

Compliance Obligations for Global Equity Programs Outside the U.S.

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Rive R. Rutke
Senior Manager
Deloitte Tax LLP
rrutke@deloitte.com

John J. Jennings
Senior Manager
Deloitte Tax LLP
johjennings@deloitte.com

Peter J. Simeonidis
Manager
Deloitte Tax LLP
psimeonidis@deloitte.com



Agenda

- Overview
- Payroll Compliance – Corporate Reporting and Tax Withholding
 - Global corporate recharge
 - Plan optimization opportunities
 - Administrative methodology
- Prior Noncompliance
- Summary and Closing Remarks

Why is Global Equity Compliance a Hot Topic?

- Today's regulatory environment:
 - Increasingly vigorous tax audit activity
 - Increase in exchange of information between countries/governments
 - Increased media exposure
 - New laws to capture mobile employee gains
- Particular focus on equity incentives and compliance with international withholding and reporting obligations
- Increased focus on corporate governance and internal controls – Sarbanes-Oxley 404



Increased Global Regulation

A growing number of countries have introduced legislation regarding corporate governance, similar to the U.S. Sarbanes-Oxley legislation.

Country	Regulation	Authority
Australia	Section 7.2 Australian Stock Exchange Listing Rules	Australian Stock Exchange
Japan	Japan Sarbanes Oxley (J-SOX) anticipated April 2008	Financial Services Agency
Singapore	Section 12 of Code of Corporate Governance	Council on Corporate Disclosure and Governance
Hong Kong	C.2 of Hong Kong Stock Exchange Code of Corporate Governance	Hong Kong Stock Exchange
UK	Provision C.2 of Combined Code and UKLA Listing Rules 9.8.6R and 9.8.10	Financial Services Authority (FSA)
EU 8 TH Directive	Audit Committees must be appointed to monitor internal controls.	EU Commission
Ireland	Companies (Auditing and Accounting) Act 2003.	Irish Government
France	Article 122 of Loi de Sécurité Financière	Autorité des Marchés Financiers
Canada	Proposed Multilateral Instrument 52-111	Canadian Securities Administration (CSA)



Company Experiences

- A routine payroll audit in the UK cost one technology company £1.4 million as a result of failure to collect income tax on share benefits.
- In the Netherlands, a routine wage tax review cost a healthcare company €2 million as a result of the Company not filing elective deferrals for income tax on share plans.
- A healthcare company's auditor would not sign off on the Swedish Company's audit due to non-compliance with respect to withholding obligations for stock options.
- A semiconductor company lost a well known court case in Japan when their CEO filed his tax return treating his stock option income as extraordinary income, instead of regular income. His assessment was almost \$750,000 in back taxes.
- A French court found a CEO guilty of tax fraud and sentenced him to a fifteen month prison term and a fine of €15,000 for failure to report stock option gains on his French tax return.

Global Equity Program Compliance

The following are compliance elements to consider with respect to global equity programs in order to manage risk and ensure the ongoing success of a company's programs:

- ✓ Payroll Compliance - Corporate reporting and tax withholding
- ✓ Accounting Considerations
- ✓ Cross Border Compliance - Globally mobile employees
- ✓ Regulatory/Employment Law Considerations

Employment Law Considerations

- Securities Law
- Labor Protection
 - Works Council
 - Severance Indemnities
 - Acquired Rights
 - Right of Offset
 - Right to Modify or Terminate the Plan
- Data Privacy
- Exchange Controls



Payroll Compliance – Corporate Reporting and Tax Withholding



Payroll Compliance & Equity Compensation

- Timing of taxation varies between countries
 - Most countries tax at exercise
 - Some countries tax at grant, vest or sale
 - Exit & trailing tax considerations
- Amount subject to tax varies between countries
 - Even for those countries that tax stock options at exercise, there may be differences in the statutory definition of fair market value
 - Italy – average price over the prior month
 - China/Taiwan – closing price on date of transaction
 - Malaysia – average of high and low on date of transaction
- Administrative infrastructure
- Broker/administrator capabilities

Corporate Reporting and Tax Withholding

Income and social tax reporting and withholding requirements differ among various jurisdictions. The administrative burden can be minimized in some countries through plan design and decisions regarding the operation of the plan:

