Granting Compensatory Equity Abroad: Applicable Tax Considerations

Presentation for:
Executive Compensation Academy –
(Monthly Training Series)
June 9, 2022

Presentation by:
Anthony J. Eppert
AnthonyEppert@HuntonAK.com
512.542.5013

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About Anthony "Tony" Eppert

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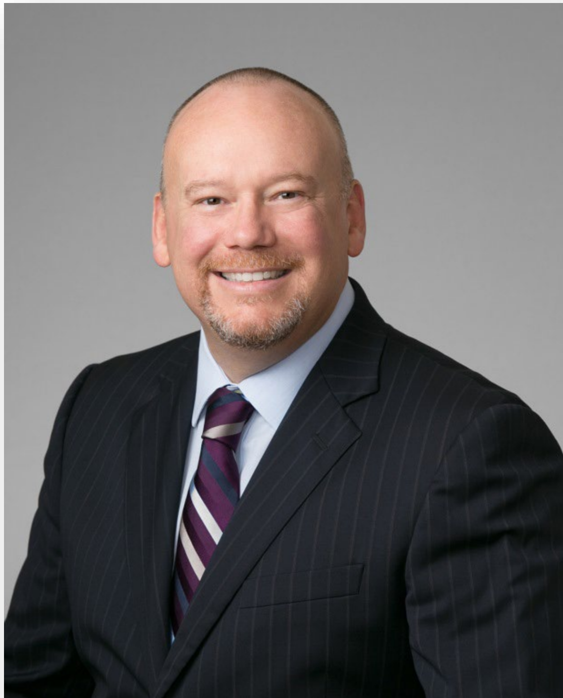

Anthony Eppert , Partner
Hunton Andrews Kurth LLP
Tel: +1.512.542.5013
Email: AnthonyEppert@HuntonAK.com

- Tony practices in the areas of executive compensation and employee benefits
- Before entering private practice, Tony:
  - Served as a judicial clerk to the Hon. Richard F. Suhrheinrich of the United States Court of Appeals for the Sixth Circuit
  - Obtained his LL.M. (Taxation) from New York University
  - Obtained his J.D. (Tax Concentration) from Michigan State University College of Law
    - Editor-in-Chief, Journal of Medicine and Law
    - President, Tax and Estate Planning Society

Upcoming 2022 Webinars

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- 2022 webinars:
  - How to Effectively Vet and Hire a Compensation Consultant (7/14/22)
  - Navigating Compensation Rules Applicable to Financial Institutions (8/11/22)
  - Preparing for Proxy Season: Start Now (Annual Program) (9/8/22)
  - Compensation Considerations Due to Upcoming Loss of EGC Status (10/13/22)
  - Aging Executives: Thoughts on Designing Succession Strategies (11/10/22)
  - [Topic TBD] (12/8/22)

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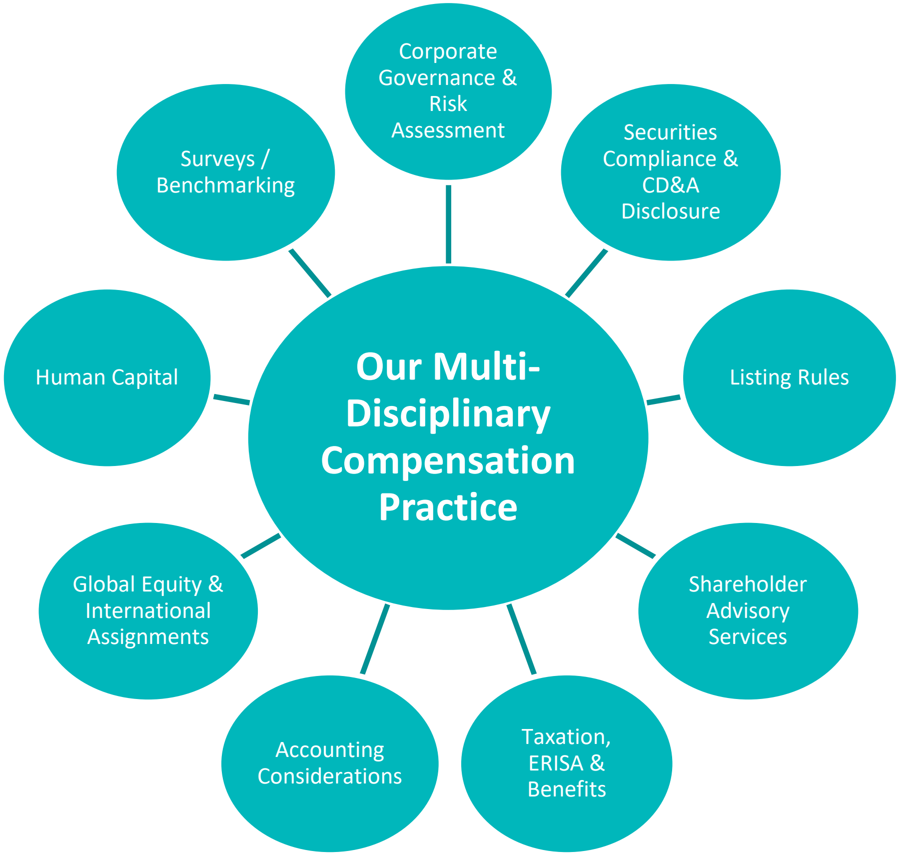
Our Compensation Practice – What Sets Us Apart

