for employees, according to which employees must avoid everything that conflicts with actions reasonably required of an employee, considering the employee’s position. In addition, the ECA explicitly prohibits competing activities. During the term of employment, an employee must not work for other employers or engage in activities that would apparently cause harm to the employer as a competing activity contrary to fair employment practices. The nature of the work and the position of the employee are taken into account in this assessment. In the event of a breach of a non-competition obligation, the employer may claim damages from the employee for any losses caused by the breach. Furthermore, an employer may be liable to pay damages jointly with a new employee if the employer knew upon recruitment that the new employee was precluded from working on the basis of a non-competition covenant.

ii Non-competition and non-solicitation obligations

The ECA sets limits to non-competition undertakings applicable after expiry of employment. Under the ECA, a non-competition undertaking may limit the employee’s right after the end of the employment relationship to conclude an employment contract with an employer engaged in operations competing with the previous employer, and also to be otherwise engaged.

\(^{12}\) 55/2001.
in competing operations, either directly or indirectly. A non-competition obligation should always be supported by particularly weighty reasons in order to be valid. In practice, a non-competition clause is typically included in management level contracts.

When assessing the particular weight of the reason for a non-competition clause, one of the criteria taken into account is the nature of the employer’s operations and the need for protection of trade secrets. Special training given to the employee by the employer and the employee’s status and duties must also be taken into account.

The prohibited activities may be restricted to cover only a certain geographical area or certain parts of the employer’s business. It is also possible to limit the restriction to cover activities with specified competitors, or to cover specific products or services of the employer.

A non-competition clause may, under the ECA, restrict the employee’s right to conclude a new employment contract or to be engaged in the trade concerned for a maximum of six months. If the employee receives reasonable compensation for the restrictions imposed by the non-competition clause, the maximum duration of the restriction is one year. Based on legal practice, the level of reasonable compensation in such cases is set at a minimum of 50 per cent of the normal salary for the full duration of the restricted period. The compensation is typically paid either as a lump sum or in monthly instalments after the end of employment.

In cases of a breach of the non-competition covenant, the employee may be liable to pay either damages for loss, or alternatively the agreed contractual penalty. The level of such penalty may not exceed the amount of salary received by the employee for the six months preceding the end of the employment relationship.

According to the ECA, a non-compete clause that does not comply with the above is void. If the duration of the restriction or the amount of contractual penalty exceeds the maximum amount provided by law, the restriction does not apply for the part by which it exceeds the limits set by the ECA.

The restrictions related to the duration of a non-competition undertaking and the maximum contractual penalty do not, however, apply to employees who, in view of their duties and status, are deemed to run an enterprise or an independent part thereof, or to have an independent status comparable to such managers. Even if the restrictions on the duration of the non-competition and level of contractual penalty provided for in the ECA are not applied to the aforementioned managers, terms unreasonably restricting competition are

13 As the ECA does not generally apply to managing directors, the terms of non-competition obligations can be agreed more freely.
14 The employer has the burden of proving that the specific, weighty reasons related to the employee’s position, or the company’s operations, do exist. The reasons need to exist both at the time when the non-competition obligation is agreed and at the time when the employer refers to the obligation – that is, when the employment relationship has been terminated. The fact that weighty grounds exist at the time of termination is not sufficient if at the time of entry into the agreement the grounds were not considered weighty enough.
15 Based on recent case law, the existence of an extensive confidentiality obligation in force also after the expiry of employment may in certain cases be considered a sufficient means for protecting the employer’s interest, as a consequence of which weighty grounds for enforcing a non-competition undertaking have not been considered to exist.
16 In addition to actual competing activities, preparations for such activities, such as the establishment of a company intended to be involved in competing activities, may also be prohibited. For preparatory actions to be considered prohibited competing activities, an intention to harm the employer is usually required.
prohibited under the Contracts Act.\textsuperscript{17} Therefore, a contract under which a person, in order to prevent or restrict competition, has undertaken not to engage in a certain activity or not to conclude an employment contract with another person engaging in such activity may not bind a party who has made such a promise to the extent that it unreasonably restricts his or her freedom. In practice, the non-competition undertakings applicable to managers rarely exceed 12 months in duration; the amount of contractual penalty is also usually within the range set in the ECA. Managing directors of large companies form an exception to this rule.

The term of a non-competition undertaking applicable after employment is calculated as of expiry of the notice period. Therefore, a release from duties during a notice period does not affect the duration of the non-competition undertaking. A non-compete clause is not, however, applicable if the employment relationship has been terminated for reasons deriving from the employer. A non-competition covenant is thus not enforceable, for example, in the case of collective redundancies.

The Ministry of Economic Affairs and Employment has on 12 June 2018 published a report on the use of non-competition and confidentiality agreements in employment relationships. The purpose of the report has been to assess the current state and identify possible development needs regarding these type of agreements. The report proposes that the regulations on non-competition agreements be amended so that the necessity, information protected and the extent of the agreements would be assessed in each case in more detail than at present. In addition, a group of Members of Parliament have introduced a bill regarding suggested amendments to the ECA. The bill proposes, for example, a limitation of the duration of post-contractual non-competition undertakings, an obligation to pay full compensation for the duration of such restricted period and an obligation for the employer to provide a written statement on the extent of the non-competition obligation. These amendments are not intended, however, to apply with regard to employees who, in view of their duties and status, are deemed to run an enterprise or an independent part thereof, or to have an independent status comparable to such managers.

Despite the introduction of the aforementioned bill and the publication of the report, no amendments to the ECA are currently expected to enter into force during the coming year.

Finnish law does not recognise the concept of non-solicitation. Based on legal practice, however, a non-solicitation clause restricting the solicitation of clients or employees of the former employer has been considered to correspond to a non-competition undertaking. Therefore, a non-solicitation obligation can only be enforced when particularly weighty reasons related to the operations of the employer are at hand and the restrictions regarding its application correspond to those set for non-competition covenants.

In the case of a transaction, non-competition covenants applicable in the employment relationship remain in force as such. It should be noted, however, that the presence of the particularly weighty reasons referred to above is determined on a case-by-case basis (see footnote \textsuperscript{14}). Based on recent legal practice, courts tend to interpret non-competition obligations restrictively, or even conclude that the weighty reasons needed for a non-competition obligation to be possible do not exist. A non-competition obligation should therefore always be drafted carefully to suit the particular case in question.

In situations where an employee is also a shareholder, or where a former shareholder continues to be employed by the company after the sale of his or her shares, the shareholder

\textsuperscript{17} 228/1929.
agreement or transactional documentation may impose a non-competition undertaking exceeding the limits in duration and the maximum contractual penalty set by the ECA. The assessment of the fairness of the restrictions relating to the separate non-competition undertakings in shareholder or transactional agreements must then be made on a case-by-case basis, based on the general prohibitions of unfair terms of contract and restricting competition.

iii Termination of service relationship

Managing directors of Finnish companies are not covered by the restrictions related to the termination of employment of employees. All other employed executives are covered by applicable employment legislation and the provisions on termination of employment relationships.

An employment relationship can be terminated based on an agreement, or based on a notice from either party. Employment legislation in general does not regulate termination of an employment relationship with an agreement. Owing to the mandatory nature of provisions in the ECA, a company cannot, however, freely agree with the employee on all issues related to termination of employment. Instead, general standards of reasonableness will limit the contents of such an agreement regarding both managing directors and employees. A typical clause of such an agreement is a release of claims against the employer.

For an employer to be able to terminate an employment contract legally, valid and weighty grounds for termination are required, which may be either organisational or related to the employee. When assessing whether sufficient grounds for termination exist, the situation is always evaluated as a whole, taking all relevant factors into account.

Organisational grounds relate to the economy, production or organisational change of the employer company. Employment can be terminated if work available has diminished materially and permanently. Valid organisational grounds are not considered to exist in a situation where the employee can be offered other duties that are suitable for his or her training and skills, or where the employee can reasonably be trained in new duties. The ECA also lists other situations where valid organisational grounds are not deemed to exist.

With regard to termination grounds related to the employee, the grounds for termination must be ‘weighty and proper’. The concept is not defined in the ECA; rather, the ECA includes a list of reasons that do not fulfil this requirement. Employees who have neglected their duties or have breached their terms of employment may normally not be

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18 Regarding an executive in the position of an employee, it is, based on legal practice, not possible to agree that the company will not have the re-employment obligation (exceptionally, this would be possible under specific collective bargaining agreements). The re-employment obligation relates to situations where employment has been terminated for organisation-related reasons.

19 The company’s size and other factors are taken into account when evaluating what is reasonable, but in general the training would only amount to a few days or, at the most, weeks.

20 These include the employer having employed, either before or after the notice of termination was given, a new employee to carry out tasks similar to those that the redundant employee had even though there has not been a material change in the operating circumstances related to the company; and where the reorganisation of the work at the company has not led to the work at the company actually diminishing.
given notice before they have been specifically warned and have thus been given a chance to change their conduct. The warning should specifically refer to the possible termination of the employment relationship if similar problems continue.

Constructive termination or voluntary termination for ‘good reason’ as concepts are not defined in the ECA, but the issue is recognised. Cases of voluntary termination for good reason are, once the employee has shown it probable that a good reason for terminating the employment relationship exists, treated as cases of unfair dismissal. The number of cases where voluntary termination for good cause is claimed to exist has been on the rise during recent years. Likewise, the number of cases relating to harassment and unfair treatment of employees in general has risen.

Severance payments to employees are not mandatory under Finnish law. Often the employer will pay voluntary severance in addition to salary for the notice period. The amount of severance varies greatly depending on the position of the employee and the type of business in which the employer operates, and also depending on the general economic and organisational situation of the company.

Change of control as such is not a ground for terminating employment contracts. In a transfer of business, however, employees are entitled to terminate employment relationships applying a specific, shorter notice period. The transfer of employment to a new owner in connection with a corporate transaction will not give rise to a severance payment if the employee terminates the employment relationship, and no custom regarding payment of such severance exists.

All companies that employ at least 20 employees in Finland on a regular basis must follow a specific negotiation process before decisions to terminate employees’ contracts based on economic or organisational reasons are taken. There is no limit regarding application of the process based on the number of employees who would be given notice of termination, and this process must thus also be followed when the organisational reason relates to just one employee in a senior executive position. The process does not relate to termination of employment, which is made based on agreement between the employer and the employee.

21 If the breach is so serious that the employer cannot reasonably be expected to continue the employment relationship, no warning needs to be given. In even more serious cases where the breach is so severe that the employer cannot be expected to continue the employment relationship even for the notice period, the employer may terminate the employment without notice. This would typically relate to serious violence at the workplace, theft or similar breaches.

22 The situation comes up when an employee terminates the employment relationship without notice and claims that the employer has breached its obligations related to the employment relationship so severely that the employee could not reasonably be expected to work even for the length of the notice period.

23 The employee is entitled to terminate the employment relationship to end on the date the business is transferred to the new owner, if he or she has received information on the transfer at least one month before the transfer date. If the employee has received the information later, he or she may terminate the employment relationship to end either on the transfer date or on another date not being more than one month from the date on which the employee received the information about the date of transfer.

24 The managing director of the company is not counted as an employee.

25 The process is specified in the Act on Co-operation within Undertakings (334/2007). Under the Act, the company risks paying a compensation of a maximum of €34,519 to each employee whose employment has been terminated or changed to part-time employment without following the negotiation process (see Chapter 9, Section 62).
V SECURITIES LAW

The Finnish Securities Markets Act (SMA)\textsuperscript{26} provides that an issuer of securities, as well as the manager of an offering, is responsible for preparing and publishing a prospectus when offering shares to the public or listing shares on a stock exchange. There are exemptions from the obligation to publish a prospectus and these relate, \textit{inter alia}, to the offering of shares to directors or employees. The publication of a prospectus is generally not required if securities are offered to existing or former directors or employees by their employer or by an affiliated undertaking, provided that the requirements set out in the SMA are met.\textsuperscript{27} The issuer of the shares is still required to make adequate information available to all offerees regarding the factors that may affect the value of the offered securities so that they are able to reasonably assess the feasibility of the investment.

There is no legal requirement in Finland for an executive to hold stock of their employer, but shares or option rights commonly form part of executive remuneration. Executives buying or selling shares of their employer entity on the public market must comply with the relevant public trading rules. In particular, executives that have been defined by the listed company as persons discharging managerial responsibilities under the EU Market Abuse Regulation (MAR)\textsuperscript{28} must comply with the rules regarding closed-window and insider trading.\textsuperscript{29} In addition to the members of the board of directors and the managing director, such persons usually include the chief financial officer and other senior executives, as deemed appropriate.

According to the MAR, all persons discharging managerial responsibilities and their closely associated persons must notify the company of every transaction relating to the company’s shares, options and other financial instruments. The company in turn is required to disclose such information as a stock exchange release. The company is responsible for maintaining a list of such persons.

There are no specific short swing-trading or anti-hedging rules related to executives in Finland. However, many listed companies recommend that the persons discharging managerial responsibilities do not actively trade in the shares or financial instruments of the company or engage in short-term trading or speculative transactions, but rather make investments in the company on a long-term basis.

In addition, according to the SMA, executives and the company are subject to an obligation to publicly disclose a flagging notification if their holding in the company reaches, exceeds or falls below the thresholds set by the law.

There are no restrictions regarding executive shareholding in private companies.

\textsuperscript{26} 746/2012.
\textsuperscript{27} The publication of a prospectus is generally not required if securities are offered to a limited number of existing or former directors or employees by their employer or by an affiliated undertaking provided that the company’s registered office is in an EEA Member State and, if seeking admission of such shares to trading on a regulated market, provided that the securities of the company are already admitted to trading on the same regulated market. A further requirement is that a document containing information on the number and nature of the securities as well as the reasons for and details of the offer shall be made available. The new EU Prospectus Regulation (EU) 2017/1129, applicable as of 21 July 2019, removes the requirement of the employer undertaking to have its registered office in an EEA Member State.
\textsuperscript{28} 596/2014.
\textsuperscript{29} The MAR, related EU regulations and the Guidelines for Insiders of Listed Companies issued by Nasdaq Helsinki Ltd contain more detailed provisions on the insider issues.
VI DISCLOSURE

The SMA, MAR and the rules of Nasdaq Helsinki Ltd regulate the disclosure obligations of listed companies. In addition, the Finnish Corporate Governance Code 2015 (the Code) includes provisions regarding, *inter alia*, the disclosure of information related to remuneration. Even though the Code is based on the comply-or-explain principle,30 no departures from reporting of the required information are allowed. The provisions of the Code apply to listed companies, irrespective of their size.

According to the Code, listed companies must publish a remuneration statement on their website, containing an up-to-date description of the decision-making procedures and main principles concerning the remuneration of the directors, the managing director and the other executives,31 as well as a report on remuneration paid during the previous financial period. Information regarding decision-making procedures and main principles concerning remuneration must be updated regularly so that the information on the website is as up to date as possible, and the report regarding remuneration paid during the previous financial period must be updated annually.

In the remuneration statement, a listed company must disclose the main principles for the remuneration schemes covering the company’s managing director and other executives.32 In addition, the financial benefits of the managing director must be disclosed in detail, but disclosure of the personal benefits of other executives is not required; aggregated information is sufficient. There is no requirement to keep the agreement with the managing director publicly available in its entirety as long as the required information is made publicly available in accordance with the Code.

The Code does not contain any materiality thresholds regarding the obligation to disclose information on remuneration. Neither the Code nor the legislation requires that the value of the incentives be estimated as long as the required information is presented.

The remuneration statement must also include information about the valid authorisations of the board of directors concerning the remuneration, as well as any decisions made at a general meeting or by the board of directors pertaining to remuneration. In addition to the foregoing, the company must, in accordance with the rules of Nasdaq Helsinki Ltd, disclose a decision to introduce a material share-based incentive programme by way of a stock exchange release setting out the most important terms and conditions of the programme.

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30 The company must comply with the recommendations of the Code or disclose a possible departure from an individual recommendation together with an explanation for the departure.

31 In the Code, the term ‘other executives’ refers to the members of the company’s management team or, if the company has no management team, to the executives specified by the company.

32 According to the Code, the disclosure shall include, *inter alia*, the division of the remuneration into fixed and variable components (short-term and long-term incentives), information on the determination of the variable components of the remuneration and the limits set on them, criteria on the basis of the remuneration and the impact of the criteria on the company’s long-term financial success, information on share-based remuneration schemes as well as relevant earning and restriction periods, compensation payable as a result of the termination of an employment or a service contract, and additional pension benefits, if any.
VII CORPORATE GOVERNANCE

The Finnish Companies Act\(^33\) and the articles of association of the company set the basis for the corporate governance of both public and private companies. In addition, the Code seeks to maintain and promote good practices of listed companies and harmonise the procedures with regard to corporate governance and remuneration. Finnish companies listed on Nasdaq Helsinki Ltd must comply with the Code, but a company with some other domicile than Finland shall generally follow the corporate governance recommendations that are applied to it in its home state.

The body that appoints a person to his or her position must decide on his or her remuneration. Thus, the general meeting of shareholders decides on the remuneration payable for board and committee work as well as on the basis for its determination. The board of directors decides on the remuneration and other compensation to be paid to the managing director. The company must specify the decision-making procedure for the remuneration of the other executives; this is usually the responsibility of the board of directors. If remuneration is to be granted in the form of shares or option rights, the general meeting of shareholders must either approve such issue of shares or option rights, or authorise the board to do so. According to the Code, the board of directors may establish a remuneration committee to prepare matters pertaining to the remuneration of the managing director and other executives as well as the remuneration principles observed by the company. The remuneration committee must have at least three members, who must have the expertise and experience required by the duties of the committee; the majority of the members of the remuneration committee must also be independent of the company. The managing director or other executives of the company may not be appointed to the remuneration committee.\(^34\)

In Finland, there are no union or works council approval requirements that need to be met in relation to remuneration of executives. Further, there are no specific provisions related to clawback or recoupment of remuneration previously paid. However, remuneration that has been paid out without grounds should be reclaimed in accordance with the general regulations on returning an unjust enrichment.

Say-on-pay is not as such applied in Finland (i.e., there is currently no requirement to bring a management remuneration programme or decision relating to the remuneration to the general meeting, or any requirement to seek the opinion of the general meeting), but the shareholders may use their right to ask questions at the general meeting relating to the information contained in the company's remuneration statement. However, the national implementation of the new EU Shareholders' Rights Directive (SHRD) introduces a requirement for listed companies to prepare a remuneration policy concerning the principles of remuneration of the board of directors and the managing director and submit it to a vote at the general meeting.\(^35\) The remuneration policy shall also include information on how the remuneration policy contributes to the business strategy, long-term interests and sustainability of the company. The remuneration policy must be submitted to a vote at the general meeting at least every four years and always in case of a material change in the policy. In addition, under the SHRD, listed companies shall be obliged to prepare an annual remuneration report that provides a comprehensive overview of the remuneration, including

\(^33\) 624/2006.

\(^34\) Recommendations 15 and 17 of the Code.

\(^35\) 2017/828. Currently, it is anticipated that the vote at the general meeting will be advisory and not binding. The deadline for national implementation of the SHRD is 10 June 2019.
all benefits, awarded over the last financial year to the members of the board of directors and the managing director. The remuneration report must be submitted to a vote at the annual general meeting.

VIII SPECIALISED REGULATORY REGIMES

i State-owned companies

The state is the majority owner or a significant minority owner in many Finnish companies. The ministry responsible for ownership steering makes decisions on most issues concerning ownership steering and use of shareholder authority; government approval of executive remuneration arrangements is thus not required. The government has, however, in recent years been interested in the remuneration policies applied in state-owned companies, and has issued guidelines in that respect. Latest changes in the remuneration framework for state-owned companies include that the companies shall describe their remuneration policy at their annual general meetings and justify the realised performance bonuses; the total amount of variable remuneration shall have a maximum limit within which the company’s board of directors decides on the short-term and long-term remuneration schemes; executive severance packages shall be reduced; and the management and personnel of listed companies are encouraged to buy shares in their own company.36

Based on approved guidelines, increased consideration is being given to transparency as well as to the varying business environments and ownership structures of state-owned companies. Bonus systems must primarily be target-based, and the amount of the bonus must correspond to the specific attributes of the company. All bonuses shall include conditions according to which they can be cancelled or adjusted. Although decisions on remuneration are made by the companies, the state does not approve of the use of options or other measures requiring the issue of new shares or supplementary pension benefits.

ii Specific business sectors

There are specific rules relating to executive remuneration in the financial sector; Finnish rules apply to most financial institutions, such as credit institutions and investment service firms in general, as well as to mutual fund management companies and alternative investment fund managers. The rules restrict the awarding and payment of variable remuneration to senior staff members of the regulated entities as well as members of staff who, in their position, may materially affect the risk profile of the relevant entity, members of control functions and staff members who receive remuneration of the same magnitude as members of the management and risk-takers.

Awards and payment of variable remuneration to the above-mentioned members of staff must be aligned with the performance and financial condition of the relevant entity and the performance of the relevant staff member. The entity must have in place remuneration policies and practices whereby the payment of a significant part (at least 40 per cent) of variable remuneration must be deferred for a period of between three and five years of 36 On 13 May 2016, the government made a resolution on state ownership policy in order to further develop and reinforce the state ownership policy and ownership steering. The resolution also contains a statement by the Cabinet Committee on Economic Policy on remuneration. The salaries and remuneration paid to the management are governed by criteria based on the long-term financial performance and overall success of the company, and on moderation.
the end of the period during which the remuneration was earned, at least one-half of the remuneration must be paid otherwise than in cash (i.e., in financial instruments linked to the equity of the entity or group company), and the disposal of such instruments must be subject to a lock-up period.37

IX DEVELOPMENTS AND CONCLUSIONS

Remuneration of top executives and tax-beneficial arrangements related to high remuneration continue to be topics subject to sharp discussion in the Finnish media and by politicians also in cases where there is no question that such arrangement is legally acceptable. Another interesting development is the recent case law of Finnish courts regarding the applicability of non-competition obligations. Based on recent Finnish Supreme Court precedent, a non-competition obligation restricting an executive from pursuing a career in a competing business after the executive contract has ended needs to be drafted carefully to protect the relevant business interests and know-how of the company, which cannot be protected by other less restrictive methods (e.g., a confidentiality undertaking).

37 Deferred remuneration may become payable at once at the end of the deferral period or pro rata during the life of the deferral period. As regards fund managers and management companies, the applicable deferral period depends also on characteristics (e.g., recommended holding period and risk profile) of the fund units that form part of the remuneration. Furthermore, the national implementation of the EU’s second Directive on Markets in Financial Instruments (2014/65, MiFID II) seeks to further reduce and prevent potential conflicts of interest between investment companies and their clients arising out of remuneration policies.
I  INTRODUCTION

In France, as everywhere else, the salaried executive remuneration is a major topic in the life and management of companies, which concerns both the legal entity, as employer, and the executives or future executives.

However, it is not easy for the concerned persons and legal professionals to master all the issues and optimisation levers existing in this field to the extent that:
a  executive remuneration covers many areas of law and requires sound skills in tax law and company law as well as labour law;
b  the principles applicable in this area, stemming from international and European regulations, the law, the case law, the branch bargaining agreements and sometimes even the administration opinions, are not gathered in the same code but dispersed in many texts; and
c  the regulations governing the matter are fluctuating and are regularly subject to changes, which presupposes a quasi-permanent legal watch.

This chapter, the result of the combined work of tax law, company law and labour law specialists, aims to summarise the principles and practices governing the setting of executive remuneration as well as its tax and social regime.

II  TAXATION

i  Income tax for employees

In France, executive remuneration is generally included in the overall income of the executive, which is thus subject to personal income tax at the progressive rate even if the category of income depends on the form of the company and the interest held by the executive in the company.

The taxable income includes all amounts paid and any benefit in kind available to the executive. It is determined by deducting inter alia mandatory social security contributions. Professional expenses are normally taken into account through a 10 per cent deduction capped at a certain threshold, which is reviewed every year although the executive may elect to deduct the actual amount of professional expenses incurred, provided such expenses are duly justified.
In France, personal income tax is calculated on the basis of the amounts declared by taxpayers, who are required to file a single return per tax household reporting all income received in the previous year. These amounts are subject to a progressive rate.

In 2018, the progressive rate (for one part) applicable to income received in 2017 is as follows:

<table>
<thead>
<tr>
<th>Portion of taxable income</th>
<th>Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>For the portion below €9,807</td>
<td>0%</td>
</tr>
<tr>
<td>For the portion between €9,807 and €27,086</td>
<td>14%</td>
</tr>
<tr>
<td>For the portion between €27,086 and €72,617</td>
<td>30%</td>
</tr>
<tr>
<td>For the portion between €72,617 and €153,783</td>
<td>41%</td>
</tr>
<tr>
<td>For the portion exceeding €153,783</td>
<td>45%</td>
</tr>
</tbody>
</table>

In addition, an additional temporary tax (Contribution exceptionnelle sur les hauts revenus) is applicable to French taxpayers whose taxable income exceeds a certain threshold. This additional temporary tax is based on the amount of income and capital gains of the taxpayer taken into account to calculate the income tax liability, increased by certain expenses deductible and other profits exempt from income tax or subject to a deferral.

This additional temporary tax is calculated at a progressive rate as follows:

<table>
<thead>
<tr>
<th>Taxable amount</th>
<th>Single, separated or divorced taxpayers</th>
<th>Married taxpayers or in a civil union</th>
</tr>
</thead>
<tbody>
<tr>
<td>Less than €250,000</td>
<td>0%</td>
<td>0%</td>
</tr>
<tr>
<td>Between €250,000 and €500,000</td>
<td>3%</td>
<td>3%</td>
</tr>
<tr>
<td>Between €500,000 and €1 million</td>
<td>4%</td>
<td>4%</td>
</tr>
<tr>
<td>Over €1 million</td>
<td>4%</td>
<td>4%</td>
</tr>
</tbody>
</table>

### ii Social taxes for employees

In France, in principle, all the benefits granted to executives in consideration or on the occasion of work are subject to social taxes (sickness, retirement, unemployment, etc.). This covers all the elements of fixed and variable remuneration, various bonuses, allowances, benefits in kind, etc.

Given the level of executive remuneration and in view of the capping of the social tax base, social taxes account, on average, for 40 per cent of gross executive remuneration (25 per cent of employer contributions and 15 per cent of employee contributions).\(^3\)

Note, however, that:

- certain benefits from which executives might profit are subject to a specific social regime: particularly supplementary defined benefit retirement schemes, share subscription and purchase options or allotments of free shares (see Section II.iii); and
- in certain limits and under certain conditions, other benefits largely escape social taxes.

Thus, there are in particular employer contributions funding supplementary defined

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2 Article L242-1 of the Social Security Code.

3 Average rate not taking account of any supplementary benefit and pension schemes set up in favour of interested parties.
contribution pension schemes, benefit schemes and sums paid under employee savings arrangements (optional profit sharing, mandatory profit sharing, savings plans, etc.) (see Section II.iii).

Specific rules apply in favour of executives sent abroad, as part of a secondment or expatriation. In this respect, France has entered into various social security treaties with other countries; in addition, a number of EC regulations must be observed.

iii Tax deductibility for employers

Principle

Executive remuneration represents staff costs and is therefore deductible from the taxable profit of companies making industrial and commercial profits.

This deductibility covers not only salaries, emoluments, various allowances, employment costs and benefits in kind but also social taxes and various expenses incurred in the interest of executive salaried staff.\(^4\)

General conditions of deduction

Deductibility of remuneration paid to executives is subject to compliance with the following conditions:

\(a\) remuneration must correspond to an actual and justified cost and may affect only the results for the period during which it is incurred;

\(b\) this remuneration must correspond to actual work; and

\(c\) it must not be excessive having regard to the importance of the service provided.\(^5\)

On this last point and in general, the authorities take the view that a payment allotted in favour of its beneficiary in return for the service provided may be regarded as excessive when it exceeds:

\(a\) that corresponding to his or her professional qualifications;

\(b\) the scope of his or her activity;

\(c\) his or her abilities specific to the company’s results;

\(d\) the amount of the company’s salaries;

\(e\) the remuneration allotted to identical jobs in the company or elsewhere; or

\(f\) the employer’s salary policy.

The tax services are particularly attentive to compliance with this last condition concerning executives who personally have sizeable holdings in the capital or are united by emotional ties or interests in persons holding control of the company. In other situations, the authorities take the view that reintegration of excess remuneration must be pursued solely in exceptional situations, particularly when the remuneration paid is manifestly exaggerated in relation to the service provided, or when factual circumstances make it possible to presume that the

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\(^4\) Deferred remuneration (non-compete compensation, defined benefit pension schemes, contractual redundancy compensation, etc.) granted by companies listed on a regulated market to their chairmen, chief executive officers, deputy chief executive officers or board members are only permitted for deduction from the net profit up to the limit of three times the annual social security cap per beneficiary.

\(^5\) Articles 39(1)1°, Paragraph 2 and 111(d) of the General Tax Code.
benefit granted has not been accorded in the direct interest of the operation on account in particular of emotional ties or interests uniting the beneficiaries to persons possessing control of the company.

**Fiscal year of deduction**

In principle, only remuneration of which the company has become a debtor during any determined fiscal year is liable to be deducted from the taxable income for this fiscal year.

Staff expenses not yet paid at the end of a fiscal year such as gratuities, bonuses and contractual mandatory profit sharing may be deducted from the results for the said fiscal year only if the company has taken, in respect of executives, firm commitments as regards the principle and method for calculating the sums owed and if the obligation to pay them during a subsequent fiscal year is therefore certain. This condition being fulfilled, these costs may, when the elements needed for calculating the sums owed are not yet known exactly on the closing date of the fiscal year, give rise to the creation of provisions corresponding, with sufficient approximation, to their likely amount, or, when the amount of them is determined exactly, be deducted in respect of the costs to be paid.

iv Other special rules

**Allotment of free shares and share subscription or purchase options**

Subject to certain conditions, specific social and tax rules apply to the allotment of free shares and share subscription or purchase options. These two tools originally followed a similar treatment: lawmakers now unquestionably favour allotments of free shares.

In both cases the benefit is exempt from the social contributions usually owed on remuneration elements. On the other hand, the benefit is subject to specific social contributions. Free shares may also benefit from a more advantageous tax regime. From 2018, benefits derived from the sale of shares acquired under these arrangements are able to benefit from the system of a single flat-rate levy on investment income, making it possible to benefit from a reduced rate of income tax.

The benefits derived from these arrangements are broken down as follows:

- **a** the discount that corresponds to the difference between the value of the share on the day of allotment of the option and the exercise price of the option (share subscription or purchase option only);

- **b** the acquisition gain that corresponds to the difference between the value of the shares at the time of their definitive acquisition or exercise of the option, and the exercise price (option) or any reduced mandatory profit-sharing (free shares); and

- **c** the capital gain on disposal that corresponds to the difference between the value of the shares when they are sold and the value at the time of the definitive acquisition or exercise of the option.

The social and tax treatment of these benefits is marked by great instability. The table below summarises the latest rules applicable, knowing that, depending on the date on which these benefits were authorised or allotted, it will be possible to apply different conditions to them.
### Allotment of free shares

<table>
<thead>
<tr>
<th>Social treatment</th>
<th>Tax treatment</th>
<th>Social treatment</th>
<th>Tax treatment</th>
</tr>
</thead>
<tbody>
<tr>
<td>When allotted</td>
<td>NA</td>
<td>NA</td>
<td>Specific employer contribution (30%) calculated either on the fair value of the options or on 25% of the value of the shares under option on the date of allotment of the options</td>
</tr>
<tr>
<td>Discount</td>
<td>NA</td>
<td>NA</td>
<td>If &lt;5%: exempted If &gt;5%: subject to social contributions in the same way as salary</td>
</tr>
</tbody>
</table>
| Acquisition gain | Specific employer contribution (20%)
+ specific salary contribution for the share of the acquisition gain >300,000 over the year (10%)
+ Social levies | Specific salary contribution (10%) + Social levies on business income (9.7%) | Subject to income tax in the same way as salary |
| Capital gain on disposal | Social levies on investment income (17.2%)
+ Other levies | Taxation as part of the single flat-rate levy (12.8%) and application, as the case may be, of the exceptional contribution on high income (3 or 4%) | Social levies on investment income (17.2%) | Taxation as part of the single flat-rate levy (12.8%) and application, as the case may be, of the exceptional contribution on high income (3% or 4%) |

* Payable when the option is exercised.
† Payable in respect of the year in which the option is exercised.
‡ Payable in the month following definitive acquisition.
§ Payable when sold.
¶ If the acquisition gain is less than €300,000 over the year, application of the social levies applicable to investment income (17.2 per cent); the share greater than €300,000 is subject to social levies on business income (9.7 per cent).
** Payable in respect of the year of sale.

### Share subscription or purchase option

<table>
<thead>
<tr>
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<th>Tax treatment</th>
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** Payable in respect of the year of sale.

### Supplementary pension schemes

Many companies have their executives benefit from a supplementary pension scheme with a view to supplementing the benefits of mandatory schemes, whether ‘defined contribution’ or ‘defined benefit’ schemes.

In tax terms, employer contributions paid to insurers to finance such schemes are deductible for the company on the double condition that the payments made correspond to a real legal commitment enforceable against the employer and that this commitment is of a general and impersonal nature, i.e. it concerns all staff or one or more determined categories of staff.

In respect of the treatment of the funding of these schemes regarding income tax and social taxes, it is necessary to distinguish defined contribution schemes from defined benefit schemes.

In respect of the defined contribution schemes, the employer contributions that fund them are, within certain limits and under certain conditions, exempt from social levies on profit from tax deductibility (Council of State, 9 November 1990, No. 88765).

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6 On this last point, according to case law, an objective category is for example represented by ‘corporate officers and employees whose total remuneration exceeds twice the cap of the executive pension scheme’ (i.e. €79,464 in 2018) or senior executives. Conversely, the grant of a personal retirement benefit cannot profit from tax deductibility (Council of State, 9 November 1990, No. 88765).
contributions\(^7\) and income tax. This supposes in particular that the scheme has mandatory membership and that it benefits an objective category of staff. Otherwise, the contributions that fund them are deemed to be part of the salary and do not enjoy any particular social or tax benefit.

For their part, random defined benefit schemes benefiting from a specific social regime come under a social regime. Funding of these schemes is excluded from the base of social security contributions owed on salaries; on the other hand, the employer pays a specific contribution based, at its option, on annuities or the funding of the scheme.

Originally advantageous, this social treatment has been eroded over the past few years by increases in the rate of these contributions and by the creation of additional contributions.

Note that the rules applicable to defined benefit schemes and their social and tax treatment are shortly likely to be profoundly altered given the necessary transposition of Directive 2014/50/EU of 16 April 2014.\(^8\) The condition of completion of career in the company specified to benefit from the preferential social regime referred to above is in fact contrary to the European Directive according to which a condition of length of service to acquire supplementary pension rights may not exceed three years.

### III TAX PLANNING AND OTHER CONSIDERATIONS

#### i Impatriates

*Article 155 B of the French Tax Code*

Executives who are called upon by a company based out of France to work for a limited period for a company based in France, and other executives who are directly recruited in a foreign country by a company based in France, are entitled to exemptions in respect of their earned income. These arrangements apply to persons who were not domiciled in France for tax purposes during the previous five years and who set their tax domicile when taking up their position in France.

Such executives are exempt until 31 December of the eighth year following the year in which they take up their position for the years when they are domiciled in France. The income tax exemption also applies to 50 per cent of certain investment income and income from intellectual or industrial property rights received in other countries (‘passive income’) and certain capital gains on the disposal of transferable securities and shares held in other countries.

#### ii Executives carrying out part of their activity out of France

*Article 81 A of the French Tax Code*

Subject to treaty relief, executives which are French resident sent abroad by their employer located in France or in another Member State of the European Union are subject to taxation in France under the same conditions as a person lawfully residing in France. However, they may benefit from full or partial exemptions.

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7 With the exception of the CSG-CRDS borne by the beneficiaries at the rate of 9.1 per cent and the ‘forfait social’ borne by the company at the rate of 20 per cent. This latter rate might, however, be revised downwards in the next few months.

8 Directive 2014/50/EU of 16 April 2014 on the acquisition and preservation of supplementary pension rights.
A full exemption of income earned in consideration for their activities out of France applies if:

a. executives were subject to a foreign income tax equal to two-thirds of that which would be due in France on the same basis (Section 81 AI of the Revenue Code); or

b. the compensation that is earned relates to an activity carried out abroad for a period exceeding 183 days during a period of 12 consecutive months if the activity relates to construction site or installation, commissioning and exploitation of industrial plants or research and resource extraction; the period is reduced to 120 days only for employees engaged in the business prospection.

A partial exemption applies if any of the preceding conditions are not met.

In this case, an executive posted abroad is taxed on the compensation he or she would have received if he or she had carried out their business in France (additional compensations paid in consideration for their stays out of France are exempt) provided that:

a. time spent out of France is used in the sole and direct interest of the employer;

b. time spent out of France is determined beforehand in amount and relates to duration and place of stay; the supplement of compensation may not exceed 40 per cent of earnings; and

c. the additional compensation is justified by a move requiring a residence of an effective duration of at least 24 hours in another state.

IV EMPLOYMENT LAW

In France, with the exception of the legal provisions on working time, executives enjoy the same legal and contractual rights as other employees.

i Working time

Executives meeting the definition given in the Labour Code are excluded from the provisions of the Labour Code on working time, the various breaks and public holidays. In practice, their working time is not, therefore, counted, and they cannot in particular claim payment of overtime. On the other hand, they benefit from paid leave like other employees.

ii Employment contract termination

Dismissal

French law does not contain any specific provision concerning the method for terminating executives’ employment contracts. The employment contract may therefore end in the context of a resignation, dismissal for personal or economic reasons, approved contractual termination or following a voluntary retirement or a retirement.

9 Article L3111-2, Paragraph 2, of the Labour Code states: ‘Regarded as having the capacity of executive are executives to whom are entrusted responsibilities whose importance entails great independence in organising their employment of time, who are authorised to take decisions in a largely autonomous manner and who receive remuneration in the highest levels of the remuneration systems practised in their company or institution.’

10 Contractual termination enables the employer and the employee in a permanent contract to agree jointly on the conditions for terminating the employment contract binding them. Individual or collective
Any personal dismissal must be justified by a real and serious cause. It may be decided for a disciplinary reason, which presupposes that the executive has committed one or more instances of misconduct sufficiently important to justify dismissal.\textsuperscript{11} It may also be decided outside any misconduct committed by the executive. Thus, the following may justify dismissal: inadequate results, professional incompetence or the executive’s physical unfitness for exercising his or her duties. On the other hand, a simple change of control cannot in itself justify dismissal of an executive.\textsuperscript{12}

In all cases the employer must comply with a procedure defined by the Labour Code that, in particular, involves inviting the employee to a prior interview and notifying the dismissal in writing.

**Severance pay**

The executive dismissed for a reason other than serious or gross misconduct is entitled to payment of compensation whose amount may not be less than that fixed by law\textsuperscript{13} or the sector collective bargaining agreement. Note that, when hired, executives often negotiate the insertion of a clause in their employment contract specifying payment of compensation in a higher amount. In practice, these clauses generally specify payment of flat-rate compensation fixed between 12 and 24 months’ salary.

Severance pay is under certain conditions and within certain limits exempt from social taxes\textsuperscript{14} and income tax.\textsuperscript{15}

In tax terms, severance pay paid outside a job protection plan is exempt from income tax at the highest of the following three amounts: (1) amount of statutory or contractual severance pay; (2) twice the amount of annual gross remuneration received in the year preceding termination; or (3) 50 per cent of the amount of severance pay received. In the last two cases the exempted fraction may not exceed €238,392.\textsuperscript{16}

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\textsuperscript{11} The consequences of dismissal vary depending on the categorisation retained by the employer (simple misconduct, serious misconduct or gross misconduct). For example, a dismissal for serious or gross misconduct deprives the executive of severance pay and his or her right to notice.

\textsuperscript{12} Note, however, that, according to case law, the contractual clause that enables the employee to terminate the employment contract, said termination being ascribable to the employer, in the event of change of management, control, merger, absorption or significant change in the shareholder base bringing about a substantial modification of the management team, is lawful provided it is justified by the employee’s duties within the company and does not hinder the right of unilateral termination of the contract by one or other of the parties (Court of Cassation, social chamber, 26 January 2011, No. 09-71.271 (No. 278 FS-PB), \textit{Sté Havas v. Audier}).

\textsuperscript{13} Statutory severance pay is calculated from the gross remuneration received by the employee before his or her employment contract is terminated. Compensation may not be less than the following amounts: one-quarter of a month’s salary per year of service for the first 10 years; or one-third of a month’s salary per year of service with effect from the 11th year.

\textsuperscript{14} Article L242-1 of the Social Security Code.

\textsuperscript{15} Article 80 \textit{duo decies} of the General Tax Code.

\textsuperscript{16} Amount applicable in 2018.
In social terms, severance pay greater than €397,320\(^{17}\) is entirely subject to social taxes. Above this, it may be exempt from social taxes\(^{19}\) within the limit of €79,464.\(^{19}\)

Note that if the duties of corporate officer and employee are combined within the same company, or companies in the same group, it is necessary to group together all the compensation received to assess the social exemption and tax deductibility thresholds.\(^{20}\)

**Notice of dismissal**

Except in the case of dismissal for serious or gross misconduct, the dismissed executive benefits from notice whose period is fixed by law or the collective bargaining agreement. As regards executives, dismissal notice is generally fixed at three months by sector collective bargaining agreements. Note that the employment contract may specify a longer dismissal notice period and that, in all cases, the employer may exempt the executive from working his or her notice. In this case the employment contract is maintained and the exemption period must be remunerated.

**Disputes/settlement**

Dismissals of executives are very regularly followed by the conclusion of a settlement under which the executive waives contesting this measure and more generally instituting any action against his or her former employer. On the other hand, the employer undertakes to pay him or her settlement compensation, which may be exempt from social contributions and income tax within certain limits and under certain conditions.

**Non-compete**

During the period of execution of the employment contract, the executive may not engage in acts of unfair competition. In principle, this obligation ceases at the end of the employment relationship (end of the notice, whether or not it is worked) unless the executive is subject to a non-compete clause, which in practice is often the case.

To be lawful and enforceable against the former employee, the non-compete clause must meet a number of cumulative conditions posed by case law.\(^{21}\) The clause must therefore:

- be vital to protecting the company’s legitimate interests;
- be limited in time. In practice, the periods of application of the clauses are fixed at between 12 and 24 months;
- be limited geographically. In practice, the scope of the clauses is generally limited to the national territory;

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17 Amount applicable in 2018.
18 The fraction exceeding the amount of the statutory or contractual severance pay is in any case subject to 9.7 per cent of payroll taxes.
19 Amount applicable in 2018.
20 In this case there are also provisions specific to compensation paid in the event of forced termination of the duties of corporate officers, which must be applied to all compensation paid in respect of termination of the employment contract and the corporate mandate. These rules are less favourable. Thus, the tax exemption is limited to €119,196 (2018 amount) and compensation in an amount greater than €198,660 is entirely subject to social taxes.
21 These conditions are imposed even if, as regards a shareholder employee or associate of the company that employs him or her, the clause is specified in the shareholder agreement and not in the employment contract (Court of Cassation, social chamber, 23 November 2011 No. 10.21.089).
take account of the specifics of the employee’s job and leave him or her the possibility of working; and

include an obligation for the employer to pay financial consideration to the employee. For the clause to be valid, this financial compensation must not be derisory. In practice, the amount of the consideration is paid monthly to the former executive and represents between 25 and 50 per cent of the remuneration that he or she received as an employee.

Note that (1) when the employee is exempted from working his or her notice, the non-compete clause binds him or her with effect from his or her departure from the company and (2) the employer may waive application of the clause if this right is specified by the employment contract.

In the event of breach of the clause by the former executive, he or she loses the benefit of the financial consideration. He or she may also be condemned to redress the loss caused to his or her former employer and to cease his or her competitive activity.

In the absence of a non-compete clause, the executive will be free to work when his or her employment contract ends. This freedom is not, however, without its limits. In particular, the former executive must not engage in acts of unfair competition, on pain of being exposed to civil sanctions (award of damages) or even criminal damages in the event of proven corruption. The following may, for example, constitute acts of unfair competition: diverting his or her former employer’s clients or hiring its employees after the creation of a competing company.

V SEcurities Law

i Prospectus

French securities law derives from EU regulations and any share issuance reserved to employees should therefore comply with prospectus directive and regulations to the extent that they fall within their scope (please refer to EU Overview chapter). However, it is worth noting that:

a EU prospectus directive and regulations provide for a broad prospectus exemption regarding ‘securities offered, allotted or to be allotted to existing or former directors or employees by their employer or an affiliated undertaking’, provided that (1) the offered securities are of the same class as the securities already admitted to trading on the same regulated market and (2) that a document is made available containing information on the number and nature of the securities and the reasons for and detail of the offer or allotment; and

22 Court of Cassation, commercial chamber, 12 May 2004, No. 02-19.199.
23 Court of Cassation, commercial chamber, 7 May 1980, No. 78-14.831.
allotment of free shares and share subscription or purchase options is not deemed to be an offering under French laws as free share and share options are not actual securities (but merely rights to obtain securities); therefore, they fall outside the scope of EU prospective directive and regulations, even though the delivery of underlying shares may subsequently require compliance with rules applicable to admission to trading of new securities.

ii Market abuse

Executive and other employees holding securities (or exercising options) are subject to all directives and regulations governing market abuse (please refer to EU Overview chapter), of which they are a particular focus because of the likelihood of possession of price sensitive information by executive officers. They may notably be subject to (1) disclosure of director dealings in being specified that the de minimis threshold applied in France is €20,000 per year and (2) a black-out period during which they must avoid any transaction.

iii Share retention

Executive directors who benefit from the allotment of stock option or free shares are subject to certain obligations to retain all or part of the options or the underlying shares. These restrictions must be established by board of directors. While in listed company they have to take into account recommendation from corporate governance code, said restrictions may be more symbolic in private companies.

VI DISCLOSURE

i Public companies

Disclosure requirements regarding executive remuneration are primarily driven by EU rules and regulations, including in particular the prospectus regulation (please refer to EU Overview chapter) as well as Article L225-37-3 of the French Commercial Code, which provides that boards of directors of companies whose securities are admitted to trading on a regulated market (or controlled by such a company) shall disclose in a corporate governance report, inter alia, the overall remuneration and benefits (including allotment of free shares and option) paid by the company on a consolidated level for each of the directors (whether or not executive). The report shall notably detail base and variable compensation as well as long-term benefits, such as pension plan or severance package.

Private and public companies
In addition, shareholders of the French société anonyme and société en comandite par actions must be informed of the total amount paid in aggregate to the five or 10 (depending on company size) persons who received the highest remuneration.

VII CORPORATE GOVERNANCE

Requirements imposed on executive remuneration derive initially from soft law requirements in France, including in particular two codes of governance drafted by employers’ associations: the AFEP-MEDEF code, mainly followed by CAC 40 companies, and the Middlenext code, followed by small and medium-sized listed companies. However, further to press scandals, French lawmakers progressively enacted one of the most stringent say-on-pay regulations in Europe. Said regulation is applicable to executive corporate officers in companies whose securities are admitted to trading only.

Employees who are not corporate officers in a listed company
Currently, the remuneration received by employee executives under their employment contract is governed by the principle of free setting of the salary and is not subject to particular governance rules, whether those rules are used by private companies or by state-owned companies. Within these companies, only the remuneration of corporate officers is capped at 20 times the average of the lowest salaries of these companies (i.e., €450,000 per year).

Corporate officers of listed companies
Remuneration of corporate officers in listed companies is now subject to a stringent two-step control by shareholders:

a Shareholders’ meeting shall approve every year the principle and criteria of remuneration of each executive director (for the coming year). This approval shall include each of the components of the remuneration, including, in particular, base compensation, yearly variable compensation, long-term variable compensation, allotment of free shares and options, exceptional remunerations and bonuses, differed benefit (retirement benefit), etc. If shareholders fail to approve the remuneration package, the relevant executive director shall benefit from the previous year’s package and, failing approval of previous packages, on the basis of previously applied practices in the company.

b Shareholders’ meeting shall also approve the payment of variable and exceptional compensation (for the previous year). Failing approval of the variable and exceptional compensation (and even if previously approved in the context of the above-mentioned shareholders’ meeting), the relevant executive director is prohibited from receiving variable and exceptional compensation.

30 AFEP is the Association Française des Entreprises Privées (French Association of Private Companies) and MEDEF the Mouvement des Entreprises de France (French Enterprise Movement).
31 Middlenext is an independent professional association representing mid-cap listed companies.
32 This remuneration should not, however, be less than the legal and contractual minimums.
33 Except when an employment contract and a corporate mandate are combined.
34 Decree No. 2012-915 of 26 July 2012 on supervision by the state of the remuneration of executives of state-owned companies.
This approval process is in addition to previously existing requirements to have the shareholders approve, upon grant, the entry into force of retirement payment, remunerated non-compete undertaking and golden parachute, which will have to be approved again prior to payment.

The above requirements strongly reduce the ability for an executive director to fully negotiate a compensation package when hired. Indeed, no agreement can be binding upon the company regarding variable compensation until payment is actually approved by the shareholders.

VIII SPECIALISED REGULATORY REGIMES

Although they cannot be detailed in this review, two layers of specific rules shall be mentioned to outline the French legal context regarding compensation.

i Collective agreements

Branches, companies and establishments may negotiate collective agreements, which may provide for additional rules and regulations. These rules need to be reviewed on a case-by-case basis. They may notably set a minimum wage requirement, improve the amount of severance pay provided for in the payment of seniority or 13th-month bonuses, or introduce additional social protection guarantees.

ii Specific regulations

Some sectors may be subject to additional binding requirements regarding the setting of compensation packages. This is notably the case regarding the banking and financial industry where lawmakers have tried to impose a shift towards long-term incentives by limiting yearly bonuses. These specific regulations need also to be reviewed on a case-by-case basis.

IX DEVELOPMENTS AND CONCLUSIONS

i Equity remuneration

After a great deal of toing and froing by French lawmakers in this respect, the allocation of free shares seems to now be considered in a positive light, to the extent that the amount at stake does not exceed €300,000.

On the listed company side, the remuneration of executive corporate officers was put under high scrutiny to the extent that it was claimed it would be detrimental to French companies when competing to hire the best managers. The medium or long-term consequence of this new regime remains to be seen, notably in order to understand whether it will be amended or is here to stay.
Chapter 7

GERMANY

Michael Brems and Jens Hafemann

I

INTRODUCTION

The term ‘executive’ typically relates to the members of management boards of stock corporations and the managing directors of limited liability companies (management board members), as well as to senior employees with management functions within the meaning of the German Works Constitution Act. While the latter group is largely subject to labour law legislation in Germany, management board members are not considered employees, with the consequence that the statutory rules, with some exceptions, will not apply to them.

This lack of regulation allows a discernible degree of flexibility as far as the terms of employment of management board members are concerned, and has led to a certain market standard for executive remuneration. In the context of the worldwide financial crisis of 2008, however, features of executive remuneration, such as an over-proportional variable and share-based compensation, over-generous retirement benefits and severance payments, became the focus of both the general public and the German legislator’s attention. This resulted in the implementation of new corporate governance and regulatory rules that are supposed to ensure that executive remuneration is better aligned to the situation and benefit of the employing company and that apply, in particular, to management board members of stock corporations as well as executives of banks, financial services firms and insurance companies (see Sections VII and VIII, for further details).

In Germany, executive remuneration is usually stipulated in an individual service or employment agreement between the executive and the employing company. Certain compensation elements, such as short-term and long-term incentive payments and retirement benefits, are commonly addressed in a side agreement or a general plan document applying to a broader group of executives.

Executives are typically not represented by works councils or trade unions.

II

TAXATION

Under German domestic law, German tax residents (i.e., individuals, including non-German citizens, who have a residence or habitual abode in Germany) are generally taxable on their worldwide income. By contrast, persons who are considered non-residents from a German tax perspective are only taxed on income received from German sources; such German-sourced

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1 Michael Brems is counsel and Jens Hafemann is a senior attorney at Cleary Gottlieb Steen & Hamilton LLP.
2 Employees with management functions may establish a representative body of their own termed a ‘speakers’ committee.’
Income generally includes executive remuneration attributable to services performed or used in Germany. In certain situations, for example, temporary assignments or deferred compensation that is allocable to services performed both within and outside Germany, Germany’s taxation rights may be limited under domestic law or applicable tax treaties. This section summarises certain German income tax rules that are generally applicable to German tax resident executives and non-German tax resident executives in connection with services performed or used in Germany.

I Qualification of income

The German Income Tax Act (ITA) does not provide for a special tax regime applicable to executive remuneration. The taxation of executive remuneration depends on whether the relevant compensation item qualifies as:

- a income from dependent personal services (Section 19 of the ITA, ‘employment income’);
- b income from independent personal services (Section 18 of the ITA);
- c business income (Section 15 of the ITA); or
- d investment income (Section 20 of the ITA).

In most cases, executive remuneration qualifies as employment income. Exceptions may apply, for example if executives are not entitled to continued pay (in the event of sickness, holiday, etc.), work for various enterprises, are entitled to more or less independently determine their place of work and working hours or are not subject to instructions. In such cases, an executive’s compensation may qualify as income from independent personal services. If executives qualify as co-entrepreneurs in their enterprise, their compensation may qualify as business income (relevant in case the German employer qualifies as a partnership from a German tax perspective). Where executive remuneration does not qualify as employment income, the income is subject to tax rules differing from the principles that are described

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3 Non-arm’s-length compensation payments received by executives that hold shares in their employer (that is treated as a corporation for German tax purposes) may also qualify as constructive dividend distributions (i.e., investment income within the meaning of Section 20 of the ITA). If executive remuneration is paid in connection with a sale of a business (e.g., under an earn-out arrangement), it is possible that the compensation will not qualify as employment income but as a retroactive purchase price increase for shares the executive held in the employer. See also BFH BStBl II 11, 948. In addition, special rules may apply to executive remuneration paid as carried interest to managers of a private equity fund (see Section 18(1) No. 4 of the ITA).

4 The qualification for German tax purposes does not necessarily follow German labour law principles. For example, board members of the management board generally qualify as employees for tax purposes but not for labour law purposes. By contrast, supervisory board members from a tax perspective generally derive income from independent services. Note, that the distinction between the management board members and the supervisory board members originates from the typical German two-tier corporate governance model for stock corporations (only a German societas europaea (SE) can have a one-tier corporate governance system). A German GmbH that is not subject to mandatory co-determination rules generally is not required to establish a supervisory board. The two-tier corporate governance system underlying the distinction between income from independent services and employment income may create specific questions in cross-border scenarios.
below. In such cases, the income should generally not be subject to wage withholding tax or social security charges, but may be subject to trade tax. Further, the services rendered by the executive may be subject to value added tax (VAT).

ii Taxation of employment income

Employment income, including salary, benefits in kind, bonuses, severance payments and deferred compensation, is generally taxed at the ordinary progressive income tax rate with a maximum rate of 45 per cent plus 5.5 per cent solidarity surcharge thereon (in total 47.475 per cent), and, if applicable, church tax. Executive remuneration paid for several years, for example income received under long-term incentive schemes with a vesting period of more than one year, may benefit from reduced tax rates applicable to extraordinary income.

Employers are required to withhold applicable income taxes from the cash salary paid to resident and non-resident executives (wage withholding tax) and remit the amounts withheld to the German tax authorities. Resident executives are generally required to file an annual income tax return. The wage tax withheld is credited as a prepayment against the assessed income tax. By contrast, the tax liability of non-resident executives is generally satisfied with the deduction of the wage withholding tax (see Section II.vi). Employers are liable towards the German tax authorities for underwithheld wage taxes; this also applies in case a third party pays the compensation subject to withholding tax.

iii Social security charges

In general, employment income is subject to social security charges (pension insurance, unemployment insurance, health insurance, long-term care insurance) if and to the extent

5 The highest tax bracket of 45 per cent applies to taxable income in excess of €260,533 (2018) for single individuals (or twice that amount for married couples filing jointly). The second-highest tax bracket of 42 per cent applies to taxable income in excess of €54,950 (2018) for single individuals (or twice that amount for married couples filing jointly).
6 The church tax varies between the states, and generally ranges between 8 and 9 per cent of the income tax.
7 Section 34(2) No. 4 of the ITA.
8 The employer is generally liable for wage withholding taxes and social security charges underwithheld (Section 42d of the ITA, Section 28e SGB IV). In addition, underwithholding may result in criminal charges. If in doubt, an employer may decide to file an application for a wage withholding tax ruling (Section 42e of the ITA). If the executive’s monthly cash wage is lower than the wage withholding tax to be withheld (e.g., if an executive is receiving substantial benefits in kind under a share compensation plan), the executive needs to provide the employer with the cash required to remit the wage withholding tax to the tax authorities. If the executive fails to do so, the employer is required to inform the tax authorities (Section 38(4) of the ITA). The employer may also be required to withhold wage taxes if the executive remuneration is paid by third parties (e.g., a foreign affiliate of the German employer) (see Section 38(13) of the ITA). For example, this needs to be observed if a foreign parent company grants stock options or other incentives to the employees of a German company. In the context of an M&A transaction, the payment of exit bonuses made by the seller to key employees of the German target company may require wage withholding at the level of the target company.
9 Exceptions apply, for example, to management board members of stock corporations, who are generally exempt from statutory social security charges (assuming that they take out private health insurance).
10 As of 2018, the social security charges amount to 18.6 per cent (pension insurance), 3 per cent (unemployment insurance), 2.55 per cent (long-term care insurance; 2.8 per cent for childless persons) and approximately 14.6 per cent (health insurance). The health insurance rate varies from insurance to insurance. Approximately half of the total social security charges must be borne by the employer.
the applicable contribution thresholds are not exceeded. The employee’s share of the social security charges is withheld by the employer (together with the wage withholding tax). Special rules apply to employees temporarily assigned abroad: Germany has entered into various social security treaties with countries in and outside the European Union; in addition, a number of EC regulations must be observed.

**iv Capital gains**

Capital gains are not subject to wage withholding tax or social security charges and may benefit from special tax rates. For example, capital gains derived from the sale of shares and various other financial instruments may qualify as investment income (Section 20 of the ITA). Investment income is generally subject to a flat tax rate of 25 per cent (plus 5.5 per cent solidarity surcharge thereon and, if applicable, church tax). As an exception to this rule, capital gains from the sale of shares are generally taxed in accordance with the so-called partial income system (Section 3 No. 40 of the ITA), under which only 60 per cent of the capital gains are subject to tax at ordinary progressive income tax rates if, at any time during the five years preceding the sale, the executive held a substantial participation of at least 1 per cent in the share capital of the relevant company (Section 17(1) of the ITA). By contrast, employment income does not benefit from the flat tax regime applicable to investment income; it does not qualify for the benefits under the partial income system. Therefore, it is important to distinguish between the benefits in kind received by an executive that qualify as employment income and any capital gains income derived subsequently.

For example, if an executive purchases a small amount of stock from the employer at a discount granted by the employer (but otherwise receives beneficial ownership of the fully unencumbered stock at that point), and several years later the stock is sold at a gain, then the executive derives a capital gain from the sale. Note, however, that the benefit resulting from the originally discounted acquisition price qualifies as employment income (and is taxable at the time of the purchase, subject to wage withholding tax, etc.). When later realised as a result of the sale, the difference between the sales price and the fair market value of the stock at the time of its acquisition qualifies as investment income subject to the flat tax regime (assuming that the partial income system does not apply).
v  **Time of taxation**

Executives are generally required to account for their income on a calendar-year basis. Employment income is usually accounted for on a cash basis (i.e., executives are generally not required to pay income taxes on employment income until they have actually received a benefit in cash or in kind). Consequently, the mere entitlement to receive employment income (even if the respective claim of the executive against the employer is due and payable) does not generally result in a taxable event. The cash-based accounting method can be used for tax-planning purposes (e.g., to reduce progressive tax rates, one-time payments can be shifted to calendar years where the expected overall income is comparably low, for example, in a retirement scenario).

vi  **Non-resident executives**

Non-resident executives are subject to tax in Germany if their compensation is attributable to services performed or used in Germany. Compensation received in the capacity as a general manager or member of the management board of a company managed in Germany is always subject to tax in Germany. Generally, the tax liability is satisfied with the deduction of the wage withholding tax. Non-resident executives who are tax-resident citizens of another EU Member State or an EEA country may apply for a tax assessment. The limited tax liability of non-resident executives results in certain disadvantages compared with the unlimited tax liability of resident executives. Most importantly, non-resident executives are not entitled to the splitting tariff (i.e., the lower tax rates applicable to married couples filing jointly) or an allowance for children. Non-resident executives who are citizens of another EU Member State or an EEA country, and who have to tax at least 90 per cent of their income in Germany, may consider filing an application for a deemed unlimited tax liability in order to benefit from the splitting tariff or an allowance for children.

Capital gains derived by a non-resident executive from the sale of shares in their German-resident employer are only subject to tax in Germany (in accordance with the partial

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15 By contrast, the grant of a claim against a third party (e.g., insurance) may result in a benefit in kind that is taxable up front (BFH BStBl. II 07, 579).
16 Section 49(1) No. 4 of the ITA. Services of non-resident executives who work outside Germany may be used in Germany if a German employer is furnished with the results of the non-resident’s work. For example, the Federal Fiscal Court decided that market analyses, that were prepared by an employee outside Germany but used by the employer’s German management, may result in a German tax liability for the employee residing abroad (BFH BStBl. II 87, 379). Under German domestic law, the compensation paid to non-resident management board members and authorised signatories of companies having their place of management in Germany also qualifies as German-source income. However, Germany’s taxation right may be excluded under an applicable tax treaty (see Section II.vii).
17 Section 49(1) No. 4(c) of the ITA.
18 See Section 50(2)1 of the ITA.
19 See Sections 50(2)2 No. 4(b) and 50(2)7 of the ITA. For example, eligible non-resident executives may decide to apply for a tax assessment in order to claim a deduction for income-related expenses, which may result in a lower tax base and therefore in overall tax savings.
20 See Section 26(1) of the ITA.
21 See Sections 50(1)3 and 32 of the ITA.
22 See Sections 1(3) and 1a of the ITA.
income method) if the executive held (or is deemed to hold) a substantial participation of 1 per cent or more at any time during the five years preceding the sale (see Section II.iv) and is not protected under an applicable tax treaty.\(^\text{23}\)

### vii Allocation of income in cross-border situations

Executives who are or become resident executives under German domestic tax law (because their residence or habitual abode is located in Germany) are generally liable for German income tax with their worldwide income.\(^\text{24}\) Executives who, in addition, maintain a permanent residence or habitual abode outside Germany (and who may, because of these or other criteria, be treated as tax residents under the domestic laws of one or several other countries) may be protected from multiple taxation if a double tax treaty applies. Tax treaties entered into by Germany generally include a ‘tie-breaker’ provision pursuant to which the tax residency of an individual may, *inter alia*, be determined by the individual’s ‘centre of vital interests’.\(^\text{25}\) Executives who do not want to tax their worldwide income in Germany should therefore carefully monitor the development of their personal and economic ties with Germany.

Germany’s tax treaties generally include a 183-day clause governing the allocation of taxation rights in respect of employment income. In principle, employment income may only be taxed in the executive’s state of residence (to be determined in accordance with the aforementioned ‘tie-breaker’ provision), unless the employment is exercised in the other contracting state.\(^\text{26}\) In this case, the employment income is taxable in the other state where the employment is exercised.\(^\text{27}\) As an exception to this rule, employment income is taxable only in the executive’s state of residence, if the conditions of the 183-day clause are met.\(^\text{28}\) The application of the 183-day clause by-and-large requires that the executive does not stay or work for more than 183 days per year in the other state where the employment is exercised.\(^\text{29}\) Moreover, the executive remuneration must not be borne by an employer resident

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\(^{23}\) In such situation, the executive may consider holding the substantial participation through a personal holding company in order to benefit from a tax treaty, or a 95 per cent participation exemption under German domestic law applicable to corporations deriving capital gains from the sale of corporate shares. The use of personal holding companies requires careful tax planning. In particular, substance requirements need to be observed. The 95 per cent participation exemption may also not be available in certain scenarios.

\(^{24}\) See Section 1(1) of the ITA.

\(^{25}\) For example, see Article 4(2) of the Organisation for Economic Co-operation and Development (OECD) Model Tax Convention. For further details, see also Federal Ministry of Finance Circular IV B 21 – S 1300/08/10027 of 12 November 2014 (Ann. 9 et seq.).

\(^{26}\) See Article 15(1) of the OECD Model Tax Convention.

\(^{27}\) If the employment income is taxable in the state where the employment is exercised, the state of residence frequently does not exercise its taxation right and applies the so-called exemption method (cf. Article 23A of the OECD Model Tax Convention). In other cases, a tax credit is granted by the state of residence (cf. Article 23B of the OECD Model Tax Convention). Certain tax treaties provide that the exemption method only applies if the income was actually subject to tax in the state where the employment is exercised (subject-to-tax clause). Moreover, German domestic law provides that the exemption method shall only be applied if the executive can demonstrate that the employment income was either taxed abroad or that the other state has waived its taxation right (cf. Section 50d(8) of the ITA).

\(^{28}\) See Article 15(2) of the OECD Model Tax Convention.

\(^{29}\) The exact calculation mechanism can vary depending on the specific tax treaty concerned (e.g., the 183-day limit may either relate to the tax year or the calendar year; the 183-day limit sometimes relates to the employee’s presence in the relevant state and sometimes to the duration of the employment).
(or maintaining a permanent establishment situated) in that other state. It should be noted that Germany has concluded tax treaties that contain certain modifications to the 183-day clause.\textsuperscript{30} Consequently, executives should check their individual tax situation carefully.

If the employment is exercised both in and outside Germany and the 183-day clause does not apply, the compensation received by the executive must be allocated between the countries concerned. Generally, the compensation should be allocated in accordance with the compensated service in the specific case. In the absence of more appropriate (non-quantitative) criteria, the compensation might have to be prorated on the basis of contractually agreed working days or hours.\textsuperscript{31} In practice, if an executive works for several group entities located in more than one country, it may be useful to enter into separate (arm’s-length) employment agreements in order to facilitate the allocation of the compensation received (salary splitting).

The apportionment of non-recurrent payments (e.g., bonus payments or deferred compensation under employee incentive schemes) constituting subsequent compensation for earlier work performed both in Germany and abroad may be of particular importance. From a German tax perspective, the attribution of taxation rights depends on whether the compensation qualifies as annex to the work carried out or utilised in Germany. To the extent this allocation is not possible (e.g., for Christmas and holiday bonuses), the compensation must be divided up in relation to the number of days worked in Germany.\textsuperscript{32}

If an executive initially working in Germany subsequently moves to another state and receives deferred compensation while residing in that other state, a double tax situation may occur where the other state claims a taxation right solely based on the time and place of payment of the compensation. In particular, if an executive is not protected from double taxation under a tax treaty, proper tax planning may require that the agreed time and place of payment of deferred compensation is determined in accordance with the local particularities of the jurisdictions concerned.

viii Tax consequences of certain typical equity compensation awards

Stock options and stock appreciation rights

The granting or vesting of non-tradable stock options does not qualify as a taxable event, and therefore does not result in employment income (i.e., no up-front taxation). The same applies to non-tradable, cash-settled stock appreciation rights (SARs), virtual stock options or similar awards under which the employer enters into a contractual promise to pay to the executive the future value of a notional stock option. By contrast, the actual exercise (or other realisation)\textsuperscript{33} of the stock option or the actual cash payment under SARs qualifies as a

\textsuperscript{30} For example, Germany’s tax treaties with Denmark and Switzerland contain special rules for certain high-level executives pursuant to which executive remuneration can be taxed in the employer’s jurisdiction of residence. Various other German tax treaties contain special rules for management board members and cross-border commuters.

\textsuperscript{31} See Ministry of Finance Circular IV C 5 – S 2369/10/10002 of 14 March 2017 (Ann. I.2.). See also BFH BStBl. II 86, 479.

\textsuperscript{32} See Ministry of Finance Circular IV C 5 – S 2369/10/10002 of 14 March 2017 (Ann. I.6.).

\textsuperscript{33} According to Federal Fiscal Court decision (BFH BStBl. II 2013, 289) the executive may consider realising the value of a stock option up front (when it may still have a rather low intrinsic value) by contributing it to a personal holding company. A subsequent realisation of additional gains at the level of the holding company could then benefit from lower corporate tax rates and, possibly, a 95 per cent participation exemption (which is not available in all cases). The holding company should not be solely used to acquire the option, given increased risk that the structure is disregarded. The valuation of the option (and,
taxable event (taxation at maturity). In the case of stock options, the executive must tax (as employment income) the fair market value of the stock received upon exercise minus the option exercise price paid. Any subsequent appreciation in the value of the received stock is treated as capital gains income (see Section II.iv). In the case of SARs or similar cash-settled awards, the cash payment received by the executive qualifies as taxable employment income. The granting of tradable stock options and SARs should not generally result in an up-front taxation (i.e., only the exercise, settlement or sale of such awards should qualify as a taxable event).

**Restricted stock and restricted stock units**

The award of restricted stock granted unconditionally and merely subject to a contractual restraint on disposal until the expiry of a predetermined minimum holding period is generally taxed up front. This means that the fair market value of the stock at the time of delivery (not taking into account the restraint on disposal), minus the purchase price paid for the stock, qualifies as taxable employment income. If, however, the restraint on disposal is structured such that a disposal is not only forbidden by agreement but legally unfeasible (e.g., because the executive requires a resolution of the employer to effect a transfer of title), the taxable realisation event is postponed as long as the restraint on disposal exists. The exact criteria for the distinction between contractual and absolute restraints on disposal are still subject to discussion.

By the same token, the granting of restricted stock that is subject to a forfeiture condition (such as continued employment or financial performance), pursuant to which the stock has to be returned in case such conditions apply, should also result in a taxable event up front if there is no absolute restraint on disposal (i.e., a condition subsequent should not prevent up-front taxation). However, the return of the stock, in the event the forfeiture condition occurs and the stock is returned, should result in negative employment income.

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34 See Ministry of Finance Circular IV C5-S 2347/09/10002 of 8 December 2009 (Ann. 1.3) for further details regarding the determination of the stock's fair market value. A tax-free allowance of up to €360 per annum may apply to the non-discriminatory grant of discounted stock (including under a stock option programme). Executive incentive schemes frequently do not meet the non-discrimination requirement for such tax-free allowance. More importantly, stock options and SARs with a vesting period of more than one year may result in extraordinary income (Section 34(2) No. 4 of the ITA) potentially benefiting from reduced tax rates depending on the individual circumstances.


36 BFH BStBl. II 09, 282. See also Ministry of Finance Circular IV C5-S2347/09/10002 of 8 December 2009 (Ann. 1.3, 1.6).


38 See Federal Ministry of Finance Circular IV B 2 – S 1300/08/10027 of 12 November 2014 (Ann. 214 et seq.). See also Federal Ministry of Finance Circular IV B 2 – S 1300/08/10027 of 3 May 2018 (Ann. 258 et seq.). In addition, the international allocation of taxation rights with respect to restricted stock subject to an absolute restraint on disposal is not free from doubt.

39 See BFH BStBl. II 09, 282.
Restricted stock units (or phantom stocks), under which the employer promises to deliver stock or cash equal to the value of a specified number of shares, are subject to different tax rules. Similarly to stock options and SARs, executives must recognise employment income only at the point in time when the shares are actually delivered or the cash is actually paid. The tax basis is the value of the shares at the time of delivery or the amount of cash received.

ix Tax deductibility for employers

Executive remuneration generally qualifies as a tax-deductible business expense and therefore reduces the corporate income and trade tax base of a German employer.\(^\text{40}\) If the executive remuneration is not paid by the employer but by an affiliated entity (e.g., a foreign parent company), cost transfer agreements are frequently required to achieve a reduction of the German employer’s tax burden. Such scenarios also generally trigger the requirement to withhold and remit wage withholding tax by the German employer, although it may not be involved in the payment processes.\(^\text{41}\) Careful structuring is required in such tripartite situations. Awards of stock options that merely dilute the shareholders’ equity do not result in a tax-deductible expense.\(^\text{42}\)

III TAX PLANNING AND OTHER CONSIDERATIONS

Typical considerations in connection with payments of executive remuneration include the following:

\(a\) making use of the cash-based accounting method by determining a favourable time for non-recurrent payments or bundling several tranches of payments, for example, in order to benefit from special tax rates for extraordinary income, reduce tax progression or avoid double taxation with respect to remuneration previously earned in another jurisdiction;

\(b\) using salary splits to facilitate the allocation of executive compensation between various jurisdictions;

\(c\) organising the executive’s individual tax situation, for example, by avoiding an undesirable unlimited tax liability in Germany, by applying for an intended deemed unlimited tax liability or by making use of the 183-day clause; and

\(d\) making use of personal holding companies to shelter capital gains income in exceptional situations; although recent legislative efforts may make such structures less efficient (portfolio exemptions).

\(^{40}\) Special rules, which restrict the tax deductibility of compensation payments made to supervisory board members and similar persons, do not apply to ordinary executive remuneration (see Section 10 No. 4 of the Corporate Income Tax Act).

\(^{41}\) See BFH BStBl. II 2017, 69.

\(^{42}\) BFH BStBl. II 11, 215. By contrast, virtual stock options result in a tax-deductible expense.
IV  EMPLOYMENT LAW

i  Severance payments

Executives do not generally have a statutory severance claim upon termination of their service or employment relationships; any entitlements in this respect need to be stipulated in their individual service or employment agreements.

Agreements with employees with management functions will only occasionally include severance clauses, because this group of executives is subject to statutory protection against wrongful dismissal under German labour law. Accordingly, a termination by the employer requires a justified reason, such as a severe misbehaviour, a continuing incapacity or redundancy. Absent a justified reason, the employer will have to reach a settlement with the employee in the course of legal proceedings that employees in Germany typically institute after receiving notice of termination from their employers. The severance amount to be paid to make the employee accept his or her dismissal is subject to negotiation, and usually depends on how the parties evaluate their chance of succeeding in the pending legal proceedings. Generally, severance payments by employers in Germany range between half and one full month’s salary (including pro rata variable payments) for each completed year of employment, but may actually be significantly higher if the employer has a weak case.

While not unheard of, it is also not very common that service agreements with management board members of non-listed companies provide for severance payments or change in control provisions. Although management board members do not benefit from statutory protection against wrongful dismissal, their service agreements frequently run for a fixed term during which they can only be terminated for good cause, which is a rather strict test under German law. A company intending to terminate the service relationship with a management board member prematurely without good cause will have to negotiate a termination agreement with the management board member, including offering him or her a severance package. The outcome of the negotiations will largely depend on the remaining term of the service relationship.

Notwithstanding the fact that service agreements with management board members of listed companies are typically entered into for a fixed term of up to five years, these types of executives are more commonly entitled to severance payments under their service agreements upon a termination without good cause. Pursuant to Section 4.2.3 of the German Corporate Governance Code (GCGC), any severance payments, including fringe benefits, should be capped at the lower amount of (1) two times the management board member’s last annual remuneration (severance pay cap) or (2) the remuneration that the management board member would have earned during the remaining term of the service agreement.

43 Service agreements, however, occasionally give the management board member the right to receive a severance payment if the company does not renew the agreement beyond its original term without having cause for the non-renewal.

44 The GCGC is a non-binding set of recommendations summarising best practices for the management and supervision of listed companies. It is reviewed and updated annually by a corporate governance commission appointed by the federal government. Listed companies must disclose on an annual basis whether they comply with the recommendations of the GCGC (‘comply or explain’).
ii  Change in control provisions

Under German law, there is no statutory termination right on the part of the company or the executive if the ownership structure of the company significantly changes. Both parties continue to be bound by the terms and conditions of the existing service or employment agreement, including any fixed-term agreed therein.

Listed companies often grant their management board members the right to terminate the service relationship prematurely within a certain time frame following a change in control event and to collect a predefined severance. Pursuant to Section 4.2.3 of the GCGC, any severance payment should be capped at three times the management board members’ last annual remuneration, which corresponds to 150 per cent of the severance pay cap.

The terms of share-based compensation and retirement benefit plans may provide for a vesting or acceleration of rights if the service relationship with a management board member is terminated as a result of a change in control.

iii  Confidentiality

Executives in Germany are by virtue of the law required to treat as confidential all trade and business secrets that they become aware of during the term of their service or employment relationship. This duty of confidentiality generally does not end when the service or employment agreement ends, but its scope is disputed.

