Long-Term Incentives: Mastering The Challenges Of Tax

Designing an effective employee remuneration structure is critical to the success of any business. The remuneration structure is an investment decision where an employer and its shareholders choose how much of the company's money they are willing to spend or how much shareholder dilution they are willing to accept with the expectation that this cost or dilution will increase the overall profitability of the business and build shareholder value. In practice, the decisions around remuneration are highly complex and the return on investment is impossible to accurately measure. Whilst there is empirical evidence to suggest that businesses with long-term incentives tend to show higher growth, it is much harder to quantify how much shareholder value an incentive really delivers. In practice, the performance of a business will always be driven by a host of factors.

As businesses become more complex and their remuneration strategies become more sophisticated, so do the tax issues associated with them. The nature of this complexity may be shown by comparing two opposing scenarios;

Scenario 1 - A Simple Scenario

A company with a small, fully UK resident employee group who are each just paid a basic salary and an annual discretionary bonus. The business in this scenario has tax reporting and withholding obligations but these are not onerous.

Scenario 2 - A Complex Scenario

A complex corporate group with a large workforce that is globally mobile between a number of diverse jurisdictions and operating 3 or 4 different share option and long-term incentive arrangements as well as salary, benefits and bonuses. The global tax issues in this case become far more significant with issues such as:

- The reporting obligations relating to the different elements of the package in the different jurisdictions
- The employer tax withholding obligations relating to the different elements of the package in the different jurisdictions
- The social tax burden arising to the employing companies in each jurisdiction
- The availability of corporation tax relief across the group
- The application of all of the issues above to individuals who have been mobile and working across different jurisdictions.

The contrast between the two scenarios is stark. In scenario 1, the issues are relatively easy to address and can be managed easily by an in-house payroll team or outsourced relatively cheaply. In scenario 2, the corporate group will need to formulate a strategy to ensure that it is fully compliant and efficient. Failure to do this may cause the remuneration package to become a huge burden for the company and put pressure on relations with local tax authorities around the world.

Of all of these different areas of complexity relating to remuneration, the most complex issues tend to be driven from having a global group with mobile employees who are awarded long-term incentives. These issues are addressed in more detail below. Whilst the complexity undoubtedly creates a compliance burden for employers which unfortunately is just a consequence of operating a complex (and hopefully successful) global business, it also creates opportunities. If the challenges are approached in the right way, an employer can operate incentive plans that are highly effective in achieving their strategic goal – to recruit, retain and incentivise the best people.

Long-Term Incentive Design And Implementation

One of the reasons that tax obligations often become a challenge that companies struggle to overcome is that the tax treatment of the incentive is not generally a "day 1" issue. If the long-term incentive is a share option plan, the tax charge is likely to arise when the share option is exercised at the end of a vesting period. This may be some years away and is subject to changes in tax law and consequently understanding these issues may not be seen as a priority. In any event, the company has numerous other non-tax issues to focus on in launching the scheme:

- Obtaining shareholder approval and support
- Designing performance criteria that fit best practice whilst motivating the participants
- Preparing communication material that maximises the positive impact on the overall business.

In the context of these priorities, the subject of tax can seem a rather dull and unwanted distraction. However, to neglect tax issues at the outset is to miss a number of important tricks. Being mindful of tax issues from day 1 is a big opportunity for a company to maximise the positive impact that it will have on participants and also make the schemes as cost-effective as possible for itself. Key areas in this regard are:

- Whilst a tax charge on the grant of an incentive such as a share option is rare, it can arise. Australia and Belgium are two jurisdictions where "tax on grant" is a genuine risk if the option is not effectively structured. These pitfalls need to be identified and pre-empted to avoid the incentive plan having a demotivating effect on participants
- Qualifying or tax advantaged plans exist in a number of jurisdictions and to take advantage of the opportunities that these plans present can be a material tax benefit. In the UK, there are 4 HMRC tax advantaged arrangements, but the benefits of qualifying plans (share options or free shares) in France or tax concessions in Australia are other examples of valuable tax incentives. It is generally the case that tax advantaged arrangements need to be planned for on set up
- As well as being important to the employee's outcome, qualifying arrangements may also give the company material savings in employer social taxes (for example, employer's national insurance contributions in the UK)
- Corporation tax relief for the employing companies in the group can be an important factor in the overall cost the incentive arrangement. The existence of an intra group recharge arrangement is often necessary for a company to claim corporation tax relief when share options are exercised, and therefore appropriate planning at the outset can have a significant overall impact on the cost for the employer.

There are clearly material opportunities for companies by including a review of tax matters as part of the implementation of the long-term incentive.

