



DEFERRING Equity-Based Compensation

Executive Summary

The purpose of this whitepaper is to address the tax, ERISA, accounting and business considerations associated with deferring equity-based compensation.

Sponsor Profile

Equity-based compensation plans are intended to align the executive's interests with the interests of the owners by focusing management's efforts on maximizing profitability.

Business considerations typically limit the use of actual stock to corporations with publicly traded stock. In addition, many public corporations impose minimum stock ownership requirements on their executive teams. These requirements are typically fulfilled by direct purchases on an exchange or through grants of equity-based compensation.

Closely-held corporations, partnerships and LLCs compete with public companies for executive talent. However, legal constraints on corporate structure as well as concerns about dilution of the interests of venture capital and dilution of voting rights limit the use of actual stock. From the employees' perspective, grants of actual stock may be perceived as less valuable given the absence of a market to sell the shares. Such organizations more often rely on equity equivalents, commonly known as "phantom" stock or share units in order to achieve the incentives available to public companies.

Types of Stock Awards

Equity-based compensation plans come in a variety of forms. All can be categorized as either actual stock or phantom stock.

Programs granting actual stock include:

- **Company stock awards**, which may include restricted stock that vests over a period of time;
- **Stock options**. Options are agreements allowing the executive to purchase stock at a specified price within a specified time period. Options are usually subject to vesting; the executive may exercise his or her right to purchase after the award vests and before the option expires, typically ten years after the grant date.

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Examples of phantom stock include:

- **"Phantom" stock plans**. An award of phantom stock is a promise to pay an amount equal to the value of one share of company stock. Payment may be made in stock or cash at a specified settlement date.
- **Restricted stock units** ("RSUs") are phantom stock awards subject to vesting conditions. Closely-held companies issue RSUs most frequently as a substitute for restricted stock grants, although many public corporations also use RSUs. Payment is most often made in the form of stock on or shortly after the vesting date.
- **Stock appreciation rights** are grants of "options" to receive payment equal to the appreciation in value of an underlying share of company stock after the grant date. SARs are intended as a substitute for stock options. Like stock options, SARs may be subject to vesting. In addition, the appreciation is determined as the current market value over the price specified at the grant date. Payment may be made in the form of stock or cash.

Tax Treatment of Awards

General Principal of Income Recognition. In general, compensation, regardless of form, is taxable when it is earned and not subject to substantial restrictions on payment. The most common restriction is a vesting schedule that results in forfeiture if certain pre-established service or performance criteria are not satisfied. If a vesting schedule applies the compensation event will not occur before the vesting date.

Stock Awards: Restricted Stock. With the exception of the special election under IRC §83(b), discussed further below (“83(b) election”), the taxation of restricted stock follows the general rules summarized above.

Example 1: A grant of 1,000 shares of stock at \$10 per share, subject to a three-year service vesting period is taxable at the end of the three-year period. If the stock is worth \$20 on the vesting date, taxable income in this example is \$20,000. This amount is ordinary income. The company may satisfy withholding requirements by (i) accepting a check from the executive or (ii) reducing the number of shares released to the executive. The company has a deductible compensation expense of \$20,000 on the vesting date.

The 83(b) election allows employees to unilaterally elect to include a restricted stock grant in income as of the grant date. The election must be filed with the IRS and the employer within the first 30 days following the grant. A timely election results in the immediate recognition of taxable income equal to the fair market value of the stock on the grant date. (In the example above, the employee would have recognized income in the amount of \$10,000 on the grant date.) Appreciation after the grant date is considered capital gain, taxable at favorable capital gains rates when the stock is eventually sold.

The executive who makes an 83(b) election is assuming risk in exchange for this bargain: If the award is forfeited (for example, upon termination of employment prior to the vesting date), or if the value of the stock declines below the fair market value on the grant date, the executive cannot claim

a deduction for the loss. In the case of forfeiture, the loss is particularly stark as the executive may be in the position of paying income tax on income he or she does not receive.

Phantom Stock Awards: Restricted Stock Units. With the exception of the 83(b) election, which is limited to employee receiving grants of actual stock, the tax treatment of RSUs is the same as for restricted stock.

Example 2: The employee receives a grant of 1,000 restricted stock units, with each unit equal in value to one share of employer common stock. The terms of the grant specify a payment, in cash or employer stock at the employee’s election, on the third anniversary of the grant date, equal in value to the shares on such date. The units will be forfeited if the executive terminates employment before the payment date. On the grant date, the shares are worth \$10 per share. On the payment date, they are worth \$20 per share. Assuming the executive remains employed on the payment date and receives payment, the executive recognizes \$20,000 of taxable income, taxable at ordinary income rates.

Note that in both of Examples 1 and 2, the executive receives \$20,000 of ordinary income, without regard to whether the award is in the form of stock or phantom stock. Also note that the 83(b) election is available only for awards of actual stock. The RSU, as a promise to pay a specified amount at a future date, is not considered to be “property” exchanged for the performance of services under §83 and therefore is not eligible for the §83(b) election. The fact that an RSU could be settled in the form of stock does not change this result.

