

Taxation of Equity Awards: The 101 Training Course

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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 2018 and 2019 Webinars

- Upcoming 2018 webinars:
 - How to Negotiate Executive Employment Contracts: Tips of the Trade (12/13/2018)
- Upcoming 2019 webinars:
 - Upcoming Proxy Season: Compensatory Thoughts from ISS (Annual Program) (1/17/2019)
 - Equity Awards: Design Tips for Navigating Blackout Periods (2/14/2019)
 - Golden Parachutes & 280G: Design Pointers on Being a Winner (3/14/2019)
 - Best Practices for Conducting the Compensation Committee Meeting (4/11/2019)
 - Anatomy of ISS (5/9/2019)
 - Tips to Increase the Longevity of the Equity Plan's Share Reserve (6/13/2019)
 - Multi-Disciplinary Facets to Net Withholding: It Ain't Boring (7/11/2019)
 - Everything Perquisites: The 101 Training Course (8/8/2019)
 - Preparing for Proxy Season: Start Now (Annual Program) (9/12/2019)
 - Stock Ownership Policies & Clawback Policies: Design Pointers (10/10/2019)
 - Employee Stock Purchase Plans: The Introductory Course (11/14/2019)
 - How to Design Restrictive Covenants & Economic Forfeitures (12/12/2019)
- Sign up here: <https://www.huntonak.com/en/insights/2018-executive-compensation-webinar-schedule.html>

Our Compensation Practice – What Sets Us Apart

- Compensation issues are complex, especially for publicly-traded companies, 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 presentation is to discuss the taxation of various equity awards, including:
 - Incentive stock options (“**ISOs**”)
 - Non-statutory stock options (“**NSOs**”)
 - Stock appreciation rights (“**SARs**”)
 - Restricted stock awards (“**RSAs**”)
 - Restricted stock units (“**RSUs**”),
 - Performance-based awards (“**PSUs**”), and
 - Employee stock purchase plans (“**ESPPs**”)

- This presentation also covers some select administrative issues that give rise to certain tax consequences, however, such will be discussed “off slides”

Incentive Stock Options

- An ISO is a stock option granted to an employee to purchase stock of the employer
 - Numerous tax rules must be satisfied for an option to qualify as an ISO
- Generally, ISOs are preferred by optionees (compared to NSOs) because of their favorable tax treatment to optionees
 - No taxable income is triggered to the optionee at the time of grant
 - No taxable income is triggered to the optionee at the time of exercise
 - However, the spread between the fair market value of the underlying stock and the exercise price at the time of exercise is an item of adjustment for purposes of calculating any alternative minimum tax (“**AMT**”)
 - The only way to eliminate the spread as an adjustment for AMT purposes is to exercise the option and sell the underlying stock within the same calendar year
 - If the stock is held for at least 2 years from the date of grant AND at least 1 year from the date of exercise (such being the “**Holding Period**”), then any gain realized on a subsequent sale of the underlying stock would be taxed at favorable capital gains rates
- Neither the grant nor the exercise of an ISO provides the company with a compensatory deduction (that is, unless there is a Disqualifying Disposition)

Incentive Stock Options (cont.)

- A “***Disqualifying Disposition***” occurs when the Holding Period (prior slide) is not satisfied. In such instances:
 - The optionee would recognize ordinary taxable income (and the company would have a corresponding compensation deduction) equal to the excess (if any) of the fair market value of the stock as of the date of exercise over the exercise price
 - Such compensation income would be added to the stock’s basis to determine any capital gain that must be recognized on the Disqualified Disposition

- In addition to satisfying the Holding Period, in order for an option to qualify as an ISO, the option must comply with all of the following tax rules:
 - Rule No. 1: The plan providing for the grant of ISOs must be approved by the company’s stockholders within 12 months before or after the date the plan is adopted by the Board
 - Rule No. 2: The plan must specify the aggregate number of shares of stock that are available for issuance under the plan AND the number of such shares subject to ISO treatment
 - Rule No. 3: The plan must specify the employees or class of employees eligible to participate
 - Rule No. 4: The option must be granted within 10 years from the date the plan is adopted or approved, and must be exercised (if at all) within 10 years from the date the option was granted

Incentive Stock Options (cont.)

