Preparation Is Key When A Non-U.S. Tax Resident Joins The Board Of Directors

Preparation is Key When a Non-U.S. Tax Resident Joins the Board of Directors, Corporate Taxation (Wg&L), Nov/Dec 2012

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In the current globalized business world, it is becoming increasingly common to find U.S. companies with non-U.S. tax residents on their boards of directors. Given this trend, it is important for companies to be aware of the U.S. and foreign tax obligations and issues that need to be dealt with when engaging a non-U.S. tax resident director.

In particular, compensation paid to a director who is not a U.S. tax resident is subject to U.S. federal tax withholding, as well as to specific tax reporting requirements, different from those applicable to U.S. resident directors. The determination of the portion of a non-U.S. resident director's board compensation that is subject to U.S. tax, the additional tax requirements that may apply in the director's home country, and the interplay of tax treaties between the U.S. and such home country add layers of complexity that also need to be considered by U.S. companies when assessing their tax obligations.[1] Even the type and structure of compensation a U.S. company typically pays to its board members may need to be rethought when a non-U.S. resident director is elected, particularly certain deferral arrangements that are common for U.S. directors but that may not work when a director is subject to taxation in a foreign jurisdiction.

Determination of non-U.S. residency

Preliminarily, it should be verified that an individual director is in fact non-resident for U.S. federal taxpurposes. In this regard, as long as the director is not a U.S. citizen or permanent resident of the United States (i.e., a green card-holder), the residency determination primarily depends on whether the director meets a substantial presence test under Section 7701(b) . Generally, the director will be a U.S. resident under the

1 Depending on the state or states in which a director provides services, U.S. state tax may also apply, although an analysis of state tax issues is beyond the scope of this article.

substantial presence test if he or she spends 183 days or more in the U.S. in the applicable tax year or as determined under a special three-year look-back formula.[2] In such case, and unless the director establishes an exemption from resident taxation under the substantial presence test, the director may be treated the same as any other U.S. resident director for tax purposes. Once it is determined that a director is a non-U.S. resident, the special tax treatment discussed below becomes relevant.

U.S. taxation of compensation paid to non-resident directors

Unless an exemption from U.S. taxation applies under a tax treaty between the United States and the director's country of residence (as discussed below), a non-resident director of a U.S. company will generally be subject to U.S. federal taxation on any compensation he or she receives for service as a board member. Notwithstanding that the director may spend only a de minimis amount of time in the United States, exemptions from U.S. taxation under short-term business visitor rules in the Code[3] or in a relevant tax treaty will not apply because the compensation is paid by a U.S. company and thus, a key condition of such exemptions will not be met.

Accordingly, the director's compensation for his or her board service will be taxable in the United States. The income will be taxed as either "Fixed, Determinable, Annual or Periodic" (FDAP) income under Section 871(a)(1)(A) , or as "effectively connected income" (ECI) under Section 871(b), which means that the income is effectively connected with the conduct of a trade or business in the U.S. From the director's standpoint, the difference in the characterization of the income is important because FDAP income is taxed at a flat rate of 30%, collected via withholding, and the director is generally not required to file a U.S. federal tax return unless he or she has other U.S. income or investments. In contrast, ECI is subject to U.S. taxation at graduated rates, the director is required to make estimated tax payments on a quarterly basis via Form 1040-ES (NR) if the withholding at source by the company is insufficient, and the director is required to file an annual U.S. federal tax return on Form 1040NR, at which point any withholding at source and estimated tax payments are credited against the director's ultimate federal tax liability for the year.

The determination of whether a particular individual is engaged in trade or business within the United States is complex and fact-specific; however, generally, performance of personal services within the United States is considered a U.S. trade or business[4] and thus, it is likely that an individual rendering services to a U.S. company by sitting on its board and attending

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2 Under Section 7701(b)(3)(A) , an individual meets the substantial presence test with respect to any calendar year if such individual was present in the United States on at least 31 days during the calendar year and the sum of the number of days on which such individual was present in the United States during the current year and the two preceding calendar years equals or exceeds 183 days, determined using the following formula: (1/1 × days in current year) + (1/3 × days in first preceding year) + (1/6 × days in second preceding year).

