Stock Options and Restricted Stock

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Stock Options and Restricted Stock

- Agenda
  - Overview of tax withholding and reporting requirements
    - Stock options
    - Restricted stock and units
  - Special situations
    - Excess withholding
    - Non-employees
    - Former employees
    - Changes in employment status
    - Divorce
    - Death
  - State taxes

Stock Options

Stock Options

- Non-qualified stock options (NQSO)
  - Subject to tax at exercise
  - Company has a reporting and, for employees, a withholding obligation
- Incentive stock options (ISO) and ESPPs
  - Subject to tax at sale
  - Company has a reporting obligation for sales
    - For ISOs, only sales that occur within a specified time period
    - For ESPPs, substantially all sales
  - Exempt from tax withholding

Non-Qualified Stock Options

- Reporting requirements
  - Employees
    - Form W-2
      - Income resulting from exercises is aggregated with employee's other income in Boxes 1, 3 (if applicable), and 5
      - Income also reported in Boxes 16 and 18, if applicable
      - Income for NQSO exercises is reported separately in Box 12 with code V
      - Any taxes withheld are also reported in the appropriate boxes
  - Non-Employees
    - Form 1099-MISC

Non-Qualified Stock Options

- Tax Withholding
  - Federal income tax
  - Social security (up to annual maximum)
  - Medicare
    - Including additional tax that applies to wages in excess of specified threshold
  - State income tax (if applicable)
  - SDI or SUI (if applicable)
  - Local (if applicable)

Non-Qualified Stock Options

- Tax Withholding
  - NQSO income is considered a supplemental payment
    - Federal income tax is withheld at W-4 rate or flat rate (currently 25%)
      - Maximum individual rate (39.6%) if supplemental payments for the year exceed $1 million
      - Deposit must be made by next business day if aggregate withholding exceeds $100,000
    - Company must make matching FICA payments and any required FUTA payments
    - For CA employees, CA state income tax must be withheld at the maximum individual rate (currently 10.23%)

Qualified Arrangements

- Qualified arrangements
  - Must comply with rigid regulatory requirements
    - Incentive stock options (ISOs)
      - Section 422 of IRC
    - Employee stock purchase plans (ESPPs)
      - Section 423 of IRC
  - Taxation is deferred until shares are sold
    - All or some of compensation income can be converted to long-term capital gain if shares are held long enough
      - Two years from date of grant/enrollment, AND
      - One year from date of exercise/purchase
  - Not subject to withholding (or matching payments)

Qualified Arrangements

- Disqualifying Dispositions
  - ISOs
    - Employee recognizes compensation income equal to lesser of:
      - Gain when shares were exercised (exercise market value less option price)
      - Actual gain on sale (sale price less option price)
  - ESPPs
    - Employee recognizes compensation income equal to gain when shares were purchased
      - Even if stock has declined in value
  - Exempt from FICA/FUTA
  - Exempt from tax withholding
    - Employee pays applicable income tax upon filing tax return at end of year

Qualified Arrangements

- Disqualifying Dispositions
  - Compensation income must be reported on employee’s Form W-2
    - Aggregated with employee’s other income in Box 1 only (income is exempt from Social Security and Medicare)
    - Also reported in Boxes 16 and 18 if applicable
      - Some states (most notably Pennsylvania) do not recognize ISOs
    - Income can also be listed separately in Box 14 (Other) with an appropriate label, if desired
    - Reporting requirement continues to apply to terminated employees

Qualified Arrangements

- Qualifying Dispositions
  - ISOs
    - No compensation income
  - ESPPs
    - Employee recognizes compensation income equal to lesser of:
      - Discount at enrollment date
      - Actual gain on sale
    - Exempt from FICA/FUTA
    - Exempt from tax withholding
      - Employee pays applicable income tax upon filing tax return at end of year