- [Continued from prior slide]
 - Rule No. 5: The optionee must be an “employee” of the granting corporation, its parent or its subsidiary (or an employee of an entity that has assumed the options pursuant to a reorganization)
 - Rule No. 6: The optionee must remain an employee from the time the ISO is granted until the date that is 3 months before the ISO is exercised (i.e., 3-month post-termination exercise period), which period can be extended to up to 1 year if termination of the optionee’s employment is due to “Disability” (and no time limit if termination of employment is due to death)
 - The terms of the plan may specify a shorter period than the above
 - Rule No. 7: The exercise price must be equal to or greater than the fair market value of the underlying stock as of the date the ISO is granted
 - However, for optionees owning 10% or more of the company’s voting power or 10% or more of all classes of stock of the company, the exercise price must be at least 110% of the fair market value of the underlying stock as of the date the ISO is granted
 - Rule No. 8: There is a \$100,000 limit on the aggregate fair market value (valued at the time the option is granted) of employer stock that can be exercisable under an ISO for the first time by an employee during any calendar year
 - Any options exceeding this limit are treated as NSOs
 - Rule No. 9: an ISO cannot be transferable (except at death), and during the employee’s lifetime the option must be exercisable only by the employee

Non-Statutory Stock Options

- NSOs are stock options that do not satisfy one or more of the requirements for ISO treatment
 - However, in order to avoid the negative tax consequences associated with Section 409A, the exercise price of an NSO must be at least equal to the fair market value of the underlying stock as of the date of grant
- NSOs may be granted to employees and to non-employees
- The tax treatment to the optionee is as follows:
 - No taxable income to the optionee on the date of grant
 - At exercise, the optionee would generally recognize ordinary taxable income equal to the positive difference between the fair market value of the underlying stock on the date of exercise and the exercise price
 - At sale, the difference between the stock's tax basis and the sale price could be captured at capital gains rates (*i.e.*, long-term capital gains rates if the underlying stock is held for 1 year or more from the date of exercise)
- The tax treatment to the company is as follows:
 - At exercise, any taxable income recognized by the optionee would be subject to withholding and employment taxes if the optionee is an employee
 - At exercise, the company would have a compensation deduction equal to the amount recognized by the optionee as ordinary taxable income

Modifications of ISOs and NSOs

- Generally, modifications, extensions and renewals of an ISO or an NSO would be deemed a new grant. If no other changes are made to the exercise price, then:
 - The ISO would lose favorable ISO treatment and be deemed an NSO (because it did not comply with Rule No. 7 (see Slide 4))
 - The NSO would likely violate Section 409A and therefore would likely be subject to adverse tax consequences under Section 409A (though this issue is resolvable with pre-planning). Such adverse tax consequences include:
 - An earlier inclusion of ordinary taxable income (earlier than likely contemplated)
 - An additional tax equal to 20% of the amount that is required to be included as ordinary taxable income, and
 - Interest, fines and penalties

- Do not forget!
 - Whenever an amendment to an outstanding option is being considered (whether an ISO or NSO), be sure to determine whether the amendment would be considered a “modification,” “extension,” or “renewal” of the option under ISO rules (if applicable) and Section 409A
 - For example, adding a “net exercise” feature after-the-fact IS a modification for ISO purposes but is NOT a modification for NSO (i.e., 409A) purposes

Stock Appreciation Rights

- A SAR is similar to an option except that it represents a “promise” to pay and provides the participant with the right to receive an amount in cash/stock equal to the excess, if any, of the fair market value of a share of the company’s common stock as of the settlement date over the “base appreciation amount” (*i.e.*, the amount similar to the exercise price)
 - Until settled, a SAR represents no ownership interest in the company
 - The base appreciation amount is typically the fair market value of the company’s common stock on the date the SAR is granted (and such is required if the SAR has optionality)
 - The promise can either be settled on a pre-chosen date or have optionality.
 - Example of a pre-chosen date: Grant 1,000 SARs with a base appreciation amount of \$20 per share. If the SAR is vested and settled when the company’s stock price is \$50, then the SAR would be settled for a cash payment equal to \$30,000 (1,000 x \$30) or the issuance of 600 shares (\$30,000/\$50)
- The tax treatment to the participant is as follows:
 - At settlement, the participant would have ordinary taxable income equal to the positive spread between the fair market value of the stock on such date and the base appreciation amount
- The tax treatment to the company is as follows:
 - A compensation deduction would be triggered at settlement; at that time a withholding obligation would apply if the participant is an employee

