Recent legislative updates

This month's issue addresses recent tax and legal changes in various jurisdictions, namely:

- *Philippines*—Potential employer fringe benefits tax imposed on equity compensation
- *Poland*—Recent rulings on the classification of equity compensation
- *United States*—Final regulations clarify when there is substantial risk of forfeiture under Internal Revenue Code Section 83
- *United States*—Compensation plan proposals in Camp tax reform draft

Country summaries

For a more comprehensive discussion, please see *Country Discussions* starting on page 2.

Philippines

Potential employer fringe benefits tax imposed on equity compensation

The terms compensation and fringe benefits have always been broadly defined under existing Philippine tax regulations. As a result, tax treatment is usually left to the interpretation of taxpayers. The distinction between compensation and fringe benefits for equity compensation becomes particularly important when discussing equity compensation granted to supervisory and managerial employees in the Philippines as this distinction can trigger additional employer taxation. This is an area that many companies have been revisiting in order to ensure that their grants to executives do not trigger an employer tax liability.

Poland

Recent rulings on the classification of equity compensation

There are currently no detailed regulations in Polish tax law that govern the taxation of income derived from equity based employee incentive plans. Generally, at the time of the taxable event, the equity income is classified as employment income. However, where the equity plan costs are not recharged to the Polish entity, such income is generally considered as earned from other sources. This treatment is in line with rulings issued by the Polish tax authorities and judgments issued by Polish Administrative Courts.

Recently, PwC has seen cases where companies have been able to obtain favorable rulings from the tax authorities which classify equity income earned under their plans as earned from other sources (even in circumstances where a recharge is in place). The advantage of this is that the employer is

not required to withhold taxes or report the income to the tax authorities and the employee is not subject to any social taxes. Instead, employees are responsible for reporting and remitting any applicable taxes due. PwC Poland can offer guidance and assist with obtaining a favorable ruling for companies recharging their equity plan costs to Poland. The information presented above will not be discussed below under Country Discussions.

United States

Final regulations clarify when there is a substantial risk of forfeiture under Internal Revenue Code Section 83

The Internal Revenue Service (IRS) has issued final regulations that tighten what constitutes a 'substantial risk of forfeiture' under Section 83. Employers who grant stock or capital interests subject to performance-based vesting conditions must now consider the likelihood that the goals will not be achieved and the likelihood that a forfeiture condition will be enforced. The IRS may challenge goals that it deems to be 'easy' to achieve and assert tax upon the grant of the property.

Compensation plan proposals in Camp tax reform draft

Congressman David Camp, the Chairman of the House Ways and Means Committee, has released proposed legislation that would dramatically change the Internal Revenue Code. If enacted, the proposed legislation would reduce or eliminate many existing tax preferences, and reform individual, trust, and corporate income tax rates, including deferral opportunities in nonqualified deferred compensation plans and deductions for executive remuneration.

Country discussions

Philippines

Potential employer fringe benefits tax imposed on equity compensation

Potential employer fringe benefits tax imposed on equity compensation. The terms compensation and fringe benefits have always been broadly defined under existing Philippine tax regulations. As a result, tax treatment is usually left to the interpretation of taxpayers. The distinction between compensation and fringe benefits for equity compensation becomes particularly important when discussing equity compensation granted to supervisory and managerial employees as this distinction can trigger additional employer taxation. Based on the Revenue Memorandum Circular (RMC) No. 88-2012 issued by the Bureau of Internal Revenue on December 27, 2012, equity awards granted to rank and file employees are considered to be compensation while equity awards granted to managerial and supervisory employees may either be considered compensation or fringe benefits depending on how the equity plan is structured.

If equity income is considered to be a fringe benefit, instead of the employee being subject to taxation, employers will be required to pay fringe benefits tax at 32% of the grossed up monetary value of the benefit. While there have been no changes to the existing Philippines tax treatment, based on the current tax climate in the Philippines, there appears to be a greater likelihood that tax authorities may consider equity compensation (to managerial/supervisory employees) to be a fringe benefit as opposed to compensation. There is a lesser chance of this being imposed where there is no recharge of the equity plan costs to the Philippines; however, this position has not yet been tested before the Philippine tax authority. Due to potentially high penalties for non-compliance, this is one area that many companies have been revisiting in order to ensure that their Philippine grants do not trigger an employer tax liability.

PwC Philippines recommend that companies granting equity, particularly to top level executives in the Philippines, have their plans reviewed in order to avoid any unintended consequences.

United States

Final regulations clarify when there is a substantial risk of forfeiture under Internal Revenue Code Section 83

Internal Revenue Code ('the Code') Section 83 provides the rules for taxing property transferred in connection with the performance of services. In general, if property is transferred to an employee or other service provider, the employee recognizes income when the property is no longer subject to a substantial risk of forfeiture, or when the employee can freely transfer the property, if earlier. At that time, the employee will recognize income equal to the fair market value of the property less any amount the employee paid for the property.

