Equity Income Sourcing and Compliance Issues for Mobile US and Non-US Employees

Authors: Valerie Diamond and Sinead Kelly
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Mobile Employee Equity Dilemma

Over the last 10 years, how, when and where people work has dramatically changed as employees have become more mobile and businesses increasingly virtual. It is no longer the case that employees work in the city, state or country where they live. In order to live in a desirable or lower-cost jurisdiction, employees may live in one city, state or country but cross a border to go to work in a different city, state or country. Employees may be sent on assignment from headquarters to set up a new operation in a different state or country because they are best positioned to ensure streamlined integration between satellite offices and headquarters. Some employees might spend their careers at the company moving from one office to another to find new opportunities or to implement a strategic growth plan. Other employees may work remotely, meaning they work from their home in a city, state or country that is different from the location of the company that employs them.

Compensating employees who are constantly on the move with equity awards that vest over a period of years is challenging to say the least. Most equity awards tie the employee's ability to vest in and earn the equity award to the employee's continued service with the company or one of its subsidiaries. If the employee's service stops, the vesting generally ceases. Therefore, if the employee is living in one location but working in a different location or is working in multiple locations over the vesting period of the equity award, the employee has, in theory, "earned" the award in multiple locations.

By the time the mobile employee ultimately vests or earns the awards and receives a benefit, such as from the exercise of an option or the vesting of a restricted stock unit, the company may find itself with a

Valerie H. Diamond is chair of Baker McKenzie's Global Equity Services Sub Practice Group. She assists companies in the design and implementation of international employee stock plans and provides advice on the tax, securities law and exchange control compliance issues that arise when options, restricted stock or purchase rights are granted to employees.

Valerie.Diamond@bakermckenzie.com

Sinead M. Kelly is a partner with the law firm of Baker McKenzie in San Francisco and concentrates her practice on US executive compensation matters and global equity and incentive compensation.

Sinead.Kelly@bakermckenzie.com

mobile employee equity dilemma. At that time, the company needs to allocate income from the equity award for tax purposes in various locations. Each of these locations may tax the employee for a portion or all of the income earned while the employee worked in or provided services associated with the location. There may also be legal compliance steps that the company must satisfy as an employee passes from location to location over the course of the vesting of the equity awards or simply because the employee resides in a location different from that of the employer.

This paper provides an overview of some of the tax and legal considerations that companies should consider when dealing with the mobile employee equity dilemma. It is intended to be a helpful guide to understanding the key issues and provide information on steps to take to begin tracking equity awards and sourcing equity income appropriately.

Why Now?

In years past, companies may have ignored sourcing and allocation of income related to equity awards and instead applied the tax rules applicable to the employee’s location at the time of the taxable event or to the employee’s “home” country regardless of the employee’s location at the taxable event. Historically, tax authorities, particularly state and non-US tax authorities, were less familiar with equity awards and were therefore often sympathetic when companies indicated that they had not kept records of where employees resided over the course of the vesting period and did not have the systems in place to allocate income from equity awards.

Increasingly, however, tax authorities are expecting companies to address mobile employee issues and consider allocating income according to their rules. Some tax authorities have implemented new rules specific to equity income earned by non-residents and have imposed fines and penalties on companies ignoring these rules. Countries outside the US have also created special rules for taxation of equity income for non-residents and some, like Singapore, have implemented special “exit” tax rules to ensure that employees pay taxes on equity award income on a deemed basis when they leave the country.

If no records have been kept as to how, when and where the employee has worked over the course of the vesting of the equity award and there is no understanding of the rules related to the taxation of the allocated income, the company may not be able to meet its legal and tax obligations. Therefore, most companies are now making good faith attempts to track their employees and allocate income from equity awards.

Understanding Tax Considerations and Sourcing

A. Key Questions and Information to Track

It is always difficult to know where to start when trying to understand tax rules relating to the mobile employee equity dilemma. I usually recommend that companies start by considering seven key questions with regard to the company's particular equity awards, the recipients of those awards and the tax and social securities requirements related to those awards. Those tax questions are as follows:

1. What type of equity award has the employee received (eg, options, restricted stock units, ESPP rights)?
2. What are the cities, states or countries in which the employee has lived or worked (or is expected to live or work) over the life of the equity award?
3. When is the timing of the taxable event for the awards in each location identified in questions 1 and 2 above?
4. What is the tax status of the employee in each location identified in question 2 above (ie, tax resident, non-tax resident, citizen)?
5. What are the obligations related to social insurance contributions for the company and the employee in each location identified in question 2 above?
6. What relief is available for avoiding double tax or double social security contributions in each location identified in question 2 above?
7. What withholding and reporting requirements apply to the company with regard to the equity awards in each location identified in question 2 above?

