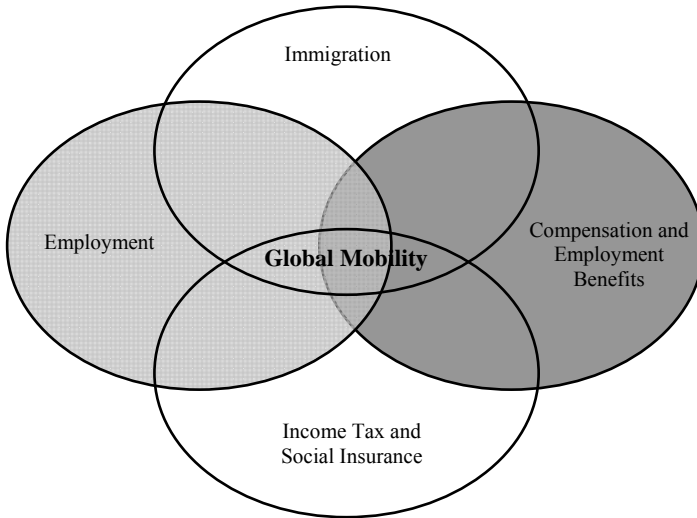


## Section 1 Introduction



### Introduction

The global movement of employees is essential to multinational organizations doing business in different countries. Getting the right people to the right places at the right time with proper support in a lawful manner is critical to the success of global businesses. Human resource professionals and corporate counsel are confronted with a maze of legal issues in multiple countries that must be considered before moving employees across borders.

When can they go? How long can they stay? What can they do while there? How can they be paid? What happens to their employment benefits during the trip? Who will be the employer while abroad? Which countries laws will apply?

What are the tax consequences to the employer and the employee? What about accompanying family members?

These issues confront employers dealing with both short-term business travelers, as well employees on long-term assignments. This is a global mobility handbook to help guide you.

## The Global Mobility Handbook

The next section of this handbook identifies the key global mobility issues to consider regardless of the countries involved. Although the issues are inevitably intertwined, the chapters separately deal with immigration, employment, compensation and employee benefits, global equity programs, and income taxes and social insurance. The final section is organized by country. For each country, this handbook provides an executive summary, identifies key government agencies, and explains current trends before going into detail on vis as appropriate for short-term business travel, training, and employment assignments. Other comments of interest to global human resource staff are also provided.

## Global Labor, Employment and Employee Benefits

There is often a gap between business necessity and practical reality when it comes to moving executives and other personnel to new countries. You have to anticipate and deal effectively with a host of interconnected legal issues and individual concerns.

Baker & McKenzie offers comprehensive legal advice on executive transfers – delivered locally around the world. We help employers plan and implement global transfers and provide on-site coverage to companies and employees in most major business communities around the globe.

Our network of Global Migration, Employment, International Executive Mobility, Global Equity Services, and Taxation lawyers assists both pre- and post-transfer to ensure that employment contracts are complete and enforceable, that employee benefits meet needs and relevant legal requirements, and that tax planning is sound and defensible. Our knowledgeable professionals are qualified and experienced in the countries where you do business. This combines to give us the unique ability to develop and implement comprehensive global migration strategies and solutions to address the many needs of executive transfers globally.

## Global Migration Services

**Client care**, including timely alerts on major changes in global mobility, immigration law and practice, quarterly newsletter outlining global developments, and regular seminars and workshops on a broad range of issues:

- **Workplace compliance**, including counseling, trainings, audits and litigation defense related to worksite enforcement and related employer initiatives
- **Advocacy** on legislative reforms and regulatory changes, and agency practices around the world
- **Design and implementation** of programs to accept immigrant investors, and schools and training programs to accept foreign students
- **Coordination** among members of our global team to obtain visas, residence and work permits from consular offices or to execute transfers to the countries where you do business
- **Transfer of staff** to existing and new multinational operations, including employees with specialist and technical

skills, executives and managers and new employees hired from overseas

- **Large-scale transfers**, including managing the immigration consequences of reorganizations, mergers, acquisitions, RIFs, redundancies, and related restructuring
- **Transfer-related immigration matters**, including permanent residence, citizenship and relocation of spouses and other dependents
- **Case management**, maintaining employee records for visa renewals, provision of status reports and planning and coordination of global immigration requirements
- **Employment, employee benefits and taxation advice** in relation to transfer of staff and auditing to ensure compliance with employers' obligations to prevent unauthorized employment
- **Ancillary transfer issues**, working with a range of professionals in relation to shipping of personal belongings and customs and excise duties
- **Establishment of new business operations abroad**, including the transfer of senior personnel to establish operations and related corporate and securities and taxation advice

## Further Information

***Bakerimmigration.com*** provides links to current articles, practice group members, subscriptions to publications, and other resources for global mobility professionals.

**Global Immigration & Mobility Update** is a quarterly publication focused on global mobility issues.

**Global Immigration & Mobility Alert** is a periodic publication that provides timely information on new developments in the global mobility arena.

**The Global Employer** is a quarterly publication covering labor, employment, employee benefits, and immigration topics of interest to multinational employers in all of the major jurisdictions of the world.

**Structuring International Transfers of Executives** is our publication providing an in-depth discussion of compensation issues for expatriates.

**Worldwide Guide to Termination, Employment Discrimination & Workplace Harassment Laws and Worldwide Guide to Trade Unions & Works Councils** is our guide to help employers manage global business change.

## Section 2 Major Issues

### Immigration

#### Executive Summary

Immigration laws, like other laws, differ from country to country. Although the specific names for the visas and the requirements differ, there are common patterns and trends - especially for countries balancing the interest of engaging in global commerce with protecting local labor markets and national security.

Treaties and bi-lateral agreements often give special privileges to citizens from specific countries (*e.g.*, benefits for European Union and European Economic Area citizens with the EU/EEA region; benefits for citizens of Canada, Mexico and the United States under the North American Free Trade Agreement). Be careful not to overlook these sometimes hidden gems when considering alternatives.

This chapter identifies these common patterns and trends. In the Country Guide Section, there is more specific, country-by-country information.

#### Current Trends

It invariably takes longer than expected to secure all of the authorizations required before a foreigner can go abroad for business. Planning in advance of advance planning is best, if such a thing is possible.

The best laid plans go often awry. Sometimes short-term business travel is the only way to meet an immediate need. But the visas that are quickly available for such trips generally are not intended for productive work or long-term assignments.

In the interest of national security and with concerns of protecting local workers, the trend continues in many countries of more actively enforcing prohibitions against unlawful employment. Penalties against employers are as common as penalties against foreign employees. And these penalties are increasingly including criminal, rather than just civil, punishments (see, *e.g.*, Kazakhstan and the US). The potential damage to an employer's reputation with the government agencies, impact on future visa requests, and potential bad publicity makes it especially important to obey the spirit, as well as the letter, of the law in this area.

With these points in mind, plan ahead and do not rely on what may have seemed like quick solutions in the past. Use of tourist visas for business travel is not a solution. And the problems only increase when family members to accompany the employee on a holiday visa and then try to enroll children locally in schools, get a local driver's license, *etc.* Shipping of household possessions and pets is also ill-advised at this stage. Many countries will require the foreigner ultimately to depart and apply for the proper visa at a consular post outside the country - often in the country where the foreigner last resided.

## Business Travel

### *Visitor Visas*

Multinational corporate groups routinely have employees visiting colleagues and customers in different countries. How easily this can be accomplished often depends as much on the passport carried by the employee as it does the country being visited. The length of the trip and the scope of activities undertaken can be key, with visa solutions for short trips (*i.e.*, under 90 days) generally more readily available.

Travel for tourism and travel for short-term business visits is often authorized by the same visa. But that is generally true only when the

scope of the intended business activity does not raise to the level of productive employment in the country being visited.

Sourcing compensation locally during the visit is routinely prohibited, but the focus usually extends beyond the duration of the trip or the source of wages. Visiting customers, attending meetings, negotiating contracts, *etc.*, are commonly permitted. Providing training, handling installation or post-sales service, *etc.*, are commonly prohibited.

### *Visa Waiver*

Most countries have provisions that waive the normal visa requirement for tourists and short-term business visitors. These visa waiver benefits tend to be reciprocal and are limited to citizens of specific countries (*i.e.*, those that extend similar benefits to local citizens). Additional requirements (*e.g.*, departure ticket) are sometimes imposed. Further, the countries that enjoy visa waiver privileges frequently changes, making it important to check for updated information with a country's consular post before making travel arrangements.

### Training

Companies with experienced staff in one country invariably want to bring newer staff from abroad for training. This is especially true when the research and development work happens in one country, the manufacturing in another, post-sales installation and support handled by regional centers, and the ultimate users spread around the world.

Many countries offer specific visas designed for training assignments (*e.g.*, Brazil, Japan). Some of these authorize on-the-job training that involves productive work. Others are limited to classroom-type training. Visas designed for employment assignments can often be used in training situations, if on-the-job training is desired and not otherwise permitted by a pure training visa.

## Employment Assignments

Visas for employment assignments are invariably authorized, but the specific requirements vary widely.

### *Work Permits*

Most countries are keen to protect their local labor market. A recurring solution is to impose some kind of labor market check as a prerequisite to issuance of a visa for an employment assignment (*e.g.*, Malaysia). These are often handled by a Ministry of Labor or equivalent government labor agency, as distinct from the Foreign Affairs governmental agency that issues visas at consular posts. In many countries, the Labor agency's authority is framed in the context of a work permit.

If a work permit or equivalent document is a requirement generally imposed for employment assignments, it is just as common for countries to have visas that are exempted from the work permit requirement (*e.g.*, Belgium). The number of exemptions greatly exceeds the general rule.

Just who is exempted, again, depends on the country. Most countries exempt employees being transferred within multinational company groups. Most countries exempt business investors and often high-level/key employees.

Education, especially higher level education in sought after fields, often can be used to qualify for employment assignments. Academic transcripts showing studies completed are frequently required. Letters verifying employment experience can be similarly useful.

### *Residence Permits*

Increasingly common is concern over national security. Background clearance checks and the collection of biometric data for identification

purposes is increasingly common today. But a number of countries have long addressed this concern with a reporting requirement. Sometimes this is done in the form of a residence permit, usually handled by a Ministry of Justice, Ministry of Interior, or equivalent agency. In other cases or in combination with the above, there is a requirement to report to local police authorities after arrival in the country (*e.g.*, France, Italy). These requirements are every bit as important to maintaining status to lawfully live and work abroad as obtaining the proper visa.

### Other Concerns

An increasing number of countries are requiring medical or physical examinations with the goal of limiting the spread of contagious diseases (*e.g.*, Saudi Arabia, People’s Republic of China, Russian Federation).

Most countries offer derivative visa benefits to accompanying family members. What constitutes a family member varies a great deal. The spouse and unmarried, minor children are commonly included. An increasing, but still minority, of countries cover different sex life partners, with same sex partners even less commonly covered (*e.g.*, Canada, The Netherlands). A few countries include more distant relatives (*e.g.*, parents in Colombia) or older offspring, generally if dependents of the principal visa applicant’s household.

Documents submitted in support of the immigration process generally need to be translated into the local language. Many countries require that public documents (*e.g.*, articles of incorporation, company registration, birth certificate, marriage certificate) be authenticated by the attachment of an internationally recognized form of authentication or “apostille” (*e.g.*, Spain). This cumbersome process generally involves first obtaining an authentic copy from the government agency that retains the official record. The second step is sending that

document to the government agency responsible for verifying that document is, in fact, authentic.

#### Further Information

See the Country Guide Section of this publication for more specific information on each country's visa requirements. Please contact your Baker & McKenzie attorney for specific guidance on current legal requirements and how they applies to your own needs.

# Employment

## Introduction

Integral to mobility planning is identifying and establishing the appropriate employment structure for the employee who is being sent to work in another jurisdiction. For planning purposes, it is important to keep in mind the laws of the jurisdictions involved, the business goals related to the foreign assignment, and the facts of the individual's situation.

## Employment Structures for International Transfers

The primary question to ask is, who will be the employer? That is, who will have the right to direct and control the activities of the employee while working abroad?. In general, multinational companies typically use one of the four following employment structures to answer this question:

- Secondment - the employee remains employed by his home country employer and is loaned or seconded to work in the foreign jurisdiction for a period of time;
- Transfer - the employee is terminated by his home country employer and is rehired by a new employer in the host country;
- Global Employment Company – the employee is terminated by his home country employer and transferred to the employ of a global employment company or “GEC”. The GEC in turn seconds the employee to work in a host jurisdiction.
- Dual Employment - the employee actively maintains more than one employment relationship simultaneously during the

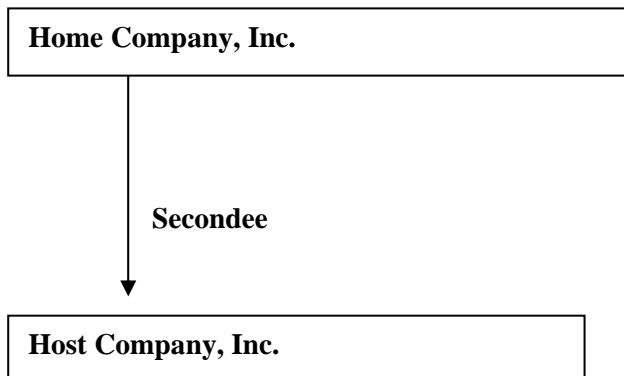
course of the assignment (that is, he works for two or more employers).

