

# Equity Awards & Employment Taxes: Design Considerations

**Presentation for:**  
Executive Compensation Webinar Series  
June 8, 2023

**Presentation by:**  
Anthony J. Eppert  
[AnthonyEppert@HuntonAK.com](mailto:AnthonyEppert@HuntonAK.com)  
512.542.5013

## Housekeeping: Questions

- 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

# Housekeeping: Recording, CE Credits and Disclaimer

- Recording
  - This presentation is being recorded for internal purposes only
- Continuing education credits
  - A purpose of the webinar series is to provide FREE CE credits
  - To that end, each presentation is intended to provide 1 credit hour in the following areas:
    - CLE: 1 credit hour (CA, FL, GA, NC, NY, TX and VA)
    - CPE: 1 credit hour (Texas)
    - HRCI: This activity has been approved for 1 (HR (General)) recertification credit hours toward California, GPHR, PHRI, SPHRI, PHR, and SPHR recertification through the HR Certification Institute
    - SHRM: This program is valid for 1 PDC for the SHRM-CPSM or SHRM-SCPSM
  - If you have any questions relating to CE credits, please direct them to Anthony Eppert at [AnthonyEppert@HuntonAK.com](mailto:AnthonyEppert@HuntonAK.com) or 713.220.4276
- Disclaimer
  - This presentation is intended for informational and educational purposes only, and cannot be relied upon as legal advice
  - Any assumptions used in this presentation are for illustrative purposes only
  - No attorney-client relationship is created due to your attending this presentation or due to your receipt of program materials

## About Anthony “Tony” Eppert



Anthony Eppert , Partner  
Hunton Andrews Kurth LLP

Tel: +1.512.542.5013

Email: [AnthonyEppert@HuntonAK.com](mailto:AnthonyEppert@HuntonAK.com)

- 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 2023 Webinars

- 2023 webinars:
  - Form 4 Training Course (7/13/23)
  - Anatomy of ISS: A Current Compensatory Perspective (8/10/23)
  - Preparing for Proxy Season: Start Now (Annual Program) (9/14/23)
  - PubCo Governance & Internal Controls: A Compensatory Perspective (10/12/23)
  - Keep It Boring: Drafting Miscellaneous Provisions in a Contract (11/9/23)
  - [Topic TBD] (12/14/23)

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.)

- 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.)

- 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

- The purpose of this discussion is to cover:
  - Comparison of net withholding to broker-assisted sales in the open market;
  - How to increase net withholding rate without shareholder approval;
  - Coordinating net withholding and tax withholding;
  - Coordinating net withholding and federal deposit rules; and
  - Miscellaneous thoughts

## Net Withholding Compared to Open Market Sales

- Advantages of net withholding provisions (compared to open market sales) include:
  - Assuming the equity plan document contains liberal share counting, the life expectancy of the share reserve should be longer because a lesser number of shares are actually issued;
  - Reduced shareholder dilution because only the net shares are considered issued and outstanding;
  - The holder receives the same economic benefit as a broker-assisted sale in the open market;
  - Broker fees are avoided;
  - Avoids blackout periods since there is no open market transaction (though check insider trading policy to ensure permissible during blackout period); and
  - More favorable treatment in calculating basic earnings per share
  
- Disadvantages of net withholding provisions (compared to open market sales) include:
  - Decreased cash flow for the company because the company has to remit its cash to the U.S. Treasury to satisfy the withholding obligation, and
  - ISS may assign a higher cost to the awards

## Increase Net Withholding: No Shareholder Approval

- The Financial Accounting Standards Board (“**FASB**”) allows employers to effectuate tax withholding of equity awards up to the maximum individual statutory rate WITHOUT triggering liability classification for accounting purposes
  - Prior to the foregoing change, stock-based awards withheld at or less than the minimum statutory rate would be classified as equity awards (*i.e.*, accounting expenses is measured at the date of grant), and stock-based awards withheld at a rate above the minimum statutory rate would be classified as liability awards (*i.e.*, accounting expense is re-measured each reporting period settled)

