TAPESTRY

INTERNATIONAL SHARE PLANS

TRAINING MANUAL

Module 4 – Global Tax Considerations

Presented by Anne Croft

Tapestry

Global Tax Considerations

In this module we will look at the key tax considerations when operating a plan globally. We will look at:

- Why does the company need to know the tax locally?
- What impact “chargeback”/”recharge” has on plans?
- What is the difference between a tax approved and a tax qualified plan?

1 Individual taxation

The company should know the impact of tax on the participants. For example:

- at what stage of the award does the individual have a tax charge?
- when there is an individual tax charge does the company have to withhold tax?
- does the company have to withhold any employer or employee Social Security?
- does the employer have to report the taxable event to the individual or to the local revenue or both?
- are there any other taxes which may become payable and when?

One of the questions we are regularly asked is, should the company provide information to participants? In some countries the employee tax may be required to comply with local laws. It is best practice to provide an indication of likely tax consequences:

- it helps manage employees’ expectations – that there might be tax to pay.
- it helps them to be “good citizens” and pay tax when it is due – especially if they need to make arrangements to pay direct to the tax authority. Providing information about completing tax returns when and how much is likely to be paid will be helpful to them.
- It also helps the company’s standing to show that it regards tax compliance by its employees as important and equips them to do it. [1]

2 Company Tax

In the case of a group the share awards will often be made by the parent. The employees who receive those awards will usually be employed by subsidiary companies. Therefore the company needs to know what the impact of granting share awards is both for the parent company and for the local employing company.

The main issues for the parent company are whether it can

- get a deduction in relation to the costs it has incurred in operating the plan, and
- recover any of those costs from the subsidiaries.

The main issues for the local employing company is whether it has any local tax compliance obligations locally and whether it has to pay for and/or can get a tax deduction for its own expenses.

3 Charge backs

3.1 Overview

The parent company may be making awards to many employees around the world. The costs of the shares and the central administration costs may be significant. The parent company will therefore want to charge the local employing companies in relation to the plan. This is sometimes called a “recharge” or a “chargeback”. The point from the parent company’s point of view is that it has incurred costs and wants to recover that cost from the employing companies. Ideally it wants to be able to claim the costs as a deduction so that its corporation tax bill is reduced whilst at the same time receiving the money from the subsidiaries as a form of payment for the shares which

[1] Our database can help you produce short tax notes at no extra cost! Ask us to show you how to do this!

©Tapestry 2012

Tapestry

will go into its capital account and will not be subject to tax. The objective therefore from the parent's point of view is to recover cash and to reduce its own tax bill.

From the subsidiary's point of view, certain of its employees will have received a benefit from the parent company. If the local employing company does not actually pay for those benefits then generally it will not be able to claim a deduction. However, if the local employing company pays money to the parent it will then have a real cost which often enables it to reduce its own tax bill.

If structured correctly this chargeback arrangement can reduce the group's overall tax bill and result in money flowing to the parent in a tax efficient way. This is therefore very desirable for the group. However, although the logic of this process is quite simple, the actual work involved in implementing a recharge can be very significant. Often some of the stakeholders within the company greatly underestimate the time and effort involved. This process can often take years and is one of the most difficult parts of the whole project.

3.2 Key considerations for charge back:

There are various technical elements in relation to the chargeback. For example:

- **Amount:**

  The company has to decide whether it is going to chargeback the "fair value" of the awards as calculated under IFRS or the "spread" (the difference between the exercise price and the cost of the shares at exercise). This will partly be a question of the company's own preferences and accounting methodology. However on a global basis there will be different rules which apply in each country which will dictate what calculation method is acceptable to the local revenue. This is normally confirmed in the global review.

- **Timing:**

  The company will also have to decide when to make the chargeback. Should it be made at the time of award or the time of vesting/exercise or should it be made on an annual basis throughout the life of the plan?

- **Exchange control:**

  If the chargeback process actually involves the movement of funds across borders then there is also the issue of exchange controls to consider. In other words, does the local country have rules protecting its currency which govern the transfer of funds across its borders. This may again complicate the process.

