COMPENSATION & BENEFITS DIGEST

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**IN THIS ISSUE**



## Restricted Stock and Restricted Stock Unit (RSU) Utilization Today—and Planning Points

Offering company stock as an element of annual compensation to executives, or even a broader group of employees, has been commonplace in Corporate America over the past 50 years. What has changed is the type of equity-based awards granted and the mix of these awards. (See our March 2019 *Digest* for data on the current mix of long-term incentive ("LTI") awards).

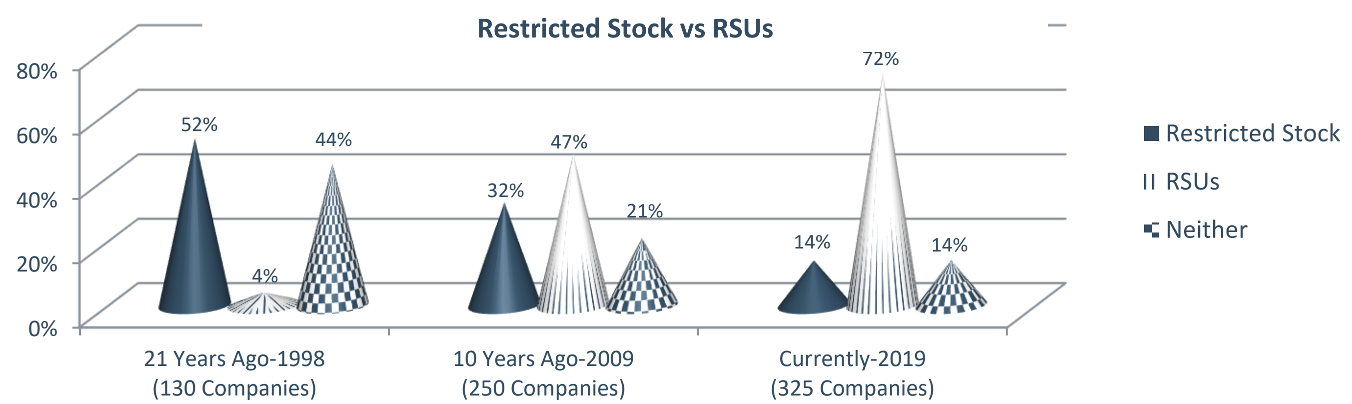
Performance-based awards have become the most common long-term incentives granted to executives at large companies today, while stock option utilization has declined. So-called "full value" awards, including restricted stock or RSUs, remain a fairly common equity-based award.

What has changed in this area over the past 20 years is the type of full-value award. There has been a marked shift away from restricted stock to the use of RSUs and more recently, the addition of performance vesting features in RSU awards. Time-vested awards have been criticized by some as "pay for pulse"—that is, it can provide significant value even without any stock price appreciation. But they remain in place at many companies, for reasons we will describe, despite the enlarged importance of corporate governance monitors. Due to recent tax law changes, we may even see the expansion of time-vested awards.

### 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 services.

A large majority of these companies have a history of making such grants annually, while others do so only periodically or as special grants to select executives. Our data is intended to reflect the annual compensation awards made to executives compared to grants made 10 and 21 years ago by Ayco corporate partners at that time.

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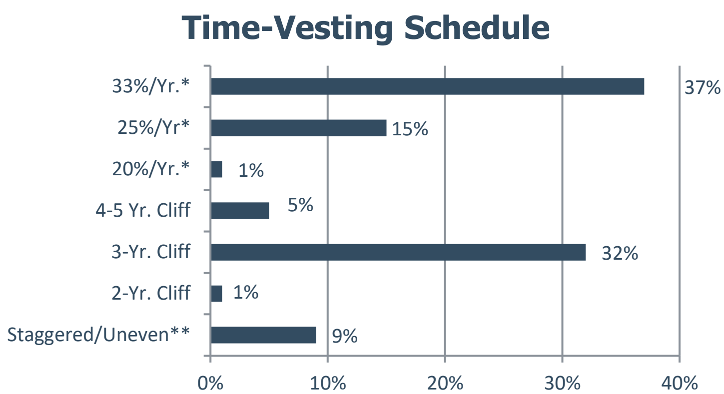
There are several reasons why RSUs have replaced restricted stock at a large majority of the companies. Primary reasons include the administrative convenience and likelihood of lower cost. Each RSU is the economic equivalent of a share of company stock. However, unlike restricted stock, each RSU is a bookkeeping entry. 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 can also be a difference in entitlement to dividend rights, and RSUs typically do not have voting rights. However, RSUs are treated as deferred compensation subject to IRC §409A, unlike restricted stock. This can impact when awards are paid out and have other tax-related implications.

### ➢ Time-Vesting

For recent awards that have a time-vesting schedule, we found just under 40% of companies use "cliff vesting", while slightly over 60% use 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:




*beginning one year after grant date
**beginning 2, 3 or 4 years after grant date

The Council of Institutional Investors, an advocacy group, recently announced an overhaul of their recommendations on executive pay. It suggests that companies explore simplifying executive compensation and utilizing restricted stock (or RSUs) that vest over five years or more.