Thus, the particulars of the confidentiality obligation are typically stipulated in greater detail in the executive’s service or employment agreement. It is customary in Germany that employers impose continued confidentiality obligations on their executives that shall also survive termination of the service or employment relationship. While this practice is generally acknowledged, the relevant confidentiality clauses will only be enforceable if their scope is very precise and if they do not impede the executive’s professional advancement in an unreasonable manner. As a consequence, employers intending to protect their customer base or market share from poaching attempts of a former executive will usually have to make the executive accept a post-termination non-compete undertaking (see Section IV.v).

Remedies for breach of the confidentially obligation during and after the employment or service relationship include civil claims for injunction and damages. During the employment or service relationship, the intentional disclosure of business secrets is a criminal offence with up to three years of imprisonment (five years for severe breaches). After the termination of the service or employment relationship, a criminal offence is only triggered in exceptional cases. For example, if the employee or the managing director discloses technical drawings and material that was provided to him or her during the employment or service relationship.

iv  Non-compete obligations during the term of service or employment

During the term of their service or employment relationships, executives are not permitted to engage in competition with their employer.

45  Section 17(1) of the Act against Unfair Competition.
46  Section 17(2) of the Act against Unfair Competition.
47  While the non-compete obligation of the management board members of a limited liability company is considered to be a part of their fiduciary duty towards the company, Section 88 of the German Stock Corporation Act includes an explicit regulation for the management board members of a stock corporation. Section 4.3.1 of the GCGC also provides for a non-compete obligation. The statutory non-compete obligation of regular employees is derived from Section 60 of the German Commercial Code.
Accordingly, executives must not do business, carry out transactions or support any activities in the employer's line of business on their own behalf or on behalf of third parties without the consent of the employer. Executives violating this obligation may face disciplinary actions and become liable for damages.

In addition to the statutory rules, it is customary to further specify the statutory obligations in an executive's service or employment agreement by means of explicit non-compete and non-solicitation clauses.

v Post-termination non-compete clauses

Apart from generally applicable unfair competition rules, executives in Germany are, as a matter of law, not bound by competition restrictions after termination of their service or employment relationships. Any such restrictions therefore need to be put on a contractual basis by entering into a post-termination non-compete or non-solicitation (or both) arrangement with the executive.

German courts take the view that post-termination non-compete clauses are only enforceable if there is a legitimate interest on the part of the employer, and the further professional career of the executive is not unreasonably restricted by the territorial and temporal scope of the non-compete obligation. While the German Commercial Code sets a specific legal framework for post-termination non-compete arrangements with regular employees (including employees with management functions), the relevant rules do not apply to management board members. As a practical matter, however, any post-termination non-compete clauses in service agreements of management board members are typically drafted along the lines of the statutory provisions in the German Commercial Code.

Post-termination non-compete arrangements usually run for a period of between one year and two years following the termination date of the executive's service or employment agreement (two years being the maximum post-termination non-compete period permitted under German employment law). An extended garden leave period that immediately precedes the termination date may actually require a shorter non-compete period or may even render a post-termination non-compete undertaking entirely unenforceable if the aggregate amount of time during which the executive was kept out of business would practically put an end to his or her professional career in the relevant industry. There are no strict guidelines as to when a garden leave that is forced on the executive would affect the scope and substance of a subsequent post-termination non-compete undertaking. Rather, any potential risks in this respect will have to be assessed based on the facts and circumstances of each individual case, and in particular, the situation in the market or business area concerned.

In order to be valid and enforceable, a post-termination non-compete arrangement must provide for an adequate financial compensation to be paid to the executive during the non-compete period. German mandatory law requires a minimum non-compete compensation for regular employees that is equal to 50 per cent of their last total remuneration under the employment agreement (including all monetary and non-monetary benefits).

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48 BGHZ 91, 1, 5.
49 Sections 74 to 75d of the German Commercial Code.
50 Section 74(2) of the German Commercial Code.
51 If the employee is released without cause on his or her part (such as in the event of redundancy), the post-termination non-compete arrangement will only be enforceable if the employer offers an increased compensation of 100 per cent of the employee's last total remuneration under the employment agreement.
As stated above, this legal requirement is not relevant for post-termination non-compete arrangements with management board members; however, there is a common understanding among legal practitioners that non-compete compensation must be offered to these persons as well. The non-compete compensation provided in post-termination non-compete arrangements with management board members typically varies between 50 per cent of their last fixed salary and as high as the full amount of their last total remuneration. It is also not uncommon to link the non-compete compensation to the reason for termination and grant a higher amount if the termination of the service relationship had not been caused by the management board member.

Other work-related income that an executive earns during the non-compete period may, to a certain extent, be deducted from the non-compete compensation, and the executive must regularly inform his or her previous employer about such earnings.52

V SECURITIES LAW

i Prospectus requirements in connection with offering securities to employees

Many typical executive compensation arrangements are considered to involve the offer of securities. The German Securities Prospectus Act implementing European Prospectus Directive 2003/71/EC, as amended by Directive 2010/73/EC, requires that an offer to the public of listed or non-listed securities may only be made in Germany after publication of a prospectus approved by the German Federal Financial Supervisory Authority (BaFin), or by an authority of another EEA country after having notified the BaFin of the approval.53

There are a number of exemptions from the requirement to publish a prospectus when offering securities in Germany.54

First, a specific employee offering exemption is available under the German Securities Prospectus Act for securities55 that are offered or allotted to existing or former directors (including management board members) or employees by their employer or by an affiliated undertaking, provided that the company has its registered office in the EEA or is listed on a regulated market, and further provided that an information document is made available containing information on the number and nature of the securities and the reasons for and details of the offer.56 This exemption is also available for companies established outside the EEA whose securities are admitted to trading either on an EU-regulated market or on a third-country market regarded as equivalent to an EU-regulated market by the European Commission.

52 Section 74c(1) of the German Commercial Code.
53 Section 3(1) of the German Securities Prospectus Act.
54 Section 4 of the German Securities Prospectus Act. When relying on an exemption to publish a prospectus in the context of an offer of securities to the public, it is important to bear in mind that a prospectus may nevertheless be required with respect to the admission to trading on an EU-regulated market of such securities.
55 If the instrument offered should not qualify as a security within the meaning of the German Securities Prospectus Act, a public offer of such instrument may nonetheless require a prospectus pursuant to the German Asset Investment Act. The German Asset Investment Act, however, provides for a comparable employee offering exemption.
56 The European Securities and Markets Authority has published recommendations as to the content of such information document.
Second, there are private placement exemptions, including, in particular, a prospectus exemption if securities are offered to fewer than 150 persons per EEA country.\textsuperscript{57}

The German Securities Prospectus Act also provides for a prospectus exemption with respect to the admission to trading on a regulated market of securities offered in employee offerings, provided, \textit{inter alia}, that the securities are of the same class as the securities already admitted to trading on the same regulated market and that an information document is made available.\textsuperscript{58}

On 30 July 2017, the European Prospectus Regulation 2017/1129 was published. It repeals the European Prospectus Directive 2003/71/EC and the German Securities Prospectus Act. Most of its provisions apply only from 21 July 2019 onwards, including the exemptions for employee offerings. The European Prospectus Regulation will further relax the employee offering exemption. Under the new rules, securities offered or allotted to existing or former directors or employees by their employer or by an affiliated undertaking are exempted from the prospectus requirement provided that the information document is made available (irrespective of whether the company has its registered office in the EEA or whether the company is listed on an EU-regulated market or a third-country market regarded as equivalent to an EU-regulated market). Thus, third-country issuers will benefit from the employee offering exemption (beginning 21 July 2019) even if they are neither listed on an EU-regulated market nor a third-country market regarded as equivalent.\textsuperscript{59} The new rules under the European Prospectus Regulation will also provide a prospectus exemption with respect to the admission to trading on a regulated market of securities offered in employee offerings, provided that the securities are of the same class as the securities already admitted to trading on the same regulated market and that an information document is made available.\textsuperscript{60}

\textbf{ii Managers’ transactions}

Since becoming effective on 3 July 2016, Section 19 of the new Regulation (EU) No. 596/2014 (Market Abuse Regulation (MAR)) has expanded restrictions on directors’ dealings in Germany, which had previously been governed by the German Securities Trading Act (GSTA). According to the MAR, ‘persons discharging managerial responsibilities’ (including management board members and those employees with regular access to inside information and the power to make certain managerial decisions) as well as persons closely associated with them, must notify the company and the BaFin of certain types of transactions promptly and no later than within three working days (instead of five working days as under the GSTA).\textsuperscript{61} These transactions now include not only those concerning shares of the company or related financial instruments (in particular, derivatives), but also those relating to debt instruments and emission allowances.\textsuperscript{62}

\begin{itemize}
\item \textsuperscript{57} Note, however, that a prospectus may be required in connection with the admission to trading on an EU regulated market of such securities.
\item \textsuperscript{58} This exemption is particularly relevant for issuers with a listing on an EU-regulated market.
\item \textsuperscript{59} Article 1 No. 4(i) European Prospectus Regulation.
\item \textsuperscript{60} Article 1 No. 5(h) European Prospectus Regulation.
\item \textsuperscript{61} ESMA and BaFin have published, and update on a regular basis, FAQs regarding MAR. Implementing Regulation (EU) 2016/523 contains a template that shall be used for the notification.
\item \textsuperscript{62} Article 10 No. 2 Delegated Regulation (EU) 2016/522 contains a non-exhaustive list of transactions triggering a notification requirement.
\end{itemize}
As before, the company is obligated to immediately publish the notification, including the executive’s name, the price and volume as well as the date and place of the transaction, and to notify the BaFin of the publication and submit the information to the Company Register. Additionally, companies must now draw up a list of persons discharging managerial responsibilities and persons closely associated with them and notify the persons discharging managerial responsibilities of their obligations in writing. Persons discharging managerial responsibilities must notify the persons closely associated with them.

The MAR now provides for a statutory ‘closed period’ of 30 days before the announcement of an interim financial report or a year-end report, during which no transactions may be conducted at all, subject to hardship exemptions. Pursuant to ESMA guidance, the relevant announcement for purposes of the closed period is the public statement whereby the issuer announces, in advance of the publication of the final year-end report (or the final interim report, as the case may be), the preliminary financial results agreed by the management body of the issuer.

There are no statutory requirements under German law that executives must hold stock of their employer.

iii Insider trading and market manipulation

Since 3 July 2016, the MAR also governs insider trading and market manipulation, following to a large extent the substance of the previous rules under the GSTA. Pursuant to Article 7 of the MAR, inside information is, inter alia, non-public information of a precise nature, relating to companies or financial instruments, which, if made public, would likely have a significant effect on the prices of those financial instruments or related derivatives. Following a decision by the European Court of Justice, where inside information concerns a process that occurs in stages, each stage of the process can already constitute inside information.

It is considered unlawful insider dealing for a person to use inside information to acquire or dispose of, for the person’s own account as well as for a third party, directly or indirectly, financial instruments to which that information relates. Going beyond the GSTA regime, cancelling or amending an order that has been placed before acquiring the inside information is now also considered insider dealing. Moreover, the use of recommendations or inducements can now amount to insider dealing in cases where the person knows or should have known that it is based on inside information. However, certain ‘legitimate behaviours’ may serve as a justification for actions that would otherwise be deemed insider dealing.

The MAR’s market abuse rules set forth an enumeration of definitions, examples and indicators in order to determine whether a person manipulated the market using false or misleading information (Article 12 et seq. MAR). Unlike before, a failed attempt already qualifies as market manipulation. Certain ‘accepted market practices’ promulgated by national regulators, and accepted by ESMA pursuant to certain procedures, may provide exemptions.

63 However, the obligation to publish managers’ transactions does not apply as long as the total amount of the transactions by an executive and the persons closely related to him or her remains below a threshold of in total €5,000 (no netting) within the calendar year.
64 Article 19(11) MAR. Articles 7 to 9 of Delegated Regulation (EU) 2016/522 provide guidance regarding certain hardship exemptions according to Article 19(12) MAR.
65 ESMA Q&A on MAR, last updated 23 March 2018, Q7.2.
66 Case C-19/11 Geld v. Daimler [2012].
67 Article 9 MAR.
Breach of insider trading or market manipulation rules may qualify as a criminal or administrative offence. The German legislator transposed the sanctions regime of the Directive on Criminal Sanctions for Market Abuse (CSMAD)\textsuperscript{68} in the German Securities Trading Act. The sanctions have become much more severe in connection with MAR/CSMAD. They include very substantial amounts for fines and public naming and shaming of violations and violators.

There are no specific German rules with respect to short swing trading of executives.

\textbf{iv Anti-hedging rules}

Under German law, there is no general prohibition for executives to hedge themselves against risks to variable elements of their compensation. However, German law provides anti-hedging rules, for example, with respect to executive remuneration by financial institutions,\textsuperscript{69} insurance companies,\textsuperscript{70} Alternative Investment Fund Managers (AIFM)\textsuperscript{71} and Undertakings for the Collective Investment of Transferable Securities (UCITS).\textsuperscript{72} According to these rules, financial institutions, insurance companies, AIFM and UCITS must take appropriate measures to ensure that executives do not limit or cancel out the risk in connection with their risk-oriented compensation elements through hedging.

\textbf{VI DISCLOSURE}

German generally accepted accounting principles,\textsuperscript{73} Section 4.2 of the GCGC and, as the case may be, International Financial Reporting Standards, require extensive annual public disclosure concerning the remuneration of a company’s management board members. The disclosure forms part of the notes to the annual financial statements and must also be reflected in a remuneration report, which forms part of the management report and provides detailed information on the principles and the amount of the remuneration of the management board members. Disclosure comprises the total annual remuneration with a breakdown for each management board member, divided into fixed and variable compensation components.\textsuperscript{74}

Privately held companies are generally subject to the same disclosure obligations; however, the remuneration of each individual management board member need not be disclosed. Certain further disclosure exemptions may apply for small companies.\textsuperscript{75}

\begin{itemize}
\item \textsuperscript{68} Directive on Criminal Sanctions for Market Abuse 2014/57/EU.
\item \textsuperscript{69} Section 8(1) of the German Ordinance regarding Remuneration in Financial Institutions. BaFin has published detailed guidelines for the interpretation of the German Ordinance regarding Remuneration in Financial Institutions.
\item \textsuperscript{70} Section 4(4) of the German Ordinance regarding Remuneration in Insurance Companies.
\item \textsuperscript{71} Note 92 of the AIFMD Remuneration Guidelines (ESMA/2013/232).
\item \textsuperscript{72} Note 94 of the UCITS Remuneration Guidelines (ESMA/2916/575).
\item \textsuperscript{73} Section 285 No. 9 and Section 314(1) No. 6 of the German Commercial Code.
\item \textsuperscript{74} Disclosure must also set forth separately the amounts attributable to base salaries, options and other share-based compensation components, insurance premiums paid by the company, expense allowances and other benefits, severance arrangements and change in control provisions.
\item \textsuperscript{75} Sections 288(1), 267(1), 293 of the German Commercial Code.
\end{itemize}
Moreover, the general shareholders’ meeting of a stock corporation may resolve, with a three-quarters majority of the votes cast, that certain remuneration-related information (in particular, a breakdown of the remuneration of each individual management board member) need not be disclosed for a period of up to five years.\textsuperscript{76}

There is no requirement to make the full text of the service agreements between the company and its management board members publicly available.

\section*{VII \hspace{0.5em} CORPORATE GOVERNANCE}

As a reaction to the worldwide financial crisis, the German parliament adopted legislation in 2009 changing certain rules on the remuneration of management board members of stock corporations in Germany.\textsuperscript{77} These changes are supposed to set incentives in favour of the sustainable development of enterprises and to prevent excessively high levels of remuneration.

\subsection*{i \hspace{0.5em} Appropriateness of remuneration and shareholder rights}

The supervisory board of a stock corporation determines the remuneration of the management board members. It must ensure that the remuneration is appropriate in relation to the management board members’ duties and responsibilities, their performance and the situation of the company; and does not exceed the customary remuneration that is granted in comparable companies without good reasons for such excess.\textsuperscript{78}

The German Stock Corporation Act\textsuperscript{79} provides that the general shareholders’ meeting of a listed company may adopt a non-binding resolution on the remuneration system for the management board members. Plans to implement a mandatory and binding shareholder vote on the remuneration system (‘say-on-pay’) based on the recommendation of the supervisory board have been considered, but never implemented. The amended Shareholder Rights Directive of 17 May 2017\textsuperscript{80} stipulates that the companies have to establish a remuneration policy concerning its directors and that shareholders have the right to vote on the remuneration policy at the general meeting. However, the Member States may provide for the shareholder vote at the general meeting on the remuneration policy to be only advisory (and not binding). A rejecting shareholder vote will trigger an obligation to amend the remuneration policy and to present it again at next year’s general meeting for another shareholder vote.\textsuperscript{81}

The companies have to submit the remuneration policy to a shareholder vote at the general meeting in each case of any material change and in any case at least every four years.\textsuperscript{82} In addition, the companies have to draw up a clear and understandable remuneration report on which the annual shareholders’ meeting has the right to hold an advisory vote.\textsuperscript{83} The remuneration policy as well as the remuneration report has to be published on the website

\textsuperscript{76} Section 286(5) sentences 1 and 2 of the German Commercial Code.
\textsuperscript{77} The Act on the Appropriateness of Management Board Remuneration, \textit{inter alia}, amended Section 87 of the German Stock Corporation Act.
\textsuperscript{78} Section 87(1) of the German Stock Corporation Act.
\textsuperscript{79} Section 120(4) of the German Stock Corporation Act.
\textsuperscript{81} Article 9a(3) of Directive (EU) 2017/828.
\textsuperscript{82} Article 9a of Directive (EU) 2017/828.
\textsuperscript{83} Article 9b of Directive (EU) 2017/828.
of the company. The German Federal Ministry of Justice has meanwhile appointed an expert committee to assist in the implementation of the amended Shareholder Rights Directive by the 10 June 2019 deadline.

According to amendments to the GCGC, a non-binding code that listed companies may either comply with or explain publicly why they do not comply with it (comply or explain), German stock corporations should generally set forth a maximum amount for each part of the management remuneration (e.g., for bonus payments and stock options).84

ii Variable compensation, stock options, and directors’ and officers’ liability insurance

In the case of a listed company, any variable compensation granted to the management board members must be determined on the basis of a multiple-year assessment that requires essentially forward-looking characteristics. Early disbursements of multiple-year variable remuneration components are not permitted.85 Short-term bonus payments that only consider the performance within a single fiscal year continue to be permissible, as long as they are combined with a long-term bonus element and the overall metrics of the variable compensation offer an adequate incentive for the management board members to pursue the sustainable development of the company with a longer perspective.86

There is a mandatory waiting period of at least four years before stock options granted to a management board member may be exercised and shares acquired thereby may be sold.87

Directors’ and officers’ insurance that a stock corporation takes out on behalf of its management board members to cover risks arising from the performance of their duties and responsibilities must provide for a deductible to be borne by the management board member of at least 10 per cent of the amount of the damages (capped at one-and-a-half times the management board member’s fixed annual salary).88

iii Reduction of remuneration

Pursuant to the German Stock Corporation Act,89 the supervisory board should reduce the management board members’ remuneration if the company’s situation deteriorates in a manner such that it would be unreasonable to continue compensating the management board members at the agreed level. A reduction may be justified by adverse economic developments because of which the company is significantly losing money, has to make general pay cuts or must carry out collective dismissals.

The management board members concerned may challenge such reduction by filing an action for specific performance. Additionally, they may terminate their service agreements with the company as of the end of the next calendar quarter by giving at least six weeks’ notice.90

84 Section 4.2.3 of the GCGC.
85 Section 4.2.3 of the GCGC.
86 Section 193(2) No. 4 of the German Stock Corporation Act.
87 Section 93(2) Sentence 3 of the German Stock Corporation Act. However, it is common practice that board members take out private insurance to close the gap.
88 Section 87(2) Sentence 1 of the German Stock Corporation Act.
89 Section 87(2) Sentence 4 of the German Stock Corporation Act.
Reforming the principles of executive remuneration in financial institutions and insurance companies has been a key topic on the agenda of the German legislator and the BaFin.

**Capital Requirements Directive IV**

In this context, Germany has implemented the new requirements as set forth by the Capital Requirements Directive IV (CRD IV, including the widely discussed bonus caps) and as specified by the European Banking Authority (EBA) by amending the German Banking Act as well as the German Ordinance regarding Remuneration in Financial Institutions (GORFI), which originally came into force in 2010.\(^{91}\) In response to the issuance by EBA of its guidelines on sound remuneration policies in 2015, BaFin amended the GORFI, effective as of 4 August 2017.

**Remuneration principles**

German remuneration principles are substantially in line with the requirements as currently set forth by the European Union. Moreover, Germany to a great extent complies with the remuneration requirements as set forth by CRD IV as from 1 January 2014. The ratio between fixed and variable compensation for employees of financial institutions is thus capped at 100 per cent of the fixed remuneration, subject to an increase to 200 per cent if explicitly approved by the financial institution’s shareholders. The scope of application for bonus caps is broader than required by the EU Directive (‘gold-plating’), given that all employees (and not just risk-takers) are subject to the cap in Germany.\(^{92}\)

However, pursuant to the principle of proportionality set forth by CRD IV,\(^{93}\) certain provisions of the GORFI apply only to certain categories of institutions, namely ‘significant’ institutions, ‘not significant’ institutions and ‘not significant’ institutions with a balance sheet total less than €3 billion. As a result, the numerous smaller German banks are exempted from various obligations, for example, the identification of internal risk-takers or the deferral of at least 40 per cent (60 per cent in case of a member of the management board or the next lower management level) of variable remuneration components over a period of at least three years. These exemptions and their conformity with CRD IV have been debated at EU level. Meanwhile, legislative amendments to CRD IV have been proposed which relate, *inter alia*, to Article 94 CRD IV (on the variable elements of remuneration).\(^{94}\) If enacted as proposed, these amendments would, among other things, allow for exempting smaller banks from certain obligations contained in CRD IV (including in relation to the variable remuneration components), subject to certain requirements.

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\(^{91}\) The German Ordinance regarding Remuneration in Financial Institutions applies to German credit institutions, German financial services institutions and German branches of non-EEA financial institutions.

\(^{92}\) See Section 25a of the new German Banking Act. For more detailed information on the European background, please see the EU Overview chapter of this publication.

\(^{93}\) See Article 92(2) of CRD IV.

\(^{94}\) Proposal for a Directive of the European Parliament and of the Council amending Directive 2013/36/EU as regards exempted entities, financial holding companies, mixed financial holding companies, remuneration, supervisory measures and powers and capital conservation measures – Presidency compromise text, Article 1(16) adding Paragraphs (3) and (3a) to Article 94 CRD IV.
The 2017 version of the GORFI determines the obligation to identify risk-takers only for ‘significant’ institutions. In addition, the obligation only exists if a measure regarding the respective risk-taker is planned. It also provides for a mandatory clawback of variable remuneration already paid out if the risk-taker proved to have a negative impact on the overall success of the company. These clawback elements may add up to the full amount of the bonus if the risk taker is personally responsible for significant losses for the company or regulatory sanctions against it, or in the case of a serious breach of external or internal rules relating to personal conduct. Members of the management board or the next lower management level are particularly affected because their variable remuneration is safe only after seven years.

Several institutions across the European Union have changed their remuneration policies and introduced ‘role-based allowances’, which institutions tend to consider as fixed remuneration, arguing that such allowances are linked to the position rather than to the performance. Role-based allowances are payments made in addition to the fixed remuneration (base salary) and the performance-based variable remuneration (bonus). However, the European Banking Authority has taken the view that these allowances should be classified as variable remuneration in case they are either (1) not predetermined, (2) not transparent, (3) not permanent or (4) revocable, or in case they provide incentives to take risks. With these allowances being considered variable remuneration, the respective remuneration policies would in some cases not comply with the limit on the variable remuneration to 100 per cent of the fixed remuneration (200 per cent with shareholders’ approval).

In Germany, the 2017 version of the GORFI provides for the abolition of all types of remuneration other than fixed and variable remuneration elements. If in doubt, an element will be deemed variable remuneration. The 2017 version of GORFI defines in detail under which conditions remuneration is considered to be fixed. The remainder is considered to be variable remuneration.

**Disclosure requirements**

All relevant institutions must disclose their remuneration principles on an annual basis, including on their websites. The published information must comprise the aggregate amount of remuneration paid out by the institution, broken down into fixed and variable components, and the number of recipients of variable remuneration. Significant institutions are subject to increased disclosure obligations and must, for example, also disclose the composition, tasks and organisation of their remuneration committee, the aggregate amount of deferred variable compensation and the aggregate amount of severance payments made.

**ii AIFMD and UCITS**

With effect as of 22 July 2013, Germany has introduced a German Capital Investment Act (GCIA), thereby transposing the AIFMD into German law. Since its incorporation into the GCIA as from 18 March 2016, the following applies to both AIF and UCITS management companies.

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95 Note the proposed changes to Article 92 CRD IV (on remuneration policies), Presidency compromise text (note above).

96 Nos. 7 and 8 of the Guidelines on sound remuneration policies under Articles 74 (3) and 75 (2) of Directive 2013/36/EU and disclosures under Article 450 of Regulation (EU) No. 575/2013.

97 See Section 16(3) of the German Ordinance regarding Remuneration in Financial Institutions.
Remuneration principles

The GCIA\(^98\) provides for regulations regarding the remuneration of an investment fund manager’s senior management and employees who either exercise control functions, whose professional activities have a material impact on the fund’s risk profile (‘risk-takers’) or who receive a total remuneration that takes them into the same remuneration bracket as senior management and risk-takers. In particular, the remuneration system of investment fund managers must promote sound and effective risk management; it must be in line with the business strategy, objectives, values and interests of the fund; any variable remuneration must be assessed over multiple years appropriate to the life cycle of the funds managed by the relevant company; and there must be an appropriate balance between fixed and variable components.

Corporate governance

In the case of ‘significant’ investment funds (i.e., in general, funds managing assets of at least €1.25 billion in the aggregate and employing at least 50 employees), a remuneration committee has to be established, which advises and controls the company in respect of its remuneration system.\(^99\)

IX DEVELOPMENTS AND CONCLUSIONS

According to the public view in Germany, the worldwide financial crisis of 2008 and its influence on the current banking and sovereign debt turmoil was, to a large extent, attributable to an executive remuneration system that incentivised short-term risk-taking over long-term sustainability. Therefore, executive remuneration, in particular at financial institutions, continues to be in the focus of public attention, and pressure remains on the German legislator to establish a tight regulatory framework. The 2017 version of the GORFI with its new definition of fixed and variable remuneration could be a good start for achieving legal clarity.\(^100\)

Several financial institutions in Germany have comprehensively amended their remuneration systems. For instance, they have introduced clawback elements for bonus and other variable payments to their executives and employees in accordance with new mandatory laws.\(^101\) Most financial institutions in Germany have increased the fixed portion of the remuneration, started to pay special allowances to bypass the bonus caps\(^102\) and have introduced creative remuneration structures (e.g., debt-based remuneration instruments that convert into equity). Many of them have, meanwhile, obtained shareholders’ approval for bonuses that amount to twice annual fixed pay.

Significant legislative measures on both national and EU level took place. Key issues were mandatory ‘say-on-pay’ votes for shareholders’ meetings, the scope of CRD IV for smaller financial institutions, the abolition of role-based allowances and mandatory clawback elements for bonus payments. In particular, a new Directive regarding the remuneration

\(^{98}\) See Section 37 of the GCIA.

\(^{99}\) No. 11.2 of the UCITS Remuneration Guidelines (ESMA/20916/575).

\(^{100}\) See Section VIII.i, concerning the remuneration principles.

\(^{101}\) Section 20(6) of the Statutory Order on Supervisory Requirements for Compensation Systems of Financial Institutions.

\(^{102}\) See Section VIII.i, concerning the European Banking Authority’s view on ‘role-based allowances’.
of management board members and supervisory board members was implemented by the European Commission. One of the main features is the obligation to establish a remuneration policy with a detailed minimum content, that has to be submitted to the general shareholders’ meeting at least every four years. The German legislator may provide that the vote is only advisory, but it is expected that, de facto, the vote has binding character. It remains to be seen whether there is further need for legislation regarding the remuneration of management board members and supervisory board members. The German legislator has to transform the amended Shareholder Rights Directive into German law by 10 June 2019. In any event, the regulation of executive remuneration will continue to be a hot topic in Germany.

Chapter 8

HONG KONG

Rowan McKenzie, Steven Sieker and Karen Man

I INTRODUCTION

Hong Kong is one of the world’s leading financial centres and for decades has been a launching ground for businesses entering the Chinese market. As Hong Kong’s economy has moved from a manufacturing-based to a service-based economy, remuneration levels have increased and pay structures have become more sophisticated. Packages often include base salary, bonuses and equity compensation. There are tax incentives for certain housing benefits, which often feature in executive compensation packages.

Following the global financial crisis, the Hong Kong Monetary Authority issued requirements concerning executive remuneration that followed similar conditions imposed in the United States, the United Kingdom and some countries in Europe. These requirements apply only to certain regulated financial institutions.

Hong Kong introduced minimum wage legislation in 2011. Payment of wages (including the time, manner and place of payment) is highly regulated and record-keeping requirements can affect even highly paid executives. Companies are generally free to structure compensation packages for their executives by mutual agreement, but must operate within the statutory regime. Bonuses are highly regulated in Hong Kong and many are unintentionally caught by legislation meant to cover 13th-month bonuses.

As Hong Kong becomes a more regulated jurisdiction for employers in general, there are likely to be additional restrictions on the way in which compensation can be structured.

II TAXATION

i Income tax for employees

Hong Kong salaries tax is chargeable on employment income that arises in or is derived from Hong Kong. In determining whether income arises in Hong Kong, the location of the employment must be examined. The most important factors are whether:

a the employment contract was negotiated and executed in Hong Kong;
b the employer is resident in Hong Kong; and
c the remuneration is paid to the employee in Hong Kong.

If the employment is located in Hong Kong, the income from such employment will be chargeable to salaries tax, although an exemption is available if the employee renders no services in Hong Kong during this employment, or if the employee is physically present

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1 Rowan McKenzie, Steven Sieker and Karen Man are partners at Baker McKenzie.
in Hong Kong for no more than 60 days in total in the year of assessment; however, even for employment that is not located in Hong Kong, if the employee is physically present in Hong Kong for more than 60 days and renders any services during that period, the income arising from the services rendered in Hong Kong will still be subject to salaries tax, albeit on a day-in-day-out basis. The salaries tax charge therefore applies to all employees, regardless of their nationality or residency. Salaries tax is charged at progressive rates, with the maximum rate being 17 per cent, but the total tax payable is capped at a standard rate of 15 per cent of the net assessable income.

**Share options**

Salaries tax will be charged upon the exercise of share options. The tax is levied on the gain realised by the exercise of the option, and this gain is calculated as the difference between the fair market value of the shares at the time of exercise, and the consideration paid for the grant of the shares.

**Restricted stock**

If there is no vesting period for restricted stock, salaries tax is charged on the fair market value of the shares at the time of grant. Discounts may be made in determining their fair market value depending on the restrictions applicable. Any distributions arising from the shares during the vesting period will not be taxable, as they are investment income. If a vesting period applies, salaries tax is charged on the fair market value at the time of vesting. Distributions that arise from the shares during the vesting period will also be taxable as employment income.

**Restricted stock units**

The legal position on restricted stock units (RSUs) is uncertain, but where they are settled completely in cash, they are most likely regarded as phantom share plans, and no salaries tax will be charged at the time the shares are allocated if no value is passed on to the employee. Salaries tax will be charged when the cash is paid. If the RSU is completely settled using shares, they would most likely be regarded as stock awards, and salaries tax would be charged when the shares vest in the employee. If the RSU is to be settled with a mixture of cash and shares, the tax treatment would depend on the particular terms of the RSU.

### ii  Social taxes for employees

In Hong Kong, employers and employees are each required by law to participate in a mandatory provident fund (MPF) scheme and to each contribute an amount equivalent to 5 per cent of the employee’s relevant income (exclusive of severance or long-service payments paid under the Employment Ordinance) to the scheme. The employee’s relevant income is currently capped at a maximum of HK$30,000 per month for the purposes of calculating the contribution. Accordingly, the maximum mandatory contribution amount required by both the employer and employee is HK$1,500 per month.

The requirement to make contributions will apply in relation to all Hong Kong employment, regardless of the nationality or the residence of the employee. An executive director receiving a salary under a contract of employment, for example, will be required to join an MPF scheme; however, a director who receives directors’ fees by virtue of being an
office holder is not an employee and therefore not required to participate in an MPF scheme. There are, however, some limited exceptions for employees who enter Hong Kong on an employment visa.

Alternatively, an employer may also operate an Occupational Retirement Schemes Ordinance (ORSO)-exempted scheme instead of participating in an MPF scheme. The contributions for such a scheme will be governed by the relevant ORSO-exempted scheme’s governing rules.

Remuneration in the form of share options and other compensation that is not expressed in monetary form is excluded from the employee’s income for the purposes of making MPF contributions.

### iii  Tax deductibility for employers

Employee remuneration is generally deductible by the employer for the purposes of profits tax, including regular contributions to an MPF scheme (up to a limit of 15 per cent of the total remuneration); however, only remuneration that can be shown to be an expense incurred in the production of profits subject to tax in Hong Kong will be deductible and, therefore, some payments to employees may not be deductible.

Remuneration will generally be deductible during the year of assessment it is incurred, but it should be noted that the Hong Kong Inland Revenue Department considers that the issue of shares by an employer to employees in fulfilment of share options or stock awards is not an expense, but a movement in the equity reserve account of the employer and therefore no tax deduction is allowed. Payments to a third party (e.g., a listed parent) for the issuance of shares may be deductible under normal rules in relation to deductibility.

### iv  Other special rules

Payments made to employees in connection with a change of control will generally not be deductible for the profits tax purposes of the employer, unless it can be shown that the payments are current expenses incurred for the production of profits.

Benefits provided by an employer to an employee in return for services rendered will generally be chargeable to salaries tax if they are convertible to cash. A benefit can be convertible by sale, but also by other means, for example, an arrangement whereby the employee can elect to surrender the benefit and accept extra salary instead. Housing and vehicles are frequently provided to employees in Hong Kong on a tax-favoured basis. This is permissible provided that the rules in relation to such benefits are properly followed.

### III  TAX PLANNING AND OTHER CONSIDERATIONS

As discussed in Section II, no salaries tax is chargeable on the income of any employee who is physically present in Hong Kong for no more than 60 days in a year of assessment, regardless of whether they are in Hong Kong employment. The simplest arrangement would therefore be one where the employee does not stay in Hong Kong for more than 60 days in a year of assessment.

Where it is necessary for an employee to be based in Hong Kong for more than 60 days in a year of assessment, a secondment arrangement can be used. It is generally accepted that a secondee continues to be employed by the original employer. If the secondment can

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be shown as non-Hong Kong employment, the employee would be subject to Hong Kong salaries tax on a time-apportionment basis, which is only chargeable for services rendered during the days spent in Hong Kong.

Some double taxation agreements may provide for an exemption from salaries tax for a foreign resident if (1) that resident is present in Hong Kong for no more than 183 days during any single year of assessment, (2) his or her remuneration is not paid by a Hong Kong-resident employer or one with a permanent establishment in Hong Kong, and (3) the remuneration is subject to tax in his or her home jurisdiction.

IV EMPLOYMENT LAW

Hong Kong employment law is broadly similar to English employment law but is less regulated, and there are some significant differences that employers need to be aware of when operating in this jurisdiction. Employment law in Hong Kong is governed primarily by the Employment Ordinance, which applies to all employees (with limited exceptions such as family members in small businesses) and to secondees on foreign employment contracts. There is no ‘at-will’ concept in Hong Kong and employment is contractual and must be terminated in accordance with contractual terms or as otherwise provided by law.

i Confidential information

Hong Kong law recognises and protects trade secrets and confidential information, but information that is public or that forms part of the employee’s own knowledge is generally not protected. The duty of fidelity or fiduciary duties will protect the employer during the employment relationship, but it is recommended that contractual provisions or a non-disclosure agreement is used to expressly protect company property during the post-employment period.

ii Corporate transfers

There is no automatic right of transfer in Hong Kong, therefore, employees must be dismissed by the seller and re-engaged by the buyer. Termination triggers the payment of statutory and contractual entitlements including severance. In Hong Kong, the term ‘severance’ has a specific legal meaning (i.e., it is payable only to certain employees when the reason for dismissal is redundancy) and should not be used to refer to a termination package in general.

On transfer, there are statutory provisions that, if followed, negate the requirement to make payments to the employee if the transfer is connected to the sale of a business or is within a single group of companies. In order to satisfy the requirements, the buyer must offer employment on terms and conditions that are the same or no less favourable, recognise prior service, and make this offer at least seven days prior to the transfer.

There are no statutory rules applying to a change in control of a company, therefore, contractual terms will govern entitlements, etc., where these exist.

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2 Cantor Fitzgerald Europe and Another v. Jason Jon Boyer and Others (HCA 1160/2011). The court upheld the right of a secondee on an employment contract governed by English law to terminate his employment with a UK company by making a payment in lieu of notice pursuant to Section 7 of the Employment Ordinance.
iii Deductions
It is not permissible for deductions to be made from an employee's salary unless they fall within one of the authorised categories set out in the Employment Ordinance. This means, for example, that employers will need to administer share incentive plans differently to ensure that employee contributions come directly from an employee's personal bank account in order to avoid criminal liability under the Employment Ordinance.

iv Gardening leave and notice periods
The effectiveness of gardening leave clauses is affected by a mandatory term in the Employment Ordinance, which allows both employers and employees to make a payment in lieu of notice to terminate the employment contract. This right cannot be overridden by any contractual provision, including a gardening leave clause. Another significant mandatory term is the employee's right to serve notice at any time. This means that contractual provisions seeking to restrict when notice can be served (at the expiry of a fixed period, for example) will be overridden by the Employment Ordinance. Therefore, the importance of having enforceable post-termination restrictions cannot be overstated.

v Post-termination restrictions
Employers typically include post-termination restrictions in their standard employment contracts for senior executives. The four common types of post-termination restrictions are:

- non-competition;
- non-solicitation of employees;
- non-solicitation or non-dealing with customers; and
- non-solicitation of suppliers.

If the post-termination restrictions are held to be enforceable, then an employer may be able to obtain an injunction to enforce the terms or obtain monetary damages.

The Hong Kong courts take a similar approach to the English courts when analysing post-termination restrictions. The restrictions must be confined to protect the employer's legitimate business interests and should go no further than necessary to protect that interest, and any restriction should not unduly injure the interests of the employee or the public. Restrictions must be reasonable in terms of duration, scope and geographical application. The courts will consider a broad range of factors when analysing whether a restriction is reasonable, which include (1) the seniority of the employee, (2) whether the employee had access to key confidential information, (3) the duration of restraints and scope of prohibited activities, and (4) whether any payments were made during the restricted period (this is not a requirement but will form part of the analysis).

The Hong Kong courts adopt a stringent approach when assessing the enforceability of post-termination restrictions. Employers should be mindful of the need to produce convincing evidence to support the reasonableness of any restrictions. In a recent high-profile financial services case, the court conducted a detailed examination of restrictions imposed on four employees, which ranged from three to 12 months in duration. The court found all the

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3 ibid.
restrictions unenforceable either on the basis that there was no breach or that the employer had failed to provide cogent evidence to justify the length of the restriction, or the drafting was too wide or ambiguous.

Unlike in other jurisdictions, such as mainland China, there is no obligation to make payment during a post-termination restraint period. The Hong Kong courts have held that payment will not render an otherwise unenforceable restriction reasonable and enforceable. The courts have also held, however, that payment could be of assistance in borderline cases.

vi Termination

Termination generally takes place by one party giving the contractually agreed notice to the other. If no notice is agreed in a signed employment contract, the Employment Ordinance deems it to be one month. Either party is entitled to terminate with immediate effect by making a payment in lieu of notice.

An employer may terminate a contract of employment without notice or payment in lieu if (1) the employee commits certain statutorily defined misconduct in relation to his or her employment or (2) on any other ground provided by common law. This is referred to as summary dismissal in Hong Kong and it does not include termination for poor performance. Employers need to exercise care when summarily dismissing employees, particularly when employees are highly remunerated. The High Court recently awarded an employee damages of over HK$15.8 million in a case for wrongful dismissal and breach of the implied duty of trust and confidence. The case was quite unusual in its facts, but it does serve to highlight the need for employers to verify core facts and to gather supporting evidence prior to summarily dismissing, as the potential cost implications of failing to do so may be significant.

An employee may resign without notice or payment in lieu and claim constructive dismissal if the employer commits a repudiatory breach of contract, such as unilaterally reducing salary or undermining the mutual trust and confidence of the employment relationship. Post-termination restrictions do not survive the employee's dismissal in breach of contract.

Employees with more than two years of service are protected against dismissal without a valid reason as defined in the Employment Ordinance. The implications for wrongful termination or dismissal without a valid reason are low value from a financial perspective. If there is an underlying risk of an allegation that termination was for a discriminatory reason then care should be exercised, as there is no upper limit on damages in such claims. In Hong Kong, discrimination is unlawful on the grounds of sex, marital or family status, pregnancy, disability or race.

In principle, there is no impediment to obtaining a full release from an employee against all employment liabilities. The level of payment to be made under any release agreement will depend upon the individual circumstances of the matter.

vii Bonuses

It is common for a bonus to form part of the total compensation package of a senior employee. There is no statutory requirement to pay a bonus in Hong Kong but depending upon the manner in which the bonus wording is articulated, certain types of bonuses will be subject to regulations in the Employment Ordinance.

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4 Grant David Vincent Williams v. Jefferies HK Ltd, Court of First Instance (HCA 320/2011).
If a bonus is annual, it is likely to fall within the definition of an end-of-year payment under the Employment Ordinance unless it is paid solely at the employer's discretion. The Hong Kong courts have interpreted this to mean that the decision whether to make a bonus payment must be discretionary. Bonuses that are not guaranteed but are based on performance formulas are not discretionary under Hong Kong law and will be regulated by the Employment Ordinance.

There are specific payment rules in the Employment Ordinance for end-of-year payments. The most significant one is that a prorated payment must be made to employees who are dismissed after three months' service in the bonus year (discounting any probationary period, and excluding cases of summary dismissal). It is not possible for employers to contract out of these payment rules, for example, by requiring an employee to be in active employment on the payment date.

If a bonus is not annual, it will not be an end-of-year payment, but if it is payment for work that has been or will be done, it will fall within the definition of 'wages' under the Employment Ordinance irrespective of whether it is discretionary. This means that the bonus will increase the value of certain statutory payments (such as annual leave pay and sick leave pay), which are based on average wages earned in the 12 months prior to the start of annual leave, sick leave or a similarly relevant date. This will have a significant upward effect on statutory payments for employees whose incomes are primarily derived from variable payments. Therefore, it is advisable to adopt bonus schemes that are both genuinely discretionary and annual as they are neither end-of-year payments nor wages in accordance with the Employment Ordinance.

The payment (or failure to make payment) of discretionary bonuses often results in employment disputes. An employer is required to exercise its discretion reasonably and in good faith and not irrationally or perversely such that no reasonable employer would have exercised the discretion in such a manner. This has been interpreted to mean that employers may take into account only those factors specified in the contract when determining whether to pay a bonus.

Following a recent Court of First Instance decision,5 employers operating discretionary bonus schemes in Hong Kong will need to be more cautious when dismissing employees part way through a bonus cycle. This is particularly so in circumstances where the employer is unlikely to be able to show a genuine reason for the dismissal and the termination would prevent the employee from becoming eligible for a discretionary bonus. In Sunny Tadjudin v. Bank of America, National Association,6 the Court found that an implied term of anti-avoidance in relation to bonuses can exist in a contract of employment and did exist in Ms Tadjudin's contract. The Court held that the bank was in breach of this implied term when it terminated the employment of Ms Tadjudin in a manner that prevented her being eligible for a bonus for 2007 under the bank's performance incentive programme.

The Court found that the implied term of anti-avoidance existed after a careful examination of the terms in the employment contract and the way in which the bank operated its discretionary bonus scheme, including its commitment to pay for performance and the lack of business efficacy without the implied term. As a result of this decision, there is a risk that the anti-avoidance term will be implied in employment contracts and all relevant

5 CFI, HCA322/2008.
6 ibid.
circumstances will be taken into account in determining whether it exists. To avoid this risk, the anti-avoidance term may be specifically excluded by an express contractual term, although this has not yet been tested in court.

The Court of Appeal recently upheld the Court of First Instance’s finding of the implied anti-avoidance term in Ms Tadjudin’s employment contract but importantly clarified that this was a finding based on the particular facts and circumstances of this case, and it did not mean that this term should be implied in employment contracts generally. It would be prudent for employers to tread carefully when dismissing employees part way through a bonus cycle while a body of case law on this implied term develops.

V SECURITIES LAW

In Hong Kong, the two major pieces of legislation regulating the offering of securities are the Companies (Winding Up and Miscellaneous Provisions) Ordinance and the Securities and Futures Ordinance.

Under the Companies (Winding Up and Miscellaneous Provisions) Ordinance, a document must comply with the prospectus content and registration requirements where that document (1) offers any shares in or debentures of a company (whether incorporated in Hong Kong or elsewhere) to the public for subscription or purchase for cash or other consideration, or (2) calculates to invite offers by the public to subscribe for or purchase for cash or other consideration any shares in or debentures of a company (whether incorporated in Hong Kong or elsewhere).

The offering of shares or debentures (or any right, option or interest in, or in relation to the shares or debentures), in a company to employees located in Hong Kong is generally subject to an exemption from the prospectus content and registration requirements. The above exemption is available if the following conditions are met:

a the offer is in respect of shares or debentures (or any right, option or interest in, or in relation to the shares or debentures) of a company;
b the offer is made to persons who are qualifying persons in respect of the company or another company that is a member of the same group of companies as the company (‘group company’);
c the offer is made by the company, a group company or the trustees of a trust established by the company or a group company that holds the shares or debentures that are the subject of the offer;
d the offer is on terms whereby the only persons who can acquire the shares or debentures are the qualifying persons to whom they are offered or, if the terms of the offer so permit, any qualifying person; and
e the offer contains a prescribed warning statement in a prominent position.

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Qualifying person, in relation to a company, means (1) a current or former bona fide director, employee, officer or consultant of the company, or (2) a bona fide dependant of any of the aforementioned persons and (3) includes a trustee of a trust established by the company or a group company that can hold shares or debentures on behalf of any of the above persons.

Prospectus requirements are also applicable in situations where an offering is made with a view to secondary offers of the shares or debentures to the public. The Companies (Winding Up and Miscellaneous Provisions) Ordinance creates a rebuttable presumption that a secondary offer to the public was intended if an offer of the shares or debentures for sale to the public is made within six months of the original allotment or agreement to allot the shares or debentures. This presumption could be rebutted if appropriate vesting schedules or restrictions on disposal of shares or debentures within a specific time period are imposed so that disposals within the relevant six-month period are prohibited. In practice, however, it may be rare for an employee to have a sufficiently large holding of shares or debentures to consider disposing of his or her stake by means of an offering to the public.

Where the offering involves products that constitute securities or structured products, such as the offering of phantom or cash-settled awards, based on the nature of the securities involved, the securities offering prohibition under the Securities and Futures Ordinance may apply. In the absence of an applicable exemption, the issue or possession for the purpose of issue of any advertisement, invitation or document containing an invitation to the public to acquire securities must be authorised by the Securities and Futures Commission. Employees located in Hong Kong constitute the public for the purpose of the securities offering prohibition under the Securities and Futures Ordinance. In such a case, depending on the nature of the securities involved, it may be necessary to rely on offering by way of private placement or other exemptions. There are no prescribed legal requirements that executives must hold stock of their employer, nor are there particular rules that apply with respect to executives selling company stock on the market. Further, there are no short swing trading or anti-hedging legal obligations that are specifically applicable to executives in Hong Kong. However, it is important to note that executives must have regard to provisions with respect to insider dealing and other market misconduct under the Securities and Futures Ordinance in dealing with listed securities or their derivatives. Where executives are also directors of a company whose securities are listed on the Stock Exchange of Hong Kong Limited, they will be subject to more stringent requirements and standards in their capacity as directors of the listed company.

11 Section 41(1) of the Companies (Winding Up and Miscellaneous Provisions) Ordinance.
12 Section 41(2) of the Companies (Winding Up and Miscellaneous Provisions) Ordinance.
13 'Structured product' is defined in Schedule 1 to the Securities and Futures Ordinance. It excludes, among other things, a product under which some or all of the return or amount due (or both the return and the amount due) or the method of settlement is determined by reference to securities of a corporation, or of a related corporation (as defined in the Securities and Futures Ordinance) of the corporation, and that is issued by the corporation only to a person who is (1) a bona fide employee or former employee of the corporation or of a related corporation of the corporation, or (2) a spouse, widow, widower, minor child (natural or adopted) or minor stepchild of such person. The policy intention behind this is to exclude certain employee incentive schemes (such as certain phantom share option schemes) that are issued by and referenced to securities of the corporation itself (or of a related corporation), from the regulatory regime for structured products.
Directors and chief executives of companies whose securities are listed on the Stock Exchange of Hong Kong Limited come under a duty of disclosure of all their interests and dealings in shares, short positions and debentures in the listed company or any associated corporation of the listed company under the Securities and Futures Ordinance. Directors and chief executives of a listed company are taken to be interested in any shares, short positions or debentures in which (among others) their spouse or minor children are interested. Particulars to be disclosed include the date on which the relevant event occurred, the total number and class of shares, short positions or debentures involved and details of changes in such interests. The listed company concerned is required to include information relating to the interests and short positions of such directors, chief executives and others in the shares, underlying shares and debentures of the listed company or any associated corporation in its financial reports.

VI DISCLOSURE

Information about benefits received by a director of a private company are subject to disclosure in the company’s annual audited statements, including the directors report therein (where appropriate), under law. Accordingly, any such benefit received by executives or employees who are also directors of a private company is subject to disclosure. These benefits include the company’s arrangements that enable directors to acquire benefits by means of the acquisition of shares or securities of the company or any other body corporate; directors’ emoluments and retirement benefits, payments in respect of termination of directors’ services and consideration for directors’ services (where applicable). Apart from submitting the annual audited statements to the tax authority for tax assessment purposes, a private company is not required to file its annual audited statements with the Companies Registry. The information about benefits received by directors that is disclosed in the annual audited statements of the private company is generally not available to the public.

Depending on the circumstances of each case, companies listed in Hong Kong may be required to publicly disclose certain remuneration information of the executives of the listed group of companies. In principle, a listed company should disclose its directors’ remuneration policy and other remuneration related matters (see Paragraph B of Appendix 14 of the Listing Rules).

A listed company is required to disclose in its financial statements information in respect of the five highest-paid individuals during the financial year, including:

- the aggregate of basic salaries, housing allowances, other allowances and benefits in kind;
- the aggregate of contributions to pension schemes;
- the aggregate of bonuses paid or receivable;
- the aggregate of amounts paid or receivable as an inducement to join or upon joining the listed company;

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15 Sections 341 to 343 and 348 of the Securities and Futures Ordinance.
16 Section 344 of the Securities and Futures Ordinance.
17 Section 349 of the Securities and Futures Ordinance.
18 The Listing Rules, Paragraph 13(1) of Appendix 16.
the aggregate of compensation paid or receivable for the loss of office; and

f an analysis showing the number of individuals whose remuneration fell within bands from zero up to HK$1 million or into higher bands.19

It is not, however, necessary to disclose the identity of the highest-paid individuals, unless any of them are directors of the listed company.20

A listed company is also required to disclose in its financial statements details of directors’ and past directors’ emoluments during the financial year, including:

a directors’ fees;

b directors’ basic salaries, housing allowances, other allowances and benefits in kind;

c contributions to pension schemes for directors or past directors;

d bonuses paid or receivable by directors;

e the amounts paid or receivable by directors as an inducement to join or upon joining the listed company; and

f the compensation paid or receivable by directors or past directors for the loss of office.21

A listed company should also disclose details of any remuneration payable to members of senior management by band in its annual report.22

In relation to any share option scheme adopted by a listed company or its subsidiaries, the listed company must disclose in its annual report and interim report the following information in relation to:

a each of the directors, the chief executive or substantial shareholders of the listed company, or their respective associates;

b each participant with options granted in excess of the individual limit;

c aggregate figures for employees working under employment contracts that are regarded as continuous contracts for the purposes of the Employment Ordinance;

d aggregate figures for suppliers of goods or services; and

e all other participants as an aggregate whole:

• particulars of outstanding options at the beginning and end of the financial year or period, including number of options, date of grant, vesting period, exercise period and exercise price;

• particulars of options granted during the financial year or period, including number of options, date of grant, vesting period, exercise period, exercise price and (for options over listed securities) the closing price of the securities immediately before the date on which the options were granted;

• the number of options exercised during the financial year or period with the exercise price and (for options over listed securities) the weighted average closing price of the securities immediately before the dates on which the options were exercised;

• the number of options cancelled during the financial year or period together with the exercise price of the cancelled options; and

19 ibid., Paragraph 25 of Appendix 16.
20 ibid., Paragraph 25.1 of Appendix 16.
21 ibid., Paragraph 24 of Appendix 16.
22 ibid., Paragraph B1.5 of Appendix 14.
• the number of options that lapsed in accordance with the terms of the scheme during the financial year or period.\textsuperscript{23}

In addition, in respect of options granted during the financial year or period over listed securities, the listed company is encouraged to disclose in its annual report and interim report the value of options granted to participants set out above during the financial year or period, and the accounting policy adopted for the share options. Where the listed company considers that disclosure of the value of options granted during the financial year or period is not appropriate, it must state the reason for such non-disclosure in its annual report or interim report.\textsuperscript{24}

A listed company should also disclose (where applicable) details of the number and remuneration of employees, remuneration policies, bonus and share option schemes and training schemes in the listed company's annual report.\textsuperscript{25}

In addition, a listed company is also required to include a statement as to the unexpired period of any service contract, which is not determinable by the employer within one year without payment of compensation (other than statutory compensation), of any director proposed for re-election at the forthcoming annual general meeting or, if there are no such service contracts, a statement of that fact. For a PRC company listed on The Stock Exchange of Hong Kong Limited, reference to ‘director’ in this context shall also mean and include ‘supervisor’.\textsuperscript{26}

\section*{VII \hspace{0.5cm} CORPORATE GOVERNANCE}

The disclosure of remuneration of executives who are directors of private companies and listed companies are set out in Section VI.

\subsection*{i \hspace{0.5cm} General rules}

Listed companies are subject to corporate governance requirements such as setting up an audit committee, remuneration committee and a nomination committee.\textsuperscript{27} The audit committee should comprise non-executive directors only and must have at least three members, at least one of whom is an independent non-executive director with appropriate professional qualifications, or accounting or related financial management expertise. The majority of the audit committee members must be independent non-executive directors of the listed company. The chairman of the audit committee must be an independent non-executive director.\textsuperscript{28} The principal objective of an audit committee is to, \textit{inter alia}, provide an independent review of the effectiveness of the financial reporting process, risk management and internal control systems.

All listed companies should set up a remuneration committee in accordance with the requirements of the Listing Rules, including Rules 3.25 to 3.27 and Paragraph B of the Corporate Governance Code and Corporate Governance Report (Appendix 14 to the Listing

\begin{thebibliography}{9}
\bibitem{23} ibid., Rule 17.07.
\bibitem{24} ibid., Rule 17.08.
\bibitem{25} ibid., Paragraph 32(7) of Appendix 16.
\bibitem{26} ibid., Paragraph 14 and 14.1 of Appendix 16.
\bibitem{27} ibid., Paragraph A.5.1 of Appendix 14.
\bibitem{28} ibid., Rule 3.21.
\end{thebibliography}
The remuneration committee must be chaired by an independent non-executive
director, and a majority of its members shall be independent non-executive directors.\(^{29}\)
The principal purpose of setting up a remuneration committee is, among other things, to
assist the board of directors to ensure that there is a transparent policy governing directors’
remuneration. It should also be responsible for making recommendations on specific
remuneration packages for executive directors and senior management, and reviewing and
approving compensation payments relating to dismissal or loss or termination of office of
executive directors.

All listed companies should establish a nomination committee that comprises a
majority of independent non-executive directors and is chaired by the chairman of the board
or an independent non-executive director. The principal purpose of setting up a nomination
committee is, among other things, to assist the board to exercise independent judgement
and plan for orderly succession. It should also be responsible for making recommendations
to the board on the appointment or reappointment of directors and succession planning for
directors, especially for the chairman and the chief executive.\(^{30}\)

ii Additional rules for special companies with weighted voting rights structures

In addition to the general corporate governance requirements, a listed company with a weighted
voting rights (WVR) structure (effective as at 30 April 2018) must establish a Corporate
Governance Committee comprised entirely of independent non-executive directors, one
of whom must act as the chairman. The Corporate Governance Committee must report
its work based on the prescribed terms of reference on a half-yearly basis. The nomination
committee of a listed company with a WVR structure must be chaired by an independent
non-executive director (see Rules 8A.27 and 8A.30 of the Listing Rules). Codified waivers
from the corporate governance requirements (e.g., remuneration committee requirements)
may be granted to qualifying companies with WVR structures seeking a secondary listing on
a case-by-case basis (see Rule 19C.11). Executive remuneration packages do not require any
union or works council approval in Hong Kong. Membership of trade unions is relatively low
in Hong Kong and collective bargaining is not recognised. Generally, employers and unions
do not enter into agreements on remuneration or otherwise.

There are additional requirements applying to executive remuneration for certain
employers in the finance industry and these are set out in Section VIII.

VIII SPECIALISED REGULATORY REGIMES

There are guidelines applying to executive remuneration for relevant employers operating
within the finance industry in Hong Kong.

The Hong Kong Monetary Authority (HKMA), which is the supervisory body for
the banking sector, issued a Guideline on a Sound Remuneration System (the Guideline) in
March 2010 (which was updated and revised in March 2015) to all authorised institutions
(AIs) (fully licensed banks, restricted licence banks and deposit-taking companies). The
Guideline applies to all AIs in Hong Kong, including in the case of locally incorporated AIs,
their overseas branches and subsidiaries subject to the HKMA’s consolidated supervision. In

\(^{29}\) ibid., Rule 3.25.

\(^{30}\) ibid., Paragraph A.5.2(d) of Appendix 14.
the case of overseas incorporated AIs, the remuneration systems applicable to officers and employees engaged in the conduct of their business and operations in Hong Kong must be sound and in compliance with the Guideline.

The Guideline provides broad guidance on the governance and control arrangements for, and operations of, AIs’ remuneration systems. It sets out key elements of a sound remuneration system, covering governance, structure of remuneration, measurement of performance for variable remuneration, deferment of variable remuneration (including minimum vesting periods, predefined performance conditions and clawback provisions) and adequate disclosure on remuneration. The Guideline distinguishes between fixed and variable incentive-based remuneration but there are no specific provisions that deal with bonuses or that impose specific limits to the relationship between fixed and variable remuneration.

Where an AI in Hong Kong is part of a banking group (either a subsidiary of a banking group or a branch of an overseas incorporated bank), it may adopt the remuneration policy formulated at group level if it can demonstrate to the HKMA’s satisfaction that the relevant group remuneration policy is broadly consistent with the principles set out in the Guideline.

The revised version of the Guideline has more prescriptive disclosure requirements and formally incorporates the relevant disclosure standards issued by the Basel Committee on Banking Supervision in its July 2011 paper on ‘Pillar 3 Disclosure Requirements for Remuneration’. Locally incorporated AIs must disclose the extent of their compliance, and explain any areas of non-compliance, with the requirements in the Guideline.31

The Guideline is classified as being a non-statutory guideline. However, as it is part of the HKMA’s supervisory framework, all AIs are expected to follow it. If the HKMA’s assessment indicates that an AI’s remuneration system is inconsistent with the principles set out in the Guideline, it will expect the AI to implement measures promptly to address and mitigate any risks identified in respect of its remuneration arrangements. If the AI fails to take timely corrective measures, this will result in the HKMA taking such supervisory measures as it considers appropriate. In extreme cases, where the HKMA has serious concerns about the interaction of the AI’s remuneration arrangements and its capital strength, the HKMA may consider the need to set a quantitative limit on the total variable remuneration payable by the AI (such as limiting total variable remuneration to a percentage of total net revenues) if this is considered necessary in all the circumstances as a capital conservation measure.

IX DEVELOPMENTS AND CONCLUSIONS

There is a continued focus on executive remuneration in the media. Although corporate governance and accountability in Hong Kong is less well developed as compared with other jurisdictions, companies continue to be placed in the spotlight by investors, shareholders and the public alike on the issue of salaries, bonuses, deferred compensation and high-value exit packages. There is a growing pressure for incentive arrangements to be structured on a long-term basis, to have an improved link between pay and performance and for increased transparency in general. Companies are responding to these pressures, as the preference is to deal with these issues internally rather than have externally imposed rules on executive pay.

31 Section 52(ba) and (c) of the Banking (Disclosure) Rules (Chapter 155M of the Laws of Hong Kong).
Chapter 9

HUNGARY

Barnabás Buzási, Melinda Pelikán, János Pásztor, Alexandra Tóth and Eszter Bohati

I  INTRODUCTION

Having heard the word ‘executive’, most people associate the term with managing directors, CEOs and other people involved in the senior management of a company, regardless of the company’s legal form. However, from a labour law perspective these persons shall be only considered as executives if they work within the framework of an employment agreement. In this case the provisions of the Labour Code apply to their legal relationship with certain alterations from the rules applicable to the regular employment relationships.

Another group of employees also form part of the executives, on the basis of the nature of their position and upon the parties’ agreement included in their employment agreement.

As these positions are particularly important from the employer’s point of view, the related rules grant to the contracting parties a greater freedom in defining the terms of their agreement. However, regarding the rules related to remuneration, the two groups mentioned above must be examined differently, as the levels of protection differ from each other.

Apart from the salary prescribed by the labour law, the employer may decide to introduce different types of allowances and compensate the executives’ work, loyalty and motivate their productivity by other means (e.g., bonuses, ensuring the possibility of taking part in employee share schemes). These allowances are usually incorporated in a detailed internal policy, by taking into account the potential ways of amendment and its difficulties, which is the most economic solution to ensure adequate protection of the employer’s interests.

Collective agreements do not apply to the executives.

II  TAXATION

i  Income tax for employees

Personal income tax consequences of executive compensation

The rules applicable to personal income tax are set out in the Act CXVII of 1995 on Personal Income Tax (the Act on PIT). Any consideration received by a private individual in any way or form – in cash or in non-cash assets – can qualify as income for the purposes of the Act on PIT. If the executive’s income becomes taxable in Hungary, the employment income will be subject to 15 per cent personal income tax (PIT) in 2018.
In general, Hungarian tax residents are subject to PIT on their worldwide income, regardless of whether the funds are transferred to Hungary. Non-residents are taxed on income from Hungarian sources only. Therefore, the tax residency of the executive has to be determined in order to ascertain whether and to what extent Hungarian PIT liability arises concerning his or her income.

**Hungarian tax resident status**

According to Section 3 of the Act on PIT, the following should be regarded as being resident for PIT purposes in Hungary:

a Hungarian citizens;
b EEA nationals who spend at least 183 days per calendar year (including the day of entry and the day of exit) in Hungary; and
c third-country nationals who have a permanent residence permit or stateless status in Hungary.

Also, individuals qualify as being resident in Hungary for PIT purposes if:

a their only permanent home is in Hungary;
b their centre of vital interests is in Hungary if there is no permanent home in Hungary or if Hungary is not the only country where they have a permanent home; or
c their habitual abode is in the domestic territory if there is no permanent home in Hungary, or if Hungary is not the only country where they have a permanent home and if their centre of vital interests is unknown.

For the purpose of a permanent home, any form of dwelling may be taken into account (e.g., a house or apartment belonging to or rented by the individual, or a rented furnished room). However, the permanence of the home is essential; this means that the individual has arranged to have a dwelling available to him or her at all times continuously, and not occasionally for the purpose of a stay, which is necessarily of a short duration (e.g., business travel, educational travel). To substantiate that the individual has a permanent home in Hungary, the requirement is usually to have at least a rented flat for which he or she is paying public utility, telephone and internet bills.

As regards the notion of centre of vital interest, the Hungarian public guideline largely follows the OECD Commentary and claims that the centre of vital interest is the country with which the personal and economic relations of the individual are closer. Thus, his or her family and social relations, occupation, political, cultural and other activities, place of business and the place from which he or she administers his or her properties should be considered. The circumstances must be examined as a whole, but considerations based on the personal circumstances of the individual (e.g., close family relatives living in the same household) must receive special attention.

**Avoidance of double taxation**

It may occur that an executive not qualifying as a Hungarian tax resident derives remuneration in respect of an employment exercised in Hungary. If there is a double tax treaty in force between Hungary and the other jurisdiction concerned, the relevant double tax treaty rules will apply to eliminate double taxation.
The double tax conventions (DTC) concluded by Hungary usually follow the OECD Model Convention on the Avoidance of Double Taxation in eliminating the double taxation of income from employment. Therefore, the remuneration of an executive would be taxable in Hungary unless:

a. he or she stays no more than a total period or periods of 183 days in Hungary in the relevant fiscal year;

b. the remuneration is paid by or paid on behalf of an employer that is not resident in Hungary; and

c. the remuneration is not borne by a permanent establishment located in Hungary.

**Stock option**

Under Hungarian law, granting stock option to the employees should not be taxable in itself. Employees will only recognise taxable income upon the exercise of the option in an amount equal to the difference between the fair market value of the shares on the date of exercise and the amount of purchase price, acquisition and transaction costs, if any. The income of a Hungarian resident private individual arising upon exercising the options would be subject to PIT at 15 per cent in Hungary.

The dividend income from the shares of a Hungarian resident private individual is subject to PIT at a rate of 15 per cent. Capital gains realised by a Hungarian resident private individual on the sale of the shares is subject to PIT at a rate of 15 per cent.

**Retirement planning**

The Act on PIT incentivises retirement planning by providing preferential tax treatment for pension insurance contracts and for placing assets in voluntary mutual pension insurance funds and in retirement accounts. Such incentives are not restricted to executives, but they can also apply to other employees.

**Social taxes for employees**

If the executive becomes subject to the Hungarian Social Security, the employment income will be subject to 10 per cent pension contribution, 7 per cent health insurance contribution and 1.5 per cent labour force contribution payable by the employee.

According to the Act LXXX of 1997 on Social Security (the Act on Social Security), the employee can become subject to the Hungarian social security system if his or her employment relationship is governed by Hungarian law or the employee carries out his or her activities in Hungary or in another Member State of the European Union to which Regulation (EC) No. 883/2004 of the European Parliament and of the Council of 29 April 2004 on the coordination of social security systems (the Social Security Regulation) applies. The Social Security Regulation has precedence over the Act on Social Security when ascertaining whether the executive is subject to the Hungarian Social Security.

The dividend income of a Hungarian-resident private individual is subject to health tax at a rate of 14 per cent capped at 450,000 forints per annum in 2018. Dividend payments distributed by or on behalf of a legal person or other organisation seated in a low tax jurisdiction are subject to health tax at 19.5 per cent payable by the recipient, in addition to the PIT.
Capital gains realised by a Hungarian-resident private individual will be subject to health tax at a rate of 14 per cent capped at 450,000 forints per annum in 2018. Capital gains arising from the sale of shares in a legal person or other organisation seated in a low tax jurisdiction would be subject to health tax at 19.5 per cent.

iii Tax deductibility for employers

The executive's remuneration, the social tax, the training fund contribution and the health tax can be accounted for as employment expenses. These expenses also reduce the corporate income tax base of the employer.

The Act on PIT defines 'certain specified allowances' including services in connection with business trips, life, accident or health insurances concluded by the employer to the benefit of its employee. These allowances and the PIT due on them payable by the employer also qualify as employment expenses, therefore, they reduce the corporate income tax base of the employer.

III TAX PLANNING AND OTHER CONSIDERATIONS

i Tax planning

If the taxes on the remuneration of the executive payable in the country of residence exceed the amount of tax that should be paid if the income were taxable in Hungary, the lower Hungarian tax rates and the exemption method under the applicable DTC can result in significant tax savings when posting the executive to Hungary. This posting structure is demonstrated in the following example (note: the tax rate applicable in the foreign jurisdiction of the example is fictional).

Posting an employee to Hungary in order to act as an executive in a Hungarian entity would require that the Hungarian entity and the foreign entity posting the employee conclude a management service agreement under which the foreign entity would provide management services to the Hungarian entity via its employee. Based on the management services agreement, the foreign entity should be compensated on an arm's-length basis that usually means that such compensation should cover its expenses and some margin.

The annual salary of an employee posted to Hungary payable by the employer, the foreign entity would be €200,000. That would be the amount of salary expenses at the foreign entity.

The amount of the management services fee would be the sum of the above-mentioned salary expenses of €200,000 and of a margin of €5,000, that is €205,000.

In case of a favourable DTC between Hungary and the jurisdiction of the foreign entity, the salary income would be taxable in Hungary. Personal income tax payable in Hungary is €30,000 (€200,000 × 15 per cent). This income should be fully exempted from taxation in the jurisdiction of the foreign entity, that would otherwise be €60,000 by applying the 30 per cent PIT rate. Therefore, the tax savings on the personal income tax would be €30,000 per year.

Based on the above, depending on the corporate income tax positions of the group companies and the social taxes payable in each country, it can be established that, because of the difference between the personal income tax burdens in Hungary and the jurisdiction of the foreign entity, significant tax savings can be achieved if the income for the foreign employee is channelled through a Hungarian entity.
Employee shareholder plan
An employee shareholder plan (ESP) organisation may be set up by an employer in order to distribute securities issued by the employer or its parent company (e.g., shares, bonds, rights on securities, etc.) and profits therefrom to the employees. The employee does not incur PIT with respect to the benefit related to the acquisition of securities distributed by the ESP organisation. Based on statutory requirements, the improvements of the financial results or certain other indicators of the entity issuing the securities concerned is a precondition for payments to the employees from the ESP. In sum, distributing funds to the employees through an ESP can be a tax effective method of paying bonuses while making the employees vested in the business performance of the employer.

Other considerations
Certain benefits provided by the employer are exempt from PIT. Among such exemptions, the employer can provide non-repayable housing allowance to the employee up to 30 per cent of the purchase price or the total cost of construction in the maximum amount of approximately €15,400 over a five-year period.

The accommodation allowance provided by the employer to the employee is also exempt from PIT up to a monthly amount of approximately €260 over the first 24 months of the employment relationship.

The reimbursement by the employer of nursery and kindergarten fees or a part thereof to the employee based on an invoice issued to the name of the employer is also exempt from PIT.

IV EMPLOYMENT LAW

Special agreement
By underlying the special nature of this type of relationship, the related rules are to be found between the special rules of the Labour Code.

Assuming that the executives’ position does not require the same level of protection, the legislator grants to the parties a greater flexibility and freedom in defining the content of the employment agreement. Accordingly, the executive’s employment agreement can deviate from most of the general rules of the Labour Code.

Conclusion
The possibility of application of these rules (i.e., the conclusion of this type of agreement) is limited to certain cases.

Executive means the director of the employer, and any other person under his or her direct supervision and authorised – in part or in whole – to act as the director’s deputy. These are typically the managing directors, CEOs and other employees filling such a position, but if the preconditions are met, a procurist may also belong to this group. In these cases, it is not a matter of choice that the employee is an executive if he or she performs his or her work within the framework of an employment agreement.

The term of the employment agreement shall be in line with the term of appointment for the position indicated in the company register.

The parties can also agree to invoke the provisions on executives if the employee fills a position considered to be of considerable importance from the point of view of the employer’s
operations (e.g., CFO, HR director) or a post of trust (chief accountant, IT manager), provided that his or her salary reaches seven times the mandatory minimum wage, which is approximately €3,020.

iii Rules of termination

In the event that the employment agreement has been concluded for an indefinite term, neither the employee nor the employer has to justify the termination. This solution creates a more favourable situation on the employer’s side; however, the termination cannot violate the prohibition of abuse of rights. The principle of equal treatment shall be also respected. Despite the fact that there is no obligation of justification, the employee has the right to sue the employer; however, it is more difficult for him or her to determine the truth.

In the case of employees participating in the management of the company, and who are typically appointed for a definite term, the lawful termination needs justification from both sides. The fixed-term employment relationship may be terminated only in limited, defined cases, detailed in the Labour Code.

Accordingly, the employer may terminate the employment relationship concluded for a fixed term exclusively during the liquidation or bankruptcy procedure against the employer, for reasons connected to the employee’s abilities, or if maintaining the employment becomes impossible because of unavoidable external reasons.

The employee may terminate the employment relationship only on the basis of such reasons, which would make it impossible for him or her to maintain the employment or which would cause disproportionate harm to him or her considering his or her circumstances.

Breaching these rules may imply an obligation to pay compensation for damages resulting from the breach of the agreement.

iv Allowances due to the employee upon termination

Upon termination, the employer and the employee shall account with each other, including the return of equipment provided by the employer having regard to the employment relationship.

Based on the Labour Code — unless otherwise agreed by the parties — the employee may be entitled to the following types of allowances.

If it is the employer who decided to terminate the employment relationship, the employee may be entitled to severance payment. The entitlement depends on the length of service, except if the employee is recognised as a pensioner at the time when the notice of dismissal is delivered or when the employer is terminated without succession, or he or she is dismissed for reasons in connection with his or her behaviour in relation to the employment relationship or on grounds other than health reasons.

The severance payment equals the sum of absentee pay due for one month in case of an employment relationship for up to three years, which shall be increased gradually up to six months after at least 25 years of service.

Also, the employee would be entitled to compensation for unused holidays, regardless of which party terminated the employment. This is the only case when compensation may be paid in lieu of allocation and ordering the use of holiday.

The Labour Code takes into account the employer’s possibly difficult financial situation at the time of termination. Thus, should the notice of termination be delivered after the opening of bankruptcy or liquidation proceedings, the employer is obliged to pay only an
amount up to six months’ absentee pay due to the employee. The remaining part of the amount otherwise due shall be payable upon the conclusion or termination of bankruptcy proceedings, or upon the conclusion of liquidation proceedings.

v Non-compete

The Labour Code creates the option for the employer to protect its rightful economic interests even after that the employment relationship is finished, by extending the employee’s obligation in this respect by means of a non-competition agreement to a definite term. The non-solicitation obligation makes part of this commitment under Hungarian law, thus every activity that may violate the employer’s legal economic interest can be restricted.

We note that the obligation of confidentiality after termination, which binds the employee without a time limitation, is for the same purpose, but the difference is that the confidentiality obligation does not require the parties’ agreement, and while the obligation of confidentiality does not require compensation, the non-competition agreement cannot be validly concluded without adequate compensation. The two obligations are frequently confused; their boundaries are blurred. The basis of the confidentiality obligation's mandatory and unlimited nature in time is the common interpretation of the Labour Code and the Competition Act.

The aim of the non-competition agreement is the protection of the employer’s lawful economic interests. However, in accordance with the principle of purpose limitation, the lawful economic interest serving as a legal basis for the non-competition shall be significant and measurable.

It is also the employer’s economic interest that limits the scope of restrictions, as the obligations undertaken by the employee need to be tailored to the purpose. It means that in order not to make it impossible for the employee to find another job, the territorial scope and the type of activity to be avoided shall be defined in the agreement by taking into account the potential threat to the employer.

The necessity of the non-competition agreement depends on the position of the employee filled at the employer’s organisation, the knowledge and expertise gained at this position, the term of the employment relationship and the employer’s position on the market, so it shall be decided on a case-by-case basis.

The rules related to the conclusion of a non-competition agreement are particularly strict, and the breach of these rules may result in the invalidity of the non-competition agreement.

An employee is entitled to adequate compensation in exchange for his or her undertaking. The minimum amount for the term of the non-competition agreement is defined in the Labour Code, which may not be less than one-third of the employee’s base wage due for the same period. However, the amount of adequate compensation shall be determined on the basis of the degree of impediment the agreement has on the employee's ability to engage in employment relationship elsewhere, also taking into account his or her education and experience, which requires the complete evaluation of all these facts. Accordingly, the non-competition agreement shall be always customised to the employee in question, by taking into account the economic and market conditions.

The payment scheduling entirely depends on the parties’ agreement. It may be paid in one single amount during or after the employment relationship, or after that the whole non-competition period has successfully elapsed. Also, the parties can agree that the compensation will be paid in monthly instalments during the employment or the
non-competition period. However, payment in advance during the employment deserves special attention, as it could happen that the overall amount of monthly instalments provided exceeds the amount otherwise due to the employee. In this case the employer is not entitled to claim back the undue amounts, which may create a financial disadvantage on the employer’s part. Another problem can be if the employment agreement terminates before the employee received the full amount of the compensation. In such a case, if adjustment has not been included in the non-competition agreement, it would be invalid, as this amount cannot be replaced afterwards.

