



Common conflicts between tax technical accuracy and practical efficiency

Navigating the maze between technical accuracy and practical application for equity compensation

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I didn't know that (Or maybe I did?)




Why this session?

- There's usually a rule for that but not everyone knows about it



The reaction to the rule is typically:

- Really? Since when?
- I didn't know that!
- Huh?
- We've always done it this way.
- You tax guys: so do I really have to do this?



Agenda



Technical vs. Practical topics to cover:

U.S. payroll reporting and the optional flat rate withholding method

RSU's – Fair market value (FMV) at vest or delivery?

Nonqualified stock options (NQSO) – FMV at exercise or sale?

W-2 filing requirements for U.S. persons employed abroad

Application of Social Tax Reporting and Withholding or Not

What would you do?

Optional flat rate withholding

Do you review individual employee facts and circumstances before using the optional flat rate withholding (22%) on supplemental wages to confirm that all conditions for its use are satisfied?

- 01 Yes, we review all employee situations to confirm conditions are satisfied
- 02 No, we use the flat rate method for all supplemental wages (BTW, what conditions?)



The optional flat rate withholding method – The technical

- Mandatory flat rate 37%
 - Required for the excess of YTD supplemental wages that exceed \$1mil
 - If mandatory flat rate applies to excess supplemental wages, the employer *may* subject the entire amount to 37% rate
- Supplemental wages not subject to mandatory flat rate withholding
 - Aggregate method prescribed if mandatory flat rate does not apply, but optional flat rate withholding may be used
- Optional flat rate withholding available if all three conditions are met:
 1. Mandatory flat rate does not apply
 2. Supplemental wages either not paid concurrently with regular wages or are separately stated in payroll
 3. Income tax has been withheld from regular wages during the calendar year or preceding calendar year

The optional flat rate withholding method – The practical

Common situations where optional flat rate may *not* apply (but companies use it anyway):

- U.S. expatriates who have been on international assignment for more than two years
 - Possibly no withholding on regular wages during assignment period
- Nonresident aliens with trailing liability
 - When was the last time that income tax was withheld from regular wages?
- Ok, so what?
 - Over or under withholding depending on circumstances
 - Where over withholding occurs, shares to cover tax withholding may be sold or retained in excess of plan provisions
 - Underpayment of employment tax could result in underpayment penalties and interest

What would you do?

Fair market value for RSU taxable income

Which FMV do you use to report compensation and tax withholding for RSUs?

- 01 For “We use FMV at vest”
- 02 For “We use FMV at settlement/delivery/transfer”



FMV for RSU income – The technical

- RSU is an unfunded, unsecured promise to pay in the future
 - It's deferred compensation
 - It's *not* property taxable under §83
- Taxable upon constructive receipt
 - Taxed when cash paid or shares transferred (taxpayer becomes beneficial owner)
 - No constructive receipt at vest unless settlement also occurs at that time
- The rules for constructive receipt address only the timing of the taxable event, not value
 - We need to look to other guidance to determine taxable value for wages

FMV for RSU income – The technical (continued)

- Compensation paid other than in cash (reg. §1.61-2(d)(1))
 - ...if services are paid for in property **the FMV of the property taken** as payment is compensation
- Stock and notes transferred to employee or independent contractor (reg. §1.61-2(d)(4))
 - If a corporation transfers its own stock to an employee or independent contractor as compensation for services, the **FMV of the stock at the time of transfer** shall be included in gross income...
- Wages for income tax withholding (reg. §31.3401(a)-1(a)(4))
 - Where services are paid for in a medium other than cash, **the FMV of the thing taken** in payment is the amount to be included as wages (reg. §31.3401(a)-1(a)(4))
- Wages for FICA taxation (reg. §31.3121(a)-1(e))
 - Remuneration paid in items other than cash shall be computed on the basis of the **FMV of such items at the time of payment**

FMV for RSU income – The practical

- What is the FMV of the stock/property/thing taken in payment?
 - Is it the FMV determined at the time of transfer?
 - Is it the FMV as previously determined that becomes taxable upon transfer (i.e. FMV value at vest used as taxable value)?
- Neither the Code nor Regulations specify a fixed rule
- What we see is most companies use at vest date FMV
 - Ease of administration, particularly for global settlements
 - Assumes minimal lag time between vest and transfer (e.g., within SEC guidelines for broker assisted transactions)
- We don't see the IRS challenging any reasonable, consistently applied, well-documented method unless they provide opportunities for manipulation or tax avoidance

FMV for RSU income – The practical (continued)

— Ok, so what?

- IRS could challenge FMV

- If FMV is undervalued

 - Possible reclassification of income from compensation to capital gain providing improper tax benefit to the taxpayer if shares held for more than one year

 - Underpayment of employment tax by employer

- If FMV is overvalued

 - Employee's tax cost could be overstated

 - Employee loss of capital to fund tax withholding

What would you do?

Fair market value for Income from Non Qualified Stock Option (NQSO) Exercises

What FMV do you use to calculate gain from the exercise of NQSO for same day exercise and sell transaction?

