Stronger case for stock-based compensation recharges under OECD Pillar Two

As multinational enterprises (MNEs) continue to grant stock-based compensation (SBC) awards more broadly and deeply within their organizations, the need to manage the cost of these equity incentive plans comes into greater focus. Many MNEs recharge the SBC award costs to the employing group entity to generate a local corporate tax deduction, which would otherwise not be available had the costs remained at the parent issuer level. With the imminent implementation of the Organisation for Economic Co-operation and Development's (OECD) Pillar Two, which sets the framework for a new global minimum tax regime, in several jurisdictions beginning in 2024, the importance of recharge arrangements has become more relevant and pronounced. This is because recharging the SBC costs can be beneficial to the employing group entity from an effective tax rate perspective due to Pillar Two considerations. This article discusses the intricacies of recharging costs associated with granting SBC awards, including common pitfalls, as well as the interplay with Pillar Two rules as they relate to SBC awards.

Back to basics – Why recharge?

For US-based MNEs that grant SBC awards globally to employees of their foreign subsidiaries or affiliates, a corporate tax deduction for the cost of such awards generally is not allowed for US tax purposes. For US tax purposes, a compensation deduction generally is only available to the "employer" or the "the person for whom services were performed." Since the US parent is neither the "employer" nor "the person for whom were performed the services" with respect to the foreign subsidiary employees, generally no deduction is available for the US parent. However, the foreign subsidiaries or affiliates may be able to claim local corporate tax deductions in the jurisdictions in which they operate in accordance with local corporate tax deductibility requirements. To secure a corporate tax deduction in the respective local jurisdiction, most jurisdictions require a cost incurred at the foreign entity level for a local corporate tax deduction to be generated. As such, the US parent company and its respective foreign subsidiary would need to enter a "recharge" agreement that legally transfers the obligation to pay for the SBC awards from the parent issuing entity to the local employing entity, given the SBC awards are part of the compensation packages of foreign employees.

Generally, under the terms of a recharge agreement, the foreign entity agrees to reimburse the US issuer of the stock (i.e., the US parent company) for the cost of equity granted to its employees. Once the recharge agreement is in place, the US issuer will send an invoice to the foreign entity that is required to be recorded as a compensation expense in their local statutory accounts subject to local accounting standards. This expense recognition typically generates the local corporate tax deduction in most countries. However, not all countries require a recharge to claim a deduction or allow a tax deduction even if there is a recharge. For example, the United Kingdom allows for a statutory corporate tax deduction provided certain conditions are met without requiring the actual cost to be recharged, while countries like Canada, Netherlands, and China do not typically allow for a corporate deduction on SBC regardless of whether the costs are recharged.

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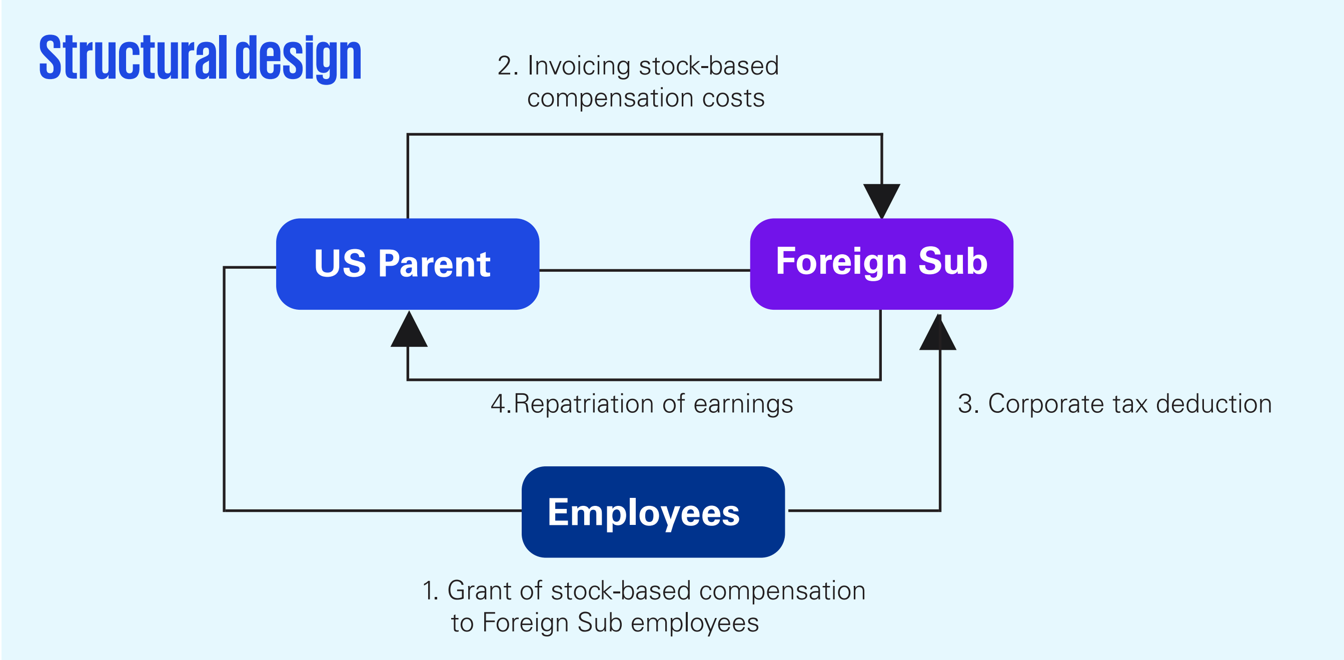
Recharging the SBC cost can also allow the US parent company to have cash repatriated from its foreign subsidiaries or affiliates tax-free back to the US. In addition, Treas. Reg. § 1.1032-3 provides that no gain or loss is to be recognized by the foreign subsidiary for the transfer by the US parent of US parent stock to the foreign subsidiary's employees. Under Treas. Reg. § 1.1032-3, the US parent's transfer of parent stock to employees of a subsidiary or affiliate generally would be viewed as a deemed contribution of cash by the US parent to the foreign subsidiary followed by a purchase of the US parent stock by the foreign subsidiary. If there is an intercompany recharge, then the recharge amount reduces the deemed cash contribution from the US parent company to the foreign subsidiary. The foreign subsidiary receives basis equal to the fair market value of the US parent's stock (i.e., the deemed cash contribution from the US parent). Thus, there is no gain or loss recognized by the foreign subsidiary for the deemed transfer by the foreign subsidiary of the US parent's stock to its employees. This can have the effect of reducing the consolidated corporate tax rate globally for a US multinational group.

