International Developments and Uncertainties Regarding Tax Withholding and Reporting Obligations for Equity Compensation

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U.S. multinationals continue to heavily use equity-based compensation, such as stock options and restricted stock units ("RSUs"), to align the financial interests of employees of foreign subsidiaries throughout the world with shareholders, while also providing as an incentive the opportunity to share in any future appreciation in the company's stock. As a consequence, these companies must navigate often complex and diverse laws in multiple countries, including securities laws, employment laws, and the always prominent tax laws. Given the current global economic climate and each country's continuous hunt for new tax revenues, the tax withholding and reporting requirements governing stock-based compensation continue to garner a high degree of attention from tax authorities throughout the world, and perhaps stand as the greatest compliance risk for global companies using equity compensation internationally. The following discussion provides updates on the tax withholding and reporting rules applicable to equity awards in certain countries, highlighting areas where a company may consider modifying practices and procedures to mitigate the impact of changing rules.

Background

In the United States, the IRS expects income and social security tax withholding in the case of equity compensation (the exercise of stock options, settlement of RSUs, etc.). This is the case whenever employees are in the United States and subject to U.S. income and social security tax jurisdiction. By contrast, in other countries, the withholding obligation is not as clear when the parent company issuing the stock is outside of the country, often depending on factors such as whether the equity-based awards are considered part of local compensation, whether the local subsidiary reimburses the foreign parent corporation for the costs of the equity compensation, and whether the employee is a tax resident at the time of the taxable event. Further, in some countries, a local subsidiary can be subject to income tax withholding/reporting obligations while not subject to social security obligations on equity compensation income. As discussed below, a number of countries are currently expanding the situations in which tax withholding may be required.

Belgium

In general, Belgian subsidiaries are not subject to income tax withholding/reporting obligations or Belgian social security contributions on equity-based awards granted by a foreign parent corporation so long as the local Belgian subsidiary is not involved in administering the equity awards and does not reimburse the foreign parent corporation for the costs of the equity awards granted to employees in Belgium. However, in a recent informal ruling, the Belgian social security authorities raised the possibility that equity compensation awards would, in fact, be subject to Belgian social security contributions where the local Belgian subsidiary is involved in the selection of award recipients in Belgium. More specifically, the Belgian social security authorities concluded that a local Belgium subsidiary of a U.S. parent corporation effectively held discretionary powers with respect to equity compensation grants made by the parent corporation to its employees in Belgium. The basis for this conclusion was that the Belgian subsidiary provided the U.S. parent corporation with a pre-selection of Belgian employees eligible to receive equity awards based on the annual performance evaluations conducted by the Belgium subsidiary. It was anticipated that the U.S. parent corporation potentially could use these performance evaluations when deciding to whom and in what amount to grant the equity awards. In this regard, the Belgian social security authorities repeatedly have stated that equity grants made by a foreign parent corporation can be deemed borne by the local subsidiary in Belgium if the grants either are financially borne (i.e., the local subsidiary reimburses the foreign parent corporation for the costs) or "morally" borne by the local subsidiary (i.e., the local subsidiary has a sort of non-financial obligation towards the employees with respect to the equity grants). In this instance, the Belgian subsidiary's discretionary powers in pre-selecting award recipients were deemed sufficient involvement to trigger social security contributions on the equity awards.

Although the informal ruling is not binding, it provides insight into the Belgian social security authorities' current thinking on this issue and suggests that U.S. multinationals should be cautious in the involvement that their local subsidiaries in Belgium exercise in connection with equity compensation awards so as to avoid triggering Belgian social security contributions.

Brazil

The income tax withholding/reporting obligations, as well as Brazilian social security obligations, on equity-based awards traditionally have been uncertain due to a lack of legislation in Brazil specifically addressing equity compensation. As such, a Brazilian subsidiary's obligations are ambiguous and, in practice, a particular subsidiary's withholding obligations can vary depending on the individual understanding and interpretation of the specific social security tax officers and judges involved. Consequently, advisors and consultants currently disagree on the impact of cost reimbursement on the taxation of equity awards, leading to companies receiving contradictory advice from different law firms and accounting firms regarding their tax withholding/reporting obligations in Brazil.