- **"Symmetry"**

  It is worth considering the point of view of the tax authorities in each particular jurisdiction. If they allow a chargeback which involves payment by the employing company to the parent and if they allowed this as a deduction from the subsidiary company's profits then this will reduce the local tax revenue. The local tax authority therefore has a clear interest in only allowing deductions which are really justified. In some countries the tax authorities accept the argument that whenever an individual is made a share award that individual will pay tax on that award. Therefore the local jurisdiction has an increased tax take. Therefore it is reasonable that the employing company should get a deduction. However this is not always accepted and that symmetry is not always true. For example for some reason the individual may not pay tax on the award and therefore the chargeback would result in a reduced tax take.

- **Mobile workers**

  Another complicating factor is that employee populations are mobile. For example, if at the time of award there are 10,000 employees in a particular country and the chargeback is calculated on the basis of the award made to those individuals the company may think that it is reasonable for the employing subsidiary to get a deduction for that amount. However, if

©Tapestry 2012

Tapestry

for example the award vests in three years' time then, at that stage, of those 10,000 employees perhaps 1000 of them will have moved to another country or left employment. Therefore the amount of tax paid locally by those employees in relation to the incentive awards will not exactly mirror the amount which was charged back. Local tax authorities are therefore nervous that the amount of tax they lose through the deduction will never be recovered through individual taxation.

The key message in relation to recharges is that they are not straightforward and will involve the local tax and finance departments in every country, who may each have their own particular views on the process. This means that implementation of an effective recharge on a global basis takes time and effort.

4 Tax approved plans

In some countries the politicians accept that share plans are a good thing. As a result of that they have developed certain "tax approved" or "tax qualified" arrangements for share plans. What this means is that if you follow a certain set of rules then the company and participant will get a favourable tax treatment. "Favourable" usually means either that the participant will pay less tax or that it will be paid at a later time or that the company and/or the employee will pay less social security.

A tax approved plan means that it has been approved by the tax authority.

A tax qualified plan means that your adviser has put in all the terms to enable it to qualify for tax relief.

On a global basis there are perhaps a dozen countries which offer favourable tax regimes for employee share plans. Some of these are trivial because the amounts concerned are so small and most companies will conclude that it is not worth changing the global process to take the benefit from these regimes. However in certain other countries where share awards are well-established the benefits of these regimes can be significant. One result of this is that individual employees and HR departments in those countries will put a lot of pressure on the centre to ensure that the incentive plans get the benefit of those tax breaks. Companies often therefore do operate tax approved share plans in relation to at least a handful of countries. The most common and important of these are the UK, France and the US. We are not going to go into great detail about any of these plans. However, we do want you to be aware of the main tax favourable plans which exist.

The most up-to-date list of tax favoured plans are available on our database. We update it as soon as we hear of new tax breaks or existing ones change. This is a summary of key plans.

4.1 The USA

In the context of employee share plans there are two primary plans you need to be aware of:

- **Incentive stock options - (ISOs)**

  These are employee options which are not subject to tax at the moment of grant or exercise as long as certain conditions are satisfied. The value of such grants is limited to $100,000 per person. These options are sometimes called s422 options.

- **Employee stock purchase plan (ESPP or 423 Plan)**

  These plans are similar to sharesave in the UK in that they require savings to be made from salary on a regular basis. The main difference from a UK sharesave is that the default position is that the money will be used to purchase shares and that there is normally no need for the individual to exercise an option to purchase the shares.

  You may also hear of 401(k) plans. However these are primarily pension related plans to which employees make contributions from pre-tax salary. They are not strictly employee share plans.

©Tapestry 2012

Tapestry

4.2 UK

The UK Government has been a keen supporter of employee share ownership for over 30 years. There are a number of plans available offering good tax breaks for the employer and employee:

- Company Share Option Plan (discretionary option plan)
- Sharesave or Saving Related Share Option Plan (all employee)
- Share Incentive Plan (all employee):
  - free
  - co-investment
  - purchased shares

  All with great tax breaks.
- Enterprise Management Incentive (small companies)

4.3 France

In France there are tax approved option plans and tax approved conditional free share plans. There are complicated requirements to qualify for these approved plans including specific holding periods and plan approval requirements. However, because the normal tax rates in France are so high these plans are very popular because, even after the recent tax rate increases, they attract much less tax than unapproved share plan rights.