Factor #1: Global corporate recharge

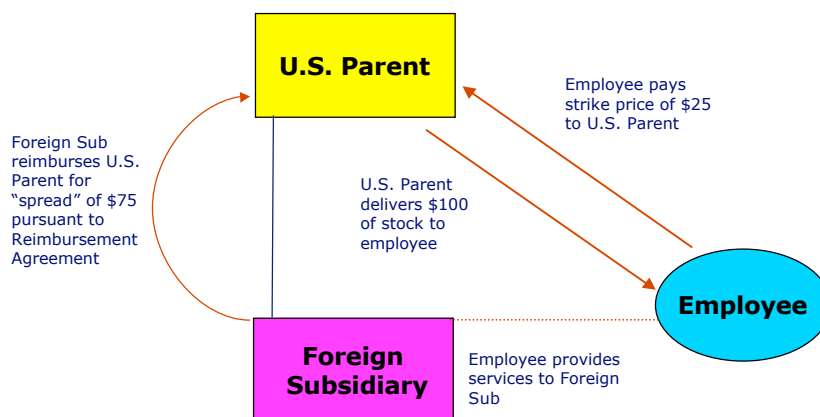
Factor #2: Plan optimization opportunities

Factor #3: Administrative methodology

Factor #1 - Global Corporate Recharge

- A U.S. employer can generally claim a deduction for the "spread" on equity-based compensation delivered to its U.S. employees:
 - Fair Market Value of Stock at Acquisition
 - Price Paid by Employee to Acquire Shares (if any)
"Spread" or "Bargain Purchase Element"
- For grants made to employees of foreign subsidiaries, the "spread" is generally NOT deductible for the U.S. employer (no employer/employee relationship) nor the foreign subsidiary (no economic cost)
- For most locations, a local tax deduction can be achieved by requiring the overseas employer to reimburse the U.S. company for the value of stock-based compensation awarded to its employees

Typical Reimbursement Agreement Structure (Stock Options)



Benefits of a Global Corporate Recharge

A global corporate recharge program can enhance the value of a company's global equity programs by:

- Obtaining tax deductions in jurisdictions where otherwise not available
- Repatriating cash from subsidiaries to the parent company in a tax efficient manner (i.e. creation of positive cash flow)
- Increasing EPS by reducing the income statement charge where a company expenses awards under FAS123R
- Reducing global effective tax rates, and
- Addressing global compliance issues and thus assisting with risk management

Benefits of a Global Corporate Recharge

Increasing EPS by reducing the income statement charge where a company expenses awards under FAS123R

Example—Reduces income statement impact by approximately
US\$7,030,000

Assumed FAS 123R Expense		\$95,000,000
Portion of Expense Incurred For U.S. Employees	80%	
U.S. Corporate Tax Rate	37%	
Income Statement Tax Benefit Offset		(\$28,120,000)
Net Impact on Earnings		\$68,880,000
Portion of Expense Incurred for Non-U.S. Employees	20%	
Average Non-U.S. Corporate Tax Rate	37%	
Income Statement Tax Benefit Offset		(\$7,030,000)
Net Impact on Earnings		\$61,850,000

In addition, a Global Corporate Recharge permits repatriation of cash to headquarters without incurring dividend withholding taxes, which improves cash flow.

Protection & Maximization of Deductions

The following documents may be necessary to achieve a sustainable corporate tax deduction. Requirements will vary by country.

- Letter from the U.S. parent company to the local country subsidiary
- Summary of the U.S. parent company's equity compensation philosophy
- Intercompany reimbursement agreement
- Hedging analysis
- Subsidiary board minutes
- Subsidiary board resolutions
- Subsidiary shareholder resolutions
- Letter from the local country subsidiary to the U.S. parent company



Global Corporate Recharge & Payroll Compliance

- Implementation of an intercompany recharge *may create a new reporting and withholding obligation* in a country where it did not exist previously (i.e. Argentina, Brazil, Mexico, Thailand)
- Implementation of an intercompany recharge *may create an additional social tax liability* (sometimes uncapped) for the employer and/or employee where it did not exist previously (i.e. Belgium, Brazil, Russia)



Factor #2: Plan Optimization Opportunities

- Identifying opportunities that deliver a greater after-tax benefit to participants at a lower out-of-pocket cost to the company
- Three key optimization opportunities to consider:
 - 1) Timing of taxation to the employee
 - 2) Plan modifications to increase benefit for employee and/or reduce cost to employer
 - 3) Type of equity award to be provided