However, the parties’ agreement may grant to the employer the possibility of withdrawal before the non-competition agreement enters into effect. Accordingly, if during the employment it became clear that the entry into force of the non-competition agreement does not serve the employer’s interest, the employer can decide not to pay the compensation and the employee won’t be bound by his or her undertakings after termination to the employment relationship.

In the event that the parties expressly included in the non-competition agreement that the employee shall be accountable for the amounts paid in advance during the employment relationship, the employer can reclaim these amounts upon withdrawal.

Another optional provision ensuring safeguard and flat-rate compensation for damage for the employer in case of breach of contract is the penalty, which requires a written form. The rate of the penalty may also be defined as a percentage of the compensation. In case of an excessive penalty, the court can reduce this amount upon the employee’s request. In addition to a penalty, the employer is entitled to demand payment for damages not covered by the penalty, which shall be also included in the non-competition agreement.

One of the core issues is that the non-competition agreement shall be concluded before the termination of the employment. In the case that the parties do not conclude this agreement at the beginning of the employment, they can conclude it at any time until the termination of the employment agreement, but the bargaining power of the employer may be weaker.

V SECURITIES LAW

Pursuant to applicable Hungarian laws, in the case of a company limited by shares (both private and public companies), a special type of shares (employee shares) may be issued to employees either for a special price (which is usually less than the face value of the shares) or without consideration.

The value of these employee shares is also limited; they may only be issued simultaneously with the increase of the respective company’s share capital, not exceeding 15 per cent of the amount of the so increased share capital.

Employee shares may only be transferred or sold effectively to another employee of the given company or to former employees of such company, provided that the deed of foundation expressly allows such transfer or sale. If the employee ceases to be employed by the company in which it owned employee shares, the former employee shall transfer such employee shares in accordance with the above rules. Consequently, employee shares cannot be sold on the market.

In the case of employee shares of a private company limited by shares, the issuance of the employee shares only needs to be notified to the Hungarian financial regulator (being the National Bank of Hungary). If a public company limited by shares intends to issue
employee shares, registration of such employee shares with the Hungarian financial regulator is required, although no prospectus and announcement shall be published with respect of such employee shares.

VI  SPECIALISED REGULATORY REGIMES

In line with EU regulations, special remuneration policies are to be mandatorily applied to certain employees in the financial and investment sector.

i  Remuneration policy in the financial sector

The remuneration policy is applicable to the executive officers of a financial institution as well as to other employees of the given financial institution who have material impact on the financial institution’s risk profile.

The supervisory body shall adopt and periodically review the general principles of the remuneration policy and the management body shall be responsible for the implementation and the execution thereof. The remuneration policy shall be reviewed by the internal control department at least annually.

Financial institutions with a market share of at least five per cent in respect of their balance sheet total are required to establish a remuneration committee, which is responsible for reviewing the remuneration of the senior officers of risk management and compliance as well as for the preparation of decisions regarding remuneration. The chairman and the members of such remuneration committee shall be those members of the management body of the financial institution who are not engaged under an employment contract with the financial institution concerned.

Financial institutions shall distinguish between basic remuneration and variable remuneration, and shall fix in their internal policy the ratio that basic remuneration represent within the total remuneration, where the variable component shall not exceed 100 per cent of the basic remuneration for each senior executive. In certain cases, financial institutions may provide variable remuneration up to 200 per cent of the basic remuneration.

At least 40 per cent – or at least 60 per cent in the case of a variable remuneration component of an amount exceeding the limit specified in the internal policy – of the variable remuneration component shall be deferred (aligned with the nature of the business, its risks and the activities of the senior executive) and paid over a period between three and five years.

Senior executives and employees of a financial institution are not allowed to undertake hedging strategies to mitigate the risk alignment effects embedded in their remuneration arrangements.

ii  Remuneration policy in the investment sector

The remuneration policy is applicable to the executive officers of an investment company as well as to other employees of the given investment company whose task is risk management and control activity.

The supervisory body shall adopt and periodically review the general principles of the remuneration policy and the management body shall be responsible for the implementation and the execution thereof. The remuneration policy shall be reviewed by the internal control department at least annually.

If the investment firm has a balance sheet total exceeding 200 billion forints, it is required to establish a remuneration committee, which is responsible for reviewing the
remuneration of the senior officers of risk management and compliance as well as for the preparation of decisions regarding remuneration. The chairman and the members of the remuneration committee shall be those members of the management body of the investment firm who are not engaged under an employment contract with the investment firm concerned.

Investment firms shall distinguish between basic remuneration and variable remuneration, and shall fix in their internal policy the ratio that basic remuneration represent within the total remuneration, where the variable component shall not exceed 100 per cent of the basic remuneration. In certain cases, investment firms may provide variable remuneration up to 200 per cent of the basic remuneration.

At least 40 per cent – or at least 60 per cent in the case of a variable remuneration component of an amount exceeding the limit specified in the internal policy – of the variable remuneration component shall be deferred (aligned with the nature of the business, its risks and the activities of the senior executive) and paid over a period of between three and five years.

Senior executives and employees of an investment firm are not allowed to undertake entering into hedging strategies to mitigate the risk alignment effects embedded in their remuneration arrangements.

VII DEVELOPMENTS AND CONCLUSIONS

The rules related to the executives are not dynamically changing parts of the related acts; these are a well-crystallised part of the Labour Code and practice.

However, owing to the entry into force of the new Civil Code in 2014, issues were raised in connection with the relation of the liability regime under the Labour and the Civil Codes.

The question is whether or not these are the liability rules of the Labour Code that shall be applied in case of damage caused by the employee to the employer.

We can state that in cases where the executive performs his or her tasks within the framework of an employment agreement, and he or she breached the obligations stemming from the employment relationship by failure to act as it might normally be expected in the given circumstances, the executive’s liability towards the employer shall be governed by the rules of the Labour Code.

In this case the burden of proof to verify the circumstances mentioned above, the occurrence of loss, as well as the causal link, lies with the employer.

The executive is also subject to full liability for damages caused by negligence. The executive is not liable, though, for any damage unforeseeable at the time of the breach or that resulted from the employer’s wrongful conduct, or that was incurred owing to the employer’s failure to perform its obligations to mitigate the damage.

However, if the breach is not related to the executive’s obligations related to his or her employment, his or her liability shall be governed by the Civil Code.

The question of liability shall be examined on a case-by-case basis.
I INTRODUCTION

The changes that have been introduced in India regarding executive compensation have brought about widespread consequences for the future of the standards of remuneration to be paid out by companies. The introduction of the remuneration committee by the Companies Act 2013 (the Companies Act) has placed considerable responsibility on them to ensure that there is a balance between the compensation packages for senior representatives and the overall objectives of the company. There has always been a demand by the shareholders of companies to ensure that the ‘pay’ is proportional to the ‘performance’ of the executives and some of the changes that have been introduced in recent times have furthered that very cause.

On the other hand, it is also important to acknowledge that there is an extremely competitive environment for employers to acquire the right kind of talent who have the requisite experience and know-how. In this context, we have tried to narrow down the possibilities that employers nowadays consider in determining executive remuneration:

a Compensation packages linked directly to the performance of the company. Compensation matrices in India are shifting towards a far more direct pay and performance model in alignment with the same trend being followed globally. Various instances in the recent past have shown that there have been pay increases that are much higher than the relative performances of the company. Improper justification or non-disclosures to the shareholders regarding *ad hoc* stock-based grants, substantial bonus payouts, etc., have led to discomfort among the shareholders and sometimes even formal disputes.

b Companies generally set ownership guidelines that require executives to own a certain proportion of the company’s equity within a prescribed time frame. This ensures an added line of security by stitching together the fortunes of the executive team and the interests of the company. Since the talent pool often looks for better remuneration opportunities, stock incentives go a long way in fulfilling such objectives of executives and also serve the employer’s objectives.

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II TAXATION

i Income tax for employees

*Income tax provisions with respect to taxation of remuneration for Indian employees compared with foreign employees*

A person pays tax in India based when income is accrued or deemed to be accrued or is received or deemed to be received in India. Further, it also depends on the residential status of a person for the purpose of levy of income tax in India. Accordingly, the Income Tax Act, 1961 (the IT Act) categorises persons based on residential status in the following manner:

a resident – which is further categorised into ordinary residents (OR) and not ordinary residents (NOR); and

b non-resident (NR).

Residential status of a person is determined on the basis of the number of days resided in India and this is computed separately for each financial year (FY). To be classified as resident in India for the relevant FY, the person must reside in India for period of 182 days or longer in that FY, or the person must have resided in India for a period of 60 days or longer during that FY and was residing in India for 365 days or more during the previous four years immediately preceding the relevant FY.

Further, 60 days as mentioned above would be replaced by 182 days in the following cases:

a a citizen of India who leaves India in any previous year as a member of the crew of an Indian ship as defined in Clause (18) of Section 3 of the Merchant Shipping Act 1958 (44 of 1958), or for the purposes of employment outside India; or

b a citizen of India or a person of Indian origin who, being outside India, comes on a visit to India in any previous year.

Further, classification of a resident as OR would be dependent on the satisfaction of both the conditions mentioned, namely:

a the person has been a resident in India for two of the 10 FYs immediately preceding the relevant FY; and

b the person has also been residing in India for a period of 730 days or more in the seven FYs immediately preceding the relevant FY.

Determination of this residential status of taxpayers is very important at the time of filing of an income tax return and the table below summarises when an income accrues, is received, arises or is deemed to have been accrued, arisen or received within or outside India in the previous year (PY):

<table>
<thead>
<tr>
<th>Particulars</th>
<th>Resident and OR</th>
<th>Resident and NOR</th>
<th>NR</th>
</tr>
</thead>
<tbody>
<tr>
<td>Income received or deemed to have been received in India, whether the income is earned in India or outside India</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Income that accrues/arisises or is deemed to accrue/arisise in India during the previous year, where the income is received in India or elsewhere</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Income that accrues/arisises outside India and is received outside India from a business controlled in India</td>
<td>Yes</td>
<td>Yes</td>
<td>No</td>
</tr>
</tbody>
</table>
The scope of compensatory payments coming within the ambit of taxability under the IT Act solely depends on whether it is covered under the definition of ‘income’. Income having been defined in the widest possible manner covers within its ambit all forms of payments made.

The IT Act breaks down income received into two different forms of classification based on the manner of engagement of person in India by an employer. Accordingly, compensation received by way of an employer–employee relationship (employment) would be classified under the head ‘income from salaries’ and the levy of tax would be in accordance with the tax rates applicable, as revised by The Finance Act 2017. The income tax payable by a person will be based on the amount of income received by that person. Please refer to the table below for the financial year 2018–2019 (Assessment Year 2019–2020):

<table>
<thead>
<tr>
<th>Income slab</th>
<th>Tax rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>Income up to 250,000 Indian rupees</td>
<td>No tax</td>
</tr>
<tr>
<td>Income from 250,000 to 500,000 rupees</td>
<td>5%</td>
</tr>
<tr>
<td>Income from 500,000 to 1 million rupees</td>
<td>20%</td>
</tr>
<tr>
<td>Income more than 1 million rupees</td>
<td>30%</td>
</tr>
</tbody>
</table>

A surcharge will be applicable over and above the income tax:

<table>
<thead>
<tr>
<th>Income slab</th>
<th>Tax rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>Income greater than 5 million rupees</td>
<td>10%</td>
</tr>
<tr>
<td>Income greater than 10 million rupees</td>
<td>15%</td>
</tr>
</tbody>
</table>

Further, education cess and secondary higher education cess will be charged as well.

The practice of engaging contractors by employers is prevalent throughout India and there is a distinction between a ‘contract of service’ and a ‘contract for service’. It is on the basis of the nature of the engagement that one can be classified as an employee or an independent contractor. An independent contractor or consultant engaged by an employer and compensation paid in lieu of services rendered by such consultant would be in the form of fees for services performed and will be taxed under the head ‘Profits and Gains from Business/Profession’ as there is no employment relationship and tax can be deducted at the rate of 10 per cent on compensation paid over 30,000 rupees.

**Compensatory payments taxable as capital gains or other special income tax rates**

Any profits or gains arising from the transfer of a capital asset effected in the previous year shall be chargeable to income tax under the heading ‘Capital gains’, and shall be deemed to be the income of the previous year in which the transfer took place. Capital gain means any profit or gain that arises due to the transfer (in any manner, including sale, exchange, relinquishment, etc.) of a capital asset from one person to another.
Notwithstanding anything mentioned above, the following has to be noted:

a the profits or gains arising from the transfer by way of conversion by the owner of a capital asset into, or its treatment by him or her as stock-in-trade of a business carried on by him or her shall be chargeable to income tax as his or her income of the previous year in which such stock-in-trade is sold or otherwise transferred by him or her and the fair market value of the asset on the date of such conversion or treatment shall be deemed to be the full value of the consideration received or accruing as a result of the transfer of the capital asset;

b where any person has had at any time during previous year any beneficial interest in any securities, then, any profits or gains arising from transfer made by the depository or participant of such beneficial interest in respect of securities shall be chargeable to income tax as the income of the beneficial owner of the previous year in which the transfer took place and shall not be regarded as income of the depository who is deemed to be the registered owner of securities by virtue of the Depositories Act 1996;

c the profits or gains arising from the transfer of a capital asset by a person to a firm or other association of persons or body of individuals (not being a company or a cooperative society) in which he or she is or becomes a partner or member, by way of capital contribution or otherwise, shall be chargeable to tax as his or her income of the previous year in which the transfer takes place and, for the purposes of Section 48, the amount recorded in the books of account of the firm, association or body as the value of the capital asset shall be deemed to be the full value of the consideration received or accruing as a result of the transfer of the capital asset;

d the profits or gains arising from the transfer of a capital asset by way of distribution of capital assets on the dissolution of a firm or other association of persons or body of individuals (not being a company or a cooperative society) or otherwise, shall be chargeable to tax as the income of the firm, association or body of individuals, of the previous year in which the said transfer takes place, the fair market value of the asset on the date of the transfer shall be deemed to be the full value of the consideration received or accruing as a result of the transfer; and

e where the capital gain arises from the transfer of a capital asset, being a transfer by way of compulsory acquisition under any law, or a transfer the consideration for which was determined or approved by the central government or the Reserve Bank of India (RBI), and the compensation or the consideration for the transfer is enhanced or further enhanced by any court, tribunal or other authority.

Compensatory payments made in the form of capital assets which in turn appreciate in value would attract capital gains tax under the heading ‘Income from Capital Gains’ of the IT Act. Taxability of capital gains would depend on the nature of the asset and they are divided into short-term capital assets (STCAs) and long-term capital assets (LTCAs). STCAs are assets which are held for not more than 36 months or less and LTCAs are assets held for more than 36 months. The criterion of 36 months has been reduced to 24 months in the case of immovable property (land, building and house property), but this change is not applicable to movable property (jewellery, debt-oriented mutual funds, etc.) They will be classified as a long-term capital asset if held for more than 36 months from the financial year 2017–2018. Some assets are considered short-term capital assets when these are held for 12 months or less. This rule is applicable with respect to (1) equity or preference shares in a company listed on a recognised stock exchange in India, (2) securities (such as debentures, bonds,
government securities) listed on a recognised stock exchange in India, (3) units of UTI, whether quoted or not, (4) units of equity-oriented mutual fund and (5) zero coupon bonds, whether quoted or not.

Depending on the nature of the capital asset, taxes are levied accordingly on the short-term and long-term capital gains. Long-term capital gains are taxable at the rate of 20 per cent. However, short-term capital gains are taxable depending on whether securities transaction tax (STT) is applicable or not. If STT is not applicable, then the short-term capital gains are included in the total income and is taxed in accordance with the income tax slab mentioned above. If STT is applicable, then short-term capital gains is taxable at the rate of 15 per cent. However, it must be noted that any long-term capital gains arising from the transfer of specific shares (i.e., equity share in a company or unit of an equity-oriented fund or unit of a business trust) would not be computed for the purpose of ‘total income’ if the transfer attracts STT and is entered into after the commencement of Chapter VII of the Financial (No. 2) Act 2004.

**Income tax consequences**

The Companies Act allows for the share application money that is received by the company to not be the full value of the relevant shares. However, the board in case of a company limited by shares may call upon such person to make payments on such unpaid shares or partly paid shares and if such payment is not made within the stipulated time period, the shares shall be forfeited in favour of the company. The board is authorised to sell or otherwise dispose of such shares in a manner they deem fit. When the company forfeits the share application money, it is considered as a capital receipt in the hands of company. The definition of income under Section 2(24) of the IT Act does not include such receipts. Specifically, it was held that the amount forfeited from shareholders for default of payment of call money was capital receipt. Further, the amount received on reissue of forfeited shares and credited to share premium account was also a capital receipt.2

The promise to deliver shares is not by itself prohibited explicitly under the IT Act; however, prohibitions have been placed regarding directors and key managerial personnel from forward dealing in the company, its holding, subsidiary or associate company. Such forward dealings include a (1) a right to call for delivery or make delivery at a specified price and within a specified time for a specific number of shares or debentures, and (2) a right, the manager may elect to call for delivery or make delivery at a specified price and within a specified time for a specific number of shares or debentures.

Given the above, if any director or key managerial person acquires shares or debentures in contravention with Section 194, that person would be liable to surrender the same to the company and shall be penalised as stated in the Companies Act.

**Income tax consequences**

In addition to what is discussed above, deferral of remuneration or consideration paid to an employee will be liable to income tax in the financial year in which it is received or accrued or arises in the hands of the employee. The scope of remuneration is relevant to consideration paid in monetary or non-monetary forms. Section 5 of the IT Act deals with the calculation

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2 *Asiatic Oxygen Ltd* (1994) 49 ITD 355 (Cal.)
of total income for the purpose of inclusion of income and therefore the financial year in which the remuneration is received by the employee would be considered as the previous year for calculation of income tax.

**Income tax consequences**

Regarding funding of incentives or similar compensatory arrangements that are intended to be paid in the future, say a trust, the compensation or benefit to be granted in the relevant manner is transferred to the trust by the company to be held in accordance with a contractual agreement and further, the beneficial interest of the compensation or benefit is vested upon the beneficiaries of the trust. Such beneficial interest will be converted into absolute ownership only upon fulfilment of the contractual obligations. Thus, the shares of the company in the event of a trust are generally (industry practice) held as follows: (1) before exercise by the employees, the trust holds the shares on its own account; (2) post exercise, the trust holds the shares on behalf of the employees; (3) these shares, though held by the trust, are recorded in the name of the trustees.

The tax implications for such transactions include the following:

a In the hands of the company, transfer of shares from the company to the trust would attract capital gains (Section 45 of the IT Act). Further, the Finance Act 2017 has brought in a new section 50CA. This section provides for considering the fair value of the shares for computing capital gains, where shares are sold at less than the fair value.

b In the hands of the trust, as per Section 56(2)(x)(c) of the IT Act, where any person receives shares for a consideration that is less than the fair market value of those shares, the difference between the fair market value and the consideration so paid shall be treated as other income in the hands of the buyer.

c In the hands of the employees, as per Section 17 of the IT Act, the employee's beneficial interest in the trust shall be considered as perquisite and taxed as salary only when shares are issued or transferred to him or her. Since Section 17 is applicable for the employees, the provisions of Section 56 (Income from other sources) shall not be applicable.

**ii Social taxes for employees**

**Provident fund contributions**

The social security contributions in India include provident fund, pension scheme and deposit linked scheme and is governed by the Employees Provident Fund and Miscellaneous Provision Act 1952 (EPFA). Every establishment employing 20 or more persons will be required to be in compliance with EPFA unless the establishment is exempted as per the provisions of EPFA. The objective of EPFA is to provide retirement and insurance benefits to employees. The EPF Act deals with the Employees’ Provident Funds Scheme 1952, the Employees’ Pension Scheme 1995 and the Employees’ Deposit-Linked Insurance 1976.

Further, in 2008 international workers have been brought within the purview of EPFA. An international worker coming to work in an Indian establishment to which EPFA applies, then the international worker is required to make provident fund contribution. However, in the event an international worker is coming from a country with which India has a social security agreement (SSA) and the international worker is contributing towards social security of the home country and enjoys the status of a detached worker is excluded from contributing in India provided the international worker obtains a certificate of coverage from the home country. Additionally, the international worker can withdraw their accumulated provident fund balances on ceasing to be an employee in an establishment covered under
EPFA. However, if a person is not covered under an SSA, he or she may withdraw the provident fund balance on retirement from service in the company at any time after 58 years of age or in the event of death, specified illnesses or incapacitation.

Every Indian employee whose basic wages are 15,000 rupees per month or less has to contribute to the employees’ provident fund. The employer must take steps to ensure that the employer’s and employee’s contributions with respect to such employees are made regularly every month. The contribution which shall be paid by the employer and the employee to the employees’ provident fund shall be 12 per cent of the basic wages (plus dearness allowance and retaining allowance). The benefit of an employees’ provident fund for employees drawing basic wages of more than 15,000 rupees per month is discretionary in the hands of the employer. Further, in case of international workers, the components of remuneration for employees’ provident fund contributions, will be the same as those applicable to domestic Indian employees. The provident fund contribution in respect of international workers is required to be made on full salary (i.e., without any wage ceiling, unlike domestic Indian employees).

The contributions made by the employee and the employer towards provident fund, pension scheme and life insurance as per the provisions of EPFA is exempted for income tax. However, 150,000 rupees is the maximum limit of the aggregate of the deduction that may be claimed under Sections 80C, 80CCC and 80CCD of the Income Tax Act 1961, which includes provident fund contributions.

**Gratuity**

In terms of the Payment of Gratuity Act 1972 (the Gratuity Act), an employee is entitled to gratuity on superannuation, retirement or resignation, provided the employee has rendered continuous service for not less than five years. Gratuity is also payable in case of death or disablement due to accident or disease; however, the completion of five years of continuous service is not required in this regard. It is pertinent to note that the Gratuity Act does not provide for any specific exemption in regard to international workers who are employed by the Indian company.

Gratuity is payable to an employee at the rate of 15 days' wages for every completed year of service (any period in excess of six months will be considered a full year of service). In case of an employee drawing monthly wages, gratuity shall be calculated by dividing the monthly rate of wages last drawn by him or her by 26 and multiplying the quotient by 15, for each completed year of service. The maximum amount of gratuity that an employee is statutorily entitled to is 2 million rupees. An employer may, however, make a higher gratuity payment, at his or her discretion. However, the gratuity received under the Gratuity Act is exempt from tax to the extent the employee is entitled to gratuity as per the formula stated above under the Gratuity Act or 2 million rupees, whichever is less.

iii  **Tax treatment of remuneration paid by the employer**

The IT Act provides for deductions from computing income under the heading ‘profits and gains of business or profession’ with regard to certain forms of expenses incurred by the employer. In respect of this, Section 36 of the IT Act deals with deductions, which include (1) all sums paid to an employee as a bonus or commission for services rendered (provided such sums would not have been payable to the employee as profits or dividend), (2) sums paid by the employer by way of contribution towards a recognised provident fund or superannuation fund subject to conditions set by the board and any contribution towards a pension scheme,
provided it does not exceed 10 per cent of the salary of the employee, and (3) sums paid by the employer by way of contribution towards an approved gratuity fund for the exclusive benefit of the employees under an irrevocable trust. Additionally, any other form of remuneration paid by an employer to the employee for the purpose of the business or profession would be allowed to be deducted as expenditure wholly and exclusively for the purposes of the business or profession. Further, income tax in India is levied in the relevant assessment year (AY) on income accrued, arisen or received or deemed to have been accrued, arisen or received in India in the previous year.

Additionally, remuneration paid to persons in cash, equity and other forms of property are liable to tax deductions in India. For the purpose of collecting tax from every source of income payable to another, tax deduction at source (TDS) was introduced. In furtherance of the same, a person who is liable to make payment of a specified nature to any other person must deduct tax at source and remit the same into the account of the central government. The TDS rates for assessment year 2019–2020 are as set out below:

<table>
<thead>
<tr>
<th>Relevant provisions under the Income Tax Act 1961</th>
<th>Particulars</th>
<th>TDS rates</th>
</tr>
</thead>
<tbody>
<tr>
<td>192</td>
<td>Payment of salary by employer</td>
<td>Applicable slab rates (as discussed above)</td>
</tr>
<tr>
<td>193</td>
<td>Interest on securities</td>
<td>10%</td>
</tr>
<tr>
<td>194</td>
<td>Dividend (other than under Section 115-O)</td>
<td>10%</td>
</tr>
<tr>
<td>194A</td>
<td>Income by way of interest other than ‘interest on securities’</td>
<td>10%</td>
</tr>
<tr>
<td>194C</td>
<td>Payments to contractors/sub-contractor (individuals)</td>
<td>1%</td>
</tr>
<tr>
<td>194J</td>
<td>Sums paid by way of fees for professional technical services, royalty, remuneration/fee/commission to a director or for not carrying out any activity in relation to any business, for not sharing any know-how, patent, copyright, etc.</td>
<td>10%</td>
</tr>
</tbody>
</table>

iv Other special rules

**Taxation on payments made to employees**

Corporate restructuring in India attracts taxability with regard to the corporate entities engaged in the restructuring. However, Section 47 of the IT Act places certain forms of corporate restructuring outside the scope of ‘transfer’ for the purpose of capital gains and hence the levy of tax under those circumstances is not taxable. Additionally, the liability of taxation does not flow down to the payments (in any form) being made to the employees of the corporate entity. TDS provisions would apply accordingly, and the corporate entity would be required to deduct tax accordingly. The employees’ remuneration would be liable to income tax at the slab rate prescribed by the income tax department under the heading ‘salaries’. There are no specific rules applicable for the payments or remunerations made to employees in connection with the restructure.

**Special tax rules**

In circumstances where the employer makes payments for premium applicable to keep in force insurance on the health of employees under a scheme framed either by the General Insurance Corporation of India or any other insurer and approved by the Insurance Regulatory and Development Authority, such payments are permitted to be deducted for the purpose of calculation of income under the heading of ‘profits and gains of business and profession’.

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III EMPLOYMENT LAW

i Non-compete

Enforceability of non-compete

By virtue of a typical non-compete clause in India, the employee undertakes to adhere to the condition that during the course of employment and after the employee leaves the services of the employer, the employee will not associate him or herself with a competitor of the employer in any capacity. The provisions of the Indian Contracts Act 1872 (the Contract Act), however, explicitly state that all contracts that are in ‘restraint of trade’ are void and unenforceable. It is important to understand that courts in India distinguish between ‘non-compete’ covenants that are operative during the term of the contract and those that operate post the term of the contract. The courts have consistently taken a view that a ‘non-compete’ or restrictive covenant operating during the term of the employment contract is enforceable while those operating beyond the term of the employment contract are not.

Given the improbability of enforcement of a post-employment non-compete, most former employers attempt to seek injunction from courts preventing an employee from joining a competitor on the grounds of anticipated breach of confidentiality obligations. The employers are also able to get adequate relief from courts more often than not in cases where very senior and significant employees are involved. The reasoning for the courts to grant such injunctions has been that senior employees of the company have extensive knowledge of the company’s business and marketing practices, customer and vendor relationships and matters of a confidential nature that are proprietary and highly valuable to the company, and any disclosure of the same would substantially damage the legitimate business interests of the company. That said, the courts, on the basis of the facts of each case, have also analysed what information could be construed as ‘confidential information’. For instance, ‘customer contact information’ is not always construed to be confidential as no entity is allowed to create monopolies or prevent competition on the basis that they have created an exhaustive list of clients or customers. In general, courts have tested this from the point of view of whether the information possesses the necessary quality of confidence and whether it is information that is not publicly available or public knowledge. Based upon the facts and circumstances of a case, courts have also stated in a few instances that though breach of confidentiality may be enforced against an employee, it cannot be used to seek an injunction preventing the employee from pursuing another vocation or business. On similar lines, courts have recognised the right of an employee to change employment in pursuit of better opportunities as a fundamental right and this right cannot be curtailed on grounds of mere possession of customer data which can also be procured from other sources.

To conclude, a non-compete clause in employment agreements beyond the term of the employment may only act as deterrent measure for the employees from joining competitors but the provision cannot be enforced in a court of law.

Geographical scope of enforceable non-compete

As aforementioned, the courts have consistently taken a view that a ‘non-compete’ or restrictive covenant operating during the term of the employment contract is enforceable while one operating beyond the term of the employment contract is unenforceable. When it comes to any geographical limitations, non-compete covenants are permissible for the protection of goodwill of the business sold to the buyer in order to ensure that the seller can
be restrained within certain reasonable territorial or geographical limits. The reasonableness of restrictions will depend upon many factors, which may include the area in which the goodwill is effectively enjoyed and the price paid for it.

**Garden leave**

A typical garden leave provision is one wherein the employer pays the employee a fixed sum of money to prevent them joining a competitor for a reasonable period of time.

The courts have ruled that while it is not possible to stop an employee from leaving, he can be restricted from joining a competitor during the term of employment. Further, the lack of enforceability of non-compete clauses has resulted in the corporate sector developing and taking recourse to a concept called ‘garden leave’, under which employees are paid their full salary during the period in which they are restrained from competing.

**Non-compete of a transaction rather than a termination of employment – if the employee is a selling shareholder**

As per the Contract Act, an agreement by which any one is restrained from exercising a lawful profession, trade or business of any kind, is to that extent void. However, the exception to this principle is when parties enter into an agreement not to carry on business of which goodwill is sold (is not void). An agreement entered into between the seller of goodwill of a business and the buyer for non-compete restraining such buyer from carrying on a similar business within specified local limits would be enforceable provided the limitations appear reasonable to the court. That said, a non-compete fee is generally paid to the promoter by the acquirers so that the promoters do not start a similar business and pose a threat to the acquired company.

**ii Non-solicitation**

**Enforceability of non-solicitation**

Non-solicitation clauses are restrictive to the extent that the employee promises not to solicit the employer’s clients or employees for a given period after the expiry of the employment tenure. Employers assert that such restrictions are necessary to protect their proprietary rights and their confidential information. Given that a ‘non-solicitation’ clause is also a restrictive covenant, the principles remain the same, although the chance of enforceability of non-solicitation clauses is significantly more if the facts and circumstances of the matter are favourable. However, note courts in India have consistently held that mere possession of customer database or information may not necessarily provide any advantage to an employee joining a competitor and the courts have also recognised the value of the relationship shared between the employee and the customer. The courts have typically stated that where employees have established connections and developed relationships with customers, the leveraging of such relationships by the employee upon joining a competitor cannot be prevented by an injunction. Contrarily, the courts have also upheld non-solicit clauses preventing employees

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3 For the purpose of clarification, a promoter includes (1) a person who has been named as such in a prospectus or is identified by the company in the annual return, (2) a person who has control over the affairs of the company, directly or indirectly whether as a shareholder, director or otherwise, and (3) persons in accordance with whose advice, directions or instructions the board of directors of the company is accustomed to act. However, nothing in clause (3) shall apply to a person who is acting merely in a professional capacity.
India

who have joined competitors from approaching customers and suppliers who are in direct competition with the previous employer. The courts generally evaluate every case on the basis of individual facts and accordingly award relief, which may include damages.

**Limitations on the scope of enforcing non-solicitation restrictions**

The chances of enforcing a non-solicitation clause in employment contracts in comparison with non-compete is significantly more. However, it also depends on the facts and circumstances of each case, and in order to enforce non-solicitation clauses, the courts\(^4\) have clarified the following principles:

- **a** Negative covenants tied up with positive covenants during the subsistence of a contract be it of employment, partnership, commerce, agency or the like, would not normally be regarded as being in restraint of trade, business or profession unless the same are unconscionable or wholly one-sided.

- **b** While construing a restrictive or negative covenant and for determining whether that covenant is in restraint of trade, business or profession or not, the courts take a stricter view in employment contracts than in other contracts, such as partnership contracts, collaboration contracts, franchise contracts, agency or distributorship contracts and commercial contracts. The reason being that in all other kinds of contracts, the parties are expected to have dealt with each other on more or less an equal footing, whereas in employment contracts, the assumption is that the employer has an advantage over the employee and it is quite often the case that employees have to sign standard form contracts without any objection.

- **c** The question of reasonableness, as with the question of whether the restraint is partial or complete, is not required to be considered at all whenever an issue arises as to whether a particular term of a contract is or is not in restraint of trade, business or profession.

**iii Termination of employment**

**Laws affecting wrongful terminations**

Termination of employment in India is regulated by the Industrial Disputes Act 1947 (the ID Act). Various states in India have also passed legislation dealing with dismissal from commercial establishments.\(^5\) The procedure for termination of employment has been separately dealt with for 'workman' and 'non-workman'. Workmen are covered under the ID Act and accordingly retrenchment has been defined as the termination by the employer of employment of a workman for any reason, other than by way of disciplinary action has to be carried out in strict adherence to the legislative requirements. As per the provisions of the ID Act, a workman is any person (including an apprentice) employed in any industry to do any manual, unskilled, skilled, technical, operational, clerical or supervisory work for hire or reward, whether the terms of employment be express or implied, but does not include any


\(^5\) The Constitution guarantees certain fundamental rights, such as equality before the law and prohibition of discrimination in education and employment on the basis of religion, sect, gender and caste. Further, the Constitution envisages certain ‘directive principles’ to guide the legislature towards social and economic goals. In an operational sense, the Constitution provides for a division of legislative powers between the Parliament (federal legislature) and State Assemblies (state legislatures). Labour and employment laws are listed under the Concurrent List, which means that the parliament and state legislatures have co-equal powers to enact laws relating to all labour and employment laws in India.
such person (1) who is employed mainly in a managerial or administrative capacity, or (2) who, being employed in a supervisory capacity, draws wages exceeding 10,000 rupees \( \text{per mensem} \) or (3) who exercises, either by the nature of the duties attached to the office or by reason of the powers vested in him or her, functions mainly of a managerial nature.

To determine if an employee is a workman or not, the Supreme Court of India, the apex court of the country, has held the following:

*The designation of an employee is not of much importance and what is important is the nature of duties being performed by the employee. The determinative factor is the main duties of the employee concerned and not some works incidentally done. In other words, what is, in substance, the work which employee does or what is substance he is employed to do. In order to determine the categories of service indicated by the use of different words like ‘supervisory’, ‘managerial’, ‘administrative’, it was necessary not to import the notions of one into the interpretation of the other. It has to be broadly interpreted from a common sense point of view where tests will be simple both in theory and in their application. The learned judge further observed that a supervisor need not be a manager or an administrator and a supervisor can be a workman so long as he did not exceed the monetary limitation indicated in the section and a supervisor irrespective of his salary is not a workman who has to discharge functions mainly of managerial nature by reasons of the duties attached to his office or of the powers vested in him.*

Given the above, if an employee is a workman and employed in the company for a continuous period of not less than one year, then the provisions of the ID Act should be adhered to while terminating the services. That said, as per the provisions of the ID Act, the procedure stated below should be followed in case of termination of service of a workman:

1. the employee has to be given one month’s notice in writing indicating the reasons for termination of services or the employee has been paid, in lieu of notice, wages for the period of notice;
2. at the time of termination, the employee has to be paid compensation, which shall be equivalent to 15 days’ average pay for every completed year of continuous service or any part thereof in excess of six months; and
3. notice in the prescribed manner is served on the appropriate government.

Additionally, the ID Act requires an employer to follow the last-in-first-out sequence while terminating employment. Accordingly, the employer is to terminate the workman who was the last person to be employed in that category. Such a sequence for termination may not be followed in situations where (1) there is an agreement between the employer and the workman to the contrary, or (2) the employer can provide adequate reasons for terminating any other workman. Having covered the scope of termination of employment of a ‘workman’ under the ID Act, it is pertinent to note that a ‘non-workman’ would be covered exclusively by the terms of the contract entered into between himself or herself (employee) and the relevant employer. There are no specific legal requirements for the termination of a non-workman other than the terms of the specific agreement although the relevant Shops and Establishments Act (the

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6 The financial benchmark that has been set would not be relevant in certain circumstances. The classification of workman is generally based mostly on the role and responsibilities of the workman in the company rather than the wages he or she is drawing.
S&E Act) of particular states provide for a minimum notice period in lieu of wages payable to such employee. Additionally, if the contract provides for more beneficial provisions, such provisions would apply over and above the requirements by the relevant S&E Act.

**Payment of severance remuneration**

In the event the company terminates the services of workman, a severance compensation has to be paid to the workman as stated above. Further, in the event of termination of employment of non-workmen, the non-workman shall be entitled to contractually agreed notice periods, or notice pay in lieu thereof, as per the relevant S&E Act, Industrial Employment (Standing Order) Act 1946, and in terms of the employment contracts. Further, a workman and non-workman are entitled to any encashment of unused leave, gratuity or any other contractual benefits as may be agreed upon between the employer or employees.

Consequently, if an employee (workman or otherwise) has committed an act of misconduct, the employer can terminate the services of such employee immediately without serving the required statutory notice period as long as the employer has satisfied due process under applicable law.

**Terminations of employment in connection with a change in control**

Where the ownership of management of an undertaking is transferred, whether by agreement or by operation of law, from the employer in relation to or that undertaking to a new employer, every workman who has been in continuous service for not less than one year in that undertaking immediately before such transfer shall be entitled to notice and compensation as stated above, as if the workman had been retrenched or terminated. However, this principle shall not be applicable to workmen in any case where there has been a change of employers by reason of the transfer, if the following three conditions are satisfied: (1) the service of the workman has not been interrupted by the transfer; (2) the terms and conditions of service applicable to the workman after the transfer are not in any way less favourable to the workman than those applicable to him or her immediately before the transfer; and (3) the new employer is, under the terms of the transfer or otherwise, legally liable to pay to the workman, in the event of his or her retrenchment, compensation on the basis that his or her service has been continuous and has not been interrupted by the transfer.

Additionally, the Supreme Court of India has held that without consent, workmen cannot be forced to work under different management and in that event, those workmen are entitled to retirement or retrenchment compensation in terms of the ID Act.

**Termination of employment ‘for good cause’ legislatively**

In addition to what is stated above, no notice period or payment of compensation is required in the case of workmen dismissed for misconduct, provided the employer conducts an internal inquiry prior to the dismissal and the due process has satisfied principles of natural justice. In the case of all other employees, there is no prescribed notice period. However, the Indian judiciary has held that termination of employment without providing prior notice would render the contract of employment as an ‘unconscionable bargain’, thus rendering it illegal. For employees who are not workmen and do not satisfy the definition of workman under the ID Act, the applicable jurisprudence allows any conditions in relation to the notice period to be addressed in the employment contract between the employee and the employer.
IV SECURITIES LAW

i Registration of securities

In India, the issue of stock options by any company is regulated by the Companies Act, and for this purpose Section 62 of the Companies Act deals with increasing subscribed capital by issuing shares to the existent equity shareholders on a proportional basis. Also, it allows for the granting of benefits to the employees of the company via a scheme of employees’ stock option (ESOP).

The issue of stock options by private companies, public companies and listed companies has been regulated separately. Accordingly, a company other than a listed company, in furtherance of issue of employee stock options have to abide by the Companies (Share Capital and Debentures) Rules 2014 (the Shares and Debentures Rules). Under the Shares and Debentures Rules, (1) the approval by the shareholders of the company is sought by the passing of a special resolution and an ordinary resolution in case of private companies,7 and (2) the company makes relevant disclosures in the explanatory statement annexed to the notice for passing of the said resolution. This includes:

a total number of stock options granted;
b identification of the classes of employees eligible for the scheme;
c vesting period, lock-in period and exercise period;
d method of valuation of the options, etc.; and
e determination of excise price in conformity with the applicable accounting policies.

The Securities and Exchange Board of India (SEBI) has formulated the SEBI (Share Based Employee Benefits) Regulations 2014, which regulates the issuances of the ESOP and Phantom Stock Options/Stock Appreciation Rights (SARs) by companies whose shares are listed on a recognised stock exchange in India or proposed to be listed. Further, for issuance of ESOP or SARs to the employee, the company should rely broadly on twin principles of complete disclosure and shareholders’ approval. Accordingly, the ESOP scheme or the SARs scheme to be offered to employees have to be approved by the shareholders of the company by passing a special resolution to that effect, along with an explanatory statement being annexed to the notice of the shareholders’ general meeting which would include necessary information as specified by SEBI. SARs are performance-based incentive plans that are generally right given to an employee entitling him or her to receive appreciation for a specified number of shares of the company where the settlement of such appreciation may be made by way of cash payment or shares of the company.

A company may grant to its executives or employees sweat equity shares. Sweat equity shares are issued at a discount or for consideration, other than cash, for providing their know-how or making available rights in the nature of intellectual property rights or value

7 Subject to the provision of the Companies Act, a resolution shall be an ordinary resolution if it is required to be passed by the votes cast, whether on a show of hands, or electronically or on a poll, as the case may be, in favour of the resolution, including the casting vote, if any, of the chairman, by members who, being entitled so to do, vote in person, or where proxies are allowed, by proxy or by postal ballot, exceed the votes, if any, cast against the resolution by members, so entitled and voting. A resolution shall be a special resolution when the votes cast in favour of the resolution, whether on a show of hands, or electronically or on a poll, as the case may be, by members who, being entitled so to do, vote in person or by proxy or by postal ballot, are required to be not less than three times the number of the votes, if any, cast against the resolution by members so entitled and voting.
additions, by whatever name called. Issuing sweat equity shares is regulated by the Companies Act, Companies (Share Capital and Debentures) Rules 2014 and listed companies have to adhere to the SEBI (Issue of Sweat Equity) Regulations 2002.

The conditions to be followed for the issue of sweat equity shares are as follows: (1) the issue is to be authorised by passing a special resolution; (2) the resolution should make certain disclosure regarding the issuance of sweat equity shares; (3) not less than one year has passed, at the date of such issue, since the date on which the company commenced business; (4) if the company is listed on recognised a stock exchange then the regulation made by the SEBI should be adhered to for issuance of sweat equity shares; and (5) if the company is not listed, then sweat equity shares will be issued as prescribed from time to time. The differences between ESOP and sweat equity shares for companies other than listed companies are as mentioned below:

<table>
<thead>
<tr>
<th>Sl. No.</th>
<th>Basis</th>
<th>Sweat equity shares</th>
<th>Employees' stock option (ESOP)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Definition</td>
<td>Sweat equity shares means equity shares as issued by a company to its directors or employees at a discount or for consideration, other than cash, for providing their know-how or making available rights in nature of intellectual property rights or value additions, by whatever name they are known</td>
<td>ESOP means the option given to the directors, officers or employees of the company or its holding company or subsidiary company or companies, if any, which gives such directors, officers or employees, the benefit or the right to purchase, or to subscribe for, the shares of the company at a future date at a predetermined price</td>
</tr>
<tr>
<td>2</td>
<td>Legislative provision</td>
<td>Section 54 of the Companies Act, read with Rule 8, Companies (Share Capital and Debenture) Rules 2014</td>
<td>Section 62(1)(b) of the Companies Act, read with Rule 12, Companies (Share Capital and Debenture) Rules 2014</td>
</tr>
<tr>
<td>3</td>
<td>Eligible category of persons</td>
<td>Company can issue sweat equity shares to directors, employees or an employee or director of the subsidiary, in India or outside India, or of a holding company of the company</td>
<td>Company can issue ESOPs to (1) employees, (2) officers of the company, and (3) directors; but cannot be issued to (1) promoters (including persons belonging to the promoter group), (2) directors or directors' relatives or the director through a body corporate holding 10 per cent or more of the outstanding equity share of the company</td>
</tr>
<tr>
<td>4</td>
<td>Lock-in period</td>
<td>Compulsory lock-in period of three years</td>
<td>Minimum period of one year between grant of option and vesting of option. Further, the company has the freedom to specify the lock-in period for the shares issued pursuant to the exercise of option</td>
</tr>
<tr>
<td>5</td>
<td>Restriction on issue</td>
<td>Sweat equity shares cannot be issued for more than 15 per cent of the paid-up equity share capital in a year or shares of value of 50 million rupees, whichever is higher</td>
<td>No such restriction</td>
</tr>
<tr>
<td>6</td>
<td>Tax implications</td>
<td>The tax incidence is applicable from the date on which the equity shares are transferred/allotted</td>
<td>The incidence of tax arises only after the exercise period, and from the period of granting of the ESOPs till the completion of the vesting period, no taxes are applicable</td>
</tr>
<tr>
<td>7</td>
<td>Procedural formalities required</td>
<td>Company has to maintain a register of sweat equity shares in Form SH-3</td>
<td>Company has to maintain a Register of Employees Stock Options in Form SH-6</td>
</tr>
</tbody>
</table>

ii Selling of stock options by executives

Under the Companies Act, no person, including any director or key managerial personnel of a company, can be part of any insider trading unless any communication is required in the ordinary course of business or profession or employment or under any law. Further, for companies listed on any recognised stock exchange or proposed to listed, SEBI has notified the SEBI (Prohibition of Insider Trading) Regulations 2015 (the Insider Trading Regulations), which chalk out a stricter and more focused regulatory regime. The regulations have put
in place a stronger legal and enforcement framework for prevention of insider trading. In terms of the Insider Trading Regulations, ‘insider’ means connected persons, persons in possession of or having access to unpublished price-sensitive information. It is intended that a connected person is one who has a connection with the company or its officers that is expected to put him or her in possession of unpublished price-sensitive information. This definition deliberately brings into its ambit persons who may not seemingly occupy any position in a company but are in regular touch with the company and its officers and are reasonably expected to have access to unpublished price-sensitive information. Further, the Insider Trading Regulations prohibit insider trading in relevance to ‘securities’, defined under the Securities Contracts (Regulation) Act 1956 and ‘securities’ include shares, scrips stocks, bonds, debentures, debenture stock or other marketable securities of a like nature in or of any incorporated company or other body corporate.

Given the above, no insider (includes directors, key managerial personnel or executives who have access to unpublished price sensitive information) shall trade in securities that are listed or proposed to be listed on a stock exchange when in possession of unpublished price-sensitive information. However, the exceptions to this principle are listed below:

- the transaction is an off-market *inter se* transfer between promoters who were in possession of the same unpublished price-sensitive information without being in breach of provisions of the Insider Trading Regulations and both parties had made a conscious and informed trade decision;
- in the case of non-individual insiders:
  - the individuals who were in possession of such unpublished price-sensitive information were different from the individuals taking trading decisions and such decision-making individuals were not in possession of such unpublished price-sensitive information when they took the decision to trade; and
  - appropriate and adequate arrangements were in place to ensure that these regulations are not violated and no unpublished price-sensitive information was communicated by the individuals possessing the information to the individuals taking trading decisions and there is no evidence of such arrangements having been breached;
- the trades were pursuant to a trading plan set up in accordance with the Insider Trading Regulations;
- when in compliance standards and requirements specified by the board of directors of the company, as it may deem necessary for the purpose of the Insider Trading Regulations. The board of directors have to formulate a code of conduct to regulate, monitor and report trading by its employees and other connected persons towards achieving compliance with these relevant regulations. The code must adopt the minimum standards set out and without diluting the provisions of these regulations.

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8 Promoter includes (1) a person who has been named as such in a prospectus or is identified by the company in the annual return, (2) a person who has control over the affairs of the company, directly or indirectly whether as a shareholder, director or otherwise, and (3) persons in accordance with whose advice, directions or instructions the board of directors of the company is accustomed to act. However, nothing in clause (3) shall apply to a person who is acting merely in a professional capacity.
iii Legal requirements for executives to hold stock

There is no legal requirement under the Companies Act for executive to hold stock of their employer and employer give stock options as an incentive to the executives. Further, in the event any of executives (includes promoters, key managerial personnel, directors or employees) of the companies listed on recognised stock exchanges or proposed to be listed hold stock in the company, they have to make certain disclosure as per the Insider Trading Regulations. The disclosures are as follows:

a initial disclosures are to be made by every promoter, key managerial person and director of every listed company on a recognised stock exchange, regarding the securities held by such person in the company on the date the Insider Trading Regulations came into effect;

b every person on appointment as a key managerial personnel or a director of the company or upon becoming a promoter shall disclose his or her holding of securities of the company as on the date of appointment or becoming a promoter to the company;

c continual disclosures are also to be made by the promoters, employees and directors to the company regarding the number of such securities acquired or disposed, if the value of such securities (whether in one transaction or in a series of transactions over a calendar quarter) aggregates to value in excess of 1 million rupees; and

d such disclosures have to be notified to the stock exchange by the company within two trading days of the disclosure.

Additionally, the definition of ‘remuneration’ under the Companies Act includes any money or its equivalent given to a director (whole-time or managing) and key managerial personnel. This implies that stock or shares issued to such directors or key managerial personnel would fall within the ambit of remuneration if the same has been given in consideration for any services rendered by them. The disclosure requirements for the purpose of remuneration has been discussed in detail under Section V.

iv Short swing trading

In addition to what is stated above, Insider Trading Regulations allow insiders to formulate a trading plan and present the same to the compliance officer for approval and public disclosure, pursuant to which trades may be carried out on their behalf in accordance with the plan. The intention of granting an option to persons who are perpetually in possession of unpublished price sensitive information is to enable such persons to trade in securities in a complaint manner. The formulation of a trading plan by an insider would enable that person to plan for trades to be executed in the future and thereby will not be hit by the prohibition under the regulations. Additionally, the executives (includes promoters, key managerial personnel, directors or employees) have to adhere to certain specifications when dealing with the trading plan under the Insider Trading Regulations and they are mentioned below:

a not entail commencement of trading on behalf of the insider earlier than six months after public disclosure of the plan;

b not entail trading for the period between the 20th trading day prior to the last day of any financial period for which results are required to be announced by the issuer of the securities and the second trading day after the disclosure of such financial results;

c entail trading for a period of not less than 12 months;

d not entail overlap of any period for which another trading plan is already in existence;
set out either the value of trades to be effected or the number of securities to be traded along with the nature of the trade and the intervals at, or dates on which such trades shall be effected; and

not entail trading in securities for market abuse.

v Anti-hedging rules applicable to executives

The RBI allows any person who is resident in India, who has a commodity exposure and faces risks due to volatile commodity prices, has the right to enter into a contract in a commodity exchange or market located outside India to hedge price risk in commodities imported or exported, domestic transactions, freight risk, etc. Hedging can be undertaken by a person in two ways, namely authorised dealers’ delegate route and reserve bank’s approval route. Authorised dealer banks provide facilities for remitting foreign currency amounts towards margin requirements from time to time, subject to verification of the underlying exposure.

V DISCLOSURE

i Companies are subject to public disclosure requirements with respect to remuneration information

All companies are required to make disclosure requirements with respect to remuneration information with respect to directors and key managerial personnel. As per the Companies Act, a company is defined as a company incorporated under this Act or under any previous company law. Further, a company may be formed for any lawful purpose by (1) seven or more persons, where the company to be formed is to be a public company, (2) two or more persons, where the company to be formed is to be a private company, or (3) one person, where the company to be formed is to be a one-person company, that is to say, a private company.

ii Types of remuneration information to be disclosed

The disclosures that are required to be made by companies, which include private, public and listed companies, are as follows:

a All listed companies have to constitute a nomination and remuneration committee (NRC), and the financial statements submitted must contain the policy set out for directors’ appointments and remuneration.

b Every company has to prepare an annual return containing the particulars as the company stood on the close of the financial year regarding the remuneration of directors and key managerial personnel.

c Every listed company has to disclose in the board’s report the following information: (1) the ratio of the remuneration of each director to the median remuneration of the employees of the company for the financial year; (2) the percentage increase in remuneration of each director, chief financial officer, chief executive officer, company secretary or manager, if any, in the financial year; (3) the percentage increase in the

9 ‘Private company’ means a company that by its articles restricts the right to transfer its shares, consequently a ‘public company’ includes any company that is not a private company. Public companies can further be classified into ‘listed’ and ‘unlisted’ companies. Listed companies are public companies that have their securities listed on any recognised stock exchange in India.
median remuneration of employees in the financial year; (4) the key parameters for any variable component of remuneration availed by the directors; (5) affirmation that the remuneration is as per the remuneration policy of the company; and (6) the ratio of remuneration of each director to the median employees’ remuneration. A key managerial person includes (1) the chief executive officer or the managing director or the manager; (2) the company secretary; (3) the whole-time director; (4) the chief financial officer; and (5) such other officer as may be prescribed.

d In the event any director who is in receipt of a commission from the company, and who is a managing or whole-time director of the company, is disqualified from receiving any remuneration or commission from any holding company or subsidiary company of such company, will be subject to disclosure by the company in the board’s report.

iii Perquisites quantified and defined

Further, except with prior approval of the board of directors, no company shall enter into any contract or arrangement with respect to the related party’s appointment to any office or place of profit in the company, its subsidiary company or associate company. The office or place of profit is held by a director if the director receives remuneration over and above the remuneration to which he or she is entitled as a director by way of salary, perquisites or rent-free accommodation. However, prior consent of the company is required only for the appointment of the director or any office or place of profit in the company its subsidiary company or associate company at a monthly remuneration exceeding 250,000 rupees.

Additionally, perquisite is defined under the Income Tax Act 1961 and includes:

a the value of rent-free accommodation provided to the assessee by his or her employer;

b the value of any concession in the matter of rent respecting any accommodation provided to the assessee by his or her employer;

c the value of any benefit or amenity granted or provided free of cost or at concessional rate (1) by a company to an employee who is a director thereof or (2) by a company to an employee being a person who has a substantial interest in the company;

d any sum paid by the employer in respect of any obligation that, but for such payment, would have been payable by the assessee;

e any sum payable by the employer, whether directly or through a fund, other than a recognised provident fund or an approved superannuation fund or a deposit-linked insurance fund;

f the value of any specified security or sweat equity shares allotted or transferred, directly or indirectly, by the employer, or former employer, free of cost or at concessional rate to the assessee;

g the amount of any contribution to an approved superannuation fund by the employer in respect of the assessee, to the extent it exceeds 150,000 rupees;

h the value of any other fringe benefit or amenity as may be prescribed. Related parties include (1) a director or his or her relative; (2) a key managerial person or his or her relative; (3) a firm, in which a director, manager or his or her relative is a partner; (4) a private company in which a director or manager or his or her relative is a member or director; (5) a public company in which a director or manager is a director and holds along with his relatives, more than 2 per cent of its paid-up share capital; (6) body-corporate whose board of directors, managing director or manager is accustomed to act in accordance with the advice, directions or instructions of a director or manager; (7) any person on whose advice, directions or instructions a director or
manager is accustomed to act; or (8) any company that is (i) a holding, subsidiary or an associate company of the company, or (ii) a subsidiary of a holding company of which it is also a subsidiary; and

any other person as may be prescribed.

Also, every contract or arrangement entered into by the company has to be referred to in the board’s report to the shareholders along with a justification for entering into such contracts or arrangements.

iv  Estimated value of incentives

Further, any company whose shares are listed on a recognised stock exchange in India and has a scheme of benefits granted to employees is governed by the Securities and Exchange Board of India (Share Based Employee Benefits) Regulations 2014 (the Share Based Employee Benefits). Accordingly, the valuation of share-based employee benefits is to be carried out in accordance with the guidance note on ‘Accounting for Employee Share-based Payments’ issued by the Council of the Institute of Chartered Accountants of India (the Guidance Note). As per the Share Based Employee Benefits and Guidance Note, there are two methods of accounting for employee share-based payments (i.e., the fair value method and the intrinsic value method) and enterprises are permitted the to use either of the two methods for accounting for such payments. However, an enterprise using the intrinsic value method is required to make extensive fair-value disclosures. Employee share-based payments generally involve grant of shares or stock options to the employees at a concessional price or a future cash payment based on the increase in the price of the shares from a specified level. Intrinsic value, in the case of a listed company, is the amount by which the quoted market price of the underlying share exceeds the exercise price of an option. Fair value is the amount for which stock option granted or a share offered for purchase could be exchanged between knowledgeable, willing parties in an arm’s-length transaction.

v  Agreements be made publicly available

The agreements that are required to be made publicly available are as follows:

a  The Securities and Exchange Board of India (Listing Obligations and Disclosure Requirements) Regulations 2015 state that no employee including key managerial personnel or directors or promoters of a listed entity shall enter into any agreement for himself or herself or on behalf of any other person, with any shareholder or any other third party with regard to compensation or profit sharing in connection with dealings in the securities of the listed entity, unless prior approval for the same has been obtained from the board of directors as well as public shareholders by way of an ordinary resolution. Provided that (1) any agreement, whether subsisting or expired, entered into during the preceding three years from the date of coming into force of this sub-regulation, shall be disclosed to the stock exchanges for public dissemination, (2) if the board of directors approve such agreement, the same shall be placed before the public shareholders for approval by way of an ordinary resolution in the next general meeting of the company, and (3) all interested persons involved in the transaction covered under the agreement shall abstain from voting in the general meeting.

b  No company shall enter into any contract or arrangement with related party without the approval of the board of directors.
c All listed companies need to formulate a policy on the materiality of related party transactions. Such transactions would need the prior approval of the audit committee, and an omnibus approval may be granted by the audit committee subject to the satisfaction of certain conditions.

d Contracts or arrangements in companies exceeding specific thresholds regarding paid-up share capital, or specific transactions can be entered into only with the prior approval of the company by a resolution passed regarding the same. The resolution cannot be voted upon by members of the company who have entered into the relevant contract or arrangement being voted on. These contracts or arrangements include: (1) sale, purchase or supply of any goods or materials; (2) selling or otherwise disposing of, or buying, property of any kind; (3) leasing of property of any kind; (4) availing or rendering of any services; (5) appointment of any agent for purchase or sale of goods, materials, services or property; (6) such related party’s appointment to any office or place of profit in the company, its subsidiary company or associate company; and (7) underwriting the subscription of any securities or derivatives thereof, of the company.

e Subject to the provisions of the Companies Act, every director of a company who is in any way, whether directly or indirectly, concerned or interested in a contract or arrangement or proposed contract or arrangement entered into or to be entered into. Every company has to maintain a register for the purpose of contracts or arrangements in which directors are interested and such registers will contain particulars of (1) companies (firms or other association of individuals) in which any director has any concern or interest, (2) contracts or arrangements with a body corporate or firm or other entity in which any director is, directly or indirectly, concerned or interested, and (3) contracts or arrangements with a related party with respect to any transactions. The said register should be kept open and accessible at every annual general meeting to any person who has the right to attend the meeting.

VI CORPORATE GOVERNANCE

i Corporate governance requirements – executive remuneration

Please refer to Section V.

ii Clawback or recoupment of paid remuneration

The specific requirements for clawback or recoupment of remuneration paid in the event of a financial restatement, misconduct, adverse change in business or other circumstance are as follows:

a The remuneration payable to directors, including managing director and whole-time director, and managers has already been discussed. However, a company, where required to and without prejudice to any liability incurred under the provisions of the Companies Act or any other law for the time being in force in India, can restate its financial statements due to fraud or non-compliance with any requirement under the Companies Act and the Rules made thereunder, the company shall recover from any past or present managing director or whole-time director or manager or chief executive officer (by whatever name called) who, during the period for which the financial statements are required to be restated, received the remuneration (including stock option) in excess of what would have been payable to him or her as per restatement of financial statements.
Where any insurance is taken by a company on behalf of its managing director, whole-time director, manager, chief executive officer, chief financial officer or company secretary for indemnifying any of them against any liability in respect of any negligence, default, misfeasance, breach of duty or breach of trust for which they may be guilty in relation to the company, the premium paid on the insurance shall not be treated as part of the remuneration payable to any such personnel. However, if the person is proved to be guilty, the premium paid on the insurance shall be treated as part of the remuneration.

The termination of any director in accordance with the Companies Act would entitle the director to compensation or damages payable to him or her in respect of the termination. The compensation or damages payable shall be in accordance with the terms of the director’s appointment or any other appointment terminating with that as director.

Additionally, if employees of a company who are eligible to receive ‘gratuity’ as under the Payment of Gratuity Act 1972 are terminated from the services of employment in consequence of any acts, wilful omission or negligence that causes substantial damages to the company, the employees can be required to forfeit their entitlement of gratuity to the extent of the damages or losses so caused to the company.

### Shareholder approvals – executive remuneration arrangements

Shareholders approvals for equity-linked remuneration has been explained in Section V.

### Board or committee approvals – executive remuneration arrangements

As per the Companies Act and Companies (Meetings of Board and its Powers) Rules 2014, the board of directors of every listed company and the following classes of companies are required to constitute an NRC of the board: (1) all public companies with a paid-up capital of 10 million rupees) or more; (2) all public companies having turnover of 100 crore rupees or more; (3) all public companies, having in aggregate, outstanding loans or borrowing or debentures or deposits exceeding 50 million rupees.

The NRC shall ensure the following:

- Identify persons who are qualified to become directors and who may be appointed in senior management in accordance with the criteria laid down, recommend to the board their appointment and removal. The NRC has been given the additional responsibility of carrying out evaluation of every director’s performance.

- Formulate the criteria for determining qualifications, positive attributes and independence of a director and recommend to the board a policy, relating to the remuneration for the directors, key managerial personnel and other employees.

- While formulating the policy, the committee shall consider the following:
  - the level and composition of remuneration is sufficient to attract, retain and motivate directors of the quality required to run the company successfully;
  - relationship of remuneration to performance is clear and meets appropriate performance benchmarks; and
  - remuneration to directors, key managerial personnel and senior management involves a balance between fixed and incentive pay reflecting short and long-term performance objectives appropriate to the working of the company and its goals.
In addition to the above, the total managerial remuneration payable by a public company, to its directors, including managing director and whole-time director, and its manager in respect of any financial year shall not exceed 11 per cent of the net profits of that company for that financial year computed in the manner as laid down in the Companies Act. Further, except with prior approval of the board:

\( a \) The remuneration payable to any one managing director or whole-time director or manager shall not exceed 5 per cent of the net profits of the company and if there is more than one such director, remuneration shall not exceed 10 per cent of the net profits to all such directors and managers taken together.

\( b \) The remuneration payable to directors who are neither managing directors nor whole-time directors shall not exceed:

- 1 per cent of the net profits of the company, if there is a managing or whole-time director or manager; or
- 3 per cent of the net profits in any other case.

These percentages shall be exclusive of any fees payable to directors for remuneration received by way of fees for attending meetings of the board or committee.

\( v \) Requirements – composition of the board or remuneration committee

The NRC constituted by the board of directors of companies mentioned in Section VI.iv has to consist of three or more non-executive directors, of which no less than half shall be independent directors. The chairperson of the company (whether executive or non-executive) may be appointed as a member of the NRC but shall not chair the committee.

\( vi \) Government approval – executive remuneration arrangements

The approval of the government for executive remuneration is required under the following circumstances:

\( a \) The total managerial remuneration payable by a public company, to its directors, including managing director and whole-time director, and its manager in respect of any financial year shall not exceed 11 per cent of the net profits of that company for that financial year computed in the manner as laid down in the Companies Act. However, the company may, with the approval of the central government, authorise the payment of remuneration exceeding 11 per cent of the net profits of the company subject to other provisions under the Companies Act.

\( b \) Subject to provisions of the Companies Act, if, in any financial year, a company has no profits or its profits are inadequate, the company shall not pay to its directors, including any managing or whole-time director or manager, by way of remuneration any sum exclusive of any fees payable to directors and if it is not able to comply with such provisions as prescribed under the Companies Act and Schedule V of the Companies Act, with the previous approval of the central government.

\( c \) In cases of no profits or inadequate profits, any provision relating to the remuneration of any director who purports to increase or has the effect of increasing the amount

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10 Schedule V annexed to the Companies Act 2013 deals with the conditions to be fulfilled for the appointment of a managing or whole-time director or a manager without the approval of the central government. Additionally, it also lists the amount of remuneration payable by companies having no profit.
thereof, whether the provision be contained in the company’s memorandum or articles, or in an agreement entered into by it, or in any resolution passed by the company in general meeting or its board, shall not have any effect unless such increase is in accordance with the conditions specified in that schedule and if such conditions are not being complied, the approval of the central government had been obtained.

vii ‘Say on pay’ vote by shareholders

Except with prior approval, which includes approval of the shareholders, the company cannot increase the remuneration in the circumstances as mentioned below:

a  To authorise the payment of remuneration to its directors, including managing director and whole-time director (in case of a public company), exceeding 11 per cent of the net profits of the company subject to other provisions under the Companies Act.

b  The remuneration payable to any one managing director or whole-time director or manager exceeds 5 per cent of the net profits of the company and if there is more than one such director, remuneration exceeds 10 per cent of the net profits to all such directors and managers taken together.

c  The remuneration payable to directors who are neither managing directors nor whole-time directors exceeds:
   • 1 per cent of the net profits of the company, if there is a managing or whole-time director or manager; or
   • 3 per cent of the net profits in any other case.

In addition to the above, the remuneration payable to the directors of a company, including any managing or whole-time director or manager, shall be determined, in accordance with and subject to the provisions of the Companies Act, either by the articles of the company, or by a resolution or, if the articles so require, by a special resolution, passed by the company in general meeting and the remuneration payable to a director determined aforesaid shall be inclusive of the remuneration payable to him or her for the services rendered by him or her in any other capacity. However, any remuneration for services rendered by any such director in other capacity shall not be so included if (1) the services rendered are of a professional nature, and (2) in the opinion of the NRC, if the company is a listed company and such class of company as prescribed, or the board of directors in other cases, the director possesses the requisite qualification for the practice of the profession.

viii Proxy advisory firms

Proxy advisory firms have been regulated by the Securities and Exchange Board of India. Proxy advisory firms provide advice to institutional investors or shareholders of a company with respect to the exercising of the rights in the company, which includes independent opinion, research and data on corporate governance issues, as well as voting recommendations on shareholder resolutions. Further, given that shareholders’ approval is required (1) to authorise the payment of remuneration to its directors, including managing director and whole-time director (in case of a public company), exceeding 11 per cent of the net profits of the company subject to other provisions under the Companies Act, (2) for remuneration payable to any one managing director, whole-time director or manager that exceeds 5 per cent...
of the net profits of the company and if there is more than one such director remuneration exceeding 10 per cent of the net profits to all such directors and manager taken together, (3) for remuneration payable to directors who are neither managing directors nor whole-time directors that exceeds: (i) 1 per cent of the net profits of the company, if there is a managing or whole-time director or manager; or (ii) 3 per cent of the net profits in any other case, proxy advisory firm may provide their recommendation to the shareholders before they give their approval to increase executive remuneration.

VII SPECIALISED REGULATORY REGIMES

i Executive remuneration – related to specific industries or companies

Executive remuneration with respect to banks in India has been regulated by the RBI under Banking Regulation Act 1949 (the Banking Act) to ensure complete transparency and accountability. In 2012, the RBI issued the Guidelines on Compensation of Whole Time Directors/Chief Executive Officers/Other Risk Takers (Guidelines – Whole Time Directors, Chief Executive Officers/Other Risk Takers) and in 2015 issued the Guidelines on Compensation of Non-executive Directors of Private Sector Banks (Guidelines – Private Sector Banks) (together, the Guidelines).

As per the Guidelines – Private Sector Banks:

a private sector banks should formulate and adopt a comprehensive compensation policy covering all their employees and conduct annual review;

b the board of directors of banks should constitute a remuneration committee of the board to oversee the framing, review and implementation of compensation policy of the bank on behalf of the board;

c banks should ensure that, in relation to compensation, for full-time directors or chief executive officers: (1) compensation is adjusted for all types of risk; (2) compensation outcomes are symmetric with risk outcomes; (3) compensation payouts are sensitive to the time horizon of the risk; and (4) the mix of cash, equity and other forms of compensation must be consistent with risk alignment;

d banks are required to ensure that the fixed portion of compensation is reasonable, taking into account all relevant factors, including the industry practice;

e while designing the compensation arrangements, it should be ensured that there is a proper balance between fixed pay and variable pay; however, variable pay should not exceed 70 per cent of the fixed pay in a year. Within this ceiling, at higher levels of responsibility the proportion of variable pay should be higher. The variable pay could be in cash, or stock linked instruments or mix of both;

f in the event of negative contributions of the bank or the relevant line of business in any year, the deferred compensation should be subjected to malus/clawback arrangements;

g guaranteed bonuses are not consistent with sound risk management or the pay-for-performance principles and should not be part of the compensation plan;

h banks should not provide any facility or funds or permit employees to insure or hedge their compensation structure to offset the risk alignment effects embedded in their compensation arrangement; and

i members of staff engaged in financial and risk control should be compensated in a manner that is independent of the business areas they oversee and commensurate with their key role in the bank.
Further, no amendment of any provision relating to remuneration of a chairman, a managing director or any other director, full-time or otherwise or manager or chief executive officer, whether that provision be contained in the company’s memorandum or articles of association, agreement entered into by it, or in any resolution passed by the company shall have effect unless approved by the RBI; and any provision conferring any benefit or providing any amenity or perquisite, whether during or after the termination of the term of office of the chairman or the manager or the chief executive officer called or the managing director, or any other director, full-time or otherwise, shall be deemed to be a provision relating to his or her remuneration.

ii Industries and employees covered

The RBI has the authority to issue rules specific to executive remuneration of banking companies covered under the Banking Act. Further, the Guidelines issued by the RBI are different for private sector banks, foreign banks and primary (urban) cooperative banks. ‘Banking company’ under the Banking Act is defined as any company that transacts the business of banking in India. Any company that is engaged in the manufacture of goods or carries on any trade and that accepts deposits of money from the public merely for the purpose of financing its business as such manufacturer or trader shall not be deemed to carry out the business of banking within the meaning of this clause.

Additionally, the employees covered under the said rules are the chairman, managing director, any other director, full-time director, manager or a chief executive officer.

iii Additional disclosure requirements

As per the guidelines issued by the RBI, the key disclosures that are required to be made by private sector bank and foreign banks with respect to remuneration are as mentioned below. Further, the disclosures are divided into qualitative and quantitative categories for private sector banks; however, the quantitative disclosures should only cover whole-time directors, chief executive officers and other risk-takers.

**Private sector banks**

a Banks are required to make disclosure on remuneration on an annual basis in their annual financial statements.

b Qualitative disclosures include: (1) information relating to the composition and mandate of the remuneration committee; (2) information relating to the design and structure of remuneration processes and the key features and objectives of the remuneration policy; (3) description of the ways in which the bank seeks to link performance during a performance measurement period with levels of remuneration; (4) description of the ways in which current and future risks are taken into account in the remuneration processes; (5) a discussion of the bank’s policy on deferral and vesting of variable remuneration and a discussion of the bank’s policy and criteria for adjusting deferred remuneration before vesting and after vesting; the (6) description and rationale of the different forms of variable remuneration (i.e., cash, shares, ESOPs and other forms) that the bank utilises.

c Quantitative disclosures include: (1) number of meetings held by the NRC during the financial year and the remuneration paid to its members; (2) number of employees who received variable remuneration award during the financial year; (3) total amount of deferred remuneration paid, number and total amount of sign-on awards made during
the financial year, details of guaranteed bonus, if any, paid as joining or sign-on bonus, details of severance pay, in addition to accrued benefits, if any; (4) total amount of outstanding deferred remuneration, split into cash, shares and share-linked instruments and other forms, total amount of deferred remuneration paid out in the financial year; (5) breakdown of amount of remuneration awards for the financial year to show fixed and variable, deferred and non-deferred; and (6) the total amount of outstanding deferred remuneration and retained remuneration exposed to ex post explicit or implicit adjustments, total amount of reductions during the financial year due to ex post explicit adjustments, and total amount of reductions during the financial year owing to ex post implicit adjustments.

**Foreign banks**

Foreign banks operating in India will be required to submit a declaration to the RBI annually from their head offices to the effect that their compensation structure in India, including that of their chief executive officer, is in conformity with the finance stability board (FSB) principles and standards.

**Rules with respect to institution based in the jurisdiction or simply operating a foreign subsidiary or branch**

Foreign banks are operating in India through branch mode of presence and the compensation policy of these banks is governed by their respective head office policies. Therefore, the RBI expected these head offices to adopt the FSB principles. Further, the compensation proposals for chief executive officers and other staff of foreign banks operating in India that have not adopted the FSB principles in their home country have to implement the compensation guidelines as prescribed for private sector banks in India, to the extent applicable to them. Further, the RBI is in charge of implementing and overseeing these rules.

**VIII DEVELOPMENTS AND CONCLUSIONS**

When dealing with executive remuneration or compensation, the trend in today’s growing market is to find a fine balance between the act of rewarding executives and the growth and progress of the company. Several instances can be pointed out where shareholders have openly communicated their reservations against the ad hoc changes in the structure of the compensation or remuneration payable to senior executives. It is also interesting to note that, in certain instances, the backlash has been from the founders of the companies.

Corporate governance in India can be said to be proactive by already having provided the ‘shareholders’ say on pay’ vote. The concept has increasingly found its place in corporate governance in India. Influence and bias are concepts that cannot be disregarded and their involvement can be detrimental to the interests of the company. The involvement of shareholders in the determination of remuneration of executives who must exercise their duties in a fiduciary manner is a step forward in maintaining the prudent financial and operational structure of companies. It is our opinion that all companies must realise that good governance practices at every level go a long way in helping the performance of the company, and awarding employees adequately, ensures the necessary and permanent growth of the company in the long run, as it serves as an incentive to further common objectives.
I INTRODUCTION

Executive remuneration encompasses many aspects of the law, starting with labour law and continuing to corporate and securities law, and tax and social benefits. Many of these areas of the law are complex and constantly developing, including legislation, court rulings and common practice. The remuneration in many sectors of the Israeli market is driven by the extensive tax benefits available for true equity compensation and it is common practice to grant executives significant equity awards both upon engagement and in follow-up grants. Furthermore, Israeli public companies and reporting companies under security law are subject to stringent approval processes when dealing with executive remuneration. More limited requirements apply to private Israeli companies. In general, legislation and common practice in Israel follow the global trends regarding executive remuneration; however, there is a slight delay. For example, as at mid 2018, neither the legislation nor the market in Israel have adopted or implemented clawback provisions.

II TAXATION

i Income tax for employees

Generally, employment income is subject to income tax, social security contributions and health tax. In certain cases, financial institutions and non-profit organisations are subject to salary tax that is levied as part of the VAT system. The taxable income also includes benefits in kind that the employee receives from the employer, directly or indirectly, and the value of such benefits is added to the employee's salary for tax purposes. In order to simplify the value calculation of some common benefits, such as company car or company mobile phone, special regulations were enacted that specify the value of such benefits.

Non-residents are subject to the same income tax rates as Israeli residents; however, they are not entitled to some of the credits that are available only to Israeli residents. Notwithstanding the foregoing, there are specific regulations that allow special tax benefits to certain non-Israeli employees, including 'foreign experts', 'foreign lecturers' and 'foreign athletes'. Employees who are residents of countries with which Israel has signed treaties for the prevention of double taxation may be subject to different taxation under the relevant treaty.

The employer must withhold income tax from the employee's salary and benefits (at the rates specified below) and transfer it to the Israeli Tax Authority (the ITA).
Income tax rates

Employment income is subject to income tax at the following progressive rates (in 2018):

<table>
<thead>
<tr>
<th>Annual taxable income (NIS)</th>
<th>2017 tax rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>Up to 74,880</td>
<td>10%</td>
</tr>
<tr>
<td>74,881 to 107,040</td>
<td>14%</td>
</tr>
<tr>
<td>107,041 to 172,320</td>
<td>20%</td>
</tr>
<tr>
<td>172,321 to 239,520</td>
<td>31%</td>
</tr>
<tr>
<td>239,521 to 498,360</td>
<td>35%</td>
</tr>
<tr>
<td>Over 498,360</td>
<td>47%</td>
</tr>
</tbody>
</table>

In addition to the above rates, a 3 per cent surtax is imposed on annual income above a threshold of 641,880 shekels (in 2018), including income from work, business, rental income, interest income, dividends and capital gains.

Exemption from ordinary income tax or reduced tax rates, or both, applies to certain members of the population – disabled or blind people, or those in military service – and to some types of employment income, such as retirement payments, payments upon death, and certain income received by a new immigrant or returning resident.

The Ordinance (see below) provides for certain credits and deductions and under some circumstances allows for the deduction of expenses associated with the creation of income and donations to approved non-profit organisations. The most common are contributions to pension funds and provident funds that are regulated under law, as well as credits points included under law.

ii Taxation of employee stock incentive plans

The taxation of employee stock incentive plans in Israel is governed by Section 102 of the Israeli Income Tax Ordinance (New Version) (the Ordinance) and the regulations promulgated thereunder. For the purpose of Section 102 of the Ordinance, the term ‘employee’ includes any officer of the company. Under Section 102, an employee equity-based benefit plan may be either with a trustee or without a trustee. Tax-favourable treatment is given only with a trustee. Where the plan has a trustee, the employer may choose one of two tax routes for the plan: an ordinary income route or a capital gain route.