3 Sections 861(a)(3) and 864(b) .

4 Section 864(b) .

board meetings in the United States would be viewed as engaged in trade or business in the United States. In turn, any income paid to such individual for the board services should be considered as effectively connected with the conduct of such U.S. trade or business. Importantly for the U.S. company, the characterization of the income as FDAP or ECI does not affect its withholding and reporting obligations, which are discussed below.

As non-residents of the United States are generally taxed only on their U.S. source income, if non-resident directors perform services partly within and partly outside the United States, another important factor impacting their U.S. taxability is the sourcing of their income. Specifically, pursuant to the Treasury regulations under Section 861 , non-U.S. resident directors should be able to reduce their U.S. tax liability by allocating their board compensation between U.S. and foreign sources. The Section 861 regulations set forth detailed rules on allocation of compensation paid, including to persons other than employees, and generally endorse that compensation is allocated on a time basis.[5] Under a time basis approach, the amount of any compensation for services that is subject to tax in the United States would be that amount which bears the same relation to the total compensation as the number of days of performance of the services within the United States bears to the total number of days of performance of services for which the compensation is paid.

Thus, for example, if the board meetings are held in the United States, while the director prepares for the meetings in his or her home country or elsewhere, the portion of the director's compensation that is attributable to the time spent in the United States at the meetings would be U.S. source income, while that attributable to the preparation time would be foreign source and not subject to U.S. federal taxation.[6] It should be borne in mind, however, that the manner in which compensation is sourced may vary depending on the type of compensation. For example, special rules are set forth in the Section 861 regulations for equity awards, which are characterized as "multi-year compensation arrangements" and defined as compensation that is included in the income of an individual in one tax year but attributable to a period that includes two or more tax years.[7] Specifically with respect to stock options, the regulations state that "the facts and circumstances generally will be such that the applicable period to which the compensation is attributable is the period between the grant of an option and the date on which all employment-related conditions for its exercise have been satisfied (i.e., the vesting of the option)."[8] By extension, then, it would appear that income from stock options granted to a non-resident director should be allocated between U.S. and non-U.S.

5 Reg. 1.861-4(b)(2)(i) .

6 If the board or committee meetings are held outside the United States or if the director attends remotely by phone, the income allocable to such meetings should not be considered U.S. source income under Section 861 . However, other tax consequences may apply as tax may also be due in the country in which the meetings are held.

7 Reg. 1.861-4(b)(2)(ii)(F) .

8 Reg. 1.861-4(b)(2)(ii)(F) .

sources based on the time the director spends performing services within versus outside the United States over the course of the option vesting period. More complex sourcing considerations may apply to other types of equity compensation, including deferred stock awards, which are typically fully vested upon grant and subject to deferred payment schedules.

U.S. withholding obligations

Since compensation paid to non-employee directors is self-employment income,[9] if the director is a U.S. resident, the income is not subject to withholding and simply must be reported at year-end to the director and the IRS on Form 1099-MISC. In contrast, compensation paid to non-U.S. resident directors is subject to non-resident withholding under Section 1441 . Specifically, regardless of whether the non-resident director's income is characterized as FDAP or as ECI, under applicable provisions of Section 1441 , the U.S. company engaging the non-resident director generally has an obligation to withhold U.S. federal tax at a rate of 30% on the income paid to the non-resident director for board services.[10] The extent of the withholding may be reduced, either by sourcing the director's income between U.S. and foreign sources and applying withholding on the U.S. source income only, or by relying on the terms of an applicable tax treaty between the United States and the director's country of residence. However, as the Large Business and International Division of the IRS has designated withholding under Section 1441 (in particular on U.S. source FDAP income) as a Tier I compliance issue, complacency in this area is ill-advised.

Sourcing of director compensation for U.S. withholding purposes

As described above, a non-U.S. resident director should generally be able to allocate his or her income between U.S. and non-U.S. sources and pay U.S. federal tax only on the U.S. source income. However, for the U.S. company engaging the director to withhold U.S. federal tax on a U.S. source basis, it will need to obtain detailed and reliable information on the director's travel, the amount of time spent preparing for board meetings, and the related location of each activity so it can accurately allocate the income it pays to the director between U.S. and foreign sources.

