TAX 101:
TAXATION OF EQUITY-BASED COMPENSATION AND CROSS BORDER ISSUES

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Equity-based compensation has long been a popular way to attract talent and align the interests of corporations and service providers. Offering this type of compensation allows cash-poor companies, and especially tech companies, to attract highly skilled individuals to join their workforce and board of directors. And with global expansions and (pre-pandemic) ease of travel, employees and executive's mobility is on the rise. This results in non-U.S. citizens moving to the U.S. and becoming, even if only temporarily, U.S. tax residents at the time that their equity-based grants, made years before they moved, vest or are ripe for exercise. Further, U.S. citizens living away from the U.S. are granted equity-based compensation in local non-U.S. companies, and such grants may give rise to tax in the U.S. at a different time than for local purposes. This Tax 101 article will examine how the different types of equity-based compensation are taxed in the U.S. and discuss some cross-border issues relating to such compensation.

STATUTORY FRAMEWORK

Individuals and entities that perform service are taxed in the U.S. on the U.S. source portion of the compensation received whether the compensation is paid in cash or in property. U.S. citizens and U.S. residents would also be taxed on any foreign source compensation income. For individuals, who are mostly taxed on a cash basis, cash and non-cash compensation is included in tax when it is received or is considered to be received (constructive receipt). Compensation income is generally sourced based on where services were physically performed. Typically, the source of multi-year compensation is apportioned between the U.S. and a foreign country based on the relative days worked in each place. For a U.S. citizen and U.S. resident the distinction between compensation income from services performed outside the U.S. (foreign sourced income) and compensation for services performed within the U.S. (U.S. sourced income) is relevant for purposes of determining eligibility for foreign tax credits should foreign taxes be imposed on such compensation income. For a non-U.S. citizen who may have compensation income from U.S. source, the income is taxed in the U.S. as effectively connected income at graduated rates on a net basis (subject to modification by treaty).

When property received as compensation is subject to substantial risk of forfeiture, U.S. taxation is generally deferred. Code §83[1] applies to transfers of property in connection with performance of services. The general rule provides for deferred

[1] All references are to the Internal Revenue Code of 1986, as amended.

taxation until the property received is not subject to a substantial risk of forfeiture.[2] When company shares are received as compensation for services performed and to be performed, they are typically not received free and clear but rather subject to a vesting schedule and other conditions. In such circumstances, U.S. tax will not be imposed at the grant of such property. Once the restrictions are removed, U.S. taxation is imposed. At such time, the excess of the fair market value ("F.M.V.") of the property (measured at such time and without regard to the restrictions imposed, except for restrictions that will never lapse) over the amount paid for the property, if any, is subject to tax as compensation income (ordinary income rates).[3]

Code §83(b) allows for an election to include in gross income the F.M.V. of the property received at the time it is received, notwithstanding that it is still subject to substantial risk of forfeiture. This allows electing taxpayers to close the compensation element in relation to the stock received at such time and allows the subsequent appreciation to go untaxed until such time as the stock is sold; at which time, the gain will be considered capital gain. The election, which must be made within 30 days of the grant, requires the taking of a chance. The forfeiture provision may actually occur and the transferred property, for which income tax was paid, may never become vested, or the F.M.V. of such property may decrease by the time it is vested. If this happened, no deduction or credit is allowed (other than a capital loss for amounts paid to acquire the property). An election cannot be revoked except with the express consent of the I.R.S.[4] However, if the price required to be paid for the property is close to the F.M.V., or if the F.M.V. is insignificant at the time of the grant, little to no tax will be due as a result of the election, reducing the risk associated with the election and making it an important planning tool.

Code §83 addresses the tax consequences of the transfer of property in a compensatory setting. It requires a transfer of property, meaning that the grant must be of a property, not a promise to pay or transfer property, and the recipient must be considered the beneficial owners of the property. Code §409A addresses the tax consequences of nonqualified deferred compensation. This may include contractual promises to transfer property in the future, which would not be immediately subject to Code §83.[5] If Code §409A applies to a compensation plan and the plan does not meet the requirements of the provision, the compensation is taxed when there is no substantial risk of forfeiture. The income is ordinary income and an additional 20% is imposed. Underpayment penalty interest may also apply, and every year between vesting and exercise, the unrealized appreciation may be subject to tax. Code §409A is complex and is not the focus of this article. It is addressed here in general terms only.

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[2] To be taxed under Code §83, property received must be either transferrable or not subject to substantial forfeiture. However, property is considered transferrable only if the transferee's rights in the property are not subject to a substantial risk of forfeiture. Therefore, in most cases the transferability factor is not an independent one.

[3] The regulations provide for various ways of valuing stock. Obtaining a letter from the Company stating the value of its stock should generally be acceptable.

[4] Revocation was allowed by the I.R.S. when there was a mistake of fact as to the value of the property transferred and the employer and employee agreed to rescind the underlying transaction in the year it occurred.

[5] A plan that only allow for short term deferral of no more than 2½ months after the end of the year in which it vests, are exempts from the treatment of "deferred compensation."