Ideally, rather than gathering this information at the time of the taxable event, companies should keep track of this information from the moment an equity award is granted through to its expiration date. This avoids the last-minute scramble to sort out the details of the grant and allocation of the income. It also ensures that the company considers legal compliance issues as well as tax issues over the life of the equity award.

B. When is the Taxation Event and What income is Taxable?

The most common forms of equity awards granted today are stock options (either incentive stock options (“ISOs”) or non-statutory stock options (“NSOs”)), restricted stock, restricted stock units or “RSUs” and employee stock purchase plan (“ESPP”) rights. For time-based equity awards, vesting or “earning” a non-forfeitable right to the shares underlying these equity awards occurs by the grantee providing service to the company that issues the shares or one of its subsidiaries. In some instances, the vesting of the equity awards is tied to performance conditions, typically the performance of the share-issuing company but in some instances the performance of the grantee or a subsidiary company. Some companies provide employees with multiple forms of awards with different vesting conditions tied to each award type.

The taxation event and taxable income of the different forms of equity awards may differ depending on the city, state or country in which the employee works or lives. For example, in the US, NSOs are typically subject to US federal income tax on the spread (ie, the difference between the exercise price and the fair market value of the shares at the exercise date) and ISOs are typically not taxed until the shares are sold. Most US cities and states and most non-US countries follow the US federal income tax rules as to when the taxation event occurs and what amounts are subject to tax at that time. However, there are states, such as Pennsylvania, that do not recognize US federal tax treatment of ISOs for state income tax purposes and will tax an ISO as if it were an NSO. Similarly, there are countries, such as Belgium, that will tax a stock option at grant if it is accepted by the employee within 60 days of an offer. Other countries, such as Israel, will delay taxation of the option until sale of the shares.

Similar complexities exist with restricted stock and RSUs. Many non-US countries tax restricted stock at the time of grant (because employees have voting and dividend rights), rather than at vesting as in the US for federal income tax purposes. Therefore, employees who are working outside the US may be taxed at grant on the restricted stock while in Germany only to find that they may be taxed again on the restricted stock when they move to the US and vest in the shares. RSUs are subject to US federal income tax at settlement, but to FICA at vesting. This may be different from the treatment under state laws or the laws outside the US. There are countries that tax the RSU at vesting before the shares are settled.

Companies need to “match up” the equity award with the rules for the city, state and country in which the employee is living or working over the life of the equity award to determine the taxation event and the taxable amount in the relevant locations. There may be situations where the company must withhold the income at different times and in different amounts. Identifying and tracking these different rules to the particular grants and individuals and their locations becomes key to satisfying tax withholding and reporting requirements.

C. What is the Tax Status of the Employee and Why does it Matter?

The trickiest issue in terms of the tax issues is understanding the employee’s status and whether he or she is a tax resident of a particular city, state or country. Most cities, states and countries have rules related to what constitutes residency and an individual is a “non-resident” when he or she fails to meet the criteria for a “tax resident.”

- For example, the US federal income tax residency test:
  - US citizens and green card holders are US residents.
  - Other persons who meet the IRC § 7701(b) “substantial presence” test: individuals in the US for 31 days in a tax year and more than 182 days in the past three years — closer connection exception if in the US for less than 183 days in the current year — are also US residents.
- Non-US countries tax residency rules vary:
  - Unlike the US, for most non-US countries, citizenship is generally not determinative of residency.
  - Residency is usually based on the individual’s length of assignment in the country, intent to reside permanently, ownership of real estate, etc.
  - If an individual appears to be a resident of two countries and there is a tax treaty between the two countries, there may be an income tax treaty residency determination, which is effectively a “tiebreaker” rule.
- State tax residency rules also vary widely and may be different than the tests used for US federal income tax residency. For example, in California, any individual who is present in California (other than for temporary or transitory purposes) may be a

resident and there is a presumption that an individual who spends nine months or more of the taxable year in California is a resident. Anyone who is not a resident under California rules is considered to be a non-resident.