In addition to these four, main structures, multinational companies sometimes use other structures, although they are not as popular. For example, in several European countries it is possible to use a “dormant contract” approach, whereby the employee’s existing employment relationship is suspended for the duration of his foreign assignment, he is formally transferred to and becomes an employee of another company during the duration of his assignment, and then his dormant contract is “revived” upon the termination of his assignment and his return to his original employer. Other possible structures include putting the employee on a “leave of absence” for the duration of the assignment, or terminating the employee and then re-hiring him as an independent contractor.

### *Secondment*

In the secondment scenario, the employee remains an employee of the home country employer, (“Home Company”) and is sent to the foreign jurisdiction to provide services for the benefit of the host country employer (“Host Company”).

### **Typical Secondment Structure**



The employee continues under his home country employment contract, except to the extent modified by the terms of his letter of assignment and duties in the host country. In exchange for receiving the services of the seconded employee, the Host Company typically pays a fee to the Home Company, usually equal to the costs of compensating the seconded employee and sending him on assignment. Sometimes there is a markup on the secondment fee, as determined in consultation with tax advisors and based on transfer pricing principles.

In documenting a secondment, great effort should be taken to expressly continue the Home Company employment relationship (and especially the “at-will” status of the employee when the home country is the United States for example) so as to provide a contractual argument against application of host country termination protections and entitlements. As a practical matter, however, it is likely that an employee employed by a company in one jurisdiction who is working at a company in another jurisdiction will enjoy the benefits of employment laws of both jurisdictions during the course of the secondment and upon termination

Another pitfall of the secondment approach is the potential “permanent establishment” issue created if an employee of one country is sent to work in another country. If that employee has the right to enter into contracts in the name of the Home Company, then the local tax authorities in the host jurisdiction may seek to impose a corporate tax on the activities of that individual on the ground that he is a taxable presence of the Home Company. Often, the “permanent establishment issue” can be avoided or at least minimized if the employee does not have the express right to enter into contracts in the name of the Home Company. Consultation with tax counsel about this issue is prudent under most circumstances.

Another challenge presented by secondment is that it sometimes will be challenging to implement where the employee, as a matter of law, must be employed by a local entity in order to receive the proper

immigration papers and work permit to enter the country. Also, in some countries an individual with a certain title (*e.g.*, CEO) must as a matter of local employment law be employed by a local company.

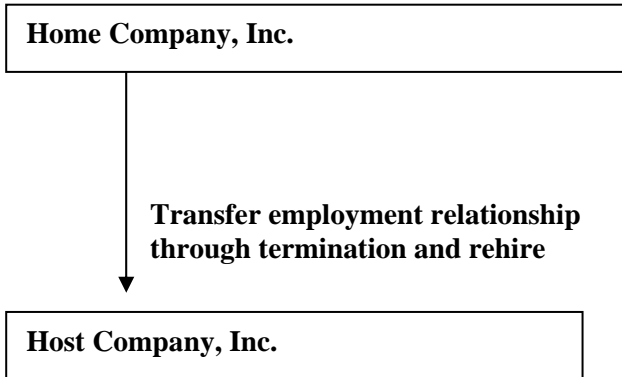
Secondments, nevertheless, remain the most common method of transferring employees to another jurisdiction. In particular, assignments are desirable where the employee has particular benefits or status that they wish to keep while working in the host country, such as a retirement or pension plan. Many US expatriates, for example, like to remain covered by their U.S.-tax qualified plans and other US style benefits while working abroad, so the secondment structure facilitates this extended participation.

### *Transfer of Employment*

In the transfer scenario, the employee's employment with the Home Company is terminated and the employee is rehired by the Host Company. This structure is the preferred approach from a pure employment law perspective because it creates a "clean break" between employing entities, and thus clarity as to what laws govern the employment relationship on a going forward basis.

Since this alternative involves a technical termination of employment, however, all associated termination obligations and benefits are triggered (*e.g.*, the payment of severance, the final paycheck and vacation payout, and so forth). In some jurisdictions, payment of severance is mandatory and cannot be waived under local law. Thus, while a preferred approach from an employment law perspective, the transfer approach is also the most expensive, typically, for the employer to implement. For additional information on termination obligations, please see Baker & McKenzie's publication ***Worldwide Guide to Termination, Employment Discrimination, and Workplace Harassment Laws***.

## Typical Transfer of Employment Structure



Documenting a transfer usually involves a two-step process. The first step is a letter agreement between the current employer and the employee to mutually terminate the employment relationship, and to waive any notice and/or severance entitlements (vacation roll-overs also can be addressed) if allowable in the particular jurisdiction and in accordance with local laws. There is also an opportunity to obtain a release of claims (if allowable under local laws) if there are any potential concerns regarding latent claims with the prior employer. The second step is an offer letter or employment agreement from the new employer. Since the employee in this situation has a “history” with the company, it is common practice not to include any probationary periods in the new offer of employment, and to recognize prior seniority.

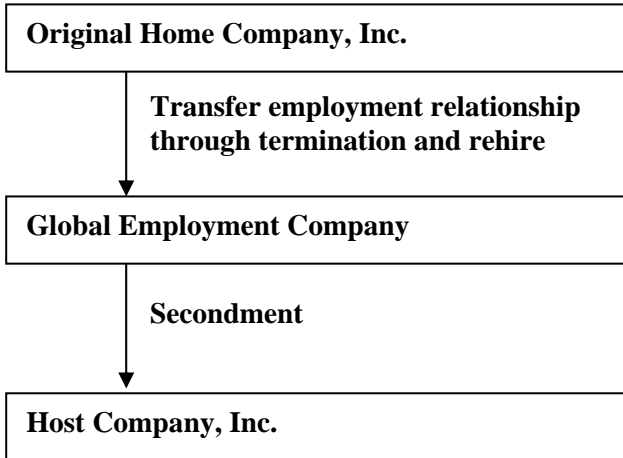
In light of the inherent cost and more elaborate transfer mechanics, multinational companies tend to use this approach vary sparingly. A long-term or permanent assignment to a new jurisdiction may suggest use of this structure, but for most foreign assignments a direct transfer will not be the first choice.

### *Global Employment Company (“GEC”)*

This alternative is something of a hybrid, combining elements from both secondment and transfer structures. First, the employee is terminated by his home country employer and transferred to a special services company (usually an affiliate) organized for the express purpose of employing expatriates. The GEC, as the employee’s employer, becomes the employee’s “Home Company”, and it then second the employee to work for an affiliate as needed.

The use of a GEC can offer employers and expatriate employees with greater flexibility (and uniformity) in structuring compensation, benefits, social security, and related taxation for their global workforce. The GEC provides an effective buffer for any permanent establishment issues that may arise, since the GEC becomes the “employer” and thus it is only the GEC that has the PE exposure. Finally, this structure limits the number of jurisdictions that are taken into account since all employees are housed in the GEC. Multinationals look to employer-friendly jurisdictions as the location for their GEC: such as the U.S., Switzerland, and Singapore. Other choices include tax-friendly jurisdictions, such as the Cayman Islands, Bermuda, Guernsey, and so forth, reducing or minimizing any tax exposure the GEC may have as a corporate entity.

## Global Employment Company (“GEC”)



Global Employment Companies are popular with multinationals who have large expatriate populations. Given the amount of work necessary to set up a GEC, however, companies with smaller expatriate populations tend not to use this alternative. Often, a GEC can be established as a “paper” company, that is, it exists for real but it contracts out for all of its services (*e.g.*, accounting, payroll, employee benefits, H.R., and so forth) with related companies.

### *Dual Employment*

In the dual employment scenario, the employee has two or more active employment relationships.

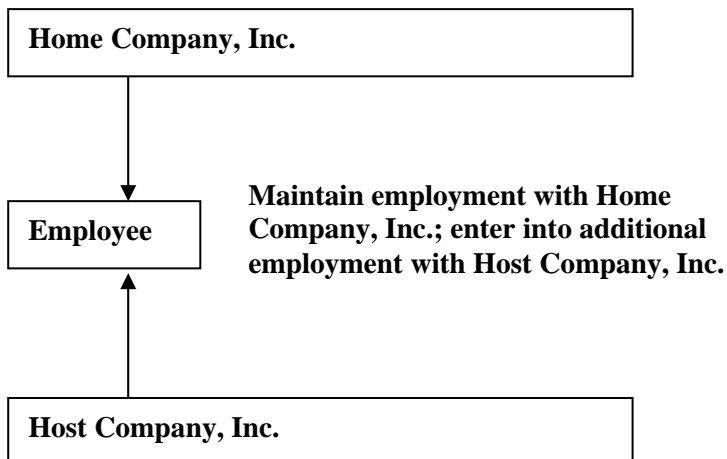
A dual employment structure is often used in a situation where the employee is in fact providing services that benefit more than one entity, such as a sales manager who is selling products covering more than one line of business, or an executive who has multiple titles and reporting relationships. Dual employment can, in some cases, achieve some favorable tax results for executives who work in jurisdictions

that tax compensation on a remittance basis, and in other situations, but careful planning is required to avoid getting the company into trouble for failing to withhold or report income where required.

This structure is more burdensome than the other structures since it requires maintaining two employment relationships, two employment agreements, multiple tax and filing obligations and the related payroll and benefits implications. As a result, it the least common structure.

Documenting a dual employment relationship usually involves one employment agreement between the employee and one company within the group, and a second employment agreement between the employee and another company within the group. These agreements should be carefully drafted to appropriately document the duties, responsibilities, time allotment and commensurate compensation for each separate employment relationship.

### Typical Dual Employment Structure



## Further Information

The Global Employment Practice works in coordination with the Global Immigration and Mobility Practice. Employment practitioners help structure employment relationships for global mobility assignments that factor in the employment laws of multiple countries/jurisdictions. They also assist multinational companies in developing corporate policies and practices for global mobility assignments, as well as guide employers on current trends and best practice solutions. They play a key role in pre- and post-acquisition integration on mergers, acquisitions and reorganizations, as well as redundancies and reductions in force.

## Compensation and Employment Benefits

### Introduction

While an employee is working on a foreign assignment, one question that always gets raised is what compensation and benefits will apply. Many multinational companies have dedicated employee benefit plans and procedures in place to cover expatriate employees and provide them with meaningful benefits. In some cases, however, the compensation and benefits package has to be specially-designed to fit the individual's situation.

The factors to consider include: the jurisdictions involved, the length of the employee's assignment, the employment structure, the employee's desire to remain covered by home country benefit plans (in some cases), whether the employee will return to his home country after the assignment, among others.

### Compensation and Payroll

Once the employer has determined how much to compensate the employee (*e.g.*, base salary, potential bonus, and so forth), the next question will be: Where will the employee be paid?

Note that in most circumstances it does not matter under local law where the employee is paid. As a result, often the employee can continue to be paid from his home country, in which case the amounts are typically deposited in a home country bank account for the employee and he then accesses the funds from a branch in the host country where he is working.

However, not every expatriate works in a jurisdiction with a bank that has branches in both the home and host jurisdictions. Accordingly, sometimes the employee receives all or a portion of his compensation

in the jurisdiction where he works, that is, from a local company in the jurisdiction.

Paying compensation to the expatriate typically is not determinative of the employer-employee relationship. A company does not become the expatriate's "employer" merely because it pays compensation. Often, companies are designated to serve as payroll agents for other companies. Accordingly, the local company might pay compensation to the expatriate as payroll agent on behalf of the expatriate's real employer in the home jurisdiction. Where compensation is delivered locally, it is subject to any applicable income tax and social tax withholdings, unless an exemption applies.

Note, however, that in a few jurisdictions local employment law does require that employees who are employed locally be paid locally. In those situations, the employee would not be permitted to be paid outside the jurisdiction in non-local currency.

Understanding local law is therefore critical to making sure that the expatriate's payroll is structured correctly and is compliant.

### Extending Tax-Qualified Plans to Employees Working Abroad

A common concern of many employees is whether they can continue to participate in a U.S. tax-qualified retirement plan while they are working outside of the United States on a foreign assignment.

A U.S. tax-qualified retirement plan may provide certain U.S. tax advantages that a foreign retirement plan cannot, such as a pre-tax contribution feature (as in the case of a plan under Section 401(k) of the Code), no current U.S. income tax on the contributions made to the plan on the employee's behalf, no current U.S. income tax on earnings of the plan prior to distribution and favorable U.S. income tax treatment upon distribution (such as tax-free rollover treatment).