In 2012, the Internal Revenue Service (IRS) issued proposed regulations refining the definition of a substantial risk of forfeiture. The IRS indicated at that time the proposed regulations were clarifications to reflect their longstanding view and were not intended as substantive changes. The IRS has now finalized those regulations without making any significant changes from the earlier proposal. Further, the new regulations do not represent a significant departure from prior IRS interpretations of the Section 83 rules.

Under the original regulations under Section 83, a substantial risk of forfeiture existed where the employee's right to the property is conditioned upon the future performance of substantial services or upon the occurrence of a condition related to a purpose of the transfer. A 'condition related to the purpose of the transfer' included a performance-based vesting provision.

The new regulations narrow the scope of what constitutes a substantial risk of forfeiture in two ways. First, the regulations provide that a substantial risk of forfeiture is limited to a service-based restriction or a condition related to the purpose of the transfer. This change is intended to clarify that no other restrictions, such as transfer or sale restrictions, are to be treated as a substantial risk of forfeiture that would delay taxation.

Second, the new regulations limit the scope of the 'condition related to the purpose of the transfer' provision. At the time the arrangement is established, taxpayers must evaluate both the likelihood the forfeiture event will occur and the likelihood the forfeiture condition will be enforced. There will only be a 'substantial' risk of forfeiture if at the time of grant there is a meaningful likelihood the condition will not be achieved. This requirement seems to indicate that certain performance conditions will not create a substantial risk of forfeiture that would postpone taxation. As an example, the preamble to the proposed regulations described a plan providing that stock will be forfeited if gross receipts of the employer fall by 90% over the next three years. In that example, the IRS indicated there was generally no substantial risk of forfeiture.

The amendments are effective on February 26, 2014, the date they were published in the Federal Register. However, the regulations provide that the rules are effective for property transferred on or after January 1, 2013. Please refer to PwC's Human Resource Services Insights for more information.

Compensation plan proposals in Camp tax reform draft

Congressman David Camp, the Chairman of the House Ways and Means Committee, has released proposed legislation ('the Draft') that would dramatically change the Code. Included in the Draft is the proposal to essentially reverse the rules for deferred compensation arrangements under Section 409A and a proposal to repeal the exclusions to the $1 million executive remuneration deduction limit for commissions and performance-based compensation.

Nonqualified deferred compensation limits

Current law imposes rules on when an employee can defer compensation and when the deferred compensation can be paid. If these rules are met, the employee is taxed when the compensation is paid and the employer claims a deduction at that time. Under the Draft, employees, directors and certain independent contractors would be taxed on compensation as soon as receipt of the compensation is not subject to future performance of substantial services. The provision would apply to all nonqualified deferred compensation. The proposal would be effective for amounts attributable to services performed after 2014. The Draft would also:

- replace the rules for deferred compensation arrangements sponsored by taxable entities under Section 409A, tax-exempt entities under Section 457(f), and nonqualified entities under Section 457A, and subject all programs to one set of rules
- require payment of compensation no later than 6 months after the service-based risk of forfeiture lapsed
- grandfather amounts earned through 2014 to allow continued deferral under current programs until 2022 and in 2023 those arrangements would be subject to the new rules

With regards to equity compensation, this proposal will effectively eliminate deferrals of current compensation. Employees will be subject to taxation on equity awards as soon as they are no longer subject to future performance of substantial services (even if they are not receiving their awards until a later period in time). Thus for example, where companies offer the opportunity to defer annual bonuses into equity awards, and those equity awards are not subject to a risk of forfeiture (i.e., you cannot lose the original bonus), such amounts would be taxed at grant.

Deduction for executive remuneration

Under current law, a corporation generally may deduct compensation expenses as an ordinary and necessary business expense. The deduction for compensation paid or accrued with respect to a covered employee of a publicly traded corporation, however, is limited to no more than $1 million per year. For these purposes, a covered employee is currently defined as the chief executive officer and the three named executive officers whose compensation is reported on the annual proxy report but not the chief financial officer. The limits do not apply to compensation paid after the covered employee separates from service. There are exclusions from the $1 million limit for commissions and qualified performance based compensation.

The Draft would repeal the exclusions to the $1 million limit for commissions and performance-based compensation (including stock options and stock appreciation rights) effective for tax years after 2014. The Draft would also:

- revise the definition of covered employee to again mirror the SEC disclosure provisions, thus adding back the CFO
- provide that once an employee qualifies as a covered person, the deduction limitation would apply for federal tax purposes to that person so long as the corporation pays remuneration to such person

Please refer to PwC's Human Resource Services Insights for more details regarding the rest of Congressman Camp's proposed legislation.

Let's talk

For more information about any of these developments, please feel free to contact any of our team members listed below.

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