Taxation of Equity – Based Compensation

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Agenda

- Equity-Based Compensation - Overview
- General Rules of Taxation
- Section 409A
- Other Issues to Consider
Equity-Based Compensation - Overview
## Award Types

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<th>Award Type</th>
<th>Description</th>
<th>Taxable Moment (US)</th>
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<td>Nonqualified Stock Options (NQSOs)</td>
<td>Offer to purchase company shares at a fixed price</td>
<td>Exercise</td>
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<tr>
<td>Statutory Stock Options / Incentive Stock Options (ISOs)</td>
<td>Offer to purchase company shares at a fixed price</td>
<td>Sale</td>
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<td>Stock Appreciation Rights (SARs)</td>
<td>Right to receive value equal to appreciation of company stock</td>
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<tr>
<td>Restricted / Performance Stock Awards</td>
<td>Award of company shares that contain restrictions</td>
<td>Vesting (or Grant)</td>
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<tr>
<td>Restricted / Performance Stock Units (RSUs or PSUs)</td>
<td>Promise to deliver company shares after restrictions lapse</td>
<td>Vesting</td>
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**Equity Grant Practices**

**PwC’s 2012 Global Equity Incentive Survey**

- Overall increase in the percentage of the employee population receiving grants
- Trends in types of equity grants: stock options and restricted stock/restricted stock units
- Predominant drivers remain the same:
Tax Compliance and Planning

- Global increase in tax legislation and audit activity related to equity compensation
- Complexities of mobile employee taxation
- The challenging compliance requirements

- Notable increase in the prevalence of tax issues driving equity compensation this year
General Rules of Taxation
Scope of Application

- U.S. employees of U.S. employers
- U.S. employees of foreign employers
- Foreign employees of U.S. companies that perform services in the U.S.
Incentive Stock Options (ISOs)

- **ISO Requirements**
- **Expiration Dates for Grant and Exercise of Options**
- **Restriction on Disposition**
- **Exercise Price >= FMV at Grant**
- **ISO Plan**
- **Limited to Employees – Directors excluded**
- **US$ 100,000 Limitation on Grants**
- **Options may only be exercised by the employee**

**ISO Plan**
## ISO Example

### Qualified Disposition

- **Sale Price**: $90
- **FMV on Exercise**: $50
- **Grant Date**: $30

**Sale Date**

**Long-Term Capital Gain**

### Disqualified Disposition

**Sale Date**

**Capital Gain**

**Ordinary Income**
Non Qualified Stock Options

NQSO Example

$90 — Sale Price

$50 — FMV on Exercise Date

$30 — Grant Date

Exercise Date

Ordinary Income

Sale Date

Capital Gain

Cost Basis

Beware of Section 409A!
Restricted Stock Example

$90  —  Sale Price

$50  —  FMV on Vesting Date

$30  —  FMV on Grant Date

Ordinary Income

Vesting Date

Capital Gain

Cost Basis

Sale Date
**Restricted Stock – Cont.**

**Effect of Section 83(b) Election**

- **Sale Price**: $90
- **FMV on Vesting Date**: $50
- **FMV on Grant Date**: $30

*Consider planning opportunities!*
Section 409A
What is Section 409A?

Section 409A covers “nonqualified deferred compensation”

Compensation which a service provider has a legally binding right to receive in one taxable year and that is payable in a later year.
Section 409A Applies to..

Section 409A applies to **any U.S. taxpayer**

- U.S. citizens and resident aliens working abroad for either a U.S.–based or a foreign-based employer
- Nonresident or resident aliens working in the U.S. who participate in a plan maintained by current or former employer based in foreign country

**Employer, whether U.S.-based or foreign-based, whose employees are potentially subject to U.S. income tax should always analyze all of its deferred compensation plans for compliance with Section 409A**
What is not deferred compensation?

- Certain **non-discounted** stock options (e.g., ISOs) and SARs (Stock Appreciation Rights)
- **Restricted stock** which is taxed under section 83
- Certain **severance pay plans**
- **Short-term deferrals**: annual compensation paid within 2½ months after the end of the tax year
- **Qualified retirement plans and annuities**
- Certain **foreign benefit plans**
- Certain **medical reimbursement arrangements**
- Bona fide vacation leave, sick leave, compensatory time, disability pay and death benefit plans
Significant consequences imposed in case of violations

- **Income inclusion** in the year of the violation on all compensation deferred for that year and all preceding taxable years

- **Interest** at the underpayment rate plus 1% from the year in which the amount was first deferred or, if later, to the year in which it is included in income

- **Additional tax** equal to 20% of the compensation required to be included in gross income

- Note: **penalties apply to individuals, not the employer**
Other Issues to Consider
Other Issues to Consider...

- TP considerations
- Compliance considerations
Assumptions:

- IL grants its employees with ISOs
- IL has chosen the Trustee Capital Gain route of taxation under section 102 of the ITO.
- Employees exercise the options and sell the underlying stock on the same day ("same day sale")
- Employees retain Israeli tax residency throughout relocation period under Israeli domestic law
**Global Mobility – Cont.**

**Scenario I – Disposition When Optionee is a U.S. Resident**

In Israel:
- Trustee withholds 25% of the entire gain (unless approval from the ITA is obtained)
- FTC allowed for taxes paid in the U.S. on U.S. source income

In the U.S.:
- Federal U.S. tax due (at the marginal tax rate) on entire amount of Compensation Element
- FTC allowed for taxes paid in Israel on Israeli source income
Global Mobility – Cont.

Scenario II – Disposition When Optionee is an Israeli Resident

In Israel:
- Trustee withholds 25% of the entire gain (unless approval from the ITA is obtained)
- FTC allowed for taxes paid in the U.S. on U.S. source income

In U.S.:
- Federal U.S. tax due (at the marginal tax rate) on U.S. source portion of Compensation Element
- Reporting requirements apply!
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Thank you!

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