TYPES OF EQUITY-BASED COMPENSATION

Generally, the most common equity-based compensation plans include the grant of one or more of (i) stock, including restricted stock, (ii) stock options, (iii) stock appreciation rights ("S.A.R."), and (iv) restricted stock units ("R.S.U.").

The grant of company stock as compensation is fairly straightforward. Stock is ordinarily granted subject to transferability restrictions and a vesting schedule so as to tie an individual to the company for a certain number of years. Once the stock vests, it is often freely transferrable (unless security law restrictions apply). The recipient may be asked to pay for the stock or not, depending on the plan terms. If payment is required, the payment is made at the grant.

Stock options on the other hand, provide the holder the option – but not obligation – to purchase a set number of the underlying stock at a set price (generally, the F.M.V. at the time of the grant) at some time in the future. If the F.M.V. of the underlying stock is higher than the set purchase price (known as the strike price or exercise price), the holder will ordinarily choose to exercise the option. Unless the plan provides for a "cashless exercise" actual payment for the underlying stock is generally required at the exercise.[6]

Stock option plans may be statutory ("qualified")[7] or non-statutory ("nonqualified"). When non-qualified options are granted, the recipient will have a taxable event upon exercise. When qualified options are granted, notwithstanding the compensatory element, for policy reasons, taxation is deferred. When stock options are granted by a foreign company, in most likelihood the plan under which the options are granted will not meet the restrictive statutory rules of the Code and be treated as non-qualified.[8]

Like stock options, S.A.R. also benefit the recipient by the increase in stock price. But unlike a stock option, a S.A.R. typically does not result in ownership of the underlying stock and a net amount (after reduction of the exercise price) equal to the appreciation in the stock value is paid. S.A.R. may be settled in company stock.

Lastly, R.S.U.'s award the holder with a payment, in cash or company stock, equal to the value of a specified number of company shares. In contrast to the grant of stock or restricted stock, until an R.S.U. is settled, it is merely a promise, a contract for future payment.

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6 It is common however for an employer to facilitate the exercise by either allowing a cashless exercise where the holder exercises and immediately sells sufficient stock to pay the exercise price or by providing a net-share settlement that allows the holder to receive shares with value equal to the intrinsic value and without the need to exercise and sell.

7 Special rules apply to options granted under Code §422 (Incentive Stock Options) and new Code §83(i) (Qualified Equity Grants).

8 While U.S. based stock option plans may also be non-qualified, a U.S. plan will provide on its terms if it meets the statutory requirements. Unfortunately, most non-U.S. plans will not address U.S. tax matters and thus will be silent. Reviewing plans for compatibility with statutory requirements is a significant effort and considering the restrictive rules, foreign plans are typically assumed to be non-qualified.

U.S. TAXATION OF RESTRICTED STOCK

As mentioned above, the transfer of property for services is taxed under Code §83. As a result, no U.S. tax applies until the restrictions are substantially removed. At such time, the spread between the F.M.V. of the stock (measured at such future time) and the basis in the stock (the price paid for the stock at the grant, if any) will be subject to tax as compensation income.

A recipient of restricted stock has the choice to include the compensation income in the gross income for the taxable year of the grant by making an election under Code §83(b). If this election is made, the F.M.V. of the stock received at the time of the grant (determined without regard to any restrictions, except those that never lapse) in excess of the amount paid for the stock, if any, is included in gross income. The election must be made within 30 days and no late election relief is available. When the amount required to be paid equals or is close to the F.M.V. at the grant, an election is ideal as no tax, or almost no tax, is imposed. The benefits of the election are that subsequent appreciation in value are not taxed until the stock is disposed, and when taxed, are taxed as capital gain. On the other hand, if the stock is granted for free, but is subject to significant restrictions, including the compensation income in gross income without disposition or certainty that in the future the stock will be worth more may be a significant burden and may result in no election being made.

Because the income, when included, is compensation income, if a non-U.S. citizen performed services in the U.S. for some time between the grant and the vesting, some of the income will be U.S. source and be subject to U.S. taxation even though the individual was not a U.S. tax resident when the stock was granted or may no longer be a U.S. tax resident at the time the stock vested. Additionally, if such individual's country of residence taxes the income while the individual is temporarily in the U.S., or simply at a different time (for example, upon the grant), double taxation may arise.

Restricted stock is not "deferred compensation" in the context of Code §409A.[9]

Lastly, when restricted stock in a foreign corporation is granted to a U.S. citizen or U.S. resident, the stock must be reported on Form 8938, *Statement of Specified Foreign Financial Assets*, and of Form 5471, *Information Return of U.S. Persons With Respect to Certain Foreign Corporations,* if the stock received meet the filing requirements. Additional compliance matters may be applicable.

U.S. TAXATION OF NON-QUALIFIED STOCK OPTIONS

When a stock option is granted no property is actually transferred (unless the option is actively traded on a securities market). Therefore, Code §83 does not apply to the grant of the option.[10] Therefore, neither the grant nor the vesting (removal of risk of forfeiture) is a taxable event. Instead, options are taxed when exercised, *i.e.*, when stock is purchased for a price lower than its F.M.V., the spread is subject to tax as

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[9] Treas. Reg. §1.409A-1(b)(4)(B).