To avoid this level of scrutiny of a director's activities, U.S. companies with non-U.S. resident directors may wish to assume the position that all compensation paid to such non-resident directors is U.S. source income for Section 1441 withholding purposes. This approach also avoids the

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9 Rev. Rul. 68-595, 1968-2 CB 378 , which confirms that fees and other remuneration received by a director of a corporation for services performed as a director, whether for attending board meetings or serving on committees of the board, are self-employment income within the meaning of section 1402(b) of the Self-Employment Contributions Act of 1954 (SECA), and not wages of an employee. Directors' SECA obligations are not addressed in this article since non-U.S. residents will not be subject to SECA contributions.

10 If the income is characterized as FDAP, Reg. 1.1441-2(b) contains the applicable withholding requirements. If (as is more likely) the income is characterized as ECI, withholding is required pursuant to Section 1441(c)(1) and the regulations thereunder, including Reg. 1.1441-1(b) .

situation where, upon audit, the company is tasked by the IRS with substantiating the foreign source portion of the income it paid to a non-resident director to justify not having withheld U.S. tax on such income. In fact, from an audit-risk perspective, the full withholding approach may have advantages for both U.S. public companies and their non-resident directors, given the highly visible disclosures in the companies' proxy statements as to the location of and compensation paid to their board members. As long as non-resident directors are able to self-substantiate the foreign source portion of their income when filing their U.S. federal tax returns and/or claim a foreign tax credit in their home countries for the U.S. tax paid, they should not ultimately suffer double taxation on the board compensation and therefore, full U.S. withholding causes, at most, a temporary cash-flow issue for the director.

On the other hand, if a company is uncomfortable with treating all of a non-resident director's compensation as U.S. source for withholding purposes, an approach that appears to strike a good balance is to inform the director that the company will assume that all board compensation is of U.S. source and subject to 30% withholding under Section 1441 unless the director provides written evidence of the portion that should be considered foreign source and, therefore, not subject to U.S. withholding. This approach (or a similar approach that attempts to source the director's compensation) would seem particularly appropriate for a U.S. company that holds any of its board meetings outside the United States as it is then more likely that a non-resident director may consider it unreasonable to have U.S. federal tax withholding applied on 100% of any board compensation.

Tax treaty exemption to U.S. withholding

The second important way in which the U.S. tax withholding may be reduced or potentially eliminated, is by the non-resident director's reliance on an exemption from U.S. taxation under an applicable tax treaty between the U.S. and the director's country of residence.[11] A number of tax treaties provide for a complete exemption from U.S. taxation on any compensation earned by a non-resident director for service on a U.S. company's board unless the director has a "fixed base" or "permanent establishment" (such as a personal office) and/or spends a specified number of days in the United States. Usually, this exemption is located under the treaty article addressing Independent Personal Services, which, in the absence of a more specific provision, is applicable to directors as self-employed individuals. More recently ratified tax treaties tend to follow the current Organization for Economic Cooperation and Development model, which contains an article specifically addressing the tax treatment

11 Reg. 1.1441-4(b)(1)(iv) provides for an exemption from withholding in the case of compensation that "is or will be exempt from the income tax imposed by chapter 1 of the Code by reason of a provision of the Internal Revenue Code or a tax treaty to which the United States is a party."

of director fees and simply provides that such fees may be taxed in the country in which the services are performed (but which of course does not preclude additional taxation in the director's country of residence).

To avail of any treaty relief, a non-resident director needs to provide the U.S. company with a Form 8233 (Exemption From Withholding on Compensation for Independent (and Certain Dependent) Personal Services of a Nonresident Alien Individual) on an annual basis.[12] To submit the Form 8233, the director will need to obtain a U.S. Social Security Number or Individual Taxpayer Identification Number, assuming he or she does not already have one.[13] Among other things, on the Form 8233 the director must state the tax treaty and provision thereof under which he or she is claiming the exemption from withholding, the country of which he or she is a resident, and sufficient facts to justify the exemption from withholding.

