Mandatory Post-Vest Holding Periods – The Non-U.S. Tax Consequences

March 2015

Mandatory post-vest holding periods are becoming increasingly popular for U.S. companies that offer stock plans to employees. The concept is simple: even though the employee has vested in her/his equity award, s/he cannot freely dispose of the underlying shares for a further period of time. There are several advantages for a U.S. company making such awards including

- Assisting the employee in meeting the stock ownership guidelines by forcing the employee to hold vested stock.
- Facilitating award claw backs, if required.
- Reduced compensation expense under ASC718 due to the post-vest sale restrictions.

While there are several ways of offering awards with a mandatory post-vest holding period, the most common form, at the time of print, seems to be an RSU award that vests but is not released to the employee until the mandatory holding period is over. A U.S. taxpayer is generally subject to social security on the vest of the RSU and income tax on the release, affording the employee access to the shares at the time of the major tax liability. However, for non U.S. participants, the tax rules can vary drastically and should be addressed prior to extending awards to those employees. The following discussion does not assume the award type will be RSUs; it is intended to illustrate the variety of tax issues that may arise.

Risk of taxation prior to the ability to dispose of shares

Some countries, such as Austria and Australia, may tax awards at vest even if the shares are released to the employee at a later date. Under current law, Australia would generally tax an award at the earlier of (i) the time when the award is no longer subject to a real risk of forfeiture, (ii) termination of employment, or (iii) the seventh anniversary of grant date, regardless of the holding period. This legislation is under review at the time of print; it is likely that the milestone of seventh anniversary will be pushed out to the fifteenth anniversary of grant. It is arguable whether the threat of a potential claw back would be deemed a real risk of forfeiture. If it is not, the employee would have a taxable event at vest (assuming the employee did not terminate and vest occurred prior to the seventh anniversary).

Taxation prior to the time the employee can dispose of the shares presents a cash-flow issue to the employee; s/he has to generate the cash required for the tax payments without being able to sell the shares. This situation also raises the possibility that the employee could pay taxes on a share value that decreases by the time s/he has the ability to sell the shares and recognize cash from the award.

Concerns with long holding periods

Some countries may change the taxation of awards that have a long holding period. Restricted share awards with a vest longer than five years may be taxed at grant in the U.K. In Germany, a holding period of over five years may be deemed to constitute an unreasonable disadvantage to the employee and an employer should be wary of the associated legal implications.

Taxation when the mandatory holding period has expired

Many countries such as Singapore will tax awards on the date that restrictions are lifted, and the employee has unfettered access to the shares. For Swiss taxpayers, taxation may be deferred until the individual is the legal holder of the share title. The obvious advantage of this taxing point is that the employee can, if necessary, dispose of some of the shares to cover her/his tax liability.

Capital gains tax advantages

On the bright side, there may be advantages of a mandatory holding period, particularly if during the mandatory holding period, the employee is holding shares, not units. Many countries, including the U.S. and India, provide capital gains tax benefits for employees who hold shares for a long period.

Qualifying and tax favored plans

Some countries go a step further and provide a favorable tax treatment for the compensation income from stock if there is a holding period attached to the shares. A mandatory post-vest holding period can assist with meeting the requirements.

- French qualifying RSU plans should, under current law, have a minimum two-year vest period plus a minimum two year hold period imposed on the shares.
- Both Spain and Italy confer tax favorable treatment on awards where the shares are held for a period of at least three years, although the benefits differ between these two countries.

In every case, the terms and conditions of the plan and the award should be reviewed to confirm taxation, as the form of the post-vest holding period and share delivery will vary by company.

Other issues

Deferred compensation and retirement plan rules can impact the taxation of an award. Canada, for example, has complex salary deferral rules that impact the taxation of employees when compensation income is deferred. The taxation of an award with a mandatory holding period may be impacted by the salary deferral rules.

Mobile employee issues

Nowhere are the inconsistences in taxation of awards more painful than for mobile employees. Consider in particular the U.S. assignee, usually a U.S. citizen sent by her/his employer to work in another country usually for a three to five year period. U.S. citizens are subject to tax on worldwide income regardless of where they are resident. However, the U.S. will allow certain exemptions for foreign earned income and credit for taxes paid to other countries on the double taxed income.

As most countries tax based on residence and not on citizenship (U.S. taxes on both), a U.S. assignee will often file tax returns in two countries for a given year. If there is a mismatch of the timing of taxation between the two countries' tax systems, the assignee may be unable to take a credit for non-U.S taxes paid on his U.S. return, potentially resulting in double taxation. Under U.S. law, unused foreign tax credits expire if they cannot be used after being carried back one year and then forward for 10 years.

Conclusion

While mandatory holding periods may have benefits, a company that wishes to implement these is cautioned to carefully review its participant population prior to implementation. A global equity tax consultant would be able to review the issues and help the company make appropriate decisions regarding the taxation and communication of such awards. To be forewarned is to be forearmed.

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