Plan Optimization Opportunities

#1 - Timing of Taxation to the Employee

- Tax before exercise (for stock options) or before distribution (for restricted stock) may create negative cash flow for the employee
- Identify the countries where this is an issue:
 - Australia, Belgium, Switzerland, etc.
- Possible solutions to address the issue:
 - Alter the vehicle: Offer RSUs in lieu of restricted shares
 - Alter the term: Change term to meet or exceed statutory definitions
 - Alter the offer: Provide for ability to decline the offer

Plan Optimization Opportunities

#2 - Plan Modifications

- Qualified or tax-favored plans can create advantages for both employees and employers
 - For example, a qualified stock option plan in France may:
 - Exempt the employer from social tax
 - Delay taxation until sale
 - Allow for a more advantageous tax rate to be achieved
 - Plan documents may need to be modified/amended
- Countries where qualified plan opportunities exist include: France, UK, US and many others

Plan Optimization Opportunities

#3 – Type of Equity Award

- One-size-fits-all plan designs may not create the desired aims of the plan (i.e., loyalty and motivation)
- Example: Stock options vs restricted stock units (RSUs)

Example 1		Example 3	
RSUs	Options	RSUs	Options
2,000	2,000	2,000	2,000
6,000	0	0	6,000
x 8,000	x 2,000	x 2,000	x 8,000
1	4	1	4
8,000	8,000	2,000	32,000
2,000	8,000	2,000	8,000
6,000	0	0	24,000

Value of Shares at Vesting (After 5 Years)			
Example 1		Example 3	
Growth Rate 5% Per Year			
RSUs	Options	RSUs	Options
N/A	€ 22.88	N/A	€ 22.88
€ 29.20	€ 29.20	€ 36.85	€ 36.85
€ 6,000	€ 24,000	€ 6,000	€ 24,000
175,200	700,800	221,100	884,400
-	(549,120)	-	(549,120)
175,200	151,680	221,100	335,280
14,400	N/A	14,400	N/A
(93,852)	(18,960)	(116,573)	(41,910)
€ 95,748	€ 132,720	€ 118,927	€ 293,370

Value of Shares at Vesting (After 5 Years)			
Example 1		Example 3	
Growth Rate 10% Per Year			
RSUs	Options	RSUs	Options
N/A	€ 22.88	N/A	€ 22.88
€ 29.20	€ 29.20	€ 36.85	€ 36.85
€ 6,000	€ 24,000	€ 6,000	€ 24,000
175,200	700,800	221,100	884,400
-	(549,120)	-	(549,120)
175,200	151,680	221,100	335,280
14,400	N/A	14,400	N/A
(93,852)	(18,960)	(116,573)	(41,910)
€ 95,748	€ 132,720	€ 118,927	€ 293,370

*49.5% is an estimated average tax rate for RSUs and 49.5% is the actual average tax rate applicable for stock options

Factor #3: Administrative Methodology

Companies typically struggle with the following questions regarding reporting and withholding:

- Where a reporting requirement exists:
 - What information needs to be reported?
 - Which entity needs to do the reporting?
 - How does information flow to the reporting entity?
- Where a withholding requirement exists:
 - At what rate must the withholding take place?
 - How is the taxable income calculated?
 - From what income source must the withholding be taken?
 - Which method of withholding best suits the company's infrastructure and philosophy?

Administration Methodology: Potential Approaches

An "Administration Methodology" defines the manner in which a company delivers shares/cash to global employees while ensuring compliance with reporting and withholding requirements in each country

Tax Withholding at Source

- Taxes are withheld from the proceeds due to an employee by the third party broker/administrator before the proceeds are remitted to the employee
- The taxes are then remitted to the local entity, either directly or through the U.S. entity, for submission to the relevant tax authorities
- The local entity will impute the gain as wages and reconcile the withholding received from the broker with the amount to be remitted to the tax authorities (if a flat rate for each country is used)
- Any additional withholding can be either (a) collected via local payroll against the employee's other locally paid compensation (if possible) or (b) fulfilled by having the employee send a personal check or wire transfer to the local entity for the remaining tax due

Administration Methodology: Potential Approaches

Tax Withholding Advanced by Company

- Pay gross proceeds or deliver shares directly to employee
- The company funds the necessary withholding and the employee is then responsible for funding the required withholding obligation via personal check, wire transfer or withholding against other locally paid compensation (if possible)

Tax Withholding Through Payroll

- In the event of a cashless exercise of stock options, cash proceeds are remitted, either directly or through the U.S. entity, to the local payroll and taxes are withheld accordingly at the correct tax rate for each employee