Qualified Arrangements

- Qualifying Dispositions
  - ISOs
    - Company has no reporting obligations
  - ESPPs
    - Compensation income must be reported on employee’s Form W-2
      - Aggregated with employee’s other income in Box 1 only (income is exempt from Social Security and Medicare)
      - Also reported in Boxes 16 and 18 if applicable
        - Some states (most notably Pennsylvania) do not recognize ISOs
      - Income can also be listed separately in Box 14 (Other) with an appropriate label, if desired
      - Reporting requirement continues to apply to terminated employees
    - Company does not receive tax deduction

Qualified Arrangements

- Section 6039 Reporting
  - Must file returns with IRS
    - ISO exercises
    - Initial transfers of ESPP shares
      - Beginning in 2010, where purchased shares are immediately deposited into captive or designated brokerage account, reporting is required at time of purchase
    - Filed on Form 3921 (ISOs) and Form 3922 (ESPPs)
      - Electronic filing required for 250 or more returns
      - Filing deadline is March 31, 2011 for electronic filers; February 28, 2011 for paper filers
    - Provide information statements to employee
      - Copy of return filing or substitute statement
      - Deadline is January 31, 2011

Restricted Stock and Units

Restricted Stock and Units

- Characteristics:
  - Shares awarded with no cash investment by employee
    - Employee may be required to pay a nominal amount, such as par value, for the stock
    - Usually no more than $.01 per share

Restricted Stock and Units

- Characteristics:
  - Shares are usually awarded subject to vesting restrictions
    - Vesting requirements may include performance goals
    - Shares are non-transferable until vested
    - Shares are held in escrow until vested and are automatically paid out upon vesting
  - Unvested shares reacquired by the company upon termination of employment

Restricted Stock and Units

- Types of awards
  - Restricted stock
    - Shares issued at grant
    - Typically entitled to voting and dividend rights
    - Stock released to employees at vest
  - Restricted stock units
    - Shares issued at release
    - May be entitled to dividend equivalents but not voting rights
    - Release may not be tied to vesting

Restricted Stock Awards

- Taxation
  - Generally taxable at vest
    - Unless Section 83(b) election is filed, then taxable at grant
  - Difference between purchase price (usually $0) and market value at vesting is compensation income
  - Taxes withheld by company (with matching payments), unless non-employee

Restricted Stock Units

- Taxation
  - Generally taxable at vest
    - Unless subject to deferred payout, then taxable at payout for income tax purposes
      - FICA/FUTA taxes are still due upon vest
    - Difference between purchase price (usually $0) and market value at vesting/payout is income
    - Taxes withheld by company (with matching payments), unless non-employee

Restricted Stock Units

- Deferral of restricted stock units
  - Elective or mandatory
    - Deferral can be until a specified date or event (such as termination of employment)
      - ERISA considerations
      - Severance payment limitations under §409A
    - Subject to strict limitations under §409A
  - Defers income taxation until payout
    - FICA taxation still occurs at vest
    - Shares can be used to cover FICA, but will result in income taxation on shares sold/withheld

Restricted Stock Units

- Acceleration of vesting upon retirement
  - Where RSUs are subject to accelerated vesting upon retirement, FICA taxes are due when the award holder becomes eligible to retire
    - FICA due at grant if the award recipient is already eligible to retire
  - Two rules facilitate collection of FICA
    - Rule of administrative convenience: allows company to delay collecting FICA until any subsequent date in the same calendar year
    - Lag method: allows company to delay collecting FICA for up to three months but requires interest to be collected
  - Also applies to restricted stock, but applies to both FICA and FIT, with no special rules to facilitate withholding

RS and RSUs Tax Treatment Summary

	Restricted Stock (Section 83)	Restricted Stock Units (Sections 451 and 409A)
Grant	Not taxable at grant unless Section 83(b) election is filed	Not taxable at grant
Vest	Income and FICA taxation on current value	FICA taxation on current value
Payout	No taxable income	Income taxation on current value
Sale	Capital gain/loss	Capital gain/loss

