Restricted Stock and Restricted Stock Unit Utilization Today

While performance-based awards have become the most common long-term incentives granted to executives at most companies today, so-called “full value” awards, including restricted stock or restricted stock units (“RSUs”), remain a common equity award. (See our March 2017 Digest for data on the current mix of long-term incentive (LTI) awards). We have noted not only a marked shift away from restricted stock to the use of RSUs and more recently, based on the recommendations of corporate governance monitors, the addition of performance vesting features in RSU awards. Time-vesting LTI has been criticized by some as “pay for pulse” – that is, it can provide significant value even without stock price appreciation.

➢ Our Latest Informal Survey
We recently updated our informal survey as to the utilization of restricted stock and RSUs at 325 companies where Ayco provides financial counseling or financial education services.

Most of these companies have a history of making grants annually, while others do so only periodically or as special grants to select executives. Our data is intended to reflect regular annual awards made to executives compared to grants made 10 and 20 years ago by Ayco corporate partners (see the graph below).

There are several reasons why RSUs have replaced restricted stock at a large majority of the companies in our survey group. The primary reason is the administrative convenience and likely lower cost. Each RSU is the economic equivalent of a share of company stock. However, unlike restricted stock, each unit is a bookkeeping entry similar to phantom stock at a private company. Stock (or sometimes cash) is not issued until restrictions lapse. Thus, RSUs do not count as outstanding shares using up the number of shareholder authorized shares. There also can be a difference in entitlement to dividend rights and RSUs typically do not have voting rights. However, RSUs are considered to be deferred compensation subject to IRC §409A, unlike restricted stock. This can impact when awards are paid out.
**Tax Planning**

Tax planning for restricted stock and RSUs often differs from that for stock options and performance awards. In one sense, planning is easier for restricted stock; executive pays income taxes at vesting or when any substantial risk of forfeiture no longer exists. Thus, there is less need to develop a timing strategy as to when to exercise and sell as with stock options. However, care should be taken to avoid appreciation of the wash-sale rule. The sale of other company stock at a loss within 30 days before or after vesting or payment can disallow the loss on the sale.

Restricted stock does offer a unique tax-planning opportunity that is not available for RSUs or other equity-based awards: the ability to convert appreciation above the grant date price from ordinary income to capital gains. This is achieved by making a Section 83(b) election within 30 days of the date of transfer (to be further described below).

One potential advantage that RSUs provide is the possibility of deferral into a nonqualified deferred compensation (NQDC) plan. But any elective deferral must meet the strict timing rules under IRC §409A. In our last informal survey of NQDC plans, approximately 18% of the surveyed companies currently allow for the elective deferral of RSUs.

**Substantial Risk of Forfeiture**

In regulations issued in 2014, the IRS clarified the rules as to what constitutes a substantial risk of forfeiture leading to taxation of restricted stock. Generally, an employee’s entitlement must be conditioned on the future performance of substantial services (i.e., continuing to work until a future date) or be tied to the occurrence of a condition related to the purpose of the transfer. To determine if the risk is “substantial”, it is necessary to evaluate the likelihood that the forfeiture will occur and that it will be enforced. Examples in the regulations indicate that certain restrictions which could lead to penalties do not create a substantial risk of forfeiture, including lock-up agreements following an IPO and limitations on sale due to SEC Rule 10b5-1. However, restrictions on the sale of company stock due to SEC §16(b) could delay taxation. Generally, non-compete clauses and clawbacks will not constitute a substantial risk of forfeiture delaying taxation.

In separate regulations issued last year focusing on deferred compensation at tax-exempt organizations, the IRS stated that an amount would not be considered subject to a substantial risk of forfeiture if the facts and circumstances indicate that forfeiture is unlikely to be enforced.