In addition to increasing tax efficiency through generating local corporate tax deductions and tax-free repatriation of earnings to the US, other benefits include increased transparency and accountability. A recharge arrangement provides a clearer and more accurate reflection of the company's financials and allows for companies to allocate the costs related to SBC awards to the appropriate business geography/unit. This promotes transparency and accountability in financial reporting and helps stakeholders to better understand the true cost of providing SBC awards to global workforces.



Common pitfalls of recharge arrangements and other considerations

Before implementing a recharge arrangement, companies should consider the challenges and potential pitfalls associated with recharging the SBC award costs. The implementation of a recharge arrangement and any subsequent deduction will increase the visibility and potential scrutiny of the foreign subsidiary/affiliates with the local tax authorities. Before allowing a corporate tax deduction, these authorities may want to verify that the local entity is complying with all its local tax withholding and reporting compliance obligations. If not, then the deduction may be challenged.

Companies should conduct a review of their tax and regulatory compliance in jurisdictions in which they will be seeking a corporate tax deduction to ensure any compliance gaps and exposures are addressed before implementing a recharge arrangement.

In countries such as Mexico, recharging the SBC cost would trigger an employer reporting and withholding requirement on the equity income at the taxable event. Absent a recharge, there would be no employer payroll reporting or withholding required. In addition, recharging to Mexico may trigger additional taxes for the foreign subsidiary/affiliate in the form of social security, if capped thresholds have not been met.

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In other countries such as France, Germany, and Singapore, there is a requirement that companies must issue the shares either from treasury or market purchase shares to allow a corporate tax deduction. There are also countries like Brazil and China where although a recharge is technically allowed, it is challenging in practice due to foreign exchange controls.

Companies should also determine if there is a benefit from a US perspective in recharging the SBC cost to certain countries. Not all countries will allow for a corporate tax deduction on the SBC cost. Canada, for example, does not allow a corporate tax deduction for stock settled awards, but a company may wish to still recharge to enable tax-free repatriation of income to the US.

While companies may still decide to implement a recharge, care should be taken to ensure the amounts recharged are not more than the income recognized by the employees. In some countries, this could be viewed as a deemed distribution, while in others, it could cause the additional amounts to be taxable to the employees.

Generally, the SBC cost to recharge will be the fair market value of the stock at the time of the taxable event less any consideration paid for the stock. For nonmobile foreign employees, the deduction could be for the entire award, while for internationally mobile employees, companies would need to determine the amounts allocable to each jurisdiction in which the employee earned the SBC award to accurately claim a deduction.

Further, despite the potential "win-win" situation of a recharge arrangement, transfer pricing policies would need to be considered. The US parent may be reimbursing a foreign entity on a cost-plus basis for services rendered by the foreign entity. If a US parent does not currently include the cost of SBC in the cost base when reimbursing for entities on a cost-plus basis, then this means no foreign tax deduction is currently being taken. In that regard, the US parent company should conduct a transfer pricing study to ensure the charges are appropriately considered.