RS and RSUs Tax Reporting and Withholding

- Reporting
  - Income at vest/payout reported on Form W-2 for employees (and former employees)
    - Same boxes as for income recognized on exercise of NQSO, except do not report in box 12
      - Can be reported voluntarily in box 14
    - Box 11 reporting required for RSUs that aren't paid out a vest
      - E.g., RSUs subject to deferral election or subject to accelerated vesting upon retirement and employee is eligible to retire
      - Report income subject to deferral in box 11 in both year of FICA taxation and in year of payout
        - Exception applies if employee is younger than 62 and has separate amounts reported in boxes 1 and 3 that are also reportable in box 11
    - Form 1099-MISC for consultants or outside directors

RS and RSUs Tax Reporting and Withholding

- Withholding
  - Federal income tax generally withheld at flat rate
    - W-4 rate is also permissible
    - Maximum individual rate if supplemental payments exceed $1 million
    - Deposit must be made by next business day if aggregate withholding exceeds $100,000
  - Social Security and Medicare
  - State taxes
    - CA: Subject to withholding at maximum individual rate (as applicable to stock options and bonuses)

RS and RSUs
Tax Payment Methods

- Cash
  - Check
    - Collecting checks from employees can be problematic
  - Payroll withholding
    - Generally must be collected in advance or in first paycheck after vest/release

RS and RSUs
Tax Payment Methods

- Shares
  - Share withholding
    - Shares with value equal to tax payment are cancelled
    - May be returned to plan reserve
    - Cash outflow for company
    - Allowing excess payments triggers liability accounting under ASC 718 (formerly FAS 123(R))
      - Rounding issues
      - A problem for overseas employees, where it can be difficult to determine the required tax withholding rate

RS and RSUs
Tax Payment Methods

- Dealing with the fractional share
  - To round up or round down, that is the question…
    - Conservative reading of ASC 718 requires liability accounting if share withholding is rounded up
    - On the other hand, clearly a rounding issue and rounding down is an administrative headache
    - Practices vary significantly by company
      - Round down and collect check for additional cash
      - Round down and collect additional from next paycheck
      - Round down and short Social Security payment
      - Round up and deposit extra payment with federal income tax
      - Round up and refund cash to employee

RS and RSUs
Tax Payment Methods

- Shares
  - Sale of shares
    - Shares sold on open market and sale proceeds forwarded to company to cover taxes
    - Volume of sales can be a problem
    - Black-out periods
    - IRS deposit requirements
    - Employees must pay brokerage fee
    - Results in flow of shares into the market place

RS and RSUs
Tax Payment Methods

- Recommendations
  - Consider requiring share withholding or sale to cover taxes
  - If employees can elect a tax payment method
    - Distribute election notices in advance of vesting
    - Consider stipulating withholding or sale as default
    - Where employees elect cash, revert to default if cash isn't received

Special Situations

Excess Withholding

- Can federal income taxes be withheld at a rate other than the flat supplemental rate?
  - Yes, in two circumstances:
    - If you use the employee's W-4 rate to determine the withholding, or
    - If the employee has received more than $1,000,000 in supplemental payments, you must withhold at the highest individual tax rate
  - For supplemental payments under $1,000,000, you must use either the flat rate or the W-4 rate
    - *Publication 15 (Circular E): Employer's Tax Guide* specifically states (on page 14) that no other rate is permitted
    - *Information Letter 2012-0063*, issued in September 2012 further clarifies the IRS position

Non-Employees

- Outside directors, consultants, and other non-employees
  - Not subject to withholding
  - Income from stock compensation is reported on Form 1099-MISC
    - Report in Box 7 (and Box 18, if appropriate)

Former Employees

- Transactions by former employees are generally subject to the same withholding and reporting requirements that apply to current employees.
  - Under Regulation §31.3401(a)-1(a)(5) any payment for services constitutes wages regardless of whether or not the employment relationship exists at the time the payment is made:

    Remuneration for services, unless such remuneration is specifically excepted by the statute, constitutes wages even though at the time paid the relationship of employer and employee no longer exists between the person in whose employ the services were performed and the individual who performed them.

