The Top Five Ways US Taxation of Non-US Residents Impacts Your Equity Awards

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Agenda

- What is a US non-resident?
- General US taxation of non-residents
- Top 5 Ways US Taxation of Non-Residents Impacts Equity Programs:
  1. Employee equity award/employment income
  2. Director equity award/employment income
  3. Dividends on US shares
  4. Capital gains on US shares
  5. US Estate Tax
- Conclusions and Tips
GENERAL NRA TAX OVERVIEW
Who is a US Non-Resident?

- Non-US citizen
- Non-US permanent resident (green card holder)
- Does not meet the “substantial presence” test – *i.e.*, spends fewer than 183 days in US in current tax year or over 3-year look-back period
- Meets the substantial presence test but qualifies for an exception, *e.g.*:
  - “Closer connection” to foreign country and in US fewer than 183 days in current tax year
  - Resident of foreign country under tax treaty tie-breaker
- Thus, non-resident may be located in or outside US
Overview of US Tax Rules for Non-Residents

- US citizens and permanent residents (green card holders) are taxed on their worldwide income
- Nonresident aliens (“NRAs”) are taxed only on income that is effectively connected with a US trade or business (“ECI”) or, with respect to other income (primarily passive income), if US source income
  - ECI – generally taxed at graduated rates
    • US tax return should be filed by NRA on 1040NR
  - Other – generally taxed at a flat 30%, withheld at source
    • NRA may not have to file a tax return
Overview of US Tax Rules for Non-Residents

Income Connected with Trade of Business in US:
- Services as employee rendered in the US
- Service as an independent contractor (e.g., director) whose earnings are from personal services rendered in the US
- Certain investors on US investment activities (not relevant to equity programs)

Other Income:
- Dividends, capital gains
- Rents, royalties, interest (not generally relevant to equity programs)

Asset-Based Taxation:
- Shares, equity awards – see estate tax discussion
TOP 5 WAYS US TAXATION OF NON-RESIDENTS IMPACTS EQUITY PROGRAMS
1. Employee Equity Award Income

- Services rendered outside the US by NRA employee are not US source – no US taxation
- NRA equity awards only subject to US tax if employee works inside US, generally during the vesting period
- Exception if NRA in the US for a short period
  - Less than 90 days under Code
    - $3,000 US source earnings limit reduces utility
  - Typically 183 days or less in 12 months under treaties
    - Not applicable if US issuer bears cost of awards
1. Employee Equity Award Income (cont’d)

- If employee is NRA at option exercise, RSU release, ESPP purchase, etc. but performed some services in US:
  - Withhold US federal tax on US source income, generally calculated by time-based allocation of income over vesting period (options/RSU), purchase period (ESPP)
  - Report on Form W-2
- Double taxation may apply with country where employee is resident
- But employee often able to claim tax credit on home country tax return for US taxes paid on US source income
1. Employee Equity Award Income (cont’d)

FICA Considerations:

– Due on wages for work performed within the US, including by a NRA, technically even for one day’s work
– Exemption available if NRA from a totalization agreement country (24 at present) and:
  • Employee remains on home-country social system while in US
  • Employee is subject to foreign social taxes on equity award income
– Special FICA exemptions for certain visa-holders (e.g., employees of foreign governments (A), crew members of ships and aircrafts (D), students (F), trainees (J), etc.)
2. Director Equity Award Income

- NRA director of US corporation taxed on US source income – based on services performed inside US (e.g., meetings in US)
- No US tax on services outside US (e.g., preparation time)
  - Short-term business visitor exemptions not applicable for director of a US corporation
- Not an employee
  - Subject to 30% withholding under Code Section 1441
  - Reporting on Form 1042-S
### Form 1042-S

