Designing Equity Compensation Abroad (Focus on Recharge Agreements)

Presentation for:
Executive Compensation Webinar Series
May 11, 2017

Presented by:
Anthony J. Eppert
713.220.4276
AnthonyEppert@AndrewsKurth.com

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Housekeeping: About Anthony "Tony" Eppert

Anthony Eppert
Partner
Andrews Kurth Kenyon LLP
Tel: +1.713.220.4276
Email: AnthonyEppert@AndrewsKurth.com

- Tony practices in the areas of executive compensation and employee benefits
- Before entering private practice, Tony:
  - Served as a judicial clerk to the Hon. Richard F. Suhrheinrich of the United States Court of Appeals for the Sixth Circuit
  - Obtained his LL.M. (Taxation) from New York University
  - Obtained his J.D. (Tax Concentration) from Michigan State University College of Law
    - Editor-in-Chief, Journal of Medicine and Law
    - President, Tax and Estate Planning Society

Our Compensation Practice – What Sets Us Apart

- Compensation issues are complex, especially for publicly-traded companies, and involve the substantive areas of:
  - Tax,
  - Securities,
  - Accounting,
  - Governance,
  - Surveys, and
  - Human resources

- Historically, compensation issues were addressed using multiple service providers, including:
  - Tax lawyers,
  - Securities/corporate lawyers,
  - Labor & employment lawyers,
  - Accountants, and
  - Survey consultants

Our Compensation Practice – What Sets Us Apart (cont.)

- At Andrews Kurth Kenyon LLP, we have a holistic and full-service approach to compensation matters, that considers all substantive areas of compensation, including:

Housekeeping: Upcoming 2017 Webinars

- Upcoming 2017 webinars:
  - Expatriate & Secondment Agreements: Top 10 Issues to Consider (6/8/2017)
  - Pay Ratio Disclosure Rules: The A-Z Training Course (7/13/2017)
  - Trends in Designing Performance-Based Equity Awards (8/10/2017)
  - Preparing for Proxy Season: Start Now (Annual Program) (9/14/2017)
  - How to Properly Design a Nonqualified Deferred Compensation Plan (10/12/2017)
  - Navigating Employee v. Independent Contractor Classifications (11/9/2017)
  - Sharing the Dream: M&A Transactions & Retaining Key Employees (12/14/2017)

