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Training Course: Restricted Stock and Restricted Stock Unit Awards (Part 3 of 3)

Presentation for:
Executive Compensation Webinar Series
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- Questions during this presentation
  - We encourage questions (even though your audio lines are muted)
  - To submit a question, simply type the question in the blank field on the right-hand side of the menu bar and press return
  - If time permits, your questions will be answered at the end of this presentation. And if there is insufficient time, the speaker will respond to you via e-mail after this presentation

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  - This presentation is being recorded for internal purposes only
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  - To that end, each presentation is intended to provide 1 credit hour in the following areas:
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About Anthony “Tony” Eppert

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- 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

Upcoming 2021 Webinars

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- 2021 webinars:
  - Preparing for Proxy Season: Start Now (Annual Program) (9/9/21)
  - How to Properly Hire and Fire an Executive Officer (10/14/21)
  - A Review of Unique Non-Employee Director Compensation Arrangements (11/11/21)
  - Thoughts on Maximizing the Deductibility of Compensatory Arrangements (12/9/21)

Sign up here: https://www.huntonak.com/en/insights/executive-compensation-webinar-schedule.html

Our Compensation Practice – What Sets Us Apart

- Compensation issues are complex, especially for publicly-traded issuers, and involve 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.)

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- The members of our Compensation Practice Group are multi-disciplinary within the various substantive areas of compensation. As multi-disciplinary practitioners, we take a holistic and full-service approach to compensation matters that considers all substantive areas of compensation

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

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- Our Compensation Practice Group provides a variety of multi-disciplinary services within the field of compensation, including:

Traditional Consulting Services

- Surveys
- Peer group analyses/benchmarking
- Assess competitive markets
- Pay-for-performance analyses
- Advise on say-on-pay issues
- Pay ratio
- 280G golden parachute mitigation

Corporate Governance

- Implement "best practices"
- Advise Compensation Committee
- Risk assessments
- Grant practices & delegations
- Clawback policies
- Stock ownership guidelines
- Dodd-Frank

Securities/Disclosure

- Section 16 issues & compliance
- 10b5-1 trading plans
- Compliance with listing rules
- CD&A disclosure and related optics
- Sarbanes Oxley compliance
- Perquisite design/related disclosure
- Shareholder advisory services
- Activist shareholders
- Form 4s, S-8s & Form 8-Ks
- Proxy disclosures

Design/Draft Plan

- Equity incentive plans
- Synthetic equity plans
- Long-term incentive plans
- Partnership profits interests
- Partnership blocker entities
- Executive contracts
- Severance arrangements
- Deferred compensation plans
- Change-in-control plans/bonuses
- Employee stock purchase plans
- Employee stock ownership plans

Traditional Compensation Planning

- Section 83
- Section 409A
- Section 280G golden parachutes
- Deductibility under Section 162(m)
- ERISA, 401(k), pension plans
- Fringe benefit plans/arrangements
- Deferred compensation & SERPs
- Employment taxes
- Health & welfare plans, 125 plans

International Tax Planning

- Internationally mobile employees
- Expatriate packages
- Secondment agreements
- Global equity plans
- Analysis of applicable treaties
- Recharge agreements
- Data privacy

Purpose of this Presentation

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- The purpose of this discussion is to help train the attendee on the design of restricted stock awards (“***RSAs***”) and restricted stock units (“***RSUs***”), including effective uses, other considerations, and tax structure

- This presentation is Part 3 of a 3-Part series, with the presentation in June and July covering:
  - June being a training course on designing an equity incentive plan (Part 1)
  - July being a training course on stock options and stock appreciation rights (Part 2)

Generally – Restricted Stock Awards

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- Generally, the grant of RSAs would constitute a corporate transfer on the date of grant but, if there is a vesting schedule, the grant would not constitute a "transfer" for tax purposes
  - A corporate transfer means the holder is entitled to voting and dividend rights even if the award is subject to a substantial risk of forfeiture
  - If the award is subject to forfeiture, then the tax transfer typically coincides with vesting

- If there is no timely 83(b) election, then the tax transfer to the holder is as follows:
  - The holder would recognize ordinary taxable income equal to the fair market value of the underlying stock (less any amount paid, such as par value) as of the earlier of:
    - The date the stock becomes transferable, or
    - The date the forfeiture restrictions lapse (*i.e.*, the vesting date or dates)
  - Until such time, any dividends received by the holder would be treated for tax purposes as compensation and not as dividends
  - After there is a tax transfer, any later sale of the stock would be treated as capital gain or loss equal to the difference between the sale price and the holder's tax basis

Generally – Restricted Stock Awards (cont.)