**Foreign Person's U.S. Source Income Subject to Withholding**

<table>
<thead>
<tr>
<th>Form 1042-S</th>
<th>Foreign Person's U.S. Source Income Subject to Withholding</th>
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<tr>
<td>1042-S</td>
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<td><strong>Income</strong></td>
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<td>1 Income code</td>
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<td>2 Gross income</td>
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<td>3 Withholding allowances</td>
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<td>4 Net income</td>
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<td>5 Tax rate</td>
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<td>6 Description code</td>
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<td>7 Total withholding amount</td>
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<td>8 Taxpayer's name</td>
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<td>9 Withholding agent's name</td>
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<td>10 Amount repaid to recipient</td>
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<td>11 Withholding agent's EIN</td>
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<tr>
<td>12a Withholding agent's name</td>
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<td>12b Address (number and street)</td>
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<td>12c Additional address line (room or suite no.)</td>
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<td>13a Recipient's name</td>
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<td>13b Recipient code</td>
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<td>14 Recipient's U.S. TIN, if any</td>
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<td>15 Recipient's foreign tax identifying number, if any</td>
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<td>16 Country code</td>
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<tr>
<td>17 NONFLOW-THROUGH ENTITY's name</td>
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<td>18 NONFLOW-THROUGH ENTITY's address (number and street)</td>
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<tr>
<td>20 NONFLOW-THROUGH ENTITY's U.S. TIN, if any</td>
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<td>21 PAYOR's name and TIN (if different from withholding agent's)</td>
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<td>22 PAYOR's state tax no.</td>
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<td>23 State income tax withheld</td>
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<td>24 Recipient's state tax no.</td>
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<td>25 Name of state</td>
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*For Privacy Act and Paperwork Reduction Act Notice, see Instructions.*

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**Form 1042-S (2013)**
2. Director Equity Award Income (cont’d)

Pro-Rate Equity Award Income, as For NRA Employees?

• Need information from director on amount of time worked within and outside US during vesting period
• Often easier / safer to withhold 30% on full gain – let director claim foreign tax credit on home country return
2. Director Equity Award Income (cont’d)

NRA Director May Be Exempt From US Tax Under Treaty:
- Some treaties provide full exemption as long as US source income not attributable to fixed base in US (e.g., Canada) and/or days in US are limited
- Others will allow credit for US tax on US source income

If Treaty Exemption Applies to Director’s Income:
- Director provides Form 8233 to corporation
- Corporation files Form 8233 with IRS
- Can stop withholding 10 days later
- Still must report on Form 1042, as treaty-exempt
2. Director Equity Award Income (cont’d)

FICA Considerations?
- None, non-employee not subject to FICA
- Also no SECA issues (Self-Employment Contributions Act)
  - NRAs not subject to SECA

Foreign Tax Considerations?
- Canada – US corporation has withholding and reporting obligations
- France – US corporation potentially has to pay a social tax on director income
- UK – Form 42 reporting obligation applies
- Be wary of other country-specific issues

See Article, Preparation is Key when a Non-US Resident Joins the Board
3. Dividends

Dividends on Vested Shares
- Contrast with dividend equivalents or dividends on restricted shares

Dividends of US Corporation are US Source Income
- Section 1441 withholding at source at flat 30%
- Participant needs to provide completed Form W-8BEN to withholding agent to claim reduced treaty rate (typically 15%)
  - Ability to claim refunds from IRS
  - Period of W-8BEN validity
3. Dividends (cont’d)

- Form 1042-S reporting by withholding agent
  - Annual Return (Form 1042)
- Form 1042/1042-S compliance is an area of IRS focus
- Issuer/Broker/Transfer Agent role
4. Capital Gains

Capital Gains on Sale of US Corporation Shares:

- NRAs are generally not subject to US income tax on capital gains on shares of US corporations
- FIRPTA exception

  • In practice, if NRA does not submit W-8BEN, 28% backup withholding on proceeds could be applicable
  • Thus, employees should be educated on importance of properly completing the W-8BEN
5. US Estate Tax Considerations

- Significant changes in general US estate tax rules during the last decade
- Residency definitions not the same as for income tax
  - Applicable to noncitizens who hold US situs assets
    - Shares of a US corporation are US situs assets
    - Shares of a foreign corporation are foreign situs
    - Stock options likely treated as US situs assets
  - Noncitizens not able to qualify for general exemption
    - Exemption limited to $60,000 of value
5. US Estate Tax Considerations (cont’d)

- Small number of U.S. estate tax treaties
  - May deem the shares to be foreign situs
  - May offer increased exemption amount
- Compliance enforced via lien provisions
  - Use of IRS-issued transfer certificates
- Separately, consider whether use of beneficiary designations is appropriate

See GES Whitepaper, *Beneficiary Designations in Equity Plans*
Conclusions

Employee Equity Awards
- Track days NRAs spend in US during vesting period
- Withhold and report US tax and FICA on pro-rata basis (W-2)

Director Equity Awards
- Consider full 30% withholding, unless treaty exemption applies
- Report on From 1042-S
- Don’t forget to check for foreign tax issues
Conclusions (cont’d)

Dividends / Capital Gains
- Confirm process for reporting for dividends paid to NRAs and for claiming treaty exemptions and applying backup withholding

Estate Taxes
- Confirm process for payment/settlement of awards following death of noncitizen employees
Questions?
Thank You

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