**Time-Vesting**

For recent awards that have a time-vesting schedule, we found almost an equal number of companies use "cliff vesting" as opposed to ratable or incremental vesting over a defined period. Vesting typically begins one year (or more) following the date of grant. For those companies with time-vesting, the following illustrates the schedule among our survey group:

An alternative award that combines features of a full-value award with a performance metric based on stock price growth is a Market Stock Unit (MSU). The number of shares actually earned will be based on the ratio of the stock price at the end of the vesting period over the stock price at grant. Thus, the actual payout can represent a different value than a full value award. Approximately 2% of our survey group currently grant these awards.
➢ To Attract & Retain
Companies which do not regularly grant restricted stock or RSUs may still utilize these awards for special situations. As an example, several companies disclosed in their 2017 proxy that they have granted restricted stock/RSUs to newly-hired executive officers to offset forfeited compensation from a previous employer, and many companies reported that they have made special grants of restricted stock or RSUs to existing executives for retention purposes. A number of companies also disclosed that they allocate a pool of RSUs or restricted stock to be used for recruitment, performance recognition or promotion awards.

A small number of companies (approximately 1% of our survey group) grant awards which vest only at retirement – so called “career shares.” These can be the ultimate retention device.

➢ Termination of Employment
If an award recipient voluntarily terminates employment prior to vesting of an award, virtually all companies forfeit the restricted stock/RSUs - although, a few plans provide discretion to pay a pro-rata portion in certain circumstances, such as an involuntary termination. In contrast, just over three-quarters of companies provide for the acceleration in vesting in the event of the death or disability of the employee. A majority of plans allow for the designation of a beneficiary to receive payment of an award upon the death of a recipient prior to payout.

Just over one-half of companies provide for an acceleration in vesting in the event of a "qualified retirement", while 10% provide for pro-rata vesting in that situation and 5% continue the vesting schedule. The definition of a qualified retirement varies among our survey group. The most common definition is at least age 55 with 10 years of service – but 8% have a lesser age threshold and 30% use an older age.

➢ Other Issues to Consider
The increase in utilization of restricted stock and RSUs is due to a variety of factors that make them attractive to both employers and employees. These include:

• Easier To Appreciate Value - It is easier for most recipients to appreciate the value at grant, as well as the future value at vesting. There is no Black-Scholes valuation needed to explain the grant date value as for stock options and no risk of the award being "underwater".

• Dividend Equivalents - Unlike stock options and most performance awards, restricted stock and sometimes RSUs will offer dividend equivalents (available at 60% of our survey group). These may be distributed as cash when dividends are paid or accrued (as cash or additional shares) and paid only when the award vests and becomes payable. Amounts are reportable as W-2 compensation and are not qualifying dividends (unless an §83(b) election is made for restricted stock when they can become qualified dividends).

• Accounting Treatment and Share Withholding - Last year, FASB issued changes to the accounting treatment of certain aspects of stock-based compensation. These include a change in the accounting for income taxes upon vesting or settlement of awards in the company’s income statement and a choice in how to account for awards that are forfeited.

One welcome change is with regard to supplemental wage withholding rules. Prior to the recent change, allowing for share withholding that exceeds the minimum statutory requirements (25% federal if supplemental wages are under $1M) results in an accounting charge – so virtually no companies allowed it to occur. Under the new rules, a company can allow for share withholding or net settlement that does not exceed the maximum statutory tax rate without negative accounting implications. However, these are only accounting changes; the IRS has yet to modify its supplemental wage withholding rules. This has created a dilemma for many companies. Should they take advantage of the FASB changes and allow employees to elect a higher flat rate share withholding percentage (without using the more inconvenient W-4 adjustment), or wait to see if the IRS modifies its guidance stated in Info Letter 2012-0063. We have already seen a dozen Ayco corporate partners allow for greater share withholding for those employees below the $1 million aggregate supplemental wage threshold.

• FICA and State Tax Issues - The timing of FICA taxation and associated withholding can vary from when income tax withholding occurs. A plan provision providing for the acceleration in vesting of restricted stock upon retirement eligibility can lead to unanticipated income or FICA taxation. This has led some companies to modify the terms of their plan to provide for a continuation of vesting rather than an acceleration. There can be a different result for RSUs which generally are not taxable until paid or available to be paid.
State tax issues can be even more complicated, especially for an executive who performs services in multiple states during the vesting period of an award (see Feb. 2015 Digest – The Conundrum of State Income Taxes). Over 20 states subject non-residents to taxation if they performed services in the state during the vesting period. However, the state tax withholding rules vary considerably and many employers will only report income and withhold state taxes for non-resident wages if required to do so.