Interplay between recharge arrangements and Pillar Two

With the OECD's introduction of Pillar Two, which establishes a new global minimum tax regime, the decision of whether an MNE should recharge the SBC award costs to its foreign subsidiaries becomes more intricate and complex. Pillar Two is set to take effect in several jurisdictions beginning in 2024.

The OECD released the Pillar Two model rules in December 2021, which are aimed at tackling tax issues that arise from the modern, globalized, and digital economy. One of the main components of Pillar Two is the establishment of a global minimum tax, which sets the framework for the new Global Anti-Base Erosion (GloBE) tax regime, for applying a minimum effective tax rate (ETR) of 15 percent to large MNEs. The rules are designed to ensure that large MNEs with consolidated revenue of over €750 million pay a minimum level of tax on the income arising in each jurisdiction in which they operate. MNEs that are within the scope of the rules calculate their ETR for each jurisdiction in which they operate, and then pay a top-up tax for the difference between their ETR per jurisdiction and the 15 percent minimum tax rate if their ETR is less than 15 percent. For example, assume an MNE's GloBE income in a jurisdiction is $100, and the covered taxes total $20. In that case, the ETR is 20 percent, so there is no top-up tax necessary since the ETR is above 15 percent. On the other hand, if the covered taxes total $10, the ETR is 10 percent. In such case, the top-up tax for that jurisdiction would be 5 percent.

The reference to Pillar Two in the context of equity awards relates to SBC. The general and default rule is that the book deduction attributable to SBC is used to calculate the MNE's GloBE income in a jurisdiction. Alternatively, the rules allow the MNE to make an election, for a five-year period, on a jurisdiction-by-jurisdiction basis, to take an actual deduction for tax purposes with respect to the SBC when calculating the GloBE income (SBC Election). In most cases, assuming the stock price has appreciated over time, there would be a higher deduction for tax purposes (versus the default book deduction), which would be beneficial for ETR purposes with respect to Pillar Two. Thus, it is crucial for MNEs to understand the corporate tax deduction rules in each local jurisdiction to assess whether they want to take the book deduction (default) or make the SBC Election to lower their GloBE income based on their tax rate in each jurisdiction for purposes of Pillar Two. The SBC Election may be beneficial to those MNEs that have a potential top-up tax due in a jurisdiction.

Thus, Pillar Two presents an opportunity for companies to undertake due diligence of their SBC policies, including assessing where the related SBC costs currently sit and reviewing the availability of corporate tax deductions in each applicable jurisdiction. If it is determined that a recharge agreement should be established for a particular jurisdiction, then the next step is for companies to decide whether to make the SBC Election rather than take the default book deduction in such jurisdiction.

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How KPMG can help

Apart from considering the tax efficiency of using either the intrinsic book value or the actual SBC expense, companies must also address the other challenges when deciding whether to recharge the cost. The impact of SBC on local tax deductions, as well as considerations given to Pillar Two, can be difficult to navigate. The KPMG Global Rewards Team can assist companies with optimizing their recharge policies to achieve tax efficiency and enhance global compliance in light of Pillar Two implementation. Here are ways in which we can help:

- Conduct global tax and regulatory health check and due diligence to identify and address compliance gaps and exposures as well as execute and address new tax and regulatory governance processes.
- Review recharge agreements from a tax legislation perspective; analyze corporate deduction rules in local jurisdictions for purposes of assessing whether to take the default deduction or to elect to take the actual deduction for purposes of Pillar Two.
- Identify and quantify potential global corporate income tax savings and tax-free repatriation benefits opportunities.
- Utilize the KPMG Global Equity Tracker tool to calculate and allocate SBC deductions for internationally mobile employees (see sample heatmap below) as well as provide clear instructions of employer tax withholding and payroll reporting obligations.

Country	Total Potential Benefit
United Kingdom	$29,169,113
Angola	$22,621,996
Nigeria	$22,469,389
Australia	$19,260,165
Indonesia	$14,473,305
Kazakhstan	$13,888,144
Thailand	$13,868,520
Singapore	$13,247,487
Canada	$10,223,593
South Africa	$4,594,080
China	$3,818,988
Kuwait	$3,440,665
Argentina	$3,228,465
Venezuela	$2,498,667
Philippines	$1,985,354
Brazil	$1,762,710
Russia	$1,672,051
Bangladesh	$1,413,019
France	$1,210,705
Colombia	$711,659
Azerbaijan	$642,510
Iraq	$446,054
Turkey	$399,062
Vietnam	$360,105
Korea (South)	$327,612
Congo (Republic of)	$321,323
Poland	$318,199
Ecuador	$308,218
Japan	$303,394
Total	$190,063,581

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