[10] Code §83(e)(3) specifically excludes the applicability of the section with respect to transfers of options without readily ascertainable fair market value.

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compensation income.[11] While the F.M.V. of the stock may significantly appreciate over the period between the grant and the exercise, there is no election available to choose to include the F.M.V. of the underlying stock in income at the grant and close the compensatory element at such time. The compensatory element remains open until the option was exercised. At such point, if the purchased stock is subject to further restrictions, Code §83 will apply.

An exception applies if the option granted has a "readily ascertainable F.M.V." In such cases, which are very limited, the grant of the option is the grant of a property and thus subject to Code §83. In these limited cases, the grant of the option would be immediately taxed (unless subject to substantial risk of forfeiture). An option can be granted with a readily ascertainable F.M.V. only when the underlying stock is publicly traded and the option itself is actively traded as well. Additionally, if the granted option includes additional restrictions the I.R.S. is likely to argue the options are not identical and that the granted option does not have the same "ascertainable F.M.V." as that of the traded option.

Stock options are a form of deferred compensation and must fit within an exception to avoid being subject to Code §409A. An option issued at a discount is subject to Code §409A. Therefore, in the U.S., most companies will issue options with strike price not lower than the F.M.V. of the underlying stock at the date of the grant. However, foreign issuers may be unaware of the perils of Code §409A and may issue options at a discount. For the U.S. citizen holders this may trigger adverse tax results, including income inclusion at the time the option vests irrespective of exercise, and annually thereafter.[12] A non-U.S. individual moving to the U.S. should review his deferred compensation arrangements to determine if any action should be taken prior to becoming a U.S. tax resident subject to Code §409A.[13]

Again, because the income included at exercise is compensation income, if any portion of it is U.S. source, non-U.S. individuals would be subject to U.S. tax. Because the source rules generally apportion the income among the working days between the grant day and the vesting day, not the exercise date, but the taxable event occurs at the exercise date, a non-U.S. individual may find that 100% of the income is subject to U.S. taxation notwithstanding such individual may have already left the U.S. Because the timing of taxation of stock options among different countries may be different, double taxation is a risk for U.S. citizens as well. For U.S. citizens, U.S. tax applies whether the income is U.S. source or foreign source. But a citizen living in a different country may have a second tax imposed on the same option, at a different point in time. Depending on the source of the income, foreign tax credit may or may not be available to offset all or some of the U.S. tax.[14]

Lastly, the holder of an option to purchase stock in a foreign corporation should report the option on Form 8938, *Statement of Specified Foreign Financial Assets*.

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[11] However, when an option is granted in non-compensatory context, such as in connection with an investment in a company or when an option is bought on an established securities market, the exercise of the option is not a taxable event.

[12] All taxes paid under Code §409A are added to the basis in the option so that when the option is exercised previously taxed amount will not be taxed again.

[13] However, non-U.S. individuals may be eligible for a one-year grace period in which they can make necessary amendments or elections.

[14] The Code allows individuals to utilize unused foreign tax credits by carrying it back one year and carrying it forward 10 years.

U.S. TAXATION OF S.A.R. AND R.S.U.

As mentioned above, the grant of S.A.R. is merely a grant of a contractual right. Therefore Code §83 (and the election thereunder) does not apply until, and to the extent, that the S.A.R. is settled using stock. Upon exercise, when the S.A.R. is settled, compensation income is included in the holder's gross income.

Similar to the grant of a S.A.R., the grant of an R.S.U. is not subject to Code §83. Therefore, despite the similar name, R.S.U., unlike restricted stock, is not eligible for a Code §83(b) election. Tax will be imposed at the time the R.S.U, is exercised, and at such time, if stock is received, Code §83 may be applicable.

Both S.A.R.'s and R.S.U.'s are forms of deferred compensation that may trigger the applicability of Code §409A and must be reviewed for compliance or the applicability of an exception.

The holder of S.A.R. or R.S.U. in a foreign corporation should report it on Form 8938, *Statement of Specified Foreign Financial Assets*.

CONCLUSION

When equity-based compensation is received, tax could apply at three different points in time (at grant, at vesting, or upon exercise) When more than one country is involved, tax could apply at different points of time. Occasionally, and especially when a foreign issuer is involved, equity-based compensation may be denominated as one form of compensation (*e.g.*, "an option") but resemble more a different type (*e.g.*, "restricted stock"). The difference in treatment may affect the taxation of the compensation in the U.S. and the ability to make a Code §83(b) election. Recipients should make sure that the form fits their tax goals. For example, when a foreign company grants a U.S. service provider stock options with a *de minimis* strike price, it may be more appropriate to treat the grant as a grant of stock and consider the making of a Code §83(b) election if the "options" are not vested; The holder will be well served if the grant letter states the U.S. treatment explicitly to avoid an alternative treatment by the U.S. taxing authorities.

Whether treated the same under the laws of the two jurisdictions or differently, cross-border equity-based compensation may be subject to double taxation and should be reviewed carefully, and to the extent possible, make appropriate elections in an attempt align the recognition of income in both jurisdictions.

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