- **Foreign/Non-Resident Alien Employees** – Many foreign countries subject restricted stock awards to tax immediately upon grant or have other limitations. This is a major reason that companies with non-resident alien employees or U.S. citizens working in foreign countries utilize RSUs, which often do not have the same consequence. Employees who work in the U.S. and a foreign country during the vesting period could be subject to double taxation – but a foreign tax credit may be available to a U.S. taxpayer to offset such taxes. Tax treaties also can play a role.

- **§83(b) Election** - Since restricted stock is considered “property” within the meaning of IRC §83, the grant of restricted stock allows the recipient the right to make a special tax election. A section 83(b) election (named for the Internal Revenue Code section which authorizes it), may be made within 30 days from the date of transfer—generally the date of grant. An individual making the election will recognize ordinary income based on the value of the stock at grant - rather than at the date of vesting. This results in subsequent appreciation being taxed at capital gains rates. A significant potential downside to this election is that if the stock is eventually forfeited, any tax paid on the forfeited stock cannot be recouped. For this reason, and due to the earlier payment date of required taxes, most executives do not make the election. However, it does provide one of the few opportunities for an executive to convert a portion of compensation which would otherwise be taxed at ordinary income rates to be taxed at lower capital gains rates.

A valid election requires the recipient of the stock to submit a copy of an election notice to the IRS and the company within 30 days of transfer of the stock. Last year, the IRS eliminated the requirement that a copy of the notice be attached to the recipient’s tax return for the year of the election, principally because most e-filing software couldn’t accommodate the attaching the election form to an e-filed Form 1040.

RSUs are not considered property (they are more akin to deferred compensation) and therefore are not eligible for this election.

- **Easier To Administer** - Restricted stock and RSUs are much easier and less costly to administer than certain other LTI awards, including stock options. Upon vesting, shares (and cash for RSUs) are issued, net of any shares withheld to pay taxes, if so elected.

- **Share Ownership & Retention Requirements** - A large majority of companies now have share ownership guidelines for key executives. In many (but not all) cases, both vested and unvested restricted stock and RSUs count toward ownership requirements. This needs to be confirmed – along with any share retention rules. (See the March 2016 Digest for our last survey on Share Ownership Guidelines).

- **Clawback Provisions** - Clawback or repayment provisions are now commonly incorporated in recent grant agreements at many companies. The SEC has issued proposed rules that will require public companies to adopt and enforce clawback policies on “excess” incentive-based compensation received by all current and former §16 officers in the event of a financial restatement due to a material error. Time-vested awards will not be subject to this new rule, but performance-vesting awards likely would be.

- **Implications For Golden Parachute Excise Tax** - Typically, upon a change in control, there is an acceleration in vesting of all unvested restricted stock/RSUs. The “value” of the acceleration will be considered in any golden parachute calculation. Based on pressure from corporate governance groups, many companies have replaced single-trigger vesting acceleration with a double-trigger requirement. This can help reduce or minimize any excess parachute potential.

- **Impact of IRC §409A** - While restricted stock will not be considered as deferred compensation subject to §409A, RSUs, phantom stock or similar awards payable in stock (or cash) at a future date are subject to IRC §409A. The most significant impact of this is the necessity of a 6-month delay in payments triggered by a separation from service made to “specified employees” at U.S. public companies. A plan that provides for the automatic acceleration in vesting upon retirement eligibility with payout delayed until after actual retirement could create §409A issues. Inasmuch as RSUs
are subject to §409A, they may be further deferred if a timely election is made. A deferral election with respect to RSUs may be made in the year prior to grant (usually extremely impractical) or within 30 days after grant. While this timing rule resulted in fewer companies allowing a deferral election for RSUs ten years ago, we are now seeing more companies allow for deferral of RSUs and performance-based awards.

IRS final regulations under §409A indicate that a choice given to an employee to elect between restricted stock and stock options, neither of which is subject to §409A, will not be subject to §409A. However, if there is a choice involving restricted stock units, any election must meet the §409A timing rules.