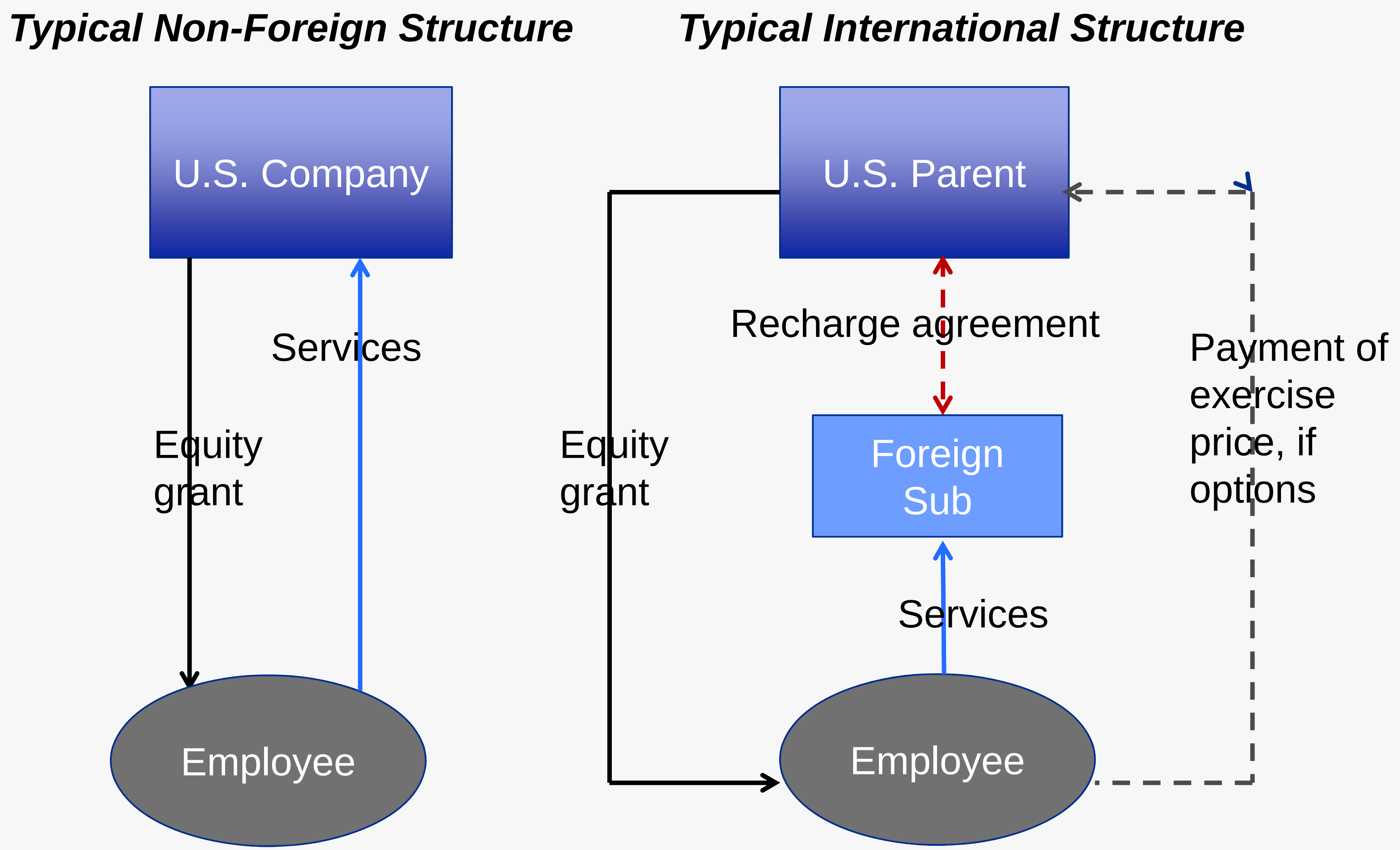
- Upcoming 2018 webinars
  - To be determined
  - Suggestions welcomed!

Purpose of this Webinar

- The purpose of this webinar is to discuss design issues that should be considered when granting equity awards to employees in foreign jurisdictions, with a particular focus on recharge agreements

- To that end, this webinar discusses:
  - Typical structure,
  - Prevalent types of awards,
  - Recharge agreements,
  - Data security,
  - Securities laws,
  - Exchange controls,
  - Entitlement issues, and
  - Certain other issues

Overview: Typical Fact Pattern



Overview: Prevalent Types of Awards

- Care should be taken in choosing the type of award that is to be provided to the employees of a foreign subsidiary
  - The type of award could have local securities implications
  - The type of award could have varying tax consequences, for example, depending upon the jurisdiction a restricted stock award could be taxed at the date of grant even if it remains subject to a vesting schedule

- Typical forms of awards in the international context are the obvious, including:
  - Stock options,
  - Restricted stock awards,
  - Stock-settled RSUs and SARs,
  - Cash-settled RSUs and SARs,
  - Bonus stock,
  - Cash awards, and
  - ESPPs and ESPP-like arrangements

Recharge Agreements: Background

- Unless specific action is taken, when a U.S. parent corporation grants equity to the employees of a foreign subsidiary, the U.S. parent is not entitled to a compensation deduction under U.S. tax laws because it is not the service recipient
  - Instead, the foreign subsidiary would be entitled to a tax deduction under U.S. tax laws equal to the fair market value of the U.S. parent's stock that is transferred to the foreign subsidiary's employees [*see* Treas. Reg. 1.83-6(a)(1)]

- And many times the foreign subsidiary is not entitled to a tax deduction under applicable foreign laws because the foreign subsidiary did not incur a "cost"

- In these instances, many U.S. companies will enter into a recharge agreement (*a.k.a.*, charge-back agreement or reimbursement agreement) with the foreign subsidiary whereby the latter reimburses the former for the "cost" of the equity