The general conditions required for the purpose of being eligible for the tax treatment applicable to a trustee plan are as follows:

a The plan must be filed for approval by the ITA.

b The allotting company should be an Israeli company or an affiliate of an Israeli company.

c The approved awards can be issued under the plan only to Israeli-resident employees or officers of the company or any affiliate or subsidiary.2

d Israeli-resident employees must be employed by an Israeli-resident company or by a foreign company with a permanent establishment or research and development centre in Israel, provided that the company received prior approval from the ITA.

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2 However, this excludes a controlling member of the issuing company, which is defined as anyone who holds 10 per cent or more of the issued share capital of the issuing company or of the voting rights in it, or who has rights to 10 per cent or more of the issuing company’s profits, or who is entitled to appoint a director in the issuing company.
The awards should vest in shares and not in cash.

The grants should be made only after the lapse of 30 days from the day the plan was submitted for approval.

Each award must be notified to the ITA by means of annual and quarterly reports.

The awards or underlying shares received upon exercise or vesting must be deposited with or controlled by a trustee for a period of:
- no less than 12 months from the date on which the grants were made, where the employer chooses the income route (income route lock-up period); or
- 24 months from the date on which the grants were made, where the employer chose the capital gain route (capital gain route lock-up period).

Each employee must accept in writing the terms of Section 102 of the Ordinance, the chosen tax route and the applicable trustee arrangement.

Certain tax rulings may be required in order to implement a certain equity plan under the trustee route.

The general terms and conditions of each tax route are as follows:

The non-trustee plan route: the awards are not required to be deposited for a lock-up period with a trustee. Any award granted under this tax route, except for non-tradable rights to acquire shares, is subject to an immediate tax event (even if the shares are subject to restrictions). The tax event for non-tradable rights to acquire shares is deferred to a later time, when the employee sells the underlying shares. Upon the tax event, the employee is taxed at his or her full marginal income tax rate (including social security and health tax). In addition, the employer is not entitled to a tax deduction in the event that the employee obtains a tax deferral.

The trustee plan or income route: the awards and any underlying shares must be deposited with a trustee for at least 12 months. The employee will be taxed at the time of sale at his or her marginal income tax rate and the employer will obtain a tax deduction.

3 Under tax regulations promulgated under Section 102, reports regarding details of the grants must be filed at the end of each quarter, on Form 146, and annually, by 31 March of the following year, on Form 156. However, for reports due in 2004 onwards the deadline has been extended indefinitely because of problems with the system; the date will be published in the future. Forms 146 and 156 are to be completed in a mechanised form by using special software that can be purchased on the market and are to be filed either on a disk or through a special system that links accountants to the tax authorities.

4 On 24 July 2012, the ITA published formal guidance regarding the deposit requirements under Section 102 (the Guidance). In short, the Guidance determines that for grants approved after 24 July 2012, the company must provide the trustee with a copy of the applicable board resolution within 45 days of the board resolution and further provide signed grant documents within 90 days of the board resolution. In relation to grants approved on or before 24 July 2012, the general requirement is that written notice should have been provided to the trustee regarding the grants within 90 days of grant. On 6 November 2012, the ITA published a clarification to the provisions of the Guidance regarding equity awards granted under trustee routes under Section 102 of the Ordinance on or before 24 July 2012. The clarification determines (among other issues) that, in relation to grants made on or before 24 July 2012, a regular transfer of the grant details in writing from the company to the trustee within 90 days of the grant date will be sufficient to satisfy the deposit requirements. The clarification further includes two alternative solutions in the event the grants were deposited more than 90 days after the date of grant. Both alternatives required a formal application to the ITA, which could have been filed by 5 November 2013. These alternatives are no longer available; therefore, any amendment of a previous delay in deposit will require a tax ruling from the ITA.
The trustee plan or capital gain route: the awards and underlying shares must be deposited with a trustee for at least 24 months. The employee will be taxed at the time of sale at a tax rate of 25 per cent. (For publicly traded companies or companies who list soon after the date of grant, only the increase in market price from the date of grant (if any) will be eligible for the reduced tax rate of 25 per cent and the remainder will be taxed as work income.) The employer will not be entitled to a tax deduction, except for circumstances in which the gain is subject to ordinary income tax rate (as detailed above), in which case a deduction is allowed where the gain is taxed as work income provided there is a charge back by the allowing company.

### iii Social taxes for employees

Employment income derived by Israeli residents is also subject to social security contributions and health tax as follows:

<table>
<thead>
<tr>
<th></th>
<th>For the portion of income up to 60% of the average salary (reduced rate) of 5,678 shekels</th>
<th>For the portion of income above 60% of the average salary and up to a total income of 43,240 shekels</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Employer</td>
<td>Employee</td>
</tr>
<tr>
<td>Social insurance</td>
<td>3.45%</td>
<td>0.4%</td>
</tr>
<tr>
<td>Health insurance</td>
<td>--</td>
<td>3.1%</td>
</tr>
<tr>
<td>Total</td>
<td>3.45%</td>
<td>3.5%</td>
</tr>
</tbody>
</table>

### iv Tax deductibility for employers

Generally, any income paid by the employer for which the employer withholds income tax from the employee’s salary is a deductible expense for the employer.

In respect of equity awards, the tax consequences for the employer (local subsidiary) will depend on the type of awards granted and whether such awards are granted under a non-trustee route, a trustee capital gains route or a trustee ordinary income route.

#### Non-trustee route

For non-tradable rights to acquire shares granted under a non-trustee plan, the employer is not entitled to a tax deduction either at the time of grant, vesting, exercise or conversion or sale. For shares granted under a non-trustee plan where the employee is taxed at the time of grant, the employer will be entitled to a deduction, in the tax year in which the employee realises the income, equal to either the amount of the employee’s work income, or the amount the allowing company charged the employer for the shares, whichever is the least. The employer will not be entitled to any deduction at the time the employee subsequently sells the shares. Where the employee is not taxed at grant, the employer will not be entitled to a tax deduction.

#### Trustee capital gains route

In respect of equity awards of a publicly traded company, the employer will be entitled to deduct, in the tax year in which the employee realises a capital gain, either the portion of the employee’s gain that is treated as work income, or the amount the allotting company charged the employer for the award, whichever is the least. This rule applies to income...
classified as ordinary income under Section 102(b)(3) of the Ordinance and not in the event in which income is subject to ordinary income tax as a result of the violation of the statutory requirements (sale or released from trust before the end of the lock-up period).

**Trustee ordinary income route**

For all types of equity awards, assuming that the stock is not sold or released from trust before the end of the lock-up period, the employer will be entitled to deduct, in the tax year in which the employee realises work income, either the amount of the employee's work income, or the amount the allowing company charged the employer for the options, whichever is the least.

### III TAX PLANNING AND OTHER CONSIDERATIONS

Hot topics in executive remuneration include the following:

- **Relocation due to the tech companies operating research and development centres in Israel:** the main effect of relocation is on equity awards, an aspect that should be examined in advance of relocation.
- **Personal services companies being used at times by executives instead of direct engagement:** this engagement structure triggers exposure to both the executive and mainly to the employer owing to reclassification issues. Any such engagement should be carefully examined prior to implementation.
- **Equity compensation:** as a result of the beneficial tax treatment that may be applied to equity awards made by companies with operations in Israel, companies are interested in implementing the most efficient plan for employee equity awards. The structure of any such equity plan will depend on the specific circumstances of the allotting company.
- **Proxy advisory firms becoming more and more significant players in the Israeli capital market and in the structuring of executive remuneration.**
- **Share Based Compensation Accounting Expenses and the effect on transfer pricing arrangements (cost plus) between Israeli subsidiaries and their parent companies.**

### IV EMPLOYMENT LAW

The relations between an executive and the engaging entity are usually reflected in an employment or service provider agreement. Personal employment contracts may be either written or oral; however, generally there is no obligation to sign employment agreements with the employees (with the exception of certain groups of employees). However, employers are required to provide all employees with written notice detailing certain required employment terms in accordance with the provisions of the Notice to the Employee and Job Candidate Law (Employment Conditions and Candidate Screening and Selection) 5762-2002 and relevant regulations, no later than 30 days after the date of commencement of their employment. A formal notice is also required to be provided when those terms and conditions are changed or updated (subject to certain exceptions).

For labour law purposes, there is no difference in legislation between executives and common employees. All employees are entitled to the protection of the relevant labour law legislation.
i Enforcement of non-compete and non-solicit provisions

In general, in certain fields, such as in the high-tech industry and with respect to senior employees, it is customary to include protective and post-termination covenants in the applicable employment agreements.

However, covenants not to compete, as well as covenants not to solicit, are rarely enforced in Israel. In general, Israeli law prefers, *prima facie*, the employee’s freedom of occupation over the employer’s right that a former employee will not compete with it. According to case law, non-compete covenants that are incurred by employees will not be enforced unless there are specific circumstances, such as the following: (1) the former employer owns a trade secret that is unlawfully used by the employee; (2) the former employer has invested unique and valuable resources in the employee’s training; (3) upon termination of the employee’s employment with the former employer, the employee received special consideration in return for his or her non-compete undertaking; and (4) when a balance between the extent of the employee’s conduct and good faith in taking the new position and the employee’s obligation of fidelity towards the former employer indicates that the enforcement of the employee’s non-compete covenant is justified. In this respect the courts will also consider the position of the employee and the field in which the employer operates.

In any event, even if a court decides to enforce a non-compete covenant, the enforcement will only be with respect to an obligation that can be considered reasonable in the scope of the employee’s position, time and geographical limitation. The court also has the power to redraft the non-compete obligation (blue pencil) in order to make it more reasonable. In order to increase enforceability of a non-solicit provision, it is recommended to limit the scope of the restriction as much as possible.

We note that the use of gardening leave provisions may increase the enforceability of non-compete covenants for the duration of the gardening leave.

A person’s non-compete and non-solicit obligations in his or her position as shareholder would be easier to enforce than a parallel undertaking made by an employee. If applicable, such undertaking should be made within the transaction documents, as a commercial provision, rather than within the employment documents.

ii Highlights for termination of employment in Israel

The general practices for termination of employment, which apply also in the case of a change of control, include, among others, performing a hearing procedure prior to making a final
decision regarding the termination of the employee’s employment, exercising good faith when making this decision, providing the employee with a prior written notice of termination, and confirming that all outstanding entitlements to which the employee is entitled are paid to him or her on time according to law.

According to the Severance Pay Law, as a general rule, an employee who is dismissed after completing at least one year of service with a particular employer or in a particular workplace is entitled to statutory severance pay.

Severance pay is calculated based on the employee’s monthly base salary (as in effect at the time of termination) multiplied by the number of years of service (prorated when applicable).

In Israel it is very common, and in most circumstances mandatory, for an employer to effect a pension arrangement for its employees. The employer’s payments to such pension arrangement are partially on account of (or in certain circumstances, in lieu of) the statutory severance pay (severance fund). Upon termination of employment, the employer transfers the pension arrangement to the employee. To the extent that payments to the severance fund were made on account of severance pay, then in addition, the employer pays the employee the shortfall between the amounts accrued in the severance fund, and the amount of statutory severance pay to which the employee is entitled by law.

There are several scenarios in which employees, although not dismissed, would be entitled to severance pay as if they had been dismissed (constructive dismissal). One of these scenarios is where employees resign by reasons of a substantial deterioration in the conditions of their employment, or in view of other matters of labour relations affecting them, and because of which the employees cannot be expected to continue their employment; the employees may also claim for a unilateral change of their employment terms, which may be considered a breach of their employment agreement with all attached implications.7

Upon termination and the carrying out of a final settlement of accounts, it is quite common that an employee is requested to sign a letter of receipt and release of claims towards the employer (‘release’).

According to Israeli case law,8 such a release does not constitute a formal bar to future claims by employees. However, a release may be enforced if the following conditions are met: (1) the employee was aware and had knowledge of the rights that he or she waived; (2) the employee was presented with a clear and comprehensible account of the sums he or she received prior to signing the release; (3) the release is clear and unambiguous; and (4) the employee signed the release of his or her own free will and not as a result of coercion by the employer.

We note that an employee cannot be forced to sign a release. On the other hand, if the employer decides to pay the employee an ex gratia (voluntary) payment or benefit over and above the legal requirement, the employer may condition such payment upon the signing of a release.

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7 Section 11 of the Severance Pay Law, 404 SH 136; LA 1271/00 Emi Matom Architects Engineers and Consultants Ltd v. Haim Avraham PDA 39 587.

iii  Methods for the transfer of employees due to mergers and acquisitions

When dealing with the issue of transfer of employees within a merger or acquisition, it is necessary to distinguish between the two primary types of acquisitions of a company: an asset transaction, which, in general, results in a change of employers, and a new legal personality of the business. In such a situation, Israeli labour law provides employees with certain protections regarding their rights in the workplace, even though their employer has changed (primarily where the employees continue to be employed in the same workplace, but by a different employer).

A share transaction is not considered a change in legal personality and therefore, all the obligations and rights of employees are preserved exactly as they existed before the sale.

The following analysis refers to asset sales only; however, in certain circumstances it may also be relevant to share transactions.

As a rule, an employee cannot be transferred to another employer without the employee’s consent. Therefore, if an employee does not give his or her consent to the transfer, the seller would need either to continue to employ the employee or to terminate his or her employment (with all the relevant implications).

If an employee agrees to transfer to the buyer, then the employment agreement between the employee and the buyer will be considered a new agreement (subject to the following proviso), even if employment with the buyer is based on the same identical terms as the prior employment with the seller. The employee’s consent to the transfer may either be in writing or implied (such as where the employee works for the buyer under the new terms of employment for a certain period).

In practice, there are two methods of transferring employees from the seller to the buyer. The first method involves the seller terminating the employees’ employment and the buyer rehiring such employees (“fire and rehire”). From the seller’s perspective, this method is identical to a normal situation of termination of employment. In such circumstances, the seller will have to carry out a final settlement of account with each person whose employment is being terminated, including providing prior notice and payment of severance pay.

The second method involves maintaining the employees’ continuity of employment, that is, the buyer ‘steps into’ the seller’s position as employer for all intents and purposes. In general, the seller and the buyer can agree that the buyer will step into the seller’s shoes as employer for all intents and purposes. In such circumstances, the buyer will assume all the seller’s obligations to the employees while maintaining the rights of the employees that are dependent on their seniority. This method increases the buyer’s financial obligations towards the employees, as certain employee rights are based on the employees’ continuity of employment with the employer. For example, the buyer’s obligation to pay severance pay upon the future termination of any of the transferred employees may be increased, as this amount derives from the employees’ last salary (which tends to increase over time), multiplied by the number of years of service.

iv  Additional issues

In recent years, there has been a revival in the area of unionising of unorganised employees, which involves new, traditionally unorganised sectors (including the high-tech, cellular and insurance sectors). Amendments in the applicable law and principal rulings have substantially limited an employer’s ability to prevent or intervene in any initial unionisation, thus facilitating the unionisation attempts.
The classification of a worker as an employee or an independent contractor is a matter of status, and, therefore, is not necessarily determined according to the contractual agreement between the parties. Accordingly, the labour courts and other authorities may reclassify a worker who was contractually defined as an independent contractor, as an employee based on the actual circumstances of the engagement, with all the financial implications of that reclassification. Employers should therefore limit the engagement of independent contracts to those who meet the legal criteria for the same.

V SECURITIES LAW

According to Section 15 of the Securities Law of 1968 (the Securities Law), companies granting securities to 35 or more non-qualified offerees (including employees) in any 12-month period must file a prospectus with the Israeli Securities Authority (ISA) and receive an ISA permit to issue the prospectus. Section 15 of the Securities Law, however, also provides certain exemptions from the requirement of issuing a prospectus.

The following are the most common exemptions used by companies that have not listed any of their securities (shares or bonds) for trade on the Tel Aviv Stock Exchange (hence, not reporting corporations):

a Section 15B(2)(a) of the Securities Law provides that an offering to employees, pursuant to a benefit plan, of securities by a company that is not a ‘reporting company’ (i.e., a company required to file reports to the ISA) and whose shares are not listed for trade on a foreign stock exchange, will be exempt from the prospectus requirement if the total consideration received by the company within such offer does not exceed approximately 19.9 million shekels (adjusted for inflation) and the total number of shares that may be issued under the awards granted in the offering, combined with all other employee offers made in the 12-month period preceding the specific offer, does not exceed 10 percent of the total issued and outstanding share capital of the company (excluding convertible securities issued to anyone who is not an employee).

b Section 15B(4) of the Securities Law provides that an offering of securities by a company that is not a ‘reporting company’ (i.e., a company that is required to file reports to the ISA) does not require the publication of a prospectus if all the following conditions are met: (1) the maximum proceeds from the offer do not exceed approximately 2.65 million shekels (adjusted for inflation); (2) the total number of shares that may be issued in the offering does not exceed 5 per cent of the issued and outstanding share capital of the company; (3) the total number of shares that may be issued under the offering, combined with the shares issued in all other offers of the company that were not made pursuant to a prospectus, does not exceed 10 per cent of the total issued and outstanding share capital of the company (excluding convertible securities issued under any previous offer); and (4) the number of individuals being offered securities under the offer, and all other individuals who participated in the past in offerings made by the company that were not made pursuant to a prospectus, does not exceed 75. This is an automatic exemption and no official request or approval is required.

Section 15D of the Securities Law provides that the ISA may exempt from any or all the provisions of the Securities Law a company:

a whose securities are listed for trade outside Israel;

b that is not a reporting company; and
that offers or sells its securities to its employees or to the employees of a corporation under its control, in Israel, within the framework of an employee benefit plan:

- if the ISA is satisfied that the laws of the country where the securities are traded sufficiently protect the interests of the employees in Israel; and
- the ISA may condition the exemption on such terms as the ISA shall prescribe for the purposes of ensuring that all the details required to be brought to the attention of the employees will be at the disposal of the employees, including a Hebrew translation of all the offering documents, and their delivery to the employees. This exemption requires a specific application to the ISA and a specific and formal approval.

VI  DISCLOSURE

Pursuant to the Securities Law and the regulations promulgated thereunder, Israeli reporting corporations (public companies and private companies with publicly traded debt) are required to provide public disclosure regarding the remuneration of senior office holders, as follows.

i  Annual disclosure

In the framework of the annual report, reporting corporations have to include detailed information regarding the remuneration of (1) the top five senior office holders who received the highest remuneration in the corporation (or in corporations controlled by it) in the relevant year, (2) the top three senior office holders who received the highest remuneration in the corporation itself, if not included under (1), and (3) any interested party entitled to receive remuneration from the corporation (including shareholders holding more than 5 per cent and board members).9

The disclosure in the annual report is in the form of a table, detailing the annual sums of all components of the remuneration, including salary, bonuses, share-based awards, pension arrangements, retirement plans and any other remuneration, whether granted by the corporation itself or by another entity, with respect to his or her service in the corporation (or in corporations controlled by it). The value of share-based awards is set according to generally accepted accounting principles.

ii  Quarterly disclosure

In the framework of the quarterly report, reporting corporations have to include information regarding any material changes in connection with office holders’ remuneration.10

iii  Ongoing disclosure

Reporting corporations have to file immediate reports regarding remuneration, in the event of (1) any engagement with the chief executive officer regarding remuneration that requires the approval of the general meeting, (2) any engagement with an officerholder that deviates from the company’s compensation policy, and therefore requires the approval of the

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9 Regulation 21 of the Securities Regulations (Periodic and Immediate Reports) 1970.
10 Regulation 48 of the Securities Regulations (Periodic and Immediate Reports) 1970.
VII CORPORATE GOVERNANCE

i Approval requirements
The Israeli Companies Law sets out the required approvals for officer remuneration in Israeli companies, which may include approvals by the remuneration committee, the board of directors, the shareholders by a regular majority or the shareholders by a majority of the non-controlling shareholders, all depending on whether the company is public or private, whether the officer is a director, a controlling shareholder, the chief executive officer or another office holder, and whether the suggested remuneration terms are consistent with the remuneration policy.13

In recent years, proxy advisory firms started to be active in the Israeli capital market and had a major effect on the design of remuneration policies and officer compensation terms.

ii Remuneration committee
In accordance with the Israeli Companies Law, Israeli reporting corporations are required to appoint a remuneration committee, consisting of at least three directors, including all external directors who will constitute the majority members of the committee.14 External directors are members of the board who comply with certain independence requirements set out in the Israeli Companies Law. The chairman of the board, the company’s controlling shareholder or a relative, a director who is employed by the company and a director who regularly provides services to the company may not be members of the remuneration committee.15 The main responsibilities of the remuneration committee are:

- to advise and make recommendations to the board of directors regarding the adoption of a remuneration policy and its continued validity once every three years;
- to advise and make recommendations to the board of directors whether to update the remuneration policy and examine the implementation thereof from time to time; and
- to decide whether to approve the remuneration of officers, when such approval is required.16

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11 Regulation 36B of the Securities Regulations (Periodic and Immediate Reports) 1970.
12 Regulation 30 of the Securities Regulations (Periodic and Immediate Reports) 1970.
13 The fifth chapter of the sixth part of the Companies Law, 5759-1999.
14 Section 118a of the Companies Law, 5759-1999.
15 Section 115(b) of the Companies Law, 5759-1999.
16 Section 118b of the Companies Law, 5759-1999.
iii Remuneration policy

The boards of directors of Israeli reporting corporations are required to adopt a policy regarding remuneration and terms of employment of officers, after examining the recommendations of the remuneration committee in this regard.\textsuperscript{17} The remuneration policy should be approved by a company’s board of directors and by a majority of the non-controlling shareholders of a company;\textsuperscript{18} however, even if shareholders’ approval is not obtained, the board of directors may still adopt the remuneration policy, provided that the remuneration committee, and thereafter the board of directors, have determined, based on detailed arguments and after re-discussing the remuneration policy, that despite the shareholders’ opposition, approval of the remuneration policy is in the company’s best interest.\textsuperscript{19}

The Israeli Companies Law sets forth certain mandatory issues that must be included in the remuneration policy, including a provision regarding reimbursement of remuneration in the event of financial restatement.

VIII SPECIALISED REGULATORY REGIMES

Israeli regulation of executive remuneration also regulates executive remuneration in the Israeli financial sector. Remuneration of executives in the Israeli financial sector is regulated by the Israeli Remuneration for Office Holders in Financial Corporations Law (Special Approval and In-admissibility of Expenses for Tax Purposes due to Irregular Remuneration) 5776-2016 (the Remuneration in Financial Corporations Law).

The Remuneration in Financial Corporations Law applies to all financial bodies in Israel, including, generally, institutional bodies, companies whose purpose is issuance of index products, mutual fund managers, portfolio managers, banking corporations and other bodies providing financial services as generally determined by the Israeli Minister of Finance (Financial Corporations), and, generally, does not apply to foreign Financial Corporations. This law applies the same rules, including caps, to all Financial Corporations, regardless of their size or scope of activity. In addition, this regulation shall also apply to controlling corporations of financial bodies (i.e., a company meets all these conditions: (1) it controls a financial body; (2) it holds more than 30 per cent of such financial body; and (3) more than 50 per cent of its assets are holdings in financial bodies in which it has control).

According to the Remuneration in Financial Corporations Law, the expected expense for the remuneration of an executive office holder, or the expected expense for the employment of an employee of a financial corporation, may not be higher than 35 times the lowest expense paid in the year preceding the date of the agreement, directly or indirectly, for the employment of any employee of such financial corporation (including contractor workers). Additionally, if the expense for the remuneration of an executive office holder or employment of an employee of a financial corporation is expected to exceed 2.5 million shekels (approximately US$700,000) (the ceiling), then it will require certain special approvals: (1) approval of the remuneration committee or the audit committee; (2) approval of the board.

\textsuperscript{17} Section 267a(a) of the Companies Law, 5759-1999.
\textsuperscript{18} Section 267a(b) of the Companies Law, 5759-1999.
\textsuperscript{19} Section 267a(c) of the Companies Law, 5759-1999.
of directors, which in a public company will include the majority of the external or statutory independent directors; and (3) in a public company, the approval of the shareholders of the financial corporation, which will include the majority of the non-controlling shareholders.

The Remuneration in Financial Corporations Law also sets a deterrence mechanism for high compensation in financial corporations, by not allowing a financial corporation to deduct from the financial corporation’s taxable income the amount of expenses for remuneration or employment that exceeds the CPI-linked ceiling.

In addition to the above, the Israeli regulation also sets certain restrictions upon the executive remuneration of officeholders in different types of third-sector corporations (non-governmental organisations).
I INTRODUCTION

The Italian government has recently introduced several measures aimed at attracting international executives to Italy. These new measures include, in particular, a 50 per cent tax break on employment income for executives moving to Italy and a new rule clarifying (favourably for taxpayers) the tax regime applicable to carried interest.

These new measures, together with other recent actions aimed, in general, at promoting business opportunities and attracting foreign investments in Italy, and the Italian extremely favourable estate tax regime (whereas transfers to a spouse or direct descendants or ancestors are currently subject to estate tax at a 4 per cent rate, on the value in excess of €1 million), have definitely increased the appeal of Italy as an attractive place to work (and live, taking into account the obvious considerations of the country’s quality of life).

At the same time, not unlike other European countries, executives in the financial services sector remain subject to strict regulations. Following the most recent financial crisis, and the various European and international regulations issued to address executives’ compensation, the Italian parliament and the competent supervisory authorities have since implemented a set of regulations intended to reduce incentives for risk-taking activities and to effectively promote compensation arrangements that can contribute to creating value for corporations and their shareholders in the long term.

As an example of these regulations, the implementation in Italy of CRD IV has resulted in the approval of a fixed cap for variable components of remuneration. Banks, investment firms and, more generally, large and medium-sized companies, have since been hard-pressed to reform their remuneration policies to adjust to these rules and principles.

In this respect, Italian companies, including public companies, tend to provide their executives with one (or a combination) of the following awards:

a cash bonuses (cash-settled awards), which include all incentives and bonuses regulated in cash, as well as incentives providing payments on the basis of the issuer’s stock value; and

b company shares or other financial instruments (equity-settled awards), granted either directly (such as stock or restricted stock grants) or indirectly (through options, restricted stock units or any other right to purchase such financial instruments).

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1 Gianluca Russo is an associate at Cleary Gottlieb Steen & Hamilton LLP. The author would like to thank his colleagues Caterina Marchionni, Danilo Santoboni, Andrea Sollecito and Fabio Gassino for their invaluable help in the preparation of this chapter.

2 These new measures include new tax rules promoting private financing transactions in Italy (such as the new ‘mini-bonds’ regime), the new patent box regime, and other tax breaks for businesses and individuals.
A recent trend, mostly in the private equity sector, is to offer top executives the option to purchase financial instruments at market value (the ‘direct investment option’). The recently enacted rule on carried interest, mentioned above, is clearly expected to further increase this trend.

II TAXATION

i Income tax for employees

Italian-resident executives

Any type of compensation, including fringe benefits, cash-settled awards and equity-settled awards, earned by Italian tax-resident workers is generally characterised as employment income subject to Italian personal income tax (IRPEF) and to social security charges (see Section II.ii), at ordinary rates, as follows:

a awards granted to Italian tax-resident employees pursuant to cash-settled awards are generally subject to IRPEF upon payment, on the entire amount received; and

b awards granted to Italian tax-resident employees pursuant to equity-settled awards are generally subject to IRPEF at ordinary rates on the amount equal to the difference between the award’s fair market value and the purchase price, if any; equity-settled awards are generally subject to tax upon the actual delivery of the relevant financial instruments.

With respect to the direct investment option, as anticipated, Article 60 of Law Decree No. 50 of 24 April 2017 has recently addressed the tax regime applicable to carried interest-type of incentives awarded to executives. The new rule provides that income derived by executives

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3 Generally, under the direct investment option, executives are entitled to invest in a company’s shares, financial instruments, or in new categories of such shares or financial instruments created ad hoc, as well as in carried interest-type of equity, usually providing no voting rights and special economic rights or a more than proportional return on the original investment made by the executives, to take into consideration the executives’ and the company’s performance. The executives subscribe for, or purchase, these financial instruments at fair market value (based on an evaluation provided by a third-party appraiser, which is paramount for taxation reasons). An ad hoc investment vehicle of which the executives would be the shareholders (sometimes together with their employers) may also be used.

4 Directors not treated as employees under Italian labour law rules are generally treated as quasi-employees for Italian tax purposes. Income realised by quasi-employees is generally subject to the same rules applicable to employment income, but social security charges may vary.

5 IRPEF is levied at progressive rates, currently up to 43 per cent on any income in excess of €75,000, plus local surcharges up to 4.23 per cent (the local surcharges vary depending on the municipality of residence).

6 The stock’s fair market value is generally calculated on the basis of (1) for listed stock, its average trading price in the rolling month preceding the delivery date, and (2) for non-listed stock, the pro rata value of the issuer’s net equity at the delivery date. According to one position of the Italian tax authorities, limitations on dividends rights should not impact the valuation of the stock per the methods above.

7 An equity-settled award granted to all employees, or to categories of employees, may benefit from a tax exemption for an amount not exceeding €2,065.83 of the stock’s fair market value in each relevant tax period, provided that the shares are not transferred back to the beneficiary’s employer or the issuer, or in any event sold within three years of the grant date (see Article 51(2)(g) of Presidential Decree No. 917 of 22 December 1986). This exemption does not apply to incentive plans extended to certain workers only (e.g., incentive plans in which only specific executives are invited to participate).

8 For instance, options are not deemed taxable upon grant, unless they are transferable.
and directors of companies and investment funds from carried interest or sweet equity-like financial instruments will be taxed as financial income (i.e., dividends or capital gains, as the case may be) and not as employment income, resulting in the reduction of the applicable tax rate from roughly 46 per cent to generally 26 per cent, which is the rate generally applicable to investments in securities generating passive income.

For this tax treatment to apply, the beneficiaries (1) must be executives or directors (consultants appear to be excluded) of companies and investment funds (or entities directly or indirectly controlled by these companies and funds) that are resident for tax purposes either in Italy or in white-listed countries, (2) must invest, in the aggregate, at least 1 per cent of the investment made by the investment fund or of the company’s net equity value, (3) must invest in financial instruments providing a pay-out more than proportional to the investment and subject to the relevant investors or stakeholders realising a minimum return on their investment (equal to their invested capital plus the hurdle rate agreed upon in the relevant by-laws or regulations), and (4) must hold the financial instruments for at least five years (unless an exit occurs).

The new provision does not clarify the tax treatment of investments made by executives that do not meet the above conditions. However, executives opting for the direct investment option may still be entitled to benefit from the more favourable tax regime provided for investments in securities generating passive income if, based on the actual terms and conditions of their investments, the investment can be assimilated to that of any other third-party investor.9

**Mobile executives**

Non-resident executives are not subject to tax in Italy, unless they perform their services hereto. Non-resident executives who perform their services in Italy are subject to tax in Italy on the portion of their compensation remunerating their Italian services.

In particular, in the case of services performed in Italy by an executive during an award’s vesting period, Italy would seek to tax the portion of the award’s value that is deemed to remunerate the work activity performed in Italy. The applicable tax treaty regime (if any) may override the domestic rules and entail an exemption from Italian taxation.10

Because employment income is generally taxed on a cash basis, an executive who is delivered stock, or receives a cash bonus, while resident in Italy for tax purposes, pursuant to an equity-settled award or a cash-settled award that was granted or vested abroad (or both),

9 Hènece, in these structures, particular emphasis must be given to the actual terms and conditions of the investment, which carry an important weight in assessing the applicable tax regime. The Italian tax authorities expressly clarified that income derived by executives from carried interest-type of awards that do not meet the requirements of Article 60 of Law Decree No. 60/2017 is not automatically treated as employment income, provided that the executives’ investment resembles that of a third-party investor.

In that respect, while the inclusion of the usual leaver provisions would be considered a sign of the employment-related nature of such award, the executives’ exposure to the risk of losing their investment would be a clear indication that the executives are treated as any other shareholder or investor and that the award’s payout is not related to their performance.

10 According to most conventions against double taxation entered into by Italy, non-resident employees and quasi-employees are subject to tax in Italy for services rendered in Italy only if they have been present in Italy for a period or periods exceeding in the aggregate 183 days in any relevant calendar year, or their remuneration is paid by, or on behalf of, an employer who is a resident of Italy, or the remuneration is borne by a permanent establishment that the foreign employer has in Italy.
would still be subject to tax in Italy on the award’s entire fair market value or cash amount (as the case may be). In these events, executives would generally be eligible in Italy for a foreign tax credit for any taxes levied abroad.

**ii Social security charges for employees**

As a general rule, the chargeable income for social security charges in Italy is equal to the corresponding base for income tax purposes. Hence, any compensation that is subject to tax as employment income would generally also be subject to social security charges.

Italian social security charges vary depending on the industry in which the employer operates and the employee qualification for labour law purposes. Executives generally benefit from a social security exemption on any annual compensation exceeding a set threshold, which, for 2018, amounts to €101,427. In addition, a special social security exemption applies, subject to certain conditions being met, with respect to employment income deriving from certain equity-settled awards extended to selected executives. Based on black letter law and in the absence of any official clarification on this point by the competent authorities, this exemption should apply only to employees and not to quasi-employees such as certain directors.

**iii Tax deductibility for employers**

Generally, any payment made by an Italian employer pursuant to a cash-settled award is fully deductible from the employer’s overall taxable business income as an employment expense. The tax allowance for costs relating to the implementation of equity-settled awards may vary, depending on the award attributed.

Except for IAS adopters, awards entailing delivery of newly issued stock should not generate a tax-deductible expense, as they do not trigger an actual expense or disbursement for the issuer. On the other hand, a tax allowance would generally be available for the

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11 Generally, social security charges for executives amount to approximately 38 per cent, approximately one-third of which is borne by the employee, while the remainder is borne by the employer. Different rules may apply to workers who are not treated as employees for labour law purposes. For example, directors who are treated as quasi-employees may be subject to a different social security regime.

12 The exemption applies to employees enrolled in the Italian social security system after 1996, or who expressly opted for the calculation of their social security benefits on the basis of the contributory system enacted in 1996.

13 According to the Italian Social Security Agency, the application of this exemption is conditional upon the awards not being extended to all employees (i.e., only awards granted to specific categories of employee, or to specific employees only, are exempted); including retaining conditions such as a minimum vesting period, performance-based vesting criteria, minimum lock-up period or the continued employment until grant; and providing the grant of equity instruments only, without contemplating a cash-settlement option (see INPS Communication No. 25602 of 12 October 2010).

14 The analysis may differ if the expense is borne by the employer on the basis of a charge-back arrangement.
expense incurred in connection with the purchase of treasury stock underlying equity-settled awards,\textsuperscript{15} provided that the relevant stock is attributed by the issuer to its own employees and not to the employees of its group affiliates.\textsuperscript{16}

As anticipated, a tax allowance for the costs accounted for in relation to equity-settled awards, including awards attributing newly issued shares, should always be available for companies adopting IAS or IFRS accounting standards.

\textbf{iv Other special rules}

\textit{Tax incentives for qualified executives}\textsuperscript{17}

Qualifying executives transferring their tax residency to Italy are entitled to a 50 per cent exemption from IRPEF with respect to their employment income earned in Italy.

Potential beneficiaries are top executives (employees or self-employed workers) who: (1) have not been resident in Italy in the five tax years preceding the transfer; (2) will be employed by an Italian entity (under an employment contract entered into with this entity or a related party); and (3) will carry out their working activity in Italy for more than 183 days in each tax period.\textsuperscript{18}

The beneficial regime applies for the tax period in which the executive transfers his tax residence to Italy and for the following four tax periods. Beneficiaries are required to maintain the Italian tax residence for at least two years.\textsuperscript{19}

\textsuperscript{15} However, it could be argued that the difference between the tax basis held in the stock (i.e., the book value increased by the expenses incurred to purchase the stock, other than interest expense) and the strike price, if any, for the issuer, should be treated as a capital loss or gain resulting from the disposal of the related shares and not as an employment expense; as such, it should be subject to the participation exemption rules, pursuant to which capital losses realised on the disposal of treasury stock recorded as financial fixed assets are disallowed for tax purposes if the relevant shareholding has been held, without interruption, from the first day of the 12-month period preceding the month in which the transfer occurs.

\textsuperscript{16} See Tax Circular No. 98/E of 17 May 2000, paragraph 5.1.1: according to the Italian tax authorities, expenses borne by an Italian parent company in connection with the grant of equity-settled awards to the employees of its group affiliates are not deductible by the parent company, as the shares are considered as being disposed of, therefore triggering a taxable event. Alternatively, should such an expense be charged back by the parent company to the relevant affiliates, the parent would be subject to tax on that amount but the affiliate would be able to take a tax allowance for the amount charged back, to be treated as a deductible employment expense.

\textsuperscript{17} The 2017 Budget Law has recently introduced a favourable tax regime (usually referred to as the Italian resident non-domiciled regime) enabling eligible taxpayers who have not resided in Italy for at least nine of the 10 years preceding the year of the transfer to opt to be taxed in Italy on their foreign-source income by paying a flat annual charge of €100,000 (and to cherry pick the foreign state or states falling within its scope). Accompanying relatives can access the same regime by paying a flat annual charge of €25,000. This regime cannot be coupled with the tax incentives for qualified executives described above (nor with the different tax breaks available to researchers and professors transferring their tax residence to Italy) and, while very favourable, would likely not be very enticing for executives deriving most of their income from employment income (which, by definition, would be subject to personal income tax at ordinary rates).

\textsuperscript{18} This regime was approved with Article 16 of Legislative Decree No. 147 of 14 September 2015, and subsequently amended with the Italian 2017 Budget Law (Law No. 232 of 11 December 2016). Requirement under point (2) does not apply to self-employed workers. The regime also applies to EU or white-listed countries’ citizens provided that they have a university degree and have worked or carried out a business outside of Italy for at least the 24 months preceding the transfer.

\textsuperscript{19} These tax allowances cannot be coupled with those available to researchers and professors pursuant to Article 44 of Law Decree No. 78 of 31 May 2010, which provides for a 90 per cent exemption from IRPEF.
Additional tax in the financial services sector

Certain executives employed in the financial services sector are currently subject to an additional 10 per cent tax levied on the portion of their variable remuneration (including compensation paid out in the form of equity-settled awards or cash-settled awards) exceeding their fixed compensation.20

Exemption for equity-based awards of start-ups

Article 27 of Law Decree No. 179 of 18 October 2012 provides a full exemption from tax and social security charges for income derived from equity-settled awards by executives, directors and consultants (treated as quasi-employees for tax purposes) of certain non-listed start-up companies. This exemption applies provided that the relevant awards are issued by a start-up company qualifying for the special regime provided for under Decree No. 179, or a company directly controlled by the start-up company, and are not purchased back by the start-up, the issuer or any entity or person directly related to it.21

Beneficial regimes for fringe benefits

Certain fringe benefits (including loans, insurance policies, housing facilities, company cars and scholarships) enjoy a beneficial regime whereby part of their value may not be subject to IRPEF or social security contributions.

Reporting obligations

With respect to equity-settled awards, if the relevant financial instruments are held abroad, the beneficiaries must report on their annual tax return the value of such financial instruments (together with any other overall offshore investments, such as financial and real estate assets).22

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20 The 10 per cent additional tax was approved, effective as of 31 May 2010, with Article 33 of Law Decree No. 78 of 31 May 2010 (converted into law with Law No. 122 of 30 July 2010). Article 33 of Law Decree No. 78 was subsequently amended by Article 23(50 bis) of Law Decree No. 98 of 6 July 2011 (as amended by Law No. 111 of 15 July 2011), which provided that the 10 per cent additional tax would apply on the entire portion of variable compensation exceeding the fixed component of remuneration and not, as contemplated before, on the portion exceeding three times the fixed component (see also Paragraph 15 of Tax Circular No. 41/E of 5 August 2011). The revised rules apply to variable compensation paid as of 17 July 2011. The 10 per cent additional tax applies only to executives, including top consultants and directors. Moreover, while the statutory rules provide for the application of the 10 per cent additional tax only to executives employed in the financial services sector (e.g., banks and investment companies), the Italian tax administration is seeking to extend the application of the 10 per cent additional tax also to executives employed by industrial holdings (see Paragraph 13.1 of Tax Circular No. 4/E of 15 February 2011).

21 This exemption has been recently extended to employees and executives of certain small-mid cap ‘innovative’ companies, that is small-mid cap non-listed companies investing in R&D activities or employing qualified personnel, or both (see Article 4(9) of Law Decree No. 3 of 24 January 2015, converted into law by Law No. 33 of 24 March 2015).

22 See Article 4 of Law Decree No. 167 of 28 June 1990, as amended with Law No. 97 of 6 August 2013, effective as of 4 September 2013.
**Stamp duties on financial assets**

A proportional stamp duty applies on the periodic reporting communications sent by financial intermediaries to their clients with respect to any financial instruments deposited therewith, including any financial instruments that are received by executives in relation to incentive awards. The stamp duty is generally computed on the nominal or purchase cost of the financial instruments at a rate of 0.2 per cent. A similar duty applies on the nominal or purchase cost of any financial asset held abroad by Italian-resident individuals, at a rate of 0.2 per cent.

**Italian financial transaction tax**

Under certain circumstances, the purchase by the executives of financial instruments under equity-settled awards may also be subject to the Italian financial transaction tax, which generally applies, inter alia, on the transfer of shares and certain equity-like financial instruments (as well as securities representing such shares and instruments, such as ADRs). The financial transaction tax applies on the transfer of the above-mentioned shares and financial instruments, irrespective of the residence of the parties involved or the place of execution of the relevant transaction, at a rate of 0.2 per cent (reduced to 0.1 per cent for transactions executed on regulated markets and on multilateral trading facilities). Hence, the application of this financial transaction tax may be relevant, in particular, in the context of the direct investment option in a private equity investment scenario.

However, the financial transaction tax does not apply with respect to the allocation to executives of shares or financial instruments in respect of profits or reserves distributions, or to newly issued shares in the context of 'stock option plans'.

### III TAX PLANNING AND OTHER CONSIDERATIONS

As anticipated, the new tax break for executives transferring to Italy and the new rule on the taxation regime of carried interest provide extremely interesting possibilities for tax-planning opportunities, as they ensure access to a very competitive tax reduction in the personal tax rates generally applicable to employment income.

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23 The stamp duty is generally levied by the financial intermediaries with which the financial instruments are deposited, on an annual basis. In the case of reporting periods of less than 12 months, the stamp duty is prorated. If the fair market value cannot be determined, the stamp duty is computed on the basis of the financial instrument's face or redemption value.

24 As indicated above, if the financial instruments' fair market value cannot be determined, this levy is applied on their face or redemption value. A tax credit is granted for any foreign property tax levied abroad on such financial assets.

25 The Italian financial transaction tax was approved with Article 1(491-500) of Law of 24 December 2012, No. 228, as implemented by Ministerial Decree of 21 February 2013 (as amended and supplemented by Ministerial Decree of 16 September 2013).

26 This exemption is expressly provided for in the technical explanations accompanying Law No. 228 of 2012. Although reference is made to stock option plans only, it is reasonable to believe that the exempted transfers should include any equity-settled awards. Moreover, the financial transaction tax does not apply to the transfers of shares of small-mid public companies (i.e., companies with an average market capitalisation lower than €500 million, as recorded in November of the year preceding the year in which the shares are transferred).
In particular, given the new rules on carried interest, it is expected that Italian-resident executives and their employers will increase exploring ways to have executives invest in financial instruments, which, while requiring an immediate financial outlay by the executives, might entail the possibility to benefit from the more favourable tax regime provided for investments in securities generating passive income.

In addition, other available planning opportunities relate to the possible structuring of equity-settled awards to ensure access to the above-mentioned social security exemption provided for equity-settled awards or – for start-up companies only – to the tax and social security exemption described above for start-ups.

However, executives and companies in the financial services sector, as well as industrial holding companies, must still give careful consideration to the impact of the 10 per cent additional tax described in Section II.iv.

Moreover, moving employees transferring into or out of Italy, who are beneficiaries of incentive awards accrued abroad or in Italy and to be delivered in a country other than the one where they were accrued, must pay attention to the applicable domestic or treaty regime before their transfer to ensure mitigation of the overall tax due in connection thereto.

IV EMPLOYMENT LAW

i Termination provisions

Executives can be dismissed for cause by their employers without any advance notice. An executive’s dismissal may be deemed for cause in cases of particularly serious misconduct (i.e., violations of the employment contract or non-employment related behaviours that result in a material breach of the executive’s duties), which irreparably undermine the fiduciary relationship with the employer.

Unless the termination is for cause, executives are entitled to be notified in advance of the termination or to an indemnity in lieu of the advance notice.27 In these cases, the termination has to be justified (i.e., based on objective reasons relating to the employer’s economic, organisational and production-related needs or on certain subjective reasons relating to the executive’s performance or conduct).28 Executives are entitled to damages29 (but, generally, not to their reinstatement)30 if they are found to be terminated without such ‘justification’ or without cause.

27 The advance notice period (and the related indemnity in lieu of the advance notice) is set out in the applicable collective bargaining agreements and usually ranges from a minimum of six months up to a maximum of 12 months, depending on the executive’s seniority.

28 Note that executives are also taken into account regarding the calculation of the thresholds relevant for the application of the rules applicable to collective redundancies (e.g., the company’s size threshold – such rules apply only to companies employing more than 15 employees – and the number of relevant terminated employees – at least five, within a 120-day span in the given territory).

29 The amount of such damages varies depending on the applicable collective bargaining agreements and the executives’ seniority, generally up to 24 months’ salary.

30 According to Article 18(1) of Law No. 300 of 20 May 1970, as recently amended, in certain cases only (including the case of a discriminatory or arbitrarily inflicted dismissal), the termination is deemed null and void and the executive is entitled to be reinstated into his or her position or to opt for an indemnity in lieu of the reinstatement (equal to 15 months’ salary), as well as to damages for an amount corresponding to his or her compensation from the date of the unfair dismissal until the reinstatement.
ii Severance payments

Italian executives are entitled to a statutory severance payment, which is due to all employees upon termination of their employment relationship, regardless of the reason for termination.31

In addition to the statutory severance payment, Italian companies sometimes provide their top executives with additional severance payouts (e.g., golden parachutes), generally in cases of termination without cause (e.g., in cases of a ‘good leaver’ termination). Such additional severance payouts are subject to the limitations provided for listed companies and banks (see Sections VII.ii and VIII).

iii Non-competition covenants and non-solicitation agreements

Pursuant to Article 2125 of the Civil Code (CC), non-competition covenants must provide, inter alia, a specific remuneration, can only cover specific fields of activities and a well-specified geographical area, and cannot last longer than five years.

Non-solicitation agreements are usually included in top executives’ agreements (or the settlement agreements following an executive’s termination) and are generally enforceable under Italian rules.

iv Clawback provisions

Clawback provisions would be enforceable if agreed upon at the time of the award’s grant or included in the award’s terms and conditions. Their enforceability would be uncertain, however, if the clawback provisions were included into existing arrangements.

V SECURITIES LAW

Several regulatory obligations or requirements may apply with respect to financial instruments awarded to executives under incentive plans.

i Public offers of securities

Article 94 of Legislative Decree No. 58 of 24 February 1998 (Consolidated Financial Act) provides for an obligation to publish a prospectus in compliance with the Prospectus Directive (2003/71/EC), in relation to all offerings to the public of financial products, unless a specific exemption applies. In this respect, the offering of financial products to directors or employees may benefit from several of such exemptions, including the following exemptions for:

a the offering of financial instruments to existing or former directors, employees or financial promoters by their employer,32 provided that the issuing company has its head

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31 This statutory severance payment accrues annually on the employer’s books, for an amount roughly equal to one month of remuneration for each year of employment, and is calculated on the basis of the employee’s salary, including any type of compensation or benefit regularly paid to him or her, with the exception of any extraordinary item of compensation. The inclusion of cash-settled awards or equity-settled awards in the computation of the statutory severance pay would depend on the actual terms and conditions of such awards. The statutory severance pay is not due for directors.

32 Or by the parent company, a subsidiary, a company on which the employer exerts a significant influence or a company subject to the control of the same company as the employer.
office or registered office in the European Union, and a document is made available to the public containing information on the number and nature of the securities and the reasons for and details of the offer;33

b financial instruments that are offered to fewer than 150 people in Italy, other than qualified investors;34
c the offering of securities35 to existing or former directors or employees,36 provided that the securities cannot be traded on capital markets;
d offerings extended to qualified investors;37 and
e offerings whose total value amounts to less than €5 million.38

ii Internal dealing transactions

With respect to Italian public companies, certain directors and executives, being ‘significant parties’ of the issuer, are treated as insiders39 and must disclose any purchase, sale, subscription of and exchanges of shares or other financial instruments of their employer in excess of €20,000.40 However, these market abuse and insider trading rules should not apply to buy-back programmes implemented by a public company to meet obligations arising from stock option plans or stock grants extended to executives or directors of the issuing company, its subsidiaries or affiliated companies.41

33 See Article 34 ter(m) of Regulation No. 11971 of 14 May 1999 (Issuers’ Regulation) issued by the Italian exchange commission (CONSOB), as amended by CONSOB Resolution No. 18079 of 20 January 2012 and by CONSOB Resolution No. 19548 of 17 March 2016.
34 See Article 34 ter(a) of the Issuers’ Regulation. This threshold has been amended by EU Directive 2010/73 and CONSOB Resolution No. 18079 of 20 January 2012.
35 See Article 34 ter(n) of the Issuers’ Regulation. The definition of securities, as reported in Article 1(1.1 bis) of the Consolidated Financial Act, includes all classes of securities that are negotiable on the capital market, including shares, bonds and other similar equity or debt securities, as well as rights to acquire such securities.
36 By their employer or by the parent company, a subsidiary, a company on which the employer exerts a significant influence or a company subject to the control of the same company as the employer.
37 See Article 34 ter(b) of the Issuers’ Regulation as amended by CONSOB Resolutions No. 18079 of 20 January 2012 and No. 18612 of 17 July 2013.
38 See Article 34 ter(c) of the Issuers’ Regulation. This threshold has been amended by CONSOB Resolutions No. 18079 of 20 January 2012 and No. 18214 of 9 May 2012.
39 See Articles 152 quinquies.1 and sexies(1)(c) and 1(d) of the Issuers’ Regulation for a list of significant parties, which include the issuer’s directors, general managers and executives having regular access to inside information. Pursuant to Article 18 of Regulation (EU) No. 596/2014 of the European Parliament and of the Council of 16 April 2014 on market abuse, a company’s insiders include all persons who have access to inside information and who are working for them under a contract of employment, or otherwise performing tasks through which they have access to inside information such as advisers, accountants or credit rating agencies.
40 See Articles 114(7) of the Consolidated Financial Act and 152 quinquies.1 of the Issuers’ Regulation. In particular, unless an exemption applies, a significant party must timely notify CONSOB (possibly through the issuer) and the issuer itself (and – when applicable – the public) of any internal dealing transactions (with the exceptions provided under Article 152 sexies(3) of the Issuers’ Regulation) carried out by such party (or its connected persons, such as his or her family members as defined in Article 152 sexies1(d) of the Issuers’ Regulation).
41 This exemption (provided for under Article 183(1)(b) of the Consolidated Financial Act) applies if the relevant transactions are carried out in accordance with Article 5 of Regulation (EU) No. 596/2014 of the European Parliament and of the Council of 16 April 2014 on market abuse.
iii Reporting obligations

Pursuant to Article 120 of the Consolidated Financial Act, executives working for public companies listed in Italy have to notify their employer or issuer and CONSOB of any transactions that result in their shareholdings in the employer or issuer exceeding or falling below 3 per cent of the capital, or reaching, exceeding or falling below certain subsequent thresholds.42, 43

iv Placement requirements

Financial intermediaries

As a general rule, any public offering of securities must be carried out through financial intermediaries duly authorised to perform placement activities. Hence, the initial offering of equity-settled awards to executives in Italy, the delivery of the underlying shares and any payments made by the grantees in connection thereto, if subject to these placement requirements, should be made through an authorised financial intermediary.

However, these placement requirements do not apply to offers extended to directors, employees and consultants of the issuer, its parent company or its subsidiaries, that are carried out at their premises.44

Financial advisers

In addition, unless the offer of securities pursuant to an equity-settled award is carried out by an authorised financial intermediary at its own premises, duly authorised financial advisers must be used to conduct the offer.45

The requirement to use financial advisers does not apply to offers to professional clients.46

42 Currently set, under Article 117 of the Issuers’ Regulation, at 5, 10, 15, 20, 25, 30, 50, 66.6 and 90 per cent of the issuer's capital, and at 3 per cent if the company is not an SME, as amended by CONSOB Resolution No. 19614 of 26 May 2016. Note that Article 120(2 bis) of the Consolidated Financial Act authorises CONSOB – under specific circumstances and for a limited period of time – to lower the 2 per cent threshold in order to protect investors and market integrity.

43 According to the previous instructions for the supervision of banks, set out in Bank of Italy's Circular No. 229 of 21 April 1999, any actual delivery of shares during any month should be notified by the issuer to the Bank of Italy if shares with a value exceeding €500,000 have been delivered in Italy during the past 12 months, including the month in question. However, by means of a communication dated 17 August 2011, the Bank of Italy temporarily suspended the obligation for issuers and financial intermediaries to file the relevant notification form, considering a more efficient regime for this ex post notification. On October 2013, the Bank of Italy conducted a consultation on the topic; which led to the approval of new rules on reporting requirements for the issue and offer of securities, repealing Title IX, Chapter I, Section IV of Circular No. 229 of 21 April 1999. The new rules, which were published on 25 August 2015 and entered into force on 1 October 2016, do not provide for any reporting obligation with respect to shares.

44 See Article 30(2) of the Consolidated Financial Act, as amended by Legislative Decree No. 184 of 11 October 2012. A general exemption is also provided, under Article 30(1), for all offers of financial instruments whose placement takes place at the premises of the issuer (including its branches, but not at the premises or branches of its affiliates).

45 See Article 31 of the Consolidated Financial Act.

46 See the MiFID (EU Directive 2004/39/EC, repealed and replaced, with effect from 3 January 2018, by MiFID II (Directive 2014/65/EU)) and the related Italian implementing laws and regulations (including, but not limited to, CONSOB Regulation No. 20307 of 15 February 2018 on financial intermediaries,
VI DISCLOSURE

i Ongoing disclosure

As a general principle, Article 2427(1), No. 16 of the CC provides that Italian companies must disclose the aggregate compensation earned in any relevant year by directors and members of the statutory auditors’ committee in the notes to the financial statements.

ii Ad hoc disclosure

Both the Issuers’ Regulation and the Consolidated Financial Act set out specific disclosure obligations for public companies in relation to compensation plans based on financial instruments that are issued in favour of members of the board of directors, employees or consultants of the issuer, its parent company or its subsidiaries.

In particular, according to Article 114 bis of the Consolidated Financial Act, an information document must be made available upon publication of the call for the general shareholders’ meeting approving these compensation plans.47

In addition, pursuant to Article 123 bis(i) of the Consolidated Financial Act, listed companies should also disclose in the report of the directors on the financial statements, or in their annual corporate governance report, any agreements between the company and its directors establishing severance payments in the cases of resignation, dismissal without just cause or termination following a tender offer on the company’s shares.48

Finally, following the approval of Legislative Decree No. 259 of 30 December 2010,49 Article 123 ter was included in the Consolidated Financial Act (on which see also Section VII), requiring the board of directors (or the supervisory board) of listed companies to approve and publicly disclose an annual report on the remuneration of directors, auditors and executives with strategic responsibilities (the Remuneration Report).50 The Remuneration Report must

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47 Pursuant to Article 84 bis(1) of the Issuers’ Regulation, the information document must be made available at the issuer’s registered office and published on the issuer’s website. The information document must be drafted in accordance with Annex 3A, Form 7 of the Issuers’ Regulation. In the event that the resolution of the shareholders’ meeting contain information subject to disclosure pursuant to Article 17 of Regulation (EU) No. 596/2014 of the European Parliament and of the Council of 16 April 2014 on market abuse, the information document were to also include: (1) a description of the recipients pursuant to Annex 3A, Form 7 of the Issuers’ Regulation; (2) the essential elements concerning the features of each financial instrument that the compensation plan relies on; and (3) a short description of the reasons behind the plans. The same provision applies to issuers of shares in relation to compensation plans based on financial instruments that are issued in favour of members of the board of directors of the same controlled companies or of other controlling or controlled companies.

48 See also CONSOB’s communication of 24 February 2011, requiring public companies to provide more detailed information on severance arrangements.

49 The Decree implements EU Recommendations 2004/913/EC, Sections II and III, and 2009/385/EC, Section II, Paragraphs 5 and 6, regarding remuneration of the members of the board of directors for companies listed in EU Member States.

50 The Remuneration Report must be published at least 21 days prior to the yearly ordinary shareholders’ meeting (i.e., the same meeting called to resolve on the approval of the financial statements).
Italy

comprise two sections, illustrating, respectively, the remuneration policy and the procedures set out to implement that policy; and the remuneration paid to the senior management (including any severance pay), specifying the remuneration paid to each director, auditor or top executive, as well as any compensation paid to a company’s executive by its controlled or affiliated companies during the fiscal year, and the expected remuneration to be received in the future by those individuals for services rendered during the relevant fiscal year.51

iii  Related-party transactions

Further disclosure requirements aimed at ensuring the transparency and fairness of related-party transactions apply to both private and listed companies. As far as Italian-listed or otherwise widely held companies are concerned, the rules issued by CONSOB on 12 March 2010 (CONSOB Regulation)52 set out both specific periodic disclosure and corporate governance requirements for related-party transactions, which specifically include resolutions regarding compensation of directors and key management personnel, with some exceptions.53

iv  Price-sensitive information

Article 114(1) of the Consolidated Financial Act provides that listed companies (and the persons controlling them) must promptly disclose to the public any inside information referred to in Article 181 of Consolidated Financial Act that directly concerns such issuers and their subsidiaries. Information on the remuneration of directors, auditors and managers with strategic responsibilities may fall, under certain circumstances, within this definition. CONSOB’s communication of 19 June 2014 has provided additional specific disclosure obligations for certain companies listed in Italy (generally, medium to highly capitalised companies) in relation to severance arrangements requiring:

a  the disclosure of any severance payment or other similar benefit, awards remaining outstanding following termination, non-compete arrangements and any other amount awarded in connection with termination, including their amount; and the moment of payment and the existence of clawback arrangements, if any;

b  an indication of these severance benefits’ consistency with the remuneration policy and, in the case of inconsistency, the provision of information on the voting procedure adopted in application of the CONSOB Regulation;

51  The incentive plans disclosed to the public pursuant Article 114 bis of the Consolidated Financial Act must also be attached to the Remuneration Report.
52  As amended with CONSOB Resolution No. 17389 of 23 June 2010.
53  Article 13 of the CONSOB Regulation specifies that the provisions of the CONSOB Regulation do not apply with respect to resolutions adopted at the shareholders’ meeting; resolutions regarding the compensation of directors entrusted with specific powers (e.g., the chief executive officer), if the shareholders’ meeting has established an aggregate maximum compensation for these directors, provided that, in both cases, such compensation is not based on the market value of financial instruments; and resolutions adopted pursuant to Article 2402 of the CC, regarding compensation of members of the board of statutory auditors. Companies may also opt, upon establishing the statutory procedures for related-party transactions, to exempt (in whole or in part) incentive plans based on financial instruments resolved at the shareholders’ meeting pursuant to Article 114 bis of the Consolidated Financial Act; and any other resolution regarding compensation of directors and key management personnel that is based on remuneration policies approved at the shareholders’ meeting, in the context of a decision-making process involving a committee composed exclusively of non-executive directors, the majority of whom are independent.
the required company to disclose the decision process made in connection with the implementation of adjustment mechanisms and, to the extent applied, the result of such implementation, providing the adjustment of the severance in cases of inadequate performance by the executives; and

disclosure of any succession planning.

These disclosure obligations are provided in the form of recommendations to the issuers and remained in force until 31 December 2014. After that date, CONSOB was supposed to assess whether and in what form the introduction of new disclosure requirements on the above-mentioned topics is required, but as of the date of writing no additional regulation was issued in this respect.

VII CORPORATE GOVERNANCE

Italian corporate governance rules, including rules on executives’ remuneration, are established primarily by the CC, the Consolidated Financial Act and the Issuers’ Regulation.

In addition, Italian-listed companies may voluntarily decide to comply with the Corporate Governance Code issued by the Corporate Governance Committee of the Italian Stock Exchange, which sets out certain corporate governance guidelines for companies listed on the Italian Stock Exchange.\(^54\)

i Procedural requirements

Statutory requirements

Compensation paid to a company’s senior managers, other than its directors, is generally determined by the board of directors or other officers so empowered.

The overall compensation paid to all directors, including cash and equity-based incentive awards, must be approved at the company’s ordinary shareholders’ meeting; however, generally it is the board of directors that determines the compensation of directors entrusted with certain powers (e.g., the chief executive officer), having taken into account the opinion of the board of statutory auditors.\(^55\)

Additional requirements may apply with respect to incentive plans. In particular, while cash-settled awards are generally implemented with the approval of the board of directors only (except in cases when they are extended to non-executive directors, for which the approval of the shareholders is required), equity-settled awards require a shareholders’ resolution

\(^54\) On 5 December 2011, the Italian Stock Exchange released a revised version of the Corporate Governance Code addressing in particular the remuneration of directors and key management personnel, as well as the disclosure obligation of the issuer in case of termination (Point 6.P.5 of the Corporate Governance Code recommends to issuers to publicly disclose detailed information on severance pays attributed in case of termination). As a general rule, compliance with the Corporate Governance Code is not imposed by the law: companies are required to disclose under the comply-or-explain principle what recommendations of the Corporate Governance Code, if any, are not being adopted and why. Although implementation of and compliance with the Corporate Governance Code are voluntary, the vast majority of listed companies in Italy do follow it.

\(^55\) If the by-laws so provide, the shareholders’ meeting may determine an overall cap for the remuneration of all directors, including those entrusted with specific powers (see Article 2389(3) of the CC).
(usually in addition to a board of directors’ resolution) to fund the plan and impose further procedural requirements, depending on whether they are implemented through the issuance of new shares or the assignment of treasury shares.

**Corporate Governance Code requirements**

Pursuant to Article 6 of the Corporate Governance Code, the board of directors, upon proposal of the remuneration committee, is required to establish a policy outlining the guidelines for the determination of the remuneration of directors and key management personnel.

Moreover, the board of directors must appoint a remuneration committee composed of either independent directors or non-executive directors, the majority of whom (including the president of the committee) are independent, and at least one of whom must be an expert in financial or remuneration matters.

**ii Substantive requirements under the Corporate Governance Code**

**Remuneration level and structure**

Article 6 of the Corporate Governance Code includes a series of principles directly addressing the structure of top executives’ compensation, to ensure that the executives’ interests are aligned with those of the company’s shareholders and that they are remunerated based on performance and results.

As to the structure of top executives’ remuneration, the Corporate Governance Code provides, *inter alia*, that:

- *a* top executives’ remuneration should guarantee an appropriate balance between fixed and variable remuneration components, taking into account the specifics of the company’s business, including its risk profile; and companies should set limits on the variable components of remuneration paid to top executives;

- *b* a significant part of any variable remuneration accrued in the hands of the top executives should be deferred;

- *c* share-based incentive plans, if properly structured, can improve the alignment of the top executives’ interests with those of the shareholders and, as a result, it is recommended that such awards should provide for a minimum vesting period of at least three years; and that, following vesting, beneficiaries should be required to retain a minimum number of shares for a predetermined period; and

- *d* remuneration of non-executive directors should not – if not for an insignificant portion – be linked to the economic results of the issuer. In this respect, non-executive directors should not be allocated share-based awards unless it is so determined with a motivated shareholders’ resolution.

**Provisions on golden parachutes**

Article 6 of the Corporate Governance Code requires that payments made in connection with the early termination of top executives (other than the statutory severance pay, such as golden parachutes) should not exceed a fixed amount to be predetermined by the company and should not be paid in the case of termination owing to the inadequate performance of the executive.
Additional requirements for listed companies

As indicated above, listed companies are subject to additional requirements when it comes to the approval and disclosure of their remuneration policy (see Section VI, on the disclosure requirements concerning the Remuneration Report).

In this respect, under Article 123-ter of the Consolidated Financial Act the say-on-pay on remuneration policies applies: the Remuneration Report is subject to the say-on-pay of the shareholders’ meeting, although its negative resolution would not be binding on the board of directors or the supervisory board.

VIII SPECIAL REGULATORY REGIMES

i Executive remuneration in the financial services sector

On 30 March 2011, the Bank of Italy published a set of regulations that addressed the regulation of executives’ compensation in the financial services sector (the BI Regulations), substantially reflecting the final Guidelines on Remuneration Policies and Practices issued by the Committee of European Banking Supervisors (now the Italian Banking Authority (EBA)) on 10 December 2010 to implement Directive 2010/76/EU (CRD III).56

CRD III has been replaced by Directive 2013/36/EU (CRD IV, on which see also the EU Overview chapter of this publication) approved on 26 June 2013 and implemented in Italy by Legislative Decree No. 72 of 12 May 2015. To ensure compliance with CRD IV, the BI Regulations were repealed with the Bank of Italy Circular No. 285/2013 of 18 November 2014 (Circular 285). Circular 285 largely confirmed the set of rules provided for under the BI Regulations, while increasing certain substantive and disclosure requirements, and also introducing a fixed ratio for variable compensation.

Circular 285 applies to all Italian banks and investment companies (SIMs) and banking and SIM groups, including foreign branches of Italian banks and SIMs and Italian branches of foreign banks and SIMs (covered entities). However, a proportionality principle applies, allowing a certain level of flexibility in applying Circular 285 provisions, depending on the covered entities’ dimension and internal organisation, and risk level. In particular, banks are divided into three categories and the entire set of rules set out under the BI Regulations would apply only to major banks.57

56 On 25 July 2012, amendments to the Bank of Italy–CONSOB Joint Regulation on Investment Services of 29 October 2007 were issued in order to also extend the application of the rules implementing CRD III to SIMs, with some minor exceptions. In addition, amendments of the Bank of Italy–CONSOB Joint Regulation on Investment Services of 29 October 2007 were also approved to implement the rules of Directive 2011/61/EU (AIFMD) with respect to remuneration policies of alternative investment funds (AIF), and the rules of Directive 2014/91/UE (UCITS V) with respect to the remuneration policies of UCITS. It should be noted that, on 31 March 2016, following its consultation on draft guidelines in summer 2015, ESMA published its final report and guidelines on sound remuneration policies under the UCITS Directive and the AIFMD. The final guidelines principally establish remuneration guidelines for management companies of UCITS funds but also include an amendment to the existing AIFMD remuneration guidelines. A separate set of regulations also applies with respect to insurance companies (see the Regulations on Remuneration Policy in the Insurance Sector, issued by the Italian control agency on the insurance sector, ISVAP – now the Italian Insurance Supervisory Authority – No. 39 of 9 June 2011). The provisions of the ISVAP regulations are similar to the BI Regulations.

57 Note that under the BI Regulations the entire set of rules only applied (entirely) to major banks with a significant international presence.
Circular 285 applies to all forms of payment or benefit made directly by – or indirectly by, but on behalf of – the covered entities, including all variable compensation, equity-based awards and certain discretionary pension benefits. In addition, Circular 285 is intended to apply to all personnel of the covered entities. However, certain more specific requirements (e.g., rules on golden parachutes) would apply only to the more relevant staff, namely those executives whose professional activities may have a material impact on the entity’s risk profile.

Circular 285 provides various guidelines on the implementation of sound remuneration practices. In particular, it provides rules on compensation structure, governance and disclosure practices.

On 14 March 2018, the Bank of Italy published a consultation paper for the amendment of Circular 285, to take into consideration the guidelines on sound remuneration policies issued by the EBA following the approval of CRD IV. The amendments proposed in the consultation paper, if approved, would affect some of the regulations described below, especially expanding their scope.

**Compensation structure**

Circular 285 provides a series of *ex ante* and *ex post* adjustments to the executives’ compensation structure to ensure the long-term alignment of the executives’ interests with those of the shareholders.

*Ex ante* adjustment measures include the requirement for covered entities to implement predetermined performance criteria based not only on financial criteria but also on non-financial parameters (such as customer satisfaction), which should take into account the overall results of the covered entities, of the business unit concerned as well as the single executive’s performance results. In determining the performance criteria (and their achievement), covered entities should consider all types of current and future risks relating to the executives’ performance, also taking into account the costs of capital and liquidity required. Performance should be assessed in a multi-year framework. In addition, the total variable remuneration paid to executives should not limit the ability of these entities to strengthen their capital base.

Most importantly, Circular 285 provides a mandatory ratio for variable components of remuneration paid to executives, which cannot exceed their fixed compensation (hence set at a ratio of 1:1, which can increase to 1:2 only with shareholders’ approval). This cap on variable compensation should also apply to the staff of subsidiaries operating outside the European Economic Area (EEA) of parent companies established in the EEA.

*Ex post* adjustments provide, *inter alia*, that:

a. variable remuneration (including deferred compensation) should be paid only if sustainable and justified in accordance with the (preferably, multi-annual) performance of the firm, the business unit and the individual concerned (in particular, the overall amount of variable compensation due should not affect the covered entities’ capital ratio), based on well-identified, objective and immediately estimable parameters;

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58 On 21 December 2016, the EBA issued its final report on guidelines on sound remuneration policies to ensure compliance with the CRD IV Directive. Competent authorities across the European Union were expected to implement the guidelines by the end of 2015.

59 Covered entities are also required to ensure that the variable remuneration is not paid through vehicles or other methods aimed at artificially evading the BI Regulations’ requirements.
variable compensation should remunerate the results effectively attained by the managers and should be reduced, or not paid at all, in the case of negative performances (malus and clawback arrangements are recommended);  
severance pay should be consistent with the executive’s actual performance and the risks taken;  
guaranteed variable remuneration is prohibited, except for first-year hirings;  
a substantial portion of the variable remuneration component (at least 40 per cent or at least 60 per cent in the case of material amounts) should be deferred over a period of at least three to five years; and  
at least 50 per cent of the variable remuneration, including the deferred portion, should consist of shares or share-linked instruments (or equivalent non-cash instruments, in the case of non-listed firms).  

**Governance and disclosure requirements**

A covered entity’s by-laws should require at least annually the approval at the ordinary shareholders’ meeting of a remuneration policy for directors, auditors and members of the supervisory boards, and any equity-based incentive plan.

In major or listed banks, the board of directors is required to appoint a remuneration committee composed solely of non-executive directors, the majority of whom are independent, which should advise the board in connection with the implementation of the remuneration policy.

**IX DEVELOPMENTS AND CONCLUSIONS**

While the implementation of CRD IV in Italy, as in Europe overall, resulted in the approval of strict criteria for the compensation of executives in the financial sector, the new tax measures recently introduced in Italy provide an effective and extremely competitive instrument to attract top level talent in Italy.

Hence, while the regulatory framework may present a challenge for financial companies, the current overall scenario presents the unique opportunity to take advantage of the new tax rules, while establishing new remuneration policies that are in line with the long-term interests of the companies and their shareholders.

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60 According to the BI Regulations, equity-settled awards (the non-deferred portion) must be subject to adequate retention policies (i.e., a minimum of two years), possibly requiring executives to hold a substantial portion of equity even following termination.
Chapter 13

LUXEMBOURG

Annie Elfassi, Cédric Raffoul, Kheira Mebrek and Arnaud Barchman Whytiers van Vliet

I INTRODUCTION

Although the word ‘executives’ does not have a legal definition, the Luxembourg Labour Code makes a significant difference between upper-level employees (cadres supérieurs who may be assimilated to executives) and non-managerial employees:

a non-managerial employees cannot exceed a certain number of working hours per day and week. The limitation on working hours does not apply to executive employees;
b non-managerial employees are entitled to compensation for overtime, either by paid rest time, by 1.5 hours of free time per additional hour worked, or through the payment of their salary plus 40 per cent. The executive employee is not entitled to payment for overtime work; and
c executives do not fall within the scope of application of certain collective bargaining agreements. They are not entitled to any remuneration for work on Sundays, whereas non-executive employees are paid for hours worked on Sundays, at the request of the employer with an increase in salary of 70 per cent.

Executives are considered to have a salary that is significantly higher than that of non-managerial employees, taking into account the time required for the performance of their duties. That is, the higher salary is in consideration for the performance of real power for effective management; or the nature of the executive’s tasks includes well-defined authority, a large amount of independence in the organisation of work and a wide freedom in working hours and in particular the absence of constraints in their schedule.

II TAXATION

i Income tax for employees

General

From a Luxembourg tax law perspective, an individual is considered a tax resident of Luxembourg provided that he or she has:

a a tax domicile in Luxembourg (i.e., a permanent place of residence in Luxembourg that is actually used and that he or she intends to maintain); or
b a usual abode in Luxembourg (a usual abode is deemed to exist after a continuous presence in Luxembourg of six months, which can overlap two calendar years).

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Determining whether an individual taxpayer is a Luxembourg tax resident or not is of importance in assessing the Luxembourg taxpayers’ liability. Luxembourg tax residents are taxable on their worldwide income (i.e., they have to report their worldwide income irrespective of its source) whereas non-Luxembourg tax residents are only taxable on their Luxembourg source income.

Luxembourg tax scale is progressive and currently ranges from 0 to 42 per cent, with a surcharge of 7 per cent for contribution to the employment fund and 9 per cent for a taxable income exceeding €150,000 (€300,000 for a household of two persons), so that the marginal income tax rate is of 45.78 per cent.

Stock options

On 29 November 2017, the Luxembourg tax authorities released a new circular letter (the New Circular LIR No. 104/2), which has replaced the circular letter issued on 20 December 2012 and the one issued on 28 December 2015 (as well as the service notes LIR/NS 104/3 of 22 May 2013 and 104/4 of 12 January 2015). The New Circular sets out amendments in relation to the tax treatments of transferable options.

While for options granted to employees prior to 1 January 2018 that are not listed nor are valued in line with a recognised financial method, the taxable basis is calculated via a lump-sum valuation method (17.5 per cent of the value of the underlying shares on the grant date), this will vary where the granting of options is made on or after 1 January 2018 (30 per cent of the value of the underlying shares). The lump sum valuation method is, however, excluded when options are granted for compensation of legal indemnities in the context of an employment relationship termination, such as those set out by law, in a contract, through a settlement agreement or following a court order.

ii Social taxes for employees

Both employees and employers are subject to social security contributions. Since 1 January 2018, the annual maximum salary for contributions has been €119,915 (except for the insurance dependence, which is not subject to the Luxembourg social security ceiling).

iii Tax deductibility for employers

Salary costs as well as social security contributions paid by an employer are expenses fully deductible from a corporate income tax perspective.

Remuneration paid by a Luxembourg company to its board members in the form of director’s fees is not tax deductible from the corporate income tax basis.

iv Other special rules

Luxembourg tax and social security treatment of termination payments

According to the Luxembourg Income Tax Law, employment income includes all income derived from the performance of a salaried activity (i.e., all remuneration, benefits and annuities granted by the employer prior to or after the termination of the employment relationship). However, the Luxembourg Income Tax Law foresees an exemption for the following termination payments:

a the statutory severance indemnity as provided for in the Labour Code or in a collective bargaining agreement;

b the indemnity established by a labour court for unfair dismissal;
the indemnity agreed upon in a settlement agreement for wrongful termination of an employment contract; and

d the voluntary layoff indemnity paid in the event of termination of an employment contract by the worker or by mutual agreement of the parties.

The termination payment as defined in point (a) above is fully exempt from tax. The termination payments specified in points (b), (c) and (d) above are exempt from tax up to €23,983.08 (at index 794.54) that is, 12 times the monthly minimum wage applicable as of 1 January of the tax year concerned. In the event that the indemnity is divided over a number of tax years, the monthly minimum wage to be taken into consideration is the one related to the tax year in which the indemnity is first paid.

The above tax exemption is not granted if the recipient is entitled to a retirement or an early retirement (regardless of the nature of the termination payment). If the recipient is (1) 60 years of age or older at the time of termination, (2) does not qualify for retirement or early retirement and (3) earns an annual taxable income exceeding €150,000, the termination allowances are exempt up to €7,994.36 (at index 794.54), that is, four times the monthly minimum wage in force on the date of payment.

In principle, the termination payments described in points (a), (b) and (c) above are not subject to Luxembourg social security contributions. In certain cases, the termination payment specified in point (d) may be subject to Luxembourg social security contributions.

III TAX PLANNING AND OTHER CONSIDERATIONS

In accordance with a circular letter of the Luxembourg tax authorities applicable as from 1 January 2014, certain expenses and allowances paid by a Luxembourg employer in connection with an inpatriate worker shall not fall within the scope of employment income or benefits in kind for the inpatriate worker.

The regime applies to inpatriates coming to Luxembourg, such as employees who are part of an international group and who are assigned to a Luxembourg office belonging to the group or employees directly hired abroad.

Hence, reasonable assignment-linked benefits and expenses are tax exempt provided certain conditions are met.