An employee may be reluctant to part with these tax benefits, unless a substantial expatriation bonus or other “gross-up” allowance is offered. Further, if the employee’s assignment will be short, he may not be able to obtain a meaningful retirement benefit from any non-U.S. retirement plan. And even if he can obtain a sizeable benefit, he may be taxable under U.S. income tax law on the contributions made to such a plan or on the vesting or accrual of such benefits.

### A Tax-Qualified Retirement Plan Must Cover “Employees”

As a first step, the plan sponsor should review the terms of the plan document and determine whether the employee’s employment abroad is covered under the plan. In other words, does the plan cover employees working outside of the United States in that particular location? If not, the plan may need to be amended.

The most critical aspect for plan participation purposes is the employer-employee relationship. In general, a tax-qualified retirement plan may not cover individuals who are not technically “employees,” that is, common-law employees of the plan sponsor or adopting employer. For these purposes, a person is in general an “employee” if the employer has the right to direct and control the activities of the person. Failure to limit plan participation to employees only may result in disqualification of the plan.

Accordingly, if the employee is seconded to work for a non-U.S. company, then he will continue to participate in the retirement plan because he technically remains a common-law employee of the U.S. employer.

Further, if the employee transfers to a foreign branch of a U.S. employer, the employee can continue to participate in the U.S. employer’s tax-qualified retirement plan because the foreign branch is merely an unincorporated association and thus is treated as an extension of the U.S. employer.

However, where the employee transfers employment to a non-U.S. parent or subsidiary organization, he would in theory no longer be ineligible for participation.

### Controlled Group Coverage

Notwithstanding, the employee's participation in a U.S. tax-qualified retirement plan can be preserved where he is transferred to employment with a member of the same controlled group as the plan sponsor or adopting employer of the plan. For these purposes, a "controlled group" is defined as a "controlled group of corporations," or "trades or businesses under common control" under the Code.

A "controlled group of corporations" is a parent-subsidiary group, in which the parent owns at least 80% of the stock of the subsidiary, or a brother-sister group, in which five or fewer individuals own at least 80% of the stock in two or more corporations, and at least 50% of such ownership is identical with respect to each corporation. Similar rules exist for "trades or businesses under common control," (which include unincorporated entities), affiliated service groups and entities that the Secretary of the Treasury through regulations deems should be treated as one employer for employee benefit purposes.

Note that the controlled group rules, for purposes of tax-qualified retirement plans, include non-U.S. entities in the definition of "controlled group," even though non-U.S. entities are technically excluded from the definition of an "affiliated group of corporations" eligible to file a U.S. consolidated group income tax return.

The IRS has ruled that because of the application of the controlled group rules, employment is tested on an entity-wide basis. That is to say, employment with any member of the controlled group will be considered to be employment with the plan sponsor (other than for deduction purposes, discussed below). Accordingly, the plan sponsor may preserve an employee's participation in the plan as long as he

transfers employment to a member of the same controlled group. The plan document should be reviewed to confirm that participation could in fact be extended in this manner.

### Potential Loss of U.S. Deduction

Even if the employee's participation can be continued because he is transferring employment to a controlled group member, the plan sponsor is not automatically entitled to a U.S. federal income tax deduction for its contributions on behalf of such employee, since the plan sponsor may only deduct contributions made on behalf of its own employees. In other words, the controlled group rules and the income tax deduction rules are not completely synchronized.

Notwithstanding, the IRS has ruled that if the controlled group member in fact adopts the plan for the benefit of the employee, the contribution *is* deductible.

Nondeductible contributions in general give rise to a special 10% excise tax payable by the employer. Notwithstanding, as long as the nondeductible amount contributed on behalf of the employee does not exceed the amount allowable as a deduction under Code Section 404 (e.g., 25% of compensation), then the 10% excise tax does not apply.

### Treat Assignment as a Leave of Absence"

If the employee will be abroad on a temporary assignment, he may also be able to remain a participant in the tax-qualified retirement plan if his assignment is characterized as a "leave of absence." The relevant Regulations provide that a tax-qualified retirement plan may cover employees who are temporarily on leave.

### Working for a "Foreign Affiliate"

Another way to continue the employee's participation in the tax-qualified retirement plan is if the employee is employed by an entity

in which an “American employer” (which includes a U.S. corporation) has a 10% or more interest (*i.e.*, a “foreign affiliate”). In that case, he will be treated as employed by the American employer for purposes of the American employer’s tax-qualified retirement plan, if certain requirements are met, including that the American employer agrees to extend U.S. Social Security coverage to all of the foreign affiliate’s employees who are U.S. citizens or residents by means of a Section 3121(l) agreement filed with the IRS.

A similar provision applies to certain employees of U.S. subsidiaries having non-U.S. operations.

#### Adoption by Foreign Employer

Plan coverage could also be continued by arranging for the foreign employer to adopt and make contributions to the plan.

#### Foreign Law Implications

There are a number of foreign laws that may have an effect on an employee’s participation in a U.S. tax-qualified retirement plan, including the following:

##### *Tax Laws*

The employee might be taxed under local rules before receiving distributions from the plan. The local tax rules may provide for taxation, for example, when benefits are accrued, when a contribution is made to the plan or allocated to a plan account on the employee’s behalf, or when the employee vests in the contribution.

##### *Labor Laws*

In certain countries, plan benefits or contributions may have to be counted when determining the employee’s dismissal pay or

termination or severance indemnities that may be payable when he leaves employment. Further, the plan benefits may run afoul of compliance with certain nondiscrimination rules. There is also a risk in some “acquired rights” jurisdictions that plan participation and benefits may not be terminated or revised unilaterally by the employer without consent of the employee.

### *Securities Laws*

If employer stock is allocated to the employee’s account under the plan, foreign securities laws may require compliance with certain registration or prospectus distribution requirements, unless exemptions are applicable.

### *Coverage under Non-U.S. Retirement Plans*

Although there are many reasons why an employee may prefer to remain a participant in a U.S. tax-qualified plan, there are number of reasons why the employee may desire to participate in a non-U.S. retirement plan instead. For example, if the employee transfers to employment with an employer who is outside of the controlled group, he may simply be unable to continue participation in the U.S. plan. Or, if the U.S. plan sponsor may not be able to, or may not want to extend coverage to the employee.

Additionally, the non-U.S. plan may provide more generous retirement benefits than the U.S. plan. For example, in a number of European countries, private pension plans provide for the cost-of-living indexation of retirement benefits. This indexation means that retirement benefits are increased for cost-of-living adjustments, which results in a larger benefit to the retiree over time.

Finally, non-U.S. tax laws may provide certain tax advantages for the employee. For example, such laws may tax the employee if he

participates in the U.S. tax-qualified retirement plan, but may not tax him if he participates in a retirement plan in the local jurisdiction.

For these reasons, participation in the local retirement plan may be attractive to the employee. This result is even more likely if the U.S. tax-qualified retirement plan does not penalize the employee for discontinued plan participation through lengthy vesting schedules, final pay benefit formulas, or restrictive definitions of “compensation.”

Some representative, non-U.S. retirement plans are described below:

In the United Kingdom, pension plans fall into two general categories: the State Scheme and private pension schemes. The State Scheme consists of a basic (flat rate) pension and the State Earnings Related Pension or “SERP.” The State Scheme is funded by mandatory contributions called National Insurance Contributions from employers and employees.

Most U.K. private pension schemes are set up by employers to supplement the State Scheme, although an increasing number of individuals are establishing their own private arrangements and pensions. Employers, and in most cases, employees will finance the scheme through an irrevocable trust that will normally comply with certain statutory requirements, in the same manner as a tax-qualified retirement plan in the United States must comply with the requirements of Code Section 401(a). If the scheme is approved by Inland Revenue, the contributions paid by the employer are deductible, the employees are not taxed on their employers’ contributions, and any investment earnings of the fund are not subject to tax.

There are several different kinds of private pension plans in Canada. These plans fall into two basic groups: registered and unregistered plans.

Registered Pension Plans, which provide for tax-deductible employer contributions, are generally either defined contribution plans or defined benefit plans. Registration of a pension plan in Canada is similar to the process of obtaining a favorable determination letter for a tax-qualified retirement plan from the IRS. Other types of registered plans include Deferred Profit Sharing Plans and Group Retirement Savings Plans (where one or more individual Registered Retirement Savings Plans are sponsored as a group plan by the employer).

Unregistered arrangements include a retiring allowance, which is a lump sum at retirement, and a Retirement Compensation Arrangement, under which employer contributions are made to a custodian and are subject to a 50% refundable tax. Pension plans may also be classified as Employee Profit Sharing Plans, Employee Benefit Plans or Salary Deferral Arrangements.

Retirement schemes in Hong Kong are regulated by the Occupational Retirement Schemes Ordinance (“ORSO”). Unless an exemption from registration applies, it is a criminal offense for an employer to operate, make a payment to, or otherwise contribute to or participate in, an unregistered scheme. The rights of members of unregistered schemes are, however, protected.

ORSO requires a scheme to be registered if it has or is capable of having the effect of providing benefits, in the form of pensions, allowances, gratuities or otherwise, payable on termination of service, death or retirement, to or in respect of persons gainfully employed in Hong Kong or elsewhere under a contract of service. An exemption to the compliance requirements under ORSO may be granted if the scheme is registered with or approved by an offshore authority which performs functions similar to those of the Hong Kong Registrar, or fewer than 10% or 50 of the scheme members, whichever is lower, are Hong Kong permanent residents.

The Mandatory Provident Fund Schemes Ordinance (MPFSO) sets out the framework for the MPF system in Hong Kong. In keeping with Hong Kong's policy of encouraging market enterprise, the legislation establishes a mandatory retirement system which is largely run by the private sector. The fundamental requirement of the MPFSO is that every employer of relevant employees must establish or join a MPF scheme. Non-Hong Kong employers will be subject to the legislation if they have employees in Hong Kong. A "relevant employee" is defined as an employee of between 18 and 65 years of age, including apprentices.

The MPFSO contains a number of specific exemptions, including ones for expatriate workers and members of existing schemes.

The employer is required to contribute 5% of the employee's relevant income to an MPF scheme. Employees who are members of an MPF scheme are required to contribute 5% of relevant income up to a ceiling contribution level. An employee who wishes to contribute in excess of the ceiling may do so.

In Japan, there are three basic types of retirement plans:

- the unfunded severance benefit plan
- the tax-qualified pension plan
- the Employees' Pension Fund plan

The unfunded severance benefit plan usually makes a distribution of a lump sum severance benefit when an employee terminates employment.

A tax-qualified pension plan is a voluntary, company-run plan that is managed by an external fund manager. Companies with tax-qualified pension plans are eligible for certain preferential tax treatment, but the

system has several deficiencies and in April 2002 the Japanese government decided to abolish it by March 31, 2012.

In its place, two new corporate pension systems were established; the Defined-Benefit Pension Plan and the Corporate Type Defined Contribution Pension Plan, both of which incorporate greater employee protections. Companies with a tax-qualified pension plan are required to (i) shift to one of the alternative systems; (ii) shift to the Small and Medium Enterprise Retirement Allowance Cooperative System; or (iii) terminate and liquidate their existing pension fund by March 31, 2012. As of that date, tax-qualified pension plans will no longer attract tax benefits.

The Employees' Pension Fund generally is available only to employers with 500 or more employees, and is a means for an employer to contract out of the earnings-related part of the social security pension program.

### *U.S. Tax Consequences of Participating in Non-U.S. Plans*

One of the most important considerations in determining whether an employee should participate in a non-U.S. pension or other employee benefit plan is the potential U.S. federal income tax consequences of such participation.

If an employee participates in a non-U.S. plan funded through a trust, his tax consequences generally are determined under Code Section 402(b), which provides in general that contributions must be included in the employee's gross income when vested. Note that limited relief is provided under several U.S. income tax treaties (*e.g.*, U.K. and Canada).

An employee who participates in a non-U.S. plan should also address any potential issues under Code Section 409A and 457A. A non-U.S.

retirement plan is potentially subject to these rules because it provides a form of nonqualified deferred compensation.

A complete review of the Code Section 409A and 457A rules is beyond the scope of this discussion. In general, if a person has a legally binding right in one taxable year to receive an amount that will be paid in a subsequent taxable year, that amount is considered deferred compensation for the purposes of Code Section 409A, unless it meets one of the exemptions.

Assuming that no exemption applies, amounts that are considered deferred compensation must comply with various requirements regarding the time and form of the payment, timing of deferral elections, and a six month delay of separation payments made to certain “key employees” of a public company.

In addition, there are prohibitions on offshore funding and funding tied to the employer’s financial condition. If the requirements are not met, the deferred compensation amounts will be taxable at the time of vesting and an additional 20% tax will apply.

