Taxline

A Quarterly Update on Developments in Personal Taxation

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TAXLINE is a quarterly publication that addresses international taxation issues of interest to mobility managers. These topics are addressed in general terms, and are based on authorities that are subject to change. You should apply the information in these articles only after consulting with your tax adviser.

Professional service providers contribute content for TAXLINE. Material in this edition was written by John Montgomery and Rajiv Thadani from the New York and Santa Clara offices, respectively, of KPMG LLP. The authors' views their own and do not necessarily the views or professional advice of KPMG LLP.

From time to time, Mercer requests various professional service providers to contribute to the material published in Taxline.

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fast fact

Did you know that **81%** of companies worldwide have external staff manage their expatriates' tax preparation and compliance?

Source: Mercer's *2012 Worldwide Survey of International Assignment Policies and Practices*

International Assignees with Equity Compensation: The Challenges of Mitigating Risk and Achieving Compliance

By Rajiv Thadani, KPMG LLP, Santa Clara

(KPMG LLP in the United States is a KPMG International member firm)

The growing cross-border movement of workers is both an impetus to and symptom of accelerating globalization. Never before have there been so many employees on international assignments or on "one-way permanent" transfers. These cross-border workers are establishing offices and plants overseas, performing "new market" research, undertaking sales, forging new partnerships and alliances with overseas companies, and facilitating mergers and acquisitions. In light of this, companies are dealing with myriad HR, immigration, and tax issues related to their employees going overseas on international assignments.

Compensation alone presents numerous issues for both the employer and expatriate employees. This gets particularly complicated when one is dealing with equity-based compensation, the focus of this article.

Companies have trended away from traditional cash lump-sum bonuses and more toward long-term incentive programs, both cash and non-cash. Indeed, equity-based compensation of cross-border employees creates many unanticipated challenges tied to when an award of equity compensation is made (in other words, where the employee is when the award is made), the timing and place of vesting and exercising, etc. The tax implications can get convoluted: Which country has taxing jurisdiction? How does the company making the award track and report it for payroll and tax purposes? What are the company's (and the employee's) tax compliance obligations?

Tax Issues When Employees with Equity Compensation Cross Borders

When employees who receive equity-based compensation cross borders, the problems multiply with each new country and with each type of equity compensation they are "paid." Issues and questions that can arise include:

- What taxes need to be withheld?
- How much? When? Where? (Sometimes, when it comes time to pay, you need quick answers to these questions in relation to all the jurisdictions concerned and each cross-border employee.)
- Unclear and inconsistent tax laws, whose complexity can be enhanced by income tax treaties and social security taxation.
- Tax reimbursement policies for expatriate employees.
- Multi-jurisdiction payroll reporting and withholding obligations.
- Additional tax filing obligations.
- Greater scrutiny and cross-border collaboration by tax authorities.

On this last point, in the current environment of belt-tightening and declining revenues, tax authorities around the world are looking critically at executive compensation. They are heightening their scrutiny of the equity-based compensation of assignees and focusing compliance enforcement through sophisticated tactics. Recently, some tax jurisdictions have been known to work in conjunction with immigration and transportation authorities to identify cross-border employees with potential tax exposure.

Processes and Policies Related to Compliance

Implementing and administering income reporting and tax withholding procedures are challenging enough when dealing with a domestic employee population. Globally mobile employees add an entirely new layer of complexity, especially in countries where companies have to fulfill compliance obligations.

In many cases, where equity-based compensation is concerned, multi-jurisdictional payroll requirements are beyond the capabilities of basic home/host payroll arrangements. To begin with, it becomes critical for a company to have a solid understanding of the reporting and withholding requirements and the risks and exposures from jurisdiction to jurisdiction. For larger assignment programs, tight settlement time-frames, large data quantities, and transparency emerge as the biggest challenges. For example, in any given location, the reporting and withholding may occur at grant, exercise, or vest date, and possibly at the time of sale. The compliance requirements of one country may mesh with those of another country (making it somewhat easier for the company), or they may not. The fact that stock administration and payroll managers may have only hours to accurately process the transaction from a withhold-to-cover standpoint make plan administration – and accurate tax treatment – even more challenging.