Restricted Stock Grants

- Generally, the grant of restricted stock would constitute a corporate transfer on the date of grant but, if there is a vesting schedule, not 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 forfeiture
 - If the award is subject to forfeiture, then the tax transfer typically coincides with vesting
- The tax treatment to the holder (assuming no 83(b) election was timely filed) 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)
 - Until such time, any dividends received by the holder would be treated for tax purposes as compensation and not as dividends
 - After such time, any sale of the underlying stock would be treated as capital gain or loss equal to the difference between the sale price and the holder's tax basis

Restricted Stock Grants (cont.)

- The tax treatment to a holder assuming an 83(b) election was timely filed is as follows:
 - The holder could attempt to capture as much of the anticipated future appreciation of the underlying stock at 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)
 - 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 when the holder 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

Restricted Stock Units

- RSUs (*a.k.a.*, “phantom stock units,” “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 settled on a pre-chosen date, and example of which is as follows:
 - Example: Grant 1,000 RSUs that vest when the company’s stock price is \$50. 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 that is settled

- 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

Employee Stock Purchase Plans

- ESPPs provide employee participants with “purchase rights” (similar to stock options) that are facilitated through payroll deductions
 - Purchases are typically provided to employees at discounted prices (up to a 15% discount is permitted) and without brokerage costs and other fees

- To qualify as an ESPP, the plan must comply with all of the following tax rules:
 - Rule No. 1: Participation must be limited to employees of the employer, its parent company or its subsidiary company
 - Rule No. 2: The company’s stockholders must approve the plan within 12 months before or after the plan is adopted
 - Rule No. 3: The plan must prohibit participation by 5% or more stockholders of the company
 - Rule No. 4: Participation must be open to all employees; however, the following may be excluded from participation:
 - Employees with less than 2 years of service,
 - Part-time employees,
 - Seasonal employees, and
 - Highly compensated employees (defined under Section 414(q) of the Code)

Employee Stock Purchase Plans (cont.)

- [Continued from prior slide]
 - Rule No. 5: Generally, all participants must have the same rights and privileges; however, limitations on the amount of stock subject to a purchase right are generally permitted (e.g., specified dollar amount, a certain percentage of compensation, etc.)
 - Rule No. 6: The discount provided under the plan cannot exceed the greater of:
 - 15% of the fair market value of the underlying stock on the date the purchase right was granted, and
 - 15% of the fair market value of the underlying stock on the date the purchase right was exercised
 - Rule No. 7: The offering period cannot extend beyond 5 years or 27 months (which of the two time periods apply depends on the manner in which the purchase price was computed under Rule No. 6)
 - Rule No. 8: All grants are subject to a \$25,000 annual accrual limit
 - Rule No. 9: Purchase rights cannot be transferable (except by will and the laws of descent and distribution) and may be exercisable only by the participant during his or her lifetime

Employee Stock Purchase Plans (cont.)

- Generally, the tax consequences to the employee participants are as follows:
 - The employee recognizes no taxable income on the grant of the purchase right
 - If the foregoing qualification rules are not satisfied, or if the employee fails to implement the purchase within 3 months of his or her termination of employment, then he or she would recognize ordinary taxable income equal to the difference between:
 - The fair market value of the underlying stock on the date of exercise, and
 - The purchase price
 - If the employee disposes of the stock after expiration of the holding period (*i.e.*, the later of 2 years from the date the purchase right was granted and 1 year from the date the purchase right was exercised), then the employee would recognize ordinary taxable income equal to the lesser of:
 - The difference between the fair market value of the stock on the date the purchase price was granted and the exercise price of the purchase right (*e.g.*, taxed on the 15% discount), and
 - The difference between the amount realized in the disposition of the stock and the exercise price of the purchase right

Don't Forget Next Month's Webinar

- Title:
 - How to Negotiate Executive Employment Contracts: Tips of the Trade

- When:
 - 10:00 am to 11:00 am Central
 - December 13, 2018