Although it is unlikely that non-US compensation plans (*e.g.*, retirement plans, equity incentive plans, cash bonus plans) would be designed to comply with Code Section 409A requirements, the IRS does apply the Code Section 409A rules to all plans globally that have US taxpayer participants.

As a first step of the analysis, it is critical to identify all of the potential compensation plans, including equity compensation plans, that will be offered to the employee. The Code Section 409A rules do provide a few specific exemptions for non-U.S. plans, and these provisions should be reviewed in connection with proposed participation by an employee.

For example, a foreign retirement plan may qualify for an exemption from Code Section 409A as a “broad-based retirement plan”. For US citizens and green card holders, the requirements for this exemption include:

- They are not eligible to participate in a US qualified plan;
- The deferral is non-elective and relates to foreign earned income; and
- The accrual does not exceed the amount permitted under Code Section 415 (*i.e.*, the US qualified plan limits).

The broad-based plan must also meet the following requirements:

- The foreign plan must be in writing;
- The foreign plan must be non-discriminatory in terms of coverage and amount of benefit (either alone or in combination with other comparable plans); and
- The foreign plan must provide significant benefits for a substantial majority of the covered employees and contain provisions, or be subject to tax law provisions or other restrictions, which generally discourage employees from using plan benefits for purposes other than retirement and restrict access to plan benefits before separation from service.

There are also Code Section 409A exemptions for plans exempt under a tax treaty, foreign social security plans, and plans that considered funded by means of a trust under the rules, among others.

In addition, Code Section 457A also applies to deferred compensation earned by a US taxpayer employee working abroad. It limits the ability to offer deferred compensation in cases where employees (who

are subject to US taxation) perform services for employers who are considered “nonqualified entities”. In general, employers based in jurisdictions that do not have a corporate income tax will be “nonqualified entities.”

Further, even non-US entities, based in jurisdictions that have an income tax treaty with the United States, and which are subject to a corporate income tax in that jurisdiction may also be considered “nonqualified entities” depending upon the extent of the corporate taxation.

A full discussion of Code Section 457A is beyond the scope of this publication, though employers are encouraged to monitor any subsequent IRS guidance on the treatment of expatriate employees for purposes of Section 457A.

### *ERISA Implications*

Because of the breadth of the definitions in the Employee Retirement Income Security Act of 1974, as amended (hereinafter “ERISA”), a non-U.S. retirement plan may inadvertently become subject to ERISA absent the application of a specific exception. In general, ERISA applies to an employee benefit plan established or maintained by any employer engaged in commerce or in any industry or activity affecting commerce.

Non-U.S. retirement plans typically do not worry about ERISA because of the statutory exemption that ERISA does not apply to a plan maintained outside the United States primarily for the benefit of persons substantially all of whom are nonresident aliens. The Department of Labor, which has primary jurisdiction for the interpretation and enforcement of ERISA, bases its determinations that plans qualify for this exemption on factors such as whether the plans cover all or primarily all nonresident aliens, whether the work location of the employees are outside the United States and whether

the plan records and documents are maintained outside the United States. Whether a plan can meet this ERISA exemption is a facts and circumstances determination.

### *Equity Compensation*

To the extent that the employer intends to grant equity compensation to the employee while he is working abroad, then a number of local tax, securities, exchange control, data privacy and other issues will arise. These issues need to be carefully considered since a violation of these local laws, even with respect to one employee, carry significant monetary fines and other penalties.

The tax consequences in each jurisdiction vary, and do not always match the U.S. tax consequences. For example, some non-U.S. jurisdictions tax a stock option at the time the employee actually exercises the option (*e.g.*, Hong Kong, Japan, Mexico, Singapore, and the United Kingdom). Other jurisdictions tax employees at the time a stock option is granted (*e.g.*, in Belgium if the employee accepts in writing within 60 days of grant). Other jurisdictions tax the grant of stock options on vesting (*e.g.*, in Australia for options acquired after July 1, 2009, that satisfy the conditions for deferred taxation.).

In addition, some jurisdictions have local tax-qualified plans (*e.g.*, France and the United Kingdom). If the equity award is granted to the expatriate under such a plan, then he will enjoy favorable income tax treatment (usually, deferred tax).

The tax consequences are further complicated if the employee is granted an equity award in one jurisdiction, but vests in that award or exercises that award in another jurisdiction. Tracking what tax liability is owed to which jurisdiction is challenging, especially with respect to employees who work in multiple jurisdictions during their expatriate assignment.

And the issues relate not only to understanding the employee's tax liabilities, but also understanding the reporting and withholding obligations that result from such taxation will be the responsibility of the equity plan sponsor and employer. Each jurisdiction has different rules regarding the sourcing of such compensation and there is little relief found in Income Tax Treaties. Accordingly, it is difficult to handle the tax issues associated with equity compensation awarded to globally mobile employees in a uniform manner.

Although U.S. issuers are generally not entitled to an income tax deduction for equity awards related to employees working for a local subsidiary, the local subsidiary may be able to obtain a local income tax deduction related to such amount. In many jurisdictions, the income tax deduction of the local subsidiary is premised upon the execution of a written reimbursement agreement between the U.S. parent company granting the equity award and the local subsidiary prior to the grant. Some jurisdictions do not permit such a deduction (*e.g.*, Canada).

The grant of equity compensation to an employee may trigger local securities law compliance issues, such as the requirement to make a filing with the local securities authorities, or to distribute a prospectus document to employees. For example, an offer document and filing in Australia is often required. In Japan, grants to 50 or more employees of an indirect or less than wholly-owned subsidiary with an offering value equal to or greater than ¥100,000,000 will require an extensive filing and annual reporting obligation. Grants of equity compensation in Europe may require a filing under the EU Prospectus Directive.

In certain jurisdictions, exchange control rules still play a large role in determining the ability of a corporation to offer equity compensation to an employee. In some jurisdictions (*e.g.*, in China), prior governmental approval is required before an equity plan can be implemented. In other jurisdictions, it is not possible to send local currency outside of the jurisdiction to purchase shares of stock

without obtaining a tax clearance certificate and submitting a funds application form to an authorized exchange control dealer (*e.g.*, in South Africa).

Further, the grant of an equity award to the employee may require compliance with local data privacy and labor rules. Certain jurisdictions have formal legislation prohibiting the transmission of certain personal information about their employees, such as name, age, seniority, and so forth, across borders, even to an affiliated company. Some jurisdictions require the employee to consent to the transfer of such information, some jurisdictions require the formal approval or notification to a local governmental authority, and some require both.

Further, the value of the equity compensation offered to the employee may give rise to acquired rights issues in certain jurisdictions, making it difficult to terminate the benefit in the future without the employee's consent. Also, the value of the equity compensation may need to be included for purposes of calculating a terminated employee's severance pay, creating a more expensive termination situation for the employer.

### *Continuing U.S. Health Benefits*

If U.S. group health plan coverage is provided to an employee and his family while they are living in a non-U.S. jurisdiction, the plan should be reviewed for any coverage gaps and other problems that may be caused by the foreign assignment. For example, U.S. group health plans often do not cover employees and their dependents while they are working outside of the United States. If a plan does provide such coverage, it may require that the employee pay his health care expenses upfront and then submit a claim for reimbursement.

Further, a U.S. group health plan may not necessarily provide for the reimbursement of bills by certain foreign doctors or hospitals if the

foreign doctor or hospital does not meet certain qualifications. Amendment of the U.S. group health plan to resolve or alleviate these problems may not be possible depending, for example, on whether the plan is self-funded or third party insurers are involved.

As a result, the employer should review the plan document and consult with its insurer, plan administrator or legal counsel before the employee leaves on his assignment to determine whether coverage can be extended.

Many multinationals sponsor stand-alone global health plans for their expatriates specifically to avoid any coverage issues under the U.S. domestic health plan.

The U.S. income tax consequences of providing health benefits to the employee and his family through the U.S. group health plan should also be considered. As a general rule, if the employee is not employed by a U.S. employer, or a foreign branch or a member of the U.S. employer's controlled group, the U.S. employer's contributions to the plan and the amounts the employee and his dependents receive through the plan may no longer qualify for tax exemptions under the Code.

Also, if the U.S. group health plan is financed through the mechanism of a cafeteria plan and the employee is no longer employed by a U.S. employer, or a foreign branch or a member of the controlled group of the U.S. employer, the employee and his dependents may lose the ability to make pre-tax contributions under the cafeteria plan.

If the employee becomes a resident in the foreign jurisdiction and is subject to local laws during his foreign assignment, the potential impact of the foreign laws should also be considered. For example, the premiums paid on behalf of the employee or benefits provided through the U.S. group health plan may be taxable to the employee or his dependents under the tax laws of the foreign jurisdiction. The

premiums or benefits may be also subject to employment tax withholding and the premiums or benefits may be includible in the calculation of severance indemnity payments an employer must make or dismissing an employee.

If the employee is a participant in an insured plan in the United States, there may also be a problem if the U.S. insurance company is not registered to conduct business in that country. Failure to comply with this registration requirement may mean the insurance agreements are unenforceable in that jurisdiction and may also trigger monetary sanctions.

Depending on the situation, the employer may want to arrange to replace or supplement the coverage provided by the U.S. group health plan. This arrangement may include:

- the purchase of a specially-designed individual policy;
- the enrollment of the employee and his family in a specially-designed group health plan;
- the enrollment of the employee and his family in an overseas emergency medical services and evacuation program; or
- the enrollment of the employee and his family in a non-U.S. nationalized or socialized health program.

Specially-designed individual or group insurance policies or plans may be useful in addressing coverage gaps and other practical problems that arise because of the foreign assignment. Overseas emergency medical services and evacuation contracts may also be useful when evacuation to the United States is necessary in order to receive a certain type or quality of health care and for referral to qualified foreign health care.

Note that if the employee is no longer covered by the U.S. group health plan he (or any “qualified beneficiary”) will no longer be eligible to elect COBRA continuation coverage since the employee would no longer be a covered employee. Query whether the employee’s transfer of employment to a non-U.S. employer could constitute a “qualifying event” for purposes of COBRA group health plan continuation coverage.

### *Non-U.S. Health Benefits*

Participation by the employee in a non-U.S. health benefit plan may raise a number of issues. Accordingly, many employees try to retain some health benefit coverage in the United States while they are overseas. Many non-U.S. countries have extensive governmental health programs. While non-local, private health plans exist in some countries, they may be structured to provide only supplemental benefits to the benefits provided by the governmental program. Whether an employee can participate in the underlying governmental program may depend on how long he has resided in the non-U.S. country or the satisfaction of other conditions.

Because of limited non-U.S. governmental program benefits, the employee may desire to have supplemental health benefits (if local law does not prohibit them). For example, some governmental programs may only provide ward level care (*e.g.*, no semi-private or private hospital rooms), require the use of certain governmental or governmentally approved facilities or providers, have long waiting periods for certain types of non-emergency care, provide lesser quality care outside of major cities, not provide coverage of certain benefits (*e.g.*, dental coverage), not be used by employees due to a local class bias and may not cover all or part of the costs of health care received while the covered individual is temporarily out of the foreign country (*e.g.*, in the United States on home leave or in another foreign country on a temporary work assignment).

## Global Equity Compensation

### Executive Summary

Equity compensation awards held by employees present new issues when those employees become globally mobile.

As multinational employers increasingly seek to motivate and retain qualified executives and employees by offering equity-based compensation and, at the same time, transfer such individuals across international borders on short- or long-term assignments, it is important to identify and address the tax, social security and legal impact of such international transfers on equity compensation arrangements. Due to the complexity and global reach of US federal tax and social security regulations, the transfer of employees into and out of the US poses particular challenges that need to be considered in advance of any such transfer of employment.

### Key Government Agencies

The Internal Revenue Service (“IRS”) and Social Security Administration (“SSA”) are the government agencies responsible for overseeing the assessment and payment of federal income taxes and social security taxes (*i.e.*, Federal Insurance Contribution Act or “FICA” taxes which include social security and Medicare tax).

In addition, the taxation of mobile employees is significantly impacted by tax treaties and other international agreements and acts, published by the US Department of State, and also by social security totalization agreements negotiated and signed by the Department of Health and Human Services under the US Social Security Act. For “American employers,” which includes corporations organized under the laws of the United States or any State, sending employees to work in a totalization agreement country for five years or less, the SSA has oversight over the issuance of Certificates of US Social Security

Coverage that in certain circumstances enable such employees to remain subject to the US social security system and exempt from social security taxes in the country to which they have been transferred.

State and local income tax and payroll tax authorities also have a stake in the taxation of equity awards held by mobile employees, depending on the time an equity award holder spends in a particular state and municipality.

Finally, the Securities and Exchange Commission (“SEC”) and the State securities regulators have oversight over any offerings of equity awards to employees in the US and the resale of shares acquired by those employees. In some instances, there are exemptions available to the issuer because the offering is to employees; however, securities laws should be considered each time an equity award is granted or exercised or shares are resold.