Establishing effective processes and coordinating (and, where necessary, consolidating) all the pieces can help reduce an employer's challenges and complications. And automation and technology should be deployed and used where appropriate. The technology a company uses should have:

- Web-based systems and features to facilitate ease of access and functionality and standardization (but with sufficient flexibility to be tailored for "local" needs).
- Easy integration with existing systems to reduce duplicative efforts and promote streamlining.
- Simple, convenient ways to enter data.
- Ability to input, store, and manipulate a variety of employee data (travel, compensation, determining global payroll withholding and reporting requirements).
- Flexible reporting – for example, the ability to create ad hoc reports.

The technology adopted and used should help automate labor-intensive tasks such as cost estimation as well as policy application. Ideally, it should also flag for reminders and alerts.

Technology can help effectively gather, consolidate, and use the various pieces of information needed for administering equity plans that include expatriates. And, ultimately, properly implemented technology will save time, increase efficiencies, lower costs, and enhance compliance.

Risk Management When Equity-Based Compensation Is Involved

Risk management continues to be a top corporate priority. Although it is extremely difficult for a company to eliminate all risks related to international assignments, the risks can be mitigated and efficiently managed. The risks can be both tangible and intangible:

- reputational – the company's good name and esteem of its brand; and
- financial – unaccrued tax costs, penalties, and interest and many other unrecoverable costs.

Employers can manage these and other risks efficiently as long as the proper foundation has been set down. The initial step should be to identify the potential areas of exposure germane to international assignments – business travelers, permanent transfers, and international assignees.

The next step should be to assess the overall tangible and intangible risks. In terms of employees' equity-based compensation, a simple exercise to aid with this step is to look at the employee's level/position, followed by a review of the fair market value of the available unvested equity income. Once the risk threshold has been determined, the internal mechanisms for reporting and withholding should be scrutinized. Many companies discover that their internal systems and knowledge are insufficient to handle multi-jurisdictional requirements effectively and properly.

Many companies turn to third-party providers or outsourcers to assist them with the entire process. Professional service firms typically have extensive knowledge in this area and may even possess custom technology tools to help sort through the various layers and levels. These firms are often engaged to undertake the sort of assessment described above, looking at the "current state" in the company (at home and where it and its assignees operate overseas), documenting processes, policies, and knowledge, noting where gaps exist, performing analysis, and recommending leading practices and appropriate changes.

The penultimate step should be to draw up an action plan in each of the home and host locations. Then, of course, the plan must be executed effectively.

To sum up, to determine that (to the extent possible) risks are mitigated, costs are contained or reduced, and proper compliance is achieved, a company must:

- be aware of the issues, practices, and rules,
- identify key risks,
- formulate a compliance plan, and
- follow through on implementation.

Consider This Scenario

A large U.S.-headquartered company has over 1,000 cross-border employees and 10,000 employees worldwide. The company was sending employees among its various offices in numerous countries across Europe, Asia, and Latin America.

The company was providing, granting, and paying stock options and restricted stock awards to its cross-border employees without any reporting or withholding in the various locations (that is, the company was reporting and withholding only in the location of the employee at the time the equity compensation accrued to the employee). The company was not reviewing the employees' work days in different locations to determine whether they were subject to any cross-border payroll withholding and reporting requirements. While the company was aware of its cross-border withholding and reporting requirements, it did not have the internal resources to address this matter. As the company became aware of the increased compliance requirements in this area, it decided to address these requirements while also trying to build-in automation, because addressing the issues manually was going to be too daunting and very inefficient.

Below are some suggested steps to take and factors to consider for employers whose expatriates participate in equity-based compensation.

Data Gathering and Analysis

(1) Review not only global reporting and withholding requirements but also the internal processes in place for supporting the cost of equity in each location.

(2) Review the risk threshold and the reporting thresholds in each location.