Stock Options and Stock Appreciation Rights. Special rules apply to the timing of income recognition and character of income related to stock options and stock appreciation rights. Because the ability to defer the gains on such “stock rights” is generally prohibited by the requirements of IRC §409A, it isn’t necessary to detail those rules here, other than to mention in passing that taxation generally occurs no sooner than the date the employee exercises his or her rights under the option.

Dividends. Restricted stock, RSUs and options may pay dividends prior to the date the award itself is taxable. Dividends may be paid in cash or additional shares of stock. Dividends are ordinary income, taxed under the principles discussed above. For example, if the dividends are paid in the form of additional restricted shares, the dividends are taxable as they vest.

Accounting Treatment of Awards

The accounting for share-based awards under generally accepted accounting principles is governed by the provisions of FASB Accounting Standards Codification (“ASC”) Topic 718, Compensation - Stock Compensation. ASC Topic 718 establishes the standards by which compensation cost is recognized and recorded for share-based awards and includes the guidelines as to measurement of the cost and the requisite service period over which such cost is to be amortized. For share-based awards associated with deferred compensation arrangements, additional guidance is available through the Deferred Compensation - Rabbi Trust Subsections of ASC Subtopic 710 -10, Compensation - General - Overall.

Share-based awards are typically measured at fair value on the date of grant and amortized over the requisite service period (which is most often the associated vesting period). Compensation cost (represented by the periodic amortization) is a component of the current period P&L while the “obligation” is classified in the equity section of the company’s balance sheet. Once fully amortized, no additional P&L impact is recorded.

However, when share-based awards are integrated with a deferred compensation arrangement, the accounting treatment may vary from the method described above depending upon the terms of the plan. In a situation where the plan allows for the awards to be settled in cash or permits the diversification of the awards out of company stock into other non-employer securities, the characterization of the awards change from equity instruments to liabilities. Consequently, compensation cost is initially recognized at fair value and re-measured and adjusted at each reporting date.

Securities Law Aspects

Adding a stock deferral component within a traditional deferred compensation plan generally would not affect the analysis of whether awards under the equity compensation plan or deferrals under the deferred compensation plan by themselves constitute securities. Note, however, that stock exchanges may require deferred compensation plan to be filed with the exchange if stock or stock derivatives are offered through the plan.

Deferrals

Restricted awards of stock, phantom shares of stock or stock options all provide some degree of tax deferral by their terms. The value of the grant and subsequent appreciation is deferred at least until the vesting date. Stock options offer the additional advantage of delaying taxation beyond the vesting date to the date when the executive exercises the option.

The opportunity for an employee to elect to defer payment (and taxation) of the award beyond the payment date specified in the original award is generally limited to awards of restricted stock units. Stock options and stock appreciation rights generally cannot be structured to defer gains on an elective basis.

Although some plans provide for a deferral of restricted stock, the deferral election technically constitutes an exchange of the restricted stock—a property right in the hands of the executive—for a promise to pay the stock on the payment date selected by the employee. The terms of such a promise are the functional equivalent of an award of restricted stock units.

Because only RSUs may be practicably deferred, sponsors considering a deferral feature should consider offering RSUs as alternatives to stock under their equity plans. Addressing this topic typically requires the plan sponsor to conduct a comparison of RSUs and restricted stock in order to understand what rights are being conceded in the event the employer switches from stock to stock units.

Feature	Restricted Stock	RSUs
Grant	Property	Promise to pay in cash or property
Timing of taxation	At vesting	Upon payment (typically at vesting)
Character of income	Ordinary income	Ordinary income
Withholding	Upon vesting	Upon payment (at vesting)
Subsequent appreciation	Capital gain	Capital gain, if paid in stock or if cash payment is invested in capital assets
Accounting Treatment	<ul style="list-style-type: none"> • “Fair value,” fixed at grant • Amortized over restriction period 	<ul style="list-style-type: none"> • If settled only in stock, same as restricted stock • If settled in cash or diversifiable in deferred compensation plan: <ul style="list-style-type: none"> – fair value expense at grant – mark to market after grant to reflect notional returns
Voting Rights	Generally available	Not available
Minimum share requirements	Credited toward requirement	May be credited, depending on plan design

As illustrated above in Examples 1 and 2 and the chart, the tax treatment of RSUs and restricted stock are basically the same. The most significant distinction is the 83(b) election available on restricted stock grants, which entails a considerable degree of risk to the executive as explained above.

Because of the economic risks of an 83(b) election, it is worth inquiring as to whether executives are making the 83(b) election in sufficient numbers to justify its availability. If not, and the lack of voting rights and the minimum shareholding requirements also are not factors, consideration should be given to making the initial grant in the form of RSUs instead

of stock. While a “swap” of restricted stock for units is possible, a swap entails coordination between the broker who retains custody of the unvested stock, the company’s treasurer, and the administrator of the deferred compensation plan.

Election Timing Rules

As mentioned above, RSUs by their terms are taxed when they are paid, typically upon vesting. A payment date beyond the vesting date may be specified by the company under the terms of the initial grant or may be elected by the service provider (employee or independent contractor) if the election satisfies the election timing requirements of IRC §409A.