### Current Trends

In recent years, there has been an increasing awareness among US and other global tax authorities that significant amounts of taxes may be owed on income derived from stock options and other forms of equity compensation awards held by employees who transfer employment across international borders. In part, the focus arises from a commentary first published by the Organization for Economic Cooperation and Development in 2002, which addressed the tax difficulties of stock options in a cross-border context.

More recently, in December 2008, the IRS announced that it has added foreign withholding tax compliance to its list of issues with the highest “Tier I” organizational priority and coordination and since then, there has been significant audit activity in this area. Although the IRS’s immediate focus is on withholding of taxes on income paid to non-US resident individuals under Section 1441 of the Internal

Revenue Code, its increased scrutiny of cross-border withholding practices sends the clear message that companies granting equity awards to US-inbound and outbound globally mobile employees cannot afford to ignore proper US tax compliance in this area.

Historically, while both employers and tax authorities have generally had arrangements in place to determine and assess, respectively, the US and foreign taxes owed on salary paid to internationally mobile employees, the proper taxation of income from equity compensation awards has commonly been overlooked. Consideration has not always been given to the fact that equity award income has usually been earned over a period of one or more years, whether over the vesting or the exercise period, during which the relevant employee may have been employed and resident in a number of different countries.

At present, however, it is clear that both US and foreign tax authorities have become aware of potential trailing tax liabilities resulting from the incorrect characterization of income from equity compensation arrangements, and are increasingly focusing their attention on this area. This means that it is important for multinational companies that have granted equity compensation awards to globally mobile employees to identify the particular tax and social security issues affecting the taxability of income from such awards and to develop strategies for dealing with these issues and tracking international tax liabilities upfront.

## Business Travel

Depending on the circumstances, foreign national employees coming to the United States on short-term business trips (*e.g.*, total stay of up to six months) may be subject to US federal income taxation on their foreign wages paid during periods spent on business within the US. This is based on the general US sourcing rule in Section 861 of the Internal Revenue Code that compensation for labor or personal services performed in the US is US source income and therefore

subject to US income tax in the absence of an exemption. Where an individual such as a business traveler performs services partly in and partly outside the US, the applicable US Treasury Regulations provide that the portion of the individual's compensation for such services that constitutes US source income should, in many cases, be apportioned on a time basis. In terms of equity awards, Treasury Regulations Section 1.861-4(b)(2)(ii)(F) characterizes income from stock options as "multi-year compensation", *i.e.*, compensation that is included in the income of an individual in one taxable year but that is attributable to a period that includes two or more taxable years.

Where stock options are held by an employee who spends time employed both inside and outside the US, the regulations indicate that it will generally be appropriate to measure US source income by reference to the number of days the employee worked in the US between the option grant date and the date on which all employment-related conditions for the exercise of the option have been satisfied, *i.e.*, the vesting date, relative to the total days worked during the vesting period (although this rule is modified in a small number of cases by a tax treaty between the US and the country in which the employee is resident). This concept applies equally to other forms of equity award such as restricted stock units which vest over a vesting period and employee stock purchase plan rights which vest/ become exercisable over a purchase period.

As a result, if US federal income tax applies to income paid to a given foreign business traveler, it will also apply to any income the employee receives from an equity award that is attributable to the US under the above sourcing rule, due to the fact that a portion of the equity award vested while the employee was on business travel in the US. In such cases, the employer of the foreign national employee will have an obligation to withhold the US federal income tax due.

In practice, a foreign national employee on a business trip will be exempt from US federal income taxation on compensation for labor or

personal services performed in the US if the individual qualifies as a “short-term business visitor” under Sections 861(a)(3) or 864(b)(1) of the US Internal Revenue Code, or if he or she is a resident of a country with which the US has an income tax treaty. Certain conditions must be satisfied for either exemption to apply, which generally require an assessment of the individual’s length of stay in the United States, the amount of compensation paid to the individual while in the United States and the nationality and/or business location of the employer. If an exemption applies, the employee should provide appropriate documentation to his or her non-US employer, including IRS Form 8233 if a tax treaty exemption is relied on for US income tax withholding purposes.

The situation with respect to FICA tax for short-term business visitors to the US is less clear cut, since the US Internal Revenue Code does not contain a specific exemption from FICA taxes for individuals temporarily performing services within the country. In the absence of an applicable social security totalization agreement, technically, FICA taxes will apply to a foreign employee on a business trip in the US, even if for only one day, and notwithstanding that the employer may have no office or other place of business in the country.

If the individual is from one of the 24 countries with which (as of the date of publication) the US has a social security totalization agreement, there should be an exemption from FICA tax under the temporary assignment provisions of such totalization agreement, provided that the foreign employee’s wages (including equity award income) earned while temporarily working in the US are subject to social security taxes in his or her home country. If a totalization agreement does not apply, but there is an income tax treaty between the US and the country of which the foreign national is a resident, it may be possible to take the position that the treaty implicitly provides for an exemption from FICA taxes, depending on the treaty.

US State taxes also need to be considered in any US-inbound transfer scenario. Although it is highly unlikely that foreign nationals on short-term business trips would be considered residents of the applicable State for income tax purposes, some States may tax the individual's compensation, including equity award compensation, if the foreign national performed services in the State. Additionally, not all States recognize US federal income tax treaty exemptions.

Thus, before a foreigner is sent on a short-term business trip to the US, it is important to confirm the extent to which the foreigner may be subject to US federal income tax, State tax and/or FICA tax and, assuming that an exemption is available, take any steps necessary to rely on such exemption. Assuming US income and/or social security tax applies to income earned or deemed to have been earned by the foreign national during the business trip, to the extent that the individual holds stock options or other equity awards that have partially vested while the individual was within the country, a tracking system needs to be established to ensure that appropriate taxes are paid when the individual ultimately realizes the income from the equity award (*e.g.*, when exercising the stock option, or exercising/vesting in such other form of equity award) after departing the US.

Similar considerations will apply when a US national is sent on a business trip to another country, depending on the local tax laws of that country and whether or not such country has entered into a tax treaty or social security totalization agreement with the US. An added complexity is that each country may have its own method of sourcing the income an employee acquires from equity awards for national income tax purposes. Many countries (including the US, as discussed above) broadly follow the model propounded by the Organization for Economic Cooperation and Development, which advocates sourcing the income employees earn upon exercise of a stock option (or similar award) between countries based on the work-days spent in each country during the vesting period; however, some adopt their own

variation of the rule (*e.g.*, grant to exercise apportionment) and yet others apply unique rules that may lead to taxation of the entire award in the country in which the employee worked at the grant date, or on the exercise date depending on the circumstances. In addition, some countries tax equity awards at entirely different times than the US (for example, options may be taxed at grant in Belgium or at vesting in Australia), further complicating the allocation of the income.

## Training

The tax treatment of equity awards granted to foreign individuals coming to the US for training assignments will depend on a number of factors, including the immigration status of the individual and whether the entity that granted the equity awards qualifies as a foreign employer under the US Internal Revenue Code.

Further, as discussed above, the US source portion of income employees receive from equity awards is generally based on the work-days the employee spent in the US during the award's vesting period relative to the total number of work-days in the vesting period. Thus, a key factor affecting the taxation of equity awards held by an individual on a training assignment is whether, pursuant to the terms of the stock plan under which the award was granted, services performed by an award-holder while on a training assignment can constitute continued employment for purposes of the award. In other words, whether the individual can continue to vest in the equity award while on the assignment.

If, under the plan terms, a period spent in training is not considered continued employment for vesting purposes and the vesting of the award is therefore suspended for the duration of the assignment, it is likely that US federal income taxes will not apply to any portion of the income the employee ultimately receives from the equity award, since no part of the award will have vested while the employee was in training within the United States. Note that while some stock plans

permit employees to continue vesting during periods of company-approved leave of absence, such periods are usually limited to a maximum of 90 days, and thus would not be suitable for a longer-term training assignment.

Assuming, as is generally the case, that continued active employment with the issuer company or one of its subsidiaries or affiliates is required in order for an award-holder to continue vesting in an equity award, an appropriate US training visa for an individual holding an equity award is likely the J-1 exchange visitor visa. The J-1 visa enables non-US persons to come to the US for paid on-the-job training assignments for periods of up to 18 months, which would usually mean that the vesting of the individual's equity awards would not have to be suspended during the period of on-the-job training.

With regard to the US tax treatment of such individual, any salary income paid to the J-1 visa holder by the sponsoring company for services performed in the United States will likely be subject to US federal income tax under non-resident source taxation rules (provided such salary is not paid by a foreign employer under Section 872(b)(3) of the US Internal Revenue Code). However, different rules need to be analyzed to determine the US tax treatment of equity award income paid to J-1 visa holders.

For instance, if the entity that granted the equity award to the J-1 visa holder is a foreign corporation, the income the individual receives from the equity award should be exempt from US federal income tax under Section 872(b)(3) of the US Internal Revenue Code, notwithstanding that the foreigner spent a portion of the period over which the award vested employed within the US. On the other hand, US federal income tax likely would apply if, for example, the equity award was granted by a US corporation to an employee of one of its foreign subsidiaries, which subsequently sent the employee for a training assignment in J-1 visa status. This is because the income from the equity award that has been granted by the US parent

corporation cannot be considered to have been paid by a “foreign employer,” as required under the relevant US Internal Revenue Code tax exemption.

Tax treaties between the US and the country in which the foreign individual is a resident may also impact the tax result. Given the complexity of the tax treatment, particularly in the equity award context, it is important to assess tax liabilities in advance of any training assignment and develop structures to ensure such obligations can be met.

With regard to US FICA taxes, the situation is generally more straightforward since non-resident alien trainees temporarily present in the US in J-1 visa status are exempt from Social Security and Medicare taxes on wages paid to them for services performed within the US, as long as such services are permitted by the US Citizenship and Immigration Services and are performed to carry out the purposes for which the trainees were admitted to the United States. Therefore, if a foreign individual has been granted an equity award due to the employment relationship, is subsequently sent to the US by the employer on a J-1 training program and the employment during the program qualifies as service under the relevant stock plan, such that the individual may continue to vest in the award while on the training program, it is likely that any income the individual may receive from the award will be exempt from FICA taxes.

As with individuals in the US on short-term business trips, State taxes should also be considered.

## Employment Assignments

The international employment assignment context is the key area in which multinational employers need to have controls and procedures in place to track and pay required US and non-US income and social security taxes on equity award income.

## *US-Inbound Assignments*

Foreign employees coming on long-term employment assignments to the US (*e.g.*, more than six months) will likely become US tax residents and be subject to federal income taxes and potentially also to FICA taxes and State and local taxes on all of their income, including equity award income, from both US and non-US sources. However, the particular challenge with respect to equity award income (in contrast to regular salary) is that it is generally attributable to all countries in which the award-holder has been employed over the period between the grant and vesting of the relevant award and may be taxable in such other jurisdictions under non-US sourcing rules. Note that different equity award sourcing rules apply under certain US tax treaties (*e.g.*, with Canada, Japan and the UK which apply a grant to exercise sourcing model), and under local laws of countries outside the US.

The result is that employees transferring into the US holding equity awards will likely be subject to federal income tax withholding on all income they receive from the awards while they are resident in the US and also subject to non-US taxes and possibly to withholding on at least a portion of the same income, subject to any relief an individual may subsequently be able to obtain under the terms of an applicable tax treaty.

In addition, in the absence of a social security totalization agreement between the US and the foreign national's home country (or if there is a totalization agreement and the transfer to the US is for more than five years), with limited exceptions, FICA taxes will apply to the equity award income. Where a foreign national is from a totalization agreement country (with the exception of Italy) and is transferred to the US for a period of five years or less, FICA taxes generally will not apply, provided that the foreigner has obtained a Certificate of Coverage from the home country social security authorities (confirming the foreigner remains subject to the home country social security system) and furnished it to the US employer.

Further, although rules will vary depending on the particular US State in which the transferred employee is employed, where an individual is transferred to work in the US on a long-term or indefinite basis, it is likely that State taxes will apply to the individual's income, including equity award income. Some States including California and New York have specific rules governing the taxation of equity award income partially earned within the State (and are focusing on this income from an audit standpoint), while many others have no specific rules and thus, resort to general principles is required to assess the tax liabilities.

On the regulatory side, if additional stock options or other equity awards will be offered to the US-inbound employee while he or she is in the US, the issuer must ensure that the offer of the securities complies with US securities laws. At the federal level, the shares offered under the equity plan will need to be registered with the US SEC or determined exempt from registration. The shares will also need to be registered or qualified as exempt from registration at the State level based on the State in which the employee is resident. In addition, it is necessary to ensure that the re-sale of shares by the employee is permissible within the US under applicable federal and State securities law registrations or exemptions.