Global Tax Compliance

The group's tax compliance obligations relating to its incentive plans are seemingly straightforward: process the gains through the relevant payroll at the right time. Whilst this may not necessarily be simple, for a sophisticated global company, one may anticipate that this is very much part of the day to day business. To take this view underestimates the complexity that is likely to exist. This complexity breaks down as follows:

1. Understanding The Rules

Whilst the global employer will be likely to operate payroll in all of its relevant jurisdictions, the application of payroll withholding to the long-term incentive will not necessarily follow the same rules as salary or bonus. Income tax withholding may not apply, or it may depend on the overall structure (withholding may depend on whether there is a corporate recharge in place). The same questions apply to social taxes and other taxes. Then there is a question of whether flat rates or marginal rates apply, and this may also differ from cash payments. The company will need to understand the rules and ensure that the payroll operator applies the rules correctly in each jurisdiction.

2. An Effective Process

The overall process for withholding on the long-term incentive will also not reflect the process for withholding on salary or bonus. If the incentive delivers shares (i.e. in the form of a share option), it is not simply a case of withholding cash in the way that would be done for a cash bonus. The employee needs to notify of their desire to exercise, the share plan administrator coordinates the process and updates the records, shares need to be sold by the broker (on the instruction of the employee) and the proceeds of sale need to be passed to payroll. The parent company and the employing subsidiary would also need to be aware of the transaction and the shares issued or transferred accordingly.

There are various techniques that companies use to help in managing this process. Net settlement is one where, in practice, the company delivers shares with a value equal to the net gain and delivers cash for the remainder of the gain that can then be used to settle the tax liability. Alternatively, an exercise process may be conditional on the sale of the shares to address the risk that the shares cannot be sold in an illiquid market.

3. Timing

Whilst the process for processing the exercise and withholding is complex, this is compounded by the fact that it needs to be completed immediately when the employee exercises under the incentive plan. The deadlines for processing gains through payroll and remitting tax to the tax authorities will differ between jurisdictions, but the requirement to remit the tax may be as soon as a matter of days. Perhaps more importantly, if the above process is not immediate, share prices will move and this could create exposure. At its most simple, if an option is exercised and a tax charge generated based on a certain share price but the shares are not sold until the share price has fallen, more shares will need to be sold to pay the tax.

Both net settlement and conditional exercise (addressed above) are geared at addressing this timing challenge, but in any event, the complex process needs to executed at speed.

4. Mobile Employees

The "icing on the cake" in this area is how to deal with mobile employees. This is hugely complex. If an individual has been working in more than one jurisdiction over the vesting period of the award, the expectation is that there will be tax obligations in more than one jurisdiction. As well as needing to review the movements of the individual and understand how the taxable gain is allocated to each jurisdiction, the specific rules for each jurisdiction then need to be applied and these may differ for mobile employees when compared to local nationals. Social tax in particular may give a surprising outcome depending on the facts and not be aligned to income tax.

The layer of complexity that arises around mobile employees can sometimes be "the straw that breaks the camel's back" for groups that want to be fully compliant. To take a challenging process that needs to be executed immediately and then multiply that burden by two or three times to account for the additional burden that comes from an employee having been mobile, may prove to be too challenging.

Employers who do not manage to allocate tax accurately to the correct jurisdiction may seek solace having at least paid full tax in one jurisdiction, and that if tax may have been underpaid in one case, there is an equal chance that it has been overpaid in another. In the current climate where tax on large corporate entities is under so much scrutiny, both of these views unfortunately reflect nothing more than a "head in the sand". If a tax authority in a particular jurisdiction determines that it has not received the right amount of withholding and social taxes for employees who have been working in that jurisdiction, the fact that too much tax may have been paid elsewhere will have little impact on its approach. This will then bring the distraction of tax enquiries and settlements and may trigger tax authorities to want to review other areas of the business.

Conclusion

The complexity that tax brings for global businesses operating long-term incentive plans is extremely daunting and can feel like a real distraction from the real purpose of the long-term incentive – to motivate and reward a highly performing workforce. However, the complexity is a reality, and if it is embraced by the employer, it can give a competitive advantage. Planning the structure to ensure that the most tax efficient approach is pursued from the outset can deliver significant efficiencies to the company and its employees.

All of the challenges of ensuring that full global tax compliance is achieved, including those relating to mobile employees can be navigated. Whilst the issues are not easy to address, these are systems and solutions that a company can implement (such as BDO's Global Equity Mobility Solution) which will mean that it can move forward in the comfort that it will meet its global obligations thanks to the appropriate systems and technology that it has in place. This is a level of comfort that in reality all companies should aspire to.

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