• **Divorce** - The IRS confirmed in PLR 201016031 that the division of restricted stock pursuant to a state court divorce decree is a nontaxable event under IRC §1041. Income reported upon vesting of the stock can be divided between the parties, with the value of stock received by the non-employee spouse reported on Form 1099-MISC. In Notice 2002-31, the IRS indicated that when stock options were transferred pursuant to a divorce order, FICA is payable by the employee on all of the options, including those transferred to the former spouse. There should be a similar result upon vesting of restricted stock or RSUs.

• **Counts Toward IRC §162(m)** - In contrast to stock options which qualify for the performance exception, time-based restricted stock/RSUs generally will count against the $1M corporate deduction limit. This can help explain why top executives may receive only performance-vesting RSU awards.

• **Cost Basis Reporting** - Both restricted stock and RSUs granted on or after 2013 are characterized as “non-covered securities”. As a result, individuals are to report any gain or loss on the sale of shares by adding the compensation element reported on Form W-2 to any basis reported on Form 1099-B. Brokers are not to report the compensation element as part of the stock’s basis on 1099’s issued.

• **Insider Form 4 Reporting** - For SEC reporting by corporate insiders (including directors), the grant of restricted stock or RSUs is an "exempt" transaction (thus, not a matchable “purchase”), but is still reportable. This means that a Form 4 must be filed within two days of the date of grant. No further reporting is required for restricted stock at vesting, unless share withholding is utilized to pay taxes (when Form 4 reporting is required with Transaction Code "F"). In contrast, RSUs are reportable on a Form 4 at vesting or when shares are issued. Reporting for both is required if shares are forfeited while the executive is a §16 insider.

### §409A Violation – Here’s Another Example

It is now over a dozen years since the enactment of IRC §409A in 2004. While the IRS has issued a series of regulations detailing the general rules, it has yet to issue regulations explaining certain aspects, including the rules for reporting violations. While companies generally have made amendments to existing plans or adopted new nonqualified deferred compensation arrangements intended to comply with the §409A rules, we are seeing inadvertent violations continuing to occur. These can result in significant tax penalties, even if corrected under IRS-approved correction procedures. There also can be situations in which plan design does not meet the sometimes extremely complicated rules. Recently, the IRS Office of Chief Counsel released an Advice Memorandum describing one such example (OCM 201725027). This guidance involves what is called a “back-to-back arrangement”. This is a relatively rare and unusual dual plan structure, although it is covered in Treas. Reg. §1.409A-3(i)(6).

A back-to-back arrangement is one in which an entity provides nonqualified deferred compensation payments to a related entity, which then makes payments to individuals working for and reporting to the intermediate entity. In the case in question, a foreign corporation and a U.S. taxpayer were parties to a deferred compensation arrangement under which the U.S. taxpayer deferred some of its management and performance fees payable for investment advisory services. The taxpayer in turn sponsored a deferred compensation arrangement for individual investment professionals which it supervised. These individual investment professionals could elect to defer certain salary or bonuses with the dual structure designed to coordinate any deferral and payment elections with equivalent provisions under the plan maintained by the foreign corporation. Thus, for example, if an individual investment professional was entitled to a payment of deferred compensation upon separation from service, the Taxpayer would likewise be entitled to a payment of the same amount from the plan maintained with the foreign corporation. (Hence the name of a “back-to-back” arrangement). The taxpayer asked the IRS to opine on
whether the structure of their arrangement met the requirements of IRC §409A. The IRS Chief Counsel indicated that it did not.

This conclusion was based on the inter-relationship between the two arrangements and how the plans operated in practice. As an example, the deferral plan between the foreign corporation and the taxpayer provided that payments were to be made to the taxpayer even when an amount was forfeited and not paid to the employee investment professional. This could happen if the individual separated from service before amounts became vested. In fact, three individuals did forfeit significant amounts upon separation from service, yet payments were still made it to the taxpayer (which, as may be obvious, were the supervisors of the investment professionals).

Under IRS regulations, this type of flow-through arrangement can meet the requirements of IRC §409A if the time and form of payment is the same under both plans and the amount of any payment under one plan does not exceed the amount of payment made to the ultimate recipient. That did not occur here.