Historically, most companies and tax advisors have taken the view that a Brazilian subsidiary was not subject to income tax withholding/reporting or Brazilian social security contributions on equity-based awards granted by a foreign parent corporation so long as the local Brazilian subsidiary did not reimburse the foreign parent corporation for the costs of equity awards granted to its employees in Brazil. However, at the end of 2007, Brazil adopted the International Financial Reporting Standards ("IFRS")[1] for financial statements, requiring Brazilian companies to expense the cost of equity awards in their statutory books of account. Because of the need to expense equity awards for financial accounting purposes, some advisors changed their position to say that a Brazilian subsidiary *might* have income tax withholding/reporting obligations on equity compensation income regardless of whether it reimbursed the cost of such awards to its foreign parent corporation.

Notwithstanding the financial accounting change, to date, tax rules remain the same and the Brazilian tax authorities have not officially announced any changes to the tax treatment of equity awards. It is not at all clear that a mere change in the accounting rules alone should create a tax withholding/reporting obligation. As such, whether the adoption of the IFRS was sufficient to change the tax withholding and reporting practices of Brazilian subsidiaries for equity awards is debatable at best.

There is even more confusion in Brazil regarding the subsidiary's social security contribution obligations. Equity awards granted by a foreign parent corporation to employees of its Brazilian subsidiary will be considered part of local compensation, and thus, subject to Brazilian social security contributions, if the awards are mentioned in any employment-related documents or if the Brazilian subsidiary otherwise refers to such awards as compensation. Furthermore, due to conflicting case law, a Brazilian subsidiary's social security contributions on equity-based awards granted by a foreign parent corporation remain uncertain.[2] One line of cases concludes

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[1] Bueno and Fonseca, "Offsetting Expenses Incurred with Stock Option Plans," 25 Int'l Rev 46, 46 (2014-2015).

[2] The risk that the tax authorities could consider the value of the shares as part of the employee's local compensation, subject to social security contributions, appears to be higher for awards where the employee does not pay any amount in order to receive the

that equity compensation income should be subject to social security contributions, as it is considered compensation arising from the employment relationship. Conversely, the second line of cases holds that equity awards should not be considered compensation and thus should not be subject to Brazilian social security contributions, as these awards are voluntary and subject to market fluctuation, resulting in a continuous risk that the employee could be harmed due to the potential devaluation of the underlying shares.

Given the current uncertain state of the law in Brazil, a number of U.S. multinational companies are waiting until the issue is decided by a higher court prior to changing their current practices. In the meantime, companies that hope not to be subject to withholding on equity awards in Brazil should avoid the use of recharge arrangements and avoid any reference to equity awards in local employment agreements and other local employment-related documents.

New Zealand

Currently, New Zealand subsidiaries generally are not subject to income tax withholding/reporting obligations on equity-based awards granted by a foreign parent corporation. However, a recently introduced bill would impose a new reporting requirement and would allow companies in New Zealand to withhold income taxes on stock-based awards on a "pay-as-you-earn" ("PAYE") basis. These new rules are expected to apply to equity compensation income derived on or after April 1, 2017.

If a New Zealand subsidiary elects into the PAYE regime under the new rules, equity compensation would be treated as "extra pay" during the relevant pay period and the New Zealand subsidiary would be required to withhold income taxes on a PAYE basis at the relevant extra pay rate.[3] If such an election is made, it applies to all recipients of equity compensation in New Zealand. At this point, it remains unclear how the New Zealand subsidiary will be expected to withhold taxes from equity compensation or, if it pays the taxes directly, how it will be reimbursed for the taxes paid on behalf of its employees.

The proposed legislation also imposes on New Zealand subsidiaries a new requirement to report all equity compensation income derived on or after April 1, 2017, to the Inland Revenue in its monthly schedule, regardless of whether the local subsidiary elects into the PAYE rules.

As these remain only proposed regulations, U.S. multinationals granting equity-based awards in New Zealand should continue to monitor developments for up-to-date information on the status of the legislation.

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shares (i.e., restricted stock units) as compared to other awards, such as stock options. Further, there are arguments to support the view that social contribution should not be due if the offeror is a nonresident entity. However, these arguments and the analysis must be made on a case-by-case basis based on the specific scenario, grant documents, and other communications delivered to employees.

3 Currently, extra pay (also called lump-sum payments) includes, among others: annual or special bonuses, cashed-in annual leave, retiring or redundancy payments, and back pay. As mentioned, extra pay is subject to special withholding procedures and rates.