    Example. A is employed by R during the month of January 1955 and is entitled to receive remuneration of $100 for the services performed for R, the employer, during the month. A leaves the employ of R at the close of business on January 31, 1955. On February 15, 1955 (when A is no longer an employee of R), R pays A the remuneration of $100 which was earned for the services performed in January. The $100 is wages within the meaning of the statute.

Former Employees

- Transaction occurs in same calendar as termination or following calendar year
  - Same withholding and reporting requirements as for current employees
    - Flat rate or W-4 rate (for payments under $1,000,000)
    - Report on Form W-2
- Transaction occurs in second calendar year following termination
  - Must withhold at W-4 rate (for payments under $1,000,000), unless taxes have been withheld from regular wages paid during the year
    - Report on Form W-2

Changes in Employment Status

- Change to non-employee status (or vice versa)
  - Withholding and W-2 reporting only on gain attributable to service as an employee
    - Allocate gain based on service as an employee during vesting period
      - Allocation is only permissible of option/award continued to vest after change to non-employee status
    - If option/award fully vested while an employee, withholding and W-2 reporting is required on the entire gain
    - If option/award vested 25% while an employee and 75% while a consultant:
      - Withholding and W-2 reporting is required on only 25% of the gain
      - Gain attributable to service as a consultant is reported on 1099-MISC

Divorce

- Options and awards transferred pursuant to divorce
  - Withholding
    - All withholding taxes are collected from ex-spouse
      - FIT
      - FICA
    - FICA/FUTA payments are based on employee's income and attributed to the employee
  - Reporting
    - Gain and FIT withholding reported on 1099-MISC issued to ex-spouse
    - Gain and FICA withholding reported on employee's Form W-2
      - Gain is reported only in boxes 3 (Social Security wages, if applicable) and 5 (Medicare wages)
  - Transfer of option in divorce disqualifies ISO

Death

- Options and awards transferred pursuant to death
  - NQSOs and full value awards
    - No income tax withholding
    - FICA withholding (and FUTA payments, if applicable) only if transaction occurs in calendar year of employee's death
      - Reported on employee's final Form W-2
  - ISOs
    - Transfer of shares to the estate is not a disposition
      - Holding periods no longer apply
      - Option can also transfer without losing ISO status (and holding periods no longer apply)
  - ESPPs
    - Transfer of shares to the estate is a qualifying disposition
      - Report compensation income on employee's final Form W-2

Death

- Options and awards gifted or transferred prior to death
  - Generally transferred to family members or trusts
  - Employee is subject to tax upon exercise just as if he/she still held the option
    - FIT and FICA withholding, FUTA payments
    - Report on Form W-2

State Taxation

- Most states parallel federal treatment
- Residency changes
  - Where employees have moved from one state to another, income for stock compensation may need to be allocated based on length of residency or amount of time worked in each state during the vesting period or life of the option
- CA and NY have been active in this area

State Taxation

- Survey Data
  - Have you implemented procedures to track, report, and withhold (if appropriate) for your domestic mobile employees where they have been employed and resident in multiple states during the life of their awards?

24.6%	Yes
42.5%	No, but we probably should
26.9%	No, because we have determined that the number of employees this impacts and the dollar amounts involved are *de minimus*
6.0%	I don't know

NASPP Quick Survey, November 2010

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About Stock & Option Solutions

- SOS has been providing solutions for stock plan challenges since 1999:
  - Strategic consulting
    - Best practices, vendor search, vendor implementations, plan roll outs, employee communications, training, etc.
  - Staffing
    - Temporary to long-term
  - Technology solutions
    - Data conversions, data integration/automation, data audits / clean ups
    - Custom applications / process automation
      - ESPP modification accounting
      - Participant communications (email, custom websites)
  - Outsourcing
    - Full-service provider, not just transactional
    - Best practices, full-time expertise, part-time cost
  - 6039 solutions
    - Aggregate participant statements
    - Mailings / year-end statements
    - IRS e-filings

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