- A recharge agreement could:
  - Allow the foreign subsidiary to capture a deduction for the "cost" under applicable foreign laws; and
  - Allow the U.S. parent to receive the monies from the foreign subsidiary free of U.S. taxation (essentially acting as a tax-free repatriation of cash)

Recharge Agreements: Basic Fact Pattern and Problem

- Basic fact pattern
  - U.S. company grants equity awards to one or more employees of its foreign subsidiary

- Basic problem
  - Under Sections 83 and 1032 of the Code, the grant is deemed to be a contribution of capital from the U.S. parent to the foreign subsidiary, followed by the payment of compensation from the subsidiary to the employee
  - Under Section 83(h) of the Code, only the service recipient (i.e., the foreign subsidiary) is entitled to a compensatory tax deduction
  - In other words, the U.S. parent would not be entitled to a deduction because the U.S. parent is not the service recipient
  - However, in many foreign jurisdictions a deduction would also not be available to the foreign subsidiary because it did not incur a "cost"

Recharge Agreements: Basic Solution and Result

- Basic solution
  - In order to incur a "cost" to the foreign subsidiary, the U.S. parent and its foreign subsidiary could enter into a "recharge agreement"
  - Under the recharge agreement, the foreign subsidiary agrees to reimburse the U.S. parent for the value of the equity award that will be granted to the employees of such foreign subsidiary
    - For appreciation-only awards, the value is typically determined as the spread between the strike price and the FMV at the time of exercise
    - For full-value awards, the value is the FMV at the time of vesting

- The desired result
  - The foreign subsidiary incurs a "cost," that if structured correctly, could result with a corporate tax deduction for the foreign subsidiary
  - Additionally, the U.S. parent receives cash equal in approximate value to the value of the equity that was transferred to the foreign subsidiary's employee
  - Finally, the funds transferred from the foreign subsidiary to the U.S. parent should be protected from U.S. taxation under Section 1032 of the Code (*i.e.*, a company recognizes no gain or loss upon receiving cash for its stock)
    - ➢ In effect, a recharge agreement effectuates a tax-free repatriation of funds from the foreign subsidiary to the U.S. parent

Recharge Agreements: Basic Fact Pattern

- Factual example assuming the award takes the form of stock options
  - U.S. parent corporation grants an option to acquire 10 shares of stock to the employee of its foreign subsidiary
  - The strike price is equal to the FMV of the underlying stock as of the date of grant, which is $1.00 per share
  - As of the date of exercise, the FMV of the underlying stock is $4.00 per share, resulting in a spread of $3.00 per share

- Prior to the date of grant, the U.S. parent corporation enters into a recharge agreement with the foreign subsidiary to provide for a payment from the foreign subsidiary to the U.S. parent:
  - Such payment being equal to the spread
  - The timing of such payment to coincide with any exercise of stock options by employee/optionees of the foreign subsidiary

- Upon an exercise of the stock option, the U.S. parent corporation would receive $10.00 from the optionee (*i.e.*, $1.00 strike price per share x 10 shares) and $30.00 from the foreign subsidiary corporation (*i.e.*, $3.00 spread per share x 10 shares), the latter pursuant to the recharge agreement

Recharge Agreements and Specific U.S. Tax Analysis

- The following analysis results when a U.S. corporate parent transfers its stock to employees of its foreign subsidiary:

- **#1 ---** The stock transfer is deemed to be a contribution of capital by the U.S. parent to the foreign subsidiary
  - The U.S. parent is deemed to have contributed the property to the capital of the foreign subsidiary as a capital contribution, and the foreign subsidiary is deemed to have transferred the property to the employee [*see* Treas. Reg. 1.83-6(d)(1)]
  - The U.S. parent should recognize no gain or loss on the deemed contribution of capital [*see* Section 351(a) of the Code]
  - The foreign subsidiary should recognize no gain or loss on its deemed receipt of U.S. parent stock

Recharge Agreements: U.S. Tax Analysis (cont.)