The company, as the withholding agent, will need to certify on the Form 8233 that it is satisfied that an exemption from withholding is warranted and that it has no reason to know that the director is not entitled to the exemption or that eligibility for the exemption cannot be readily determined. The company must forward a copy of the Form 8233 to the IRS. It may then reduce withholding on any payments made to the director at least ten days thereafter unless the IRS objects to the application of the exemption in the meantime. Importantly, the fact that the IRS does not object to the withholding exemption within the ten-day period does not preclude it from subsequently raising an objection based on any facts that were known to the company but not disclosed to the IRS as part of the ten-day review process. Further, if after submitting the Form 8233 to the IRS, the company becomes aware that any of the information in the Form 8233 was false or that the director's eligibility for the withholding exemption can no longer be readily determined, it has an obligation to promptly notify the IRS in writing and to withhold the full amount of tax due under Section 1441 on any subsequent payments made to the director.

U.S. reporting obligations

Section 1461 requires the U.S. company paying compensation to a non-resident director to report all payments that were subject to withholding under Section 1441 and any taxes withheld during the applicable year on a Form 1042-S (Foreign Person's U.S. Source Income Subject to Withholding). The Form 1042-S must be filed with the IRS, with a copy to the director, by March 15t h of the calendar year following the year in which the income was paid (this deadline applies regardless of whether the Form is filed electronically or in hardcopy). In addition, details of the payments to the non-resident director must be included on the U.S. company's Form 1042 (Annual Withholding Tax Return for U.S. Source Income of Foreign Persons). It should be noted that Form 1042 reporting is

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12 Reg. 1.1441-4(b)(2) sets forth the requirements to obtain a withholding exemption under a tax treaty.

13 Alternatively, the director may attach a completed Form W-7 or Form SS-5 to the Form 8233 showing that he or she has applied for a number.

required even if no tax was withheld on the income paid.[14] In this regard, to the extent the income was exempt from tax withholding pursuant to a treaty, this needs to be reported on the Form 1042-S, using a specific code to indicate a treaty exemption.

Foreign tax considerations

Rules will vary depending on a director's country of residence but, in general, a non-U.S. resident member of a U.S company's board will likely be fully subject to home country taxation on any compensation received for U.S. board service, in addition to the U.S. taxation discussed above. In most cases, the director should be able to mitigate any double taxation by claiming a foreign tax credit or tax deduction in his or her home country for the U.S. taxes paid on the U.S. source board compensation, but exceptions may apply, particularly if the director is not resident in one of the 67 countries with which the United States currently has a tax treaty.

What is perhaps more surprising is that, in certain cases, the U.S. company engaging the foreign director has its own tax obligations in the director's home country. For example, directors are considered as employees for Canadian tax purposes.[15] As such, notwithstanding its non-residency in Canada, a U.S. company engaging a Canadian resident director is required to withhold applicable Canadian taxes on compensation paid to the director and to report the income to the Canada Revenue Agency (CRA) on an annual basis on Form T4. To meet these tax obligations, the U.S. company must obtain a tax filing number from the CRA. From a practical perspective, it is generally appropriate to engage a payroll service provider in Canada to handle the required tax reporting and payment to the CRA.

Meanwhile, to the extent that amounts paid by a U.S. company to a French resident director are viewed as director fees under French law and within the meaning of Article[16] (Director Fees) of the tax treaty between the U.S. and France, the company is required to pay a French social security tax on the income which, as of 8/1/12, applies at a flat rate of 20%. 16

If the U.S. company does not have a branch in France, to make the payment it would have to register with the Centre National des Firmes Etrangeres (National Center for Foreign Companies) and pay the social security tax directly to this Center. Alternatively, if the company has subsidiaries in France, it may appoint one of those subsidiaries as its representative in France which may make the payment on its behalf.

Further, although a U.S. company should not have U.K. income tax or National Insurance contributions withholding or reporting obligations on

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14 Reg. 1.461-1(b)(1).

15 See paragraph 153(1)(a) of the Canadian Income Tax Act, subsections 102(1) and 104(2) of the Canadian Income Tax Regulations, as well as document 2009-0345151E5 - 'Directors' fees paid to non-residents, Part XIII' issued by the Canada Revenue Agency on 1/25/10.