- Finally, if an individual is a tax resident of a particular city, state or country, it may be difficult for the individual to lose its tax residency status, even if he or she leaves the location. For example, a California resident typically must leave California for at least 546 days to be a non-resident, and, in Israel, the employee must file a form waiving his or her residency rights.

D. Sourcing of Equity Income

Determining which location may tax equity income is generally tied to the employee's tax residency status.

In most cities, states and countries, if the employee is a **tax resident** at the time of taxation event, then he or she is likely to be taxed on all of the equity income by the city, state or country of residency (exclusions/exemptions can apply if income is earned outside of the city, state or country). In other words, if the individual is a tax resident of the location, he or she is likely to be taxed on 100% of the equity income in the location of residence even if he or she was not in the location over the life of the award.

On the other hand, if the employee is a "**non-resident**" of the city, state or country at the time of the taxation event, but has a connection to that city, state or country because he or she worked in the country over the life of the equity award, then the employee is likely to be subject to tax in the non-resident country on a "sourced" basis. This means that the employee will be subject to tax on the portion of the income from the equity award that was earned while the individual was working in the non-resident location.

- Most jurisdictions will tax income sourced to the jurisdiction if any vesting occurred while the employee was working in the city, state, country.
- If an employee is taxed on a "source" basis, it is important to determine what measurement the non-resident city, state or country will use to determine to prorate the allocable equity income for tax purposes in the relevant jurisdictions (eg, where

the employee worked from grant to vest, where the employee worked from grant to exercise, etc.)

- US Treasury Regulations endorse sourcing stock option income based on workdays in the US between the option grant date and the vesting date.
- State rules may differ from US federal income tax sourcing rules. For example, Virginia and California allocate income based on the workdays from grant to exercise, rather than from grant to vesting. Some states have different rules, such as looking solely at whether the employee was in the state on the grant date or whether the equity award appreciates over its life.
- Some US income tax treaties (or protocols thereto) with non-US countries provide that the proper method to allocate option income is from grant to exercise, rather than from grant to vesting.

Mobile employees are often faced with taxation on the income from the equity awards in more than one location. The employee may be a tax resident of one location that taxes 100% of the income from the equity awards as well as a non-resident of one or more locations (based on having worked in countries over the measurement period) that will also tax a portion of the award. This means that the company may find itself faced with withholding 100% of the spread in one location and 40% of the same spread in another location. At the end of the day, the mobile employee may end up with less after-tax income due to double taxation of the same income.

E. What are the Social Insurance Obligations?

Along with income tax, equity income may be subject to FICA or other employment, payroll or social security taxes. The rules for measuring and allocating income from equity awards for mobile employees for social security contributions purposes do not always mirror the income tax rules. Therefore, when sorting out residency and sourcing rules for equity income, it is important to consider and apply the rules for income tax and social security contributions separately — recognizing that the two may differ and be in conflict.

Additionally, the rules for allocating income for social security contributions purposes may not be as clear as income tax rules. This is because the social security authorities have fewer resources than the income tax authorities do.

It may also be difficult to calculate the social insurance contribution taxes on equity awards when employees are mobile because the calculation often requires year-to-date compensation information as a result of earning ceilings and contribution limits. Obtaining this information may prove challenging if an employee moves from one location to another, particularly if payroll systems are not centralized.

Finally, for employees working outside the US, the liability for social security contributions on the equity income may depend, among other things, on which entity employs the individual, how long the employee is on assignment and whether the costs of the equity award are charged by the US parent company issuer to the local country employer. In some countries (including the UK), it is also possible to shift the liability for paying employer social security contributions to the employee. Therefore, the company needs to understand who the employer is, the status of the employee's assignment, the details of tax recharge programs and if any special social insurance contribution agreement terms apply to an award to determine what amounts are to be allocated for social security purposes. Again, that allocation may be different from income tax treatment in terms of amount, timing and allocation.