If the service provider is making the election to defer payment, IRC §409A requires the election to be in writing and to include (i) the number of units being deferred, (ii) the time when payments commence, and (iii) the payment schedule. With respect to timing, one of the following rules must be met:

- An election may be filed prior to the end of the tax year preceding the tax year in which the RSU is granted.
- An election may be filed within 30 days of the date the RSU is granted, provided the vesting date occurs at least 12 months after the election window (in other words, vesting must occur at least 13 months from the date of grant).
- An election may be filed up to 12 months prior to vesting, provided the deferred payment date occurs no earlier than the fifth anniversary of the vesting date.

- An election may be filed up to 6 months prior to the end of the vesting period if vesting is contingent upon attaining pre-established performance criteria and the attainment of the criteria is not ascertainable at the time the election is made.
- Separate elections may be made for the deferral of dividends payable during the vesting period. If dividends are not subject to vesting, the election generally must be made in the year prior to the year of the award.

Example (30-day rule): A restricted stock unit is granted on June 1, 2017 with a three-year cliff vesting schedule (vesting on June 1, 2020). Absent an election to defer, settlement will occur on the vesting date. Because vesting does not occur until at least 12 months after the date of grant, the executive may elect to defer payment of the RSU beyond 2020 if the election is made by July 1, 2017 (i.e., by the 30th day after the date the RSU is granted).

Example (12-month/five-year rule): A restricted stock unit is granted on June 1, 2017 with a three year cliff vesting schedule (vesting on June 1, 2020). Absent an election to defer, settlement will occur on the vesting date. Provided the employee elects a new payment date that is no earlier than June 1, 2025 (five years after the vesting date), the executive may elect to defer payment of the RSU at any time prior to May 31, 2019 (12 months prior to the vesting date). For a plan that generally pays accounts upon the earlier of the specified date or termination of employment, the stock must be continue to be deferred to at least June 1, 2025 to satisfy the five-year requirement if termination should occur prior to that date.

Example (performance-based RSU): Executive is granted an award of restricted stock units on June 1, 2017. Pursuant to the award, the number of RSUs being granted will vary depending upon specified performance criteria that will be measured over a three-year period commencing on the date of grant (between June 1, 2017 and May 31, 2020). The RSUs will be settled only if the performance criteria are satisfied. Assuming the RSUs otherwise qualify as performance-based compensation, the executive may elect to defer payment of the RSUs at any time prior to November 30, 2019.

Earnings Gains and Losses— Diversification and Dividends

The service provider's deferred RSU account will fluctuate in value with the value of the underlying shares of company stock. While this is typical for the vesting period, companies generally take one of two paths with respect to diversification after the stock vests:

- **Allow Diversification.** Under this line of reasoning, the executive should have the same diversification privileges with respect to deferred RSUs as he or she would have had if the RSU had not been deferred. If the executive could have sold the shares received under a standard RSU and reinvested it elsewhere, he or she also should be able to diversify his deferred RSUs among the other notional investments offered under the deferred compensation plan. The change in accounting treatment from equity to liability is not viewed as a material disadvantage since cash deferrals (salary and bonus) are already

marked to market to reflect earnings gains and losses based on the performance of the notional investments offered under the plan.

- **Prohibit Diversification.** As mentioned in the accounting discussion above, the program is treated as a liability for purposes of the accounting rules if the plan allows the participant to diversify. This means the award is marked to market, with attendant volatility in corporate earnings as the award fluctuates in value. Companies that wish to avoid the volatility to their earnings statements may prefer to prohibit diversification and pay the deferred award in shares of company stock.

Dividends. Prior to vesting, the equity plan will determine if and when dividends (or dividend equivalents for RSUs) are paid. Dividends accruing during the vesting period may be paid immediately (even though the award itself is still unvested) or accumulated until the vesting date and paid along with the award. Dividends accruing under either arrangement may be further deferred along with the award, subject to the deferral election timing rules discussed above.

The continued accrual of dividends on deferred RSUs after the vesting date is determined under the terms of the deferred compensation plan.

Deferred dividends may be "reinvested" in the form of additional shares of phantom stock or diversified into other investments offered under the plan. The approach is determined under the terms of the deferred compensation plan, reflecting the company's position on diversification described above.

Employer Stock in Rabbi Trusts

Generally, setting aside shares of company stock (for example, by depositing shares in a grantor (“rabbi”) trust) will not operate as a financial hedge against deferred RSUs. However, deferred RSUs settled in shares don’t require a financial hedge. Such shares are considered to be treasury stock for financial accounting purposes. However, the shares issued to the trust continue to enhance benefit security since they remain available for payment to executives, for example, in the event of a change in control.

Shares liquidated or issued in kind as payment from a rabbi trust also have an important tax benefit. Under IRC §1032, the gains on the shares are not taxable to the corporation. Treas. Reg. §1032-1. However, to receive this benefit, the payment must be made from the corporation (or a rabbi trust set-up by the corporation) that issued the stock. See Treas. Reg. §1032-3, Example 10.

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