(3) Review both the number of people receiving equity-based awards and the total number awards being granted to determine the scope of the payroll issues to be addressed.

(4) Determine who within the company is responsible for fulfilling withholding and reporting requirements.

(5) Identify the key stakeholders within the company and ascertain their priorities with respect to past, present, and future awards.

(6) Determine what processes (if any) are in place to accurately track both domestic and international travel – in particular, tracking the number of days per year in each location, by expatriate.

(7) Find out how the company's current payroll system handles nonresident withholding and whether it has any international or shadow payrolls in place.

(8) Determine the company's risk threshold.

(9) Determine how the company will handle additional liabilities and reporting from a tax equalization perspective.

(10) What is the company's tax equalization policy on equity in general? Does the company address it in its policy? If it is not equalized, how will the company handle the potential increased taxation that equity plan participants will be subject to?

(11) Decide how any new processes and procedures will be communicated to the employees and whether the stakeholders identified any obstacles or issues that need to be addressed in that regard.

Systems/Processes Development and Implementation and Communication

(1) A taxability matrix outlining the company's withholding and reporting obligations can be prepared and used as a basis for analyzing the company's priorities and current processes/practices.

(2) Discuss process changes with the company's global locations that would be affected, and determine the difficulty of implementing the new process in those locations. Then begin the internal education and communication processes.

(3) Prepare tax cost projections to estimate the potential past tax liabilities involved in order for (1) the auditors to determine whether any reserves should be booked and (2) the company to determine how to address this matter going forward.

(4) Consider and deploy a proven technology tool to automate travel tracking and for determining the global payroll withholding and reporting requirements on the equity compensation.

(5) Roll out communications to employees regarding any new policies and procedures put into place.

Based on our experience working with multinational companies, these are some of the key action steps and procedures that can be undertaken to help pinpoint and address the particular issues a company could be having with its compliance obligations related to its expatriated employees' equity-based compensation. This type of undertaking is well worth the effort. It is important that the company should actively seek to engage the various stakeholders – those within the company as well as external stakeholders/service providers – to assist. Moreover, all stakeholders need to be involved and aware of the issues. And all parties should work together to not only provide the information necessary but also to redress the issues that may have hampered efficiencies and improvements to inputs as well as outputs.

Conclusion

Compensating globally mobile employees has become more creative and complex. We are no longer living in the days of simple salary, benefits, and foreign-service premiums/allowances. Increasingly, equity-based compensation is being used to attract, retain, and incentivize employees, including those taking international assignments. But this trend comes with complications when we consider assignees. Typically, only after the employee leaves on assignment do program managers turn their attention to the many questions and issues that inevitably pop up that would have been better addressed before that employee left. Ignoring the risks of not adequately tracking the different countries that assignees travel to and where they exercise their rights to that compensation (for example, vesting in or exercising a stock option, buying or selling stock) and addressing the unique and ever-changing payroll reporting and withholding requirements in every jurisdiction in which those assignees operate, can be very detrimental, carrying reputational risks as well as potential penalties and other financial costs.

Considering the complex nature of equity-based compensation in a multi-jurisdictional context, it is perhaps not surprising that many companies have struggled to find the most effective way of meeting their obligations. Properly assessing your company's existing processes, procedures, and policies with respect to equity-compensated employees who travel and work overseas and effectively managing the company's (and employees') compliance obligations globally have never been more important.

The author wishes to acknowledge the contributions made by Prisco Morelos and Wendy Oxendine to this article.

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When Employees Perform Services in Multiple U.S. States: The Potential Risk Exposures

by John Montgomery, KPMG LLP, New York City (KPMG LLP in the United States is a KPMG International member firm)

Employees in the United States often will travel to states other than their home state for work. They may travel across state borders as part of their daily commute or travel cross country pursuing sales and marketing opportunities, for training, meetings, conferences, to negotiate contracts, etc. Employees traveling into other states as a part of their business responsibilities can create complex compliance and tax requirements for the employer based upon the amount of time spent in those states. For example, an employer may have an employee who resides in New York and whose primary work location is in New York, but travels to California to perform services as a part of her normal duties.

