

# HR & Tax Alert



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## China – Greater Flexibility for Equity-based Incentive Plans

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### Executive summary

On 5 January 2007 the State Administration of Foreign Exchange (SAFE) issued detailed implementation rules for the Administrative Measures Governing Foreign Exchange of Individuals (The Measures) announced by the People's Bank of China on 25 December 2006. The Measures allow for inflows and outflows of currency to enable deals under employee stock purchase plans ("ESPP") or stock option plans, either through foreign currency purchases or one's own foreign currency account. The Measures and implementation rules became effective on 1 February 2007.

### Background

Equity-based compensation plans have been popular in China for companies to attract and retain their employees, in particular, members of senior management. However where such plans are offered by overseas companies constraints in implementation have reduced the allure. Normally, under an ESPP, the employer withholds part of an employee's salary to buy stocks at a discounted price. Under relevant PRC foreign exchange regulations, companies in China can only pay their employees in RMB. The purchase of stocks in an overseas market in a foreign currency by using the RMB funds generated from the payroll deductions would be regarded as foreign exchange arbitrage and is prohibited. Before the Measures, there were no channels for the purchase of foreign currency to enable "domestic" individuals to invest in overseas capital assets. As a result very few foreign companies if any offer ESPP to their Chinese

employees. Also, to avoid risks, companies allow same-day sale to Chinese employees for their stock option plans.

### The measures

The Measures have eased the above constraints. Same-day sale is not the only way for a stock option plan to allow the participation of Chinese employees.

The Measures and Detailed Rules set out requirements for foreign exchange transactions of domestic individuals participating in the aforementioned plans.

- Employees' foreign exchange transactions under such plans are subject to the approval of the foreign exchange authorities. The application should be lodged by the employer or domestic agent on behalf of all participating employees.
- Inward remittances of gains or dividends realized from overseas capital assets should reach the foreign currency account of the employer or the agent before being deposited into the employee's foreign currency account. The sale of the foreign currency is also allowed after the remittance reaches the account of the employer or agent.
- An individual may purchase or sell foreign currency up to USD 50,000 respectively per person per year. The quotas are subject to SAFE adjustment based on the surveillance of foreign exchange receipts and payments. Upon approval an individual may purchase or sell additional foreign currency amounts as needed for

- transactions related to an equity-based incentive plan.
- Inflows and outflows of remitted currency under an equity-based incentive plan should be reported to SAFE for the purposes of statistical surveillance of foreign exchange receipts and payments.

Clarification of various implementation details from the authorities are expected including:

- The qualifications needed by a domestic agent engaged to obtain approval from SAFE,

- Details of the information required for the approval process,
- Whether the initial approval for purchase or sale of foreign currency by an employee participating in a plan for automatically suggests an approval for such purchases or sales to exceed the annual limit of USD 50,000.

#### **Next steps**

In the light of these changes HR officers at companies with Chinese employees may wish to reconsider the equity-based compensation plan and build in more flexible terms to reward such employees.

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