General conditions at the level of the inpatriate worker are that:

a the inpatriate worker must be resident in Luxembourg;

b he or she should not have been resident or subject to income tax in Luxembourg for the five years preceding the application of the inpatriate regime, nor have lived at a distance of fewer than 150km from the Luxembourg border;

c in case of intra-group assignment, the inpatriate must:

- have five years’ seniority within the international group or sector concerned;
- be in an employment relationship between the sending company and the employee;
- have the right to return to the home company on the expiry of the secondment period; and
- have a contractual arrangement between the sending company and the host company; and

d in case of a recruitment, the inpatriate should be able to evidence an in-depth specialisation in a sector or profession for which it is difficult to recruit in Luxembourg.
Conditions concerning the Luxembourg employer are that:

a. the Luxembourg employer must employ (or undertake to have in the mid-term) at least 20 full-time employees; and

b. the number of inpatriate workers should not exceed 30 per cent of the total number of full-time employees.

Conditions relating to employment are that:

a. the employment activity should not consist of temporary work; and

b. the annual gross remuneration must be at least €50,000.

The New Circular provides for a list of ‘exempt’ assignment-linked benefits such as the one-off expenses linked to the transfer of residence, home staging expenses, travel expenses on special occasions (e.g., births, weddings), certain housing expenses up to the lower of €50,000 (€80,000 for couples) and 30 per cent of the inpatriate worker’s total annual fixed remuneration, certain school fees and cost of living allowances.

Expenses and allowances paid by the Luxembourg employer remain deductible from the Luxembourg company’s taxable basis for corporate income and municipal business tax purposes.

The inpatriate regime applies for a maximum period of six years and ceases to apply when the relevant conditions are no longer met. By 31 January of each year at the latest, the Luxembourg employer must provide the Luxembourg tax authorities with a list of the inpatriate workers it employs. Failure to respect the New Circular’s provisions will lead to revocation of the inpatriate regime.

IV EMPLOYMENT LAW

i Restrictive covenants

As a general principle, a balance has to be struck between the freedom of occupation, which is a fundamental right enshrined in the constitution, and the legitimate interest of the employer to protect its business. Luxembourg courts recognise non-solicitation and non-compete covenants, provided that they comply with applicable law, they are reasonable in time, scope and geographical coverage.

Non-compete

Non-compete clauses are regulated by the Labour Code. In accordance with Article L125-8 of the Code, in order to be valid, a non-compete clause must fulfil the following conditions:

a. it must be in writing;

b. it must apply only to employees who go on to run their own company after leaving their employer;

c. the employee signing the employment contract or any modification containing a non-compete clause must be at least 18 years old;

d. the employee must earn an annual salary of at least €55,518.22 (value based on Index 814.40) on the day that the employee leaves the company;

e. it must refer to a specific professional sector and professional activities that are similar to those performed for the former employer;
it must be limited to 12 months, beginning on the day that the employee’s employment contract ends; and

it must be limited geographically to Luxembourg.

A non-compete covenant is not enforceable against the employee in case the employer has terminated the employment relationship for gross misconduct while not authorised to do so, or if, upon termination, the employee has not been granted the legal notice period.

**Non-solicitation**

Non-solicitation covenants are not expressly provided for in the Labour Code but are rather based on civil law principles.

They are generally enforceable provided that they are reasonable (i.e., not broad or ambiguous).

Usually, if a court decides that a restrictive covenant is unreasonable or uncertain, it has two alternatives:

- strike down the whole restrictive covenant (i.e., declare the voidance of the clause); or
- sever the offending parts of the restriction, if the language permits, and save the rest (as for illegal clauses in order to most appropriately cure the illegality while preserving as much as possible the parties’ intentions).

**ii Release of claims**

The employee’s release of claims can be foreseen either:

- in a separation agreement between an employer and a departing employee specifying terms of the employee’s separation from employment, including a release of claims against the employer in exchange for a benefit; or
- in a settlement agreement between an employer and an employee who has asserted certain claims against the employer based upon his or her employment, through which it is intended to settle and resolve all the disputes and claims, including a release of claims against the employer in consideration for the payment of a settlement amount.

**iii Unfair termination of employment**

Unfair termination of employment refers to the process of dismissing the employee in the absence of a real and serious cause.

In determining whether an employee has been unfairly terminated, the labour courts consider the cause of termination and whether the employer had a sufficient and justifiable reason to terminate the employment contract. If an employee is found to have been terminated unfairly, he or she will be awarded a compensation for the financial or moral damages suffered following the termination.

Any unfairly dismissed employee is under a duty to mitigate his or her loss, such as, for example, actively searching for a new job. If they fail to comply with this duty, the court will consider that their losses are not directly linked to the termination, and will reduce the damages accordingly.

The compensation for damage is not confined by the Labour Code. Judges in the labour courts have a broad discretion to decide on the amount of said compensation.
iv Severance payments

Only employees dismissed with notice are entitled to a severance payment calculated according to their length of service. Severance payments are calculated as follows:

a. from five up to 10 years of employment – one month’s salary;
b. from 10 up to 15 years of employment – two months’ salary;
c. from 15 up to 20 years of employment – three months’ salary;
d. from 20 up to 25 years of employment – six months’ salary;
e. from 25 up to 30 years of employment – nine months’ salary; and
f. over 30 years of employment – 12 months’ salary.

v Change of control

There are no specific rules applying to terminations of employment in connection with a change in control. Termination of employment must be for real and serious cause and cannot occur just because a different owner takes over the management control of a company.

vi Transfer of employment in connection with a corporate transaction

There are no specific rules on severance payment that apply to a transfer of employment in connection with a corporate transaction.

Under Article L127-1 et seq. of the Labour Code, there is an automatic transfer of the employment contract in case of a modification in the employer’s legal situation (e.g., sale or merger) and provided the criteria set by case law are met, meaning that it is a transfer of a stand-alone business that maintains its identity within the transferee.

In share deals, there are no specific employment law provisions setting any requirements. In case the transfer of employment is made on a voluntary basis, the consent of the employee concerned is required.

V SECURITIES LAW

Pursuant to the law of 10 July 2005 on prospectuses for securities, as amended (the Prospectus Law), no offer of securities shall be made to the public within the territory of Luxembourg without the prior publication of a prospectus duly approved by the Commission de Surveillance du Sector Financier (CSSF) or, as the case may be, approved by the competent authority in another EU Member State and duly passported in Luxembourg. The offer of shares or securities to directors and employees in Luxembourg customarily falls within the scope of the Prospectus Law. That said, the Prospectus Law foresees a number of exemptions to the obligation to draw up a prospectus.

This will be the case for offers of securities addressed to fewer than 150 natural or legal persons in Luxembourg, other than qualified investors (as defined in the Prospectus Law, which cross-refers to the definition of professional clients under Directive 2014/65/EU of 15 May 2014 on markets in financial instruments (MiFID II)) or, alternatively in the event this exemption cannot apply, to offers of securities offered allotted or to be allotted to existing or former directors or employees by their employer or by an affiliated undertaking provided that the issuer has its head office or registered office in one of the Member States and a document is made available to the interested parties containing information on the number and nature of the securities offered and the reasons for and details of the offer. The new
prospectus rules set out under Regulation (EU) 2017/1129 of 14 June 2017 on prospectuses, which will replace the former regime, save for certain exceptions, as from 21 July 2019, has maintained these exemptions, which will therefore continue to apply going forward.

Depending on the circumstances, directors or employees who were offered securities may in turn be subject to certain disclosure obligations. This will notably be the case where said securities are admitted to trading on a stock exchange within the European Union. Indeed, pursuant to Regulation (EU) No. 596/2014 on market abuse (the Market Abuse Regulation), persons discharging managerial responsibilities (PDMRs) within an issuer whose securities are admitted to trading on a regulated or a multilateral trading facility (both in the sense of MiFID II), and persons closely associated to PDMRs, are required to notify the issuer and the CSSF of every transaction conducted on their account relating to the securities issued by the issuer. This notification must be made as soon as possible and no later than three trading days following the transaction. PDMRs typically include members of the administrative, management or supervisory body of the issuer but also senior executives who have regular access to inside information (in the sense of the Market Abuse Regulation, that is, broadly, price-sensitive information) and power to take managerial decisions affecting the future developments and business prospects of the issuer. Persons closely associated to PDMRs – that includes a spouse or a partner considered to be equivalent to a spouse in accordance with national law, a dependent child, a relative who has shared the same household for a certain period of time, and a legal person, trust, partnership, the managerial responsibilities of which are discharged by such PDMR or a person closely associated to him or her – will also be subject to the same disclosure requirements. The Market Abuse Regulation sets out a de minimis threshold of €5,000 per calendar year so that no notifications are required in case the cumulative value of the transactions remains below that threshold per calendar year.

It is worthy of mention that the Market Abuse Regulation also prohibits any person to make use of inside information, that is, non-public price-sensitive information relating to the issuer or its securities admitted to trading it may hold, to acquire or dispose of, for its own account or for the account of a third party, directly or indirectly, financial instruments to which that information relates, as well as any attempt thereto (commonly referred to as insider dealing). In addition, it is prohibited for any person to disclose inside information to anyone else (except where the disclosure is made in the normal exercise of an employment, profession or duties) or, while in possession of inside information, to recommend or induce anyone to acquire or dispose financial instruments to which the information relates.

Directors or employees holding securities also need to consider the disclosure obligations deriving from the law of 11 January 2008 on transparency requirements in relation to information about issuers whose securities are admitted to trading on a regulated market, as amended (the Transparency Law). Under the Transparency Law any person acquiring or disposing of a shareholding in an issuer whose shares are admitted to trading on a regulated market must notify the issuer and the CSSF of the proportion of voting rights held by that person where following an acquisition or disposal said proportion reaches, exceeds or falls below one of the thresholds of 5, 10, 15, 20, 25, 33.3, 50 or 66.6 per cent of the total voting rights outstanding within the issuer. The Transparency Law further extends this disclosure requirement to persons who are not directly shareholders but can either exercise the voting rights attached to the relevant shares or hold financial instruments that on maturity give the right to acquire shares of the issuer or in the absence of any such physical settlement have a similar economic effect. The notifications must be made as soon as possible and no later than four trading days following the transaction by the relevant shareholder.
While there are generally no legal requirements for executive employees to hold stock of their employer, nor any limitations in respect of the number of securities that employees may hold, the articles of association of the issuer may however contain certain limitations or specific disclosure requirements.

Several other rules and guidelines can apply to Luxembourg companies offering shares to their employees. Notably, companies that are subject to the Ten Principles of Corporate Governance issued by the Luxembourg Stock Exchange (those will, as a rule, be the companies whose shares are admitted to trading on the regulated market operated by the Luxembourg Stock Exchange) need to comply with certain principles on directors’ remuneration and ‘comply or explain’ recommendations with respect to the offering of shares to directors (e.g., guidelines on share allocations, share options and other rights to acquire shares, vesting rules).

Additionally, entities (credit institutions and investment firms) subject to Directive 2013/36/UE on capital requirements (CRD IV) as transposed in the law of 5 April 1993 on the financial sector, as amended, will further need to comply with the limitations on remuneration set out therein in accordance with their regulated status. More generally, regulated entities of the financial sector will also need to bear in mind the rules and guidelines issued by the CSSF with respect to remuneration policies for regulated entities. Notably, the CSSF recently confirmed the adoption of the guidelines on sound remuneration policies issued by the European Banking Authority (EBA/GL/2015/22) in circular CSSF 17/658 applicable to credit institutions and investment firms.

VI DISCLOSURE

CSSF Circular 10/437 implementing Commission Recommendation 2009/384/EC of 30 April 2009 establishes guidelines regarding the remuneration policies in the financial sector (the Circular). This Circular applies to financial undertakings: all entities, legal and natural persons, subject to the CSSF’s prudential supervision. These financial undertakings include, but are not limited to, credit institutions, investment firms, managers of pension funds and of collective investment schemes. Branches set up abroad as well as branches of similar entities set up in Luxembourg whose registered office or central administration is located outside the European Economic Area are included in the scope of the Circular.

The Circular requires financial undertakings to establish, implement and maintain a remuneration policy that is consistent with and promotes sound and effective risk management and that does not induce excessive risk-taking. The structure of the remuneration policy shall follow a set of rules established therein. Once designed, the remuneration policy has to be submitted to the CSSF as part of the supervisory review process, as an element of internal governance and disclosed to the public either in the form of an independent remuneration policy statement, a periodic disclosure in the annual financial statement or in any other form.

Disclosure requirements under the Circular apply on an individual and on a consolidated basis. They apply to the remuneration of (1) members of the administrative and management bodies and (2) categories of staff whose professional activities have a material impact on the risk profile of financial undertakings. Remuneration granted only on a fixed basis is exempted from disclosure requirements.

Information that shall be disclosed to the public is the following:

a information concerning the decision-making process used for determining the remuneration policy, including if applicable, information about the composition and
the mandate of a remuneration committee, the name of the external consultant whose services have been used for the determination of the remuneration policy and the role of the relevant stakeholders;

- information on the link between pay and performance;
- information on the criteria used for performance measurement and risk adjustment;
- information on the performance criteria on which the entitlement to shares, options or variable components of remuneration is based; and
- the main parameters and rationale for any annual bonus scheme and any other non-cash benefits.

Regarding the level of the disclosed information, the nature, size and specific scope of activities of the financial undertaking concerned may be taken into account.

Moreover, credit institutions and investment firms that maintain a website shall explain therein how they comply with the remuneration policy requirements.

VII CORPORATE GOVERNANCE

Luxembourg companies whose shares are admitted to trading outside of Luxembourg may voluntarily decide to comply with the Ten Principles of Corporate Governance of the Luxembourg Stock Exchange, which set out certain corporate governance guidelines and recommendations with respect to the implementation of a fair remuneration policy for directors and members of the executive management.

From a corporate perspective, compensation paid to a company’s directors or officers and executives is generally determined by the board of directors and approved at a general meeting of shareholders.

Additional requirements may apply with respect to incentive plans, such as stock option plans, warrants schemes, long-term incentive plans, restricted stock units agreements, which should, in principle, be approved by the company’s board of directors.

Luxembourg companies of a certain size and belonging to an international group usually have a remuneration committee that establishes a remuneration policy outlining guidelines for determination of the remuneration of management members and key personnel.

VIII SPECIALISED REGULATORY REGIMES

The law of 23 July 2015 (the 2015 Law) implementing, *inter alia*, CRD IV has brought about changes that mainly relate to the access to financial sector activities, corporate governance and remuneration, prudential rules, capital buffers and administrative penalties. These changes are now reflected in the amended law of 5 April 1993 on the financial sector (the New FSL).
The CRD IV and Regulation (EU) 575/2013\(^2\) (CRR) recast and replace the Capital Requirements Directives (i.e., the Banking Consolidation Directive\(^3\) and Capital Adequacy Directive).\(^4\)

The provisions of the 2015 Law apply in particular to CRR institutions, which are defined in the New FSL as ‘institutions within the meaning of article 4(1)(3) of the CRR’ (i.e., credit institutions or investment firms within the meaning of the CRR).

The main provisions regarding remuneration introduced by the 2015 Law in the New FSL are briefly outlined below

i **Identified staff**

The new rules on remuneration apply to staff members who have a material impact on an institution’s risk profile.

ii **Fixed or variable remuneration**

The 2015 Law makes a distinction between fixed and variable remuneration:

\[ a \]

the basic fixed remuneration (salary) must reflect the relevant professional experience and organisational responsibility as set out in an employee’s job description as part of the terms and conditions of employment; and

\[ b \]

variable remuneration (bonus) must reflect a sustainable and risk-adjusted performance as well as performance in excess of that required to fulfil the employee’s job description as part of the terms of employment.

iii **Bonus cap**

For variable remuneration, the following two principles now apply:

\[ a \]

the variable component may not exceed 100 per cent of the fixed component of each individual’s aggregate remuneration; and

\[ b \]

the shareholders of the institution (excluding staff concerned by the ratio) may approve a higher maximum level of the ratio between the fixed and variable components of remuneration provided that the overall level of the variable component does not exceed 200 per cent of the fixed component of the aggregate remuneration for each individual.

iv **Malus and clawback**

Up to 100 per cent of the total variable remuneration must be subject to *malus* or clawback arrangements. Institutions must set specific criteria for the application of *malus* and clawback that may apply in particular situations.

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v  Deferral

It is foreseen that at least 50 per cent of the variable remuneration must consist of a balance between (1) shares (or equivalent equity interests) and (2) instruments that reflect the credit quality of the institution as a going concern. Equally, the New FSL now expressly states that at least 40 per cent of the variable remuneration must be deferred over a period of not less than three to five years. When the amount of the variable remuneration component is particularly high, at least 60 per cent must be deferred.

IX  DEVELOPMENTS AND CONCLUSIONS

The New Circular (as mentioned above) amends the tax treatment of the warrants for any grant to employees as from 1 January 2018, and imposes reporting obligations for employers.

Warrants may be offered to employees provided that: (1) the employees are considered as executives (cadres supérieurs) within the meaning of the provisions of the Labour Code (see Section I); (2) the portion of remuneration paid in warrants may not exceed 50 per cent of the total yearly gross remuneration of the executive; and (3) the face value of the warrants does not exceed 60 per cent of the value of the underlying asset.

Any warrant scheme implemented as of 1 January 2018 must comply with the grant notification to be sent to the Luxembourg tax authorities in a timely manner, in particular, at each granting date of the warrants.

The New Circular provisions complete the initiatives taken by the Luxembourg tax authorities aiming at creating a favourable tax environment for attracting highly-skilled workers.
I INTRODUCTION

The Mexican legal system has been subject to a considerable number of changes. Congress has approved a major reform to the Federal Labour Law, and also recently approved major reforms in the energy, tax, antitrust and bankruptcy sectors.

These reforms have triggered international corporations to look again at Mexico as an investment alternative, which is resulting in the implementation of a more complex structure of compensation for executives in Mexico. Along with many countries that have recently been targeted by international investors, there is a trend in Mexico to change the current short-term structure into a medium or long-term structure.

Even though a special set of laws or a special area of law does not apply to the compensation and remuneration of executives in Mexico, special sections within Mexico’s laws delimit executive remuneration and the applicable structures. We also believe that new legal precedents will be issued in the short or medium term that will provide investors and executives with more certainty, especially in the employment and tax fields.

Below, we detail some of the most important changes in the tax and labour laws that have a direct impact on the compensation structures of executives in Mexico.

II TAXATION

i Income tax for employees

There are two scenarios in which individuals could be subject to tax in Mexico for income earned as executive compensation: where individuals are regarded as being resident in Mexico; and where individuals are not Mexican residents, but have earned income considered to have derived from a Mexican source.

Generally speaking, individuals who have established their abode in Mexico should be regarded as Mexican residents (regardless of the number of days they spend in Mexico). In cases where individuals also have abodes in other countries, a tiebreak rule regarding the centre of vital interest of such individuals should be applied.

1 Alejandro Santoyo and Francisco J Peniche Beguerisse are partners at Creel, García-Cuéllar, Aiza y Enríquez SC.
In the case of international staff who maintain their abode in their home country, a further analysis must be made with respect to any tax treaty provisions, in which case, the tiebreak rules may lead to a different outcome than those under the domestic tax rules to define their tax residency.

Mexican residents are obliged to pay income tax on all the income they earn on a worldwide basis; therefore, compensation earned from both Mexican employers and foreign sources is subject to tax in Mexico.

Employers paying income to executives are obliged to withhold income tax when it is effectively paid. ‘Income derived from subordinated personal services rendered’ (employment income), which includes salaries, fringe benefits, bonuses, allowances and other concepts deriving from a labour relationship, as well as profit-sharing and termination payments, is subject to taxation.

Taxes withheld by employers are considered as an advanced tax payment that can be credited against the annual tax liability computed through the annual tax return of each individual. If compensation is received from a foreign employer, withholding is not applicable, because Mexican executives are obliged to pay the corresponding tax liability to the tax authorities before the 17th day of the month subsequent to the month when the income was received.

Both the advanced tax payments and annual tax liability are computed by applying a progressive table, under which a maximum rate tax of 35 per cent applies to annual income of 3 million pesos or more. Employment income paid to non-Mexican resident employees will also be subject to tax when services have been rendered in Mexico. The initial 1259,900 pesos is tax-exempt; a subsequent tax rate of 15 per cent applies for income earned up to 1 million pesos; and a maximum rate of 30 per cent for payments above that threshold. Tax withheld to foreign executives is a final tax payment, and foreign executives do not have any obligation to file tax returns or to comply with any other formality in Mexico.

ii Equity-based employment income

Income derived from equity-based plans such as restricted stock awards, restricted stock units (RSUs) or stock options are not considered as capital gain; therefore, they are subject to taxation as any other ordinary income would be.

In the case of RSU awards where the executive does not receive the stock immediately, but instead receives it according to a vesting plan, the RSUs are assigned at fair market value when they vest. Upon vesting, they are considered taxable income.

Amounts derived as dividend equivalent during the vesting period should be treated as employment income and not as dividend because the employee does not own any stock under RSU programmes.

Under a restricted stock award plan subject to forfeiture during the vesting period, the executive is not taxed at the time of the grant; instead, the employee is taxed at vesting, when the restrictions have lapsed. The amount of income subject to tax is the difference between the fair market value of the grant at the time of vesting minus the amount paid for the grant, if any.

Income earned from stock options granted by the employer or by any of its related parties is also regarded as employment income when the exercise price is zero or when it is lower than the fair market value of the underlying stock. The granting of stock option awards is not subject to taxation.
Once the participant has become the owner of the awarded stock, dividends received should be subject to income tax at two different levels: ordinary income subject to income tax; and dividends subject to an additional 10 per cent tax that is withheld by Mexican issuers, or paid directly by the participant in the case of foreign dividends.

If the cost of any of these equity-based awards is borne by the foreign related party of the Mexican employer, the employment income would be regarded as received from a foreign employer, and the participant would have to compute and directly pay the tax liability.

If the cost of the award is charged to a Mexican employer, a withholding obligation for the employment income would derive for the employer. Different methods exist for employers to have the funds to pay for the withholding tax. The most common is to have the foreign related party sell enough stock in the market to have the necessary funds to transfer 35 per cent of the tax liability to the Mexican employer. The executive’s tax basis is equal to the amount paid for the stock plus the amount included as employment income. Upon a later sale of the shares, assuming the employee holds the shares as a capital asset, the employee would recognise capital gain income or loss; this may be subject to a reduce rate of 10 per cent if the capital gain is executed through the stock exchanges.

iii Social taxes for employees

Social security taxes (contributions) have to be paid both by employees through withholding, which is achieved by the employer applying an overall rate of 2.38 per cent over the adjusted daily wage, and by the employer, who has to pay up to 9.66 per cent.

The employment income regarded as the basis for computing these contributions is subject to a cap that is determined based on a multiple of the value of the Unit for Measurement and Adjustments (UMA). The maximum amount of salary that may be used to compute the social security contributions equals 25 times the UMA.²

Currently, the maximum annual social contributions per employee are approximately 60,000 pesos for the employer portion and 15,000 pesos for the individual employee portion.

Mexico has entered into international agreements for social security purposes with Canada and Spain. Under these agreements, employees from these countries may generally work in Mexico and qualify for certain exemptions related to social security taxes. In addition, under such agreements, employees are entitled to preserve their weekly contributions, during the time they work in a different country, for pension matters.

Additionally, employers must contribute 5 per cent of salaries (also limited to 25 times the UMA) to Infonavit (the Institute of the national housing fund), which provides funds for the construction of housing for workers.

Employers also make contributions equal to 2 per cent of an employee’s compensation (also considering the limit of 25 times the UMA) to the retirement plan, Afore, which is managed by a bank in the employee’s name.

Social taxes are substantial in any employment relationship in Mexico and the social security authorities are entitled to audit and determine tax assessments as it so happens with any federal tax.

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² The current value of UMA in 2018 is 80.60 Mexican pesos.
iv  Profit sharing
In accordance with Mexican laws, employees shall participate in the profits of the company at a percentage rate fixed by the National Committee of Profit Sharing. The percentage fixed shall constitute the employees’ share in the profits of each company and is computed by applying the rate of 10 per cent to an adjusted net income used for income purposes.

Profits to be distributed shall be divided in two equal parts. The first part shall be shared equally among all the employees, taking into account the number of days worked by each employee during the year, irrespective of the amount of each employee’s remuneration. The second amount shall be shared out in proportion to the total sum of the remuneration earned, irrespective of the number of days worked during the year.

For the purposes of the profit sharing distribution, ‘wage’ shall mean the amount actually received by each employee as a daily rate. It shall not be deemed to include extra payments, payments in kind and other payments referred to as integrated salary.

General managers and general directors of a company are not entitled to participate in the distribution of profits.

v  Tax deductibility for employers
Expenses incurred by employers for payments made to employees are generally regarded as deductible for income tax purposes if they were effectively paid in cash, through wire transfers or paid in kind when different from debt securities.

Regardless of whether bonuses were paid in respect of services rendered during the prior tax year, they can only be regarded as deductible during the tax year in which they were effectively received by the employee.

Other formal requirements must be complied with, such as taxes being correctly withheld to furnish electronic tax receipts, and the correct registration of employees before the Mexican Social Security Institute.

From 2014, in order to establish a ‘tax symmetry’ between deductible expenses for employers and taxable income for employees, the deduction of expenses incurred for payments regarded as exempt employment income (such as the savings funds, pension funds, fringe benefits and other benefits) is limited to 47 per cent of the cost of such payments. This deductible percentage can be increased up to 53 per cent in the event that the fringe benefits are not reduced in respect of the prior tax year.3

There are additional limitations for specific items of employment expenses incurred. The most relevant are that deductible bonuses cannot be higher than the annual compensation earned by the highest-ranked executive; the total bonuses paid during the year cannot be of a higher amount than the annual salaries during that year; and bonuses cannot exceed 10 per cent of the total employer’s deductible expenses.

vi  Other special rules
There are no special tax rules that affect compensation or incentive plans applicable in cases of a change in control of a company.

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3 The Mexican Supreme Court solved amparo claims in this regard and issued case law, stating that the deductibility limitation of 47 per cent of compensation paid to employees is constitutional. Hence, employers are required to apply such deductibility limitation of compensation paid to employees.
Life and health insurance are regarded as fringe benefits that, in order to be regarded as deductible, must be widely granted to all employees. It is also possible to comply with this requirement if such insurance is granted only to those employees who are part of a union, or if such insurance is exclusively granted to those employees that are not part of a union. One further interpretation is that the ‘widely granted’ concept could also be accomplished if such insurance is granted to all employees that are at the same level or that have the same characteristics (e.g., executives).

III TAX PLANNING AND OTHER CONSIDERATIONS

To better administrate the profit amount that has to be distributed (see Section II.iv), it is common for Mexican corporations to incorporate a service structure. In this type of structure, one entity within a group will have the sole purpose of acting as the group’s business and income centre, while another entity within the same group acts as the exclusive employer of the personnel who render services to the entity acting as the income centre.

These structures have to be carefully formulated; otherwise, both entities could be considered to be responsible for the corporation’s employment obligations.

IV EMPLOYMENT LAW

i Labour law overview

Private labour and employment relationships in Mexico are regulated by Article 123, Section A of the Federal Constitution (CPEUM), and by the Federal Labour Law (LFT), which regulates Article 123.

Both the CPEUM and the LFT are the result of the Mexican Revolution, which is why the guidelines established in the LFT are based on the social principle of protecting the working class. This is clearly reflected in Article 18 of the LFT, which stipulates that ‘in the case of doubt, the interpretation most favourable to the employee must prevail’.

Under the LFT, employees shall not be discriminated against based on their position within the company. This principle applies not only to lower positions in a company, but also to higher positions. As such, in accordance with the LFT, people in management positions and executives of companies are entitled, just as any other employee, to, *inter alia*, payment of overtime, holidays, Christmas bonuses and rest days.

The following list of special rights and obligations are applicable to trust employees (directors or executives) in Mexico:

\[\begin{align*}
& a \quad \text{they cannot be members of the same union as the rest of the employees;} \\
& b \quad \text{they cannot vote in the event of an inter-union conflict;} \\
& c \quad \text{they cannot represent the employees in mandatory joint commissions;} \\
& d \quad \text{their employment relationship can be terminated because of a 'loss of confidence';} \\
& e \quad \text{employers can legally refuse to reinstate them in the case of litigation;} \\
& f \quad \text{administrators, directors and general managers are not entitled to participate in mandatory profit distributions;} \\
& g \quad \text{they are considered as *de facto* representatives of the employer;} \\
& h \quad \text{a probation period of up to 180 days can be agreed for them; and} \\
& i \quad \text{their training and instruction relationship can be agreed for a period of up to six months.}
\end{align*}\]
ii Restrictive covenants

Labour overview

From a Mexican labour perspective, non-competition obligations and other restrictive covenants such as non-solicitation are very difficult to enforce. In theory, these types of obligations are likely to be considered contrary to the principle of ‘work freedom’ embodied in Article 5 of the CPEUM, which establishes that any individual can perform any kind of services or activities, provided such services or activities are not illegal; therefore, any restriction on an individual to engage with a company or to perform specific activities would not be valid or enforceable.

Furthermore, and different from many jurisdictions, Mexico’s labour courts cannot issue injunctions or cease and desist orders that may impede a company from hiring an individual or an individual to accept employment from a company.

Consequently, post-employment non-competition or non-solicitation obligations would be very difficult to enforce in Mexico before the labour courts.

Civil overview

From a Mexican civil law perspective, non-compete obligations are agreements between two parties in which one party accepts the responsibility not to compete in a certain market during a certain period of time in a determined territory. To secure compliance with such an obligation, parties will usually agree on the payment of an indemnity that will be triggered in the event of contravention.

Based on the above, the main object of the obligation will be a negative covenant – that is, a covenant to refraining from doing something. It is important to note that, according to Mexico’s civil laws, a negative covenant must be possible and lawful; that is, there shall be no contradiction of Mexico’s public laws or common standards of conduct. A party who fails to comply with the covenant will be subject to the payment of damages.

One of the most important principles in Mexican civil law is that parties are bound by what they expressly agree to, and also by the legal consequences of good faith, common practice and traditions. Based on this principle of contractual freedom, a non-compete agreement will be legal and enforceable under Mexican civil law when non-competition clauses or agreements are entered into to prevent unfair competition. Consequently, as long as a non-compete clause or agreement is intended to offer advance protection and assure strict confidentiality and a high standard of loyalty to prevent future losses or any kind of economic damages, we consider it to be lawful under civil law. Non-compete obligations are limited for a defined term, and to a defined territory, set of clients, and activities, products or services.

Mexican civil law recognises the validity of sanctions or penalties arising from a breach of a non-compete obligation and establishes some limitations: the amount of the penalty cannot be greater than the principal obligation, and a judge can reduce the amount of the penalty when the obligation was ‘partially complied with’.

iii Termination of employment

In accordance with the LFT, an employment relationship is deemed as ‘the rendering of a personal service by one person to another, under the latter’s direction and control, in consideration for the payment of a salary’.

It is very important to note that in Mexico, ‘employment at will’ is not recognised, even for managerial positions or executives. Employment relationships in Mexico are ruled
by a ‘stability principle’ that states that, unless a just cause or a justified ground to terminate a relationship exists, employees cannot be terminated without being entitled to a severance payment.

**Termination of an employment relationship**

The LFT provides that an employment relationship may be terminated for the following reasons:

- **by mutual agreement**;
- **death of an employee**;
- **termination of the specific job or the term of the capital investment**;
- **the physical or mental incapacity or disability of the employee**;
- **force majeure or acts of God**;
- **the self-evident non-profitability of the operation**;
- **the depletion of the resources of an extractive industry**; and
- **insolvency or bankruptcy being legally declared**.

**Termination 'for cause' of an employment relationship**

The LFT provides that an employer can only terminate an employment relationship ‘for cause’ in the event that the employee carries out one or more of the specific causes provided in the LFT.

**Severance payment**

Employees dismissed without a justified cause (wrongful termination) are entitled to receive the following severance payment:

- **three months of compensation at a rate equivalent to an employee’s daily salary**;
- **a total of 20 days of daily compensation for each year of services rendered**;
- **a seniority premium, equal to 12 days of salary per each year of services rendered, with a salary limitation of up to twice the minimum wage, if an employee’s salary exceeds that limitation**;
- **back salaries from the date of the dismissal throughout the first 12 months of litigation**.
  After the first 12 months of litigation, a monthly interest at a rate of 2 per cent over the amount of 15 months of salary will be generated; and
- **the accrued and proportional part of employment benefits**.

In accordance with the LFT, an employee has the option in the event of a wrongful termination to receive the above-mentioned severance payment, or to ask for his or her reinstatement to his or her job.

**Daily total compensation**

Daily total compensation or integrated salary is deemed as the payroll salary, plus any fringe benefits such as commissions, compensations, allowances and other benefits in kind.

The commissions, bonuses or premiums to which an employee may be entitled, derived from his or her activities as a sales employee, are considered to be part of the employee’s salary; thus, they should be integrated into his or her salary for purposes of the calculation of

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4 In 2018, the minimum wage in Mexico is 88.36 pesos per day.
the statutory severance. To measure the average salary of a sales employee, the sum of his or her salary and any commission or bonuses achieved during the past year of services should be divided into 365 days.

iv Overview of employment liabilities derived from equity incentive plans

It has become common practice in Mexico for companies to allow their Mexico-based executives to participate in equity incentive plans (options, stock options, restricted units, etc.). It is important to note that participation in equity plans, if not correctly formalised, could trigger the following employment-related risks.

Potential joint liability

In terms of the LFT, the employer is solely responsible for the employment relationship; consequently, only the employer should be obligated to pay salaries and benefits to its employees. In the event that the participation of an executive in an equity plan is not correctly documented or formalised, there is a potential risk that the foreign entity and the Mexican subsidiary will be construed as being jointly liable for all the employment terms and conditions of the participant. This potential liability would arguably derive from the fact that employment with the local entity is a condition to entitlement under the equity plan.

Moreover, a Mexican labour court may potentially establish a link between the foreign entity and the local subsidiary as being jointly responsible for the terms and conditions of the plan, as the income deriving from the awards may be deemed as part of the employees’ compensation scheme.

Integration in local compensation

In accordance with the LFT, in the case of termination of employment without a justified cause, employees are entitled to receive a severance payment. Two of the three severance concepts are based upon a ‘daily total compensation amount’.

In our experience, whenever executives and those in management positions are terminated, it has become common practice for such terminated employees to request the integration of the daily proportion of the amounts gained in equity awards plans into the daily salary. To date, the labour courts have not ruled on whether benefits gained from equity plans paid by related entities should be considered as part of an employee’s compensation for severance purposes.

It is important to note that the LFT specifically provides that in the event of doubt, the interpretation that is most favourable to the employee shall prevail. Accordingly, it is critical to have undisputed evidence to support the argument that the participation of local employees in an equity plan should not be considered as an employment benefit.

On 10 June 2016, the labour courts issued a resolution in which they ruled that the options and benefits derived from a stock option plan are not to be considered part of the employees’ compensation unless such grant is included in the individual employment agreement of the employee.5

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5 Although we consider that the rationale used by the labour courts is incorrect, this is, to the best of our knowledge, the only employment resolution in this regard.
V SECGURITIES LAW

The Mexican Banking and Securities Commission has issued General Rules Applicable to Issuers. These Rules establish that amounts of any type paid by Mexican issuers and subsidiaries during the past year to persons making up the board of directors, as well as amounts for relevant executives and individuals having the character of related persons, must be disclosed.

Disclosure should include the total estimated or accrued amounts intended to be paid as pension, retirement or similar plans offered by the Mexican issuer and subsidiaries to the above-mentioned persons.

In addition, the disclosure must include a description of the type of compensation and benefits that all of the above-mentioned persons received from the Mexican issuer on a group basis; and any agreements or programmes issued for the benefit of the members of the board of directors, relevant executives or employees of the Mexican issuer that allow them to participate in the Mexican issuer’s capital, describing the rights and obligations, as well as the mechanism for distributing stock and determining the prices at which shares will be distributed.

VI DISCLOSURE

Mexican companies are not legally obligated to disclose any information regarding executive remuneration. Recently, the Mexican Business Co-ordination Board issued recommendations in its Code of Best Corporate Practices that have been widely adopted by both public and privately owned companies.

There is a clear recommendation that the board of directors disclose the remuneration policies and a breakdown of the compensation earned by the chief operating officer and relevant executives in the company’s annual report to stockholders.

Public companies are obliged to disclose information regarding the annual compensation paid to the chief operation officer and relevant executives. Disclosure must be made on a group basis, and not considering any specific threshold.

VII CORPORATE GOVERNANCE

One of the most frequently adopted recommendations contained in the Code of Best Corporate Practices is for the board of directors to have the capacity to approve recommendations made by the management regarding the chief executive officer’s compensation and performance, as well as regarding other highest-ranking officers. Additionally, it is recommended that termination payments for these officers are approved by the board of directors. The performance and compensation programme should be disclosed in the company’s annual report to enable investors to have comfort in this respect.

The board of directors must carry out these activities through a compensation committee, which should be composed of at least three, and not more than seven, independent board members who do not have any conflict of interest.

Clawback or recoupment of remuneration provisions agreed with employees in Mexico (including executives) are not enforceable, as such provisions are contrary to the payment obligations contained in the LFT.
VIII SPECIALISED REGULATORY REGIMES

Regulated financial institutions such as banks, broker dealers and insurance companies are subject to specific rules provided by the regulatory authorities; however, these rules do not include any limitation on the amounts or kind of compensation that must be paid to executives. These rules are established so that entities can establish remuneration policies that take into consideration not only the financial results of the current year, but also the associated risks that result and are incurred by the entity during a reasonable period of time.
I INTRODUCTION

Executive remuneration in the corporate field in general, and specifically within financial markets, attracts wide interest in the Netherlands. Key developments are, among others, (1) the 2016 revision of Dutch corporate governance rules, introducing a more principle-based focus on long-term value creation for the company, effective management and the supervision thereof, and (2) the status of Dutch remuneration rules in the financial and insurance markets including a 20 per cent bonus cap, which extend the scope of European norms substantially and which are subject to debate within the Dutch parliament ever since Brexit came into play and which the Dutch parliament has again proposed to strengthen even further.

Below, we outline the principal tax and labour law consequences.

II TAXATION

i Income tax for employees

Dutch income tax is levied from individuals who are (deemed to be) resident in the Netherlands (Dutch resident taxable persons), as well as from individuals who are not (deemed to be) resident in the Netherlands but receive Dutch-sourced income (foreign taxable persons).

Dutch resident taxable persons are, in principle, taxable on their worldwide income, although (partial) exemptions may apply in specific cases. Foreign taxable persons are taxed on certain statutorily defined types of Dutch-sourced income, which, for instance, include directors’ remuneration and income from employment in the Netherlands. Bilateral tax treaties to avoid double taxation may limit the taxation rights of the Netherlands.

The Dutch Income Tax Act 2001 makes a distinction between three classes (‘boxes’) of taxable income. Each box has its own rules for calculating the taxable base and its own applicable rates.
Box 1 income

Box 1 income includes, among others, income derived from business activities in the Netherlands, income from employment and income from miscellaneous activities.

On income that qualifies as income from employment, the employer collects and remits Dutch wage withholding tax. The wage withholding tax withheld can be credited against the income tax liability of the employee. Wage withholding tax and box 1 income tax rates are progressive and the maximum rate is 51.95 per cent for income exceeding €68,507 gross. Other than Dutch-resident taxable persons, foreign taxable persons with Dutch-sourced income are generally not subject to Dutch national insurance contributions. The wage withholding tax and box 1 income tax rates for Dutch resident taxable persons and foreign taxable persons are as follows for 2018:

<table>
<thead>
<tr>
<th>Bracket</th>
<th>Yearly Box 1 income (including income from employment)</th>
<th>Income/wage withholding tax rates (including national insurance contributions) for Dutch resident taxable persons and certain foreign taxable persons</th>
<th>Income/wage withholding tax rates (excluding national insurance contributions) for certain foreign taxable persons</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>€0–€20,142</td>
<td>36.55%</td>
<td>8.9%</td>
</tr>
<tr>
<td>2</td>
<td>€20,143–€33,994</td>
<td>40.85%</td>
<td>13.20%</td>
</tr>
<tr>
<td>3</td>
<td>€33,995–€68,507</td>
<td>40.85%</td>
<td>40.85%</td>
</tr>
<tr>
<td>4</td>
<td>€68,507 or more</td>
<td>51.95%</td>
<td>51.95%</td>
</tr>
</tbody>
</table>

As state pension contributions are only levied from individuals that have not yet reached the state pension age, lower national insurance contribution rates apply if a Dutch resident taxable person is older than that.\(^5\) In addition to these lower national insurance contribution rates, an extended second wage withholding tax and income tax bracket applies if a Dutch resident taxable person was born before 1 January 1946.

On the other sources of box 1 income, such as income derived from business activities in the Netherlands and income from miscellaneous activities, no Dutch wage tax is levied. The income tax and national insurance contributions are levied against the same box 1 rates as set out above.

Executive directors, supervisory board members and non-executive directors

Generally, the remuneration of an executive director qualifies as income from employment in the Netherlands. As such, wage withholding tax will be withheld on his or her remuneration, which can be credited against the income tax liability.\(^6\)

An individual can also fulfil the position of a supervisory board member in a two-tier board, as well as the position of non-executive director in a one-tier board. The concept of non-executive director is relatively novel in the Dutch market.

As of 1 January 2017, Dutch private limited liability companies and public limited liability companies are no longer obliged to withhold wage withholding tax on the remuneration paid to a supervisory board member. There was uncertainty as to whether

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\(^5\) The state pension age is 66 years (for 2018–2020) and is gradually increased.

\(^6\) Based on most tax treaties to avoid double taxation concluded between the Netherlands and other countries, the Netherlands is, in principle, allowed to levy income tax on the remuneration received by directors, supervisory board members and non-executive directors of Dutch public and limited liability companies, although exceptions may apply depending on the specific treaty.
a non-executive director for the purposes of this rule is considered similar to a supervisory board member. As of 1 January 2018, non-executive directors of listed companies are not considered to have a deemed employment relationship for Dutch wage tax purposes. Thus, a non-executive director of a listed company is treated similarly to a member of the supervisory board for Dutch wage tax purposes and no Dutch wage tax needs to be withheld on the remuneration paid to non-executive directors.

Depending on the activities of the supervisory board member, his or her remuneration may qualify as profit from business activities or income from miscellaneous activities. Alternatively, the company and the supervisory board member may opt for treatment as income from employment, resulting in the company being obliged to withhold wage withholding tax.

**Box 2 income**

Box 2 income includes taxable income derived from holding a ‘substantial interest’ in an entity. This substantial interest is generally present if an individual together with his or her partner holds an interest of 5 per cent or more of (a class of shares in) the total issued capital of the entity. This income (including capital gains) is subject to a rate of 25 per cent. In addition, an individual working for a company in which he or she holds a substantial interest is deemed to earn a wage of at least €45,000 (for 2018), which wage is taxed as income from employment in box 1. If an individual works for more companies in which he or she holds a substantial interest, per each company he or she is deemed to earn this wage (e.g., if an individual works for three companies in which he or she holds a substantial interest he or she is deemed to earn at least €135,000 gross in 2018). Upwards and downwards corrections to this amount may apply, as well as a full exemption for companies that perform activities of a passive nature (e.g., holding companies).

**Box 3 income**

Box 3 income concerns taxable income derived from a deemed return on savings and investments. This deemed return on savings and investments is fixed at a percentage of the individual’s yield basis at the beginning of the calendar year (1 January), insofar as the individual’s yield basis exceeds a statutory threshold (in 2018, €30,000). The individual’s yield basis is determined as the fair market value of certain qualifying assets held by the individual less the fair market value of certain qualifying liabilities on 1 January. The deemed return percentage to be applied to the yield basis increases progressively depending on the amount of the yield basis. In 2018, the marginal deemed return percentage ranges between 2.017 per cent and 5.38 per cent. These percentages are revised annually. The deemed return on savings and investments is taxed at a rate of 30 per cent.

**ii Stock options, stock appreciation rights, restricted stock and restricted stock units**

**Stock options**

Stock options are taxable for wage tax purposes when they are exercised, sold or transferred. Thus, no tax is due upon the grant of the options. Tax will be levied on the option benefit. The option benefit is the difference between the exercise price of the option and the fair market value of the underlying shares at the time of exercise minus the option premium paid (if any). This is also true if the option is cash-settled.
The option benefit will be added to the other income from employment received by the executive in the year of exercise and is taxed in box 1 (i.e., progressively up to a maximum rate of 51.95 per cent). The employer should withhold the appropriate amount of wage withholding tax and pay this amount to the Dutch tax authorities on behalf of the employee. Assuming that the wage withholding tax will be recovered from the employee, this is typically done by having the employing company holding back a number of shares at the time of the exercise and using the proceeds of those shares to satisfy the withholding obligation. If the withholding tax would not be recovered from the executive, the taxable benefit needs to be grossed up, which would result in considerable additional cost to the employing company.

**Stock appreciation rights**

If the executive receives stock appreciation rights, then no actual shares will be transferred to the executive. Instead, a cash payment is made to the employee, the amount of which is linked to an increase in value of the shares in the company (i.e., the shares are tracked). A cash payment in relation to stock appreciation rights is taxed at the time the payment is made and the employer will need to make the necessary wage withholdings at the time of payment.

**Stock awards, restricted stock and restricted stock units**

According to Dutch tax law, the grant of shares is subject to wage withholding tax at the moment the rights on the shares have become unconditional. If time is the only remaining condition for the transfer of the shares, then the employer will need to withhold wage withholding tax based on the value of the shares at that time. The fair market value of the underlying shares at the moment these shares become unconditional, minus any purchase price to be paid by the executive is treated as income from employment (box 1). Restricted stock units (RSUs) are also taxed upon vesting of the underlying shares (i.e., at the moment the employee receives an unconditional right to receive shares). If the RSUs are cash-settled at the moment of vesting, the amount in cash received constitutes the income from employment.

Under certain conditions, a discount for wage withholding tax purposes can be applied on the value of listed shares granted if a lock-up period has been agreed on. For example, for 2018, a 16 per cent discount applies in respect of a lock-up period of four years, and a 13 per cent discount for a three-year period. If the employment of the recipient of the shares terminates during the lock-up period, a mandatory redelivery against a value lower than market value should constitute deductible ‘negative income’ for the recipient.

If the shares increase in value after vesting, no more additional taxes are due on dividends and capital gains. Capital gains and dividends received in relation to the shareholding are generally not taxed provided that the executive together with his or her partner does not hold a substantial interest (5 per cent or more) in the company. Instead, the fair market value of the shares will be included in the box 3 yield basis as discussed above.

### iii Social security contributions

The Netherlands maintains a broad system of social security measures. The social security contributions can be divided into three categories:

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7 Unconditional means that there are no other conditions for the transfer of the shares to the employee, other than conditions in time. Continuing employment is also a ‘condition in time’ for this purpose.

8 Supreme Court, 15 April 2016, Case No. 14/06257, ECLI:NL:HR:2016:635.
National insurance contributions. These contributions cover for state pension payments, widows’ and orphans’ benefits, long-term healthcare and child benefits. These contributions are levied in conjunction with the wage withholding tax and box 1 income tax rates as shown in Section II.i over an income of at most €33,994 gross. As such, these contributions are levied on all sorts of compensatory payments, whether in cash or in kind. In the event a foreign taxable person earns Dutch-sourced income, supranational regulations may restrict the Netherlands in levying these contributions.

Employee insurance contributions. These relate to social security aimed at employees, such as sickness benefits, incapacity insurance and unemployment insurance. These contributions are payable by the employer calculated as a certain percentage of the gross salary paid to the employee, with a maximum gross salary of €54,614 (for 2018). Remuneration paid to executive directors is generally subject to employee insurance contributions and remuneration payable to supervisory board members are in principle not subject to employee insurance contributions.

Income-dependent health insurance contributions to be paid by self-employed individuals.

iv Tax deductibility for employers

Remuneration paid in cash to employees is generally deductible for Dutch corporate income tax purposes. No corporate income tax deduction is available for Dutch companies in respect of share awards and employee share options. If the stock options will be cash-settled in each circumstance, arguments are present that the option scheme in fact should be considered a cash bonus, which may result in a tax deduction for corporate income tax purposes at the level of the Dutch company.

The costs of certain rights, of which the value is directly or indirectly mainly determined by the change in value of those rights such as (but not limited to) stock appreciation rights are also not deductible. The latter restriction only concerns rights that are granted to employees who earn more than €565,000 gross (2018).

v Other special rules

For employees hired from abroad, or seconded to a Dutch company or branch, under circumstances a special provision applies that – upon request – provides for a tax-free payment of up to 30 per cent of the employee’s employment income, which is then considered as a compensation for ‘extraterritorial’ costs. As a result of this 30 per cent ruling, the effective maximum income tax rate is reduced from 51.95 per cent to 36.4 per cent. The most important conditions to be satisfied are (1) an annual gross wage exceeding €53,280 (for 2018), which amount is inclusive of the 30 per cent tax-free payment, (2) that the employee has resided outside a 150-kilometre radius from the Dutch border for a minimum of 16 months during the 24 months preceding commencement of employment, and (3) that the employer qualifies as a withholding agent for wage withholding tax purposes. The employee and employer need to file the request for the 30 per cent ruling jointly. The 30 per cent ruling was effective for a period of eight years, which period was reduced by any period spent in the Netherlands during the last 25 years, irrespective of whether the employee actually enjoyed Dutch-sourced income from employment. The Dutch government recently announced that the term of the

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9 For some expenses, deductibility is explicitly denied, for instance, for administrative fines.
30 per cent ruling will be decreased as per 1 January 2019 to a maximum of five years for all 30 per cent rulings. No transitional period will be granted for employees who currently have the 30 per cent ruling for an eight-year period.

In respect of supervisory board members, the employer and supervisory board member need to opt for wage withholding in order to apply for the 30 per cent ruling.

III EMPLOYMENT LAW

i Non-competition covenants

In principle, non-competition covenants, including a penalty clause, are permitted and enforceable in the Netherlands. In certain sectors and for certain professions, the use of non-competition covenants in employment contracts is common practice. Under the laws of the Netherlands, a covenant restricting the employee’s right to work in a certain way after the end of the employment agreement is only valid if:

a. the employment agreement is entered into for an indefinite period; and
b. if the restrictive covenant is agreed upon in writing with an adult employee.

A non-competition covenant in an employment agreement for a definite period can only be enforced if it becomes apparent that the non-compete restrictions are necessary on compelling grounds in the interests of the business. These grounds need to be substantiated in writing at the time the covenant is agreed. Furthermore, employers may not derive any rights from non-competition clauses if the employment agreement’s ending is a consequence of culpable behaviour of the employee. Non-competition covenants must be reasonably limited in terms of a time frame and territory.

While the laws of the Netherlands only regulate non-competition clauses, it is commonly understood that non-solicitation clauses fall within the scope of its legislation.

ii Enforcement of restrictive covenants

In the Netherlands, restrictive covenants can be enforced against a former employee if the latter does not comply with its contractual restrictions. Restrictive covenants may also be enforced against an employer: the court may (partially) set aside a stipulation if the clause is not deemed to be necessary on compelling business grounds or if the interests of the employees are unfairly prejudiced by it in proportion to the interests of the employer. This could include, *inter alia*, a limitation of the time frame or the regional scope in which the provision applies. In addition, if a non-competition clause significantly restrains an employee from working other than in the service of the employer, the court may order the employer to pay a compensation for the duration of the restrictive covenant.

iii Termination

In the Netherlands, there is a distinction between the dismissal of statutory directors (i.e., directors under the articles of association) – which offers a more flexible dismissal regime – and non-statutory executives.

For listed limited liability companies (NV), it is prohibited to enter into an employment agreement with a statutory director. Instead, an agreement to provide services, commonly referred to as a management agreement, would typically be entered into. Dismissal rules following from Dutch employment law do not apply to such management agreements. An alternative is that the executive is employed by another group company while being appointed
at the level of the listed company as a statutory director. For NVs that are not listed as well as for private limited liability companies (BV), it is permitted and common practice to enter into an employment agreement with a statutory director. With respect to statutory directors, we note that a statutory dismissal by a resolution of the corporate body that appointed him or her also results in the termination of his or her employment agreement by operation of law (unless a prohibition to give notice applies, for example, in case of sickness). It is generally assumed that a management agreement will also terminate by operation of law in case the director is dismissed by the competent corporate body, but this has not been confirmed by the Dutch Supreme Court yet.

If the company has a works council, the advice of the works council should be requested prior to the unilateral dismissal of the director, that is, other than in case of termination by mutual consent. A works council must be requested to render its advice in a timely manner – in any event before the competent corporate body resolves to dismiss the director – by means of a written request for advice, in order for the works council to be able to exercise influence on the decision. The works council does not actually have the possibility to block the dismissal in case all procedural aspects of the consultation process have been complied with. If no request for advice has been submitted, a works council can ask the court to force the company to do so and to prohibit all further steps until the consultation process has been completed. In case the company is an NV and the shareholder’s meeting is the corporate body that has the right to appoint and dismiss members of the board of directors, in case of an intended dismissal, the works council should be given the opportunity to determine its position prior to the shareholders’ meeting’s decision to dismiss the board member. The shareholders’ meeting needs to be informed of the works council’s position in due time prior to the meeting. In addition, in this situation, the works council has a right to provide its views during the shareholders’ meeting. Failure to enable the works council to exercise these rights does not impact the shareholders’ meeting’s authority to pass the resolution; it could, however, impact the relationship with the works council.

With respect to executives that have not been appointed as a statutory board member, the following applies. In principle, employment contracts may be terminated at any time by mutual consent between the employer and employee. This also applies to executives that have been appointed as a statutory board member and that are engaged on the basis of an employment agreement. Parties may agree if, and to which extent, as part of the settlement agreement, notice periods and statutory compensations are taken into account. We note that it is mandatory to provide employees a two-week reflection period with effect from the moment the settlement agreement is signed by both parties. In this period, employees have the right to dissolve the settlement agreement.

Except for an urgent cause such as theft, fraud or serious misconduct, unilateral termination by the employer is not permitted without the prior approval of the Institute for Employee Insurance (UWV) (for economic reasons and long-term sickness absence) or the Subdistrict Court (for personal reasons such as underperformance or culpable behaviour). The Subdistrict Court and the UWV shall only dissolve the employment agreement if the employer has a reasonable ground for termination, as exhaustively stipulated in the Dutch Civil Code (DCC).

If an employer wishes to unilaterally terminate an employment contract of more than two years, a statutory severance fee is payable. The amount is based on the age of the employee and the number of years of employment and is capped at €79,000 for 2018 or one year’s salary if the employee’s annual salary exceeds the aforementioned amount. Further to
that, it is common practice that executives agree on contractual severance packages, for which
we refer to Section VI on corporate governance and Section VII on specialised regulatory
regimes below.10

IV SECURITY\n
Under the Dutch Financial Supervision Act (FSA) it is prohibited to offer securities to the
public in the Netherlands, unless an approved prospectus approved has been made generally
available. The FSA contains various exemptions to this prohibition, three of which are worth
mentioning in the context of employee stock option plans. Firstly, an offering of securities
is exempt if the securities are offered to fewer than 150 persons in the Netherlands. Second,
an offering of securities is exempt if the securities are offered by the employer to employees
(including executives), provided that the employer has its registered office or head office in the
European Economic Area (EEA) and a document containing certain specified information
regarding the offering has been made public. Thirdly, an offering does not fall within the
ambit of the prohibition when the instruments awarded under the plan are non-transferable.

The market abuse regime as established under the Market Abuse Regulation (MAR)
applies to, and imposes restrictions on the ability of executives to effect transactions in
company securities. In practice, the prohibition on insider trading is most restrictive. In
addition to the market abuse regime, the MAR contains rules on insider lists and mandatory
closed periods.

Under the FSA, each executive of a Dutch company listed in the EEA has to notify
the Authority for Financial Markets (AFM) (1) within two weeks of his or her appointment
of the number of shares and votes held by the executive upon his or her appointment as
executive, and (2) immediately of every change in the number of shares or votes held by the
executive.11 The AFM maintains a public register of the notifications on its website.

There are no legal requirements that executives must hold securities of their employer
and there are no anti-hedging rules – other than the restrictions pursuant to the MAR –
prohibiting executives from engaging in transactions that are designed to hedge to lock in the
value of holdings in the securities of the company. A company cannot require employees to
buy shares (e.g., by using a cash bonus to buy shares).

Finally, there are no statutory rules on short swing-trading, except for the requirements
as set out under Section VI on corporate governance below.

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10 In the Netherlands special rules apply to ‘excessive severance payments’. Insofar as employees with annual
salary starting at €544,000 (the amount for 2018 and is index-linked annually) receive a fiscally defined
severance payment that exceeds the benchmark salary, the employer must pay an employer’s levy of 75 per
cent on the part that exceeds the benchmark salary. This amount cannot be recovered from the employee
and as such it is a cost item for the employer.

11 Section 5:48 FSA.
V DISCLOSURE

Pursuant to the DCC, Dutch-listed public companies must disclose in the explanatory notes to their (consolidated) annual accounts the total amount of remuneration, including pension costs and other awards, of the (former) managing directors and (former) supervisory directors in the relevant financial year. This information must be disclosed on a group basis rather than for individual managing or supervisory directors. For the purpose of the DCC, these disclosure obligations relate to the members of the statutory board only. Consequently, it does not apply to members of the executive committee or other senior employees who are not formally part of the management board. Dutch GAAP law, therefore, applies a narrower scope than IFRS, whereby this group extends to ‘key management personnel’.

In addition, the DCC prescribes that public (listed) companies include in the explanatory notes to their annual accounts information about (1) the composition of the separate elements of the remuneration package, (2) the company’s share option plans and (3) loans, guarantees and advance payments granted by the company or its subsidiaries to management board and supervisory board members. This information must be disclosed on an individual basis to the extent that it relates to management board members or supervisory board members, whereas information about the employees’ option awards can be disclosed on a group basis. Information about the stock option plans must also be provided in respect of options that have been awarded to employees who participate in the plan.

The DCC does not include a definition of ‘remuneration’ but a description can be found in the Dutch Accountancy Directive. As this information forms part of the annual accounts, it is assumed that remuneration components (including perquisites) are quantified in order to add up to the aggregate amount of awards payable to a director in a particular financial year. The DCC prescribes that the implementation of the remuneration in general is included as a discussion item on the agenda of the annual general meeting of shareholders prior to the adoption of the annual accounts.

Obviously, disclosure of information will depend on what the law prescribes for dispersing (financial) information to shareholders and third parties. For example, a Dutch company’s (adopted) annual accounts must be deposited with the Dutch Commercial Register and, for listed companies, also be disclosed via publication on the company’s website and sent to the AFM. Other information is often also made publicly available at the occasion of the convocation of a general meeting of shareholders. This applies to a company’s remuneration policy and any share award plans for which the DCC requires that they are

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12 Section 2:383 DCC.
13 As well as all other companies that cannot make use of the exemption for small companies set out in Section 2:396 DCC.
14 Disclosure is held to mean ‘public disclosure’ by making information known to the general via publication in public registers or publicly accessible websites.
15 As included in IAS 24.26.
16 Sections 2:383c to 2:383e DCC.
17 Section 2:135 Paragraph 5a DCC.
18 Annual accounts of private (i.e., non-listed) companies do not need to be published in the Dutch Commercial Register if that company complies with the requirements set forth in Section 2:403 DCC, which includes the inclusion in consolidated accounts and the issue of form of parent guarantee by the consolidating company.
19 Sections 5:25m Paragraph 6 and 5:25o FSA.
approved by the general meeting. If a works council is established, it has a right to render its opinion in relation to the remuneration policy and to provide a verbal explanation of its opinion during the shareholders’ meeting.

A listed company must disclose information that must be provided to the general meeting, either for discussion or approval, by making this information available at the company’s website from the convocation of the general meeting of shareholders. Listed companies must keep this information available for at least one year following publication.

For further disclosure requirements, we refer to Section VI on corporate governance and Section VII on specialised regulatory regimes below.

VI CORPORATE GOVERNANCE

The principles and best practices for corporate governance of Dutch listed companies are set out in the Dutch Corporate Governance Code (the Code), the DCC, and sector-specific regulations (as referred to below).

i Corporate governance rules following from the DCC

With respect to NVs, the following corporate governance rules follow from the DCC:

a a public company must have a remuneration policy in place, which must be approved by the general meeting of shareholders;

b in case a works council is established at the level of the public company or any of its subsidiaries (if the majority of the employees of such subsidiary work in the Netherlands) the works council should be given the opportunity to determine its position with respect to the remuneration policy and to provide the shareholder’s meeting with its position, prior to the shareholder’s resolution being made, in which the remuneration policy is approved. In addition, the works council has a right to provide their views during the shareholders’ meeting.

c remuneration of statutory board members is set by the general meeting of shareholders, unless the articles of association state otherwise. If a supervisory board is established, the supervisory board determines the individual remuneration of a statutory board member within the boundaries of the remuneration policy;

d if according to standards of reasonableness and fairness, it would be unacceptable to pay out (part of) variable remuneration that was previously allocated to a current or former to a statutory board member, the corporate body that is entitled to set the remuneration may hold back (part of) the variable remuneration; and

e a company is authorised to reclaim, in full or partially, 100 per cent of the variable remuneration previously allocated to a current or former statutory board member (cash as well as any instruments), provided that the payment took place on the basis

With regard to the remuneration policy, it should be noted that according to the recently amended Shareholders’ Rights Directive this will have to be an advisory vote on the remuneration report, at least for large companies. The Dutch government may opt to have the report as a discussion item on the agenda for small and medium-sized companies. Whether the Dutch government will do that is unclear at the moment. A second new element is that the supervisory board will have to address in the next remuneration report how the advisory vote of the general meeting has been taken into account.

Section 5:25 Paragraph 3 of the FSA.

Section 2:135 DCC.
of incorrect information regarding the achievement of the goals underlying the variable remuneration or regarding circumstances on which the variable remuneration depended.

**ii Corporate governance rules following from the Code**

The rationale behind the Code is to create long-term value creation for the company, effective management and the supervision thereof, risk control, remuneration and the relation with the shareholders and stakeholders. The Code is considered as ‘soft’ law – it works on a comply-or-explain basis – it is market practice that Dutch-listed companies generally adhere to the principles and best practice provisions of the Code.

Executive remuneration has a prominent place in the Code. The starting point is that the company must have a clear and understandable remuneration policy that applies to its management. The supervisory board is responsible for the implementation of the remuneration policy, which must be adopted by the general meeting of shareholders. The supervisory board nominates a remuneration committee, which is responsible for the preparation of a remuneration proposal for each individual board member. The proposal must be in accordance with the company’s remuneration policy. Additionally, the proposal must at least describe (1) the components of the board member’s remuneration, (2) the amount of fixed and variable remuneration, (3) which performance criteria are applied, (4) the scenario analyses that were carried out, and (5) the pay ratios within the company and its affiliated.

The Code furthermore requires in best practice provision 3.2.2 that each individual board member must give his or her opinion concerning his or her own remuneration proposal. The underlying thought of this provision is to create awareness among board members with respect to their remuneration.

We note that the Code requires that shares being awarded to executives as remuneration should be held for at least five years after they are awarded. In addition, the Code stipulates that if options are being awarded, they cannot be exercised within three years after they are awarded.

The Code does not contain limitations with respect to the amount of the board member’s fixed or variable remuneration, nor does the Code prohibit board members to receive equity-related remuneration.

In the event of dismissal, golden parachutes of a board member are capped at one annual fixed salary.

Further to that, the Code contains disclosure requirements. The Code stresses the importance of a clear and comprehensible remuneration policy for which purpose it provides further specifications for the items that need to be addressed by the (remuneration committee of the) supervisory board when drawing up the company’s remuneration policy. The Code applies the principle that the implementation of this remuneration policy is accounted for; the supervisory board must render account of the implementation of the remuneration policy in its remuneration report, which should be posted on the company’s website, and the key elements of a management board member’s management agreement must be placed on the company website.

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23 The Dutch Corporate Governance Code, December 2016, Preamble, p. 7.
24 Best practice provision 3.2.1.
VII SPECIALISED REGULATORY REGIMES

Specific rules regulating executive remuneration have been issued in the Netherlands mainly for the financial and insurance sector and for public and semi-public sector senior officials.

i The financial sector

The executive rules for the financial sector are mainly included in the FSA. The FSA contains specific rules on the content, disclosure and implementation of a financial institution’s remuneration policy, as well as a 20 per cent bonus cap, guaranteed variable remuneration, severance pay, malus and clawback.

Variable remuneration

In general, a 20 per cent bonus cap applies to all persons working under the responsibility of a financial undertaking, as defined in the FSA, regardless of whether the financial undertaking has its official seat in the Netherlands, and a Dutch branch of a financial undertaking with its official seat outside the Netherlands, which is required to have a licence for a branch in the Netherlands pursuant to the FSA (not being a bank or an investment firm to which Articles 92 to 96 of CRD IV apply). A financial undertaking is defined in the FSA and includes, among other things, banks, investment firms but also insurance companies. We note that the 20 per cent bonus cap does not apply to branches located in the Netherlands of financial undertakings that are governed by the remuneration rules of Articles 92 to 96 of CRD IV (being, in short, banks or investment firms as defined in CRD IV). The following exceptions to the 20 per cent bonus cap apply:

a if the remuneration of persons working in the Netherlands does not follow from a collective labour agreement, it is possible to grant variable remuneration with a maximum of 100 per cent of its fixed annual remuneration to such persons individually, as long as the average of the ratio between the variable and the fixed remuneration of the whole group of persons working in the Netherlands whose remuneration does not follow from a collective labour agreement does not exceed 20 per cent. In July 2018, the Dutch Minister of Finance (the Minister) published a letter to the Dutch parliament in which he proposed that this exception shall be monitored closely and may even be abolished in the future. The evaluation of the Dutch remuneration rules shows that this exception to the bonus cap is currently used commonly throughout the financial sector, whereas, according to the Minister, the purpose of the exception is that it should only be used in exceptional cases (such as for key IT staff), and not for regular staff. Subsequently, the Minister notes that it is currently not certain whether the exception will remain in place as is. At this stage, no specific amendments to the statutory wording have been proposed;

b for staff predominantly (at least 50 per cent of their time) working outside the Netherlands, an individual bonus cap of 100 per cent applies;

c for staff predominantly (at least 50 per cent of their time) working outside the EEA, an individual bonus cap of 200 per cent may apply, subject to shareholder approval and the procedure pursuant to CRD IV;

d for staff working at an international holding company (which is the top holding within the EEA but not necessarily globally) of a financial undertaking with its official seat in the Netherlands and to which Article 1:114 FSA applies, but with its activities predominantly outside the Netherlands, a bonus cap of 100 per cent applies provided...
that within a period of five consecutive years at least 75 per cent of all staff belonging to the international holding company’s group work outside the Netherlands for three (not necessarily consecutive) years; and

e an increase of the fixed remuneration is possible as the FSA does not limit a financial undertaking in increasing fixed remuneration. In July 2018, the Minister also published a legislative proposal containing suggested amendments in this respect:

- if state aid is given to a bank or an insurance company, there should be a statutory obligation to claw back part of the fixed remuneration of management board members. The purpose of this measure is to hold management board members personally liable when the taxpayer pays for the losses of failing banks or insurance companies;
- components of fixed remuneration of which the value depends on the value of a financial undertaking, such as the share price, should be subject to a certain lock-up period. The purpose of the measure is to align the interests of management board members and employees with the long-term interests of the financial undertaking; and
- the remuneration policy of a financial undertaking should prescribe how the remuneration of both management board members and other employees is set, in proportion to the public function of the financial undertaking. This statement must be made public. The purpose of the measure is to ensure that financial undertakings take into account their public function when setting their remuneration frameworks and that they can publicly take accountability in that respect afterwards.

The legislative proposal is currently open for consultation to the public until the end of August 2018, and will likely be discussed in the Dutch parliament in Q4 2018. It is currently not clear when and if the proposed amendments will enter into force;

f it is possible to award a retention bonus of up to 200 per cent per cent of the annual fixed salary, if the following strict conditions are met: (1) the retention bonus must be necessary in relation to a sustainable change in the organisation; (2) the sole purpose of the retention bonus is to retain the respective person for the organisation; (3) in the year that the retention period ends and the retention bonus is effectively awarded, the sum of all variable remuneration that the respective person is awarded may not exceed 100 per cent of his or her fixed annual pay or, if shareholders’ approval has been obtained in line with the requirements of CRD IV, 200 per cent; and (4) the regulator has given its prior written permission. Further to that, a retention bonus must comply with the general requirements that apply to variable remuneration (e.g., with respect to identified staff, under sector-specific legislation); and

g it is possible to grant a sign-on bonus that is not capped at the first year of a new hire if it relates to the commencement of activities of the person and the undertaking maintains a sound solvability rate and equity capital base.

Any legal act in breach of the remuneration requirements of the FSA, including a breach of the bonus cap, is considered null and void.

We note that the Regulation on Sound Remuneration Policies under the FSA 2017 contains specific rules applicable to identified staff of banks and investment firms, which
relate to the way remuneration components and structures are set up and the way a firm controls or mitigates risks arising from its remuneration policy and the implementation thereof, including specific rules on the composition, deferral and retention of variable pay.

For identified staff of insurance companies, next to the remuneration rules following from the FSA, the Commission Delegated Regulation (EU) 2015/35 (Solvency II) provides for an additional regulatory framework on remuneration, containing rules on pay-out, deferral and the structure of variable pay. As of November 2017, it is no longer required to pay part of the variable pay of identified staff of insurance companies in instruments.

For identified staff of fund managers, next to the remuneration rules following from the FSA, the Alternative Investment Fund Managers Directive (EU) 1095/2010 (AIFMD) and Directive 2009/65/EC (UCITS) provide for an additional regulatory framework on remuneration, containing rules on pay-out, deferral and the structure of variable pay, with specific rules on carried interest.

**Severance**

No severance may be paid to a person working under the responsibility of a financial undertaking in case:

- **a** the termination of the employment is at the initiative of the respective person, unless it is a consequence of severe culpable behaviour or negligence on the side of the employer;
- **b** severe culpable behaviour or negligence on the side of the employee; or
- **c** failure of the undertaking, in case of a daily policymaker within the meaning of the FSA. A daily policymaker is known to the regulator and the undertaking as he or she is subject to a suitability and reliability assessment within the meaning of the FSA.

Also, severance of daily policymakers of financial institutions with their seat in the Netherlands is capped at 100 per cent of their fixed annual salary pursuant to the FSA. Any legal act in breach of severance cap is considered null and void.

**ii Public and semi-public sector**

In the Netherlands, senior government officials’ salaries cannot exceed those of government ministers. This is laid down in the Public and Semi-public Sector Senior Officials (Standard Remuneration) Act. This Act also applies to the salaries of senior officials of organisations in the semi-public sector, such as hospitals, schools and public broadcasters. The maximum salary for senior officials in 2018 is €187,000 gross, which includes holiday allowance, end-of-year allowance, pension contributions and expenses. The maximum severance for senior officials is capped at €75,000 gross.

Public and semi-public institutions must publish information in their annual financial reports on remuneration and redundancy payments paid to officials. They must also forward this information electronically to the relevant minister. An important role exists for the accountant of the institutions in terms of disclosure.

**VIII DEVELOPMENTS AND CONCLUSIONS**

Executive remuneration remains a highly debated feature of the corporate landscape. On the eve of Brexit, the evaluation of the remuneration requirements under the FSA including its 20 per cent bonus cap, have been debated heavily in the Dutch parliament, resulting in
proposals to again strengthen the rules applicable to financial undertakings in the Netherlands. It is expected that the Dutch parliament will review these proposed amendments by the end of 2018.

Executives that qualify for the 30 per cent ruling receive a tax-free allowance of 30 per cent of the employee’s total remuneration (salary plus tax-free allowance) during a period of eight years. The remaining 70 per cent of the remuneration is taxable at the progressive domestic Dutch income tax rates with a maximum of 51.95 per cent, leading to a maximum rate of 36.365 per cent effectively. The 30 per cent ruling is a very attractive facility for executives in the Netherlands. Although it has been announced the eight-year period will be shortened to five years, it is not expected that the 30 per cent ruling facility will be abolished in the coming years.
Chapter 16

PORTUGAL

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I INTRODUCTION

With the exception of the financial sector, senior executive compensation is not subject to special rules or regulations under Portuguese law.

There is, therefore, a high degree of flexibility for parties to arrange remuneration schemes that better suit the interests of both companies and employees.

The way companies choose to structure and implement these remuneration schemes is influenced by a multiplicity of factors, namely (1) by the tax and social security regime, seeking the least costly solutions, for both employer and employee; (2) by the labour rules, that in Portugal are particularly restrictive, trying to adopt forms of remuneration that enable some degree of flexibility and the possibility of altering its value and structure; and (3) by management reasons, granting benefits designed to encourage productivity and increase loyalty and length of service. These benefits may be subject to the company's performance results (performance-related margin and bonus system, equity participation or stock options) or to the employee's performance (either individual or group performance evaluation) or they can be deferred benefits for the purpose of discouraging a change of job to a competing company (pension schemes, among others).

II TAXATION

i Income tax for employees

Tax residency is the key concept of Portuguese income taxation rules. An individual is deemed to be resident in Portugal if he or she spends over 183 days in Portuguese territory or if he or she has their main abode in this country. Therefore, strictly under domestic rules, if the individual’s primary place of residence is in Portugal, that person will be considered a Portuguese resident even if he or she spends most of the year abroad.

Individuals that are classified as residents in Portugal for tax purposes are subject to Portuguese personal income tax on their worldwide income (i.e., irrespective of where their income is generated). On the other hand, non-residents are subject to tax only on the income that is deemed to be obtained in Portugal.

The tax is levied on specific categories of income, defined as Category A to Category H. In general, active income (including employment compensation) is taxable at progressive rates of up to 48 per cent (on income in excess of €80,000) whereas passive income (dividends,
Portugal

capital gains and interest) is taxable at a fixed rate of 28 per cent. An additional progressive surcharge is applicable at the following rates: 2.5 per cent on taxable income exceeding €80,000 and up to €250,000; and 5 per cent on taxable income exceeding €250,000.

Income earned by non-resident individuals is generally subject to withholding tax at the rate of 25 per cent. The payer is responsible for withholding the applicable tax.

Compensation for employment work (salaries) is included in Category A of taxable income. Fringe benefits and all other forms of compensation related to the employment relation are also generally subject to tax under Category A.

The attribution (for free or at a discounted value) of shares by the employer to the employee is taxable as employment income and there is no taxation until the shares are effectively acquired, either by a transfer for no consideration (or a discounted value) or by exercising the option to acquire the shares at the strike price. In both cases the difference between the consideration paid by the employee and the fair market value of the shares on the date of acquisition is characterised as employment income and is subject to tax according to the rules described above.

Any gains realised on a subsequent transfer of those securities or any dividends received are subject to withholding tax in Portugal at the rate of 28 per cent. This rate is final for both resident and non-resident individuals.

All deferred payments, according to Portuguese tax rules, should only be taxed upon effective attribution (i.e., only in the year they are paid or made available to the employee).

Pension fund contributions made by the employer are immediately taxable as employment income where such contributions are individualised and constitute acquired rights of the employee. By contrast, contributions made by the employer that are not individualised or do not constitute acquired rights of the employee are not taxable on the moment of the contribution, but rather on the moment the funds are paid to the beneficiary. In these cases, if the funds are paid by the pension fund before the retirement age, the income is also classed as employment income.

Lastly, it is also important to consider that there is a special tax regime for individuals that become residents in Portugal under the Non-Habitual Residents tax regime (NHR). This regime was designed to attract foreign individuals to Portugal and under this regime individuals will benefit from preferential rates as well as full exemptions in certain categories of income, as further explained below.

ii Social taxes for employees

In Portugal, there are no different rules concerning social taxes applicable to residents and non-residents.

Regular salary (excluding extraordinary bonuses) for work that is materially executed in Portugal is subject to social security contributions at the rate of 23.75 per cent for the employer and 11 per cent for the employee.

Employers with no establishment in Portugal who hire employees to work within Portuguese territory must register before the Portuguese Social Security and enter into a mandate contract appointing the employee as the company representative for social security purposes. Social contributions shall be paid by both parties, at the ordinary rates.
iii  Tax deductibility for employers

Remuneration paid to the employees is generally deductible by the employer without exception and, to this effect, there is no difference on the basis of the level of or qualification of the employee. However, certain incurred expenses, such as extraordinary bonuses paid to members of the board, incurred or supported by entities subject to Corporate Income Tax are subject to a penalty taxation at the level of the company. The most noticeable example is the case of bonuses that are subject to such penalty tax at the rate of 35 per cent. The form in which remuneration is paid does not affect the amount or the timing of deductibility.

iv  Other special rules

No special rules apply to the taxation of compensation paid to employees in the context of an event of change of control.

