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Employee Share Schemes

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Introduction

This in-brief guide is designed to provide an overview on key aspects of employee share schemes in Hong Kong, why they are offered and how they can be implemented.

Our Hong Kong office advises on all aspects of employee share schemes in Hong Kong and can co-ordinate, with our international network of partner firms, on the implementation of schemes across the Asia Pacific region.

This publication provides general guidance only - expert advice should be sought in relation to individual circumstances.

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Why share schemes are offered?

Share schemes are alternatives to cash remuneration and other benefits-in-kind to reward employees. In Hong Kong, share schemes are common amongst start-ups, large private companies, companies belonging to an international group and listed companies.

Share schemes have several advantages over cash remuneration since they can:

- Align employees' interests with shareholders' interests
- Motivate employees
- Retain employees and attract talent
- Lower working capital requirement and relieve cash-flow constraints
- Offer better tax advantages.

Designing a scheme

A Hong Kong company may sometimes offer its local employees a share scheme designed by its non-Hong Kong head office or holding company, in which case only the implementation and compliance issues will be relevant. In some cases, local variation of an international scheme will be created to cater for local regulation (for example, in some jurisdictions there may be restrictions on foreign exchange or direct ownership of foreign shares).

When an employer wishes to introduce a new share scheme, a benefits lawyer is often involved to find the best structure for an employer.

Factors that may affect the choice of scheme include, but are not limited to:

- Set-up cost
- Administration and compliance costs
- Effect on dilution of management control and earnings
- Target employees
- Retention effect

Types of employee share scheme

As Hong Kong is an open economy without any foreign exchange or capital control, any form of employee share scheme offered elsewhere can be made available to Hong Kong employees.

Share-based schemes like a share option scheme or share purchase plan are most popular amongst listed companies and member companies of international groups.

Companies with a concern over management control and earnings dilution may prefer to offer shares with restricted rights or restricted share units which can be converted into ordinary shares with full rights after vesting and certain conditions are satisfied.

Some schemes may only offer employees shares in the company when their rights vest, while others offer an option for them to take either shares or cash.

There are cash-based share schemes under which employees can only take cash when their rights vest, for example, the share appreciation rights scheme, which is popular for new start-ups.

Some cash bonus schemes are operated and calculated based on the performance of a company's share price, but such bonus schemes are outside the scope of this brief.

Implementation issues

In Hong Kong, the implementation of a share scheme does not require consultation with an employee or trade union. However, attention must be paid to several key areas and legal advice should be sought before a share scheme is implemented.

Regulatory

The offer of shares, rights in shares or other forms of securities to the public in Hong Kong is a regulated activity. Very generally speaking, any offer made to more than 50 people will constitute an offer to the public in Hong Kong. A prospectus or an offering document which meets certain requirements must be prepared to accompany a public offer unless an exemption applies. Violation of these rules will attract a heavy penalty.

An offer of shares to employees in Hong Kong under an employee share scheme, i in most circumstances, is covered by an exemption,; therefore, no prospectus, regulatory approval or filing is required There will be more uncertainty when the scheme covers securities other than shares or if the offeree extends beyond employees; legal advice should be sought in this situation.

Taxation

Hong Kong maintains a territorial-based individual income regime (known as "salaries tax") with a maximum rate of taxation not exceeding 15% of an individual's net income. Hong Kong does not tax profits on disposal of capital assets, and dividend income is exempt from tax.

There is no tax concessionary treatment for any employee share scheme due to the more straight-forward tax system in Hong Kong. No employee share scheme will need any approval or filing with the Inland Revenue Department of Hong Kong.

Benefits from employee share schemes are a taxable perquisite from employment and, unless otherwise specified, will be taxed when they vest. A share option is taxed when it is exercised – the amount of benefit is the difference between the market price when an option is exercised and its exercise price.

Employment

A share scheme creates a separate contractual relationship between an employer and employee. Participation in a share scheme should not affect the existing rights and duties of an employee.

In addition, certain aspects of employment law may affect the operation of share schemes that are offered by international groups to Hong Kong companies. For example, Hong Kong law generally prohibits deduction from wages even with the consent of the employee, including collection of contributions from employees (for example, for the operation of a share purchase plan); therefore, this will need to be affected through other means.

Data privacy

The Personal Data (Privacy) Ordinance in Hong Kong regulates, amongst other things, the use, processing and storage of personal data. Personal data is data that is directly or indirectly related to a living individual which would enable the individual to be identified. An employee should have in most circumstances provided consent for the employer to make use of his/her personal data for employment-related purposes in a personal information collection statement ("**PICS**"). The scope of the PICS should be reviewed to ensure that employees' personal data can be used for the administration of share schemes (and to pass such data to a third party for this purpose). If necessary, the scope of the PICS should be amended, and new consent be sought from the employee.

Discrimination

Anti-discrimination laws exist in Hong Kong to prevent, amongst other things, employees from being treated less favourably by reason of the employee's sex, pregnancy, marital status, disability, race or family status. Employers should establish procedures to enable selecting employees to participate in share schemes or awarding employees on a fair and non-discriminatory basis.

Social security

Unlike other jurisdictions, Hong Kong does not maintain a contributory social security system. Mandatory contributions on "relevant income" are required to be made by employers and employees to approved privately-run mandatory provident fund schemes. Benefits from share schemes, which are not monetary payments, do not fall within the definition of "relevant income" and do not affect the amount of mandatory contribution.

On-going issues

Although a Hong Kong employer is under no general obligation to withhold salaries tax for employees (except when an employee is under notice of termination of employment and intends to leave Hong Kong for one month or longer), the employer must file tax returns for employees on an annual basis. Any taxable rights accruing to an employee as a result of the operation of a share scheme must be reported by the employer to the Inland Revenue Department in the year of assessment in which it took place.

Disputes may sometimes be brought by an employee regarding his/her rights and entitlement under a share scheme. Such disputes rarely result in court action due to scheme rules often providing a way to resolve any disagreement. Disputes are regularly resolved by the board of the Company or a committee appointed by the board, and such decision is usually final and binding on a participant of a share scheme. Legal advice will often be required before the board or the committee makes any decision.

Changes in law may affect the cost, efficiency and even the legality of a scheme. An employer should be vigilant and seek legal advice to assess the effect of any such change when it occurs.

For further information on this subject please contact:

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