## Increase Net Withholding: No Shareholder Approval (cont.)

- Shortly thereafter, NYSE amended its compensation FAQs to provide that (See FAQ Question C-1):
  - An amendment to allow for the maximum tax withholding (as opposed to the minimum tax rate) would NOT be a “material amendment” requiring stockholder approval
  - The shares forfeited that were never issued may revert back to replenish the equity plan’s share reserve (*i.e.*, the equity plan has liberal share counting)
  - However, if the amendment applies to issued and unvested shares (*e.g.*, restricted stock grants), then the amendment would be permitted as a non-material amendment (*i.e.*, an amendment not requiring shareholder approval) only if the withheld shares are forfeited (*i.e.*, no reversion to the equity plan)
- NASDAQ guidance is generally the same as the above, however, it did not specifically address the issue of “issued” shares
- In sum, the FASB change creates a real solution to the problem of holding illiquid stock (either because the company is privately traded or because the recipient has material non-public information at the time of vesting or exercise of stock options)
  - The minimum federal supplement withholding rate is generally 22%, and
  - The maximum federal individual tax rate is 37%

# Coordinating Net Withholding and Tax Withholding

- Important to remember is that accounting rules did not change tax rules
- Generally, there are only two types of wages with respect to employees
  - Regular wages (looking to the Form W-2 for the withholding amount), and
  - Supplemental wages
- Under the Treasury regulations, supplemental wages include:
  - Taxable income resulting from the lapse of a vesting schedule (*i.e.*, vested property),
  - Taxable income associated with the exercise of a non-statutory stock option (*i.e.*, a non-ISO), and
  - Taxable income resulting from non-qualified deferred compensation arrangements

- According to the IRS, supplemental wages can only be withheld in accordance with one of the following:
  - The flat rate (*i.e.*, 22% for supplemental wages less than \$1mm, and highest marginal rate for supplement wages over \$1mm), or
  - The aggregate method
- The aggregate method involves the employer “aggregating” regular and supplemental wages, and then using the employee’s Form W-4 to determine the applicable withholding rate
  - To accomplish the desired goal of maximum withholding, the employee could file a revised Form W-4 and the employer could elect to use such immediately

# Coordinating Net Withholding & Federal Deposit Rules

- Generally, employment taxes (*i.e.*, income taxes, FICA/FUTA) will attach at some point in the life cycle of an equity award
  - Attach at the time of vesting (or at the time of an 83(b) election) with respect to restricted stock and property, and
  - Attach at the time of exercise with respect to non-statutory stock options (there is no employment tax for ISOs)
  
- Federal deposit rules – Generally
  - Semi-weekly deposits are required if the employer reports total employment taxes exceeding \$50,000 on IRS Form 941 for a 4-quarter look-back period beginning July 1 and ending June 30
  - Monthly deposits are required if the employer reported \$50,000 or less in total employment taxes during the look-back period
  
- For a semi-weekly depositor, the deposit dates are:
  - For wages paid on Saturday, Sunday, Monday or Tuesday, the employer must deposit by the following Friday
  - For wages paid on Wednesday, Thursday or Friday, the employer must deposit by the following Wednesday

- Next day deposit rule
  - Under this rule, if an employer accumulates \$100,000 or more in employment taxes on any day during a deposit period, then it must deposit these taxes by the end of the next business day
  - This rule is often triggered due to vesting of equity awards, payouts of bonuses, regular wage payments, etc.
  