The amounts received for employees for the termination of the employment contract are exempt up to the average of the regular salary subject to taxation of the last 12 months multiplied by the years of work. This exemption does not apply for termination payments to directors and board members.

On the other hand, for Social Security purposes, no liability to contributions arises in respect of the compensation for termination of employment contract, except in some cases of termination by agreement.

III  TAX PLANNING AND OTHER CONSIDERATIONS

Individuals that transfer their tax residency to Portugal may apply for the NHR tax regime. This regime allows for rate reductions or exemptions on certain categories of income, as further explained below.

The NHR regime is applicable for a period of 10 consecutive years, from the year of the registration as a resident on Portuguese territory. Taxpayers that cease to be residents in any of those years may still apply the regime in any subsequent year that they return to Portugal, but always within the original 10-year period.

Under the NHR rules, foreign source employment income (including salary) is exempt from tax in Portugal to the extent it was effectively taxed in the source country (i.e., either in the country where the employment is effectively exercised or where the employer is resident for tax purposes).

If this income is not taxed abroad, then the foreign source compensation income is taxable under the same rules that apply for domestic sourced income.

In turn, domestic source employment compensation income is generally taxable at progressive rates (of up to 48 per cent on income in excess of €80,000), unless it relates to employment in a ‘high value-added activity’, which consists of activities that are specifically listed, in which case the income is taxable at the fixed rate of 20 per cent.

In any case, if the employer is a non-resident entity without a branch or any other form of permanent establishment in Portugal, this income, even if taxable, will not be subject to withholding tax in this country.
IV EMPLOYMENT LAW

i General remarks
Portuguese employment law is applicable to all employees regardless of their qualification or position in the employer’s organisation. Hence, executives’ and senior executives’ employment contracts are subject to the same worker protection rules and regulations as other employees, although there are some exceptions, most of them related to working time limitations. One important exception is the possibility of hiring senior executives, whose jobs presume a special trustworthiness, under the regime of service commission. This type of employment contract may be used for admission of new personnel or be applicable to pre-existing employees. The general rules on termination are not applicable here (see Section IV.iii).

The Portuguese Labour Code (LC) has several rules about remuneration that should be taken into consideration when designing compensation and benefits schemes. The most relevant is the prohibition to reduce pay, even with the employee’s consent, except where expressly provided for by law (such as the adoption of exceptional measures for companies in economic difficulties) or by collective agreement. However, this prohibition does not affect the grant of variable payments or bonuses related to the employee’s or the company’s performance, provided that certain conditions are observed. It is also possible to remove pay supplements directly dependent on the terms and conditions under which the work is rendered, provided there is a clear connection between the payment in question and the work conditions that justify that payment.

In the majority of cases, remuneration is agreed on a monthly basis, but for senior executives it is becoming more frequent to establish an annual amount. Because the LC establishes that all employees are entitled to holiday and Christmas allowances, when remuneration is agreed on an annual basis it should be clear that this amount already includes the above-mentioned allowances.

Long-term incentive plans (such as the grant of bonuses related to the company’s performance or stock options) are not regulated by employment law and can be subjected to specific conditions in order to avoid that the benefits emerging from these plans have retributive nature and are therefore subject to the guarantee provisions regarding retribution.

ii Restrictive and non-solicitation covenants
As a general rule, the employee’s right and freedom to work render null and void any restrictive covenants after the employment’s termination. There are, however, exceptions, and non-compete agreements are allowed provided that the four following requirements are simultaneously met:

a the covenant is put down in writing, under the employment contract or under the termination agreement. It can also be included in any other document, such as share acquisition agreements, which are subject to the same rules if the selling shareholder is an employee;

b the performance of a competing activity is likely to cause harm to the employer;

c the non-compete clause may be applicable for a maximum of two years after termination of the contract or up to three years if the activity performed entails a special relationship of trust or access to sensitive information; and

d the employee is granted compensation for the period in which his or her activity is restricted.
There is no legal rule establishing the amount that should be paid to the employee for the period of the non-compete clause. However, in the event of an unlawful dismissal or termination on specific grounds by the employee, the above-mentioned compensation shall at least correspond to the amount of the monthly basic salary paid to the employee at the time of his or her termination. Otherwise the non-compete clause cannot be invoked. The employer can, nonetheless, subtract from the compensation the income eventually earned by the employee following the termination of the contract.

If the employee fails to comply with the non-competition clause, the employer may request him or her to reimburse the compensation paid as well as seek compensation in excess of that amount if the damage suffered by the employer is higher.

Exclusivity clauses, under which the employee is prevented from pursuing any other professional activities during his or her employment contract, are not subject to specific legal provisions and are commonly used for executives.

Non-solicitation covenants of customers or clients are only allowed if they result from a non-competition covenant that fulfils the above-mentioned requirements.

Finally, any agreement settled between employers in order not to hire each other’s employees will be null and void.

iii Termination of employment

Termination of open-ended employment contracts cannot be made by the employer outside a ‘just cause’ scenario. This concept includes both disciplinary dismissals and dismissals based on objective grounds, as expressly provided for under the LC.

The LC foresees the following types of dismissal: dismissal based on unlawful conduct of the employee (or disciplinary dismissal); redundancies or dismissals resulting from the elimination of jobs (collective dismissals and individual redundancy); and dismissal for failure to adapt (which is not used in practice).

The dismissal may only occur after following a complex procedure that takes several weeks to be completed. If the proper procedure is not observed, the dismissal is considered unlawful even if there were reasons to terminate the employment contract.

In case of disciplinary dismissal, the employer does not have to pay compensation for the termination of the employment contract nor provide for a notice period, although the dismissal procedure must always be completed.

In case of redundancies (collective dismissal or individual redundancy) the final decision has to be issued observing a prior notice period of 15, 30, 60 or 75 days, depending on the employee’s seniority. In the event of a collective dismissal or individual redundancy, employees are entitled to a compensation. The rules about compensation were updated in 2011, 2012 and 2013. For contracts entered into force after 1 October 2013, the compensation corresponds to 12 days of basic pay and seniority allowances per year of employment, capped at 12 times the basic monthly salary or 240 times the minimum wage (currently €139,200).

Ordinary employment contracts are not allowed to establish different rules on termination (whether more or less favourable to employees). Therefore, it is not possible to agree in advance (in the original employment contract or in another complementary agreement) on the value of the compensation to be paid if case of termination (the ‘golden parachute’ clauses). This, however, does not make it invalid for the parties to enter into a termination agreement and to agree on the compensation amount under that agreement.

The dismissed employees may file a claim before a labour court in order to challenge the termination of their labour contracts.
If the court decides that there was any illegal procedure or lack of reasons or formalities on the dismissal, the employees may choose between being reinstated in the company, or receive a compensation ranging between 15 and 45 days of base remuneration plus seniority bonus per year or fraction of year of seniority, with a minimum of three months of base remuneration plus seniority bonus.

On both situations, the employees shall be entitled to the salaries that they would have received if the dismissal had not taken place and to an eventual compensation for damages suffered.

If the employer is a company that has nine employees or fewer, or if the employees dismissed are managers or senior executives, the employer can oppose reinstatement. This is provided that the employer can show that the employee’s return would seriously interfere with and prejudice the company’s ordinary activities. The court must assess the employer’s arguments. In this particular case, the employee will be entitled to a compensatory award equivalent to between 30 and 60 days of basic pay and seniority payments for each full year or fraction of a year’s service, subject to a minimum of six months of base remuneration plus seniority bonus.

The general rules on termination are not applicable to executives who have been hired through the special regime of ‘employment contract in commission’. In this case, termination by the employer does not need to be justified nor is it necessary to follow a specific procedure. Both parties may terminate the employment relationship at will, by giving a prior notice of 30 days or 60 days to the other party, depending on whether the contract lasted up to two years, or more than two years. Termination by employer initiative gives the employee the right to a compensation corresponding to 12 days of basic pay and seniority allowances for each year of employment. The notice period and the compensation amount may be increased under the employment contract in commission (this not being possible under ordinary employment contracts).

The reasons that may lead to a unilateral termination of the contract by the employee with just cause are expressly stipulated by law. Those reasons may be related, among others, to an unlawful behaviour by the employer (constructive termination) or to objective reasons (such as the lawful modification of employment conditions). If it becomes immediately impossible to continue the employment relationship in ways to be considered as just cause, an employee may terminate it immediately, without prior notice. In this event, the employee is entitled to compensation to be determined between 15 and 45 days of base pay and seniority pay for each year worked, depending on the amount of compensation and the extent of the employer’s unlawful conduct, and may not be less than three months of base pay and seniority pay. Change of control as such is not a valid cause for termination, neither for the employer nor for the employee. The employment contract remains into force with the same terms and conditions previously agreed. Even for senior executives that may have a special relationship with the previous owner, the change of control is not cause for termination, as the employer remains the same – the company – despite the changes in its ownership structure.

Under Portuguese law (which broadly speaking is a transposition of the regulations contained in EU Directive 2001/23/EC, of 12 March) the transfer of an undertaking does not constitute cause for termination by the employer. Employment contracts will be automatically transferred to the transferee in the exact terms and conditions into force at the moment the transfer occurs. However, the employee’s right to oppose the transfer of his or her employment contract to the transferee is now (since March 2018) expressly included in the Portuguese employment law. The employee is entitled to oppose the transfer of his or her
employment contract whenever a transfer may cause him or her serious loss, namely by the transferee’s evident insolvency or difficult financial situation or, also, if the employee does not trust transferee’s policies regarding work organisation. The above-mentioned grounds are so broad and subjective that one can question if the employee is truly obligated to justify his or her opposition. As an alternative, the employee is entitled to terminate his or her employment contract, this termination being considered a unilateral termination with just cause. The employee will therefore be entitled to a monetary compensation calculated in accordance with the rules applicable to a collective dismissal.

V  SECURITIES LAW

According to Portuguese securities law, a share plan has regulatory implications solely if it can be qualified as a public offer.

An offer is deemed to be public in the following circumstances:

a  if the offer of securities is addressed, wholly or partially, to unidentified recipients;

b  if the offer is addressed to all the shareholders of a public company;

c  if the offer is, wholly or partially, preceded or accompanied by a prospecting or a solicitation for investment’s intentions from unidentified addressees or promotional material; and

d  if the offer is addressed to at least 100 persons who are non-qualified investors resident or established in Portugal.

The application of these criteria to share plans is not always straightforward, the key question lying on the qualification of the plan as an offer of securities. For example, ‘phantom’ stock purchase plans, in principle, should not be qualified as offer of securities, as they do not involve effective acquisition of securities.

If the share purchase plan involves a public offer, a filing will be required with the Portuguese Securities Market Commission (CMVM) and the need to approve a prospectus. Acceptances of the offer have to be transmitted through an authorised financial intermediary.

An important exemption of the prospectus requirement is granted for public offers of securities to existing or former directors or employees by their employer that has securities already admitted to trading on a regulated market or by an affiliated undertaking, provided that a document is made available containing information on the number and nature of the securities and the reasons for and details of the offer.

Otherwise, registration with CMVM is not required in connection with the offering of securities to current or former members of the management or workers’ bodies by their respective employer, company in a controlling or group relationship with the latter or by a company subject to common ownership, provided that the issuer has its statutory or effective place of business in the European Union and a document providing information on the number and nature of the securities as well as the reasons and characteristics of the offer is available.

Directors of an issuer of securities admitted to trading on a regulated market (or of a controlling company), as well as related persons, shall notify the CMVM, within five working days, of all transactions carried out on their own account, on account of third parties or on their behalf, involving shares of said issuer or related financial instruments, where the value of such transactions reaches €5,000.
In addition to the general rules of information on inside information, issuers and persons acting on their behalf or account have to draw up insiders lists (e.g., lists of persons with access to privileged information), with the law providing for a set of specific duties associated with this obligation (comprising an obligation to include on the list, inter alia, the person’s identity, the reasons for their inclusion and the date of inclusion; to keep the list strictly up to date; to inform the relevant person of his or her inclusion on the list and the legal consequences in case of disclosure or misuse of inside information; to keep the list for a period of five years; and to immediately forward the updated list to the CMVM whenever it so requests).

VI DISCLOSURE

Disclosure of information on remuneration of members of corporate bodies of public companies is subject to statutory law and regulations approved by the CMVM, requiring disclosure of remuneration policies approved on an annual basis to be included in the respective accounts and the corporate governance annual report if applicable.

Disclosure should cover individual and aggregate remuneration of directors and members of the audit body – referring the components giving rise to the variable remuneration – as well as the parts of the remuneration already paid and those payable in the future.

Public companies shall be entitled to adopt a corporate governance code different from regulations approved by the CMVM, provided, however, that the same applies equivalent disclosure rules and principles.

Disclosure requirements embody the principle of ‘comply or explain’ pursuant to which justification should be provided in relation to each of the requirements not complied with by the relevant company.

Presently there is a statutory principle of ‘say on pay’ by the shareholders, who are called to review the statement of remuneration policy of members of the corporate bodies.

VII CORPORATE GOVERNANCE

As a general statutory rule, approval of remuneration of members of the corporate bodies of a company is entrusted to the general meeting or to a corporate remuneration committee designated for the purpose (and enjoying of independence from the management bodies).

Certain adjustments to this principle may exist depending on the corporate governance structure adopted (for instance, in dual public companies inspired by the German model, competence is transferred from the general meeting to the supervisory board).

The Companies Code allows the remuneration of executive directors to partially consist of a percentage (the maximum amount of which needs to be set out in the articles of association) of the company’s profits, whereas remuneration of directors with supervisory functions (i.e., members of the audit committee) must mandatorily consist only of a fixed sum (this solution is often recommended for all non-executive directors).

Public companies are subject to enhanced corporate governance requirements on approval of remuneration for members of the corporate bodies, in particular directors and executives. The latter remuneration should be structured in a way to allow alignment with the interests of stakeholders, be based on performance valuation and not incentivise excessive risk assumption.
In this context there are various recommendations in relation to performance evaluation criteria, growth of company and value obtained to shareholders, adoption of a variable remuneration component payable on a deferred basis, remuneration caps, etc. Clawback and recoupment provisions may be considered particularly in the context of executive directors’ agreements, although no express requirement existing on the matter (but without prejudice in any event of statutory provisions on directors liability with regard to the company).

VIII SPECIALISED REGULATORY REGIMES

Portugal has implemented the EU regulations and the European Banking Authority orientations on remuneration on the financial sector, which cover remuneration of the members of the board and also staff members whose professional activities have material impact on the institutions’ risk profile. In these cases, it is necessary to implement specific remuneration policies that must follow certain guidelines and are subject to some restrictions, in particular regarding variable remuneration (see EU Overview chapter).

There are also specific rules on remuneration of directors and management board members of companies owned or controlled by the government, although executives under employment contracts are not covered by those rules.

The special measures that, over the financial crisis period (2011–2015), imposed a salary reduction and freeze on career progression for civil servants and employees of companies owned or controlled by the Portuguese state were eliminated in 2017–2018.

IX DEVELOPMENTS AND CONCLUSIONS

The tax regime and its constraints are likely to continue their influential role on how remuneration schemes are designed, particularly with regard to executives. Considering the high tax burden in Portugal, any change in income taxes of both individuals and companies will certainly influence how remuneration schemes are organised. However, at the moment, there are no relevant reforms announced in this field.

The increasing pay gap between executives and workers in general, especially in large companies, has been making the headlines for the past few months. In view of that, one of the political parties that support the present government has announced their intention to propose legislation that would penalise the companies, either public or private, when the above-mentioned pay wage exceeds a certain limit. However, so far, those measures have not been proposed and it is not expected that such legislation will ever see the light of day.
INTRODUCTION

Aside from being subject to United States federal laws and regulations on the matter of executive remuneration, Puerto Rico has a number of local laws and regulations that affect executive compensation. Although executive compensation arrangements are usually contractually agreed to between the parties, and therefore tend to be more diverse than standard employment agreements, there are particularities in our jurisdiction, especially in the areas of employment law and taxation, which must be taken into consideration.

In this chapter, we will discuss some of the most important issues that impact the compensation structures of executives in Puerto Rico.

TAXATION

In Puerto Rico, the tax rules for executive compensation require the interplay of Puerto Rico and US Federal laws, such as the Puerto Rico Internal Revenue Code of 2011, as amended (the PR Code), the US Internal Revenue Code of 1986, as amended (the US Code) and the Employee Retirement Income Security Act of 1974, as amended (ERISA). Executive compensation provisions in the PR Code are comparable to those under the US Code. However, they are not identical.

Under the PR Code, the tax provisions related to executive compensation are limited to a couple of sections, which have not been significantly amended since their approval. Furthermore, only a few regulations have been issued by the Puerto Rico Treasury Department (the PRTD) under these sections; thus, regulations issued under the previous Puerto Rico Internal Revenue Code of 1994, as amended, are still in effect as long as the provisions in the PR Code remain unchanged. We hereby provide a summary of those provisions.
Compensation for personal services rendered in Puerto Rico is gross income subject to Puerto Rico income tax. Compensation for personal services include wages, commissions, bonuses, vacation or sick pay, among others. Such compensation is subject to income tax withholding based on the withholding tables published by the Secretary of the PRTD every year.2

Compensation will be subject to withholding even if paid by means other than cash, including stocks, property or bonds. The fair market value of the property received as payment will be considered as wages subject to withholding. In cases where the services are paid with corporate stock, the fair market value of the shares at the date of transfer will be considered compensation. If at the time of the transfer the shares are substantially restricted, such that no fair market value may be attributed to said shares, the employee will receive wages for an amount equal to the fair market value of the stocks at the time the restrictions end (even if such event occurs in a future calendar year after the employee renders the services).

Wages are also subject to Puerto Rico disability and unemployment tax.

Pursuant to Section 1031.01(a)(1) of the PR Code, compensation for personal services is part of the taxpayer’s gross income. Generally, income from services rendered in Puerto Rico constitutes income from sources within Puerto Rico, whereas income from services rendered outside Puerto Rico constitutes income from sources outside Puerto Rico. By exception, services rendered in Puerto Rico by a non-resident individual who is temporarily in Puerto Rico for a period or periods not exceeding 90 days in total during the taxable year and whose compensation does not exceed US$3,000 total for services rendered as an employee or under a contract with a non-resident individual, or a foreign corporation or partnership not engaged in trade or business in Puerto Rico, is not considered Puerto Rico source income.

Individuals are subject to regular Puerto Rico income tax rates from 7 per cent up to a maximum of 33 per cent. In addition, individuals with net income subject to alternative minimum tax equal to or more than US$150,000 are subject to alternative minimum tax rates between 10 per cent and 24 per cent. Currently, there is a tax reform (House Bill No. 1544/Senate Bill No. 909) under the consideration of the Puerto Rico Legislative Assembly that lowers individual regular income tax rates to a maximum of 31 per cent and changes the current alternative minimum tax rules.

Severance payments

Act No. 4 of 26 January 2017, as amended, known as the Labour Transformation and Flexibility Act, amended Section 1031.01 of the PR Code to exclude severance payments from the definition of gross income.3 Therefore, severance pay received by a former employee, up to the amount such employee could have received under the severance formula provided by Act No. 80 of 31 May 1976, as amended, is tax exempt.4 It is still unclear how the PRTD treats severance payments for purposes of determining an individual’s net income subject to alternative minimum tax in the Puerto Rico income tax return.

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2 The last withholding tables published by the PRTD are for wages paid after 31 December 2016, which are still in effect.
3 29 Laws of Puerto Rico Annotated (LPRA) 121, et seq.
4 29 LPRA 185 et seq.
Severance payments are not subject to Puerto Rico income tax withholding, as provided by Section 1062.01 of the PR Code. Note, however, that severance payments are subject to social security tax and Medicare tax (commonly referred to as FICA payroll taxes), as provided by US Federal law.5

**Employees’ trusts**

If certain requirements are met, trusts set up by employers that are part of a stock bonus, pension or profit-sharing plan are subject to a beneficial tax treatment. Plans that meet all requirements established in Section 1081.01 of the PR Code are deemed ‘qualified’, which has income tax benefits to both the employer and the employees.

To be qualified, certain tests must be met to guarantee adequate coverage to rank and file employees and to avoid discrimination in favour of highly compensated employees. For these purposes, a ‘highly compensated employee’ refers to an employee in Puerto Rico who is described in the PR Code Section 1081.01(d)(3)(E)(iii), including: (1) an individual holding more than 5 per cent of the voting or total value of all classes of stock of a corporation that is the participating employer; (2) an individual holding more than 5 per cent of the capital or interest in profits of the employer, in case of an entity that is not a corporation; or (3) an employee that for the previous taxable year earned compensation in excess of US$150,000. For purposes of determining whether an employee is holding more than 5 per cent of the stock, capital or profits, the rules of controlled groups under PR Code Section 1010.04, related entities under PR Code Section 1010.05 and affiliated service groups under PR Code Section 1081.01(a)(14)(B) shall be taken into consideration.

When a pension, stock bonus or profit-sharing plan is qualified under Section 1081.01 of the PR Code, the fund established to provide such benefits is exempt from Puerto Rico income tax. In addition, if the plan is tax exempt for Puerto Rico income tax purposes and all the participants in such plan are Puerto Rico residents, the trust is also treated as exempt under the US Code, as provided by Section 1022(i)(1) of ERISA. As a result, income earned by the trust in the United States is not subject to US taxation. A plan may exclude from coverage employees who are non-resident aliens and whose income is not deemed Puerto Rico source income and still benefit from the preferential Puerto Rico income tax treatment.

Employees are taxed in the year in which they receive a distribution from the trust. In general, employees’ pre-tax contributions to such plans are excluded from their gross income in the taxable year in which the contributions are made. Thus, such employee contributions are not subject to Puerto Rico income tax at such time.

Contributions made by an employer to a qualified plan may be deducted against its business income on its Puerto Rico income tax return, subject to certain limits provided in Section 1033.09 of the PR Code. These limits vary depending on whether the employer is making contributions to a pension plan, stock bonus or profit-sharing plan. In the case of contributions to a qualified retirement plan in excess of the amount deductible, the employer is subject to a 10 per cent penalty tax (although this contribution may be carried forward or deducted in future taxable years, subject to the applicable limits).

Act No. 106 of 23 August 2017 amended Section 1081.01 of the PR Code with respect to the tax treatment of total distributions from a qualified plan made after 31 December 2017. In such case, lump-sum distributions paid to an employee within one taxable year due to

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separation of service or plan termination are generally taxed as ordinary income subject to
the regular individual income tax rates. However, lump-sum distributions subject to Puerto
Rico income tax withholding at source (and if the amount withheld is deposited with the
PRTD), will be taxed at a 20 per cent tax rate (instead of the regular individual income tax
rates). The 20 per cent tax rate could be reduced to 10 per cent only in certain cases. If within
60 days upon receiving a lump-sum distribution from a retirement plan the employee elects
to roll it over to another qualified retirement plan, no tax consequences will be triggered for
the employee at that time by reason of this distribution.

**Employee stock options**

Pursuant to Section 1040.08 of the PR Code, if certain conditions are met with respect to
employee stock options, then:

- no income is recognised when the employee exercises the option, nor at the time the
  stock is transferred to the employee;
- no deduction may be claimed by the employer corporation (or its parent or subsidiary)
  as a business expense with respect to the transferred stock; and
- only the amount paid pursuant to the option is the amount received by the corporation
  for the transferred stock.

The rules listed above apply if during the period commencing when the option is granted and
ending three months before the date the option is exercised, the individual is an employee or
director of the corporation granting the option (or the parent or subsidiary of the corporation).

In other stock option cases, the portion related to the increase in value from the time
the option is granted to when it is exercised will be deemed wages, if the transfer is not
substantially restricted. Any discount granted by the employer between the stock option price
and the share’s fair market value will also be deemed wages. In this scenario, the employee
receives wages when he or she exercises the option based on the excess between the stock’s
fair market value at the time the option is exercised and the price paid by the employee for
the stock.

**ii Social taxes for employees**

FICA payroll taxes apply in Puerto Rico in the same manner as in the United States.

**iii Tax deductibility for employers**

Section 1033.01(a)(1) of the PR Code allows employers to claim a deduction on its Puerto
Rico income tax return as an industry or business expense, a reasonable amount paid or
incurred during the taxable year for wages or compensation for personal services rendered.
The Secretary of the PRTD is authorised to determine the reasonableness of the compensation
and may disallow or limit the deduction if found unreasonable.

For purposes of deduction, salaries are deemed implicitly paid when they are credited
to the account of, or are separated for the benefit of an employee, such that he or she may
withdraw and collect them at any time, even if he or she does not take possession of the funds.

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### Other special rules

Premium payments made by an employer for group or collective life insurance policies, covering the lives of its employees, are exempt from Puerto Rico income taxes for an amount of up to US$50,000 in coverage. Premiums in excess of the maximum US$50,000 coverage allowed are taxable to the employee in the taxable year in which the premiums are paid.\(^7\)

Premiums paid as part of a life insurance policy covering the life of an employee or officer, or any other person with financial interests in the taxpayer's business, cannot be deducted when the taxpayer is the beneficiary of the policy.

In addition, employer contributions to a health or accident plan for the benefit of its employees are tax-exempt for Puerto Rico income tax purposes.

### III TAX PLANNING AND OTHER CONSIDERATIONS

In 2012, the Puerto Rico government approved two acts as part of its efforts to attract foreign investors to Puerto Rico: Act No. 20 of 17 January 2012, as amended (Act 20) and Act 22 of 17 January 2012, as amended (Act 22). Many executives have shown interest in these Acts due to the attractive tax incentives package both acts offer. In summary, Act 22 grants a Puerto Rico income tax exemption on dividends and interest from all sources, and on capital gains derived from the appreciation of securities after commencement of Puerto Rico residency (certain requirements apply). Entities with Act 20 tax grants are subject to a fixed 4 per cent Puerto Rico income tax rate, 100 per cent Puerto Rico income tax exemption on dividends and partial exemption on real and personal property tax and municipal gross receipts tax.

Although these Acts have no specific provisions related to executive compensation, on 15 October 2015, the PRTD issued Administrative Determination No. 15-22 regarding salary imputation rules to shareholders or partners who are also employees of an entity with an Act 20 tax grant (the Officer-Owner). Pursuant to Section 1040.09 of the PR Code, the Secretary of the PRTD may impute compensation income to certain taxpayers when adequate to prevent tax evasion or to clearly reflect the income of a business. In cases where the Officer-Owner has an annual salary that is less than US$350,000 for services rendered to the Act 20 entity in which the Officer-Owner has a proprietary interest at the end of the taxable year, the Secretary may assess the reasonableness of that salary and impute additional income up to US$350,000, if appropriate. Income imputation depends on the facts and circumstances in each case and the Secretary of the PRTD may consider the economic status of the Act 20 entity, the Officer-Owner's job responsibilities, and salaries earned by executives in similar positions.

### IV EMPLOYMENT LAW

As Puerto Rico is subject to US federal law, in order to qualify as an executive, an employee must meet the requirements of the Fair Labour Standards Act. That is, the employee must earn a minimum salary of US$455 per week, or US$23,660 per year. The employee's

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\(^7\) See Section 1031.02(a)(2) of the PR Code.
compensation must not be subject to reduction because of variations on the quality or quantity of work performed. In addition, to qualify as an executive, all of the following requirements must be met:

- the employee's primary duty must relate to managing the business or one of its recognised departments or subdivisions;
- the employee must customarily and regularly direct the work of at least two full-time employees (or their equivalent in part-time employees); and
- the employee must have the authority to hire or fire employees, or the employee's recommendations as to hiring, firing, promotion or demotion must carry particular weight.

If an employee qualifies as an executive, as in most US jurisdictions, in Puerto Rico, the terms and conditions of compensation are typically governed by contractual agreement between the employer and the employee, rather than being statutorily established, as in the case of rank-and-file employees. Parties may negotiate a broad variety of compensation and benefits, such as, for example, stock options, incentive plans, tax equalisation, other deferred compensation and bonuses.

**i Non-competition and non-solicitation agreements**

At an executive level, covenants not to compete are not unusual. They are enforceable in Puerto Rico, under general freedom of contract principles, as long as they comply with certain requirements.

Non-competition agreements may not be against public policy. According to case law established by the Puerto Rico Supreme Court, for a covenant not to compete to be valid in this jurisdiction it must be made in writing, in exchange for adequate consideration, and must not impose an undue burden on the employee. The non-competition clause must be tailored to the employer's legitimate need to protect its business in terms of duration, geographical limitation and clients affected.8

The clause must be limited to the geographical area, clients, and type of service strictly necessary to protect the employer's interests. In addition, a non-competition agreement must not exceed 12 months, although longer periods have been found valid for shareholders and consultants.9 The more parity that exists between the parties negotiating the agreement, the more likely it is that its terms will be upheld. As to the requirement that adequate consideration be provided, if the non-competition clause is part of the original employment agreement, no independent consideration is required. However, if the non-competition clause is required after the individual has become employed, independent consideration must be provided. What constitutes ‘adequate’ consideration varies by industry, position, and by the employee’s overall compensation package.

Under general freedom of contract principles, provisions for non-solicitation of employees may be enforceable. These provisions are generally included in non-competition agreements, separation agreements and settlement agreements. However, the Puerto Rico Constitution and case law of the Puerto Rico Supreme Court provide for the right of every employee.

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employee to choose and resign freely from his or her employment. Thus, in the absence of a valid agreement to the contrary, or an employment contract for a fixed period of time, any employee is free to resign and work for any other employer, including a competitor.

Similarly, under general freedom of contract principles, non-solicitation of customer provisions may be valid. These provisions are generally included in non-competition agreements, separation agreements and settlement agreements.

ii Termination of executive employees

Contractual agreements for executive employees typically include clauses that set forth the terms and conditions governing their separation from employment. Many agreements include a severance benefit based on the employee’s total compensation.

It must be noted that Puerto Rico is presently a ‘for-cause’ jurisdiction, meaning that if a court concludes that an employee was terminated without just cause, he or she is entitled to statutory severance. Act No. 80, as amended, establishes a seniority-based formula to calculate statutory severance, which is currently capped at a maximum of nine months’ salary for all employees hired after 26 January 2017. Employees hired before 26 January 2017 may use the prior, more favourable formula, which does not include a monetary cap. Although claims under Act No. 80 cannot be prospectively waived at the beginning of an employment relationship, they can be addressed and settled in the context of a termination agreement.

‘Just cause’ under Act No. 80 has been defined as:

a. that the employee commits a pattern of improper or disorderly conduct;

b. that the employee commits a pattern of deficient, inefficient, unsatisfactory, poor, tardy or negligent performance;

c. repeated violation of the reasonable rules and policies established by the employer for the operation of the business, so long as those rules and policies have been timely provided to the employee in writing;

d. total, temporary or partial closing of the employer’s operations;

e. technological changes to the organisation, reorganisation or restructuring, as well as changes related to the style, design, or nature of the product that is produced or handled by the business, or the services rendered to the public; and

f. reductions in force made necessary due to a decrease in volume of production, sales or earnings, whether anticipated or prevailing at the time of the termination; as well as such those made with the purpose of increasing the competitiveness or productivity of the business.

Of course, this definition of just cause is not intended to be taxative, and the Puerto Rico Supreme Court has clarified that the definition of ‘just cause’ extends to any reason related to the good and normal operation of the business, and not to the whims of the employer. Act No. 80 also contemplates constructive discharge. In this scenario, the employee must establish that he or she had no other reasonable alternative but to resign from his or her position due to arbitrary and capricious conduct by the employer designed to force the resignation.

The elimination of Act No. 80 is currently a topic being actively discussed in the context of the negotiations between the government of the Commonwealth of Puerto Rico and the

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10 29 LPRA 185a, et seq.
11 29 LPRA 185a, as amended.
12 29 LPRA 185b, as amended.
Puerto Rico

Fiscal Control Board established by the Puerto Rico Oversight, Management, and Economic Stability Act (PROMESA). The Fiscal Oversight Board has strongly advocated for doing away with Act No. 80 and making Puerto Rico an ‘at-will’ jurisdiction, arguing that will incentivise hiring and, consequently, stimulate the economy. This position has been met with strong resistance from local congress, which has now voted against repealing the statute twice.

iii Applicability of Puerto Rico employment laws to executive employees

In addition to being covered by Act No. 80, discussed above, executive employees in Puerto Rico receive a statutorily established Christmas bonus of a maximum of US$600.13 The employer is free to establish, through company policy, bonuses over that amount. Likewise, bonuses exceeding that amount may be contractually negotiated. Any bonus paid by the employer will be credited towards the statutory amount required.

Executives in Puerto Rico are also statutorily entitled to maternity leave and legally established breaks for breastfeeding or the expressing of breast milk.14 Under Puerto Rico law, any woman who gives birth or adopts a child under the age of five is entitled to eight weeks of paid leave, with employment secured. Furthermore, breastfeeding mothers are entitled to two 30-minute breaks to breastfeed their child or express breast milk.

Likewise, executive employees are covered by Puerto Rico’s Short-Term Non-Occupational Disability statute. This statute provides nominal monetary compensation of US$133 per week for non-occupational short-term disability for a period of 26 weeks, and employment reservation of one year.15 Long-term disability benefits are only available by company policy or contractual agreement.

Unlike hourly employees, executive employees in Puerto Rico are not statutorily entitled to vacation and sick leave. Vacation and sick leave benefits for executives may be established by company policy, or in the employment agreement. Once these benefits have been recognised by the employer, they must be honoured.16

In addition to the above, executive employees are also protected from discrimination and retaliation in the workplace under local law, in the same manner as non-exempt personnel. It is worthwhile to note that, while federal employment discrimination statutes exclude the possibility of individual liability for supervisors for discriminatory actions or workplace harassment, under Puerto Rico law, direct action against supervisors is expressly permitted. Accordingly, executive employees may be held personally liable for intentional discrimination, harassment or retaliation.

Further, on 8 March 2017, Puerto Rico enacted legislation that specifically prohibits employers from enquiring about an employment candidate’s salary history, including salary, benefits, perquisites and any other form or remuneration, or combination thereof.17 The law entered into force immediately after its enactment, though employers were granted a one-year grace period to enter into full compliance with its provisions. Presently, employers are expected to be fully compliant.

13 Act No. 148 of 30 June 1969, 29 LPRA 501 et seq.
14 Act No. 3 of 13 May 1947, 29 LPRA 467 et seq. and Act No. 427 of 16 December 2000, 29 LPRA 478 et seq.
15 Act No. 139 of 26 June 1968, 11 LPRA 201 et seq.
17 Act No. 16 of 8 March 2017, 29 LPRA 251, et seq.
V SECURITY LAW

Any aspects of executive remuneration in Puerto Rico pertaining to Securities Law are governed by US federal law. Therefore, regulation of these matters is identical to that of the United States.

VI DISCLOSURE

Disclosure of executive remuneration for Puerto Rico public companies is regulated by US federal law. As to privately held corporations, under Puerto Rico law, disclosure is limited to the filing of an annual report with the Puerto Rico Department of State, which must include a balance sheet. In the case of corporations with an annual business volume in excess of US$3 million, the annual report must include an audited balance sheet. Any disclosure to regulatory entities would be dependent on a particular corporation’s operations and the laws and regulations that apply to the same.

Under Puerto Rico law, there is no obligation to disclose the remuneration of corporate directors or executives.

VII CORPORATE GOVERNANCE

As with matters pertaining to Securities Law or Corporate Disclosure, corporate governance of Puerto Rico public corporations is subject to US federal law. At a local level, Puerto Rico has not adopted a corporate governance code applicable to privately held corporations. Accordingly, it is up to each company to establish such corporate governance codes or by-laws as it deems appropriate for its operation.

VIII SPECIALISED REGULATORY REGIMES

As is the case in the United States, certain industries in Puerto Rico, such as the finance industry, are subject to special federal regulation in the area of executive remuneration. Compliance with regulatory entities would be dependent on a particular corporation’s operations and the laws and regulations that apply to the same.

IX DEVELOPMENTS AND CONCLUSIONS

Matters relating to executive remuneration in Puerto Rico are certain to evolve as the Fiscal Control Board continues to enact measures under PROMESA to reshape the financial and, by consequence, employment landscape of Puerto Rico. Broad changes are anticipated both to the local tax code and employment legislation. In the employment context, the tendency seems to be towards a general liberalisation of the employer–employee relationship, thereby allowing the parties to contractually agree to such terms as they see fit. However, given the resistance of the government of the Commonwealth of Puerto Rico to enact some of the proposed changes, the outcome remains to be seen.

I INTRODUCTION

Russian law does not provide for specific regulation of executive remuneration in the form of equity plans, and until recently, there were no special regulations related to cash remuneration. Recently, the legislator introduced special rules regulating the remuneration of executives in companies where the state has a stake (certain limits on payments in the case of termination of employment, etc.). The only non-state economic sectors for which some rules on remuneration have been introduced so far are the banking sector (on 1 January 2014, the Central Bank of Russia implemented regulations on remuneration in credit organisations that set certain requirements for the remuneration of risk-takers in credit organisations) and financial industry (non-state pension funds, insurance companies, certain securities markets participants – since 14 July 2016); mainly they follow the principles of EU Capital Requirements Directive IV in this respect.

II TAXATION

i Income tax for employees

Generally, Russia taxes the worldwide income of its tax residents and Russian-sourced income of non-residents.

In accordance with the provisions of the Tax Code of Russia (the Tax Code), the Russian tax resident is an individual who spends at least 183 calendar days within 12 consecutive months on Russian territory. All days when an individual stays in Russia (including days of arrival and departure in case of travelling) are taken into account while calculating the number of days for tax residency purposes. It is important that days spent travelling outside Russia for short-term treatment or study (less than six months) are also counted as spent in Russia.

The final tax status of an individual is determined for the tax period (which is the calendar year from 1 January to 31 December).

Individuals considered as Russian tax residents are obliged to pay personal income tax on their worldwide income received (salaries or other remunerations, dividends, sale of property, capital gain, etc.). The general personal income tax rate is 13 per cent. However, the 35 per cent tax rate applies to the certain types of income received by the Russian tax...
residents, such as interest on bank deposits exceeding certain limits; prizes and winnings received within promotional campaigns where the relevant income exceeds 4,000 roubles; and certain others.

Non-resident individuals pay personal income tax at the 30 per cent rate on all Russian-sourced income except for dividends from Russian companies, which are taxed at the 15 per cent rate. Income received from the sources located outside the territory of Russia is not taxable for non-residents. There are certain exceptional cases when a non-tax resident pays the personal income tax at the 13 per cent rate. Foreign nationals who have the status of highly qualified specialist pay 13 per cent personal tax on the employment remuneration irrespective of their actual tax status.

Tax legislation in Russia does not specifically regulate the taxation of the compensatory payments to executives. In the meantime, the Tax Code includes a list of specific compensatory payments that may be exempted from taxation, for example, dismissal payments, compensation for damage caused by injury or other impairment of health and some others.

Those compensatory payments that are not included into the above-mentioned list are taxed under general rules.

If an incentive programme assumes the establishment of a special structure, the employee may be subject to additional reporting obligations.

For example, if the executive, being a Russian tax resident, becomes a participant in a fund, trust or partnership, the individual may fall under the controlled foreign company regulation.

In such a case, the executive employee will have extra requirements on disclosure of information, regular reporting on the structure and tax payment on income received by the structure in an appropriate part that belongs to the individual. The legal qualification of such special arrangements may differ and should be specially analysed in each particular case.

As a rule, personal tax obligation arises once an employee receives cash or in-kind income. Thus, receipt of cash on a bank account or delivery of shares, which lead to the receipt of the actual benefit, may be taxable events from the Russian perspective. Generally, there are no personal income tax implications in connection with deferral of the remuneration.

In the case the shares are granted free of charge or purchased by an employee at a price below fair market value, the employee obtains a taxable benefit. The taxable income is the difference between the fair market value of the securities and their actual purchase price.

Owing to the specifics of the Russian law there is a risk that share options may be classified as non-traded financial instruments that, in turn, may lead to double taxation of an employee (1) at the moment when the employee is granted a share option, and (2) when the option is exercised. Although there were no public negative cases and most incentive schemes are unlikely to be classified as non-traded financial instruments, which are subject to tax at grant, monitoring the practice and regularly assessing possible obligation to pay personal income tax at grant of an award is recommended. Eligible employees may also apply for official clarification from the Russian Ministry of Finance in order to check the position of the fiscal authorities.
ii Social taxes for employees

In Russia, social contributions are the sole obligation of employers and they should not be withheld from the remuneration of an employee. Obligatory social contributions are paid on most remuneration and benefits paid to an employee except for certain types of payments, such as dismissal payments, compensation of business trips expenses, voluntarily insurance contributions (if the insurance contract term is more than one year) and some others.

Since 2018, an employer is obliged to pay social contributions in the following schemes:

a) Pension fund contribution of 22 per cent is payable on the annual income of an employee up to 1,021,000 roubles and 10 per cent above the threshold;

b) Social insurance fund contribution of 2.9 per cent is payable on the annual income of an employee up to 815,000 roubles. For foreigners and stateless persons (except for highly qualified specialists) this rate is 1.8 per cent within the threshold; and

c) Medical insurance fund contribution of 5.1 per cent is paid on all remuneration without any thresholds.

The thresholds are subject to annual revision taking into account the growth of the average remuneration in Russia.

Besides the obligatory social contributions, employers are also obliged to pay accident insurance contributions. The applicable rate varies from 0.2 per cent up to 8.5 per cent and depends on the degree of professional risk that the employer’s activity entails.

iii Tax deductibility for employers

In accordance with the provisions of the Russian Tax Code, remuneration of employees (both monetary or in-kind) is tax deductible for the employer, regardless of whether the employee is an executive or rank-and-file worker.

The Tax Code requires that the expenses be documented in a proper way (including the condition that payment of a remuneration or benefit should be made on the basis of an employment or collective agreement) and incurred for business purposes of the company. As a rule, expenses on employees’ remuneration and incentives are deductible on an accrual basis.

It might be important for deduction purposes that incentives are paid in connection with the employee’s professional results and achievements. Otherwise, if incentives are paid to an employee, for example, as a birthday present, expenses will not be deductible.

Obligatory social security and accident insurance contributions are also deductible for profit tax purposes. Besides that, any employer can insure employees’ health and life voluntarily.

In this case, there is no difference between executives and other employees. Payments for such insurance may be deducted for profit tax purposes if the voluntarily insurance contracts are concluded:

a) for a period of not less than five years;

b) with the Russian insurance companies having a licence for the relevant activity; and

c) during these five years, such contracts do not provide for insurance benefits, including those in the form of rents and (or) annuities, with the exception of insurance payments in case of death and (or) harm to the health of the insured person.

Otherwise, if any of these criteria is not met, the insurance costs cannot be deducted.
iv Other special rules

There are no special rules on taxation of the executives or other employees with respect to the change of control in the company or reincorporation in low-tax jurisdictions.

It should be noted that any in-kind benefit of an employee should not exceed 20 per cent of the gross monthly salary (including shares). Otherwise, the employer may be subject to an administrative liability in a form of fine. Moreover, this may result in difficulties in the deduction of relevant expenses.

Remuneration paid to the members of a board of directors is generally non-deductible and is not subject to social security contributions. This remuneration should be paid upon a decision of the general shareholders’ meeting.

If the company has an employment or civil contract with a member of the board of directors (taking into consideration, that obligations under this contract are not the same as director’s functions), the remuneration may be deductible. Moreover, social security contributions are to be paid.

The other important issue connected with a director’s remuneration is that most double taxation treaties contain a clause on directors’ fees. This clause generally states that a director’s fees may be taxable in the country where the company paying the fee is registered and considered a tax resident, with no respect to the tax residency of the director.

III TAX PLANNING AND OTHER CONSIDERATIONS

Russian legislation does not provide for special favourable tax treatment for executives. However, there is a general possibility that may be used for the reduction of the employer’s tax burden in respect of the employee, being the foreign national.

Thus, Russian legislation provides a special regime for highly qualified foreign specialists (HQS) working in Russia.

HQSs are foreign citizens with experience, skills or achievements in a particular field of activity, invited to work in Russia and whose remuneration is:

a not less than 83,500 roubles for one calendar month – for highly skilled professionals who are scientists or teachers, as well as for highly qualified professionals involved in the work by residents of industrial production, tourism and recreation, special economic zones and some others;

b not less than 58,500 roubles for one calendar month – for foreign nationals involved in the work by residents of a technology-innovative special economic zone;

c at a rate of not less than 1 million roubles for one year (365 days) – for highly qualified specialists, that is, medical, teaching or research workers, in the case of an invitation to engage in the corresponding activity in the territory of the international medical cluster;

d without any requirements for the size of salary – for foreign nationals participating in the ‘Skolkovo’ project;

e at a rate of not less than 83,500 roubles for one calendar month – for foreign nationals involved or employed within legal entities engaged in activities on the territory of the Republic of Crimea and Sevastopol; and

f not less than 167,000 roubles for one calendar month – for other foreign nationals.
Those employees who are treated as HQS shall be taxed at 13 per cent rate of the personal income tax regardless of the tax residency status. However, it should be noted that the 13 per cent rate applies only to employment remunerations; all other income (including, sale of personal property, etc.) shall be taxed based on the tax residency status.

The other issue that should be taken into account is that the Russian law on currency regulation and currency control sets a number of limitations. These limitations apply to currency residents (Russian nationals or foreign nationals who reside in Russia on the basis of a residence permit).

Generally, currency transactions are forbidden between currency residents. Moreover, currency limitations should be noted when an employer grants an employee shares. Frequently, this may lead to the necessity to open an account in a foreign bank for the purposes of holding shares and receipt of income (i.e., dividends and other proceeds).

Once the foreign bank account is opened, the currency resident is obliged to notify the Russian tax authorities of the bank account (particularly, on opening, closing, changes of any bank account details), to report annually on cash transactions via the account and to perform the transactions that are allowed by Russian legislation. For example, a currency resident may receive dividends on non-Russian shares, but credit proceeds from the sale of securities that are not listed on the Russian or certain foreign exchanges (included in the list of the foreign exchanges mentioned in Point 4 Article 27 of Federal Law No. 39-FZ ‘On Securities Market’) to a foreign bank account of the currency resident are prohibited. Violation of the prescribed rules may result in a fine of 75 to 100 per cent of the amount of the illegal currency transaction.

IV EMPLOYMENT LAW

Non-competition covenants in employment relations are restricted. A ground for this lies in the provisions of the Russian Constitution and Labour Code, which declare freedom of labour, including freedom to choose work and profession as one of the fundamental principles of regulation of labour relations and other relations directly related to them. Therefore, a Russian court will most likely not enforce the non-competition covenants in employment relations. However, court practice in relation to non-competition covenants has not yet been developed.

It is not widespread practice to include non-solicitation provisions in employment contracts. However, some employers, especially subsidiaries of international companies, tend to include such provisions. We believe that such provisions can be enforceable depending on their actual contents and scope as well as circumstances of a particular case, at least partly. However, court practice on this issue has not yet developed, so it is difficult to predict whether the court will uphold its enforceability. Restrictions in the Russian labour law will significantly limit what a party will be able to claim in connection with a breach of the non-solicitation obligation.

Release of claims is not enforceable under Russian labour law. It will most likely be treated as a restriction of the legal capacity of a person granting a release of claims. Even if an employee voluntarily releases its employer from the claims, the release will not be enforceable.

Employment relations can be terminated only on the grounds specifically set out by law. Russian labour law does not provide for such grounds of termination of employment as involuntary termination ‘for good cause’, ‘constructive termination’ or voluntary termination for ‘good reason’.
An employment contract can be terminated at any time by agreement of the parties. Also, an employee may terminate the employment contract by his or her initiative by giving a respective notice. An employer may terminate an employment contract at its initiative on the following grounds set out by the Labour Code:

- liquidation of the company;
- staff redundancy (reduction of the number of employees);
- unsuitability of the employee for the position or work because of insufficient qualification (to be confirmed by attestation);
- repeated breach of job duties;
- single gross breach of employment duties, namely, unjustified absence from work during the whole working day or shift or more than four hours during a working day, unauthorised disclosure of commercial, state secret or other secret protected by law including personal data of other employees, showing up to work intoxicated, committing theft, misappropriation of funds, intentional destruction or damage to the property confirmed by decision of a court or another competent state body, breach of health and safety rules if it led to major consequences (industrial accident, catastrophe);
- committing faulty actions by an employee responsible for dealing with monetary or commodity valuables, if this gives grounds for a loss of trust in the employee; and
- presentation of false documents to an employer when entering into the employment contract.

Apart from the above, the law sets special grounds for termination of employment, with the CEO and some other senior managers at the initiative of the employer, namely:

- change of the owner of the employer’s assets. This termination ground applies only to CEOs, their deputies and chief accountant (this is a special ground different from the change in control, which it usually does not cover; it applies, for example, in the case of privatisation of a state-owned enterprise);
- taking an ungrounded decision by the CEO, head of a branch or representative office, their deputies or chief accountant that resulted in making the employer’s property unsafe, unauthorised use or other damage to the employer’s property;
- a single gross breach of job duties by the CEO, head of a branch or representative office or their deputies;
- dismissal of the CEO of the company in accordance with insolvency laws;
- termination of employment with the CEO of the company on the ground of a decision of company’s authorised body; and
- dismissal of the CEO, members of the collegial managing body (management board) on other grounds provided by their employment contracts.

The Labour Code provides for payment of severance in a limited number of cases, for example, in the case of liquidation of the company or staff redundancy, in the amount of a monthly or fortnightly average earnings. However, in addition, in the cases mentioned the employer is obliged to pay yet another monthly average earnings amount if an employee remains unemployed for two months after dismissal and in some cases one more monthly average salary.

If an employment contract with the CEO of the company is terminated by a decision of the authorised body (shareholders’ meeting or board of directors) before expiry of its term, the employer should pay to the CEO a compensation, which cannot be less than three
average monthly earnings of the CEO. The employment contract with the CEO can provide for higher compensation in case of such termination. Such compensation is payable in the absence of guilty acts or omissions of the CEO.

There are no specific rules in relation to severance upon a transfer of employment in connection with a corporate transaction. If a transfer of employment occurs, severance will be paid if applicable, according to the general rules.

V SECURITIES LAW

Russian securities law does not provide for special regulation of employee equity plans or any exemptions for such programmes from the general rules. Thus, where the law requires registration of securities and prospectus, this rule will apply to implementation of employee equity plans. Therefore, application of some programmes may require registration depending on the terms of the programmes. Generally, the following programmes can be used: offering of new securities of Russian companies in Russia, offering of existing securities of Russian companies and foreign securities distribution.

Registration with the Central Bank of Russia (CBR) is required in case of issuance or offering of a Russian company’s new securities to employees.

There are two ways to offer new securities, namely to offer new shares by subscription or issuer’s options. The second approach involves the conversion of options into shares at a certain later date. For both shares and issuer’s options, issuance and distribution procedures are similar. Because employee equity programmes usually imply an offer of shares to a limited predefined group of offerees, they would normally not require registration of a prospectus where the number of offerees falls within the prospectus exemption criteria.

An issuer’s option is a book-entry serial registered security in accordance with the Federal Law on the Securities Market. In compliance with Russian rules governing placement of securities convertible into shares, placement of such securities requires a special procedure of registration.

Securities laws set out certain specific rules for issuing options; of these, the most important are that the number of shares of a certain category (type) that can be acquired through options may not exceed 5 per cent of the number of shares of such type placed as of the date of the filing of documents for the state registration of the options issue; and the decision on the issuance of options may provide for restrictions on their circulation.

The transfer of existing shares in connection with employee benefit programmes should be exempt from registration requirements. For this reason, use of existing shares may be chosen by the company to apply the programme. In order to implement this method, the company buys its own shares from shareholders or the market to distribute them. It is important that the company may not hold these shares for more than a year; after the expiry of the one-year period, shares must be sold or redeemed. In certain cases, pre-emptive rights may arise (depending on the type of company, etc.).

An employee stock ownership fund that is based on the use of the company’s net profit can be established. This fund accumulates sold shares for their further distribution among employees. If employees pay for such shares, all the money received should be used to replenish the fund.

Under Russian securities market legislation, offering of foreign shares to the Russian employees and acquisition of such shares by them may be considered a type of placement or circulation of foreign shares in Russia. Russian legislation permits circulation of such
shares only in a limited number of situations, which may require registration of foreign securities with a Russian stock exchange or the CBR, admittance to circulation in a Russian market, qualification of foreign financial instruments as securities in accordance with the requirements of the Russian law, specific qualification of a buyer as a qualified investor, etc. Usually, employee equity programmes do not imply public circulation of foreign shares. However, even non-public circulation is subject to some requirements set by securities laws mentioned above. Regulations of the Federal Financial Markets Service (the former regulator of financial markets) introduced certain rules regulating acquisition of foreign financial instruments by Russian employees, but they do not exclude certain general requirements to private circulation of foreign shares. Therefore, employers should consider the possible negative consequences of offering foreign securities to Russian employees.

Generally, there are no specific rules governing company stock selling by executives. However, executives can be subject to insider trading rules if they qualify as insiders. The rules on insider trading may pose some restrictions, for example, to trade in a company’s stock. In some cases, they will be able to trade if they comply with the notification or consent procedure. Liability for non-compliance with the rules on insider trading may differ from simple consequences such as void transaction, damages to injured persons to administrative or criminal liability. However, there are no anti-hedging or similar rules.

Furthermore, companies may set their own particular rules and procedures. The inner rules usually follow the legislation of relevant countries and practice of its application.

The other important requirements relate to reporting and apply to executives holding or trading in company stock. Generally, they are based on the rules of disclosure of information by the issuers of securities, public companies and their executives.

VI DISCLOSURE

The state requirements on disclosure of information apply to legal entities that publicly issue securities and are required to disclose the information on compensation of executives. Besides that, legal entities related to the state and receiving state support such as state corporations, federal state unitary enterprises and public joint-stock companies in which the state is the major shareholder are also required to disclose additional information on compensation of executives in the explanatory notes to their accounting statements.

Disclosure of information is carried out in the following forms:

a material fact statement;
b quarterly and annual report;
c securities prospectus; and
d annual and semi-annual consolidated financial statement.

Public joint-stock companies (i.e., ones that issue publicly shares and other securities convertible into shares) are obliged to disclose information on compensation of executives, including but not limited to their annual reports, securities prospectus and material fact statement.

Non-public joint-stock companies (i.e., ones that cannot issue shares and other securities convertible into shares publicly), if the number of their shareholders exceeded 50 shareholders, or non-public joint stock companies that publicly issue securities are also required to disclose information on compensation of executives (e.g., in annual reports).
All the information that requires disclosure is disclosed in the forms prescribed for disclosure of such information. The form of disclosure of information also determines the timing.

i  Material fact statements

Information to be disclosed in material fact statement

A material fact statement should outline information on changes in percentage of held shares in the charter capital of the issuer or its controlled entities (if such entities are material to the issuer) of the following persons:

- members of the board of directors;
- members of the collective executive body (the management board);
- the sole executive body (the CEO); or
- members of the board of directors, members of the collective executive body, the CEO of the management company (if applicable).

Material fact statement disclosure timing

The information disclosed in material fact statements should be published in a newswire service – not later than one day after; and on the company's website – not more than two days later. The terms are calculated from the date of occurrence.

The text of the material fact statement should be available on the company’s website for not less than 12 months from the date on which the term for its publication expired, and in the event it was not published within that term, from the date of publication,

ii  Quarterly reports and prospectuses

Information to be disclosed in quarterly reports and prospectuses

Quarterly reports and prospectuses should disclose information on:

- persons serving in the management bodies of the company, and in particular their share (ordinary shares) in the charter capital of the issuer and the number of shares that can be acquired by such a person after the exercise of issuer options. This rule also applies to the issuer’s dependent companies and subsidiaries; and
- each governing body, including all types of remuneration (base salary, bonuses, commitment fees, benefits and compensation of expenditures); remuneration payments made separately for participation in the work of the relevant management body; and other types of remuneration already paid in the course of the respective period, including information on approved decisions or actual agreements with respect to such payments in the current financial year. Regulation related to CEOs may differ from the general. There is no requirement to provide information on the remuneration of the individual holding the office of CEO in a prospectus and quarterly report.

Confidentiality agreements cannot contain a clause preventing the above-mentioned information from disclosure. The only possible exception from this rule is information on the CEO’s remuneration, which can be excluded from disclosure in a quarterly report or a prospectus.
**Disclosure timing for quarterly report**

The quarterly report shall be published by the issuer within 45 days of the end of the respective quarter.

The quarterly report should be available on the issuer’s website for not less than five years from the date when the term for its publication expired, and in the event that it was not published within 45 days of the end of the respective quarter, from the date of its publication.

**Disclosure timing for prospectus**

The issuer shall publish the prospectus on the website before the date of the beginning of share placement.

The text of the registered prospectus should be available on the website from the date when the term for its publication expired, and for not less than five years from the date of publication on the website of the text of registered report on the results of share issue.

In case the prospectus was registered after state registration by the CBR of the report on share issue (additional share issue) results or submission to the CBR of notification of share issue (additional share issue) results, a statement on prospectus registration should be made by way of its publication in a newswire service – not later than one day, and on the company’s website – not later than two days from the date of publication of information on the registration of the prospectus on the website of the CBR, or the date of receipt of the CBR written notification on the registration of the prospectus, whichever date is the earlier.

**iii  Consolidated financial statement**

**Information to be disclosed in the consolidated financial statement**

International Financial Reporting Standards regulate the content of the consolidated financial statement.

**Consolidated financial statements disclosure timing**

The issuer shall publish its semi-annual consolidated financial statement within three days of its drawing up, but in any case within 60 days of the end of the second quarter, and an annual consolidated financial statement within three days of the drawing up of the auditor’s report, but in any case within 120 days of the end of the relevant year.

**iv  Annual report**

**Information to be disclosed in the annual report**

An annual report should contain information on the CEO, members of the management board and members of the board of directors, including, but not limited to the number of their participatory shares in the charter capital of the issuer. In the event that transactions on the acquisition or disposal of shares belonging to said persons within the reporting year have been concluded, the annual report should also contain information on such transactions (date, contents, category and the amount of shares transferred).

The annual report should also include criteria of determination of the amount of remuneration or compensation of expenditures and information on each governing body, including all types of remuneration (base salary, bonuses, commitment fees, benefits and compensation of expenditures); remuneration payments made separately for participation in the work of the relevant management body; and other types of remuneration already
paid in the course of the respective period. Regulation related to CEOs may differ from
the general. There is no requirement to provide information on the remuneration of the
individual holding the office of CEO in an annual report.

**Disclosure timing for the annual report**

The annual report shall be published within two days of drawing up minutes of the annual
general meeting of shareholders or meeting of the board of directors on approval of the
annual report.

The text of the annual report should be available on the website for not less than three
years from the date when the term of its publication expired, and in the event that it was not
published within that term, from the date of its publication.

Information in the form of an annual report, a prospectus, a quarterly report or a
material fact statement should be disclosed on a group basis with respect to each governing
body. This obligation applies to the board of directors, the management board and the CEO
(the sole governing body).

Regulations on disclosure do not set a materiality threshold for executive compensations
or require specific disclosure of perquisites at the moment.

Quarterly reports and prospectuses should disclose information on actual agreements
with respect to payments made during the current financial year. However, the CBR has
issued no clarification as to how and in what form this information is to be disclosed, and
as a matter of practice, companies disclose only the fact of the existence or absence of such
agreements, and not the agreements themselves.

**VII CORPORATE GOVERNANCE**

In Russia, only certain public companies are subject to some corporate governance
requirements to remuneration.

The rules are set by the CBR for companies whose securities are traded or intend to be
traded at the stock exchange.

One of the documents is the Code of Corporate Governance approved by the CBR
in 2014 (the Code), which sets out some recommendations in this respect. The Code is not
mandatory for Russian companies, but is recommended for joint-stock companies admitted
to trading at the stock exchange. In particular, the Code recommends forming a remuneration
committee consisting of independent directors that develops remuneration policy of the
company subject to approval by its board of directors. It further recommends implementing
a remuneration policy that sets forth transparent mechanisms of setting remuneration for
the executives, board members and other key employees and sets out types of payments.
The Code also recommends limiting compensation payments to executives and other key
employees in case the company terminates their employment at its initiative (the ‘golden
parachute’) with twice the annual fixed remuneration of the respective employee.

Russian law does not set specific rules allowing clawback or recoupment of remuneration
previously paid in the event of a financial restatement, misconduct, adverse change in business
or other circumstances, save for special regulations for certain officials or employees of credit
and some other organisations (see Section VIII for more details). The excess salary paid to an
employee can be recovered only if this was caused by a calculation fault or a court confirmed
an employee’s fault in his or her failure to perform work normatives or an excessive amount was paid because of the illegal actions of an employee (and this has been confirmed by a court).

The Federal Law on Joint Stock Companies and Federal Law on Limited Liability Companies require approval of payments to members of the board of directors, interested-party transactions and major transactions.

The law does not require the payment of any remuneration to members of boards of directors. A general meeting of shareholders or participants may decide on setting and paying any remuneration to members of the board of directors.

In the Information Letter of the Central Bank of Russia No. IN-015-28/41 on sources of remuneration payment to the members of the board of directors (supervisory council) of a joint-stock company, the CBR clarifies that the Federal Law on Joint-Stock Companies and the Code do not link the payment of remuneration to members of the board of directors (supervisory board) of the company with a company’s profit for the reporting year, allowing the general meeting of shareholders to decide on the payment of the said remuneration and in the absence of the company profit for the reporting year.

Existing court practice treats employment contracts with CEOs or relevant provisions of employment contracts setting their remuneration, including bonuses, other compensations, remuneration under incentive programmes as interested-party transactions and, where applicable, major transactions. Such transactions currently require prior corporate approval, as set out by law.

Starting from 1 January 2017, rules on approval of major transactions have been modified. Currently, major transactions include (1) transactions that provide for acquisition or disposal, or possibility of disposal of the property which value makes 25 per cent or more of the assets value of the company as per its latest balance sheet, and (2) transactions providing for the company’s obligation to grant temporary use of its property or grant a licence to use its IP objects, whose value makes 25 per cent or more the assets value of the company as per its latest balance sheet. Major transactions are subject to approval by general meetings of shareholders or participants if the value exceeds 50 per cent of the assets value of the company as per its latest balance sheet. Such transactions should be approved by three-quarters of the votes of shareholders holding voting shares who attend the general meeting. Major transactions subject to approval by the board of directors are major transactions whose value is more than 25 per cent and up to 50 per cent of the assets value of the company as per its latest balance sheet. Such transactions should be approved unanimously by all members of the board of directors. Transactions entered into in the course of the usual business of a company, transactions on placement (sale) of ordinary shares or issuable securities convertible into ordinary shares, transactions mandatory for a company by law, as well as a number of other transactions, are not subject to approval as major transactions. Starting from 1 January 2017, the requirement for approval of interested-party transactions has also been changed. According to the introduced amendments, interested-party transactions are transactions in which the CEO, member of a collegial managing body (management board), member of the board of directors (supervisory board), a controlling person or any person who is entitled to give binding instructions to the company, if such person (or such person’s spouse, parents, children, foster parents or children, siblings or controlled persons) is:

a a party to, beneficiary of, intermediary or representative in the transaction with the company;
b a controlling person in a company who is a party to, beneficiary of, intermediary or representative in the transaction with the company; or
c holds a position in management bodies of the company that is a party to, beneficiary of, intermediary or representative in the transaction with the company.

Persons indicated above should notify the company about the entities controlled by them and entities to whom they can give binding instructions, as well as about potential interested-party transactions, within two months of the date when they became or should have been aware of the facts that qualify them as interested persons.

The law no longer requires mandatory preliminary approval of interested-party transactions. Instead, companies are obliged to notify boards of directors or management boards of interested-party transactions before entering into them. Where all members of the board of directors are interested in a transaction or there is no board of directors in the company, such notification should be made to the shareholders or participants of the company. CEOs, members of the board of directors or management board, or shareholders or participants holding at least 1 per cent of voting shares are entitled to request prior approval of an interested-party transaction. In a non-public joint-stock company, such consent shall be granted by a majority of votes of non-interested members of the board of directors; if such directors do not make a quorum set by the company’s charter, the transaction shall be subject to approval by the general meeting of shareholders. In a public joint-stock company, such transaction shall be approved by the majority of non-interested directors who are not (and were not during one year preceding the decision):

a a CEO or a managing company of a company, member of its management board, a member of managing bodies of the managing company;
b a person whose spouse, parents, children, sisters, brothers or siblings are members of managing bodies of the management company or a manager of the company; or
c a person controlling the company or its managing company who performs a CEO’s functions or is entitled to give mandatory instructions to the company.

In a limited liability company, the interested-party transaction shall be approved by a majority of votes of non-interested members of the board of directors or a majority of general meeting of shareholders.

In a joint-stock company, an interested-party transaction is subject to approval by the majority of votes of non-interested shareholders in the following cases:

a if the cost of the property that is a subject of a transaction or series of related transactions is 10 per cent or more of the balance sheet assets value of the company on the last reporting date, except for transactions described in the following two paragraphs;
b if a transaction or series of related transactions are the sale of ordinary shares that are more than 2 per cent of ordinary shares previously placed by the company and ordinary shares into which previously placed issuance securities convertible into shares can be converted; and
c if a transaction or series of related transactions are the sale of preferred shares, that amount to more than 2 per cent of shares previously placed by the company and shares into which earlier placed issuance securities convertible into shares can be converted.
In a limited liability company, interested-party transaction is subject to approval by the majority of votes of non-interested shareholders if the transaction price or value of assets that are subject matter of the transaction is 10 per cent or more of the balance sheet assets value of the company on the last reporting date.

The charter (articles of association) of a limited liability company or a non-public joint-stock company may establish different procedure of approval of interested-party transactions or totally exclude a requirement for the approval of interested-party transactions.

Where an equity remuneration plan involves the issue of shares, such issue is subject to the requirements and procedures set out by the Federal Law on Securities Markets. These procedures include, inter alia, a general meeting of shareholders (or board of directors, if the charter of the company provides so) taking a decision on the placement of securities and approval of the decision on the issue of securities by the board of directors. The issue of securities is subject to registration with the market regulator (currently the CBR).

Government approvals are not required in respect of the executive remunerations of executives of companies where the state does not hold a stake. Certain restrictions are set for amounts of remuneration of executives of state-owned companies.

VIII SPECIALISED REGULATORY REGIMES

Generally, there are not many special regulations for the specific industries in terms of remuneration regulations (we do not discuss the rules and limitations applicable to executives of companies or enterprises with state ownership).

Special regulations are set for banks by the instruction of the CBR on the evaluation of the labour remuneration system in a credit organisation (the Instruction). The Instruction came into force on 1 January 2015.

The Instruction sets forth the criteria of evaluation of labour remuneration systems in credit organisations by the CBR (its Department of Surveillance of key system credit organisations).

In particular, the Instruction provides that remuneration of employees of credit organisations should be set depending on the risk level to which a credit organisation may be (or has been) exposed (as a result of employees’ actions), inter alia:

a for departments of a credit organisation that conducts transactions with risks calculation of the variable remuneration component is based on:

- quantity figures characterising these risks and planned profit for these transactions;
- the amount of its own funds that are sufficient to cover the risks taken; and
- the volume and price of loaned and other attracted funds sufficient to cover the risks taken;

b at least 40 per cent of the total target remuneration (before adjustment) of the risk-takers should be variable. Risk-takers are the members of the executive body and other employees taking the risks;

c internal policies of a credit organisation provide (and these policies are applied) in respect of the risk-takers:

- deferral and further adjustment of not less than 40 per cent of the variable component of a remuneration based on terms of receiving the financial results of a credit organisation activity (the deferral must be not less than three years).

Internal policies of a credit organisation must provide also a possibility to reduce
or to eliminate a variable part of a remuneration if the financial result of a credit organisation is negative in a general or in particular activity;

- combination of monetary and non-monetary form of labour payment that is sensitive to financial results of a credit organisation and to risks taken by a credit organisation (in case of absence of a non-monetary form of remuneration the employment contracts with risk-takers must provide for adjustment of a deferred part of remuneration based on the price of shares of a credit organisation); and

- the preceding paragraph is not applicable to a credit organisation established in the form of a limited liability company or a fair market price for shares of a credit organisation cannot be determined based on listed share prices.

Further, the Instruction requires that operations of compliance departments and risk management departments be organised in accordance with the Instruction and in particular, that fixed remuneration makes at least 50 per cent of the total remuneration of employees of compliance departments and risk management departments.

The Instruction establishes a board of directors (supervisory board) of a credit organisation as the corporate governance body responsible for the organisation, monitoring and control over labour remuneration system.

Also, the Instruction sets forth the obligation of a credit organisation to disclose information on the labour remuneration system on a regular basis but at least once per calendar year.

Special regulations are set for non-state pension fund, securities market participants, management companies and insurance organisations by the information letter of the CBR No. IN-06-54/53 of 14 July 2016 on recommendations on remuneration system organisation and disclosure of information of the labour remuneration system in above-mentioned organisations (the Information Letter).

The Information Letter recommends establishing a remuneration system in such organisations taking into account their risk management policies.

It is recommended to establish fixed remuneration and variable remuneration for the sole executive body, members of the collective executive body and other employees taking risks. In accordance with the Information Letter, a significant part (40 to 60 per cent) of risk-taking employees’ remuneration shall be variable. However, for employees undertaking activities on internal control, risk management, report preparation or valuation of assets or liabilities establishing a significant part (40 to 60 per cent) of remuneration as fixed remuneration is recommended.

The Information Letter also recommends determining the list of risk-takers.

The Information Letter provides that a board of directors (supervisory board) of the organisation or its general meeting of shareholders (or participants) shall:

- create a special committee (remuneration committee). The main duties of this committee shall be preparation of the management body’s decisions on remuneration system organisation;
- consider questions on the organisation, monitoring and control over the labour remuneration system;
- confirm (approve) and review the organisation’s policy on remuneration on a regular basis, but at least once per calendar year;
- organise work on conformity assessment of the remuneration system of the organisation’s business model, its strategy; and
confirm the amount of the organisation’s wage funds. It is important that payment of variable remuneration does not lead to the loss of financial sustainability.

The Information Letter also sets forth the obligation of the organisation to disclose information on the labour remuneration system on a regular basis, but at least once per calendar year.

The Information Letter is of a recommendatory nature and shall not be binding, because Central Bank’s information letters are not normative legal acts. However, it is strongly recommended following the provisions of the Information Letter for all relevant organisations.
I INTRODUCTION

Owing to the globalisation of the markets and the current economic situation, Spanish companies have undergone a major process of internationalisation, with increasing numbers of employees and executives having been posted abroad in recent years.

As a consequence of this internationalisation process, executive remuneration has been affected on certain legal and tax issues.

In this regard, the Spanish tax legislation has been including some regulations to (1) promote the mobility of employees and executives to foreign countries, and (2) attract talent to be located in Spain.

From a corporate governance point of view, the remuneration of directors and executives has recently increased public interest in both listed and unlisted companies. Institutional shareholders pay special attention to the remuneration policies of executives and directors, as they are considered a reliable indicator of good corporate governance of companies.

This attention has been manifested in recent years in the issuance of recommendations and codes of good practice of membership associations, and the use by the companies of advisers on corporate governance, ‘proxy advisers’ (i.e., ISS, Glass Lewis & Co., etc.) to define the position with regard to matters related to remuneration of members of the board of directors and executives.

The main objective of this chapter is to provide an overview of the Spanish tax and legal implications for directors’ and executives’ remuneration.

II TAXATION

i Income tax for employees and executives

Tax residence

Under Spanish Personal Income Tax Law2 (SPIT Law), an individual is tax resident in Spain if one of the following requirements is met:

a When the individual remains in Spain for more than 183 days in the calendar year. Sporadic absences are not considered unless the individual provides evidence that he or she is a tax resident of another country.

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1 Eduardo Gómez de Salazar is a partner and Ana Ortiz García is a senior associate at J&A Garrigues, SLP.
b When the individual’s place of activities or centre of economic interests is directly or indirectly located in Spain.

Additionally, SPIT Law establishes a rebuttable presumption whereby the individual is deemed to be tax resident in Spain where, pursuant to the foregoing test, his or her spouse (not legally separated) and minor children, who are dependants of the individual, habitually reside in Spain.

For the purposes of tax residence, it is important to note that Spanish legislation does not allow the tax year to be split. Consequently, if a person meets the test to be deemed resident or non-resident in Spain for tax purposes, he or she will maintain that status for the entire tax year, that is, from 1 January to 31 December.

In practice, and assuming that this is a controverted issue, the Spanish Tax Authority (STA) usually accepts, as evidence to prove the tax resident status in another country, the tax resident certificate issued by the local tax authority within the meaning of Article 4 of the Double Tax Treaty.

Residents’ taxation

Tax residents are subject to personal income tax (PIT) on their worldwide income, regardless of the residence of the payer and where the income has been obtained, according to a progressive scale between 19 and 45 per cent (the 45 per cent would be applicable for a tax base as from €60,000) in tax year 2018.3

Saving income (i.e. dividends, interest and capital gains) is subject to taxation in Spain according to a progressive scale between 19 and 23 per cent (the 23 per cent would be applicable for a tax base as from €50,000) in tax year 2018.

Non-residents’ taxation

Non-tax residents are subject in Spain to Non-Resident Income Tax4 (NRIT) only for the income deemed to be obtained or generated in Spain.

In this sense, employment income is deemed to be obtained or generated in Spain when it is derived, directly or indirectly, from an activity performed in the Spanish territory. The flat tax rate applicable for non-tax residents in Spain in 2018 is 24 per cent, or 19 per cent for tax residents in another European Union (EU) Member State or in the European Economic Area (EEA).

In particular, savings income obtained by non-resident taxpayers are taxed at a flat tax rate of 19 per cent.

ii Social taxes for employees

Under Spanish legislation, companies must pay social security contributions to cover the social benefits to which employees have a right within the framework of the social security

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3 Final taxation depends on the rates approved by the Autonomous Region where the taxpayer has his or her tax residence. For instance, in Madrid the marginal tax rate is 43.5 per cent for tax year 2018.

4 Legislative Royal Decree 5/2004, of 5 March, which approved the Amended Text of Non-Resident Income Tax Law.
The obligation to contribute arises at the beginning of employment and continues throughout, including the situations of temporary incapacity, maternity, paternity or risk during a pregnancy.

The contribution base for social security charges in Spain does not exactly correspond to the base for income tax purposes. As a general rule, any income would generally be subject to social security charges and there are some concepts that are not taxable but, conversely, are part of the contribution base.

The monthly base is capped at €3,803.70. The employee contribution is 6.35 per cent (i.e., €241.53 per month). The aggregated rate for the employer contribution depends on the type of contract and the type of activity but generally ranges between 31 and 34 per cent.

Employees’ social security contributions are tax deductible on personal income taxation.

### iii Tax deductibility for employers

Costs derived from the remuneration paid to employees and executives are deductible for the employer for Spanish corporate tax purposes as long as (1) the accounting expense borne by the employer is linked to an activity effectively performed in favour of the employer, (2) if applicable, the approval procedure settled by corporate legislation has been followed, and (3) that formal transfer pricing requirements should be fulfilled.

### iv Other special rules: exit tax

The SPIT Law includes an exit tax that subjects to taxation certain unrealised gains on equity and other financial assets as a consequence of the change in the tax residence status of a Spanish taxpayer, provided that the following requirements are met:

- The taxpayer should have maintained his or her tax residence status in Spain for at least 10 of the last 15 tax periods.
- The taxpayer must hold shares whose market value exceeds:
  - €4 million; or
  - €1 million if the taxpayer has more than 25 per cent of participation in the entity.

When the above conditions are met, the taxpayer must include in his or her PIT taxable base of the last tax residence period in Spain the positive difference between the market value of the shares and their acquisition cost.

In addition, two different regimes can be identified when the change of residence is made to the EU or the EEA or, in other cases, to a different state. In the first scenario the tax levy could be deferred for 10 years if certain conditions are met, including a formal claim from the individual. In contrast, and in the second scenario, the tax would be demanded immediately unless the taxpayer requests a deferment for a period of five years (extendable for an additional five years in cases of work reasons).

### v Reporting obligations

Tax residents in Spain are obliged to report to the STA, using tax Form 720, their assets, comprising bank accounts, financial assets (i.e., shares, investment funds, etc.) and real estate held outside Spain, if at 31 December of the first year of declaration the valuation of...

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5 Social Security base in force as from 1 August 2018 approved by the Spanish General Budget Law for 2018.
any of these groups of assets exceeds €50,000. In subsequent years, there would only be an obligation to submit Form 720 when there is an increase of €20,000 in the valuation of the different groups of assets or the cancellation of an asset previously reported.

This form has to be filed before the end of March every year (in respect of assets held on 31 December in the previous year).