4.4 Other countries

Various other countries do have tax qualified arrangements. The list includes Germany, Australia, Canada, Hungary, Israel and Ireland. Whether or not it will be worthwhile implementing any tax approved arrangements in such countries depends on the company's employee populations in those countries.

The two key points to take away are:

- firstly, that such tax approved plans do exist and your employee populations in those countries may push hard for your global incentive arrangements to take advantage of those tax breaks
- secondly, any time that a company implements a country specific arrangement that will make the global process more difficult to manage.

In all cases, to take advantage of tax qualified plans, a company will need to get specific advice as to the local requirements.

We can help and advise on establishing tax favoured plans in all countries that have them.

5 Other tax issues

As we have just seen, several countries have specific arrangements in place which recognise that employee share incentives are a good thing and should be encouraged with specific tax advantages. However, it is also true that countries are very aware that there is significant tax evasion and tax avoidance which takes place generally. Especially in times of austerity countries want to increase their tax revenue and want to be seen to be clamping down on tax avoidance.

In the context of employee share plans what this means is that certain specific activities are caught by tax rules which are designed to prevent tax avoidance. The three main areas where this is happening are:

- **Tax deferral arrangements**: these are arrangements whereby the taxpayer sets up a structure so that tax can be paid at some point in the future. The purpose of this, from the taxpayer's point of view, is to enable him to choose when to pay tax so that ideally he can pay the tax when the tax rates are lower.

©Tapestry 2012

- **Suspicious structures:** the second main target of these measures is certain structures which are seen to be heavily involved in tax avoidance. One example is the use of trusts which in many countries are regarded with suspicion. This point can also apply to the use of offshore companies and nominee arrangements.
- **Offshore Financial Institutions:** The third main target is any kind of financial institution which can hold assets offshore. The reason these institutions are under suspicion is because they can include the classic Swiss bank account and revenue authorities believe that certain of their citizens put their assets in such offshore accounts with the specific intention of hiding the assets so that they do not have to pay tax.

5.1 Tax deferral – section 409A of the US internal revenue code

- **Background**

  In 2004 the American Jobs Creation Act (AJCA) added section 409A to the internal revenue code. The purpose of this legislation was to prevent individuals and their employers from deferring the payment of benefits so that the tax on those benefits was also deferred. The 409A regulations are extremely complicated and have hundreds of pages of detailed regulations. The consequences of a breach of 409A are severe and include up front penalty tax payable by the individual at 20% and also require the employer to admit that they have not been 409A compliant. If an employer were to admit this then that would increase their chances of audit. For both these reasons companies and individuals are very anxious to avoid not complying with section 409A.

  The reason this clashes with employee incentives is that employee incentives are designed to be multi-year rights. They are also designed to deal with various different potential future sets of facts. For example plan rules often have to deal with takeovers and mergers, changes in the capital structure, sales of the employing entity, all different types of leaver (both good leaver and bad leaver) and any other situation which is normally foreseeable in the life of a company.

  Under section 409A a company can either ensure that the plan comes within an **exemption** or can make the plan 409A **compliant**. In order to make a plan compliant it would have to be rewritten in a very US orientated manner. For the reasons we discussed above companies generally do not want their plan (which they want to operate on a global basis in many countries) to be a very US specific document. Therefore companies try to come within exemptions.

- **Short-term deferral exemption**

  The most relevant exemption is the **short-term deferral** exemption. In essence what this means is that any payment under the plan must be made by 15 March in the calendar year following the vesting of the award. The reasoning behind this 15 March date is that it is very normal in the US for bonuses to be paid at Christmas time and therefore this is designed to deal with the payment of year-end bonuses. However this does not work well with the normal structure of global share plans.

  For example if a plan has a performance measure based on total shareholder return ("**TSR**") and that TSR is measured in the 90 day period after the year-end then it is perfectly possible that the award would vest on the 31 December but that the calculations as to performance would not be completed until after 31 March. This would mean that payments under the plan would be made after 31 March which would not be within the short-term deferral exemption.