- Generally, the penalty for late deposits are as follows:
  - 2% of the underpayment if the deposit is 1-5 days late,
  - 5% of the underpayment if the deposit is 6-15 days late,
  - 10% of the underpayment if the deposit is 16 or more days late
  - 15% in certain situations where the employer received notice from the IRS
  
- How the next day deposit rule applies to the administration of equity awards is contained on the next few slides



- Non-statutory stock options (“**NSOs**”)
  - Generally, employment taxes are triggered due to the exercise of an NSO
  - A technical issue is whether taxes arise on the date of exercise or whether they arise on the date the employee receives the underlying stock (which could be a few days later)
  - According to an IRS field directive, IRS examiners are instructed to NOT challenge the timeliness of deposits relating to NSOs if:
    - The employer deposits the taxes within one day from the date the employee received the underlying stock, AND
    - The date the employee received the underlying stock is not more than 3 days from the date the stock option was exercised
  
- Restricted stock
  - Employment taxes are due at vesting (or upon filing an 83(b) election, if earlier)
  - The above field directive does not apply to restricted stock grants
  
- Deferred RSUs and phantom awards
  - The award is subject to FICA taxes at vesting, even if income taxes are deferred under Section 409A to a later date
  - However, due to a rule of administrative convenience, the employer is permitted to withhold FICA taxes at the same time it withholds income taxes if vesting and settlement of the award are in the same calendar year

- How is the next day deposit rule satisfied in situations where the employer is waiting for the employee to remit his/her withholding dollars to the employer?
  
- Solutions include:
  - Over withhold on other cash compensation due to the employee (assuming the next day deposit rule coincides with payroll and there is sufficient payroll to satisfy the deposit obligation)
  - Subject to satisfying Section 402 of SOX, the employer could estimate the probable withholding and deposit the amounts early to the IRS, then on the required due date the employer could then direct the IRS as to how that early deposit should be allocated
  - The employer could require the employee to transfer to the employer, in advance of the deposit due date, the estimated withholding obligation (and when the actual deposit is calculated, any overage can then be returned to the employee)
  - Implement a “net withholding” whereby the employer withholds a sufficient number of shares of stock equal in FMV to the employee’s portion of the withholding obligation

## Miscellaneous Thoughts

- Remember that Section 402 of SOX prohibits personal loans from a public company to any of its directors or executive officers
  - This issue should be vetted any time the employer “advances” such employee’s tax withholding obligation to the IRS
  
- Counting mechanisms – net basis v. gross basis
  - Equity incentive plans with liberal share counting (e.g., forfeited shares that were subject to an outstanding award revert to and work towards replenishing the share reserve) are counted/depleted on a net basis
  - In contrast, shares registered pursuant to a Form S-8 are counted/depleted on a gross basis (*i.e.*, forfeited shares would count towards and deplete the remaining share reserve subject to the Form S-8)
  - This means . . .
    - Do not rely upon your equity incentive plan capitalization table to determine how many shares remain available under the Form S-8
    - When determining how many shares to register under a Form S-8, always register more than are then available under the equity incentive plan

## Miscellaneous Thoughts (cont.)

- With respect to any equity plan amendments to increase the tax withholding rate, such an amendment would be viewed by ISS as administrative
  - However, for those equity plans with liberal share counting, the foregoing applies only if the amendment stipulates that only the shares netted/withheld up to the minimum tax withholding rate may be recycled (*i.e.*, those shares netted/withheld on the spread between the minimum rate and the maximum rate could not be recycled and must be forfeited)

## Miscellaneous Thoughts (cont.)

- Who or which entity is entitled to the compensatory deduction depends upon which person or entity is the “service recipient”?
  - This question is particularly important in the factual scenario where a key employee is sharing in an earnout on a post-CIC Transaction basis (*i.e.*, the buyer is likely the service recipient)
  - The service recipient is the one who receives the services related to the award
  - The service recipient is the one entitled to the compensatory deduction
  - The service recipient is the one required to satisfy any income tax withholding, and pay the employer portion of any FICA or FUTA

## Miscellaneous Thoughts (cont.)

- 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

## Don't Forget Next Month's Webinar

---

- Title:
  - Form 4 Training Course
  
- When:
  - 10:00 am to 11:00 am Central
  - July 13, 2023