- **#2 ---** To avoid application of the carryover basis rules of Section 362 of the Code (which would require the foreign subsidiary to likely have a $0.00 basis in the U.S. parent's stock since the U.S. parent would not likely have any basis in its newly issued stock), the following is deemed to occur immediately prior to the transfer from the foreign subsidiary to the employees [*see* Treas. Reg. 1.1032-3]*:*
  - The U.S. parent is deemed to have contributed cash to the foreign subsidiary in an amount equal to the fair market value of the transferred U.S. parent stock; and
  - The foreign subsidiary is deemed to have purchased the stock of the U.S. parent at fair market value with the cash contribution it is deemed to have received

- The result of #2 (above) is that under Section 1012 of the Code the foreign subsidiary would have a cost basis in the transferred stock of the U.S. parent equal to its then fair market value [*see* Treas. Reg. 1.1032-3(b)(2), (e) Ex. 5]

Recharge Agreements: U.S. Tax Analysis (cont.)

- **#3 ---** The result of #1 and #2 (prior slides) is that the U.S. parent's tax basis in the stock of its foreign subsidiary is increased by the fair market value of the stock that is deemed to have been contributed to such foreign subsidiary, less the amount of any reimbursement the U.S. parent receives under any recharge agreement [*see* Section 358 of the Code]. This means that either:
  - If the U.S. parent is fully reimbursed under a recharge agreement for its deemed contribution, then the U.S. parent would not increase its basis in the foreign subsidiary stock; or
  - If the U.S. parent is NOT fully reimbursed under a recharge agreement, then the U.S. parent would increase its basis in the foreign subsidiary stock by the spread that is not reimbursed

- **#4 ---** A recharge agreement can facilitate a tax-free repatriation of cash
  - According to Priv. Letter Ruling 201014049, if a recharge agreement is used in connection with the above, then the reimbursement payment that the U.S. parent receives would not constitute a distribution with respect to the foreign subsidiary's stock. This means that:
    - There would be no distribution under Section 301 of the Code, and
    - The U.S. parent would not recognize any taxable income due to its receipt of any cash under the recharge agreement

Recharge Agreements: Cost Benefit Analysis

- Properly implementing recharge agreements in conjunction with a global equity program takes time and has an associated cost for administrative support and the support of outside professionals

- A cost benefit analysis should be performed to determine whether cash flow benefits would result because the foreign subsidiary would pay less foreign jurisdictional taxes
  - Obviously, the effective tax-free repatriation is a benefit

Recharge Agreements: “Incur” a Cost

- The ability of the foreign subsidiary to recognize a foreign deduction equal to the fair market value of the stock being transferred by the U.S. parent to the employees of the foreign subsidiary will vary from country to country
  - In a few countries, a recharge agreement is not necessary in order for the foreign subsidiary to recognize a deduction (*e.g*., the United Kingdom)
  - In a few other countries, no deduction is available to the foreign subsidiary even if a cost is incurred (*e.g.*, Canada, Netherlands)

- However, in many foreign jurisdictions a foreign deduction is available if:
  - The foreign subsidiary is financially responsible for the costs of the U.S. parent stock that is awarded to the employees of the foreign subsidiary,
  - Such responsibility is documented with a recharge agreement, and
  - Such recharge agreement is in place before the date of grant (such timing of entering into the recharge agreement is required in many countries)

- Keep in mind that even in instances where a foreign deduction is not available to the subsidiary, the tax-free repatriation of cash may still be beneficial to the U.S. parent

Recharge Agreements: Issues to Consider

- A determination needs to be made on whether the “cost” is limited to the spread (if stock options) or full fair market value
  - Additionally, should start-up costs, administrative costs and/or social insurances be included in the cost?

- A determination needs to be made as to whether the foreign jurisdiction requires the foreign subsidiary to withhold tax on the amount of any reimbursement to the U.S. parent that is made pursuant to a recharge agreement
  - Such a requirement applies in some countries

Securities Requirements and Exchange Controls

- Securities compliance could require the issuance of a prospectus in conjunction with the award
  - A filing with jurisdictional authorities may also apply

- Exchange controls are found in many foreign jurisdictions
  - Exchange controls are the restrictions applied by a foreign government that regulate the flow of cash and certain property to and from such foreign country

- If exchange control rules apply, approval from the foreign government is generally required (though sometimes only a notification to such foreign government is required)
  - For example, cash flow that results when employees of the foreign subsidiary exercise a stock option, and the exercise price flows to the U.S. parent
  - As another example, cash flow that results when a foreign subsidiary remits cash under a recharge agreement

Data Privacy

- Consider that the typical fact patter is that the equity incentive program is administered at the U.S. parent entity

- Foreign jurisdictions typically have data privacy rules that are more robust than U.S. laws and could apply to the foreign subsidiary’s transfer of employee data to the U.S. parent entity (data privacy refers to prohibitions on the transmission of employee specific personal information such as name, age, seniority, etc.)