- Compensation issues are complex, especially for publicly-traded issuers, and involve substantive areas of:
  - Tax,
  - Securities,
  - Accounting,
  - Governance,
  - Surveys, and
  - Human Resources

- Historically, compensation issues were addressed using multiple service providers, including:
  - Tax lawyers,
  - Securities/corporate lawyers,
  - Labor & employment lawyers,
  - Accountants, and
  - Survey consultants

Our Compensation Practice – What Sets Us Apart (cont.)

- The members of our Compensation Practice Group are multi-disciplinary within the various substantive areas of compensation. As multi-disciplinary practitioners, we take a holistic and full-service approach to compensation matters that considers all substantive areas of compensation



Our Compensation Practice – What Sets Us Apart (cont.)

- Our Compensation Practice Group provides a variety of multi-disciplinary services within the field of compensation, including:

Traditional Consulting Services

- Surveys
- Peer group analyses/benchmarking
- Assess competitive markets
- Pay-for-performance analyses
- Advise on say-on-pay issues
- Pay ratio
- 280G golden parachute mitigation

Corporate Governance

- Implement "best practices"
- Advise Compensation Committee
- Risk assessments
- Grant practices & delegations
- Clawback policies
- Stock ownership guidelines
- Dodd-Frank

Securities/Disclosure

- Section 16 issues & compliance
- 10b5-1 trading plans
- Compliance with listing rules
- CD&A disclosure and related optics
- Sarbanes Oxley compliance
- Perquisite design/related disclosure
- Shareholder advisory services
- Activist shareholders
- Form 4s, S-8s & Form 8-Ks
- Proxy disclosures

Design/Draft Plan

- Equity incentive plans
- Synthetic equity plans
- Long-term incentive plans
- Partnership profits interests
- Partnership blocker entities
- Executive contracts
- Severance arrangements
- Deferred compensation plans
- Change-in-control plans/bonuses
- Employee stock purchase plans
- Employee stock ownership plans

Traditional Compensation Planning

- Section 83
- Section 409A
- Section 280G golden parachutes
- Deductibility under Section 162(m)
- ERISA, 401(k), pension plans
- Fringe benefit plans/arrangements
- Deferred compensation & SERPs
- Employment taxes
- Health & welfare plans, 125 plans

International Tax Planning

- Internationally mobile employees
- Expatriate packages
- Secondment agreements
- Global equity plans
- Analysis of applicable treaties
- Recharge agreements
- Data privacy

Purpose and Scope of Slide Deck

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- It is common for a U.S. corporation to grant equity-based compensation to foreign employees working in foreign jurisdictions

- The problem that often arises, is that when a U.S. parent corporation grants stock to an employee of a foreign subsidiary, the U.S. parent is not entitled to a compensation deduction (*i.e.*, because the U.S. parent is not the service recipient)
  - And in some cases, the foreign subsidiary is also not entitled to a deduction under applicable foreign laws

- The purpose of this Slide Deck is to discuss how a recharge agreement (*a.k.a.*, a charge-back agreement) could:
  - Capture a deduction at the foreign subsidiary level for foreign law purposes, and
  - Act as, from the U.S. parent's perspective, a tax-free repatriation of cash from the foreign subsidiary to the U.S. parent

The Basic Fact Pattern and Basic Problem

- Basic fact pattern
  - U.S. company grants equity awards to one or more employees of its foreign subsidiary
- Basic Problem
  - Under Sections 83 and 1032 of the Code, the grant is deemed to be a contribution of capital from the U.S. parent to the foreign subsidiary, followed by the payment of compensation from the subsidiary to the employee
  - Under Section 83(h) of the Code, only the service recipient (i.e., the foreign subsidiary) is entitled to a compensatory tax deduction
  - In other words, the U.S. parent would not be entitled to a deduction because the U.S. parent is not the service recipient
  - However, in many foreign jurisdictions a deduction would also not be available to the foreign subsidiary because it did not incur a "cost"

The Basic Solution and Result

- Basic solution
  - In order to incur a “cost” to the foreign subsidiary, the U.S. parent and its foreign subsidiary could enter into a “recharge agreement”
  - Under the recharge agreement, the foreign subsidiary agrees to reimburse the U.S. parent for the value of the equity award that will be granted to the employees of such foreign subsidiary
    - For appreciation-only awards, the value is determined as the spread at the time of exercise
    - For full-value awards, the value is the full value at the time of vesting