- 01 For “We use the FMV of the share on the date of exercise and certify this in writing to our broker”
- 02 For “We use FMV of the share on the date of the sale”



Compensation from NQSO – The technical

- For NQSO that lack a readily ascertainable fair market value, the service provider recognizes income at the time of the exercise of the options
 - Most options do not have a readily ascertainable FMV at grant unless they are tradeable or otherwise transferable and the taxpayer is able to establish a value
- The time for recognizing this income and for determining the FMV of the stock is the first day that the transferee's rights in the stock are “substantially vested” (e.g., at exercise)
- The income recognized at exercise is the FMV of the stock received minus the amount paid, if any, for that stock (e.g., the exercise price)
- A subsequent sale of stock obtained at exercise generates capital gain or loss
 - e.g., exercise and sell transactions

Compensation for NQSO– The practical

- Some companies use the FMV of the stock at sale, not at exercise to report compensation
 - This is both technically acceptable and practical provided proper procedures are followed
- Revenue Procedure 2002-50
 - A broker may treat a sale as an "excepted sale" for purposes of broker reporting requirements if the service provider obtains substantially vested shares of stock from the exercise of an option and on the same day sells the shares through a broker
 - i.e., no Form 1099-B required to report proceeds from the sale of stock
 - The service recipient must certify in writing to the broker that the service recipient will report any compensation income generated by the exercise of the option, or disposition of the stock acquired from the exercise of the option
 - The exception provided does not apply if the service recipient uses an amount other than the sale price of the shares to calculate the compensation income generated to the service provider by the option exercise.

Compensation for NQSO– The practical (continued)

— Ok, so what?

- Failure to use the proper FMV results in possible reclassification of income from wages to capital gain or loss
 - Any unintended reclassification results in underpaid employment taxes
 - Employees need clarity on the FMV used to properly report stock sales on their tax returns
- Whether or not the sale of stock is treated as an excepted sale that relieves broker reporting the employee must report the stock sale on his or her income tax return

What would you do?

W-2 for U.S. citizen or resident employee of a foreign subsidiary

Do you issue Form W-2 to report share-based compensation for a U.S. citizen or resident employed by one of your foreign subsidiaries who does not work in the U.S.?

- 01 For “We do not issue a Form W-2 (and didn’t know we had to)”
- 02 For “We do issue a Form W-2”



W-2 filing for U.S. persons employed abroad – The technical

- U.S. citizens and residents will have wages for U.S. tax purposes even though they are employed by a foreign employer and do not perform services within the U.S.
- Wages includes remuneration for services performed by a citizen or resident...of the United States as an employee of a nonresident alien individual, foreign partnership, or foreign corporation whether or not such alien individual or foreign entity is engaged in trade or business within the United States.
- An employer is required to report wages to the IRS and provide a statement to the employee (e.g., Form W-2) if the employer paid compensation of \$600 or more to the employee, unless an exception applies

W-2 filing for U.S. persons employed abroad – The technical (continued)

- An exception is available for payments by (1) a non-U.S. payor for (2) services performed outside the U.S., and (3) paid and received outside the United States
- A controlled foreign corporation (e.g., a subsidiary of a U.S. corporation) is considered a U.S. payor for this purpose so **no** exception is available and a W-2 is required
- If the foreign employer is not a CFC then it may or may not be required to issue a W-2 depending on the employee's facts and circumstances
 - If the employee has wages subject to U.S. tax withholding then a W-2 is required
 - Must consider both income and FICA taxation

- *HINT: Check with your corporate tax group on your structure*

W-2 filing for U.S. persons employed abroad – The practical

- As a practical matter many companies do not issue Form W-2 for U.S. citizens and residents of a U.S. corporation's foreign subsidiaries
 - Some accept risk for reporting failure but most are unaware of the requirement
- The issue typically surfaces when a U.S. parent settles share-based awards for those U.S. persons employed abroad
- Whether or not the employee works within the U.S. does not change the requirement to issue Form W-2, although it could alter the tax withholding obligation depending on the employee's facts and circumstances
- Ok, so what?
 - Penalty for failure to issue Form W-2
 - Failure to report and withhold tax
 - Underpayment of employment taxes
 - Employee unaware of reportable income

What would you do?

Application of Social Tax or Not

For your mobile employees with awards sourced over two or more jurisdictions, do you source award income for social tax reporting and withholding purposes?

- 01 Yes, we source award income for social tax
- 02 No, we apply social tax on current work location only



Application of Social Security– The technical

- Under the FICA tax provisions, unless an exception applies, taxes are imposed on wages paid with respect to services performed by **employees working in the United States** (regardless of the citizenship or residency of either the employer or employee), and on **U.S. citizens and residents working outside** the United States for American employers.
- Unless an exception applies, the term wages for FICA tax purposes includes all amount paid in respect of employment and the cash value of all amounts (including benefits) paid in any medium other than cash. (IRC 3121(a) IRC 3306(b)) The *name* by which the payment is designated (e.g. salaries, fees, commissions, etc.), the *basis* upon which it is paid (e.g. percentage of profits, hourly, daily, etc.) and the *medium* in which it is paid (e.g. **stock options**, property, cash) are generally immaterial. (reg. § 31.3121(a)-1(c) (d) and (c) ; reg. §31.3306(b)-1(c), (d), and (c))
 - Furthermore, amounts paid for employment are considered wages even if, at the time of payment, the employer-employee relationship no longer exists. (reg. § 31.3121(a) -1(i) ; reg. § 31.3306(b)-1(i))

Application of Social Security– The practical

- Payroll Limitations

- Social Security/ID numbers
- Deactivation

- Tracking global compensation

- Social tax caps or limits

- Tracking mobile or business travelers into the US, around the world

- And more!

Hint: An Employee Stock Purchase Plan (ESPP) is an exception!

Reminders

- Identify long term expatriates and non US leavers not eligible for flat withholding
- Review vest vs settlement date handling of FMV
- Identify US citizens in organization worldwide for US reporting
- Don't forget the social tax implications; work with your payroll teams



Questions?



Thank you



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