GTN Newsletter – August 2017

Avoiding Tax Equalization Surprises on Equity Income

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The typical responsibilities of a global mobility manager are both complex and varied. They handle unusual requests from demanding mobile employees while enabling the movement of talent within the company. Nowhere in the job description does it read “collection agent,” although this is the exact role that many play when a U.S. outbound mobile employee has a large restricted stock unit (RSU) award that vests.

The tax equalization settlement amounts at issue can be significant. In this newsletter, we explain why these situations occur and solutions that may be available to mitigate having the employee owe the company.

However, before we discuss the tax issues surrounding mobile employees and tax equalization settlements, we would first like to explain two myths that cause these situations.

Myth 1: The amounts withheld through the U.S. payroll system are intended to match the individual U.S. tax liabilities.

Reality: The amounts withheld through the U.S. payroll system are based on a complex set of requirements and payroll regulations. Although the amounts withheld for U.S. federal and state income taxes from the payroll system are ***reported*** on the U.S. individual income tax return, the ***withholding*** amount is based on the mandates of the payroll regulations, not the individual’s actual tax liability.

The discrepancy between amounts withheld and an individual’s actual tax liability can be problematic. In some cases, the required withholding under payroll law will result in a large overpayment of tax on the annual tax return. In other cases, the required withholding will result in a large balance due on the annual tax return.

Myth 2: Complying with the global payroll reporting and withholding obligations on equity awards will also help to ensure proper implementation of a company’s tax equalization policy.

Reality: Complying with the global payroll reporting and withholding obligations on equity awards can be mutually exclusive from properly executing a company's tax equalization policy. Specifically, most companies' tax equalization policies include guidelines on how to minimize a large balance due to the company on the equalization calculation. However, complying with the global payroll reporting and withholding obligations on equity awards can often result in the employee owing the company on the tax equalization unless specific measures are taken to avoid this situation.

Why is this important? For an employee that is tax equalized, having a large tax equalization settlement due to the company can lead to many challenging situations including:

- A large write-off for the company if they are unable to collect from the mobile employee. This often occurs if the employee leaves the company before the annual tax equalization calculation is prepared.
- Awkwardness within the organization while the HR, payroll, and business units wait for the employee to repay the company.
- The tax issues for a mobile employee are often quite confusing even in the best of circumstances, so owing a large amount to the company, either as an out-of-pocket payment or with actual tax refunds, can be alarming and frustrating.

In order to illustrate the issue and the possible solutions, we have prepared a detailed case study available here: Case Study - Tax Equalization on Equity Awards

The case study provides additional accounting rule references and detailed discussion beyond the scope of this newsletter. We recommend reviewing the case study for additional technical discussion regarding the issue and the possible solutions.

In summary, assuming no advanced planning, the case study shows that the employee would need to have funds available to pay the employer for a $150,000 tax equalization settlement, as well as pass along a federal refund of $250,000 to the employer. To avoid the challenging situations noted above, the company should avoid having an employee owe it $400,000.

Potential Solutions:

Solution 1 – Remove tax equalized employees from the net settlement requirement; instead, allow them to "sell to cover."

Industry data consistently shows that net settlement (i.e., withholding shares to cover the taxes due) is – by far – the most popular tax settlement methodology for full-value awards, such as RSUs. This should come as no surprise since finance teams tend to prefer the anti-dilutive impact of this approach.

This favorable balance sheet result comes at a cost – i.e., reduced flexibility when selecting your tax rate. Specifically, the U.S. Generally Accepted Accounting Principles (GAAP) governing net settlement state that "good" accounting (i.e., fixed accounting) is preserved for a net settled award if withholding occurs at a rate that's less than or equal to the maximum statutory rate.

Though withholding at the hypothetical rate would provide a good tax answer (since we would have a close approximation of the mobile employee's actual tax liability) doing so via share withholding runs the risk of triggering liability accounting. The U.S. Financial Accounting Standards Board (FASB) has, on multiple occasions, considered and rejected a specific exemption for hypothetical tax.

A straightforward solution to this problem exists if your plan allows participants to sell shares to cover the taxes due (i.e., "sell to cover"). This is because market-based transactions such as "sell to cover" are not subject to the same maximum statutory rate requirement. Thus, you can choose the rate that provides you the best estimate of the actual tax liability, generates cash at the point of transaction, and sends the payment directly to the employer.

If you are considering switching from net settlement to sell to cover, we recommend you consult with three critical stakeholders:

1. Your legal team to ensure this tax settlement method is permitted under your plan.
2. Your finance team to ensure they're comfortable with the less desirable dilution impact.
3. Your plan administrator / broker to ensure "sell to cover" functionality can be supported.

<u>Solution 2 – Continue to net settle, but do so based on the maximum host country rates.</u>

If the employee is subject to mandatory foreign withholding on the equity income, the company can withhold tax at rates up to the maximum applicable foreign tax-withholding rate. This option is a new alternative that has emerged under recent accounting rule guidance. Where the U.S. GAAP-imposed ceiling was once a country's minimum statutory rate, it is now that country's maximum rate.

In addition, since the equity income is subject to mandatory foreign withholding, the company is not required to withhold U.S. federal income tax (although the wages would be reportable for federal tax purposes and subject to Medicare tax withholding).

Please see the Case Study for more guidance on implementing this solution.

<u>Solution 3 – Reduce U.S. federal withholding, and collect hypothetical taxes as a separate transaction.</u>

To illustrate this solution, we will use the same facts as the case study, but assume the employee has been on assignment to Japan, not the U.K., and is therefore **not** subject to mandatory withholding on the equity income (as Japan does not typically require mandatory withholding for employees working on assignment in Japan). For this scenario, the solution to avoid a large balance due to the company on the tax equalization would be the following:

- Have the payroll department utilize the aggregate withholding method, rather than the supplemental withholding method.
- Have the employee complete a W-4 with hundreds or even thousands of withholding exemptions to ensure no federal tax withheld on the equity income.
- After the employee receives equity income, request that the employee write a separate check to the company to pay hypothetical tax. Note that in this scenario, the hypothetical tax rate could be any rate the company would like, since it is a separate transaction.

Other issues that arise related to tax equalization of equity income include equity income earned in multiple counties including the U.S. and state income tax. These issues and possible solutions are discuss in more detail in the case study.

Summary

As explained above, there are potential solutions for avoiding large tax equalization settlements from mobile employees. Although it will require some work to implement these solutions, the payoff from not having to collect from mobile employees may well be worth the effort.

If you have any questions regarding the topics above, or if you would like to discuss which solution might be best for your company, please feel free to contact Brett Sipes at bsipes@gtn.com or +1.619.758.4083 or Geoff Hammel at geoff.hammel@ispadvisors.com or +1.215.438.4772.

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