- The result
  - The foreign subsidiary incurs a “cost,” that if structured correctly, could result with a corporate tax deduction in the foreign jurisdiction
  - Additionally, the U.S. parent receives cash equal in approximate value to the value of the equity
  - Finally, the funds transferred from the foreign subsidiary to the U.S. parent should be protected from U.S. taxation under Section 1032 of the Code (i.e., a company recognizes no gain or loss upon receiving cash for its stock)
    - In effect, such acts as a tax-free repatriation of funds from the foreign subsidiary to the U.S. parent

Overview: Basic Fact Pattern

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- Factual example assuming the award takes the form of stock options
  - U.S. parent corporation grants an option to acquire 10 shares of stock to the employee of its foreign subsidiary
  - The strike price is equal to the FMV of the underlying stock as of the date of grant, which is $1.00 per share
  - As of the date of exercise, the FMV of the underlying stock is $4.00 per share, resulting in a spread of $3.00 per share
- Prior to the date of grant, the U.S. parent corporation enters into a recharge agreement with the foreign subsidiary to provide for a payment from the foreign subsidiary to the U.S. parent:
  - Such payment being equal to the spread
  - The timing of such payment to coincide with any exercise of stock options by employee/optionees of the foreign subsidiary
- Upon an exercise of the stock option, the U.S. parent corporation would receive $10.00 from the optionee and $30.00 from the foreign subsidiary corporation, the latter pursuant to the recharge agreement

Specific Tax Analysis

- When the U.S. parent transfers its stock to an employee of its foreign subsidiary
  - According to Treas. Reg. 1.83-6(d)(1), the U.S. parent is deemed to have contributed the property to the capital of the foreign subsidiary as a capital contribution, and the foreign subsidiary is deemed to transfer the property to the employee
  - According to Section 351(a), the U.S. parent should recognize no gain or loss on the deemed contribution of stock
  - According to Section 1032(a), the foreign subsidiary should recognize no gain or loss on its deemed receipt of U.S. parent stock

Specific Tax Analysis (cont.)

- Generally, the carryover basis rules of Section 362 of the Code would require that the foreign subsidiary have $0.00 basis in the U.S. parent stock, since the U.S. parent would not likely have any basis in newly issued stock
  - Thus, the foreign subsidiary could recognize gain on the transfer of the U.S. parent stock to the employees of the foreign subsidiary

- HOWEVER, to avoid the foregoing conclusion, Treas. Reg. 1.1032-3 deems the following to occur immediately prior to the transfer of U.S. parent stock from the foreign subsidiary to its employees (and with respect to stock options, such is deemed in the year of exercise):
  - It is deemed that the U.S. parent contributed cash to the foreign subsidiary in an amount equal to the FMV of the transferred U.S. parent stock
  - It is deemed that the foreign subsidiary purchased the stock of the U.S. parent at FMV with the cash contribution it is deemed to have received

Specific Tax Analysis (cont.)

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- Resulting from the analysis on the prior slides, under Section 1012 of the Code, the foreign subsidiary would have a cost basis in the transferred stock of the U.S. parent equal to its then FMV (see also Treas. Reg. 1.1032-3(b)(2), (e) Ex. 5)

- Resulting from the analysis on the prior slides, under Section 358 of the Code, the U.S. parent's basis in the stock of its foreign subsidiary would be increased by the FMV of the stock deemed contributed to such foreign subsidiary, less any reimbursement it receives under the recharge agreement
  - Thus, if the U.S. parent is fully reimbursed under a recharge agreement for its deemed contribution, such U.S. parent would not increase its basis in the foreign subsidiary stock
  - In contrast, if the U.S. parent is NOT fully reimbursed under a recharge agreement, then the U.S. parent would increase its basis in the foreign subsidiary stock by the spread that is not reimbursed
  - And if the foreign subsidiary reimburses more than the value of the equity (certain costs, etc.), then Section 1032 might not apply to the excess, and as a result under Section 302, any such excess could be treated as a taxable dividend from the subsidiary to the U.S. parent

Specific Tax Analysis (cont.)

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- According to Private Letter Ruling 201014049, if a recharge agreement is used in connection with scenario set forth in the prior slides, the reimbursement payment that the U.S. parent receives would not constitute a distribution with respect to the foreign subsidiary's stock
  - In other words, no distribution under Section 301 of the Code
  - This means the U.S. parent would not recognize taxable income due to its receipt of any cash under the recharge agreement (though check to make sure the reimbursement does not exceed the value of the equity, and if yes, then whether such excess could be treated as a taxable dividend from the foreign subsidiary to the U.S. parent)

- Under Treas. Reg. 1.83-6(a)(1), the foreign subsidiary would be entitled to a tax deduction equal to the FMV of the U.S. parent stock that is transferred to the foreign subsidiary's employees

End Result?