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- In contrast to the prior slide, if the holder makes a timely 83(b) election:
  - The holder could attempt to capture as much of the anticipated future appreciation of the underlying stock at long-term capital gains rates by making an "83(b) election" within 30 days from the date of grant
    - The purpose of an 83(b) election is to limit the ordinary taxable income element to the value of the stock on the date of grant (which is hopefully lower than the amount of ordinary taxable income the holder would otherwise recognize at the time of vesting)
    - This means the holder would be taxed at the time of the initial grant (at the time when the fair market value of the underlying stock is hopefully lower, compared to waiting until vesting)
    - Thereafter, any increase in the fair market value of the underlying stock subject to the 83(b) election would be taxed at capital gains rates if the holder later sells the underlying stock

- The tax treatment to the Company is as follows:
  - If the holder is an employee, the Company would have a withholding obligation and employment taxes at the time the holder recognizes ordinary income
  - Additionally, the Company would have a corresponding compensation deduction at that time

Generally – Restricted Stock Units

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- RSUs (*a.k.a.*, "phantom units" or "synthetic equity") are similar to SARs in that they represent a "promise" to pay as opposed to a current grant
  - However, different from a SAR, an RSU provides the holder with an amount in cash/stock equal to the full fair market value of a share of common stock (*a.k.a.*, a "full value award")
  - Assuming an RSU is to be settled in stock, an RSU represents no ownership interest in the Company until it is settled
  - The promise is then settled on a pre-chosen date, an example of which is as follows:
    - Example: Grant 1,000 RSUs that vest when the Company's stock price is $50 per share. When the RSUs vest, the holder would receive cash/stock equal to $50,000 (1,000 x $50) or 1,000 shares of common stock (with a value equal to $50,000)

- The tax treatment to the holder is as follows:
  - At settlement, the holder has ordinary taxable income equal to the then fair market value of the underlying stock

- The tax treatment to the Company is as follows:
  - If the holder is an employee, the Company has a withholding obligation at settlement
  - The Company would be entitled to a compensatory deduction

Employment Taxes – Administrative Issues

- Consider structuring all vesting provisions of RSAs and RSUs to occur on the first payroll date that immediately follows satisfaction of the vesting schedule, thus mitigating the frequency of having to comply with the IRS "next day" deposit rule
  - As background, if an employer accumulates $100,000 or more in employment taxes on any day during a deposit period, then it must deposit these taxes with the U.S. Treasury by the end of the next business day
  - If vesting occurs during a non-payroll cycle and no net-withholding provision applies, then the employer will have to get the money from the employee by the next day
    - Beware: Under Section 402 of SOX, publicly-traded issuers cannot extend credit or provide loans to executive officers. Thus, it is an open issue on whether an employer's advancement of the deposit to the IRS prior to getting the money from the executive is a "loan" or an "extension of credit"
  - How can the employer satisfy the next day deposit rule in situations where the employer is waiting for the holder to remit sufficient dollars to the employer? Solutions include:
    - Over withhold on other cash due to the employee (*e.g.*, regular paycheck, bonus, etc.)
    - Subject to Section 402 of SOX (addressed above), the employer could estimate the withholding amount and then deposit such amounts early with the IRS. Then on the required due date the employer could instruct the IRS on how that deposit should be allocated
    - Require the employee to transfer the estimated withholding obligation to the employer prior to the deposit date
    - Implement a "net withholding" feature

Employment Taxes – Administrative Issues (cont.)

