

*Presenting a live 90-minute webinar with interactive Q&A*

## **Executive Compensation Issues for Foreign Employees: Granting Incentives, Deferred Compensation, Tax Issues, and More**

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TUESDAY, JUNE 15, 2021

1pm Eastern | 12pm Central | 11am Mountain | 10am Pacific

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Today's faculty features:

James P. Klein, Senior Counsel, **Pillsbury Winthrop Shaw Pittman**, New York

Ekaterina (Kate) Napalkova, Partner, **Proskauer Rose**, Los Angeles

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# MULTINATIONAL EXECUTIVE COMPENSATION ISSUES: GRANTING INCENTIVES, DEFERRED COMPENSATION, TAX ISSUES AND MORE

Jim Klein, Pillsbury Winthrop

June 15, 2021 1:00 pm – 2:30 pm EDT

The Pillsbury logo, consisting of the word "pillsbury" in a lowercase, sans-serif font, is displayed in a dark red color on a white rectangular background.

# OUTLINE

- I. Types of Executive Compensation: general overview
- II. Equity Compensation: description, use and tax consequences
- III. Deferred Compensation: description, use, tax and ERISA consequences
- IV. Key considerations for employers in structuring deferred compensation
- V. Administrative challenges

# Presentation

- Each speaker will have comments on each topic
- The time will be split approximately equally
- There will be a question and answer period at the end of the presentation
- Jim Klein's slides will deal mostly with "outbound" situations and tax issues and he will start each of the five topics
- Kate Napalkova's slides will deal mostly with "inbound" situations and will cover benefits/labor issues as well as some tax issues

# I. Types of Executive Compensation

- The first crucial determination on structure: expatriate executive structure or “localized” executive?
- In any structure, another initial determination is: who is the employer? Under home or host principles?
- What role has “secondment” in these structures?

# Expatriate or Localized?

- Will the executive retain home country connection?
- Will the assignment be short (5 years or under) or indefinite?
- Will the position be filled by internal transfer? Local hire? Third country national?
- Can the appropriate package be implemented in the specific location?
- Will competitive pay be measured locally, or from the home country?
- Will taxes be borne as incurred, “equalized” or “protected”?

# Who Is the Employer?

- This is important for many reasons: US tax deduction, US benefit plan coverage, social security coverage/taxes, visa representations, “doing business” and branch presence
- While US and nonUS legal employer can be determined very differently (mostly on common law v. civil law jurisdictions), many of the US tax and nontax rules are generally determined the same (control, 20 factor test, etc.)
- Controlled group can sometimes be important, but consolidated return will decide deductibility of compensation both current and deferred)

# “Secondment”

- Old British military term
- It should only be used with old British soldiers
- It has no meaning in US tax, employment, ERISA or social security law
- Don't use it, and if someone uses it on you, say you don't know what it means (although pronounce it correctly)
- Another confusing term: payroll



# Multinational Executive Compensation Issues: Granting Incentives, Deferred Compensation, Tax Issues and More

**Ekaterina (Kate) Napalkova**  
Partner  
Proskauer

June 15, 2021  
1:00 pm – 2:30 pm ET

Proskauer»

# Types of Executive Compensation: General Overview

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- Different levels / types of compliance:
  - Tax
  - Labor
  - Immigration
  - Securities
  - Federal, State and Local Corporate Law Requirements
  - Payroll
  - Health & Welfare

# Types of Executive Compensation: General Overview

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- General US Structure
  - Cash Compensation
    - Base Salary
    - Annual Bonus
    - Mid-Term / Long-Term Cash Incentives
  - Equity or Equity-Linked Compensation
    - Stock Options (NQSOs, ISOs)/SARs, Restricted Stock, RSUs/PSUs, Phantom Equity
    - Partnership equity or equity-linked compensation (generally, profits interests)
    - ESPPs
  - Deferred Compensation
    - Non-Qualified Deferred Compensation
    - Excess benefit plans (SERPs, Top Hat)
  - Benefits and Perquisites
    - Health & Welfare
    - Perquisites
    - Tax Gross-Ups, Tax Equalization
    - Reimbursement/Expat Benefits

# Types of Executive Compensation: General Overview

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- Compensatory Elements <> Non-Compensatory Features
  - Term contracts
  - Severance/garden leave
  - Restrictive covenants
  - Data privacy
- Important to have holistic view of executive compensation when relocating employees from the US to a non-US jurisdiction or when bringing non-US employees into the US
  - Market practice/expectations
  - Labor laws/labor relations
  - Immigration
  - Disclosure (public company)
  - Restrictive covenants
  - Data privacy
  - Corporate law and corporate tax considerations

# Types of Executive Compensation: General Overview

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- Also important to have holistic view of who is the “employer”
  - Non-US employer may be affiliated with US employer, which may make a difference for certain forms of compensation (e.g., IRC 409A) but not others (e.g., IRC 457A)
  - Certain compensation and benefit plans may need to be amended to cover (or exclude) entities, depending on business goal
  - Impact of non-US employer entity doing business in US – federal, state and local filings may be implicated on the corporate level
  - Choice to place inpatriate or expatriate employee in a U.S. entity or non-U.S. entity is meaningful
- Is there an “employer” / “employee” relationship?
  - Can be particularly important for immigration law issues – for example, when inpatriating a worker from a non-US country to the US, whether the worker is an employee or a non-employee (including a partner) can affect the visa that the worker can qualify for
- Public companies
  - ESG considerations
  - Disclosure
  - NEO status
  - Pay ratio