- The recharge agreement could result in the foreign subsidiary incurring a "cost," such that the foreign subsidiary is entitled to a deduction under local foreign law

- Additionally, but separate, the tax analysis on the prior slides shows how the U.S. parent could effectuate what is essentially a tax-free repatriation of cash

Issues to Consider: Perform a Cost Benefit Analysis

- Properly implementing recharge agreements in conjunction with a global equity program takes time and has an associated cost for administrative support and the support of outside professionals

- A cost benefit analysis should be performed to determine if there are cash flow benefits resulting from reduced taxes paid by the foreign subsidiary in the foreign jurisdiction
  - Obviously, the effective tax-free repatriation is a benefit

Issues to Consider: Incur a "Cost"

- The ability of the foreign subsidiary to recognize a foreign deduction equal to the FMV of the stock being transferred by the U.S. parent to the employees of the foreign subsidiary will vary from country to country
  - In a few countries, a recharge agreement is not necessary in order for the foreign subsidiary to recognize a deduction (e.g., United Kingdom)
  - In a few other countries, no deduction is available to the foreign subsidiary even if a cost is incurred (e.g., Canada, Netherlands)

- However, in many foreign jurisdictions a foreign deduction is available if:
  - The foreign subsidiary is financially responsible for the costs of the U.S. parent stock that is awarded to the employees of the foreign subsidiary,
  - Such responsibility is documented with a recharge agreement, and
  - Such recharge agreement is in place before the date of grant (such timing of entering into the recharge agreement is required in many countries)

- Keep in mind that even in instances where a foreign deduction is not available to the subsidiary, a tax-free repatriation of cash may still be beneficial to the U.S. parent

Issues to Consider: Amount of Cost to Incur

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- A determination needs to be made on whether the cost is limited to the spread (if stock options) or full fair market value
  - Additionally, should start-up costs, administrative costs and/or social insurances be included in the “cost”?

- With respect to internationally mobile employees who transferred from one foreign subsidiary to another foreign subsidiary during the vesting schedule, a question that arises is how much of the equity cost should be allocated among the two or more foreign subsidiaries. Allocation models include:
  - Total Elapsed Time - each vesting tranche has a cost allocation to two or more foreign subsidiaries based on the amount of time the employee was employed by the foreign subsidiary from the grant date
    - Example: If the employee received an equity award on January 1, 2022 with an annual 3-year graded vesting schedule, and the employee transferred to another foreign subsidiary on July 31, 2022 prior to the 1st vesting tranche even becoming satisfied, then the cost reimbursement would be split between all 3 vesting tranches (58% to the first foreign subsidiary for Year 1, 29% to same subsidiary for Year 2, and 19% to same subsidiary for Year 3)

  - Elapsed Time within Vesting Tranches – Same as above except that only the time within a vesting tranche is counted
    - Example: Same as above example, except that since only the time spent within a vesting tranche is counted, the reimbursement would be 58% to the first foreign subsidiary for Year 1, and 0% to such subsidiary for Years 2 and 3

Issues to Consider: Withholding Taxes

- A determination needs to be made as to whether the foreign jurisdiction requires the foreign subsidiary to withhold tax on the amount of any reimbursement to the U.S. parent that is made pursuant to a recharge agreement
  - Such a requirement applies in some countries

Issues to Consider: Exchange Controls

- Exchange controls are found in many foreign jurisdictions
  - Exchange controls are the restrictions of a foreign government that regulate the flow of cash and certain property to and from such foreign country
  - If exchange control rules apply, approval from the foreign government is generally required (though sometimes only a notification to such foreign government is required) in order for the foreign subsidiary or its employees to remit cash under the recharge agreement to the U.S. parent

Issues to Consider: Typical Global Equity Issues

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- Foreign jurisdictions typically have data privacy rules that are more robust than U.S. laws
  - Data privacy refers to prohibitions on the transmission of employee specific personal information such as name, age, seniority, etc.
  - Foreign jurisdictions vary on whether or not governmental approval of such transmissions is necessary or whether it is sufficient to have only the consent of the employee

- Entitlement issues
  - Local rules should be consulted to determine whether the employer can terminate the plan at any time in the future without jeopardizing an accrued right of the employee (thus needing the employee's consent) and to determine whether the value of equity compensation must be used to determine an employee's severance pay
  - Remember to have a provision in the equity agreement whereby the employee acknowledges and agrees that the equity award is not an entitlement

Don’t Forget Next Month’s Webinar

- Title:
  - How to Effectively Vet and Hire a Compensation Consultant
- When:
  - 10:00 am to 11:00 am Central
  - July 14, 2022