When an employee performs services in a state, then wages earned by that employee for services performed in the state may be subject to reporting and the withholding of tax on those wages. Regular wages, bonuses, deferred compensation, and equity compensation may all be affected. When an employee resides in one state but works in another – for example, she works in Ohio but lives in Kentucky – each state's withholding requirements and exceptions may apply. But, in general, employers must withhold taxes in the state(s) in which the employee performs services.

Exceptions may relieve employers from the duty to withhold taxes in multiple states for the same employee. These exceptions are usually based on either the existence of reciprocal agreements or de minimis thresholds (under which employers can ignore amounts below a certain breakpoint).

When determining whether to withhold taxes in multiple states or whether they can claim an exemption from withholding, employers with employees who spend time working in more than one state in the United States should consider these factors (in each affected state):

(1) whether the state imposes a state income tax withholding obligation;

(2) specific state income tax withholding requirements for residents and nonresidents;

(3) whether the affected states have a reciprocal taxing agreement; and

(4) whether the state has a de minimis withholding threshold with respect to wages paid to nonresident employees.

Reciprocal Agreements

Employers should consider state reciprocity rules when determining whether to withhold state income taxes on wages earned by an employee performing services in a state where he or she does not reside. In many instances, reciprocal agreements may limit employers' duty to withhold taxes to the state of residence. For example, New Jersey and Pennsylvania have a reciprocity agreement in place.[1] So, employers of New Jersey residents who perform services in Pennsylvania allow the employer to withhold taxes only on the wages earned by the employee in New Jersey. But, absent a reciprocal agreement, an employer must consider the laws and regulations of both the resident and work states.

Reciprocal agreements generally allow an employer to report and withhold state income tax only in an employee's state of residence. Obviously, this eases the administrative burden on both employees and the employer. Note that both employers and employees may have to make specific filings to receive this benefit.

Many states have forms that are required to be completed by employees to request exemption from withholding tax in a nonresident reciprocity state. Employers must retain these forms in employees' files. Failure to produce the required forms upon audit may eliminate the reciprocity benefit for the employee and result in an assessment of taxes to the employer by the work state.

De Minimis Thresholds

A few states have an exception to the withholding of wages on nonresident employees performing services within their jurisdiction. Employers must comply with state laws that require income tax withholding based on employees meeting or exceeding varying types of earnings or work thresholds. Unfortunately, states apply these thresholds inconsistently; they are generally based on factors such as:

(1) the first day of work in that location,

(2) a certain number of days worked in the state, or

(3) a monetary threshold based on the employee's personal exemptions, standard deduction, or filing threshold.

Thirty-seven states' tax laws have no nonresident de minimis thresholds and follow the premise that withholding is required starting with the first day that a nonresident employee works in the state. Thirteen states[2] have implemented some type of a nonresident de minimis threshold for withholding of state income taxes on wages earned by nonresident employees. Some of these states do not apply the threshold to certain types of equity compensation, creating more compliance complexity for employers.

Obstacles to Compliance and Risks of Non-Compliance

Due to the complexity of nonresident withholding rules and regulations, employers are forced to expend considerable time, money, and effort in order to comply with their withholding responsibilities. Because compliance with each state's withholding rules can be burdensome to administer and monitor, companies have adopted varying approaches to address multi-state withholding issues.

Often, a company's payroll system's constraints and limitations prevent or curtail full compliance in this area. In addition, many companies lack the ability to gather information and track their employees' movements into multiple states. Consequently, companies have approached compliance in many ways:

(1) Not complying with the withholding rules no matter how often their employees work in nonresident states or outside their principal work states.

(2) Setting a minimum for dollars earned or for hours or days worked to begin withholding. Once that threshold has been met, catch-up withholdings are calculated.

(3) Withholding on every dollar earned in every state where the company transacts business and where its employees perform services, either regularly or periodically.

(4) Withholding in states that have a more aggressive audit approach.