- For the above reasons, employee consent to the transfer of data is recommended

- Foreign jurisdictions vary on whether or not governmental approval of such transmissions is necessary or whether it is sufficient to have only the consent of the employee

Entitlement Issues

- Foreign laws should be consulted to determine whether the employer can terminate the equity plan at any time in the future without jeopardizing an accrued right in favor of the employee
  - If the right to the equity is an accrued benefit, then consent of the employee is likely required before the plan could be terminated

- Another issue relating to entitlement is whether the value of the equity compensation must be used to determine an employee's severance pay

- Remember to have a provision in the equity award whereby the employee specifically acknowledges and agrees that the equity award is NOT an entitlement. For example, have the employee specifically agree that:
  - Participation in the plan is discretionary, and
  - That termination of employment will result in the loss of unvested stock

Other Issues

- Is electronic execution of the documents by the foreign subsidiary’s employees permissible

- Is the foreign subsidiary allowed to satisfy any withholding by withholding from the foreign subsidiary’s employee’s salaries

- Is the equity plan document and related materials required to be translated into the local non-English language

Document Considerations

- Sub-plan considerations
  - Typically, grants to employees of foreign subsidiaries will be pursuant to a sub-plan to the U.S. parent's equity incentive plan, with such sub-plan being specific to a particular foreign jurisdiction

- Award agreement considerations to address include:
  - Labor laws
  - Data privacy
  - Venue

Don’t Forget Next Month’s Webinar

- Title:
  - Expatriate & Secondment Agreements: Top 10 Issues to Consider
- When:
  - 10:00 am to 11:00 am Central
  - June 8, 2017

Firm Locations

AUSTIN
111 Congress Avenue
Suite 1700
Austin, TX 78701
P +1.512.320.9200
F +1.512.320.9292

BEIJING
Room 2007, Capital Mansion
No. 6 Xin Yuan Nan Lu
Chao Yang District
Beijing, China 100004
P +86.10.8486.2699
F +86.10.8486.8565

DALLAS
1717 Main Street
Suite 3700
Dallas, TX 75201
P +1.214.659.4400
F +1.214.659.4401

DUBAI
Andrews Kurth (Middle East) DMCC
45th Floor
Mazaya Business Avenue, BB2
Jumeirah Lakes Towers
P.O. Box 118273
Dubai, UAE
P +971.4.567.0767
F +971.4.567.0768

HOUSTON
600 Travis Street
Suite 4200
Houston, TX 77002
P +1.713.220.4200
F +1.713.220.4285

LONDON
Andrews Kurth (UK) LLP
16 Old Bailey
London EC4M 7EG
United Kingdom
P +44.20.3053.8300
F +44.20.3053.8299

NEW YORK – BATTERY PARK
One Broadway
New York, NY 10004
P +1.212.425.7200
F +1.212.425.5288

NEW YORK – MIDTOWN
450 Lexington Avenue
New York, New York 10017
P +1.212.850.2800
F +1.212.850.2929

RESEARCH TRIANGLE PARK
4505 Emperor Boulevard Suite
330 Durham, NC 27703 P
+1.919.864.7200

SILICON VALLEY
1801 Page Mill Road
Suite 210
Palo Alto, CA 94304
P +1.650.384.4700
F +1.650.384.4701

THE WOODLANDS
Waterway Plaza Two
10001 Woodloch Forest Dr.
Suite 200
The Woodlands, TX 77380
P +1.713.220.4800
F +1.713.220.4815

WASHINGTON, DC
1350 I Street, NW
Suite 1100
Washington, DC 20005
P +1.202.662.2700
F +1.202.662.2739