### *US-Outbound Assignments*

Since US federal income tax applies to all income earned by US citizens and permanent residents (*i.e.*, green card holders) anywhere in the world, equal if not greater challenges are presented when a US employer transfers a US citizen or permanent resident employee to work outside the US. Irrespective of the fact that such outbound employees may very likely become tax resident of and fully subject to income tax in the country to which they are transferred, in the absence of an exception under the US Internal Revenue Code, federal income tax withholding and reporting obligations will apply to all of the income earned by the transferred employees.

An exclusion from US federal tax applies under Section 911 of the US Internal Revenue Code for a certain amount of foreign income earned by a US citizen or resident (*e.g.*, up to \$91,500 for 2010), although this is not helpful in the equity award context if, as may often be the case, the individual's salary income alone surpasses this threshold.

An exception that may be useful for equity award income applies under Section 3401(a)(8)(A)(ii) of the US Internal Revenue Code if a US-outbound US citizen's income (including equity award income) is subject to mandatory foreign tax withholding in the country in which he or she is employed, which, for equity award income, varies by country and by whether the local employer entity bears the cost of the equity award. This exception also applies only to US citizens and not to green card-holders, which increases the administrative complexity of applying the exception on a broad basis.

Another exception to US federal tax withholding may apply under the foreign tax credit provisions of Section 901(b) of the US Internal Revenue Code, to the extent the transferred employee has indicated eligibility for a foreign tax credit on Form W-4, although the application of this exception needs to be carefully reviewed on a case by case basis.

Regardless of whether a US tax withholding exemption applies to all or a portion of a US-outbound employee's equity award income, if the employee is a US citizen or resident it is necessary to report the entire income on the employee's Form W-2 for the applicable year.

If an individual employee is subject to double tax on equity award income as a result of withholding by his or her employer or former employer in two or more countries, relief may be available under the terms of an applicable tax treaty, although that can be little comfort to the employee when almost all of the proceeds from, for example, a stock option exercise is initially withheld to meet multi-country tax obligations.

Depending on the outbound US citizen or permanent resident's employer entity and the existence of a totalization agreement between the United States and the country to which the individual is transferred, US FICA tax may also apply to the individual's equity award and other income.

In the absence of a totalization agreement, where a US citizen or permanent resident is employed outside the US by an "American employer" (e.g., a branch of a US corporation), US FICA taxes apply and must be withheld from the individual's income, including equity award income.

If a totalization agreement applies and an individual's equity award income would otherwise be subject to non-US social security taxes, US FICA taxes will generally no longer apply if the transfer is for more than five years, although there are some variations depending on the terms of the applicable totalization agreement. In this US-outbound context, it is important to consider equity award income separately from salary as a totalization agreement will not apply in the absence of double social security taxation and equity award income paid by a US parent company to employees working at a subsidiary or affiliate outside the US is sometimes not subject to local country social security taxes, while salary is rarely (if ever) so exempt. It should also be noted that, unlike the federal income tax regulations, the FICA regulations provide no basis for apportionment of multi-year compensation such as equity award income, which can increase the complexity of meeting US withholding obligations in cases where it is possible to apportion income for income tax purposes.

### *Solutions to Double Tax Issues*

To ease the potential tax burden of internationally mobile employees or a select portion of such employees (e.g., executive-level employees), most multi-national employers have a tax equalization or tax protection policy. These policies ensure that, from a tax

standpoint, an international employment assignment is at least tax neutral and, in the case of protection programs, potentially tax favorable for the assignee.

Under a typical equalization policy, tax-equalized employees on foreign assignment will pay approximately the same amount of income and social security taxes as they would have paid had they remained in the US or their home country, with the employer paying any taxes that exceed this amount, and the employees reimbursing the employer if the amount of tax they actually pay is less than their home country tax liability would have been. A tax protection policy operates in substantially the same way, with the key difference being that the employee does not have to reimburse the employer if his or her actual tax liability is less than the home country liability.

### *Developing an Approach to Compliance*

As is demonstrated by the complexity of the foregoing rules, in advance of sending employees holding equity awards on employment assignments to or from the US, employers need to collect information and develop systems that will enable them to track and calculate the amount of the equity award income subject to taxation and potentially to employer withholding and reporting obligations in each applicable jurisdiction, and the extent to which exemptions from US federal tax income and FICA tax withholding may apply in different employment transfer scenarios.

An essential component of any compliance model is a reliable data collection system to gather and monitor key details that will be determinative of the US and foreign tax and social security treatment of a given transferee. At a minimum, such details include:

- The individual's citizenship;
- US or foreign permanent residency status;

- US or foreign visa status; and
- Time spent in each country during the periods over which the individual's equity awards have vested and whether the individual's employment transfer is intended to be on a short or long-term basis (including if it will for more or less than five years).

In addition, for US FICA tax and, in some cases, State social tax purposes for US-outbound employees, it is necessary to track whether the entity or entities employing the individual outside the US are US or foreign corporations and, if a US corporation, the State of the entity's incorporation.

Where a tax equalization or tax protection policy exists and income from equity awards is covered under the policy (some policies cover regular wages or other specified items of compensation only), it is necessary to be able to separately track the amount of equity award income paid to tax-equalized/tax-protected employees and calculate and pay both the US and foreign taxes actually due based on the individual's residency and/or citizenship status, and the amount of home country taxes that would have been payable had the individual not gone on assignment.

For companies with a large internationally mobile population, it is important to track patterns of international transfer, develop models that will generally apply to common inter-company transfers (*e.g.*, US to UK or India to US) and create assumptions about employment assignments and categories of employees that will facilitate the development of a system that is both compliant and workable.

Finally, regulatory considerations should not be overlooked. To the extent that equity awards are offered to employees while on international assignment within or outside the US, issuers of such awards must ensure that they comply with any securities law

prospectus, registration or exemption filings and any applicable foreign exchange control, labor law, data privacy or other filings that may be necessary to offer equity awards under the local law of the country in which the assigned employee is resident.

### Other Comments

As is clear, compliance with income and social security tax requirements is the key concern when equity award-holder employees transfer to and from the US.

Legal issues affecting equity awards also need to be considered in certain transfer situations, particularly where US-based employees are transferred on a long-term basis from the US to countries where securities law, foreign exchange regulations, tax-qualified plan requirements or other legal restrictions impact the equity award agreements and mean that it is necessary or desirable to modify the terms of such awards to comply with local law or gain the benefit of a favorable local tax regime. To the extent possible in light of accounting issues and plan limitations, it is important to structure equity award grants to allow for flexibility to address legal issues that may arise in the global employment transfer context when an employee is relocated after the grant date. For companies making new grants of equity awards on a global basis, a useful best practice in this regard is to adopt a single global form of award agreement that includes a country-specific terms appendix and a relocation provision. Then, if an award-holder goes on international assignment after the grant date, the agreement's relocation provision gives the issuer authority to apply the terms set forth in the appendix to the agreement for the country of transfer, to the extent necessary to comply with applicable laws or administer the grant.

## Further Information

The Global Equity Services Practice, supported by tax treaty colleagues, works in coordination with the Global Immigration and Mobility Practice, on global mobility assignments. GES practitioners provide streamlined advice on both the US and non-US tax, social security and legal aspects of short- and long-term international employment transfers in the equity awards context. They also assist multinational companies in developing an approach to global equity compensation tax liabilities that combines the degree of legal protection and operating flexibility most appropriate to the interests of the relevant company.

# Income Tax and Social Insurance

## Introduction

An employee who works abroad is always concerned about the possibility of double income taxation and being subject to social insurance in more than one country. This issue arises not only because of expatriate status, but also because of a number of other factors, such as:

- The income tax, social insurance, and other relevant laws of more than one jurisdiction are involved;
- Many jurisdictions have special rules that apply to the cross-border transfer of employees;
- Many income tax issues revolve around the employee's citizenship, nationality, or residency; and
- The provisions of an income tax treaty or other international agreement may apply to reduce the employee's liability for income tax and social insurance.

As a representative example of how many jurisdictions approach these issues and provide limited relief to expatriates and other mobile employees, this discussion focuses on some of the key US federal income tax and Social Security provisions that apply to expatriates, whether outbound or inbound. Consult with tax counsel to understand the potential application of these or similar provisions to the facts or any particular assignment.

## US Federal Income Tax: Short Term Assignments

Where an employee lives and works abroad, it is natural to assume that the country where he is assigned will seek to tax the

compensation. Notwithstanding, many jurisdictions have provided income tax relief for short-term assignments. Understanding how these rules work in any particular country is key to effective tax planning.

If there is no relief under the host country's domestic tax law for employees who are short-term business visitors in that jurisdiction, often there may be relief under an applicable income tax treaty entered into between the host jurisdiction and the jurisdiction from where the employee is coming.

As of the date of publication, the United States has income tax treaties in force with 65 countries. Several income tax treaty provisions may be relevant to mobile employees. The provision addressing "dependent personal services" or "income from employment" is primarily directed at certain short-term assignments.

For example, Article 14 of the US – UK Income Tax Treaty provides a general rule and two exceptions regarding income from employment. In general, salaries, wages and other similar remuneration derived by a resident of the home country in respect of employment is taxable only in that country unless the employment takes place in the host country. If the employment takes place in the host country, the host country may tax it.

An exception may provide for remuneration derived by a resident of the home country for employment in the host country to be taxable only in the home country if:

- The individual is present in the host country for a period or periods not exceeding 183 days in any twelve-month period commencing or ending in the taxable year;
- The remuneration is paid by or on behalf of, an employer who is not a resident of the host country; and

- The remuneration is not borne by a permanent establishment that the employer has in the host country.

Therefore, in the case of an employee who is treated as a US resident under this Treaty, such employee may avoid UK income tax on remuneration in respect of employment in the UK if: he is not present in the UK for more than 183 days during any twelve month period; he is paid by or on behalf of an employer outside of the UK; and the remuneration is not deducted by a permanent establishment which the employer has in the UK.

Many of the US tax treaties have similar, but not always identical language. Some treaties look at whether the has spent more than 183 days in a calendar year in the host country (in addition to the other requirements). In other cases, the time limit may be less than 183 days, or there may be a maximum compensation limit imposed.

It should be noted that the OECD has recently indicated that the “employer” for purposes of treaty analysis is not necessarily the legal employer. The OECD recommends that an “economic employer” concept be used in applying this type of income tax treaty provision.

Consequently, when structuring short-term assignments in countries that are adopting the “economic employer” concept, the activities and the interactions of the employee with any host country entity need to be reviewed. The treaty exemption will only be available if the home country entity meets the test of the “economic employer” and if the other tests are met (*i.e.*, 183 days and no chargeback of compensation costs to the host entity).

In similar fashion, care needs to be taken to ensure that compensation costs related to the employee are not inadvertently charged against and reimbursed by a host country entity or permanent establishment in the host country if there is intended reliance on this treaty exemption. Finally, the existence of a treaty exemption may still require the

mobile employee to complete an individual income tax filing in the host country in some cases.

Treaty provisions providing relief from the potential double taxation of retirement plan participation or distributions and stock option-related income may also be available and should be reviewed in cases of longer term assignments. These provisions are currently present in only a small number of US income tax treaties.

### Traveling and Temporary Living Expenses

Under US income tax rules, an employee may be able to exclude amounts paid by the employer for traveling and temporary living expense while “away from home” in the pursuit of a trade or business, including amounts expended for meals and lodging that are not lavish. Code Section 162(a)(2) allows an exemption for expenses that are ordinary and necessary while the employee is temporarily away from home.

Whether an employee is “away from home” is a facts and circumstance based determination. However, in no event can the international assignment be considered “temporary,” if it is expected to last more than one year.

### US Federal Income Tax: Long-Term Assignments

In addition to the income tax relief the United States provides to its taxpayers who are on short-term assignments, it also provides some relief for US taxpayers who are on long-term assignments (meaning one year or more).

### Foreign Earned Income and Housing Exclusion

One of the most valuable tax planning devices for a US taxpayer employee who is working outside of the United States is the ability to

elect to exclude “foreign earned income” from gross income under Code Section 911.

The maximum amount of foreign earned income that can be excluded is indexed and is currently \$91,500 per year. It can be elected only by a “qualified individual”, meaning a person whose “tax home” is in a foreign country and who is either:

- A citizen of the US who is a bona fide resident of a foreign country for an entire taxable year; or
- A citizen or resident of the US who, during any period of twelve consecutive months, is present in a foreign country or countries for at least 330 full days of such period.

A qualified individual must elect to exclude foreign earned income on IRS Form 2555, or a comparable form, which must be filed with the individual’s US federal income tax return for the first taxable year for which the election is to be effective. Individuals who expect to be eligible for the exclusion may adjust their federal income tax withholding by completing an IRS Form 673 and filing it with their payroll department.

In addition to the foreign earned income exclusion, a qualified individual may elect to exclude from gross income a “housing cost amount,” which relates to certain housing expenses attributable to “employer provided amounts.”