- **Exempt plans**

  There are certain types of plan which are exempt from the requirements of section 409A. These include:

- US style qualified stock options (ISOs)
- non-qualified stock options when the exercise price set at the time of grant is not less than the **fair market** value of the shares
- stock-settled stock appreciation rights

Cash settled stock appreciation rights are **not** normally exempt.

The problem with the exempt plans is that these exemptions relate purely to US style plans. If the company has developed a global plan or is operating a plan based on the norms in another country (for example a UK sharesave plan) then that will not come within one of these exemptions. In particular it is worth noting that UK sharesave plans do not come within the exemption because they usually involve a discount and they involve a six-month exercise window. This means that, for US taxpayers, sharesave plans can give them serious US 409A tax problems.

As you know many UK plans and many global plans involve the use of a trust. Section 409A is very suspicious of trusts which are outside the US. This means that it is likely that if you use a non-US trust to supply shares to US plans you may also have a problem with section 409A.

The key message from this is that for almost any plan which involves US tax payers you have to look carefully at section 409A. This requires a detailed review of your plan by US lawyers.

5.2 Trusts – France

Trusts are an Anglo-Saxon concept. Generally speaking trusts are not recognised in continental European legal systems. However the French tax authorities have recently passed (in 2012) legislation requiring reports to be made about trusts to the French tax authorities.

Generally speaking any trust which has a French settlor (settlor means the person who sets up the trust), or which has French beneficiaries, or which has French assets, must be disclosed to the French tax authorities. There is a requirement to disclose the existence of any such trusts and any changes made to any such trust. There is also an annual reporting requirement. These French reporting requirements are very new and it is as yet unclear whether the kind of trusts which are used in employee share plans will be caught by this legislation. However, it is an example of a tax authority in a jurisdiction, even where that jurisdiction does not recognise trusts, thinking that there is tax revenue to be had by examining such bodies.

5.3 FATCA USA

The Foreign Account Tax Compliance Act (FATCA) is a new piece of US tax legislation which is designed to prevent tax avoidance by ensuring that US taxpayers who have assets held in foreign bank accounts have to declare any income they receive on those accounts.

The intention therefore is only to catch US taxpayers. However the rules have been drafted so that any foreign financial institution (FFI) is caught and must either withhold tax in relation to US taxpayers or make regular reporting to the US Internal Revenue service. The problem from the point of view of foreign financial institutions, which includes for example share plan administrators in the UK, is that they do not know who is a US taxpayer. Generally such institutions do not keep records of people's nationality and they also do not know who, for example, has a green card.

There has very recently been an intergovernmental agreement between the UK and the US government on this issue. The UK government is similarly committed to reducing tax avoidance. However the UK government does not want UK business to be burdened with unnecessary reporting to the US tax authorities. How exactly this will work out is not yet clear. However, it is an example of a country deciding that a particular branch of industry - namely financial institutions - can be forced to help the government to prevent tax avoidance.

 ©Tapestry 2012

6 Mobile employees

One of the key challenges in managing a global share plan is how to deal with employees who are mobile. For example if an individual is granted an option while he is living in the UK and he then transfers for two years to France and then moves to Australia where he then exercises the option - in which countries does he have to pay tax?

Generally speaking the answer is that he will have to pay tax in all those countries. The difficulty is in being able to calculate what tax is due in which country and arranging a process which will deliver the correct money to the correct revenue. One of the reasons this is difficult is that individual mobility is very unpredictable. For example, one individual may move from the UK to France to Australia whereas another may move from the UK to Germany to the US. It is very difficult to design a process which takes into account all the possible changes. Companies either have to deal with this on an individual basis which means that in relation to each employee who is mobile they will have to pay a tax adviser to advise in relation to that individual's own circumstances or they have to develop some kind of automated system which deals with this mobility and the calculation of tax that is due.

However, the company decides to deal with this issue it will only be able to so if it has accurate data. Therefore the first thing a company must do is create a system which tracks exactly where its employees are on a multi-year basis and retain that information.

7 Action!

Have a look to see whether your company informs employees of potential tax liability? How does it track mobile workers? Does your company operate chargeback in all countries/all plans?

 ©Tapestry 2012