## II. Equity Compensation

- Stock options, stock grants, restricted stock, RSUs, carried interests all may exist in various jurisdictions, with some similarities in tax result, but some important differences
- Sourcing of gains on stock plans, particularly stock options, can be extremely complex, based usually on location of services, not location of employer
- Limited income tax treaty coverage (addressed later)
- Important role of UK Employee Benefit Trusts (EBTs, important outside UK as well)
- Controversial role of “carried interests”

# Stock Plans Internationally

- Beware stock option plans with discounts, bad measurement dates, zero, nil or token exercise price
- Record keeping can be very problematic; particularly for mobile executives, “final” country can tax all the gain, but the question becomes foreign tax credits
- US-style restricted stock plans require a transfer of legal ownership, with unpredictable results outside the US, particularly with 83b elections

# Employee Benefit Trusts (EBTs)

- Very common in the UK to hold stock for various stock plans (grants, awards, satisfactions, etc.)
- Also common in UK commonwealth countries
- Specific language of the trust agreement must be reviewed
- Can be consider a “funded” plan under US tax and ERISA law, and that’s usually a problem
- Fairly easy fix: convert to employer grantor trust, usually by providing a potential alternative source of satisfying plan obligations

# Carried Interests

- Popular, but under attack in the US
- Like a stock option (really SAR), but with all capital gain
- Very complex partnership structure, with executives having partnership interests in the gain on partnership assets
- Some evidence it works outside the US
- Deduction issues

# Equity Compensation: Description

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- What constitutes equity or equity-linked compensation?
  - Traditional equity or equity-linked compensation
    - Stock Options (in the US – NQSOs, ISOs)
    - SARs
    - Restricted Stock
    - RSUs/PSUs
    - Partnership – Capital Interests, Profits Interests/Carried Interest/LTIP Units
    - Phantom equity (corporation and partnership)
  - Phantom and similar awards
    - Corporation – phantom shares
    - Partnership – phantom units
  - Important to note that certain cash-based awards that track equity can be viewed as a security for US and non-US securities law purposes

# Equity Compensation: Use

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- Typically used in the US to give employee “skin in the game”
- Issues can arise in particular in multinational companies with multiple independent business units
  - Granting equity at the parent level may not incentivize desired behavior or may not be sufficiently targeted
  - Granting equity at subsidiary level may result in complexity, may implicate securities and tax laws

# Equity Compensation: US Tax Consequences

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- Stock Options / SARs
  - Section 409A – discount or zero exercise stock options; term of more than 10 years; “service recipient stock”
  - Consider disallowing grants of stock options to US taxpayers under foreign plans
  - Before inpatriating employees into the US evaluate whether stock options comply and, if not, consider accelerating vesting before inpatriation to avoid 409A consequences
- RSUs/PSUs; phantom interests
  - Section 409A/Section 457A – deferred compensation rules
- Capital Interests
- Profits Interests/Carried Interest
  - Profits interest safe harbor; Section 83(b) election
  - Employee/Partner dynamic – cannot be both in the US
- Section 280G
- Section 162(m) (public companies)

# III. Deferred Compensation

- For executives, deferral of bonus and long term plan gains, less often for pensions
- If the plan is “funded” in the US sense, this characterization will drive the taxable event for the executive, the deduction for the employer and the ERISA exemption for top hat plans
- Funding in the US tax sense is usually decided on the “access to creditors” issue (also call Rabbi trust status)
- On the employer deduction side, one enters the obscure and confusing world of IRC section 404A

# Funded v Unfunded

- Unfunded plans can benefit from the ERISA top hat exemption
- Unfunded plans can often be structured to generate taxable income only at the point of payment (but beware 409A and 457A)
- Unfunded plans only generate a deduction as paid (special exception for 404A)
- Funded plans will generally be taxable by the US when vested
- Funded plans will sometimes be deductible in advance of payment, and sometimes never be deductible (the IRC section 404 defined benefit plan problem, courtesy of Reg. 1.404(a)-12(b)(3) and IRC section 663)

# The Lost World of 404A

- Strange, somewhat incomprehensible tax rule from 1980
- Threatened to be “deadwooded” several times
- Very significant tax effect after passage
- The only provision allowing for deduction for accrued unfunded compensation
- Viewed as overcoming IRS ruling positions
- Regulations tried, but with no result
- Actually used by old, large multinationals



# Deferred Compensation – Section 457A

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## Prohibition on offshore deferred compensation with onerous tax consequences

- Nonqualified deferred compensation arrangement sponsored by a “nonqualified entity” is includible in taxable income when the deferred amount is no longer subject to a 457A “substantial risk of forfeiture”.
- If amount is not determinable at that time, the amount will be subject to tax on the date that the amount first becomes determinable, at which point the tax for the year of income inclusion will be increased by the sum of (1) an additional amount of tax equal to 20% of the amount included in income plus (2) a premium interest tax factor