The term “employer provided amounts” means any amount paid or incurred on behalf of the individual by the individual’s employer that is foreign earned income for the taxable year without regard to Code section 911. Thus, salary payments, reimbursement for housing expenses, or amounts paid to a third party are included. Further, an individual will have earnings that are not “employer provided amounts” only if the individual has earnings from self-employment.

For 2010, the maximum amount of the housing cost exclusion is generally \$12,810 (*i.e.*, 14% of the maximum foreign earned income exclusion for a full taxable year). However, the IRS has issued guidance providing upward adjustments to this maximum in a number of high housing cost locations.

A qualified individual may make a separate election to exclude the housing cost amount on the same form and in the same manner as the foreign earned income exclusion. An individual does not have to make a special election to claim the housing cost amount deduction.

However, the individual must provide, at a minimum, the following information: name, address, social security number, name of employer, foreign country where tax home is established, tax status, qualifying period of bona fide residence or presence, foreign earned income for the taxable year, and housing expenses.

### Foreign Tax Credit

Another valuable tax planning device for the US employee who works outside of the United States is the ability to receive a tax credit for foreign or US possession income tax paid or accrued during the taxable year. The credit also applies against taxes paid in lieu of income taxes, a category which includes withholding taxes.

Note that an individual may not take a credit for taxes paid on foreign income that is excluded from gross income under Code section 911 foreign earned income and housing exclusion. The credit is available to any employee who is a US citizen, resident alien of the US, or a resident alien who is a bona fide resident of Puerto Rico during the entire taxable year.

The foreign tax credit is subject to a specific limitation. It is generally limited to the same proportion of the employee's total US tax which the employee's foreign source taxable income -but not in excess of the

entire taxable income - bears to the entire taxable income for the taxable year.

Whether an employee has foreign source taxable income for purposes of this limitation depends on the type of income involved and, in some cases, the residency status of the employee.

For example, with respect to wages, the employee has foreign source income if the services are performed in a foreign country. With respect to interest, the employee has foreign source income if the interest is credited to a bank account in a foreign country or if the employee invests in foreign bonds that pay interest in a foreign currency. Income from the sale of personal property by a US resident is US source income regardless of the place of sale. Similarly, income from the sale of personal property by a nonresident is generally sourced outside the US.

In the event that an employee cannot use all of the foreign tax credit, he is permitted to carry back the unused credit one year and to carry forward the unused credit for ten years.

### Participation in Non-US Compensation Programs

In many cases, the employee becomes a participant in a compensation or benefit plan sponsored by an employer in the host country. Such participation may have adverse US income tax consequences, especially in connection with the Code Section 409A and 457A deferred compensation rules.

A complete review of the Code Section 409A and 457A rules is beyond the scope of this discussion. In general, if a person has a legally binding right in one taxable year to receive an amount that will be paid in a subsequent taxable year, that amount is considered deferred compensation for the purposes of Code Section 409A, unless it meets one of the exemptions.

Assuming that no exemption applies, amounts that are considered deferred compensation must comply with various requirements regarding the time and form of the payment, timing of deferral elections, and a six month delay of separation payments made to certain “key employees” of a public company. In addition, there are prohibitions on offshore funding and funding tied to the employer’s financial condition. If the requirements are not met, the deferred compensation amounts will be taxable at the time of vesting and an addition 20% tax will apply.

Although it is unlikely that non-US compensation plans (*e.g.*, retirement plans, equity incentive plans, cash bonus plans) would be designed to comply with Code Section 409A requirements, the IRS does apply the Code Section 409A rules to all plans globally that have US taxpayer participants.

As a first step of the analysis, it is critical to identify all of the potential compensation plans, including equity compensation plans, that will be offered to the employee. The Code Section 409A rules do provide a few specific exemptions for foreign plans, and these provisions should be reviewed in connection with proposed participation in a non-US compensation plan by an employee.

For example, a foreign retirement plan may qualify for an exemption from Code Section 409A as a “broad-based retirement plan”. For US citizens and green card holders, the requirements for this exemption include:

- They are not eligible to participate in a US qualified plan;
- The deferral is non-elective and relates to foreign earned income; and
- The accrual does not exceed the amount permitted under Code Section 415 (*i.e.*, the US qualified plan limits).

The broad based plan must also meet the following requirements:

- The foreign plan must be in writing;
- The foreign plan must be non-discriminatory in terms of coverage and amount of benefit (either alone or in combination with other comparable plans); and
- The foreign plan must provide significant benefits for a substantial majority of the covered employees and contain provisions, or be subject to tax law provisions or other restrictions, which generally discourage employees from using plan benefits for purposes other than retirement and restrict access to plan benefits before separation from service.

There are also Code Section 409A exemptions for plans exempt under a tax treaty, foreign social security plans, and plans that considered funded by means of a trust under the rules, among others.

In addition, Code Section 457A can also apply to deferred compensation earned by a US taxpayer employee working abroad. It limits the ability to offer deferred compensation in cases where employees (who are subject to US taxation) perform services for employers who are considered “nonqualified entities”. In general, employers based in jurisdictions that do not have a corporate income tax will be “nonqualified entities”.

Further, even non-US entities, based in jurisdictions that have an income tax treaty with the United States, and which are subject to a corporate income tax in that jurisdiction may also be considered “nonqualified entities” depending upon the extent of the corporate taxation.

Employers are encouraged to monitor any subsequent IRS guidance on the treatment of expatriate employees for purposes of Section 457A.

## US Federal Income Tax – US Inbound Assignments

Employees who are sent to work in other countries even for relative short assignments may nonetheless be subject to local income tax on the compensation they earn for working abroad, unless there is a local tax exemption for such limited work or unless the provision of an income tax treaty provides an exemption. In the US, for example, the Internal Revenue Code provides a limited exemption for employees working on a short term basis, but it is practically of no use since the compensation earned during the period of assignment cannot exceed \$3,000. Other jurisdictions may have similar statutory exemptions for short-term assignments, but generally speaking they are rare.

### Taxation as a “Resident”

The principal concern for an employee who comes to work in the United States (and who is not a US citizen or does not want to become a US citizen) is whether he will be taxed as a resident alien or a nonresident alien.

As a resident alien, he will be taxed in the same manner as a US citizen, namely, all worldwide income, including any compensation paid or earned outside of the US, will be subject to US federal income tax. A resident alien is able to offset this US tax liability by a tax credit or a tax deduction for foreign income taxes paid, subject to certain limitations.

As a nonresident alien, he will be taxed only on income “effectively connected” with the conduct of a US trade or business at the same rate and in the same manner as US citizens and residents, but with some limitations (*e.g.*, not able to file returns jointly with a spouse). In

addition, there will be a flat 30% tax rate on certain investment and other fixed or determinable annual or periodic income from sources within the US, that is not “effectively connected” with the conduct of a US trade or business.

The employee’s performance of services in the US will be deemed to be the conduct of a US trade or business. The compensation he receives therefore will be “effectively connected” with a US trade or business and will be taxable at the same rate as US citizens and residents.

In general, an employee will be treated for tax purposes as a “resident alien” if the employee:

- Is lawfully permitted to reside permanently in the US (*i.e.*, the “green card” test); or
- Is in the US a substantial amount of time (*i.e.*, the “substantial presence” test).

The “green card” test is much as its name suggests. This covers foreign nationals granted alien registration cards.

The “substantial presence” test is satisfied if, in general, the employee is present in the US for:

- At least thirty-one days during the current calendar year; and
- The sum of days present in the US during the current calendar year, plus 1/3 of the days present in the preceding year, plus 1/6 of the days present in the second preceding year equals or exceeds 183 days.

There is effectively an exception to the “substantial presence” test if a foreign national is present in the United States on fewer than 183 days and if has a tax home and closer connection to a foreign country.

In the event the inbound executive does not satisfy either of the two tests described above, it is possible to elect to be treated as a resident under certain circumstances.

A nonresident alien who is temporarily present in the US as a nonimmigrant under the foreign student F visa or exchange visitor J visa may exclude from gross income compensation received from a foreign employer or an office maintained outside of the US by a US person.

In addition, wages, fees or salary of an employee of a foreign government or an international organization are not included in gross income for US tax purposes if: the employee is a nonresident alien or a citizen of the Philippines, the services as an employee of a foreign government are similar to those performed by employees of the US government in foreign countries, and the foreign government grants an equivalent exemption to US government employees performing services in that country.

Finally, nonresident aliens may be entitled to reduced rates of, or exemption from, US federal income taxation under an applicable income tax treaty between the country of which they are residents and the US.

A nonresident alien who claims an exemption from US federal income tax under a provision of the Code or an applicable Income Tax Treaty must file with the employer a statement giving name, address and taxpayer identification number, and certifying the individual is not a citizen or resident of the US and the compensation to be paid during the tax year is, or will be, exempt from income tax, giving the reason for the exemption. If exemption from tax is claimed under an Income

Tax Treaty, the statement must also indicate the provision and tax treaty under which the exemption is claimed, the country of which the nonresident alien is a resident, and enough facts to justify the claim for exemption.

### Participation in Non-US Compensation Programs

As previously discussed, Code Section 409A has very broad application. In the case of employees who come to work in the United States, there is also a concern that certain non-US plan benefits could be subject to the adverse consequences of Code Section 409A. Accordingly, the employee's participation in non-US compensation programs must be reviewed for Section 409A compliance the same as for US programs.

For example, some non-US stock option plans may not meet the requirements of the fair market value grant exemption from Code Section 409A. Stock option plans that provide for an exercise price that is less than the fair market value on the date of grant may have this problem. If the employee becomes a "resident alien" of the US while working here, then grants under such plans may be particularly problematic.

Notwithstanding, there are some transitional rules under Code Section 409A in regard to deferred compensation which vests prior to the employee's becoming a US tax resident. Again, as in the case of all US employees who go work abroad, it is critical to identify all of the plans and arrangements which could be potentially subject to taxation under Code Section 409A in advance of an employee's assignment to the United States.

### US Social Security: FICA and Other Implications

One of the major concerns for an employee working outside of his home jurisdiction is whether compensation will be subject to local

social insurance taxes (as most of the world calls it) or Social Security (as the US calls it). The concern arises from the employer's standpoint as well, since in many jurisdictions social insurance taxes are imposed both on the employee and the employer.

Social Security taxes in the United States are relatively low, in comparison with those of other jurisdictions, so with respect to a US employee who is working abroad, more often than not there is a desire to remain covered by US Social Security and avoid the imposition of local social insurance taxes, where possible. Continuing to be covered by US Social Security also allows the employee to build up his eligibility for a maximum Social Security benefit upon retirement.

In general, Social Security contributions must be paid on the earnings of a US citizen or resident alien working for an American employer anywhere in the world. An "American employer" is defined as:

- The US or any instrumentality thereof;
- An individual who is a resident of the US;
- A partnership, if two-thirds or more of the partners are residents of the US;
- A trust, if all of the trustees are residents of the US; or
- A corporation organized under the laws of the US or any state.

Special new rules apply to companies that contract with the US federal government so that certain foreign entities may also be considered "American employers" for purposes of this rule.

Thus, a US employee who is seconded to work abroad, and thus continues to be employed by the home company, will remain covered

by US Social Security and FICA taxes will be withheld from his compensation as a result.

Similarly, a US employee who works outside the United States for a foreign branch or division of a US employer will remain covered by US Social Security, since technically, a branch or division is a mere extension of the home company.

On the other hand, a US citizen or resident who is employed outside of the US by an employer who is not an “American employer” will not be remain covered by the US Social Security system and thus FICA taxes will not be withheld from his compensation.

Notwithstanding, there is a special election available to certain employees to remain covered by US Social Security while working abroad. If the a US citizen or resident is working for an “American employer”, as defined above, and if the US employee is sent by that American employer to work for a “foreign affiliate”, as defined below, then the American employer may enter into a voluntary agreement under Section 3121(l) of the Code to continue the US Social Security coverage of that individual. A “foreign affiliate”, is defined as a foreign entity in which an American employer owns at least a 10% interest. This voluntary, but irrevocable, agreement in effect extends Title II of the Social Security Act to service performed outside of the US by *all employees* who are citizens or residents of the US, except with respect to service or remuneration that would be otherwise excluded from the terms “employment” or “wages” as defined in Code Section 3121 had the service been performed in the US.

Under this voluntary agreement, the American employer pays the employer and employee portion of FICA taxes that would be imposed if such wages were subject to FICA taxes under the general rules, including any applicable interest and penalties. There is no legal requirement that the employee reimburse the American employer for

the employee's share of the tax, although some companies do in fact require such reimbursement.

### Totalization Agreements

Just as the expatriate might want to avoid the problem of being subject to income tax by more than one jurisdiction, an employee and his employer will also want to avoid the problem of double social security coverage.

Double coverage may occur when an employee remains covered by the social insurance taxes of both his home jurisdiction and the host jurisdiction. For example, a US employee who is employed by an American employer or "foreign affiliate" of an American employer will remain covered by the US Social Security system.