F. What Relief from Double Taxation is Available?

When employees are subject to tax in two or more jurisdictions on the same equity income, they may be able to seek relief from that double tax result through a variety of different "relief" mechanisms. Some jurisdictions may exclude amounts of trailing tax income if they are below a certain threshold or provide tax "credits" if the same income was taxed in another jurisdiction.[1] There may also be double tax treaty relief available, which may determine what the country of residency is for the employee and the degree to which taxes may be imposed on a non-resident employee. An important point to keep in mind when it comes to treaty relief is that the relief generally belongs to the employee taxpayer and may not relieve the company from its obligation to withhold or report tax on the same income in more than one jurisdiction.

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[1] Relief for US Tax Residents (subject to tax in US on worldwide income):

- Internal Revenue Code § 911 exclusions — A qualified individual may exclude foreign earned income up to USD 102,100 (2017) and housing costs from gross income subject to US federal income taxation.
- Internal Revenue Code § 901(b) foreign tax credit — A US tax resident can claim a foreign tax credit for foreign taxes imposed on "foreign source" income.

For US income tax treaties, keep in mind that:

- Most treaties do not directly address equity compensation.
- Provisions on stock options have been included in the following US treaty protocols: Canada, Japan and the UK. RSUs are not addressed.
- Most treaties have an exemption if the time spent in the US does not exceed 183 days in a 12-month period, provided a non-US subsidiary bears the cost of the award.
- US tax treaties contain a savings clause which preserves the right of the US to tax its citizens as though the treaty did not exist, which means that US citizens generally may use treaties to reduce non-US taxes only, and not US taxes.

For a list of all US Income Tax Treaties, see:
http://www.irs.gov/businesses/international/article/0,,id=96739,00.html.

Moreover, there may be agreements between locations addressing double social security or FICA contributions due on the same equity income (the US refers to these double social security agreements with non-US countries as "Totalization Agreements"). To complicate things, the relief available for double taxation under these social security agreements may not be in harmony with income tax treaty relief as previously explained.

For US Social Security Totalization Agreements, you should note that:

- There are a limited number of agreements with the US (currently 26).
- Generally, agreements tend to have provisions that if the assignment is short (generally five years or less) and the employee will be returning to the "home country," the employee only pays social insurance in the "home country" (the employee will need to provide a so-called "certificate of coverage").

For a list of all US Totalization Agreements, see:
http://www.socialsecurity.gov/international/agreements_overview.html.

G. What Withholding and Reporting Requirements Apply?

A final point of consideration is determining which jurisdiction's withholding and reporting rules apply to the equity income in light of a mobile employee's movement over the life of the equity award and tax residency status.

As mentioned above, the rules for when a company must withhold or report on equity income do not always track the employee's tax treatment on the equity income. There may be situations where the employee has relief from double taxation of the income, but the employer is still responsible for withholding and reporting on the income. Moreover, there may be situations where the company is not responsible for withholding, but the employee must pay the taxes due. For example, there is no tax withholding for equity award income in Hong Kong but the equity income remains taxable; it is up to the employee to report and pay the taxes due.

US federal income tax withholding requirements vary depending on whether there is foreign withholding on the same income and the US tax status of the individual. US taxpayers are generally subject to withholding and reporting on their worldwide income. However, a mandatory foreign withholding exemption is available for US citizens who are subject to mandatory withholding on the same income in a foreign country. This same exemption does not apply to US taxpayers who are "green card" resident aliens. Therefore, the company would need to treat US citizens and US green card holders differently for US federal income tax withholding purposes, even if these employees transferred from the US to the same foreign location at the same time. Non-resident aliens, on the other hand, are generally subject to US federal income tax withholding and reporting on their US source income only.

Non-US withholding and reporting requirements may depend on the involvement of the local entity and whether costs are recharged locally. For example, if the US parent company charges the equity costs to a Thai employer, that employer must withhold tax at the employee's equity tax event; however, if the costs are not charged to the Thai employer, it need not withhold tax. It would be up to the employee to report and pay the taxes due.

Employees are generally able to request tax refunds for double tax withholding amounts, although refunds are difficult (if not impossible) to obtain in some countries. Therefore, it becomes important for the employer to know when it is obligated to withhold and on what amounts.

Over-withholding can be a real problem for employees and may reduce the value of the benefit the equity award was intended to provide.