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- With respect to RSUs that are subject to a deferral feature, an employer should verify that its administrative procedures will capture FICA taxes at vesting (*i.e.*, capturing FICA taxes at the later point when the RSU is settled is often too late)
  - Though under a rule of administrative convenience, an employer is permitted to withhold FICA taxes at the same time it withholds income tax if vesting and settlement of the award are in the same calendar year
- In situations where vesting is fully or partially accelerated when an employee "retires" (typically defined as the employee attaining a certain age, having a requisite number of years of service, and having a separation from service), a bifurcated analysis applies to employment taxes. Such is:
  - If the award is time based, then the substantial risk of forfeiture is no longer present the moment the individual satisfies retirement eligibility, because all that the individual has to do is quit to receive the award. As a result, FICA taxes are owed at the time the individual satisfied retirement eligibility
  - However, if the award is performance based, then it is likely that the performance schedule would continue to act as a substantial risk of forfeiture even if the individual otherwise satisfied the requirements for retirement. As a result, FICA would continue to be deferred until the performance condition becomes satisfied

Typical Forfeiture Provisions

- Typical forfeiture provisions for RSAs and RSUs include:
  - Unvested forfeit if there is a failure to satisfy the vesting schedule (whether time-based or performance-based vesting);
  - Unvested and vested forfeit if there is a failure to timely execute the Award Agreement;
  - Unvested and vested forfeit if the holder violates the non-compete or makes a contention that the non-compete is not valid;
  - The award forfeits to the extent the holder fails to comply with any withholding obligation; and
  - The holder's employment is terminated by the Company for Cause

Issues for Privately-Held Companies

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- Should the holder become a party to the shareholders' agreement?
  - Sometimes the shareholders' agreement is a sweet-heart deal between a small group of founders and its provisions are not intended to apply to the participants
  - In that situation, the award agreement will need to address one or more of the following:
    - Rights of first refusal,
    - Rights of repurchase,
    - Drags and tags,
    - Put rights, and
    - Voting proxies

- With respect to RSAs, it is common for the stock certificates to be held by the CFO/Treasurer (in escrow) during the vesting period. And too, it is common that any dividends paid with respect to unvested shares would also be subject to the escrow
  - This requirement is typically addressed in the award agreement

Example of Pros and Cons for an 83(b) Election

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- The following example compares the tax consequences of receiving restricted stock with and without an 83(b) election
  - Please note this is a hypothetical example using hypothetical tax rates!

- Assumed Facts
  - Employee receives 10,000 shares of restricted stock on February 1, 2021, when the fair market value per share was $10.00
  - The award vests 100% on the two-year anniversary of the date of grant (*i.e.*, no interim or graded vesting)
  - When the 10,000 shares vest on January 31, 2023, the fair market value per share is $30.00
  - Employee then sells the shares for $400,000.00 in May 2024, when the fair market per share is $40.00

Example of Pros and Cons for an 83(b) Election (cont.)

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Assuming an 83(b) Election Is Filed with 30 Days from the Date of Grant:

Ordinary income upon grant on 2/1/21:	$ 100,000.00
Ordinary income tax on 2/1/21 (40% x $100,000):	$ 40,000.00
Ordinary income upon vesting 1/31/23:	$ 0.00
Capital gain at sale 5/24 ($400,000 - $100,000):	$ 300,000.00
Capital gains tax on 5/24 (23.8% x $300,000):	$ 71,400.00
Aggregate Tax on Award:	**$ 111,400.00**

Assuming NO 83(b) Election is Filed:

Ordinary income upon grant on 2/1/21:	$ 0.00
Ordinary income upon vesting 1/31/23:	$ 300,000.00
Ordinary income tax 1/31/23 (40% x $300,000):	$ 120,000.00
Capital gain at sale 5/24 ($400,000 - $300,000):	$ 100,000.00
Capital gains tax on 5/24 (23.8%x $100,000):	$ 23,800.00
Aggregate Tax on Award:	**$ 143,800.00**

Example of Pros and Cons for an 83(b) Election (cont.)

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- In the prior example, the tax cost to the employee for failing to make an 83(b) election is $32,400 ($143,800 - $111,400)
- In sum, the greater the increase in the value of the shares during the vesting schedule, the greater the tax cost to the employee for failing to make an 83(b) election.
- However, when determining whether to make an 83(b) election:
  - The employee must carefully consider the risk that his or her employment could be terminated prior to full vesting of the Award
  - By way of an example, if the employee files an 83(b) election but his or her employment is terminated prior to vesting, then the employee will forfeit all of the shares and, using the example on the prior slide, the employee will have paid $40,000 in tax for which he or she generally cannot claim a full refund

Don't Forget Next Month's Webinar

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- Title:
  - Preparing for Proxy Season: Start Now (Annual Program)
- When:
  - 10:00 am to 11:00 am Central
  - September 9, 2021

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