**If subject to 457A, compensation cannot be structure to comply with 457A**

# Deferred Compensation – Section 457A

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## “Nonqualified Entity”

- No affiliated group concept – employee must be mapped to a legal entity
  - Entity entitled to take corporate income tax deduction under U.S. principles for the compensation of the employee
- Employment structure used to expatriate or inpatriate employees will matter
  - Secondment by/to US domestic entity
  - Direct employment by a foreign entity
- If the employing entity is a “nonqualified entity” for a particular year (determined as of the last day of the employee’s taxable year in which the deferred compensation is no longer subject to a substantial risk of forfeiture), 457A applies to compensation in that year
- Employer’s status as “nonqualified entity” may change from year to year

# Deferred Compensation – Section 457A

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## “Nonqualified Entity” = “tax indifferent” in the US

- Foreign Corporation unless substantially all of its income is (1) effectively connected with the conduct of a trade or business in the US or (2) subject to a comprehensive foreign income tax (i.e., comprehensive income tax treaty/foreign country with a comprehensive income tax and not taxed under materially more favorable regime than the corporate income tax otherwise generally imposed by that country
  - Similar rules applicable to partnerships

# Deferred Compensation – Section 457A

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## **Very narrow short-term deferral exemption**

- Paid within 12 months after the end of the service recipient's taxable year in which the right to compensation is no longer subject to a substantial risk of forfeiture
- Service recipient = entity to which the services are directly provided when right to compensation becomes vested
- Substantial risk of forfeiture exists only if the service provider's right to compensation is "conditioned upon the future performance of substantial services"; performance objectives do not count towards substantial risk of forfeiture analysis

## IV. Employer Considerations

- Will the compensation be deductible?
- Which entity will get the deduction?
- Should some executives be given an expat package and others localized?
- Can localization be part of the employer's executive development program?
- Can tax protection/equalization cover joint return issues? Passive income? Deferred compensation payments?
- Which country's medical plan should apply?

# Employer Considerations

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- **What is the behavior that the compensation is intended to incentivize (or dis-incentivize)?**
- **How does the “payoff” to the company of the behavior compare to the administrative and economic burden of the compensation lever that is chosen? (Ideally, these will balance out.)**
- **What are the optics effects (internal and external)?**
- **What precedent is being set for future inpatriation/expatriation decisions?**

# V. Administrative Challenges

- The role of income tax treaties
- The role of social security totalization treaties
- Tax protection/equalization and the timing of income and reporting
- Reporting of income to the IRS
- Withholding and remittance of withholding

# Income Tax Treaties

- After analysis of US and nonUS taxation, then check if there is a treaty and the key treaty provisions (normally under the Dependent Services clause or the Pension clause(s))
- Highly stylized language; protocols easier to read (but rarely melded)
- Huge exception: the “savings clause” limiting the application of some of the treaty protections for US citizens and/or residents
- Must be claimed

# Social Security Totalization

- Generally sorts out coverage, and “totalizes” benefits
- Classic practice: US expat goes on foreign assignment for under 5 years, stays out of foreign social security and in US social security
- Problems if not validly in US social security
- Some tricks used to avoid high social security taxes (eg, France)
- Benefit deems to be full career, then pro-rated for actual coverage

# Timing of Income and Reporting/Withholding

- Problems particularly for expat assignees
- Executive expects or is promised monthly after-tax pay, just like at home
- Complex issues of advances, non-excludable travel, taxable rental payments, pension accruals, medical reimbursements, treaty protection claims
- Common, but bad, practice: sort out the taxes due after the year closes (and often after assignment ends) and then start filing W-2s, treaty protections, remittance of withholdings, etc.

# Reporting and Withholding

- The problem of the unknown US citizen “walk on”
- Non US employers subject to US rules on W-2 and withholding
- Enforcement once rare, but available through income tax treaties, and now worldwide, through FATCA
- Reporting and withholding must be in USD
- Penalties not too bad *unless the executive doesn't pay the tax*

# Administrative Challenges; Planning Opportunities

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## Laying the Groundwork

- Identify whether expatriate/inpatriate is U.S. citizen or permanent resident
- Identify all compensation in which expatriate/inpatriate participates or may be eligible to participate outside of the US
- Identify the broad goals of the expatriate/inpatriate compensation program

## Identify Plans

- Can/should expatriate continue to participate in U.S. plan? Plan amendment required?
- If expatriate participates in foreign plans, do foreign plans need to be amended to comply with U.S. law?

# Administrative Challenges; Planning Opportunities

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## Tax Considerations

- For inpatriates, identify any compensation that may need to be amended (including acceleration or freezing of vesting) in order to avoid adverse tax consequences.
- Identify which entity will be the direct employer of the expatriate and whether Section 457A is a concern.

## Other Considerations

- For expatriates and inpatriates, confirm that outbound HR records are appropriately protected for local data privacy purposes
- For expatriates and inpatriates, confirm that employment agreements/offer letters are amended to comply with local laws (severance/garden leave, restrictive covenants)



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