16 Pursuant to the Second Finance Bill for 2012 introduced by new French President Hollande, the rate of this social security tax was increased from 8%.

compensation paid to a U.K. resident director as long as the company does not have a taxable presence (i.e., a place of business or permanent establishment) in the U.K., details of any equity award grants or payments to the director are reportable by the U.S. company on a Form 42 (Annual Share Schemes Return), due by July 6t h following the end of the applicable U.K. tax year. Fortunately, this is not a particularly onerous filing and the U.S. company should have little practical difficulty filing the Form 42 on its own behalf.

In many cases a U.S. company without a taxable presence in a foreign country will not have foreign withholding, reporting, or social security obligations on compensation paid to directors resident in such country. However, to avoid the liability and reputational damage that may arise from failure to meet applicable foreign tax obligations, it is important to confirm the existence of such obligations at the outset of electing a non-U.S. resident director to the board.

Structuring compensation packages for non-resident directors

Last but certainly not least, when electing a foreign resident director, it is important to consider whether changes should be made to the typical director compensation package to ensure its effectiveness and appropriateness in light of foreign tax laws.

In particular, it is common for U.S. companies to allow their non-employee directors to defer their board compensation, whether paid in cash or stock, and/or to compensate such directors using deferred equity award arrangements, such as deferred stock units or similar awards. Under a typical deferred stock unit award, an individual is granted a fully vested (i.e., non-forfeitable) stock award that provides the right to receive shares on a future defined payment date.

From a U.S. federal tax standpoint, provided that any voluntary deferral of compensation by a director is properly structured to comply with Section 409A and that any deferred stock unit or similar deferred stock award is paid out on its pre-specified payment date or event, federal income tax will apply only when the compensation is paid to the director. However, it is commonly the case that such deferral arrangements are ineffective from a foreign tax perspective, with the undesirable result that a non-U.S. resident director may face home country taxation on board compensation prior to its receipt. Any such timing difference between the U.S. and home country taxable event may also jeopardize or complicate the director's ability to claim a home country tax credit or deduction (as applicable) for the U.S. tax payable on the director's U.S. source compensation, because home country taxation may occur in one tax year, while the credit/deduction may not be available until a subsequent tax year when U.S. tax ultimately applies.

By way of example, a wholly voluntary deferral of otherwise non-forfeitable compensation will typically be ineffective for income tax purposes in France, the Netherlands, and the U.K. Thus, it is generally inadvisable for directors resident in these countries to elect to defer receipt of their board compensation beyond its original payment date. While under French tax laws, a non-voluntary deferral of compensation, such as pursuant to the grant of a deferred stock unit, is likely to be respected for tax purposes, this is not the case in the Netherlands or the U.K., where local country taxation will apply upon grant of a deferred stock unit on the basis that the underlying shares are non-forfeitable at that time. As a result, companies granting deferred stock units or similar awards to directors in the Netherlands or the U.K. may want to consider some design changes (such as forfeiture in the event of misconduct) in an effort to avoid taxation of the awards upon grant.

Meanwhile in Canada, it is usually possible to structure share-based deferrals of income (including voluntary deferrals and the grant of deferred stock units) so that they are effective for Canadian income tax purposes. That said, due to salary deferral arrangement rules, care must be taken with any related cash payments (e.g., dividend equivalents), because such cash amounts may taint the entire deferral arrangement and result in taxation upfront. Similarly, voluntary deferrals of cash compensation will be effective in Canada only if they are structured to comply with the salary deferral arrangement rules, which will either mean ensuring that the deferral period does not exceed three years or permitting deferral only until the director's death, retirement, or other termination of service and basing the payment on the value of the company's shares within the one year period before the termination of service and ending at the payment date.

There are countries in which typical U.S.-style director compensation packages will be as tax-effective as in the United States. However, there are many exceptions and circumstances in which specific rules or procedures will need to be followed to avoid unfavorable tax consequences. It is therefore crucial to investigate these issues early and ensure that compensation packages provided to non-U.S. resident directors are properly structured so as to achieve their intended remunerative purpose.

Conclusion

Many advantages may flow to a U.S. company, particularly a multinational, if it elects a non-U.S. resident to its board of directors. However, it is essential to be aware of the unique U.S. and foreign tax obligations that apply, both for the company and the director, and to structure the compensation package offered to such director in a tax-efficient manner. While pitfalls may lie in wait for the unwary, proper preparation and planning can ensure a successful outcome for all involved when a non-U.S. resident joins the board.

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