III OTHER TAX CONSIDERATIONS

Spanish tax legislation provides specific rules regarding the taxation of the remuneration of employees and executives who are tax residents in Spain.

i Exemption for services rendered abroad
Executives with a labour relationship can benefit from an exemption on salary income received for work physically performed abroad, up to €60,100, as long as the recipient of the work performed abroad is a non-resident company in Spain or a permanent establishment located abroad, and the country where the work is performed has an identical or analogous tax to personal income tax and is not considered a tax haven.

The exemption is applicable on the proportional part of the salary corresponding to work days abroad and the specific remuneration received in relation to the services rendered abroad.

ii Expatriation bonus allowance
Executives assigned abroad under a labour contract may apply tax exemption on the excess of the total compensation that they would have received if they were working in Spain.

The expatriation bonus allowance and the exemption for services rendered abroad are not compatible; consequently, the executive may opt for applying one of them exclusively.

iii Per diems and assignment expenses exempt from taxation
There is an exemption on per diems and assignment expenses when the individual travels to a municipality other than the habitual workplace and residence of the taxpayer for a period of less than nine consecutive months.

The amounts exempt from taxation vary depending whether the municipality is in Spain or abroad and if the travel requires an overnight stay or not.

iv Special Inbound Tax Regime (Impatriate Regime)
The SPIT Law establishes a special tax regime for employees and directors who acquire the tax resident status as a consequence of an assignment to Spain, or to the appointment as a member of the board of directors with no relevant participation in the company. Under this regime, individuals can be taxed according to the NRIT Law even if they are considered tax residents in Spain, provided that the following requirements are met:

- the individual must not have had a tax resident status in Spain for the last 10 tax years prior to his or her transfer to Spain;

6 According to the criteria of the Spanish General Directorate of Taxes, this exemption is applicable when the assignment is longer than nine consecutive months.
the transfer to Spain must be made under an employment contract (an assignment letter is also valid) or by getting a position as a member of the board of directors of a Spanish company; and

c the income obtained in Spain should not be considered as being obtained through a permanent establishment.

The Impatriate Regime applies during the tax period in which the taxpayer acquires his or her tax resident status in Spain (i.e., the first calendar year following the transfer in which the taxpayer stays in Spain for more than 183 days) and the following five years.

The benefit of this regime is essentially that all the employment income obtained during each calendar year of application of the special regime will be taxed at the following flat rates: 24 per cent up to €600,000 and 45 per cent for the excess over €600,000. Employment income obtained before the transfer to Spain and after the date of departure from the Spanish territory will not be taxed under the Impatriate Regime.

In accordance with the current regulations, in order to apply for this regime it is necessary to fulfil certain compliance procedures in Spain within a period of six months after the date of registration of the employee or the director with the Spanish Social Security Administration or the date of maintaining social security contributions in the home country.

v Pension commitments schemes

Contributions or allocations paid by employers for pension commitments in the terms established by the First Additional Provision of the revised text of the Pension Plans and Funds Regulation Act, and in its developing regulations, have a special tax treatment when allocated to persons to which the benefits are linked.

The tax allocation of said contributions to employees is voluntary, but the decision adopted must be maintained until expiry of the insurance contract. Nevertheless, when both saving and risk contingencies are assured (as happens, for example, regarding retirement and death) the tax allocation will be mandatory for risk assurance if the premium exceeds €50.

Notwithstanding the aforementioned, in any case, the tax allocation of insurance premiums shall be mandatory for an amount that exceeds €100,000 per year per taxpayer with respect to the same employer when premiums grant the employee irrevocable rights over the pension.

vi Delivery of shares

Under the current SPIT Law, an annual exemption of €12,000 can be applicable to the remuneration in kind derived from the delivery of shares of a company to its employees as a consequence of the participation in the company or other group company, if:

a the offer is made to all employees of the company in which the employee renders his or her services;

b the employee does not sell the shares during the three years following the date on which he or she acquires them; and

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7 Spanish Royal Legislative Decree 1/2002, of 29 November, which approved the text of the Law of Regulation of Pension Plans and Funds.
the employee, together with his or her spouse and their relatives to the second degree, does not have a direct or indirect interest of more than 5 per cent in the company or in any other group company.

While the SPIT Law requires that the delivery of shares has to be made to active workers, this exemption should not be applicable to any member of the board of directors.

vii Exemption on severance payments
Under the SPIT Law, indemnities for worker dismissal or severance payments derived from the termination of ordinary employment contracts will be exempt from taxation in the obligatory amount established in the Workers’ Statutes8 (WS). The amount exempted is limited to €180,000.

viii Reduction on irregular income
A 30 per cent reduction on employment taxable income can be applicable as long as said employment income has been generated over a period of more than two years and, in the previous five tax years, the individual has not received any other income generated in more than two years during which the reduction has been applied. This reduction can also be applicable to certain types of income that are considered as notoriously irregular even if they have not been generated in more than two years.

The maximum amount that can benefit from the reduction is limited to €300,000.

In order to apply the reduction, the income must always be paid in a lump sum (it must be imputed for tax purposes in a single tax period), except for certain cases of termination of the employment contract when the payment is made in instalments.

IV EMPLOYMENT LAW

i Commercial relationship v. employment relationship
The most commonly accepted view, adhered to by the Supreme Court and referred to as the ‘link theory’, is that when both a senior executive employment relationship and a relationship as a director of a company exist at the same time, the employment relationship as a senior executive is regarded as being encompassed within the commercial relationship.

According to this theory, the existence or non-existence of an employment relationship depends not on the content of the activity performed (as the functions of members of the board of directors and of companies’ senior executives generally coincide) but on the nature of the link and of the position occupied by the person performing the activity. If the link is structural, with the executive being incorporated within the board of directors of the company, the relationship will in all cases be viewed as commercial, not as a labour relationship.

ii Special employment relationship for senior executives
Article 1.2 of the Royal Decree on senior executives’ contracts defines ‘senior executive’ as:

8 Royal Legislative Decree 2/2015, of 23 October, which approved the consolidated text of the Workers’ Statute Law.
workers who exercise the powers vested in the legal owners of the enterprise and relating to the general objectives thereof, independently and with full responsibility limited only by the direct instructions and criteria of the person or of the higher bodies of governance and management of the entity respectively occupying the position of legal owner(s).

Based on the above, for an employment relationship to be deemed one of senior executive, the following hallmarks must be present:

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\begin{align*}
  &a \quad \text{Reporting directly to the managing body of the company, without any body or person interposed between the two, so that the senior executive's powers of independence and full responsibility are only limited by the direct instructions and criteria emanating from the managing body of the company, regardless of the form it takes, that is, from a chief executive officer to a collective body.} \\
  &b \quad \text{Exercise of general powers of the company, inherent in the legal ownership of the company and relating to its general objectives. The exercise of the inherent powers must fall within the scope of the company's fundamental or strategic decisions, regardless of whether or not the executive has been formally empowered, provided that the powers exercised \textit{de facto} display these hallmarks.}
\end{align*}
\]

iii Post-contractual non-competition covenant

Non-competition covenants are allowed under Spanish legislation. Article 21.2 of WS establishes that a post-contractual non-competition covenant after termination of an ordinary employment contract cannot be longer than two years and will only be valid if:

\[
\begin{align*}
  &a \quad \text{the employer has an effective industrial or commercial interest; and} \\
  &b \quad \text{there is an adequate compensation for the employee.}
\end{align*}
\]

A non-competition covenant in senior executives’ employment contracts is quite similar to covenants in ordinary contracts, with basically the same requirements. Article 8.3 of RD 1382/1985 enables the parties to sign a post-contractual non-competition covenant, with similar terms to Article 21.2 of the WS for ordinary contracts.

In the event of relationships of a commercial nature, post-contractual non-competition covenants are not subject to the above-mentioned requirements.

iv Severance payments derived from termination of employment

The WS establishes different causes by which an ordinary employment contract can be terminated. The main types of termination as decided by the employer are classified as two types of dismissal: (1) disciplinary dismissal, and (2) objective dismissal (based on economic, organisational, productive or technical grounds, among others).

Spanish employment contracts are entitled to a statutory severance payment, which is due upon termination of the employment relationship.

The WS establish different amounts of severance payment depending on the type of dismissal, according to the following table:

<table>
<thead>
<tr>
<th>Type of dismissal</th>
<th>Severance payment in case of fair dismissal</th>
<th>Severance payment in case of unfair dismissal</th>
</tr>
</thead>
<tbody>
<tr>
<td>Disciplinary</td>
<td>No.</td>
<td>33 days per year of service with a limit of 24 monthly payments (there is a specific transitional regime for contracts preceding 12 February 2012).</td>
</tr>
<tr>
<td>Objective</td>
<td>20 days per year of service with a limit of 12 monthly payments. Additionally, 15 days’ notice is required.</td>
<td></td>
</tr>
</tbody>
</table>

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In some cases, terminations are deemed null and void when they involve an employee being reinstated and entitled to receive pay from termination to reinstatement date.

In the event of a special employment relationship for senior executives, the RD 1382/1985 establishes the notice period and statutory severance payments in the event that no agreement is specified in the employment contract.

V   SECURITIES LAW

The grant of rights to receive shares under share-based incentive plans implemented in Spain are not usually considered a 'public offering of securities' under Spanish Security Law, but a private one, given that they do not offer transferable shares. Consequently, as a general rule, provided that such rights are not transferable, no filing requirements have to be complied with before the Spanish Securities Markets Authority (CNMV) at the time of granting the right to receive shares, as the Spanish rules regarding offers of securities will not apply.

Nevertheless, in general terms, at the time of the delivery of shares, if the shares are transferable, under Spanish regulations, following EU Directives on prospectus and public offerings, a prospectus filing requirement with the CNMV may be triggered, unless the offering is addressed, among others, to fewer than 150 natural or legal persons per EU Member State, other than qualified investors.

In addition, according to Spanish regulations and Directive 2003/71/EC, the obligation to publish a prospectus shall not apply to a public offering of securities addressed to existing or former directors or employees by their employer or by a company of its group that has securities already listed on a regulated market, provided that a document is made available containing information on the number and nature of the securities and the reasons for and details of the offer.

Furthermore, in particular for non-EU companies, additional regimes may apply based on the nature of the offeror and on the terms and conditions of the offering.

The acquisition, maintenance and sale of listed shares held abroad by Spanish residents shall be subject to reporting obligations with the Ministry of Economy and Competitiveness, unless the shares are deposited in a securities account kept with a Spanish investment firm or a Spanish financial entity. In this case, the Spanish depositary entity would automatically carry out the above-mentioned reporting obligations. In addition, in this event, ongoing reporting requirements with the Bank of Spain may be triggered.

VI   CORPORATE GOVERNANCE

i   Spanish Corporation Law

Articles 217 to 249.bis of the Spanish Corporation Law (SCL) impose obligations in relation to the remuneration granted to directors and executives. In particular:

a Remuneration system of directors in their capacity as such:

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9 Regulation (EU) 2017/1129 of the European Parliament and of the Council of 14 June 2017, on the prospectus to be published when securities are offered to the public or admitted to trading on a regulated market, and repealing Directive 2003/71/EC.

10 Legislative Royal Decree 1/2010, of 2 July, which approved the revised text of the Spanish Corporation Law.
The remuneration system will determine the remuneration concepts to be received by the directors in their capacity as such (i.e., a fixed remuneration, assistance allowances, etc.).

The maximum amount of the annual remuneration of all directors in their capacity as such shall be approved by the shareholders’ meeting of the company.

Unless the shareholders’ meeting determines otherwise, the distribution of the remuneration shall be established by a decision of the board, which shall take into account the functions and responsibilities attributed to each director.

**b** Compensation based on shares of the company:

- When the remuneration system includes the delivery of shares or stock options, or remuneration referenced to the value of the shares, it shall be expressly provided in the by-laws of the company. The application will require an agreement of the shareholders’ meeting of the company, and shall refer to certain aspects.

**c** Remuneration of executive directors:

- When a member of the board of directors is appointed CEO or is granted with executive functions under another title, it will be necessary to conclude a contract between him or her and the company. This contract must be previously approved by the board of directors with the favourable vote of two-thirds of its members;
- the contract must include all the concepts for which the top executives can obtain remuneration for the performance of executive duties; and
- the contract must be in accordance with the remuneration policy approved by the company shareholders’ meeting.

**d** Remuneration of executives reporting directly to the board of directors:

- In the case of executives reporting directly to the board of directors of the company, their compensation must be established by the board of directors, as it is considered a basic term of their contracts.

### ii CNMV Good Governance Code

On 24 February 2015, the CNMV published the new Good Governance Code of Listed Companies, completing the reform of the legal framework of corporate governance in Spain, which pursued the following objectives:

- to ensure the proper functioning of the governing and administrative regulations of Spanish companies;
- to build trust and transparency for shareholders and investors;
- to improve internal control and corporate responsibility; and
- to ensure the correct internal distribution of functions, duties and responsibilities.

The provisions of the new Code are applicable as of 2015, in respect of which companies will render account in the annual good governance reports that they submit before the CNMV from 2016 onwards.

The new Good Governance Code contains 25 principles that serve as a basis for the various recommendations. The main conclusions of the new Code regarding variable remuneration are as follows:

- a relevant component of variable remuneration must be linked to a long-term period;
- equity-based incentives should be an important element of the variable remuneration;
- variable remuneration must be subject to predetermined and measurable performance criteria that factor in the risk assumed to achieve a given outcome;
the remuneration must promote the long-term sustainability of the company and long-term value creation; and

e incentive schemes must include clawback clauses.

VII DISCLOSURE

i Remuneration policy of top executives

According to Article 529 *septdecies* of the SCL, the remuneration policy of directors of a company shall determine the remuneration of the directors in their capacity as such, within the system of remuneration provided in the by-laws of the company, and must necessarily include the maximum amount of annual remuneration to be paid. This provision would only be applicable to listed companies.

The determination of the remuneration of each director in his or her capacity will be the responsibility of the board of directors, which will take into account the functions and responsibilities attributed to each director, membership of board committees and other relevant employees according to objective circumstances.

In addition, pursuant to Article 529 *octodecies* of the SCL, the remuneration of executive directors included in their contracts must be aligned with the remuneration policy of directors of the company, which shall establish their remuneration package.

ii Annual remuneration report

According to Article 541 of the SCL, the boards of directors of listed companies must prepare and publish an annual remuneration report of directors (ARR), including the remuneration received in their capacity as directors and for their executives’ functions.

In this regard, the report must have:

\[ a \] complete, clear and understandable information regarding the remuneration policy of the top executives that will be applicable in the current year;

\[ b \] a global summary of the implementation of the remuneration policy of the closed year; and

\[ c \] details of the remuneration accrued by all concepts by each top executive in the current year.

The ARR will be communicated as a relevant fact by the company. The shareholders’ meeting of the company should vote as a separate item of the agenda.

The Ministry of Economy or, with its express authorisation, the CNMV, will determine the content and structure of the ARR, which may contain information, among other matters, on the amount of fixed remuneration components, variable remuneration concepts and the performance criteria, as well as the role of the remuneration committee.

iii Website publication

Pursuant to the SCL, both the remuneration policy and the ARR will be made available on the company’s website after the company shareholders’ meeting.
VIII SPECIALISED REGULATORY REGIMES

There is a specific regulation for certain sectors that imposes restrictions on the remuneration paid to certain employees and executives of companies operating in those sectors.

Among others, the entities affected by these specific provisions are credit institutions, management companies of collective investment institutions, management companies of closed-end investment companies and insurance companies.

The limitations will mainly affect (1) the determination and form of payment of the variable remuneration approved (i.e., clauses malus and clawback), (2) the design and payment of social security insurance, and (3) the limits and form of reimbursement of severance payments.
INTRODUCTION

The remuneration of executives, especially of Swiss public companies, has become a subject of public debate since the financial crisis of 2007. While in the past the salaries of executives were considered to be part of the private domain, the view has shifted since the publishing of the figures of the remuneration and bonuses of bank executives who held key positions in banks that had to be bailed out by the taxpayer. In the wake of the public discussion, an initiative was launched and accepted by the Swiss voters in March 2013. As a result, the Swiss Federal Constitution was amended, and stricter rules were introduced for the remuneration of directors and managers of public companies in Switzerland. The idea behind the initiative was to expand the mandatory powers of the shareholders’ meeting to the composition and the compensation of the board of directors and the management (‘say-on-pay’ legislation). The regulations that implement the stricter rules since 1 January 2014 provide for a temporary regime that will remain in place until Parliament has enacted the relevant law.

No specific statutory limitations on the compensation of executives have been introduced. However, the aggregate remuneration of the board of directors, the executive management board and any advisory board has to be approved separately by the shareholders’ meeting. Pursuant to the existing regulations, the fixed remuneration may be approved, either prospectively for the period until the next annual general meeting of shareholders, or retrospectively for the preceding business year. Since inception of the regulations in 2014, certain standards have been developed by publicly listed companies in terms of compensation of board and management members. However, the exact degree of flexibility still remains unclear, and there is a risk of civil liability and criminal sanctions because of a violation of the rules. With regard to executives in private companies, no special disclosure or other rules apply.

TAXATION

Income tax for employees

Swiss tax resident executives are subject to unlimited taxation in Switzerland. All income from employment (whether paid in cash or in kind) is basically subject to ordinary income taxation in the year of realisation. Income taxes are levied on a progressive scale and the applicable tax rates depend on three factors: the executive’s overall annual income (including other

1 Matthias Oertle is a partner, Franziska Stadtherr-Glättli is a counsel and Patrick Schärli is an associate at Lenz & Staehelin.
personal income such as investment income, income from real estate, etc.), the executive’s tax residence (cantons and municipality) and the executive’s marital status. Capital gains realised on privately held assets are, however, exempt from income taxation (with the exception of Swiss real estate gain).

For Swiss nationals, foreign nationals with a permanent residence permit or married to either a Swiss national or a foreigner holding a permanent residence permit, income taxes are levied on a self-assessment system (i.e., any tax payments are made by the executive). For all other foreign national executives, income taxes are withheld at source by the Swiss employer. Even if subject to taxation at source, executives are required to file an annual tax return and are subject to retroactive ordinary taxation.

Non-resident executives performing services in Switzerland may become subject to limited taxation in Switzerland with respect to their remuneration earned for such services. Tax treaty rules may override the domestic tax rules and result in an exemption from Swiss income tax.

ii Taxation of employee incentive plans

Employee stock options are basically subject to taxation upon exercise. For options taxed upon exercise, the entire capital gain realised upon exercise will be subject to ordinary income taxation. An exception applies for listed options not subject to forfeiture, which will be taxed upon grant. For options taxed upon grant, the listed option price will be the relevant tax base.

Employee shares are taxed upon grant or, if subject to forfeiture, upon delivery. The fair market value of an employee share, minus the purchase price to be paid for by the employee, if any, qualifies as taxable income from employment. A tax discount of approximately 6 per cent per annum is available for restricted employee shares (fractions of a calendar year are also taken into account when calculating the tax discount). An early release of the restriction period leads to additional taxable income. If employee shares are sold back to the employer for less than fair market value in the event of termination of the employment, the executive may apply for a tax deduction in the amount of the loss realised.

Any capital gain realised upon the subsequent sale of the shares is generally a tax-free capital gain, unless the employee qualifies as a professional securities dealer for income tax purposes because of substantial debt financing. However, if the taxable basis of the share upon grant (or exercise, in case of options) was determined based on a recognised valuation method (instead of fair market value), such valuation method will basically again be applied upon sale, and any difference between the sales price and the recognised valuation will be qualified as taxable employment income.

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2 Maximum income tax rates vary significantly within Switzerland: from 22.5 per cent in the canton of Zug up to 46 per cent in the canton of Geneva.
3 Provided that the total income from employment exceeds 120,000 Swiss francs per annum (500,000 Swiss francs per annum in Geneva).
4 Such as the 183-day rule. See also Section III.i regarding internationally mobile executives.
5 In case of unlisted shares, the fair market value is determined either based on recent third-party transactions or based on a recognised valuation method as agreed upon with the competent tax administration.
6 Calculation formula: 100/(1.06)n.
7 For example, an employee share subject to a five-year restriction period benefits from a tax discount of 25.274 per cent for income tax purposes.
8 Cantonal tax practice varies in this respect.
Restricted stock units (RSUs) and share awards are subject to taxation upon vesting. Other than that, the same rules apply as for employee shares.

Any other type of share-related compensation schemes, such as phantom shares or stock appreciation rights (SARs), as well as any deferred cash incentives (subject to adjustments or forfeiture), and profits interests are subject to ordinary income taxation upon payment.

### iii Social taxes for employees

Any income from employment is subject to the following Swiss social security contributions (current rates for 2018), which are shared equally between employer and employee:

- **a** 10.25 per cent for old-age insurance, invalidity insurance and loss of income fund (there is no cap);
- **b** 2.2 per cent for unemployment insurance payable for remuneration up to 148,200 Swiss francs; and
- **c** 1 per cent ALV (unemployment insurance) solidarity surcharge on the annual remuneration above 148,200 Swiss francs (no cap).

The executive’s share of social security contributions must be withheld by the employer from the executive’s salary and must be borne by the executive. The employer’s share of social security contributions must, by mandatory Swiss law, be borne by the employer and cannot be shifted to the employee.

With respect to employee shares and options, the income relevant for tax purposes is the relevant basis for social security purposes (which means that any tax discount for restricted employee shares is taken into account for social security purposes).

In addition, pension fund contributions are payable on the remuneration paid to executives, subject to certain limitations. Occupational benefit plans are mandatory for employees with annual salaries between currently 21,150 Swiss francs and 84,600 Swiss francs. In addition to the minimum legal coverage, many occupational benefit funds offer improved benefit plans for management that insure additional parts of the executive’s salary, subject to a cap of 842,400 Swiss francs. Contribution rates depend on the age of the executive. Typically, contributions are shared between employer and executive, but improved benefit plans for management often provide for exclusive contributions by the employer.

Income resulting from employee options, shares and other incentive plans is normally not insured under a pension scheme.

### iv Tax deductibility for employers

The company’s profit as reported in its financial statements prepared based on Swiss accounting principles is relevant for tax purposes. Corrections may be made only if the remuneration of an executive, who is also a shareholder, is considered to be excessive. While cash payments are generally fully tax-deductible, payments in the form of equity awards are tax-deductible only to the extent the company reported an expense in its books, which may vary depending on how the shares are made available to the executive.

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9 Contribution limit as of 1 January 2018.

10 While a (re)purchase of own shares or intra-group cost recharge usually leads to a business expense and, therefore, a tax deduction, this is not necessarily the case if shares are newly issued by way of conditional share capital.
Any employer social security contributions due on executive remuneration are fully tax-deductible.

v Other special rules
One-off severance payments may (in whole or in part) be subject to preferential income taxation if the executive is older than 55 years; gives up his or her professional activity completely; and is faced with a pension fund contribution gap because of early termination.

III TAX PLANNING AND OTHER CONSIDERATIONS
i Overview
Swiss-resident executives are subject to worldwide taxation, subject to unilateral exemptions (real estate and permanent establishment abroad) and prevailing tax treaty provisions (such as the 183-day rule).

For internationally mobile executives, special rules apply with respect to the income taxation of employee options, RSUs, SARs and any other share awards: if an executive was not exclusively tax-resident in Switzerland during the vesting period, Switzerland will tax only that portion of the income that is attributable – in proportion of the vesting period spent in Switzerland divided by the overall vesting period – to Switzerland. It is important to note that this rule applies in all cases – not only if the executive moves to Switzerland and is a Swiss tax resident upon exercise or realisation, but also if he or she has already left Switzerland and realises such income while being tax-resident outside Switzerland. In this case, the (former) Swiss employer company is required to withhold and pay the executive’s Swiss income taxes. If the executive is no longer on the Swiss payroll, the Swiss employer must ensure that income taxes (and social security contributions) are finally passed on to the executive.

Depending on the applicable rules of either a social security treaty or the agreement on the free movement of persons concluded between Switzerland and the European Union, non-resident executives or executives with secondment arrangements may continue to be subject to their foreign social security system, which might be more advantageous than the Swiss system not only with respect to the (state and company) pension benefits, but also with respect to the contribution limit.

ii Expatriate tax status
Expat rules were tightened as of 1 January 2016. Executives who are seconded to Switzerland temporarily by their foreign employer may claim additional deductions from certain employment benefits, such as housing allowance and international school fees, for a maximum of five years.

Because of worldwide taxation, offshore sourcing arrangements are irrelevant from a Swiss tax perspective. Foreign personal service companies may be qualified as a tax-avoidance scheme if they have no substance in the country of incorporation.

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11 Example: option with vesting period of four years was granted abroad, executive moves to Switzerland after two years and exercises the option immediately after vesting. Switzerland will tax 50 per cent of the option gain (50 per cent of vesting period was spent in Switzerland).

12 Deductions as well as conditions and requirements vary among the cantons.
IV EMPLOYMENT LAW

Except for the ‘say-on-pay’ legislation applicable to executives of Swiss public companies, Swiss law does not provide for any special rules in employment law that apply to executives that are different from the rules applicable to regular employees. In particular, executives who simultaneously hold positions in any corporate body – for instance, as members of the board of directors of a Swiss (privately held) company – are not subject to any special rules in terms of their remuneration, termination or any other aspect of their employment. The appointment of executives to, and their removal from, any corporate positions is governed by the relevant rules of Swiss corporate law, while Swiss employment law governs the terms and conditions of their employment. Following the implementation of the ‘say-on-pay’ legislation, on 1 January 2014 the remuneration of most senior executives (members of the board of directors and of the management board) of public companies in Switzerland is subject to detailed rules that have a direct and material impact on their employment contract (see subsection v).

i Non-competition

In many industries in Switzerland it is common to impose non-competition covenants on executives; within certain limits (see below), such covenants are permitted. They are enforceable by specific performance, provided the relevant non-competition provision expressly allows the employer to specifically enforce the covenant. It is also common to include a liquidated damages provision in the non-competition covenant as a preventive measure. The amount of the liquidated damages will be reviewed by a Swiss court and, if considered excessive, will be reduced at the discretion of the court to an appropriate level.

A non-compete covenant is subject to certain limitations. For one thing, it is only valid if the executive has access to customer data, or to manufacturing or business secrets of the employer (or both), the exploitation of which could significantly harm the employer. In addition, any non-compete covenant must be limited in terms of geographical scope, time and activity. Such statutory limitations are designed to make sure that the executive’s career prospects are not unduly impaired by the non-compete covenant.

The term of the post-contractual non-compete covenant may generally not exceed three years. In practice, non-compete undertakings are typically concluded for terms of between six months and two years. Although the payment of any consideration for the non-compete covenant is not a condition for its validity, it does improve its enforceability, especially if the term exceeds one year. To date, Swiss courts have not generally taken into account the length of any garden leave in determining the enforceability of non-compete covenants.

As a matter of law, any non-compete covenant will cease to apply if the employment is terminated by the employer, unless the executive has set a reason, or even provoked the termination. Swiss courts at their discretion may restrict non-compete covenants in scope, if they are considered excessive.

By contrast, non-competition covenants that are entered into in the context of a transaction, such as the sale of a company by employee shareholders, are, as a general
rule, not subject to the strict limitations that apply to employment contracts. Given that employee shareholders will typically receive a certain compensation for the non-competition undertaking, the relevant covenants will be enforceable even if they are broad in scope and for a term in excess of three years.

Non-solicitation covenants (either of customers or employees) are valid and enforceable under Swiss law to the same extent, and subject to the same restrictions as non-competition covenants.

ii Termination

As a matter of Swiss mandatory law, any employment may be terminated by either the employer or the employee ‘for important reasons’ with immediate effect. Generally speaking, a termination ‘for important reasons’ is considered justified if the relationship between the parties has been disrupted up to a point where neither party can be expected to continue the relationship. Swiss courts are quite restrictive when it comes to admitting ‘important reasons’, especially if notice of termination is given by the employer.

The concept of ‘constructive dismissal’ has been developed by Swiss courts and doctrine, but is not based on any statutory law. According to the concept, any unilateral modification of a material term of the employment contract by the employer (e.g., the terms relating to job profile, compensation or other financial benefits) is deemed to be a dismissal of the executive. The argument of a ‘constructive termination’ is of particular relevance if the executive is subject to a post-contractual non-competition covenant, as such covenant will cease to be effective in the event the employment contract is terminated by the employer (see above).

A release of claims from an executive is subject to the general rules governing releases under Swiss law. The executive may only release the employer from any claims of which he or she was aware at the time the release was executed. In addition, if the executive waives a right to which he or she is entitled as a matter of mandatory law without obtaining in exchange adequate consideration from the employer, the relevant waiver or release may be deemed invalid. This rule is based on the statutory provision of Article 341 of the Swiss Code of Obligations, pursuant to which an employee may not validly waive any claims arising from mandatory law during and for 30 days after termination of the employment agreement.

iii Severance

Although Swiss employment law provides for the payment of severance upon termination of the employment to employees who are older than 50 years and who have been employed for at least 20 years, the relevant provision has been superseded in practice by the compulsory company pension scheme, which was introduced in Switzerland in 1985. As a result, unless the relevant individual employment contract specifically provides for the payment of severance in the case of termination, the termination of executives does not trigger any severance payment by the employer. The same holds true for the termination of an executive as a result of a change of control of the employer: unless the executive’s employment contract expressly provides that the change of control of the employer constitutes a termination event that gives rise to a special severance payment, the change of control does not affect the

17 Article 337 of the CO.
18 Article 339b of the CO.
continued effectiveness of an executive’s employment contract. Any severance payments for members of the board of directors or the management board of a public Swiss company are unlawful according to the ‘say-on-pay’ legislation that became effective on 1 January 2014.

iv Overtime
As a matter of Swiss public labour law, the employer is required to compensate overtime either by extra time off or by payment in cash. However, this rule does not apply to senior executives as they are not subject to the restrictions of the labour law. Senior executives are typically expected to work overtime, and their wages are deemed to include compensation for overtime. According to the labour law, a senior executive is defined as an employee who exercises a ‘higher management function’.

v Restrictions applicable to executives of Swiss public companies
According to the regulations on ‘say-on-pay’ and on excessive executive remuneration, certain forms of compensation of the members of the board of directors, executive management board and advisory board of a Swiss stock corporation whose shares are listed on a stock exchange in Switzerland or abroad are prohibited, such as severance payments, remuneration payments made in advance and commissions related to the acquisition or transfer of businesses. In addition, loans, pension benefits, performance-related remuneration or the allocation of shares and options made to any director or executive manager are unlawful, unless expressly provided for in the company’s articles of incorporation.

In addition to imposing restrictions on executive remuneration, the regulations on ‘say-on-pay’ introduce a limitation of one year for notice periods and for the term of fixed-term service contracts for directors and executive managers of Swiss public companies. The regulations also limit the number of board and executive management positions that any director or executive manager of a Swiss public company may hold in other companies.

Criminal sanctions may be imposed on members of the board of directors, the executive management board or the advisory board in the event of an intentional breach of the new regulations.

V SECURITIES LAW
i Participations of and trading by executives
Directors, executives and other employees of Swiss companies are neither required nor generally restricted to hold shares or other securities of the employer company. However, they have to be careful not to make use of any insider information when they trade in securities of a public company. Article 154 of the Swiss Financial Market Infrastructure Act prohibits insider trading and provides for criminal sanctions of up to five years of imprisonment. In line with the EU Market Abuse Regulation, an administrative regime against the abuse of insider information was also introduced in Article 142 of the Swiss Financial Market Infrastructure Act. Most public companies have enacted internal regulations that govern the trading in their securities and that typically provide for blackout periods during which trading is not allowed. Regulated financial institutions are subject to additional organisational requirements set out in a circular on market abuse issued by the Swiss regulator FINMA.
Switzerland

Registration requirements

As a general rule, shares or options may be awarded to employees in Switzerland under an employee participation plan without any government authorisation, regulatory notification, filing or registration, provided that the options granted and the shares to be acquired are not listed and are not sought to be listed on a Swiss stock exchange.

Pursuant to the Swiss Federal Collective Investment Schemes Act and its implementing regulations, to offer an employee participation plan in the form of a collective investment scheme does not qualify as a distribution of a collective investment scheme and thus does not require authorisation from FINMA. The exemption, however, only applies if the employee participation plan comprises investments in the employer company or a company of the same group, is addressed to employees subject to an employment relationship that has not been terminated, and constitutes part of the employees’ compensation.

Swiss corporate law requires issuers to prepare an offering prospectus whenever newly issued shares are publicly offered for subscription. The prospectus requirement may also apply to the issuance of new shares in Switzerland based on the exercise of options previously allocated by an employer to its employees.

An offer is deemed public if the invitation to subscribe for shares is addressed to an ‘unlimited number’ of persons. Swiss law provides neither for a threshold in respect of the number of participating investors (or potential investors to whom the offer is addressed), nor for any express exemptions (such as a ‘qualified investor’ exemption) or similar safe-harbour rules. In line with a conservative approach, an offer directed at or made to 20 or fewer potential investors qualifies as a private offering and does not require an offering prospectus. In light of the EU Prospectus Directive and the EU Prospectus Regulation, respectively, the previous Swiss legislation governing collective investment schemes, and proposals for an amendment of the Swiss prospectus rules, this view has been criticised as being too strict. Pursuant to this more liberal approach, the number of addressees is not the only decisive criterion, and the concept of the offer being directed to a ‘limited circle’ of offerees also includes a qualitative element. Based on the manner in which investors are approached, an offering to more than 20 potential investors may be permissible if the offering is directed at or made to a defined circle of persons (such as employees), clearly distinct from the public at large.

Assuming a prospectus or similar information memorandum has been published abroad (e.g., pursuant to foreign regulations), such document should – for reasons of equal treatment – be also made available to the Swiss employees.

The new Swiss Financial Services Act, which has recently been passed by the Parliament, but not expected to become effective before 2020, will, among other things, provide for new prospectus rules that will replace the existing rules of Swiss corporate law. The new legislation will provide for employee participation plan exemptions that are mostly in line with the current Swiss rules. In particular, the new legislation will provide for an exemption from the prospectus requirement for securities offered or allocated by an employer or related company to existing or former members of the board of directors or executive management and its employees. The impact of the new rules can, however, only be assessed once the Swiss government has published the relevant implementing ordinances (level 2 regulations), which is expected to occur later in 2018.

19 Article 652a of the CO.
20 Article 37(1)(g) of the new Swiss Financial Services Act.
iii Reporting requirements

According to the listing rules of SIX Swiss Exchange, companies whose equity securities have their primary listing on SIX Swiss Exchange are subject to certain reporting obligations applicable to management transactions. The members of the board of directors and of the executive management board have to report their transactions in equity securities, options and related financial instruments to the company within two trading days. For the purpose of disclosing management transactions, the term financial instruments includes contracts that provide or permit a cash settlement and other contracts for difference whose performance depends on the market value of the equity securities. Any acquisition or disposal made under the control of the executive and having a direct or indirect effect on his or her assets is subject to the reporting obligation. This includes securities acquired by the executive’s bank based on an asset management agreement. In addition, transactions have to be reported if carried out under the significant influence of the executive by spouses, persons living in the same household, companies controlled by the executive or other related parties.

The duty to disclose management transactions to the relevant exchange formally lies with the company. Therefore, the company has to ensure that its directors and executives comply with their reporting obligations.

The Directive of SIX Swiss Exchange on Disclosure of Management Transactions exempts transactions based on an employment agreement or as part of a compensation scheme from the reporting obligation, provided that the decision whether to carry out the transaction is not up to the executive. Granting options to an executive pursuant to the terms of an employee share option plan does not trigger the reporting obligation. A notification is required only once the executive exercises his or her options or sells the securities.

The notification to the company by the executive needs to include, inter alia, the name and position of the executive as well as the aggregate number of the equity securities or financial instruments and the total value of the transaction. The company is required to disclose the data electronically to SIX Exchange within three trading days following the notification. SIX Exchange publishes such information – except for the name of the executive and the date of notification to the company – and makes it publicly available in a database for a period of three years.

iv Restrictions on cash settlement of stock options

Domestic and foreign companies with a (main) listing of their equity securities on a stock exchange in Switzerland are generally subject to the Swiss tender offer rules. These rules have to be observed in case a tender offer voluntarily includes unlisted employee share options. In the event that the (target) company acts in concert with an offeror, a repurchase of employee stock options by the company or a modification of the terms form part of the offer, resulting in the applicability of the tender offer rules. However, the possibility to provide for a cash settlement of employee stock options as such is not restricted.

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22 Article 56, Paragraph 4 of the Listing Rules.
23 Article 56, Paragraphs 5 and 6 of the Listing Rules.
VI DISCLOSURE

Privately held companies in Switzerland are generally not required to disclose any information about their remuneration policy. In contrast, the remuneration of executives of Swiss companies whose shares are listed on the Swiss stock exchange or abroad became subject to disclosure rules that were introduced as part of proper corporate governance in public companies. According to the ‘say-on-pay’ legislation, the disclosure duties have been extended.

i Disclosure requirements of ‘say-on-pay’ legislation

Pursuant to the regulations governing the remuneration of directors and managers of public companies, the articles of incorporation of a Swiss stock corporation have to specify, *inter alia*, the maximum notice period of the employment agreements of the members of the executive management, the maximum amount of any loans and pension benefits granted to members of the board of directors, executive management board and advisory board, and the principles governing the performance-linked remuneration and the allocation of shares and options to members of the board of directors, executive management board and advisory board. The regulations allow the setting aside of a supplemental amount in order to cover the fixed remuneration of newly hired members of the executive management board after the annual shareholders’ meeting.

The board of directors is required to prepare a separate compensation report annually. Such compensation report needs to specify the aggregate amount of the remuneration paid directly or indirectly to the members of the company’s board of directors; the members of the company’s executive management board; the members of the board of advisers (if any); and previous members of the company’s board of directors, executive management board and board of advisers if such remuneration either relates to their former activities for the company or is out of line with market practice. Further, any remuneration paid directly or indirectly to related persons of the aforementioned individuals needs to be disclosed on a no-name basis.

In addition to the aggregate remuneration for the respective corporate body, the individual remuneration figure relating to each member of the board of directors and of the board of advisers, respectively, has to be disclosed. With regard to the members of the executive management board, it is currently sufficient to disclose the total figure together with the name, position and amount of the highest-paid executive (usually the CEO).

The term ‘remuneration’ is defined broadly and includes any fees, salaries, bonuses, participation in turnover or the business results, services and benefits in kind, allocations of shares and conversion or option rights, sign-on bonuses, collateral commitments in favour of third parties, waivers of claims, fringe benefits and any payments or benefits for additional work.

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24 Article 14, Paragraph 1 of the Ordinance Against Excessive Compensation in Listed Companies (Ordinance); cf. Article 663b bis, Paragraph 1 of the CO.
25 Article 16, Paragraph 1 No. 1 and paragraph 2 of the Ordinance.
26 Article 14, Paragraph 3 of the Ordinance; cf. Article 663b bis, Paragraph 4 of the CO.
27 Article 14, Paragraph 2 of the Ordinance; cf. Article 663b bis, Paragraph 2 of the CO.
Apart from the remuneration, any outstanding loans and credit facilities granted to members of the board of directors, of the executive management board and of the advisory board are to be specified in the compensation report.\textsuperscript{28}

In addition, public companies have to disclose the participations in the company and the conversion and option rights directly or indirectly held by any current member of the board of directors, of the executive management board and of the board of advisers (or by any of their related persons).\textsuperscript{29} The information needs to be provided on an individual basis, specifying the name and function of the respective member. The disclosure obligation is not limited to securities granted to the executive as part of his or her remuneration, but it does most likely not apply to financial instruments other than securities or conversion and option rights.

\section*{Further disclosure requirements}

Irrespective of their place of incorporation, companies whose equity securities have their primary or main listing on SIX Swiss Exchange have to comply with the disclosure requirements set out in the SIX Swiss Exchange’s Directive on Corporate Governance. The Directive applies to all types of legal entities – not only stock corporations – irrespective of the type of equity security that has been listed. Both domestic and foreign companies have to explain in their annual reports, \textit{inter alia}, how the remuneration and the participation programmes for directors and the executive management are determined, and they need to specify the basic principles and features. Companies that are not subject to the ‘say-on-pay’ legislation because they are based abroad are also required to disclose the information of the compensation report (see above). The principle of ‘comply or explain’ applies: to the extent certain information is not disclosed, the annual report needs to give substantiated reasons for such non-disclosure.

Finally, the accounting regulations (such as IAS 24) applied by Swiss companies may require the disclosure of certain aspects of the compensation of key members of management.

\section*{CORPORATE GOVERNANCE}

With the implementation of the ‘say-on-pay’ legislation with effect as of 1 January 2014, all Swiss stock corporations whose shares are listed on a stock exchange in Switzerland or abroad are subject to certain corporate governance requirements that specifically apply to executive remuneration. The requirements do not apply to companies incorporated outside Switzerland that operate in Switzerland, irrespective of whether they are listed on a Swiss stock exchange.

The main requirement regarding executive remuneration is that any compensation in any shape or form (i.e., base salary, variable salary, cash bonus, share and option grants) is as a matter of law subject to the approval of the annual shareholders’ meeting. Absent such shareholder approval, a Swiss public company is not allowed to pay any remuneration to its members of the board, advisory board or executive management. Pursuant to the regulations in place, the shareholder approval may be given in advance for the following financial year or office term, or retrospectively after the end of the relevant financial year or office term. The shareholder approval does not relate to the compensation of the individual director

\textsuperscript{28} Article 15, Paragraph 1 No. 1 of the Ordinance; cf. Article 663b \textit{bis}, Paragraph 3 of the CO.

\textsuperscript{29} Article 663c, Paragraph 3 and Article 959c, Paragraph 2, No. 11 of the CO.
or executive, but rather to the aggregate remuneration paid to the board of the directors, the executive management and any advisory board. The shareholder approval is binding on the company and is required on an annual basis. By contrast, no approval of executive remuneration is required by any union or works council or by government.

Under the ‘say-on-pay’ legislation, Swiss pension funds are required to exercise their voting rights on certain subject matters, such as the election of the board of directors and the approval of the remuneration.\textsuperscript{30} The duty to vote imposed on pension funds together with the obligation to disclose the exercise of the voting rights strengthened the position of the proxy advisers in Switzerland. However, despite the increased general sensitivity to the topic of executive remuneration, the ‘say-on-pay’ legislation so far has not reduced the average compensation of directors or managers.

Every Swiss public company needs to provide for a compensation committee that is elected directly by the shareholders’ meeting on the basis of a proposal of the board of directors. All members of the compensation committee must also be members of the board of the company. Unlike the Swiss Code of Best Practice for Corporate Governance, which recommends that all members of the compensation committee be non-executive and independent, the ‘say-on-pay’ legislation does not impose any such qualification on members of the compensation committee.

\section*{VIII SPECIALISED REGULATORY REGIMES}

Generally speaking, there are no regulatory regimes in Switzerland that affect the rules that apply to the remuneration payable to executives. One exception applies to the Swiss finance industry, whose regulator, FINMA, issued a circular in October 2009,\textsuperscript{31} pursuant to which the compensation in the banking and insurance industry had to comply, \textit{inter alia}, with the following principles:

\begin{itemize}
\item[a] structure and level of compensation have to enhance risk awareness;
\item[b] any variable compensation components have to be designed to be conditional on the long-term success of the institution;
\item[c] variable compensation components must be allocated based on criteria that enhance the sustainability of the business; and
\item[d] part of the compensation needs to be deferred and subject to the future success of the institution.
\end{itemize}

The above guidelines only directly apply to (1) large banks, securities dealers and financial groups and conglomerates, which, pursuant to the applicable provisions of the Capital Adequacy Ordinance, are required to maintain equity capital in the amount of at least 10 billion Swiss francs, and (2) insurance companies, insurance groups and conglomerates, which, pursuant to the applicable provisions of the Insurance Supervision Ordinance, are required to hold equity capital in the amount of at least 15 billion Swiss francs. As for all other Swiss regulated financial institutions, FINMA recommends taking the guidelines into account when drafting their remuneration schemes. In addition, FINMA has the discretion to order, on a case-by-case basis, individual financial institutions to apply the rules (or

\textsuperscript{30} Article 22 the Ordinance Against Excessive Compensation in Listed Companies.

\textsuperscript{31} FINMA Circular 2010-1 Remuneration Schemes, issued on 21 October 2009, effective as of 1 January 2010, last amended on 22 September 2016.
only selected rules) set out in the remuneration circular. Although the legal validity and enforceability of these FINMA guidelines are not entirely clear, the rules promulgated therein have set a standard of ‘best practice’ in the Swiss finance industry.

IX DEVELOPMENTS AND CONCLUSIONS

Despite initial concerns, Swiss public companies were able to manage the implementation of the ‘say-on-pay’ legislation without major problems. So far, shareholders have always – and mostly with clear majority – approved the executive remuneration of Swiss public companies as proposed by their boards of directors.
INTRODUCTION

29 March 2019 is the date scheduled for the United Kingdom’s formal departure from the European Union (Brexit) although this is expected to be followed by a transition period governing the EU’s relationship with the UK until the end of 2020. The direct impact of Brexit on executive remuneration is not expected to be great but no one can predict what the general effects will be. In the meantime, EU rules continue to apply and the General Data Protection Regulation (GDPR) came into force on 25 May 2018 with important consequences for those handling employee data. As promised, the government has introduced corporate governance reforms including a requirement for certain UK quoted companies to publish the ratio of CEO pay to average pay. Also, FTSE All-Share companies that experience a vote of 20 per cent or more against a shareholder resolution or withdraw such a resolution prior to a vote can now expect to see this publicised on a register maintained by the Investment Association. Employment status has been making headlines with the launch of a government consultation on the subject and the decisions in a number of high-profile court cases. An important development for those working through personal service companies is the likely extension of the ‘off-payroll’ rules to the private sector (probably in 2020) with the result that some clients will have to withhold tax from payments to intermediaries.

TAXATION

Income tax for employees

The rules determining an individual’s residence for UK tax purposes are complex and depend on the person’s particular circumstances. In the United Kingdom, an individual’s liability to tax is determined by whether he or she is resident and domiciled in the country. The underlying principle is that those with the strongest links to the United Kingdom should pay more tax than those with weaker connections.

Historically, the concepts of residence and domicile were not defined by statute; however, this changed significantly from 6 April 2013 when a statutory residence test was introduced and the pre-existing concept of ordinary residence was effectively abolished.2

Broadly speaking, individuals who are UK-resident and domiciled in the United Kingdom are subject to UK income tax on their worldwide income, whereas those who are not pay tax only on income with a UK source. Recent changes to the domicile rules mean

1 Mahesh Varia is a partner at Travers Smith LLP.
2 Finance Act 2013, Sections 218 and 219 and Schedules 45 and 46.
that individuals who are UK-resident for more than 15 of the past 20 tax years are deemed to be UK-domiciled for tax purposes. Further, individuals with a UK domicile of origin and a UK place of birth will be deemed UK-domiciled for UK capital gains and income tax purposes whenever they are resident in the United Kingdom. The rates of income tax for the 2018–2019 tax year\(^3\) are as follows:

<table>
<thead>
<tr>
<th>Bands</th>
<th>Rate</th>
<th>Tax on band</th>
</tr>
</thead>
<tbody>
<tr>
<td>Basic rate</td>
<td>Up to £34,500</td>
<td>20%</td>
</tr>
<tr>
<td>Higher rate</td>
<td>£34,501 to £150,000</td>
<td>40%</td>
</tr>
<tr>
<td>Additional rate</td>
<td>Over £150,000</td>
<td>45%</td>
</tr>
</tbody>
</table>

Generally, all compensatory payments are subject to income tax at the rates referred to in the above table. There are, however, certain forms of tax advantaged share plan under which benefits are taxed as capital rather than income, provided specified statutory criteria are met. Capital treatment is more favourable than income treatment for a number of reasons. To begin with, the highest rate of capital gains tax for most assets\(^4\) is currently 20 per cent. Further, individuals are able to utilise an annual exemption from capital gains tax in respect of gains of up to £11,700 (for the tax year 2018–2019). The tax advantaged plans commonly used for executives are the company share option plan (CSOP) and enterprise management incentives (EMIs). One particular feature of EMIs is that the disposal of shares acquired pursuant to them can benefit from a lower capital gains tax rate of 10 per cent.\(^5\)

Companies have to self-certify their tax advantaged plans as meeting the necessary HMRC requirements. All share incentive arrangements (including those that are non-tax advantaged) must be registered with HMRC and an online annual return filed by 6 July.

Plans under which participants own shares from the outset remain popular and can give rise to growth that is taxed as capital. The government continues to be mindful of arrangements that seek to disguise remuneration as capital, and has introduced a number of anti-avoidance measures to combat them.\(^6\) In recent years, the judicial view of tax-avoidance arrangements has moved with the result that HMRC has won some important cases in this area.\(^7\) The UK income tax rules for non-tax advantaged stock options, restricted share acquisition plans and restricted stock units are set out in the table below. It should be noted that in the United Kingdom it is common for restricted stock units to be structured as nil-cost stock options as these offer greater flexibility over when income tax becomes payable and enable employers’ social security obligations to be transferred to employees.

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\(^3\) The UK tax year runs from 6 April to 5 April.

\(^4\) There is an 8 per cent surcharge on disposals of chargeable residential property and receipts of carried interest.

\(^5\) Taxation of Chargeable Gains Act, Section 169I(7A)–(7R).

\(^6\) For example, Income Tax (Earnings and Pensions) Act 2003, Part 7A.

United Kingdom

<table>
<thead>
<tr>
<th>Option</th>
<th>Restricted stock acquisition plans</th>
<th>Restricted stock units (structured as a nil cost option)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tax treatment upon grant</td>
<td>No tax</td>
<td>No tax if unrestricted market value paid; otherwise, income tax on discount if election to be taxed on grant is made</td>
</tr>
<tr>
<td>Tax treatment upon vesting</td>
<td>No tax</td>
<td>Income tax may arise on lifting of restrictions if unrestricted market value is not paid or if no election is made to be taxed on grant</td>
</tr>
<tr>
<td>Tax treatment on exercise</td>
<td>Income tax on the difference between market value of shares on exercise and exercise price paid</td>
<td>N/A</td>
</tr>
<tr>
<td>Tax treatment upon sale of underlying shares</td>
<td>Capital gains tax payable on difference between share sale price and market value of shares on exercise</td>
<td>Capital gains tax payable on difference between share sale price and market value of shares on acquisition (if no tax paid on vesting)</td>
</tr>
</tbody>
</table>

Special rules apply to share-based incentives held by internationally mobile employees. These provisions require employers and employees to monitor the award-holder’s residence over the ‘life’ of the award. In the case of a share option this will generally be from the date of grant until the award ‘vests’.

As a matter of good corporate governance, it is becoming increasingly common for part of a bonus paid to an executive to be deferred, either on a voluntary or compulsory basis. The deferred element of the bonus is usually provided in the form of an option that vests after a period of time. Sometimes executives are given a matching award in the form of a stock option exercisable after two to three years, subject to the satisfaction of performance criteria.

Where remuneration is deferred or waived, care needs to be taken to ensure that an income tax charge is not inadvertently triggered before such deferral or waiver can take place. Charges can arise under the disguised remuneration legislation if a third party, such as an employee benefit trust, earmarks cash or assets to individual executives. Recent Finance Acts have included amendments that widened the scope of these anti-avoidance provisions.8

The use of clawback to recover payments made in the event of misconduct or misstatement is starting to gain popularity and is compulsory for certain companies within the financial sector. Following a 2014 Upper Tribunal decision in which a taxpayer successfully sought tax relief in respect of a bonus that was subject to clawback, HMRC published guidance on the circumstances in which such a claim can be made.9

ii Social taxes for employees

In most circumstances, where income tax is payable, the employer is required to account for tax under the pay-as-you-earn (PAYE) collection system. Failure to recover this tax from an employee can lead to additional costs for the employer and further tax liabilities for the employee. To guard against this, it is important that incentive plans contain appropriate indemnities. Where tax is payable under PAYE, social security charges (national insurance contributions (NICs)) will also be due. For the 2018–2019 tax year, employee NICs are charged at 12 per cent for earnings of between £162.01 and £892 per week. Above this

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threshold, they are uncapped at a rate of 2 per cent. Employers also have to account for NICs at a rate of 13.8 per cent in respect of employees with weekly earnings above £162. These are also uncapped, and create an additional uncertain liability for an employer. In recognition of this, it is possible for employer NICs to be transferred to the employee in certain limited circumstances, such as the exercise of share options.

Many employers are able to reduce their employer NICs by £3,000 every year by applying the ‘Employment Allowance’; however, this is no longer available for companies where the only employee is the director of that company.

### iii Tax deductibility for employers

Under UK law, the general rule is that a corporation tax deduction is available for expenses incurred wholly and exclusively for the purposes of a trade. Generally, employee salaries and associated costs such as employer social security contributions will be deductible under such principles. An exception to this is where the salary is paid more than nine months after the end of the period of account for which the deduction is claimed.\(^{10}\) In these circumstances, any deduction is deferred until the accounting period in which the salary is actually paid.

A statutory corporation deduction is available in respect of employee share acquisitions and the exercise of share options provided certain conditions are met.\(^{11}\) The conditions relate to the type of business carried on, the nature of the shares acquired and the employee's tax position. Anti-avoidance legislation restricts the availability of corporation tax deductions for contributions to employee benefit trusts to the point at which qualifying benefits or expenses are paid out of the contributions and within certain time limits.

### iv Other special rules

A change in control (such as a takeover or share sale) can affect the statutory corporation tax relief available to a company on the exercise of options over its stock. Most plan rules state that options become exercisable following a change of control. One of the preconditions to claiming corporation tax relief in respect of such exercise is that the stock acquired is in a company either listed on a recognised stock exchange or not under the control of an unlisted company. Because an acquisition or takeover by a private or AIM-listed company\(^{12}\) might mean that this condition ceases to be met, a statutory provision was introduced to give corporation tax relief for a period of 90 days following a takeover by an unlisted or AIM company.\(^{13}\)

When CSOP options are exercised within three years of grant, they can only receive favourable tax treatment in prescribed good leaver circumstances. These include injury, disability and redundancy, and cessation of employment within a group following a business sale or a sale of the subsidiary for which the individual works. Tax relief is also available when CSOP options are exercised in the event of certain cash takeovers. Some companies have historically experienced difficulties with their CSOP options on a takeover as their shares

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\(^{10}\) Corporation Tax Act 2009, Section 1288.

\(^{11}\) ibid., Part 12.

\(^{12}\) AIM is a sub-market of the London Stock Exchange.

\(^{13}\) ibid., Section 1016(1A).
often cease to satisfy the statutory requirements following a change of control. To remedy this, legislation specifically preserves income tax relief where the plan rules permit options to be exercised 20 days either side of a change of control.¹⁴

In the United Kingdom, the tax rules for benefits can be complex. While some are taxable under a statutory regime known as the benefits code,¹⁵ others are subject to their own special rules. Some benefits (such as employer contributions to registered pension schemes, within prescribed limits) are exempt from tax altogether. In the past, payment in the form of benefits in kind has been used as a means of avoiding social security contributions. This is less prevalent now that most benefits attract NICs. Some companies offer their employees a range of benefits from which they can make a selection to suit their particular circumstances. These are known colloquially as ‘cafeteria’ or ‘flex’ schemes, and usually involve the allocation of points or credits that can be spent in purchasing benefits. Under salary sacrifice arrangements, employees are allowed to give up a proportion of their taxable pay in exchange for a tax-exempt benefit such as employer pension contributions or childcare vouchers. These need to be structured carefully to ensure that the desired tax result is achieved. Following concerns that these ‘optional remuneration arrangements’ were being used too widely, the first Finance Act of 2017 introduced measures to restrict the benefits that can attract tax and NICs relief through salary sacrifice to pension, childcare and certain health-related benefits.¹⁶ These apply from 6 April 2017, subject to some transitional provisions for pre-existing arrangements.

Since 6 April 2016, a tax exemption for qualifying business expenses that are paid or reimbursed by an individual’s employer has been available and the dispensation regime (under which employers can agree with HMRC for certain payments to be made to employees free of tax) ceased to exist.¹⁷

Certain forms of termination payment can benefit from a £30,000 tax-free allowance¹⁸ (and escape social security contributions in their entirety). Following a review of the tax and NICs treatment of termination payments, legislation was introduced in the second Finance Act of 2017 to provide that from 6 April 2018, all notice pay (whether contractual or otherwise) is subject to income tax and social security contributions as earnings.¹⁹ From April 2019, it is expected that termination payments above the £30,000 allowance will be subject to employer social security contributions as well as income tax.

### III TAX PLANNING AND OTHER CONSIDERATIONS

An individual coming to work in the United Kingdom who is not domiciled here can claim to be taxed on the remittance basis in respect of his or her overseas earnings. These are broadly earnings with a foreign employer (i.e., one that is non-UK-resident) where the duties of the employment are performed wholly outside the United Kingdom (it should be noted that duties performed in the United Kingdom that are merely incidental to those carried out abroad are ignored for this purpose). In order to be taxed on this basis, some individuals

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¹⁵ ibid., Section 63(1).
¹⁶ ibid., Section 69A.
¹⁷ Finance Act 2015, Sections 11 to 14 and 17.
¹⁹ Finance (No. 2) Act 2017, Section 5(3).
enter into dual contracts under which their UK and non-UK employments are separated although the circumstances in which the remittance basis of taxation will be available under such arrangements are limited.

Where an individual does not have separate employments, he or she might be able to claim overseas workday relief on his or her non-UK duties. Overseas workday relief is only available to individuals who are non-UK domiciled and based here for fewer than three years.

It is not possible to avoid UK tax simply by providing services through a personal services company. Legislation exists\(^{20}\) that deems payments made to service companies to be employment income if, were it not for the existence of the service company, the relationship between the client and worker would be one of employment. If the worker is within the charge to UK income tax, these anti-avoidance rules apply wherever the company is incorporated or resident. The UK government has recently modified the rules applicable to agencies and in Finance Act 2017 introduced anti-avoidance legislation applicable to off-payroll workers in the public sector.\(^{21}\) In May 2018, the government published a consultation paper exploring whether and how these anti-avoidance rules can be extended to the private sector.\(^{22}\)

The United Kingdom has a wide network of double taxation treaties, most of which are based upon the OECD Model Convention. These usually include a tie-breaker clause to determine the residence of an individual, and articles dealing with taxing rights over employment income and the avoidance of double tax. In circumstances where there is no double taxation treaty, UK domestic law can give unilateral relief for overseas tax as a credit against the individual’s UK tax liability.

Since 1 September 2013, an additional form of employment status, ‘employee shareholder’, has existed.\(^{23}\) An individual adopting this status exchanges certain employment rights for tax advantaged shares in the business for which he or she works. The tax reliefs given to this status were, however, reduced with effect from 17 March 2016\(^{24}\) and were removed completely for shares acquired in consideration of employee shareholder agreements made on or after 1 December 2016.\(^{25}\)

IV  EMPLOYMENT LAW

i  Non-competition covenants

In the United Kingdom, the use of non-competition covenants in employment contracts for executives is commonplace. While historically their value has tended to be as a form of deterrent rather than as an enforceable right, in recent years the courts have perhaps shown a greater willingness to uphold non-competition covenants. In each case, the courts will look carefully at whether the covenant in question is necessary to protect the relevant business. Covenants are only enforceable to the extent that they go no further than is necessary to protect the legitimate interests of the person’s employer.

\(^{21}\) Finance Act 2017, Section 6, Schedule 1.
\(^{23}\) Growth and Infrastructure Act 2013, Section 31 and Finance Act 2013, Section 55 and Schedule 23.
\(^{24}\) HM Treasury: Budget 2016, Paragraphs 1.126 and 2.193.
\(^{25}\) Finance Act 2017, Sections 12 to 14.
ii  Non-solicitation covenants

Non-solicitation covenants are more likely to be successful if they relate to existing rather than potential customers. Other relevant factors will be the individual’s role in attracting the business in question, his or her level of seniority, whether the individual had previously dealt with the particular customers in question and the loyalty of customers within that particular sector. As regards poaching employees, although there is no prohibition on an employee choosing to follow a former colleague, the courts have held that there are circumstances in which an employer has a legitimate interest in maintaining a stable workforce.26

iii  Enforceability of restrictive covenants

Generally, the courts will also consider the geographical reach and time duration of restrictive covenants to ensure they go no further than is necessary. In light of the increasing globalisation of business, courts are perhaps more willing to enforce covenants with a wider geographical reach provided this is necessary to protect the business’s interests.27 There is no set time period, as in each case it is necessary to look at how long is needed to protect the particular business; however, six to 12 months is generally regarded as the upper limit of enforceability. If the employee in question is placed on gardening leave (i.e., he or she is retained as an employee during his or her notice period, but not required to come into the workplace), this will affect the period of restriction the court is prepared to enforce. Recent case law has demonstrated that account will be taken of the time taken on gardening leave when determining how long a post-termination covenant can last.28

Restrictive covenants in documents, such as share acquisition agreements and shareholders’ agreements, are subject to the same rules on restraint of trade as those that appear in an employment contract. The courts are sometimes more willing to enforce broader restrictions contained in commercial documents that have been negotiated at arm’s length. Any payments made to individuals for entering into restrictive covenants outside the terms of the employment contract are taxed as employment income. Usual practice is to allocate a specific proportion of any consideration to the restrictive covenant rather than leave it for the UK revenue authorities to attribute a larger sum.

iv  Termination of employment

Where an executive’s employment is terminated, there are a number of claims that he or she might bring against his or her former employer. A claim for wrongful dismissal can be made where the employer terminates a contract in breach of its terms. Usually this happens where an employer does not give adequate notice of termination. If an employer amends an employee’s contract without his or her consent or otherwise fundamentally breaches the contract, the employee might be able to resign and claim that he or she has been constructively dismissed.

An employee who has been unfairly dismissed may be able to bring a statutory claim either instead of or in addition to any claim for wrongful dismissal. In most cases, the employee must have worked for a minimum period of time to be eligible for such remedy.

26 See Dawnay Day & Co Ltd v. D’Alphen and others [1997] IRLR 285, where a one-year non-solicitation covenant in an employment contract applicable to directors and senior employees was held to be enforceable.

27 See, for example, Egon Zehnder Ltd v. Mary Caroline Tillman [2017] EWHC 1278 (Ch). The covenant in that case was later declared invalid by the Court of Appeal on different grounds.

although there are exceptions. A claim must usually be made within three months of the dismissal, and the levels of compensation are in most cases limited by statute. Currently the compensation limit is the lower of £83,682 and a year’s gross salary, plus a ‘basic award’ of up to £15,240 (giving a maximum limit of £98,922), although this is revised every year.

An executive who has been singled out for whistle-blowing or because of their gender, age, race, religion, belief, sexual orientation, gender reassignment, marital status, pregnancy or maternity or disability could also have a claim in respect of which there is no limit on the compensation that can be awarded.

An employer seeking to effectively settle statutory claims brought by an employee can do so by entering into a settlement agreement. This is a binding agreement between the parties that has to meet certain statutory requirements, including a condition that the employee has received independent legal advice in relation to the agreement.

Companies incorporated in the United Kingdom might need to obtain shareholder approval in respect of termination payments made to directors. Such approval is also required where the payment is in connection with a transfer of the company’s business or a takeover. There are exceptions for payments made pursuant to existing legal obligations or as damages, so these provisions generally apply to payments that are ex gratia.

Representative bodies of institutional shareholders, such as the Investment Association, produce guidelines on best practice for listed companies in respect of severance payments. Such companies will generally take these guidelines into account, as they can influence the way in which key shareholders will vote.

UK-incorporated companies whose shares are listed on the London Stock Exchange are subject to additional requirements in respect of termination payments. The Companies Act 2006 (see Section VII) requires quoted companies to submit their policies on termination payments to a shareholder vote at least once every three years. Any payments subsequently made in accordance with this policy must then be announced to the market.

V SECURITY LAW

UK securities rules need to be taken into account when structuring share-based executive remuneration, and can primarily be found in the Financial Services and Markets Act 2000 (FSMA 2000) and the Prospectus Rules, which form part of the Financial Conduct Authority’s (FCA) Rules and Guidance.

i The Prospectus Rules

The Prospectus Rules were introduced to implement the Prospectus Directive29 in the United Kingdom. Under these Rules, it is unlawful for a company or firm, wherever incorporated or registered, to make an offer of transferable securities to employees in the United Kingdom unless a prospectus approved by the FCA (or the competent authority of another EEA state) has been published, or an exemption applies.

The starting position is the same for both private and publicly traded entities. In particular, transferable securities are defined as those that are negotiable on the capital market. ‘Capital market’ is not defined and is given a broad interpretation.30

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In the United Kingdom, the grant and subsequent exercise of an employee share option will not generally give rise to an obligation to publish a prospectus. This is because the FCA takes the view that employee share options (whether nil cost or otherwise) that cannot be assigned or transferred by the employee to a third party (as is usually the case) are not negotiable on the capital market and, therefore, are not transferable securities. The FCA also considers that the exercise of an employee share option is not an offer of the underlying shares to the public. Whether private company shares are negotiable on the capital market is a matter of fact, depending on the rights of the shares in question.

There are a number of exemptions from the need to file a prospectus. For example, an offer currently falls outside the requirements of the Prospectus Rules if the aggregate consideration payable under the offer across the whole of the EEA is less than €8 million (increased from €5 million following the coming into force of the Prospectus Regulation) calculated over a period of 12 months,31 or if the offer is made to fewer than 150 people in each EEA Member State.32 Even where none of the above exemptions is available, a prospectus will not be needed for an offer made to employees provided certain conditions are met.33 Instead, an employee information document will have to be made available to employees receiving the offer that contains information on the number and nature of the securities offered, and the reasons and details of the offer.34 The exemption for offers of securities to directors and employees applies to all companies with a head office or registered office in the EEA, and to non-EEA companies with securities traded either on an EEA regulated market or a non-EEA market that is deemed by the European Commission to have an equivalent legal and supervisory framework.35

In June 2017, the EU adopted the Prospectus Regulation,36 which introduces directly applicable rules that repeal and replace the Prospectus Directive. One key change for employee incentives is that from 21 July 2019, the exemption for offers made to directors and employees will no longer be limited to companies with EEA head offices or registered offices and employees will no longer be limited to companies with EEA head offices or registered offices and non-EEA companies with securities traded on EEA regulated or equivalent markets.

ii The Financial Promotion Regime

The Financial Promotion Regime governs the circumstances and manner in which a company or firm can communicate an invitation or inducement to engage in investment activity to the public (including employees) in the United Kingdom. In particular, unless an exemption from the regime is available, any such communication must be made by a person authorised by the FCA or the Prudential Regulation Authority (PRA), or the contents of the communication must be approved by a person authorised by the FCA or the PRA. Breaching the Financial Promotion Regime is a criminal offence.37

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32 Section 86(1)(b) of FSMA 2000.
33 Prospectus Rules 1.2.2R(5) and Section 85(5)(b) of FSMA 2000.
37 Sections 21 and 25 of FSMA 2000.
Communications to employees regarding the acquisition or sale of shares, and the grant or exercise of options, are likely to be caught by the application of the Financial Promotion Regime. There is, however, a fairly broad exemption for participation in employee share schemes. In particular, the restriction on financial promotions does not apply to any company or firm (or any member of the same group as such company or firm) where the communication is for the purposes of an employee share scheme. As such, particular care must be taken to ensure that this exemption is available, and advice should be sought, especially when third parties (including in the context of a takeover) wish to communicate with employees of an unconnected company or firm regarding their share-based remuneration arrangements.

VI DISCLOSURE

This section summarises the requirements for disclosure of share dealings by directors and senior employees in the context of share-based executive remuneration. It should be read in conjunction with Sections VII and VIII.

i Private companies

For companies (wherever incorporated) whose shares are not admitted to trading on the Main Market of the London Stock Exchange or AIM, there are no requirements under English law for the disclosure of directors’ or senior employees’ interests in their shares. Companies may, however, be required to make certain disclosures in the directors’ report forming part of their annual report and accounts, and the level of detail will depend on the accounting standards being used as well as the size of the company concerned.

ii Listed companies

The Listing Rules are published by the FCA and set out the minimum requirements for securities listed on the Official List. Chapter 5 of the Disclosure Guidance and Transparency Rules within the FCA Handbook provides that at the end of every calendar month during which an increase or decrease in the issued share capital of the company takes place, the company must disclose to the market the total number of shares in each class that it issues.

The EU Market Abuse Regulation (EU MAR) came into force on 3 July 2016 and has had direct effect in the UK from that date. EU MAR replaced the UK’s civil law rules on insider dealing (although not the criminal offence). It also prescribes when certain individuals may deal in a company’s securities and imposes disclosure requirements on those individuals and those closely associated with them. Although in broad terms the principles of disclosure and insider dealing remain very similar, EU MAR applies to AIM-listed companies as well as those whose shares are admitted to trading on the Main Market of the London Stock Exchange. Article 19(1) of EU MAR requires all PDMRs (defined in the same way as FSMA 2000) and persons closely associated with them (PCAs) to notify both the company and the FCA of all transactions in the company’s securities or financial instruments conducted on

39 See Paragraph 60(2) of the Financial Services and Markets Act 2000 (Financial Promotion) Order 2001 for a definition of employee share schemes.
their own account or for the account of a third party. The notification must be made within three business days of the transaction and the company must announce the transaction within the same time limit. Under EU MAR, companies must tell PDMRs about their disclosure obligations and keep a list of both the PDMRs and their PCAs. PDMRs must, in turn, notify each of their PCAs in writing of their disclosure obligations.

EU MAR imposes additional restrictions on when PDMRs can and cannot deal in shares and securities. Although there is no requirement for companies with shares on the Official List to have a dealing policy, as a matter of good practice, most companies choose to have such a policy to ensure PDMRs and their PCAs comply with their obligations under EU MAR.

PDMRs of companies whose shares are admitted to trading on the Main Market of the London Stock Exchange by way of standard listing must comply with EU MAR.

Companies whose shares are admitted to trading on AIM must, as well as complying with EU MAR, comply with the AIM Rules for Companies. The AIM Rules impose a requirement for AIM companies to have a ‘reasonable and effective dealing policy’.

VII CORPORATE GOVERNANCE

The UK corporate governance regime comprises a mixture of statutory rules, codes and investor guidelines. The extent to which these apply to a company will often depend upon where the company is incorporated, whether it is a quoted company, the size of the company and, in some cases, the type of activity undertaken by it.

i Statutory controls

The Companies Act 2006 sets out rules that apply to UK-incorporated companies, including requirements that:

a details of directors’ remuneration are disclosed in the company’s annual report and accounts;41

b shareholder approval is obtained for certain termination payments made to directors;42

c service contracts lasting longer than two years are approved by shareholders.43

UK-registered quoted companies44 are subject to an additional requirement to produce an annual report on their directors’ remuneration that is subject to a shareholder vote. Since 1 October 2013, the directors’ remuneration report has been split into two parts. The first part comprises the policy report. This sets out the company’s current and future policy on executive remuneration, and is subject to a binding vote (i.e., 50 per cent approval is required) at least every three years. The second part of the report sets out how the policy has been implemented during the year and is subject to an annual advisory vote. If the implementation report is not passed, a vote on the policy report is required at the next AGM. The company’s

41 Companies Act 2006, Section 412.
42 ibid., Section 217.
43 ibid., Section 188.
44 Broadly, those whose equity share capital is included in the FCA’s Official List, officially listed in an EEA state or admitted to dealing on the New York Stock Exchange or NASDAQ. This does not include companies traded on AIM.
approach to exit payments needs to be included in the remuneration policy, and is therefore subject to a binding vote. The Companies (Miscellaneous Reporting) Regulations 2018 were published on 17 July 2018. The Regulations contain various new reporting requirements for public and private companies that will require them to more clearly explain decisions on executive pay. One of the key changes is a new requirement for UK-registered quoted companies with more than 250 UK employees to report pay ratio information comparing the remuneration of the CEO with the 25th, 50th and 75th percentiles of the full-time equivalent remuneration of the company's UK employees. The new requirements will apply in relation to financial years starting on or after 1 January 2019. This means that reporting will begin in 2020 covering activities undertaken and information collected in 2019.

ii Regulatory controls

The Financial Reporting Council (FRC)\(^\text{45}\) publishes the UK Corporate Governance Code (the Code), which sets out standards of good practice in relation to board behaviour including remuneration, accountability and its relationship with shareholders. The Code is technically voluntary; however, all companies with a premium listing of equity shares in the UK, whether or not incorporated in this country, are required to report on whether they have applied the Code and explain areas of non-compliance.\(^\text{46}\)

The Code requires executive directors' remuneration to be designed to promote the long-term success of the company. It states that the performance-related elements of directors' remuneration should be 'stretching' and applied rigorously and, where appropriate, companies should consider using non-financial performance metrics, such as customer satisfaction, as well as financial measures. It also includes a requirement that performance-related plans for executive directors include provisions that enable the company to recover sums paid or withhold the payment of any sum (i.e., malus and clawback) but leaves it to the remuneration committee to determine the circumstances in which this should apply.

In July 2018, the FRC published an amended UK Corporate Governance Code that will take effect for financial years beginning on or after 1 January 2019.\(^\text{47}\) One key change is that the Code stipulates that a company should engage with its workforce through one or a combination of the following: (1) appointing a director from the workforce; (2) creating a designated non-executive director; or (3) establishing a formal workforce advisory panel. If the company does not choose one of these methods then it should explain what alternative arrangements are in place and why it considers them to be effective.

iii Institutional investor guidelines and the Stewardship Code

Shareholders of listed companies are encouraged to use their voting powers to ensure good corporate governance. Institutional investors (such as pension funds and insurance companies) are represented by investment committees, many of which publish guidelines for best practice on share-based remuneration. The guidelines issued by the Investment Association, the Pension Lifetime Savings Association and the Pensions and Investment Research Consultants Ltd are often considered.

\(^{45}\) The FRC is the independent regulator in the UK with responsibility for promoting good corporate governance.

\(^{46}\) A company with a premium listing on the Official List must meet the most stringent standards.

The Stewardship Code was first published by the FRC in 2010 and will be consulted on later in 2018. It sets out good practice for institutional investors when engaging with companies listed in the United Kingdom. The principles within the Stewardship Code apply on a comply-or-explain basis, and state that institutional investors should have a clear policy on voting and should vote all the shares they hold. The FRC is keen to encourage overseas investors holding shares in UK-listed companies to comply with the Stewardship Code, and for UK institutional investors to apply it to their overseas holdings.

iv The Listing Rules
The Listing Rules provide that certain forms of incentive arrangement require prior shareholder approval before they can be implemented. These include employee share schemes involving the issue of new shares, and long-term incentive plans in which directors are entitled to participate.48

v AIM and private companies
Companies with securities traded on AIM do not need to comply with the Listing Rules, but have their own rules and their own source of corporate governance guidelines, for example, the Corporate Governance Code published by the Quoted Companies Alliance, the Corporate Governance Policy and Voting Guidelines for Smaller Companies published by the Pension Lifetime Savings Association, the Institutional Shareholder Services UK and Ireland Proxy Voting Guidelines and the European Corporate Governance Guidelines. From 28 September 2018, AIM companies are required to adopt a corporate governance code49 and on 13 June 2018, the FRC issued a draft of the Wates Corporate Governance Principles for Large Private Companies for consultation.50

VIII SPECIALISED FINANCIAL SERVICES REGULATORY REGIMES
The United Kingdom has seen similar trends to many other developed countries in the scrutiny and the regulation of remuneration in the financial services sector. These have been heavily shaped by EU legislation. Generally, the strictest and most well-developed regulations have been applied first to systemically important banks, with similar provisions gradually extended to the wider financial services sector. From 2013 onwards, there has been a significant increase in the number of different remuneration codes applied by the FCA and PRA to different types of financial services firms, reflecting the implementation of various EU regimes and the separation of responsibility between the two regulators. The current set of codes is shown below:

48 Listing Rule 9.4.1.
49 AIM Rule 26.
PRA-regulated insurers that are subject to the Solvency II Directive must comply with remuneration rules in the Solvency II Delegated Regulation, but as these are directly applicable, they have not been transposed into the PRA Rulebook.

### General principles

Broadly, the general principle of the codes is that firms should establish and maintain remuneration policies and practices that promote sound and effective risk management. Some firms may find that they are subject to more than one code.

The codes are generally divided into a number of principles, some of which apply to the whole firm and others of which apply only to staff whose activities have a material impact on the firm’s risk profile (known as Code Staff). In certain cases, other requirements attach to senior managers and groups.

Although many of the requirements in the different codes are similar and reflect broadly correlative EU standards across industry sectors, there are nonetheless key differences between them that may make applying some codes more onerous. For example, the CRR Firms Remuneration Code, the IFPRU Remuneration Code and the Dual-Regulated Firms Remuneration Code each contain a specific ‘bonus cap’ requirement derived from the CRD IV Directive. This requires that the variable remuneration of Code Staff must not exceed 100 per cent of fixed remuneration or 200 per cent if shareholder consent has been obtained. The other codes do not apply a hard numerical cap of this nature.