Impact on Reporting and Withholding Requirements

The implementation of a recharge, plan optimization and the administrative process followed can impact reporting and withholding:

- France – Plan optimization affects conclusion
- Brazil – Recharge affects conclusion
- Belgium – Administrative methodology affects conclusion

	REPORTING/WITHHOLDING REQUIRED			
	<i>Optimized Plan</i>	<i>Recharge</i>	<i>Pay Through Payroll</i>	<i>Withholding Advance Permissible</i>
COUNTRY 1	YES	YES	YES	NO
COUNTRY 2	NO	YES	YES	YES
COUNTRY 3	NO	NO	NO	NO
COUNTRY 4	YES	NO	YES	YES

The Tax Withholding Process

- **RSUs** - Vesting and distribution are planned events, determination of withholding and reporting consequences can be determined prior to vesting
- **Stock options** - Calculations are performed at time of exercise. With short turnaround time, may require upfront streamlining.
- Withholding analysis to determine “minimum statutory withholding rates” for equity awards
- Taxable equity award income and withholding may need to be apportioned for mobile employees
 - Using assignment locations and dates or self-certification to calculate a blended withholding rate of tax to apply to the income on the vesting date for RSUs or stock options upon exercise

Accounting for Equity Compensation & FAS123R

- Paragraph 35 of FAS 123R states that if the number of shares withheld exceeds the number of shares needed to meet the [minimum statutory withholding rate](#), the entire award shall be classified as a liability
- Auditors may assert that this triggers liability accounting for the plan
- The rule impacts awards settled in shares, which generally includes:
 - Restricted stock
 - Restricted stock units (RSUs)
 - Stock settled stock appreciation rights (SARs)
 - Stock options are often excluded as stock option exercises are often settled in cash
- The concept of minimum statutory requirement often does not exist outside the U.S. and in most U.S. states

Prior Noncompliance



Why Do Issues Arise?

- Foreign affiliate lacks knowledge of the incentive compensation (programs typically administered centrally)
- Foreign affiliate lacks knowledge of local laws
 - Often assumes the income is not taxable because paid from abroad
 - Assumes no responsibility to report and/or only the employee must report
- Local laws are unclear
- Assessment of low risk of non-compliance (“no one else does it”)
- Payment Methodologies

Mapping Strategies to Specific Countries

- Integrating country- and company-specific factors with exposure levels can be helpful in prioritizing countries and in determining the company's approach.

		Sophistication of Tax Authorities		
		Low	Medium	High
Financial Exposure	High			Proactively Address?
	Medium			
	Low	Correct Prospectively?		

- Factors used by companies include the sophistication/history with the tax authorities, criminal vs. civil exposure, the existence of a recharge, tax amnesty programs, etc.

Compliance Ratings

- Low Compliance:**
 - Aware of cross-border compliance issues and have just begun to address the topic, or have not formally addressed the topic
 - Limited compliance with withholding and reporting obligations in many countries, states, cities, provinces and local jurisdictions
 - No formal policy to address cross-border compliance
 - Inconsistent treatment of cross-border employees
- Moderate Compliance:**
 - No formal policy in place to address cross-border equity compensation. Cross-border issues are addressed as necessary for certain subsets of plan participants, i.e., VIP executives, countries with sophisticated tax authorities, countries with large grants/awards, etc.
 - Tracking system in place for a certain subset of plan participants (typically international assignees)
 - Cross-border calculations may be performed for subset of plan participants
 - Broker/Administrator has limited involvement with Company's process to achieve global compliance
- High Compliance:**
 - Formal policy in place to address cross-border equity compensation
 - Adheres to reporting and withholding obligations in most if not all jurisdictions where the plan participants are subject to tax
 - Has tracking mechanism in place to identify cross-border movements amongst award recipients
 - Broker/Administrator is involved with Company's process to achieve global compliance
 - Internal process established or outside vendor engaged to assist with income apportionment and withholding responsibilities for Company

Summary & Closing Remarks

- Corporate governance and full regulatory compliance are more important than ever before due to:
 - Increasingly vigorous tax audit activity
 - Increase in exchange of information between countries/governments
 - Increased media exposure
 - New laws to capture mobile employee gains
- Particular focus on equity incentives and compliance with international withholding and reporting obligations. Noncompliance leads to significant exposure for companies:
 - Interest and penalties
 - Tax “gross up” payments for underpaid taxes
 - Bad publicity
 - Possible criminal sanctions
- Implementation should be carefully managed and ongoing maintenance addressed

QUESTIONS ?