Some of these approaches can result in a failure to fully comply with each state's laws and regulations on wage reporting and withholding, and can create substantial audit risk, public relations risk, and financial risk. From a financial risk perspective, in addition to penalties and interest on the tax that should have been withheld in a state, an employer may also be held liable for the taxes that should have been withheld from the employee's wages.

Many states have been very aggressive over the last decade in auditing employers for state income tax withholding, with a strong focus on nonresident employees performing services in the state. These audits can result in significant assessments to the employer.

Some companies have taken the following practical measures:

- Establishing manual or electronic time-keeping processes that allow for the timely capture of employee work data by state on a "pay period" basis.
- Requiring managers/supervisors to project, in advance, the number of hours they expect their employees to work outside their resident states on a regular basis (usually monthly or quarterly). They use these projections to allocate wages among the states for withholding purposes, followed by a "true-up" of the actual withholding either quarterly or annually.
- Allocating wages based on time employees spent in particular states in the prior year.
- Monitoring and tracking employee travel via expense reimbursement systems and requiring adjustment or allocation of prior wages consistent with the travel receipts. Note this method is an "after the fact" method of correcting the withholding, not at the time of actual timesheet reporting. It requires matching time with the expenses and an end-of-period "true up," which may violate state regulations and result in assessments, tax liabilities, penalties, and interest based upon the late payment or failure to deposit state income tax withholdings on a timely basis.

Proposed Legislation in the 112th Congress

As a result of the complexity of state rules and regulations, and the burden placed upon employers to comply with each state's wage reporting and tax withholding responsibilities, legislation was proposed in the 112th Congress (HR 1864)[3] to limit states' authority to tax income of employees working outside their home states. H.R. 1864 would have provided that a state, other than the state of an employee's residence, may tax employees that are present in the "nonresident" state to perform employment duties only if the aggregate number of days of employment in the nonresident state during the calendar year exceeded 30. Employees traveling to a nonresident state for fewer than 30 days would have no income tax liability in the nonresident state, nor would the employer have a withholding obligation. But, after the 30-day threshold was reached in a calendar year, the employer would have income tax withholding and reporting obligations for wages earned during every day that the employee was present in the state during the tax year. Under the legislation, the term "employee" would exclude professional athletes, professional entertainers, and certain public figures.

H.R. 1864 would not have covered the issue of allocation of nonresident wages as it relates to supplemental wage payments such as equity and deferred compensation. It remains to be seen whether similar legislation will be introduced in the 113th Congress.

Conclusion

It is not unusual for foreign nationals who come to work in the United States to spend time working in more than one state. "Working" in more than one state can encompass simply a single activity in one other state or a broad range of activities, from attending a training program to participating in a meeting to investigating a potential new market for company operations/activities. But these simple and seemingly innocuous activities can create tax liability and tax compliance exposure for both employees and employers.

While this issue may seem daunting and the compliance risks high, companies can start creating a process to address this issue. States have become assertive when trying to capture taxes that should be (or should have been) withheld and remitted periodically. Managing this compliance process can be very labor-intensive for employers, but a combination of technology tools and a strong service provider can provide the appropriate systems and necessary support to address these compliance issues.

With a comprehensive program to manage multi-state tax withholdings on earnings, employees can focus on the work at hand, and employers can be free of worry about compliance or reputational risk in various jurisdictions.

Footnotes:

1 New Jersey Publication NJ-WT, New Jersey Gross Income Tax Instruction Booklet for Employers (Rev. 12/11), p. 3; Pennsylvania 72 PA Cons. Stat. § 7356(b).

2 As of November 1, 2012, these states have implemented a de minimis threshold below which employers need not withhold taxes on earnings of nonresident employees: Arizona, Connecticut, Georgia, Hawaii, Idaho, Maine, Nebraska, New Mexico, New York, Oklahoma, South Carolina, Utah, and Wisconsin.

3 HR 1864 passed the House of Representatives on May 15, 2012, and was sent to the Senate (S. 3485). S. 3485 was introduced in the Senate Finance Committee on August 2, 2012, and did not pass while the 112th Congress was in session.

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