At the same time, a host jurisdiction may impose its social insurance taxes on the employee's compensation merely by the fact that the employee works there ( a fairly common approach in non-US jurisdictions). In such a case, double contributions to both social security systems may be required on behalf of the employee and also by the employer, reducing the mobile employee's compensation and increasing the company's social tax burden.

A further problem that may be encountered by the outbound mobile employee concerns fragmented social security coverage. A US citizen or resident who has worked for less than 10 years and who transfers employment to a foreign country will not continue to qualify for a maximum US Social Security benefit while working for the foreign employer, since he no longer continues to earn "quarters of coverage" to qualify for a US Social Security benefit.

Further, if the expatriate's employment history includes a lot of temporary assignments in different foreign jurisdictions, the employee

may find at the end of his career that the employee does not qualify for a social security benefits under any country's system.

To address these problems, many jurisdictions have entered into a type of international agreement with other jurisdictions called a "Totalization Agreement." A Totalization Agreement provides a set of rules to determine when employment will be covered by which country's social security system to avoid the problem of double coverage. Note that a Totalization Agreement does not change the domestic rules of a country's social security system. It does not impose coverage if employment would ordinarily not be covered.

In the case of the United States, there are 24 such agreements. In general, each Totalization Agreement follows the "territoriality" principle. That is, employment for purposes of social insurance taxes is covered only by the laws of the country in which the work is performed.

An exception to this territoriality rule exists where the employee is sent by the home country employer to be on temporary assignment in the other jurisdiction. In that case, the employee will be covered by the social security system of the home country. A "temporary assignment" is generally defined to be one expected to last five years or less. Note there are some variations to these rules, so it is recommended to check the applicable Totalization Agreement to determine what provisions apply in each case.

With regard to benefits, a Totalization Agreement permits an employee to combine or "totalize" periods of coverage for purposes of determining eligibility for coverage. For example, to qualify for a minimum US Social Security benefit under the Totalization procedure, the executive must have at least six quarters of coverage in the United States system. The Totalization Agreements contain parallel provisions for each country, so that if the combined or "totalized" periods of coverage are sufficient to meet the eligibility

requirements for benefits, then *pro rata* benefits are payable from each country's social security system.

In the event an employee wishes to take advantage of the “temporary assignment” exemption, he will need to obtain a certificate of coverage from the responsible authorities in his home jurisdiction to verify his continued coverage while working abroad.

In the United States, an application for such a certificate must be made to the Social Security Administration, and must contain the following information: full name of the outbound mobile employee, date and place of birth, citizenship, country of permanent residency, social security number, place of hire, name and address of employer in the US and the other country, and dates of transfer and anticipated return. If the employee is transferring to France, the employee must also certify that there is medical coverage under a private insurance plan, since France imposes this certification requirement on anyone who seeks exemption from French social security tax.

### Social Security Implications for Inbound Assignments

In the case of an employee who is coming to work in the United States, such employment will be subject to US social security coverage unless the performance of services does not come under the definition of “employment” for Social Security purposes. There is a specific exemption for nonresident aliens who are here in the US under the F or J visa, for example.

An inbound employee who does not qualify for those exemptions from US Social Security will be subject to FICA wage withholding on compensation unless an exemption under a Totalization Agreement in effect with the country of origin can be claimed. For example, if the employee is here on a “temporary assignment”, then the applicable Totalization Agreement can be relied upon as an exemption from the application of US Social Security taxes. In that event, the employee

who need to produce a certificate of coverage from the home country authority to claim the exemption.

## Selected Concerns from the Employer's Perspective

### *Availability of Corporate Income Tax Deduction*

One of the primary issues from the employer's standpoint is whether the costs of the expatriate's compensation are deductible, and if so by which entity. Under US federal income tax principles, the entity that is the common law employer, that is, the entity that has the right to direct and control the activities of the employee, is entitled to the income tax deduction. Note this principle may be similar in non-U.S. jurisdiction, so it would be prudent to consult with a tax advisor on any tax deduction question.

Accordingly, if the employee is seconded to work abroad for another company, he remains a common law employee of the sending employer, and that employer is entitled to deduct the costs of the employee's compensation. Similarly, if the employee's employment is in fact transferred to another company (that is, another corporate entity, such as a subsidiary, a parent company, or a brother-sister company), it is that other entity that has the right, under US federal income tax principles. Even if the company is related to the employee's original employer, the original employer is not entitled to deduct the costs of compensation because the benefit to such employer is deemed to be only an indirect or derivative benefit. For these purposes, a division or branch is deemed not to be a separate "company" for income tax deduction purposes.

### *Permanent Establishment Risk*

One key issue that always needs to be considered in structuring international assignments or transfers is whether the structure will inadvertently create a "permanent establishment" whereby the

employing entity is considered to be doing business in the host country and subject to corporate income tax on an allocable amount of its net income. In the case of short-term assignments, or “informal” assignments, where the employee is seconded to work in another jurisdiction (and thus remains technically employed by the seconding company) this risk may be higher if the short-term assignment structures are not specifically reviewed by tax counsel.

For example, employees or technical consultants may be sent to a host country for varying lengths of time in response to compelling business needs without any formalized review. Such quick decisions raise the potential risk of the home company inadvertently creating a permanent establishment in the host country. Local tax agencies are quick to assume that a company has created a taxable local presence if the home company has personnel with negotiating or contracting powers maintains technical support services outside the home country, or otherwise pursues revenue-producing operational activities.

A company that unwittingly creates a permanent establishment abroad often finds itself obligated to file tax returns with a foreign tax agency, to observe local accounting standards for foreign tax purposes, and to pay higher taxes on a worldwide basis. The existence of a permanent establishment may also trigger registration, filing, and publication obligations for the company.

The activities that could constitute a permanent establishment vary by jurisdiction, based on income tax treaty provisions, and the structures of the employment relationships. The concept of “permanent establishment” has been undergoing significant changes following guidance from the Organization of Economic Community and Development (“OECD”).

### *Tax Equalization and Tax Protection Programs*

In order to minimize the expatriate's potential exposure to double income taxation by both the home country and the host country, the employer can implement a tax equalization or tax protection program. Such a program will not change the actual tax liabilities in either country, but it will provide a consistent approach for handling the complex income tax situation of any particular expatriate.

A tax equalization program provides that the employee on foreign assignment will pay no more and no less than the income taxes (the "stay-at-home-taxes") he would have paid in the event he had not gone on a foreign assignment. It requires the employee to pay a hypothetical tax equal to the stay-at-home-taxes. The hypothetical tax is computed at the beginning of the year, and an amount equal to one twelfth of the hypothetical tax is withheld from the employee's income each month. At the end of the year, the employee's actual income taxes, both US and foreign, are compared to the hypothetical tax. If the actual taxes are *more* than the hypothetical tax, the employee is reimbursed for the difference. If the actual taxes are *less* than the hypothetical tax, the mobile employee must re-pay the difference back to his employer. This approach assures that an employee who moves from a high tax jurisdiction to a low tax jurisdiction does not enjoy a windfall by virtue of the low tax rates.

A tax protection program also involves the calculation of a hypothetical tax. However, it is intended only to reimburse the employee in the event the employee incurs additional tax liability as a result of the foreign assignment (for example, where he ends up working in a higher taxing jurisdiction).

Thus, under a tax protection program, if at the end of the year the actual taxes are more than the hypothetical tax, the mobile employee is reimbursed for the difference. If the actual taxes are less than the hypothetical tax liability, the mobile employee is not required to pay anything back to his employer and would realize a benefit.

There are many variations on tax equalization and tax protection programs. Some employers cover state and local taxes as well as US federal and foreign income taxes. What type of income is included, and what is excluded, is dependent on the company and the discussions it has with its tax advisors.

Since tax equalization and tax protection programs represent payments of compensation over a number of tax years, for US taxpayer employees there are potential Code Section 409A issues. The company providing such a program needs to ensure that the tax equalization/tax protection program complies with Code Section 409A. Often, consultation with tax counsel is needed for this purpose.

Whatever changes are made to comply with or be exempt from Code Section 409A should be reflected by appropriate changes to the language in the policy document.

Given the complexity of the hypothetical tax calculation, some companies will engage the services of an accounting firm to make the necessary determinations and prepare the various income tax returns for each affected employee. In this way, the employer can be assured that its employees are handled consistently and that their tax returns are prepared and filed on time.

### *Budgeting and Cost Projections*

Given the significant incremental costs generally related to an international assignment (*e.g.*, employer paid housing, additional allowances, tax equalization, home leaves, transition allowances), the company should prepare cost projections of the total expected international assignment cost including estimates of US and foreign income tax, in cases where the employee is eligible for either tax equalization or tax protection.

### *Compliance: Withholding and Reporting*

As more multinational companies focus on compliance-related issues, it is not surprising that the area of global mobility has received some attention. In particular, companies often look to review their processes and procedures for making sure that the appropriate taxes (income, social taxes, *etc.*) are withheld from their employees' pay, and that the appropriate reporting of such pay (which differs from country to country) is being done. More often than not, withholding and reporting problems occur when compensation is paid outside of the jurisdiction where the employee is working, or there is some internal confusion regarding which entity is obligated to withhold on compensation and at what applicable rate. Given the prevalence of global pension and compensation programs, it is not surprising that the details regarding individual participants who are working in perhaps dozens of jurisdictions sometimes become complex and burdensome to monitor.

Notwithstanding these challenges, vigilance is paramount. Local tax authorities have, based up recent audits and news accounts, announced their intention to focus more on the activities of expatriates and their employers to make sure that compliance with applicable withholding and reporting obligations is maintained. As local governments search for more revenue to address their fiscal budget concerns, they will look harder at this area.

## **International Employment Transfer Checklist**

Employee Information:

Employee Name:

Position:

Home Location:

Host Location:

Manager(s):

Location(s) of Manager(s):

Duration of International  
Transfer:

Employee's Citizenship (please  
also indicate if employee holds  
permanent residence/landed  
immigrant status in any other  
country):

Employee's Current Tax  
Residency:

Current Employee Benefits:

Planned Assignment Start Date:

Planned Assignment End Date:

Compensation (currency, amount and source):

Any Accompanying Family Members (names, relationships, citizenship and any permanent residence/landed immigrant status details):

### **Employment Structure:**

Options:

- Assignment/secondment
- Transfer
- Transfer followed by assignment/secondment
- Transfer with dormant home country employment relationship
- Dual employment?
  - Consider pro's and con's of each option
  - Once structure has been determined, draft appropriate documentation

- Determine applicable employment laws

Individual Income Tax:

- Applicable tax treaty?
- Home location withholdings required?
- Host location withholdings required?
- Tax equalization?

Social Security:

- Applicable social security treaty?
- Home location withholdings required?
- Host location withholdings required?

Permanent Establishment / Doing Business:

- Local entity required?
- Permanent establishment exposure (applicable tax treaty)?
- Intra-company secondment agreement?
- Doing business exposure?

Benefits / Equity:

- Can/should home country benefits be maintained (applicable plans)?

- Can/should host country benefits be obtained (applicable plans)?
- Determine impact of assignment on equity (existing grants / new grants)?

Immigration:

- Can visa/resident permit/work permit be obtained (options)?
- What additional information/documents are needed?
- How long will it take to secure approvals?
- Any steps required to protect current resident status, if any?
- Any steps requires to protect eligibility to naturalize, if relevant?

Others:

- If an international transfer does not appear the right option, are there alternative staffing models (*e.g.*, local hires)?

## Global Mobility Questionnaire

### In general

Specific requirements vary, depending upon the countries and visa involved. The purpose of this questionnaire is to identify the documents and information generally required for most assignments. Additional documentation and information may be needed as the visa process continues due to variations in immigration and employment authorization laws in various countries.

### *The Applicant*

1. Name
2. Contact information (including email and telephone/fax numbers)
3. Complete copy of passport(s)
4. Updated resume (include a description of all previous jobs, including general information about the number and titles of people supervised, and the dates of employment)
5. Copies of diplomas and/or transcripts for university and advanced degrees
6. ***Detailed*** description of the applicant's current job duties (including the number, titles, and duties of any employees the applicant supervises)
7. Copy of birth certificate (original may be required later)
8. Copy of marriage certificate, if applicable (original may be required later)

9. If any accompanying family members, please provide:
- Relationship to primary applicant (*e.g.*, spouse, child)
  - Complete copy of relative's passport(s)
  - Copy of birth certificate (original may be required later).

*Proposed assignment:*

1. ***Detailed*** Description of the applicant's proposed job duties (including number, titles, and duties of any supervised employees), compensation (amount and source of payment)
2. Proposed dates of assignment
3. Address of proposed new job site
4. Name of proposed employer abroad
5. Relationship to current employer, if any (*e.g.*, parent, subsidiary, branch office)
6. Name of company contact (including email and telephone/fax numbers).