The new SYSC 19F code relating to the remuneration of sales staff is designed to implement the MiFID II remuneration requirements in the UK.\(^{51}\) It is considerably shorter than the other codes and contains provisions that are generally less prescriptive. Broadly, it

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\(^{51}\) Directive 2014/65/EU.
imposes an overarching obligation on relevant firms to ensure that when they are providing MiFID investment services to clients, they do not remunerate or assess the performance of staff in a way that could create a conflict with the duty to act in the client’s best interests. Despite its title, the code does not only apply to sales staff, but also to other individuals, including senior management, to the extent that their remuneration could create a conflict encouraging them to act against the interests of clients. From October 2018, the SYSC 19F code will contain additional remuneration requirements applicable to firms acting as distributors of insurance products. These requirements are very similar to those that apply to MiFID services under the same code, essentially requiring firms to ensure that they do not use remuneration structures, sales targets or other arrangements that could conflict with their duty to act in their clients’ best interests or could incentivise staff to recommend particular insurance contracts when other products would better suit their clients’ needs.

From time to time, European regulators issue guidance on the EU legislation underpinning certain codes, which may require the FCA and PRA to reassess the UK domestic implementation of those rules. For instance, the European Banking Authority (EBA) issued guidelines in 2015 that emphasised that ‘role-based allowances’ (which a number of British banks had paid as fixed remuneration to avoid the bonus cap) must be considered to be variable remuneration unless they meet strict criteria to be classified as fixed remuneration under rules implementing CRD IV.

Where a firm breaches an applicable remuneration requirement, the FCA or PRA (or both) may take appropriate enforcement action.

ii Proportionality
Not all firms have to give effect to the remuneration requirements in the same way and to the same extent. Each of the codes (with the exception of the new SYSC 19F code) contains the concept of proportionality, under which the firm must comply with the requirements in a manner and to the extent that is appropriate to its size, internal organisation and the nature of its activities. The FCA and PRA have produced guidance for many of the codes explaining the relevant factors in determining how proportionality applies. Firms of greater significance and posing the greater risk to financial stability fall within the highest proportionality level and will have the greater levels of compliance.

Proportionality is a key political issue, as in February 2016, the FCA and PRA refused to apply the EBA’s interpretation of proportionality under the CRD IV regime to relevant UK firms. The EU is seeking to clarify the application of proportionality under the CRD regime in its proposed CRD V Directive, which, if adopted as originally drafted, will introduce defined quantitative criteria for these purposes. It will also contain an exhaustive list of which remuneration principles can be disapplied on the grounds of proportionality, which will not include the bonus cap. This would represent a significant change from the current UK approach. However, at the time of writing, negotiations on the CRD V text are continuing and it is possible that a somewhat more flexible approach to proportionality may eventually be retained in the final text.

iii Remuneration policies, record-keeping and reporting
Firms must ensure that their remuneration policies and practices are clear and well documented and that proper records are kept to evidence compliance with the applicable codes. Certain
firms may also be required to report remuneration details to the FCA or PRA on an annual basis for comparison and benchmarking purposes and to make public disclosures of certain aggregated remuneration data.

IX DEVELOPMENTS AND CONCLUSIONS

Corporate governance reform is definitely the prevailing theme for this year and, from 2020, many companies (including those in the private sector) will find themselves having to more clearly explain and justify the reasons for their decisions on executive pay. Those working within the ‘gig’ economy may feel the effects of the ‘off-payroll’ rules if (as we expect them to be) they are extended to the private sector. With Parliament’s time continuing to be dominated by Brexit, large-scale legislative changes in the field of incentives and remuneration are not expected. Instead, company behaviour is most likely to be guided by the views of shareholders and the force of public opinion.
INTRODUCTION

Governmental regulation of private sector executive compensation practices, particularly at US public companies, has been a visible focus of public policy for the past few decades. Regulation has principally taken the form of special tax, corporate disclosure and securities listing rules under federal law, many of which are technical and non-intuitive and have had unintended consequences. The most important recent developments include comprehensive tax reform legislation enacted in 2017, an advisory say-on-pay regime and a complex regulatory regime for deferred compensation that subjects employees to the risk of punitive taxes for certain payments of compensation that are made after the compensation has been earned. The 2008 financial crisis caused US regulators to focus special attention on compensation in the financial services industry, in accordance with global mandates focused on that sector, resulting in the adoption and proposal of several executive compensation-related regulations pursuant to the Dodd‒Frank Wall Street Reform and Consumer Protection Act (the Dodd‒Frank Act).

Specifically, this year, as a result of the US Securities and Exchange Commission’s (SEC) finalised regulations under the Dodd‒Frank Act, public companies were required to disclose the ratio of chief executive officer to median employee pay. In recent years, the SEC has also proposed rules pursuant to the Dodd‒Frank Act covering (1) the recoupment of incentive-based compensation from current and former executive officers that had been awarded erroneously, (2) disclosure of the relationship between compensation actually paid to executive officers and the financial performance of the company, and (3) disclosure about whether directors, officers and other employees are permitted to hedge or offset any decrease in the market value of equity securities granted by the company as compensation or held, directly or indirectly, by employees or directors. Moreover, in 2016, rules were proposed that would (1) prohibit incentive-based payment arrangements that US regulators determine might encourage inappropriate risks by certain financial institutions by reason of providing for excessive compensation or that could lead to material financial loss, and (2) require those financial institutions to disclose information concerning incentive-based compensation arrangements to the appropriate US regulator. However, the prospect for

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adoption of many of these proposed rules seems unlikely in light of the regulatory priorities of the current US administration. Additionally, there has been an increased focus in recent years on environmental, social and cultural concerns, including pay equity, harassment and other issues raised by the #MeToo movement. Legislatures have responded to these concerns in various ways. For example, in connection with 2017 tax reform, legislators disallowed deductions for certain settlements related to sexual harassment if such settlements are subject to nondisclosure agreements.

In addition, the structuring of executive compensation in the United States is significantly affected by state, rather than federal, rules that govern the fiduciary responsibilities of corporate directors and agreements not to compete. Neither federal nor state law imposes generally applicable statutory requirements governing the basics of the employment relationship or the structure, type or amount of incentive arrangements. Rather, employment relationships in all states are governed by contractual commitments made between the employer and the executive and, in the absence of such commitments, employment is at will, which means generally that either party can terminate the employment relationship at any time, for any or no reason.

As a result, executive compensation arrangements in the United States include a very diverse range of practices and approaches. However, particularly among public companies, best practices have substantially influenced approaches to certain issues.

II TAXATION

US citizens and resident aliens are taxed on their worldwide income. Non-resident aliens are taxed on income from US sources, which generally includes all compensation attributable to the performance of services by an executive in the United States. This section describes the US federal income tax rules generally applicable to US citizens and resident aliens, and to non-resident aliens in connection with services performed in the United States (hereinafter, collectively, US executives). Special allocation rules may be applicable to incentive and deferred compensation allocable to services performed both within and outside the United States. This chapter does not extend to describing state and local tax rules, which vary considerably.

Except as described below, US corporations are generally entitled to deduct compensation paid to US executives at the same time as the compensation is required to be taken into account by the executives as ordinary income (as described below), and in the same amounts. No deduction is available for income taxable at capital gains rates.

In 2017, the US enacted comprehensive tax reform legislation pursuant to the Tax Cuts and Jobs Act (TCJA), which included certain executive compensation reforms, described in greater detail below.

i Ordinary income and capital gains tax rates

Compensation income for US executives – including, for example, salary, bonuses, taxable employment benefits (such as the use of a company car for personal purposes) and income from the exercise of employee stock options – is generally taxed as ordinary income at

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4 Treasury Regulations Section 1.861-4(b)(2).
5 An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018, Pub. Law No. 115-97 (2017).
graduated rates, with a maximum rate of 37 per cent, which for the 2018 tax year starts at taxable income in excess of US$600,000 for married individuals filing jointly. Married individuals filing separately are currently subject to a maximum rate of 37 per cent on all ordinary income in excess of US$300,000, and the 37 per cent rate is applicable to income of single taxpayers above US$500,000. Capital gains are subject to income tax at a maximum rate of 20 per cent if the property has been held for more than a year.

ii  Income tax withholding and reporting
Employers are required to withhold income taxes from compensation paid to US executives and remit the withheld amounts to the US Internal Revenue Service (IRS). Employers are also required to report annually to the IRS the amount of compensation paid. The withholding rules apply to non-US employers, but practical and jurisdictional issues make it difficult for the IRS to monitor and enforce these requirements, particularly for non-US companies that have no business presence in the United States. US executives who have insufficient amounts withheld from their compensation may be required to make quarterly payments directly to the IRS to avoid penalties.

iii  Employment tax and withholding
US executives employed by US entities are required to contribute to the US Social Security and Medicare systems, which provide retirement, disability and health insurance benefits to participants. Social Security tax contributions are made through payroll withholding by the US executive at a rate of 6.2 per cent of income up to US$128,400 for 2018. In addition, employers are required to contribute 6.2 per cent of income up to US$128,400 on behalf of each of their US executives. For Medicare taxes, US executives and their employers each must contribute 1.45 per cent on all earnings. Unless an agreement with the government is implemented under Section 3121(l) of the US Internal Revenue Code of 1986 (the Code),6 US executives employed by non-US entities are not required to contribute, and no benefit accrues for them under the system as a result of such employment. For most US executives, this circumstance will not be material because the maximum benefit is relatively small and because many will in any case earn the maximum benefit by reason of other (prior or subsequent) employment. In addition, a supplementary 0.9 per cent Medicare tax is imposed on payroll income of US executives (but not employers). Although there have been several legislative efforts in recent years to repeal or replace the Patient Protection and Affordable Care Act, such efforts have been unsuccessful, and it appears that changes in these taxes are not likely.

iv  Accounting for tax
US executives are required to account for their income on a calendar-year basis. Generally, income is accounted for on a cash basis (i.e., a US executive is generally not required to pay income taxes on compensation income until he or she has actually received the compensation in cash or other property). Notwithstanding the general cash-basis accounting rule referred to above, there are three important rules that effectively require accrual accounting. These are discussed below.

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6 Section 3121(l) of the Code permits a non-US subsidiary of a US corporation to enter into an agreement to permit US employees of the subsidiary to participate in the Social Security system.
Deferred compensation

Section 409A of the Code imposes a complex tax regime in respect of deferred compensation. Compensation may be considered to be deferred compensation if the promise to pay the compensation is made in a year and the payment may be made in any subsequent year. Conditional promises are within the scope of Section 409A. For example, an employer’s promise in December 2017 to pay a US executive a bonus some time in 2019, unless profits for 2018 are below US$100 million and provided that the US taxpayer executive’s employment continues until the end of 2018, is deferred compensation unless an exemption applies.

Generally, the purpose of Section 409A is to ensure that employers and employees cannot change the timing of payment of compensation in order to take advantage of changes in applicable tax rates or other circumstances. Section 409A applies, often in unexpected ways, to many routine compensation arrangements, including promises to pay severance or holiday, to reimburse for housing costs or to make future stock awards. Failure to comply with the rules may result in immediate taxation of the deferred compensation (even if the compensation is not then payable), and the imposition on the employee of a 20 per cent tax in addition to regular income taxes and an interest component calculated generally from the date that the deferred compensation was earned. The requirements of Section 409A apply to both the documentation of deferred compensation arrangements, which must reflect the many technical requirements of the rules, and the administration and operation of the arrangements. Virtually all employment and compensation agreements with US executives must reflect the rules under Section 409A.

Section 409A imposes three basic requirements in respect of deferred compensation. First, when a promise to pay deferred compensation is made, the timing of payment must be established. Any attempt to change the timing of payment, by either the employer or the employee, is subject to significant limitations. Second, a payment of deferred compensation may be made only at certain permitted times. Generally, there are six permissible payment events: death, disability, separation from employment, change in control, a specific calendar date or the hardship of the employee. Third, payments of deferred compensation to senior executives of public companies (including non-US companies) may not be made during the six-month period following termination of employment, subject to exceptions.

An exception from the requirements of Section 409A for ‘short-term deferrals’ provides one of the more important opportunities to effectively avoid the Section 409A regime. Under the exception, if a promise to make a compensation payment is subject to a material condition (such as, for example, continued employment) and the payment will always be made within approximately 75 days of the end of the year in which the condition is satisfied, then the rules of Section 409A generally do not apply. There are also exceptions for limited payments of severance benefits, reimbursements of expenses that are made shortly after the expense is incurred and other types of payments that may be relevant in particular situations. Section 409A also prohibits an employer from setting aside amounts in a non-US account or other funding vehicle to provide for the payment of deferred compensation. In some jurisdictions, such funding arrangements are common and provide tax benefits, but they may give rise to substantial adverse tax consequences for US taxpayer executives.

Employers located in tax havens or subject to certain tax benefits

As with Section 409A of the Code, Section 457A of the Code also can result in accrual, rather than cash, accounting for deferred compensation in certain circumstances, and
non-compliance with these rules can result in the imposition of an additional 20 per cent tax. However, the application of Section 457A is considerably narrower than that of Section 409A. Generally, the accrual rules of Section 457A apply to deferred compensation payable to a US executive for services rendered to an entity that is not organised in a jurisdiction that has entered into a tax treaty with the United States, or that is subject to a comprehensive income tax but benefits from a favourable tax regime or arrangement, or is otherwise entitled to exclude significant portions of its non-resident source gross income from tax. Very generally, the penalty provisions of Section 457A apply to deferred compensation payable by such entities that has an uncertain value when earned. Notably, as under Section 409A, there is a short-term deferral exception under Section 457A, but it is significantly more limited.

The doctrine of constructive receipt
The third rule that effectively requires accrual basis accounting for compensation is commonly referred to as the doctrine of constructive receipt. When an employee uses a cash basis method of accounting, the employee only recognises compensation for tax purposes when the compensation is actually received. Under the doctrine of constructive receipt, compensation is treated as actually received – that is, it is constructively received – if the employee has the unrestricted current right to receive the compensation, even if the employee elects not to accept it. The doctrine of constructive receipt, the contours of which have largely been shaped by court decisions, requires that employers be cautious about offering US executives opportunities to receive compensation currently or in the future. Such offers often will also fall foul of the rules under Section 409A.

Acceleration of income recognition
Section 83 of the Code permits the intentional acceleration of income by US executives in limited circumstances. The opportunity to accelerate income under Section 83 is commonly referred to as the ability to make a Section 83(b) election.

Section 83 of the Code governs the taxation of transfers of property (most commonly employer stock) in connection with the performance of services. Preliminarily, consider the tax consequences to a US executive whose employer promises to pay him or her a bonus of 100 shares of stock in three years if he or she remains employed for the full three-year period (the vesting period). Under the cash-basis accrual rules described above, he or she generally will be required to recognise ordinary income equal to the value of the shares when they are delivered, at the end of the vesting period. Now consider the tax consequences if the employer delivers the stock at the time of the promise, and the US executive agrees not to transfer the stock during the vesting period and to return it to the employer if his or her employment ends before the vesting period expires: the US executive would also be subject to tax at the end of the third year based on the value of the stock at that time, unless he or she makes a Section 83(b) election.

A US executive who makes a Section 83(b) election is permitted to recognise income at the beginning of the vesting period in an amount equal to the value of the 100 shares at that time. Any appreciation in the value of the shares during the vesting period will be taxed, at the time that the shares are sold, at typically lower capital gains rates.

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7 Treasury Regulations Section 1.451-2.
There are some negative consequences to making a Section 83(b) election. First, the US executive must pay taxes to the IRS at the beginning of the vesting period, and the amount to be paid generally will need to be taken from his or her savings or other earnings. Second, if shares are forfeited because the US executive's employment ends before expiry of the vesting period, there is no refund of the taxes paid by the executive at the beginning of the period.

Tax consequences of equity compensation awards
A substantial portion of a US executive's compensation package typically consists of equity-based incentive awards. A description of some common types of equity awards used in the United States, and the basic federal income tax consequences for US executives who receive them, follows.

Stock options and stock appreciation rights
A non-qualified stock option (as contrasted with an incentive stock option, described below) is a right to purchase stock at a fixed price in the future. Most non-qualified stock options have terms of 10 years. For tax and other reasons, the exercise price (i.e., the fixed price at which the stock subject to the option can be purchased) is typically equal to the fair market value of the stock at the time that the stock option is awarded. Stock options are usually awarded subject to a vesting condition, such as either continued employment or the satisfaction of performance-related criteria. Stock options usually terminate upon or shortly after the termination of employment of the option holder.

A stock appreciation right (SAR) is an incentive award that is financially identical to a stock option but differs because the value upon exercise is delivered to the employee, who is not required to pay any amount to purchase the underlying stock. Employers sometimes use cash-settled SARs, rather than stock options, so that legal restrictions related to the sale or ownership of stock do not apply or to avoid issuing actual equity to executives.

A US executive is generally not required to recognise income at the time that he or she is awarded a non-qualified stock option or SAR. Rather, the US executive is taxed at the time that the award is exercised. The value at exercise is taxed at ordinary income rates as compensation. If stock is received upon exercise, any subsequent appreciation (or depreciation) in the value of the stock is treated as a capital gain (or loss).

The tax consequences described in the preceding paragraph do not apply to incentive stock options that qualify for special tax treatment. The special rules for incentive stock options were intended to provide tax benefits to executives, subject to certain conditions. Specifically, gains from incentive stock options may not be required to be recognised until the stock underlying the stock option is sold, and that gain may be taxable at capital gains rates, rather than regular, graduated rates. Historically, there was a substantial tax risk for most US executives of earlier taxation under the alternative minimum tax rules. The alternative minimum tax is a parallel regime for income tax under which taxpayers who are not liable for regular income tax (because, for example, they qualify for large tax deductions) are nevertheless liable to pay a minimum amount of tax, which can be significant. For this and other reasons, incentive stock options were not widely used. However, the TCJA increased the alternative minimum tax exemption and phase-out amounts, and this change may cause companies to reconsider the use of incentive stock options going forward.
Restricted stock and restricted stock units

Restricted stock and restricted stock units (RSUs) are two common types of equity awards under which US executives may be entitled to earn the full value of a share of employer stock, and not just the future appreciation as with stock options and SARs. An award of restricted stock is a current transfer of stock from the employer to the executive, subject to a forfeiture condition (such as continued employment or financial performance). If the forfeiture condition occurs, then the stock must be returned. When a share of restricted stock is awarded, the share is treated as outstanding under US corporate and accounting principles, so that it can be voted on and dividends may be payable to the holder of the stock. Frequently, dividends paid on restricted stock are subject to the same forfeiture conditions as the restricted stock itself. As discussed above, restricted stock is taxed under Section 83 of the Code.

RSUs, also sometimes referred to as phantom stock, provide a substantially similar financial benefit to US executives as restricted stock, but are subject to different tax rules. An RSU is a promise to deliver stock, or cash equal to the value of a specified number of shares of stock, in the future. The promise is usually subject to a vesting condition, but the delivery date does not have to be coincident with the satisfaction of the vesting condition. The US executive must recognise income for US federal income tax purposes only when the shares or cash are delivered, in an amount equal to the value of the shares at that time or the amount of cash paid. Under US corporate and accounting principles, the shares are not treated as outstanding until they are delivered, so they cannot be voted on and no dividends are paid on the shares until the delivery date. No Section 83(b) election can be made for shares subject to an RSU. RSUs are subject to the requirements of Section 409A of the Code described above, unless they are exempt as short-term deferrals, and in any case are not subject to the rules of Section 83.

Profits interests

Profits interests are a type of equity award commonly used in the US in certain limited business contexts, typically involving investments by private equity or hedge funds. Profits interests have financial characteristics for executives that are similar to stock options, but the income to the executive is largely taxed at capital gains rates, rather than as ordinary income provided that certain conditions, including a three-year holding period requirement, are met. The term profits interest refers to an interest in a business enterprise organised as a partnership. The use of an entity taxed as a partnership as part of the ownership structure of a business is necessary to be able to take advantage of the special rules available for profits interests. A Section 83(b) election can be made for a profits interest.

Private company options and restricted stock units

The TCJA added a new Section 83(i) to the Code. Under Section 83(i), certain employees of privately held corporations who receive company stock in connection with the exercise of an option or the settlement of an RSU award may elect to defer tax for up to five years post-vesting, subject to specified eligibility requirements, which are quite restrictive.\(^8\) The

\(^8\) For example, the employee must meet the statutory definition of ‘qualified employee’, and the private company must have a written plan under which, in the applicable calendar year, not less than 80 per cent of all employees who provide services to the company in the US are granted stock options or RSUs with
amount of income required to be recognised at the end of the deferral period is based on the value of stock on the original exercise or settlement date. Private companies are required to notify employees of the Section 83(i) deferral election opportunity on or prior to the time that an option or RSU vests, and failure to provide this notice will result in a fine of US$100 per missed notice, subject to a cap of US$50,000 per year.

The following chart summarises the federal income tax treatment to US executives of common types of equity awards:

<table>
<thead>
<tr>
<th></th>
<th>Option</th>
<th>Restricted stock</th>
<th>Restricted stock unit (promise to deliver stock in the future)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tax treatment upon grant</td>
<td>Non-event</td>
<td>• No 83(b) election: non-event</td>
<td>Non-event</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• 83(b) election: ordinary income equal to the fair market value (FMV) of the shares acquired (less any purchase price)</td>
<td></td>
</tr>
<tr>
<td>Tax treatment upon vesting</td>
<td>Non-event</td>
<td>• No 83(b) election: ordinary income equal to the FMV of the shares acquired</td>
<td>Non-event</td>
</tr>
<tr>
<td>Tax treatment upon delivery</td>
<td>Ordinary income equal to the excess of FMV of shares acquired over the exercise price</td>
<td>N/A</td>
<td>Ordinary income equal to the FMV of the shares acquired</td>
</tr>
<tr>
<td>Tax treatment upon sale of underlying shares</td>
<td>Capital gains equal to the excess of sales proceeds over amount previously recognised as ordinary income</td>
<td>Capital gains equal to the excess of sales proceeds over amount previously recognised as ordinary income</td>
<td>Capital gains equal to the excess of sales proceeds over amount previously recognised as ordinary income</td>
</tr>
</tbody>
</table>

vi Special deductibility rules

There are two important exceptions to the generally applicable deductibility rule for compensation paid to US executives described above.

First, Section 162(m) of the Code limits the ability of a US public corporation to take tax deductions for compensation in excess of US$1 million per year paid to certain covered executives, including the CEO. Prior to the enactment of the TCJA, covered executives under Section 162(m) included a company’s CEO and the three other most highly compensated executive officers, other than the CFO. Further, there was a significant exception from the deductibility limit for qualified performance-based compensation. Effective in 2018, the scope of covered executives under Section 162(m) was expanded to include the company’s CFO, and once an executive qualifies as a covered executive, the deduction limitation applies indefinitely. The TCJA also eliminated the qualified performance-based compensation exception and expanded the scope of companies subject to the rule. The TCJA provides transition relief that preserves the deductibility of compensation provided pursuant to written binding contracts in effect on 2 November 2017 and not materially modified thereafter.

Second, a corporation that pays an annual bonus that is fully earned in a taxable year not later than two-and-a-half months following the end of that taxable year may deduct the bonus payment for the taxable year in respect of which it was earned, even though it is not paid, and the US executive who receives the payment is not required to include the amount in income until the following year.

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the same rights and privileges to receive qualified stock.
Golden parachute excise tax

Sections 280G and 4999 of the Code provide for a special 20 per cent excise tax on certain US executives, and a loss of deduction for their employers, for certain payments made in connection with a change in control of the corporation. Practically, these rules apply only to public corporations, as an exception applies for privately held corporations whose shareholders approve the compensation payments. The tax rules only apply to the extent that the change in control compensation payable to a US executive equals or exceeds a minimum threshold of three times the executive’s average compensation from the corporation during the previous five years. If that threshold is crossed, then the amount of change in control compensation in excess of one times that average is subject to the tax and non-deductible. Change in control compensation includes cash and stock payments linked to the change in control, including the accelerated vesting of equity and other incentive awards. Exceptions apply for reasonable compensation earned prior to and following the change in control. Any amount paid, or payable pursuant to an agreement entered into, within one year prior to the change in control, is rebuttably presumed to be linked to the change in control.

Medical benefits

Rules under the Patient Protection and Affordable Care Act (commonly referred to as ‘Obamacare’) continue to be implemented, but the mandate requiring individuals to purchase a minimum level of health coverage was effectively eliminated under the TCJA. While the rules have only limited applicability to executives, aspects of some executive arrangements, involving special medical care arrangements for executives, may be affected by the rules. Various legislative proposals to repeal and replace the Patient Protection and Affordable Care Act have been introduced, but none of these proposals have been enacted.

TAX PLANNING AND OTHER CONSIDERATIONS

Special, limited, transitional rules apply under Section 409A of the Code for US aliens who become US taxpayer executives and who entered into deferred compensation arrangements prior to becoming US taxpayer executives. Generally, the rules provide a one-year period to amend such arrangements to comply with Section 409A. In addition, as noted above, Section 409A prohibits an employer from setting aside amounts in a non-US account or other funding vehicle to provide for the payment of deferred compensation. Consideration should be given to any such arrangements maintained for the benefit of US aliens who become US taxpayer executives.

EMPLOYMENT LAW

Employment contracts and severance benefits

As noted above, most of the terms and conditions of an executive’s employment are established by contract between the employer and the employee, and not by statute.

Executives typically enter into contractual agreements with their employers, which provide that, if an executive’s employment is involuntarily terminated, he or she will be entitled to a severance benefit that is usually a multiple of compensation – for example, one to two times the executive’s average total compensation for the previous three years. Often, other ancillary benefits are also provided, such as vesting of equity-based compensation
awards. The employer’s obligation to pay severance is almost always conditioned on the executive agreeing to release the company from any legal claims that the executive may have against the company. The severance benefit can be paid in either instalments over time or as a lump sum. It is uncommon for severance benefits to be reduced in the event that the executive obtains new employment following his or her dismissal.

ii Agreements not to compete or solicit

Many US companies require their executives to agree, as part of their employment terms, that after their employment ends they will not disclose confidential information about the company to other persons, disparage the company, solicit the company’s employees or customers or, sometimes, compete with the company. While confidentiality provisions are often very broad and continue indefinitely, non-competition and other restrictions are usually narrowly tailored to the particular company’s circumstances and extend for a limited period (e.g., as little as six months or as long as five years). Furthermore, the enforceability of non-competition provisions, in particular, is often subject to some uncertainty, and in some jurisdictions (e.g., California) non-competition provisions are generally unenforceable unless the non-competition agreement is negotiated in connection with the acquisition of a business in which the executive is an owner. Typically, the enforceability of such provisions is linked to whether they are viewed as a reasonable means to protect the company’s proprietary interests, viewed in light of the public policy favouring employment. Garden leave or similar provisions, under which an employee is paid during a period of notice prior to termination of employment or forced inactivity, are used intermittently. There have been proposals in recent years suggesting that non-competition provisions should be further limited, and some states have narrowed their non-compete laws, which suggests that these proposals are gaining momentum. For example, Massachusetts recently passed a law that, among other items, limits post-employment non-competes to a maximum period of 12 months and absent an agreement to the contrary, requires employers to pay 50 per cent of the former employee’s back salary during the restricted period. The new Massachusetts law applies to non-competition agreements entered into on or after 1 October 2018.

iii Change in control benefits

It is very common for US public companies to provide certain benefits to their executives if there is a change in control (CIC) in order to provide a strong retention incentive and to assure equitable treatment to management in the event of a sale of the company.

Enhanced severance benefits and accelerated vesting of outstanding incentive awards are the two most common types of supplemental CIC benefits. Enhanced severance benefits provide a strong incentive for executives to remain employed notwithstanding the prospect of a sale of the company. Often, the enhanced severance benefits are paid if the executive is dismissed or if the executive voluntarily ends his or her employment after a CIC because of an adverse change to his or her job (e.g., a demotion or a pay reduction) following the CIC. These are commonly referred to as terminations for good reason. In the past, it was also not unusual for senior executives to be entitled to voluntarily quit their jobs following a CIC and receive enhanced severance benefits. This is referred to as a single-trigger arrangement (as

10 Massachusetts Noncompetition Agreement Act, MGL Chapter 149 Paragraph 24L.
contrasted with a double-trigger arrangement, under which two events beyond the executive’s control—that is, both a CIC and involuntary termination of employment—had to occur for the executive to be entitled to the benefit, and it provides a very strong retention incentive, because executives who work until the CIC occurs are assured of the ability to collect these enhanced benefits. However, single-trigger arrangements have become less common on the basis that they are unnecessarily generous.11

Accelerated vesting of incentive awards assures executives that they can participate in the sale that constitutes the CIC with a portion of their otherwise unvested incentive compensation. Accelerated vesting can occur after only a single trigger (i.e., immediately upon the CIC) or it can be a double-trigger provision (i.e., accelerated vesting occurs if the executive’s employment is terminated involuntarily without cause or voluntarily for good reason shortly after a CIC).

tv Salary history bans
In recent years, several US states and certain cities have adopted or proposed legislation that would prohibit employers from enquiring about an employment applicant’s salary history. Salary history is generally defined broadly to encompass salary, bonus and other forms of remuneration. These legislative efforts are primarily aimed at reducing gender pay inequality and the prohibition appears to apply only to new hires.

V SECURITIES LAW

i Offerings and resales of securities
The Securities Act of 1933 (the Securities Act) requires that offers and sales of securities be registered with the SEC, subject to certain exceptions. Many typical executive compensation arrangements, including in particular stock options, are considered to involve the offer and sale of securities. For US public companies, and for non-US companies that are listed for trading on a US exchange, registration is not burdensome and is the typical approach. For other companies, two types of exemptions are typically available. First, such companies typically can rely on an exemption under Rule 701 under the Securities Act that specifically exempts sales pursuant to employee benefit plans, subject to certain conditions.12 The principal condition is that if more than US$10 million in value of securities is offered or sold during any 12-month period, extensive financial disclosure is required to be made to participants of the plan.13 Second, there are various private placement exemptions. Generally, for offerings to very small numbers of senior executives, the statutory exemption for private placements is often utilised, under which there are no specific conditions associated with the offering. Regulation D under the Securities Act provides detailed rules for offerings to larger groups of executives, including a rule for offerings to an unlimited number of executives who qualify

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11 2011–2012 Study of Executive Change-in-Control Arrangements, Meridian Compensation Partners LLC.
as accredited investors (i.e., meet certain financial requirements related to their net worth or income). Regardless of the approach for complying with the registration requirements of the Securities Act, anti-fraud provisions of that law will apply and, as a result, disclosure of material information concerning the issuer is normally highly recommended.

Very senior executives (referred to as affiliates and often limited to the top two or three most senior executives of a company) who acquire securities in registered offerings may nevertheless be permitted to resell those securities on the market in the US only pursuant to Rule 144 under the Securities Act. Typically, for registered securities being resold by affiliates, compliance with Rule 144 only requires the filing of a simple one-page form with the SEC. For securities acquired in private placements, resale in a public market, if one exists, may require compliance with that same form-filing requirement as well as a six-month holding period requirement under Rule 144.

ii Cashing out, repricing or modifying the terms of equity awards
Under the US securities laws, consideration must also be given to whether the cashing out, repricing or modification of a stock option or other equity award would constitute a ‘tender offer’. The tender offer rules apply when the recipient is asked to make an investment decision as to whether to accept the cashing out, repricing or modification of the terms and conditions of the award. If such action constitutes a tender offer, a public company would have to comply with various requirements, such as the mandate to (1) file with the SEC a Schedule TO and all written communications made by the public company relating to the tender offer from and including the first public announcement as soon as practicable on the date of the communication, (2) disclose the essential features of the tender offer, including any risks that award recipients should take into account when making the decision whether to accept the offer, (3) keep the tender offer period open for at least 20 business days from its commencement, (4) ensure that all award recipients are given the opportunity to participate in the offer, and (5) ensure that the consideration paid to any award recipient represents the highest consideration paid to any other security holder for securities tendered in the offer.  

iii Registration of issuers
When executive compensation plans involve offerings to large numbers of employees, consideration must be given as to whether the issuer of the securities being sold must, as a result, register as a public company with the SEC. In 2012, legislation was passed increasing the number of holders of securities of any class that is permissible without such registration to 2,000 employees, no more than 500 of whom may be non-accredited investors.

iv Insider trading and short-swing trading
Generally, anti-fraud provisions of the US securities laws prohibit executives from trading in securities of their employers on the basis of material non-public information. The determination of whether information constitutes material non-public information, and whether a purchase or sale of securities is on the basis of material non-public information, is typically a very fact-intensive inquiry that is informed by court opinions rather than

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14 17 CFR Section 240.13e-4 (2018). Certain of these requirements are waived in certain circumstances, if the public company is incorporated outside the United States.

bright-line rules. Rule 10b5-1 under the Securities Exchange Act of 1934 (the Exchange Act) provides a safe harbour under which executives can enter into trading programmes that provide them with a defence against claims that they traded on the basis of material non-public information, subject to certain conditions.16

Separately, a complex regulatory regime prohibits executives of US public companies from profiting from short-swing price movements in their company’s stock.17 Generally, senior executives are required to return to the corporation any profits derived from purchases and sales of stock within any six-month period, regardless of the order of the transactions. These rules are inflexible and do not depend on the possession of any non-public information. They apply to trading in the actual securities of the public company, as well as in options and other derivative securities, the value of which depends on the value of stock of the public company. The rules include a broad exemption for purchases and sales by executives with the company itself, subject to certain conditions.

v Share ownership guidelines and anti-hedging provisions

Most large US public companies require executives to own employer stock in order to align the interests of executives and shareholders. Typically, employers permit new executives to accumulate shares to meet their guidelines over a period of years and through outright ownership or equity compensation programmes. The amount of stock required to be owned is typically related to the executive’s salary or seniority in the organisation, or both. In 2015, the SEC proposed rules requiring companies to disclose whether they permit employees, officers or directors, or any of their designees, to engage in transactions that are designed to or have the effect of hedging or offsetting any decrease in the market value of equity securities that are granted to them as compensation, or are held directly or indirectly by them. The proposed rules would not require a company to prohibit hedging transactions or to otherwise adopt practices or policies addressing hedging by any category of individuals, nor would disclosure be required as to whether hedging has actually occurred (whether or not in violation of any applicable policies). The proposed rules have been included on the SEC’s rule-making agenda for 2018, but whether the SEC will issue final rules this year, and the substance of any such rules, remains unclear. Nonetheless, many companies already restrict executives from hedging their ownership of company stock through short sales, put options or other similar financial instruments.

VI DISCLOSURE

US public companies are required to provide extensive annual public disclosure concerning the compensation of typically five of their most senior executives.18 Three years of information is required, including disclosure concerning salary, bonus, the value of equity awards made, pensions accrued during the year and the value of certain perquisites. This disclosure is generally required to be set out in the annual proxy statement related to the election of corporate directors.

16 17 CFR Section 240.10b5-1 (2018).
17 Section 16(a) of the Exchange Act (15 USC Section 78p(a)) and the rules thereunder.
This year, US public companies were required to disclose (1) the median of the annual total compensation of all its employees, except the CEO, (2) the annual total compensation of its CEO, and (3) the ratio of those two amounts.

Under the SEC’s proposal pertaining to the recoupment of erroneously awarded compensation, a company listed for trading on a US exchange would be required to file its compensation recovery policy as an exhibit to its annual report. Furthermore, if during its last completed fiscal year it either prepared a restatement that required recovery of excess incentive-based compensation or there was an outstanding balance of excess incentive-based compensation relating to a prior restatement, a listed company would be required to disclose the date on which it was required to prepare each accounting restatement, the aggregate dollar amount of excess incentive-based compensation attributable to the restatement and the aggregate dollar amount that remained outstanding at the end of its last completed fiscal year.

The SEC has also proposed rules requiring companies to disclose in a table the comparison between the compensation actually paid to their most senior executives to total shareholder return (TSR) and include a description of this relationship between pay and performance in either narrative or graphic form. A company would be required to disclose executive compensation actually paid for its CEO using the amount already disclosed in the proxy statement, making adjustments to the amounts included for pensions and equity awards. The amount disclosed for the remaining executive officers would be the average compensation actually paid to those executives. As the measure of performance, a company would also be required to report its TSR and the TSR of companies in a peer group.

Finally, US public companies are required to publicly disclose information about material new compensation arrangements and agreements for senior management at the time such agreements are established or entered into.

VII CORPORATE GOVERNANCE

i Independent directors

For US public companies, various requirements dictate that the compensation of senior executives be established by members of a company’s board of directors who are independent of management. Currently, there are at least five definitions of the term ‘independent’ as it is used for these purposes. These different definitions apply to a number of different tax and securities rules, as well as rules promulgated by the US listing exchanges.

ii Say-on-pay vote and proxy advisory firms

Since 2011, large public companies have been required to submit their pay decisions for senior executives to an advisory, non-binding vote of shareholders. Shareholders are permitted to decide on the frequency of these votes. At most companies, they occur annually.

An important factor influencing the outcomes of these say-on-pay votes has been the proxy advisory firms, which are entities that help institutional investors analyse and vote on annual proxy statements. Two proxy advisory firms – Institutional Shareholder Services (ISS) and Glass Lewis & Company – constitute 97 per cent of the proxy advisory firm industry.¹⁹

with ISS the dominant force in the market. The combination of the growth of institutional investor portfolios, the growing length and complexity of proxy statements, and a perception that institutional investors have a fiduciary duty to vote the proxies for all the companies in their portfolios, has contributed to a significant growth in the power and influence of these proxy advisory firms. Companies closely watch the voting policies of the firms, and monitor which of their large investors tend to vote in accordance with the firms’ recommendations.

The firms develop guidelines and issue voting recommendations both in connection with a company’s annual meetings, and any special item (e.g., a proxy contest or merger proposal) put before shareholders for approval. In the case of ISS, its recommendations on company say-on-pay votes take into consideration factors such as pay for performance, problematic pay practices (i.e., excessive perquisites or a change in control payment exceeding three times base salary and average (or target) bonus), and the level of board communication and responsiveness to shareholders. In addition to say-on-pay, these firms have policy guidelines on compensation matters, such as the election of directors who will comprise the compensation committee, as well as proposals to adopt or amend equity plans. These matters are often affected by the proxy advisory firm’s say-on-pay recommendation. For example, if a company previously received a negative recommendation on a say-on-pay resolution related to an issue that is still ongoing, ISS or Glass Lewis may also recommend voting against any compensation committee members up for re-election.

iii Indemnification

It is standard in the United States for public companies to agree to indemnify their senior executives for legal claims that may be made against them that arise from their employment, usually unless the executive has engaged in misconduct or gross negligence. Such litigation is not uncommon. In addition, many executive employment agreements provide supplementary indemnification rights and protections to executives, including, for example, the right of the executive to have the company pay the executive’s legal fees in disputing any such claim as they are incurred.

iv Environmental, social and cultural issues

In recent years, there has been an increased focus from both shareholders and legislatures on environmental, social and cultural issues in the corporate governance space, including issues arising from the #MeToo movement. One recent example of this heightened focus is the TCJA’s addition of a new Section 162(q), which prohibits deductions for (1) settlements or payments related to sexual harassment or sexual abuse if such settlements or payments are subject to a non-disclosure agreement, or (2) attorneys’ fees related to such settlements or payments. This new Code provision is aimed at discouraging employers from keeping confidential payments made in connection with sexual harassment settlements.

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VIII SPECIALISED REGULATORY REGIMES

As noted above, the financial crisis that began to unfold in 2008 caused US regulators to focus special attention on compensation in the financial services industry, in accordance with global mandates focused on that sector. In the spring of 2016, US regulators re-proposed rules under Section 956 of the Dodd–Frank Act that seek to prohibit incentive-based compensation arrangements that US regulators determine might encourage inappropriate risks by providing excessive compensation or incentives that could lead to material financial loss to financial institutions. While it is unlikely that these rules will be finalised, the re-proposal took a more prescriptive approach than prior guidance in this area, with mandates such as:

a requiring deferral of at least 50 per cent of incentive compensation for a minimum of three years for executive officers of covered financial institutions with US$50 billion or more in total consolidated assets (‘covered institutions’);

b prohibiting incentive-based compensation arrangements for executive officers, employees, directors or principal shareholders (‘covered persons’) that would encourage inappropriate risks by providing excessive compensation;

c requiring a clawback provision that allows the covered institution to recover incentive-based compensation for seven years following vesting if the covered institution determines that the individual engaged in (1) misconduct that resulted in significant financial or reputational harm, (2) fraud, or (3) intentional misrepresentation of information used to determine the individual’s incentive-based compensation;

d requiring policies and procedures for incentive-based compensation arrangements that are commensurate with the size and complexity of the institution to help ensure compliance with the re-proposed rule’s requirements and prohibitions; and

e requiring annual reports on incentive compensation structures to the institution’s specific US regulator.

IX DEVELOPMENTS AND CONCLUSIONS

The regulation of executive compensation in the United States remains in a state of flux. Following the 2017 election, legislative proposals have been introduced that would repeal or modify many executive compensation measures under the Dodd–Frank Act, including the SEC’s final and proposed rules described in this chapter. The ultimate outcome of those legislative proposals remains uncertain. However, the combination of populist politics and institutional investor concerns suggest that the United States will not see a substantial decrease in the legislative and regulatory focus on executive compensation issues.
Appendix 1

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Mr Brems joined the firm in 1996 and became counsel in 2004. He received an LLM degree from Columbia University School of Law in 1998 and a doctorate in law (dr iur), _summa cum laude_, from the University of Würzburg in 1995. He passed the second state
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Barnabás Buzási is a senior associate in the employment practice group at Wolf Theiss Budapest. As Barnabás has been working on employment matters for over six years, he has an in-depth knowledge of the constantly changing Hungarian labour regulations. As well as handling everyday employment matters, he has experience in employment restructuring, preparation of executive and general employment contracts as well as advising in employment related litigation cases. Barnabás completed his studies at the University of Szeged (JD) where he has also been lecturing on corporate law. He has attended semesters at the University of Potsdam studying international law and European law and a specialist master’s course at the University of Pécs in employment law.

**FRANCISCO A COUTINHO**  
*Mattos Filho Advogados*

Francisco Coutinho’s practice focuses on corporate matters, including executive compensation, corporate governance and mergers and acquisitions transactions. He counsels public and private companies, business conglomerates, foreign investors and private equity funds. He is a bachelor of law (PUC São Paulo) and a postgraduate in business administration (FGV São Paulo and ITAM Mexico).

**JANET COOPER**  
*Tapestry Compliance LLP*

Janet Cooper is co-founder and partner at Tapestry and is based in London. Janet has over 25 years’ experience advising leading global companies on executive and employee share plans and corporate governance. Janet has developed the UK’s only professionally recognised qualification for share plan professionals, the ICSA Cert ESP. Janet has advised many of the global banks on the new remuneration regulations affecting them and is the legal adviser to
the global banks’ trade organisation, AFME (the Association of Financial Markets in Europe) on remuneration. Janet was awarded Proshare’s inaugural ‘Services to Employee Share Ownership’ Award in 2015.

In 2016, Janet was awarded an OBE by the Queen for Services to Equality, Women’s Empowerment and Employee Share Ownership. Janet is on the advisory board of ProShare and is a co-founder of the Global Equity Organisation, and has been on the board for 18 years. She is also a trustee of the RNLI (Lifeboats). Prior to founding Tapestry, Janet was global head of the Linklaters incentive team for 20 years.

RICARDO CUNHA LEAL
Campos Ferreira, Sá Carneiro & Associados
Ricardo Cunha Leal graduated from the University of Coimbra in 2016 and was admitted at CS Associados as a trainee, where he joined the tax team.

ANNIE ELFASSI
Loyens & Loeff Luxembourg
Annie Elfassi, attorney-at-law, is a partner and heads the Luxembourg employment law practice at Loyens & Loeff Luxembourg. She advises clients on employment law, social security questions and corporate restructuring involving employment law aspects.

GABRIEL FLANDIN
Willkie Farr & Gallagher LLP
Gabriel Flandin is a national partner in the corporate and financial services department of Willkie Farr & Gallagher LLP in Paris. Mr Flandin focuses on mergers and acquisitions, private equity transactions, restructuring as well as joint venture structuring and unbundling.

Mr Flandin is fluent in French and English.

Prior to joining Willkie in 2012, Mr Flandin was counsel at Freshfields Bruckhaus Deringer LLP (primarily based in Paris, he spent almost one year in the New York office of the firm, working notably as in-house lawyer for Deutsch Group). He has also worked as a corporate and tax law lecturer at the University of Montpellier, where he still gives lectures from time to time.

Mr Flandin graduated from the Bordeaux Business School and studied law at the University of Montpellier, where he obtained a five-year Business Law degree (Magistère-DJCE). Mr Flandin was also laureate of the EY Law Trophy in 2004 (Best Tax Lawyer).

LARS FOGH
Gorrissen Federspiel
Lars Fogh is co-head of tax and well known as a specialised tax lawyer. He serves a large number of Danish and international corporate clients and works predominantly with transactions, restructurings, corporate and shareholder taxation and structuring of cash and share based incentive remuneration schemes for top management and key employees.
Further, Mr Fogh litigates transfer pricing and direct and indirect tax cases before the National Tax Tribunal and the ordinary courts. He is ranked in *Chambers Global*, *Chambers Europe* and recommended in *The Legal 500*.

**PEDRO FURTADO MARTINS**  
*Campos Ferreira, Sá Carneiro & Associados*


Pedro Furtado Martins’ practice focuses on employment, social security and pension funds and he has combined his practice as a lawyer with the teaching profession.

**ANA ORTIZ GARCÍA**  
*J&A Garrigues, SLP*

Ana Ortiz García is a senior associate in the human capital services department of J&A Garrigues, SLP. She has extensive experience in designing and implementing compensation systems and remuneration formulas, and in providing multidisciplinary advice in the human resources area on board member and senior executive remuneration. She also provides recurring advice to clients on managing international assignments and on designing and implementing international mobility policies. As a member of this line of business since 2002, she has advised domestic and multinational companies, listed and unlisted, from every industry, on the design and implementation of their compensation systems.

**ORLY GERBI**  
*Herzog Fox & Neeman, Law Office*

Orly Gerbi is the head of HFN’s labour and employment law department. She leads a professional team consisting of over 30 team members, six of whom are partners, in what is known as one of Israel’s foremost labour law practices. Ms Gerbi and her team are constantly ranked in the first tier in domestic and international ranking guides. The labour and employment law department is one of the stand-out practice groups among Israeli law firms. The department combines the experience and expertise normally found in a leading boutique law firm with the capabilities of a major full-service international law firm.

**EDUARDO GÓMEZ DE SALAZAR**  
*J&A Garrigues, SLP*

Eduardo Gómez de Salazar is a partner in the human capital services department of J&A Garrigues, SLP. He has broad experience in the design and implementation of remuneration policies for listed and unlisted companies in a range of sectors and industries. Notable among the remuneration systems he has helped to implement are medium and long-term incentive plans for employees and managers payable in cash or shares, retirement-linked remuneration systems and flexible remuneration plans. Eduardo has also analysed the implications of the implementation of different types of remuneration systems from a tax and legal standpoint, as well as the requirements linked to fulfilment of the special conditions imposed on employee remuneration at entities operating in sectors subject to specific regulation (credit institutions,
investment services firms, management companies, insurers, etc.), and has advised on the international assignment of workers, among other matters.

MARIANGELY GONZÁLEZ-TOBAJA

Adsuar Muñiz Goyco Seda & Pérez-Ochoa

Mariangely González-Tobaja received her bachelor’s degree, summa cum laude, in Business Administration (accounting major) from the University of Puerto Rico, Río Piedras Campus. She obtained her juris doctor degree, magna cum laude, from the University of Puerto Rico Law School. Mrs González’s practice includes Puerto Rico income tax, sales and use tax, municipal licence tax and property tax. She also assists clients in obtaining tax incentives grants with the Office of Industrial Tax Exemption under various tax incentives acts, including but not limited to Act 20 (export services); Act 22 (individual investors that move to Puerto Rico); Act 73 (industrial incentives); and Act 83 (green energy). Mrs González has represented clients on various tax matters before the Puerto Rico courts, the Puerto Rico Treasury Department, the Municipal Revenue Collection Center and the Municipalities. She is also a certified public accountant since 2010.

PHILIPPE GRUDE

Willkie Farr & Gallagher LLP

Philippe Grudé is special European counsel in the tax department of Willkie Farr & Gallagher LLP in Paris. He focuses on the tax aspects of IPOs, LBOs, mergers and acquisitions and other reorganisations of businesses.

Mr Grudé regularly handles complex tax issues relating to mergers and acquisitions and other high-profile transactions. He has significant experience in the areas of tender offers, stock or asset purchases and private offerings of securities.


DITTE GRUNDTVIG LARSEN

Gorrissen Federspiel

Senior legal counsel Ditte Grundtvig Larsen has extensive practical experience with employment law aspects of major national and international transactions where she advises on transfer of employees and collective bargaining agreements under applicable TUPE regulation, information and consultation obligations, and redundancies.

Ms Grundtvig Larsen has assisted on a number of large-scale IPOs, including with respect to IPO-related incentive schemes and service agreements for senior executives. Her expertise also covers employment law advice in relation to outsourcing projects and specialist advice on processing of personal data in an employment context.

She has conducted a number of seminars on various employment-related topics, including as lecturer at Cph Business.
MARIEL Y HAACK
Adsuar Muñiz Gayco Seda & Pérez-Ochoa

Mariel Y Haack joined AMG in 2005. She is currently a shareholder in the firm’s labour and employment department. Her areas of practice include representation of management before administrative agencies and in federal and Puerto Rico courts in wrongful discharge cases, discrimination suits, wage and hour and benefits claims; general counselling with clients regarding avoidance of litigation, as well as compliance with Puerto Rico and federal labour laws, employment discrimination statutes (such as the Americans with Disabilities Act, Age Discrimination in Employment Act, Title VII of the Civil Rights Act of 1964, etc.), ERISA, and other laws governing various aspects of employment; appellate practice in both federal and Puerto Rico courts; and employment-based immigration, including H-1B visas for professional and individuals with specialised knowledge; L visas for intra-company transfers for executives, administrators, professionals and individuals with specialised knowledge; E visas for treaty investors and treaty traders; labour certifications, employment-based permanent resident petitions and naturalisation. Ms Haack’s practice also includes defending insurance claims in the area of employment practices liability. She also represents major airlines serving Puerto Rico in labour and employment matters and aviation law.

Ms Haack is admitted to the Puerto Rico Bar, the US District Court for the District of Puerto Rico, and the United States Court of Appeals for the First Circuit.

JENS HAFEMANN
Cleary Gottlieb Steen & Hamilton LLP

Jens Hafemann is a senior attorney based in the Frankfurt office of Cleary Gottlieb Steen & Hamilton LLP. Mr Hafemann’s practice focuses on tax law and corporate transactions.

Mr Hafemann joined the firm in 2008. From 2008 to 2012, he was resident in the Frankfurt office, and from 2012 to 2013, he was resident in the New York office. He received an LLM degree from the University of Cambridge in 2005. He passed his second state examination in the state of Hamburg in 2007 and the first state examination at the Bucerius Law School in 2004. He also received an LLB degree from the Bucerius Law School in 2003.

Mr Hafemann is a member of the Frankfurt am Main Bar. He is also a certified tax adviser.

RAOUL HAGENS
Allen & Overy

Raoul Hagens specialises in corporate law and is a deputy civil law notary. He has experience across a wide range of areas, including mergers and acquisitions, joint ventures, fund structuring, equity capital markets, corporate restructurings and corporate governance of (listed) companies.

He joined Allen & Overy in 2008 after studying law at Leiden University and the University of London (2007), he obtained his notarial bar exam in 2012. Raoul publishes regularly in legal journals on matters of Dutch corporate law (with a focus on accounting law) and is one of the authors of the corporate law commentary published by SDU publishers.

Major clients that Raoul has worked for in the past include Koninklijke KPN NV (telecom), Heijmans NV (infrastructure and project management) and the Sapinda Group (investments).
JOHANNA HALTIA-TAPIO
Hannes Snellman Attorneys Ltd

Johanna Haltia-Tapio is a specialist partner and heads the employment law practice at Hannes Snellman. She is a recognised expert in employment law, advising clients on all aspects of employment law. Ms Haltia-Tapio’s expertise encompasses both employment law-related issues in transactions, outsourcings and corporate restructurings, as well as manager contracts, termination agreements, redundancies and consultation procedures. She also advises clients on the harmonisation of employment-related benefits pensions, incentive programmes and personnel policies.

Ms Haltia-Tapio graduated from the University of Helsinki in 1999 and joined Roschier Holmberg Attorneys Ltd the same year. She joined Hannes Snellman in 2005, and was appointed specialist partner in 2018.

MATTHEW HUNTER
Tapestry Compliance LLP

Matthew Hunter is an associate based in Leeds. Matthew advises many of the large global banks and asset managers on the legal and tax compliance for their executive and employee incentive arrangements. Matthew has a particular focus on the analysis and implementation of global financial services remuneration regulations.

ANNIINA JÄRVINEN
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Anniina Järvinen is a senior associate in Hannes Snellman’s M&A group. She specialises in corporate and securities market law. Ms Järvinen has experience in advising clients, inter alia, in relation to general corporate governance and capital markets matters.

Ms Järvinen graduated from the University of Helsinki in 2012 and joined Hannes Snellman the same year. Prior to joining Hannes Snellman, Ms Järvinen worked for the Finnish Financial Supervisory Authority in the conduct of business supervision department. She has also worked at Cleary Gottlieb Steen & Hamilton LLP in London.

JONATHAN KELT
Baker McKenzie

Jonathan Kelt is a consultant in the corporate and securities practice of Baker McKenzie in Sydney. He regularly advises clients on equity incentive plan structuring and establishment, phantom equity and replicator plans and executive remuneration. He has advised a broad range of publicly listed and private clients on the structure and establishment of their incentive arrangements and on all aspects of compliance (including ASX listing rules, Corporations Act and termination benefits compliance).

ERICA KIDSTON
Baker McKenzie

Erica Kidston specialises in taxation with a focus on advising on employment taxes and employee share schemes. She regularly advises Baker McKenzie’s global clients on the tax consequences of terminating employees’ employment, fringe benefits tax issues, design and
impact of employee share schemes, pay-as-you-go withholding and associated reporting requirements and relocating to Australia.

ARTHUR KOHN
Cleary Gottlieb Steen & Hamilton LLP
Arthur Kohn is a partner based in the New York office. His practice focuses on compensation and benefit matters, including executive compensation, pension compliance and investment, employment law and related matters.

Mr Kohn is distinguished by Chambers USA as one of the leading lawyers in the area of employee benefits and executive compensation and is recommended by PLC Which Lawyer? yearbook. In Above the Law, Mr Kohn was voted as one of the ‘Top Partners to Work For – New York’. Mr Kohn teaches the ‘Taxation of Executive Compensation’ course at the New York University School of Law as an adjunct faculty member. In 2011, he was selected for the National Association of Corporate Directors’ Directorship 100, a list of the most influential people in corporate governance and in the boardroom. Mr Kohn is a member of the advisory board of the John L Weinberg Center for Corporate Governance at the University of Delaware.

Mr Kohn is also a member of the executive committee of the Columbia College Alumni Association. He received a JD degree and an undergraduate degree from Columbia University in 1986.

Mr Kohn joined the firm in 1986 and became a partner in 1995. He is chair of the firm’s global professional responsibility and risk management committee and past co-chair of the firm’s New York office diversity committee, its corporate governance practice group, and its pension and employee benefits committee.

Mr Kohn is a member of the New York Bar.

DIMITRI KOLIAS
Allen & Overy
Dimitri Kolias is an associate within the employment and benefits practice group in Amsterdam. He focuses on employment law in a broad sense, which includes reviewing employment agreements, dismissals, remuneration policies, reorganisations, works councils, transactions, collective bargaining agreements, social security matters and employer’s liability.

Dimitri joined Allen & Overy in November 2016 after graduating from the University of Amsterdam in labour and corporate law.

MICHAL LAVI
Herzog Fox & Neeman, Law Office
Michal Lavi is an associate in HFN’s tax department. She specialises in particular in the equity-based compensation field, which includes, among others, advising clients regarding all aspects of designing, implementing and managing equity-based compensation plans and benefits for employees and executives, and representing clients during any interactions with the Israeli tax authorities or other relevant authorities. In addition, Ms Lavi is involved in the formation of various types of investment funds, including venture capital funds, private equity funds, hedge funds and real estate funds, and provides advice to the funds following the formation.
LAURI LEHMUSOJA
Hannes Snellman Attorneys Ltd
Lauri Lehmusoja is a counsel in the tax group of Hannes Snellman. In particular, he advises clients in matters related to international taxation and incentive schemes. He is a frequent lecturer in various conferences and seminars, and is currently also an officer on the International Bar Association's taxes committee.

Prior to joining Hannes Snellman in 2011, Mr Lehmusoja worked for a Big Four tax consultancy firm, and he also gained experience at the Finnish tax administration.

KAREN MAN
Baker McKenzie
Karen Man's practice focuses on financial services regulation, mergers and acquisitions and general commercial matters. She frequently advises multinational clients on complex matters, such as establishment, structuring and operation of various financial services businesses (including brokerage, fund management, foreign exchange, wealth management and private banking), structuring of cross-border operations, development of new product/service offerings, cross-border financial services mergers and acquisitions, and dealing with regulators in licensing and regulatory inspections.

Ms Man graduated from the University of Sydney with a BEc (1993) and an LLB (1995). She is admitted as a solicitor in Hong Kong, England and Wales, and New South Wales.

ROWAN MCKENZIE
Baker McKenzie
Rowan McKenzie is regularly involved in advising on complex and sensitive matters on all aspects of employment law in Hong Kong and on a regional basis. He has acted in high-profile cases, including representing the new employer at all stages of the recruitment process in the highly publicised Cantor Fitzgerald v. Boyer (2012) case. Mr McKenzie has also authored numerous articles on Hong Kong employment law and is an editorial board member for LexisNexis Practical Guidance. He is ranked as a leading individual for employment law in Hong Kong by Chambers Asia and The Asia Pacific Legal 500.

He graduated from the Australia National University with a BA and from the University of New South Wales with an LLB. He is admitted as a solicitor in Hong Kong and New South Wales.

KHEIRA MEBREK
Loyens & Loeff Luxembourg
Kheira Mebrek, tax adviser, is a senior associate of the tax department of Loyens & Loeff Luxembourg. She specialises in personal income tax law, including employment tax, the setting up of incentive plans, estate planning for high net worth individuals and social security aspects.
MARTIM MORGADO
*Campos Ferreira, Sá Carneiro & Associados*

Martim Morgado is a founding partner of CS Associados and was previously senior associate and partner at PLMJ – AM Pereira, Sáragga Leal, Oliveira Martins, Júdice & Associados.

Martim’s practice covers company law, M&A and private equity.

ELENA NOVIKOVA
*ALRUD Law Firm*

Elena Novikova joined ALRUD in 2005 with more than five years’ experience in taxation and accounting and leads core projects of ALRUD tax practice in corporate taxation, M&A, tax audits and tax litigations.

She possesses profound experience in corporate restructuring and provides ALRUD clients with advice on a diverse range of complicated tax issues, supports them during tax audits, represents clients’ interests in negotiations with state authorities, and participates in performing tax due diligence and tax audits.

Elena graduated from Moscow State Academy of Business Administration specialising in financial management and accounting. In 2005 she successfully gained a qualification in international standards of financial statements – ACCA DipIFR.

Together with the ALRUD tax team, Elena provides ongoing tax support for most long-term clients with regard to their business in Russia and the CIS.

MATTHIAS OERTLE
*Lenz & Staehelin*

Dr Matthias Oertle is a partner in the Zurich office and heads the employment and pensions practice. Mr Oertle attended the University of Zurich in 1986 (*lic iur*) and in 1990 (*dr iur*). He was admitted to the Zurich Bar in 1988 and joined Lenz & Staehelin in 1991, becoming a partner in 1996. Some of the works of which he is author and co-author include ‘Employment and Labour Law – Switzerland’, in *European Lawyer Reference Series* (fourth edition, London 2012); ‘Employment Law in Conflict with the Regulations regarding Excessive Executive Remuneration’, *Gesellschafts- und Kapitalmarktrecht* 1/2014, p. 44 ss; and ‘Commentary on the Regulations regarding Excessive Executive Remuneration, Art. 28’, *GesKR-Kommentar VegüV* (Zurich/St Gallen 2014).

MARC OOSTENBROEK
*Allen & Overy*

Marc Oostenbroek specialises in domestic and international corporate tax law. His practice is strongly transaction-driven and is a mixture of mergers and acquisitions, private equity, corporate restructuring, structured finance, employment benefits and investment funds. Marc also focuses in particular on all tax aspects (wage withholding tax, income tax and social security contributions) relating to management agreements, severance payments, options, equity incentives, the 30 per cent ruling and other labour-related matters.

Marc has advised many of Allen & Overy’s clients, including funds, on the most suitable and tax-efficient structure, taking into account the investment considerations as well as the particular investor constraints.
JÁNOS PÁSZTOR

Wolf Theiss

János Pásztor is a senior associate heading the tax practice group at Wolf Theiss Budapest. He completed his studies at the Faculty of Law of Eötvös Loránd University and has an LLM degree in international taxation (Vienna University of Economics and Business). He is also a qualified and chartered tax adviser in Hungary. Prior to joining Faludi Wolf Theiss in 2014, János worked at Ernst & Young Hungary as a tax manager and attorney-at-law. János specialises in domestic and international tax planning, tax restructuring and also provides comprehensive tax and legal advisory services for high net worth individuals. He regularly represents clients in tax litigation proceedings relating to all major types of taxes. János also frequently gives presentations at domestic and international events on cross-border taxation, tax litigation and tax restructuring, as well as providing lectures on tax matters. János speaks fluent English and German.

MELINDA PELIKÁN

Wolf Theiss

Melinda Pelikán is a senior associate leading the banking and finance practice group at Wolf Theiss's Budapest office. Prior to joining Wolf Theiss in 2014, she gained valuable experience in the area of banking and finance working at CIB Bank as a senior legal counsel, and in the Budapest office of international law firms. She has more than 12 years of experience and assists clients in project, real estate and acquisition finance and restructuring, as well as cross-border financing and factoring projects. Melinda completed her legal studies at the Eötvös Loránd University in Budapest. She speaks English and Spanish.

STEPHEN PENFOLD

Tapestry Compliance LLP

Stephen Penfold is an associate based in Leeds. Stephen advises UK and global companies on the design and implementation of their executive and employee share incentive arrangements across all sectors, with a particular focus on global plans.

FRANCISCO J PENICHE BEGUERISSE

Creel, García-Cuéllar, Aiza y Enríquez, SC

Francisco Peniche Beguerisse is a partner at Creel, García-Cuéllar, Aiza y Enríquez SC, where he heads the labour employment and social security law practice. Mr Peniche Beguerisse advises clients on labour and employment matters, including but not limited to the hiring, transfer and termination of executives; executive compensation and remuneration advice; employment matters related to corporate transactions; reorganisations; and negotiation and execution of collective bargaining agreements. He also represents clients in major downsizings and was recently engaged by several employers in Mexico to offer his opinions in connection with the application of the data privacy laws. Mr Peniche Beguerisse holds both bachelor's and master's degrees in law (LLM) from the Panamerican University, and undertook postgraduate studies at Yale University and Georgetown University.
Mr Peniche Beguerisse has been highly recommended as a leading attorney by Chambers and Partners in *Chambers Latin America* in 2016. His legal services were also recognised and recommended in Tier 1 by *The Legal 500 Latin America*.

**OLGA PIMANOVA**  
*ALRUD Law Firm*  
Olga Pimanova advises domestic and international clients on corporate and M&A projects. Olga has vast experience in developing and advising on employee remuneration and incentive programmes, including employee share plans, both share-settled and cash-settled, advising on specifics of implementation of global share plans in Russia.

Olga advises domestic and international clients on staff restructurings, dismissals, including support in negotiations and employee-related issues in M&A transactions.

Olga graduated from the Moscow State Institute of International Relations (University) under the Russian Ministry of Foreign Affairs, department of international law, specialising in civil and international private law.

**SHACHAR PORAT**  
*Herzog Fox & Neeman, Law Office*  
Shachar Porat is a partner in HFN’s tax department and heads the firm’s employee benefits and executive compensation practice. Shachar has extensive experience in representing and advising the firm’s clients, including Israeli and multinational publicly listed companies, start-up companies as well as other privately held companies, investment funds, financial institutions, executives and senior employees regarding all aspects of designing, implementing and managing equity-based compensation plans and benefits. Within the scope of her work she provides legal advice in numerous fields, including corporate law, securities law, labour law and taxation. Ms Porat takes an active role in all of HFN’s M&A transactions, IPOs, investment transactions and corporate restructuring, and provides day-to-day advice to a large variety of the firm’s clients.

**DARIO ABRAHÃO RABAY**  
*Mattos Filho Advogados*  
Dario Abrahão Rabay is a partner of the firm in the labour and employment and executive compensation practice. He represents many of the largest Brazilian and multinational companies in various industry sectors in labour disputes with labour courts and administrative labour authorities. He also advises clients in all aspects of labour and employment matters, including executive compensation and benefits. Dario joined the firm as a partner of labour and employment practice in February 2016.

**CEDRIC RAFFOUL**  
*Loyens & Loeff Luxembourg*  
Cédric Raffoul, attorney-at-law, is a partner in the banking and finance department of Loyens & Loeff Luxembourg. He specialises in securities laws and capital markets regulations advising Luxembourg and foreign corporate clients and financial institutions on capital
markets and financing transactions including debt and equity transactions, initial public offerings, takeovers, placements of securities, listings and on all related regulatory matters.

NAOMI REIJN

*Allen & Overy*

Naomi Reijn is an associate within the employment and benefits practice group in Amsterdam. Naomi focuses primarily on remuneration within financial institutions and listed companies, from both a regulatory as well as a transaction perspective. Furthermore, she is experienced in employment law, including dismissals, reorganisations and transactions. From August 2015 until December 2015, she was on an in-house client secondment at NLFI, the shareholder of ABN AMRO Bank, SNS, ASR and Propertize. Naomi is part of the financial markets regulation practice group.

JULIA ROZENBLIT

*Cleary Gottlieb Steen & Hamilton LLP*

Julia Rozenblit is a practice development lawyer based in the New York office. Her practice focuses on executive compensation and benefits matters.

Ms Rozenblit was an associate at the firm from 2010 to 2014, and rejoined in 2017 as a practice development lawyer. She received a JD, *cum laude*, from New York University School of Law in 2010, and an undergraduate degree, *summa cum laude*, Phi Beta Kappa, from Duke University in 2007.

Ms Rozenblit is a member of the New York Bar.

GIANLUCA RUSSO

*Cleary Gottlieb Steen & Hamilton LLP*

Gianluca Russo is an associate at Cleary Gottlieb Steen & Hamilton LLP, based in Milan. He graduated with honours from the Libera Università degli Studi Sociali Guido Carli in Rome in 2001, and received an LLM in international taxation from the New York University School of Law in 2006 on a Gerald L Wallace Foundation Scholarship. He is a member of the Bar in Rome. Mr Russo is the author of several publications in Italy and abroad on various taxation and executive compensation matters.

Mr Russo’s practice focuses on tax matters and compensation and benefit matters, including executives’ compensation, the benefits aspects of mergers and acquisitions and the tax implications of employee incentive plans. He also regularly advises on Italian and international tax issues.

ALEJANDRO SANTOYO

*Creel, García-Cuéllar, Aiza y Enríquez, SC*

Alejandro Santoyo is a partner at Creel, García-Cuéllar, Aiza y Enríquez SC, where he heads the tax practice. His practice comprises tax advisory services for M&A, capital markets, structured finance, estate planning and private equity. He is a leading adviser for financing transactions and international taxation for cross-border business activities.

He holds a BS from the Instituto Tecnológico Autónomo de México, a JD from Universidad del Valle de México and an MBA from the University of Texas.
PATRICK SCHÄRLI

*Lenz & Staehelin*

Patrick Schärli practises securities law and financial services regulatory law. As part of his practice, Mr Schärli also advises clients on disclosure obligations under Swiss stock exchange laws and regulations.

Mr Schärli graduated from the University of Lucerne (MLaw) in 2010 and was admitted to the Aargau Bar in 2012. In 2015, he graduated from the University of Chicago Law School’s LLM programme.

EDWIN J SEDA-FERNAÑDEZ

*Adsuar Muñiz Goyo Seda & Pérez-Ochoa*

Edwin J Seda-Fernández is the director of the firm’s labour and employment department. His active practice encompasses counselling and representing clients in all areas of labour and employment law. A substantial element of his practice consists of representing management in union campaigns, negotiation of collective bargaining agreements, labour arbitration, and proceedings before the National Labour Relations Board. Mr Seda-Fernández also defends vigorously but judiciously employers in wrongful discharge, employment discrimination, benefits, and wage and hours claims in Puerto Rico and federal courts, including the United States Court of Appeals for the First Circuit.

Mr Seda-Fernández has extensive experience in counselling employers in workforce reductions, business reorganisations and employment aspects of mergers and acquisitions. He has lectured extensively before commercial and professional associations, including the Puerto Rico Manufacturing Association, the Puerto Rico Chamber of Commerce, the Council on Education in Management, the National Business Institute, the Puerto Rico Hotel and Tourism Association, the Program for Professional Development of the University of Puerto Rico and the Association of Labour Relations Practitioners. He has also taught courses in Labour Law and Jurisprudence, Collective Bargaining, and Labour Relations at the Business Administration Faculty of the University of Puerto Rico, Río Piedras. Mr Seda-Fernández is admitted to the Puerto Rico Bar, the US District Court for the District of Puerto Rico, and the United States Court of Appeals for the First Circuit.

SEAN SELLECK

*Baker McKenzie*

Sean Selleck is a partner in the employment practice of Baker McKenzie, based in the Melbourne office. He is one of the coordinators of Baker McKenzie’s multi-disciplinary executive remuneration and employee compensation team in Australia. He advises his clients on all aspects of employment law: compliance, preparation of contracts and policies, terminations and restructures. He also represents his clients in all types of disputes.

JAYA SHRUTHI

*IndusLaw*

Jaya Shruthi, a member of the employment law practice group, regularly advises various multinational companies in relation to employment law risk mitigation, compensation and benefits and all kinds of HR queries around employment laws. In particular, she has extensive
experience in drafting and negotiating a wide range of employment contracts, employment policies and opinions on complex questions of employment laws.

STEVEN SIEKER

*Baker McKenzie*

Steven Sieker has written and contributed to a number of publications in Hong Kong, Canada and internationally, and is the author of the Hong Kong volume of the CCH series *Tax Planning and Compliance in Asia*. Mr Sieker is ranked as a leading individual for tax in Hong Kong by *Chambers Asia*, *Citywealth Leaders List* and *Guide to the World’s Leading Tax Advisers*. He is also nominated by the *Guide to Leading Practitioners* as one of the pre-eminent practitioners with expertise in private equity in China.

Mr Sieker’s practice focuses on Hong Kong, Canadian and Asian regional tax advisory work, estate planning and tax litigation. He frequently represents clients in tax disputes with the Inland Revenue Department in Hong Kong.

Mr Sieker graduated from the University of Alberta with a bachelor of arts (honours) first class, from Dalhousie University with an LLB, and from NYU with an LLM. He is admitted as a solicitor in England and Wales (non-practising) and Hong Kong, and as a barrister and solicitor in Alberta, Canada.

SUZANNE SIKKINK

*Allen & Overy*

Suzanne Sikkink specialises in employment law. She has experience in a wide range of employment law-related matters, varying from dismissals, restructurings and union and works council relationships to compliance and social media, remuneration and (cross-border) corporate law-related employment matters (both in an advisory role and litigation). Within these areas of law, Suzanne has particular knowledge and experience in the field of outsourcing/transfer of undertaking, employee representation and incentives. Suzanne is a member of the editorial staff on the legal journal *Tijdschrift voor Arbeid & Onderneming*.

MORTEN SKJØNNEMAND

*Gorrissen Federspiel*

Partner Morten Skjønnemand is specialised within the corporate aspects of employment law and has extensive experience and a strong insight into the transactional and corporate aspects of employment. He advises on all aspects of law related to top management and key employees.

Mr Skjønnemand is also widely experienced within the preparation and administration of cash and share based incentive remuneration schemes and provides advice on the interaction between international law and Danish law when international incentive schemes are introduced to Danish group companies. Further, he has expertise within the EU regulation on remuneration in the financial sector.

Mr Skjønnemand heads Gorrissen Federspiel’s Corporate Counsel Academy – a post-qualifying seminar and education programme targeted at in-house lawyers of Danish companies.
FRANZISKA STADTHERR-GLÄTTLI
Lenz & Staehelin
Franziska Stadtherr-Glättli practises Swiss and international taxation for individual and corporate clients. Ms Stadtherr-Glättli specialises in executive compensation and tax planning for high net worth individuals. Other areas of her practice include pension funds and social security law.

In 1999, she attended the University of Bern (lic iur) and joined Lenz & Staehelin. She became a certified tax expert in 2002 and attended the University of Virginia (LLM) in 2004. Ms Stadtherr-Glättli is a member of the International Fiscal Association and the Swiss Fiduciary Chamber. She is a lecturer at the Swiss Tax Academy for international taxation, expatriates and social security treaties.

ALEXANDRA STEAD
Baker McKenzie
Alexandra Stead is an associate in Baker McKenzie's Australian tax practice. Her focus is on Australian taxation and international tax planning related to direct investment in Australia by multinational corporations, as well as tax planning for outbound investment by large Australian enterprises. She has advised clients across a range of industry sectors, including the technology, infrastructure, real estate and consumer goods industries.

ALEXANDRA TÓTH
Wolf Theiss
Alexandra Tóth is an associate in the tax practice group. Before joining the tax team at Faludi Wolf Theiss, Alexandra had gained valuable experience at the National Tax and Customs Authority, where she worked for seven years; thus, she has significant experience in the tax authority practice. Her special areas of interest are direct taxes, local taxes and transfer pricing. She has several publications and presentations to her name on this subject. Alexandra completed her studies at the Faculty of Law of Eötvös Loránd University. She speaks English.

EFRAT TZUR
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Efrat Tzur is a partner in HFN's corporate and securities department. Her practice focuses on corporate and securities law, with a particular emphasis on providing advice for public companies, as well as advising on public offerings of securities on the Tel Aviv Stock Exchange and advising companies on M&A and investment transactions.

OLIVIER VALK
Allen & Overy
Olivier Valk specialises in corporate law, with a focus on mergers and acquisitions involving listed companies and corporate governance. He joined Allen & Overy in October 2011 after graduating from Utrecht University and Durham University (UK). His recent experience includes advising on a number of leading transactions, such as SHV on its public offer for Nutreco, TNT Express on the public offer by FedEx, and Ahold on its cross-border legal merger with Delhaize.
In addition, Olivier gained experience in the employment law practice group, advising on remuneration and co-determination matters, as well as an in-house lawyer during his secondment to the Dutch employment law team of Royal Dutch Shell in The Hague.

MAHESH VARIA  
*Travers Smith LLP*

Mahesh Varia is a partner at Travers Smith and heads its incentives and remuneration group. He specialises in incentive arrangements (including their taxation) and advises companies, directors, trustees and employees on a wide range of issues, both in the context of corporate transactions and on an advisory basis, and has advised on share scheme issues in relation to a number of IPOs. Mr Varia has been recognised as a leading individual in his field by *Chambers and Partners* and *The Legal 500* directories and is a regular speaker at and chairman of conferences on employee incentives. He is a Fellow of the Association of Taxation Technicians and an executive committee member of the Share Plan Lawyers Group.

NAMITA VISWANATH  
*IndusLaw*

Namita Viswanath’s practice involves advising and strategising with clients on employment management, employment risk mitigation and compliance matters. Namita has significant experience in advising clients from diverse industry sectors on a range of employment-related matters, including company policies and handbooks, employment and severance contracts, reduction in force exercise, design and implementation of employee compensation and benefits plans, and conducting disciplinary proceedings and all kinds of harassment inquiries. Namita also is actively involved in all employment law issues for complex corporate restructurings.

JOHN WALKER  
*Baker McKenzie*

John Walker is the head of Baker McKenzie’s Asia-Pacific tax practice and the head of the firm’s structured assets group in Australia. His focus is on the tax aspects of corporate and debt restructures, M&A, spin-offs, takeovers, funds and unwinding structured finance transactions. He also deals regularly with the Australian Tax Office in the context of private and class rulings, settling outstanding tax liabilities, industry risk reviews and tax policy initiatives.
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