A final point to note is that to the extent that mobile employees are “tax-equalized” while on an employment assignment, it is necessary to adopt an alternative withholding and reporting process which ensures that the amount of tax withheld from the employee is consistent with the amount required to be withheld under the applicable tax-equalization policy. Typically, a “hypothetical” tax is withheld that is ultimately intended to approximate the amount of tax the employee would have paid had he or she remained in his or her home jurisdiction. However, the actual amount of tax that will need to be remitted to the applicable tax/social security authorities will be calculated in accordance with the rules otherwise described herein.

Understanding Legal Issues

If a US public company grants equity outside the US, there are legal (non-tax) issues that should be addressed when employees move from one jurisdiction to the next or work across borders. Among the issues companies need to consider are the following:

- *Regulatory Considerations*
    - How do securities laws, exchange controls or other restrictions apply to mobile employees?
    - Are any exemptions available for mobile employees?
- *Securities Laws*
    - Usually “Territorial” — meaning if an employee is in a territory at the time of offer/grant, subject to securities restrictions; sometimes based on location at vesting or share issuance.
    - Securities registration is sometimes avoided if an exemption is filed or if an award is limited to cashless exercise or cash settlement.
- *Exchange Controls*
    - What limitations can apply? No grants or exercises of foreign shares, no exchange of currency, repatriation of proceeds of sale.

    - Limitation often applies to local national/residents only (not to expats working on assignment), eg, State Administration of Foreign Exchange approval in China (although expatriates **may** be included).
- *Labor Issues*
    - Is the mobile employee employed by the local employer or does he remain on home country payroll? This may affect how labor laws apply.
    - Special rights may apply once the employee resides or habitually works in the country, eg, Danish Stock Option Act.

One of the easiest ways companies can address non-tax mobility issues is through the use of a global award agreement with country-specific appendices. Baker McKenzie pioneered this approach with its clients about 10 years ago after one of its clients faced the problem of employees moving to a new location where different rules applied and modifying the award after the grant date resulted in negative accounting and legal consent issues. The client wanted to add a restriction to the grant agreement at the time of the employee transfer, but it could not do so without the employee's agreement and the employee would not agree to the change.

To avoid these post-grant compliance issues, we recommend using one grant agreement that contains terms and restrictions for all countries in which awards are made and provides that it is a condition of the grant that if the employee moves, he or she will be subject to the agreement's terms for the country of transfer. This "global" form of agreement takes planning at the time of the grant but is easier to manage (and leads to better compliance) over time. In addition, the stock team does not need to determine the location of each employee receiving the award (provided all possible locations are included in the agreement); the stock team can provide the same form of grant agreement for all grantees worldwide.

Having a "global" agreement is not the end of the discussion. Companies still need to track employees over the life of the equity award to ensure that the company's securities, exchange control and other filing obligations are met and compliance with legal rules is maintained. For example, once an employee transfers to a country where securities filings are triggered by share issuances (such as Thailand), that employee needs to be counted and disclosed for purposes of the ongoing filings. The fact that the employee was not in the country on the grant date does not avoid the company's filing obligation. Transfer into the country may also trigger an immediate exchange control report in China or Vietnam or a need to fill out a special enrollment form to participate in the ESPP, such as in the Czech Republic.

Companies need to keep a compliance matrix to monitor compliance at each stage of the award: grant, vesting, exercise and expiration of the equity award. At each stage, there may be steps necessary to comply with local law. We recommend this matrix be reviewed with the company's legal adviser at least once or twice a year.

Parting Words – Steps to Better Compliance

Dealing with the mobile employee dilemma can be a challenge, but it is not impossible. I hope this paper offers you some tips for resolving mobility issues and gives you a sense of where to start when addressing the dilemma. Even a small step is a start.

In closing, I offer these seven steps to improve your company's equity sourcing and legal compliance position.

1. Assess the nature of your mobile employee population and awards.
2. Establish a tracking system to measure and allocate equity income that you can manage.
3. Develop "assumptions" about mobile employees appropriate for your employee population so you can act swiftly when a tax event occurs.
4. Prepare information for key locations and key taxation events in advance.
5. Implement procedures for multi-location withholding prior to tax events.
6. Provide grant documentation for multiple countries in one form and make sure grant recipients have access to it.
7. Update your compliance steps at least once a year.

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