The IRS also found that there was another §409A failure. This one related to when the plans made payments. Under IRS regulations, if a plan sets fixed or specified payment dates, an actual payment may be made 30 days before a specified date or anytime until the end of the taxable year in which a specified date occurs. In this situation, payments were not made at the same time under both plans. As a result, the IRS found that the plans were not operated in accordance with the §409A rules.

Permissible Payment Triggers - Under IRC §409A, payments from a nonqualified deferred compensation plan may only be paid in the event of one of the following events:

- a service providers’ separation from service;
- the service providers’ disability;
- the service providers’ death;
- a specified date or fixed schedule defined in the plan;
- a qualified change-in-control event;
- the occurrence of an unforeseeable emergency.

Consequences of Failure to Comply With §409A - Failure to comply with the §409A requirements, with limited exceptions, result in the entire amount of any deferred compensation being taxable in the year in which it vests (unless previously subjected to taxation), a 20% penalty on the amount involved, plus a premium interest penalty. These penalties are incurred by the plan participant and not the plan sponsor or employer.

Inadvertent Violations – We are aware of at least a dozen Ayco corporate clients that experienced inadvertent violations of §409A rules. In some cases, this could have been the result of the failure to timely defer compensation, while in other cases, it was the result of failure to timely make payments. The IRS does have an approved correction procedure. However, it does require timely action and generally will result in the 20% penalty tax being incurred by the recipient. In almost all cases, an employer will reimburse the individual for such a penalty tax if the employer or plan administrator was responsible for the inadvertent violation.

2017 Summer InnerCircle Conference

This year’s Ayco Summer InnerCircle Conference will be held August 2-3, 2017 at the Albany Capital Center in Albany, NY. Scheduled presentations and speakers include:

- Prospectives on Today’s Workforce
  Edith W. Cooper, EVP & Global Head of Human Capital Management, Goldman Sachs & Co.
- A Conversation with Larry Fink
  Lawrence D. Fink, Chairman and CEO, BlackRock, Inc.
  Tim O’Hara, President and CEO, The Ayco Company, LP
- Today’s Legislative and Regulatory Environment
  Chris Gaston, Sr. Policy Director, Davis & Harman LLP
- Employee Engagement: Insights & Strategies
  Cait Lamberton, University of Pittsburgh
- Emerging Trends in Healthcare
  Brian J. Marcott, President & CEO National Business Group on Health
  Cora Tellez, CEO, Sterling Health Services Administration Inc.
- Executive Compensation – Where We Are Today
  Vicki Creamer, Sr. V.P. & Chief HR Officer, ITT Inc.
  Peter Warwick, Chief People Officer, Thomson Reuters
  John J. Quatrone, Sr. Vice President, Global HR General Motors Company
  Jeffrey M. Kanter, Managing Director, Frederic W. Cook & Co.

For more information about this year’s conference and to register to attend, go to aycoinnercircle.com and use event code AYCOIC2017.
Did You Know...

- In a recent decision by a New York appeals court dealing with the state of domicile of an individual, and thus, state tax exposure, the location of the individual’s dog was considered a key factor *(Matter of Blatt).*

  According to a recent survey by the American Pet Products Association, 60% of U.S. households own a dog, 47% own a cat, 12% own freshwater fish and nearly 8% own a bird.

- According to IRS Publ. 6292, there were 246.9 million income tax filings in Fiscal Year (FY) 2016, including 77.8 million paper filings and 169.1 million e-filings. The IRS projects that total filings will increase by an average annual rate of 0.9% reaching 265 million in 2024, while paper filings will decrease to 60 million in 2024.

About This Newsletter

This newsletter is prepared for colleagues and friends of The Ayco Company, L.P. by its Benefits & Compensation Group (BCG) and is designed only to give notice of, and general information about, the developments actually covered. It is not intended to be a comprehensive treatment of recent legal developments or the topics included in the newsletter, nor is it intended to provide any legal advice. Any advice contained in the communication including attachments and enclosures is intended for the sole use of the addressee and is limited to the facts and circumstances actually known to the author at the time of this writing. Certain tax matters may require you to consult with your tax counsel. For more information on any of the topics covered, contact Richard Friedman, Vice President, BCG (518-640-5250) or email us at rfriedman@ayco.com.

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