Peru

In general, Peruvian subsidiaries are not subject to income tax withholding/reporting obligations on equity-based awards granted by a foreign parent corporation so long as the local Peruvian subsidiary does not reimburse the foreign parent corporation for the costs of the equity awards granted to its employees in Peru. However, based on a recent Peruvian Supreme Court decision, Peruvian tax authorities could potentially impose income tax withholding/reporting obligations on Peruvian subsidiaries even absent a reimbursement of the costs of the equity-based awards to the foreign parent corporation.

More specifically, the Peruvian Supreme Court held that a group of companies paying compensation to the same employee in exchange for services provided to such companies are jointly liable for any employment law obligations involving that employee's services. According to the court, the service provider is considered an employee of the "group" of companies as opposed to an employee of a specific company, and is allowed to bring a cause of action associated with his employment against any of the companies involved. It is important to note that this case did not specifically address equity-based awards or similar instruments, nor did it involve group companies located in different countries.

The Supreme Court's decision potentially increases the risk that the Ministry of Labor and Employment Promotion ("Ministry of Labor") would adopt the view that a Peruvian subsidiary of a foreign parent corporation is jointly liable for equity compensation awards granted by the foreign parent company (with the resulting income thereby being classified as "employment income"), regardless of whether the local subsidiary in Peru actually bore the costs of the awards via a reimbursement arrangement. Furthermore, to the extent the Ministry of Labor adopts this view, the *Superintendencia Nacional de Aduanas y de Administración Tributaria* (the Peruvian tax authorities or "SUNAT") similarly could determine that a Peruvian subsidiary is subject to income tax withholding and reporting obligations on equity compensation granted by its foreign parent corporation (again, on the basis that the equity income should be classified as employment income).

Although it is unclear whether the SUNAT would impose income tax withholding/reporting obligations on Peruvian subsidiaries based solely on the Supreme Court's decision, the case does cause concern for multinational companies granting equity awards in Peru and companies should monitor related developments in Peru in the coming year.

Romania

On January 1, 2016, a new fiscal code entered into force in Romania, exempting certain equity awards (e.g., awards granted under a so-called stock option plan[4]) from taxation both at the time of grant and at the time of

[4] A "stock option plan" is defined as a program launched by a company listed on a regulated market or an alternative market trading system, whereby employees, directors, and managers of that company or any affiliate are granted a right to company-issued shares for

vesting or exercise of the award, provided certain requirements are met. Although the new fiscal code clarifies the taxation of equity compensation in Romania, it also raises confusion over a Romanian subsidiary's income tax withholding/reporting obligations on equity-based awards granted by its foreign parent corporation under a plan that does not meet the requirements for the tax exemption.

More specifically, under the new fiscal code, if the equity awards qualify for the exemption, regardless of cost reimbursement, no income tax or social security contributions will apply at the time of grant, exercise, or vesting and, accordingly, the Romanian subsidiary will not be subject to tax withholding/reporting obligations. Conversely, for equity awards that do not qualify for the new exemption, income tax and social security contributions are triggered at the exercise of a stock option or at the vesting of a restricted stock unit, and the local subsidiary in Romania likely will be responsible for tax withholding and reporting on the realized taxable income to the extent the local subsidiary bears the cost of the awards via a reimbursement arrangement.

In this regard, equity compensation generally is considered a type of salary benefit under Romanian law, as the employee receives the income as a consequence of his/her employment with the Romanian subsidiary. The general rule under the fiscal code provides that the "payor of income" is subject to income tax withholding/reporting obligations on the equity-based awards and to the extent the local subsidiary in Romania reimburses the foreign parent corporation for the costs of the equity awards, the Romanian subsidiary arguably becomes the payor of the taxable income realized from the equity awards.

U.S. multinational companies granting equity compensation to employees of its Romanian subsidiary should determine whether their equity compensation plan currently qualifies for the tax exemption under the new Romanian fiscal code and monitor for potential clarification by the Romanian tax authorities regarding a local subsidiaries' tax withholding and reporting obligations for nonexempt awards.

Conclusion

Foreign subsidiaries of U.S. multinationals are subject to complex and often uncertain tax withholding and reporting obligations on stock-based compensation granted by their parent corporations. As discussed above, changes in accounting standards as well as employment law concepts can impact the analysis of the withholding obligations, as can relatively small changes in practices. As these withholding obligations continue to be a great compliance risk for companies using equity-based awards internationally, global companies should monitor updates and developments in the area and consider changing their practices, as needed, in order to minimize risk and exposure.

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either no consideration or for a preferred price, where a minimum period of one year exists between the date of grant and the date of vesting or exercise of an award.