### ➢ Performance Vesting

Time-vesting may not necessarily align the interests of executives with shareholders or with the achievement of corporate goals. As a result, some companies have now incorporated a performance feature in a portion (or in a few cases, all) of their restricted stock/RSU grants. Thus, "pay for pulse" becomes "pay for performance". Performance-based restricted stock is similar to, but somewhat distinct from, performance shares or share units. We now count just over 25% of our survey group with a performance feature for at least some grants, including quite a few companies that have incorporated this feature into awards for the first time within the past two years. In fact, the most recent RSU awards had *only* a performance-vesting feature at several members of our survey group for some or all executives. These would be shown in the proxy disclosure table that reflects the relationship between compensation paid to key executives and the company's total shareholder return. It also helps in getting a "thumbs up" from ISS and Glass Lewis in their shareholder voting recommendation.

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. The number of shares actually earned will be based on the ratio of the stock price at the end of the vesting period to the stock price at grant. Thus, the actual payout can represent a different value than a full value award. Fewer than 2% of our survey group currently grants these awards.

### ➢ 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—the executive pays income taxes at vesting or when any substantial risk of forfeiture no longer exists. RSUs are taxable when payable, which could be deliberately designed to be later than the vesting date. Thus, there is less need to develop a timing strategy as to when to recognize income. Care should be taken to avoid any inadvertent violation of the wash-sale rule. The sale of other company stock at a loss within 30 days before or after the vesting or payment date can disallow any loss on the sale.

Restricted stock does offer a unique tax-planning opportunity that is not available for RSUs; 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 of RSUs is the possibility of deferral into a nonqualified deferred compensation (NQDC) plan. Any elective deferral must meet strict timing rules under IRC §409A. In our last informal survey of NQDC plans, just under 20% 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 which will result in the taxation of restricted stock. Generally, entitlement to the award 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 entitlement. 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 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 within six months of a purchase under SEC §16(b) could delay taxation. Generally, non-compete clauses and clawbacks will not constitute a substantial risk of forfeiture delaying taxation.

### ➢ 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 2019 proxy that they have granted restricted stock/RSUs to newly-hired executive officers to offset forfeited compensation from a previous employer. Several companies reported 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 a qualified retirement, so called "career shares." These can be viewed as an 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. However, a few plans provide the employer 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 among our survey group allow for the designation of a beneficiary to receive payment of an award upon the death of a recipient prior to payout.

Just over half of the companies in our survey group provide for an acceleration in vesting in the event of a "qualified retirement", while 5% continue vesting. This can help drive a recipient's retirement decision. Pro-rata vesting rather than full vesting is in place at 10% of the companies.

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 lower age threshold and 30% define normal retirement at an older age (e.g., age 62 or 65).

### ➢ Other Issues to Consider

The current 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 potential future value at vesting. There is no Black-Scholes valuation needed to explain the grant date value, as there is for stock options, and no risk of the award being "underwater". Performance-based awards can offer an opportunity to receive more than 100% of the value if stated performance targets are achieved; but also can risk less than full payouts.

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

- *Share Withholding*: Prior to a change made a few years ago, a plan that allowed for share withholding that exceeded the minimum statutory requirements (currently 22% federal tax withholding if supplemental wages are under $1M) resulted in an accounting charge to the company—so virtually no companies allowed it to occur. Under the current rules, a company can allow for share withholding or a net settlement that does not exceed the maximum statutory tax rate (37% federal rate currently) without negative accounting implications.

However, the IRS has yet to modify its supplemental wage withholding rules, which has created a dilemma for many companies. Should they take advantage of the accounting rule 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 supplemental wage threshold.

- *FICA Tax Differences*: Restricted stock is taxable for both income and FICA taxes (including the Additional Medicare Tax) based on the value when the award vests and is no longer subject to a substantial risk of forfeiture. In contrast, the timing rules for these taxes may not be in sync for RSUs. While any FICA generally will be payable upon vesting of the RSU, income taxes are to be calculated, and tax withholding occurs, based on the value at the scheduled payment date. For a few companies in our survey group, this is the first quarter of the calendar year after the vesting date.

  A plan provision allowing for the acceleration in vesting upon retirement eligibility can lead to unanticipated income and FICA taxation for restricted stock. This has led some companies to alter the terms of their plan to change any automatic vesting. There can be a different result for RSUs which generally are not income taxable until paid or available to be paid.

- *State Tax*: State tax issues can be complicated, especially for an executive who performs services in multiple states during the vesting period of an award (see the September 2017 *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. 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 can also play a role.

- *§83(b) Election*: Restricted stock is considered "property" within the meaning of IRC §83. This allows the recipient the right to make a §83(b) election within 30 days of 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 any subsequent appreciation being taxed at capital gains rates. A potential downside to this election is that if the stock is forfeited prior to vesting, 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 don't 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 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. It no longer is necessary 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 attachment on an e-filed Form 1040.

  RSUs are not considered property under IRC §83 (it is more akin to deferred compensation) and therefore are not eligible for this election.

- *Private Company Deferral Option*: Under IRC §83(i), which was enacted in 2017, employees at private companies who receive RSUs now have an opportunity to elect to defer income taxes for up to five years following the stock becoming essentially vested (or upon the stock becoming publicly traded, if earlier). At least 80% of eligible employees must receive this award for this choice to be available.

- *Share Ownership & Retention Requirements*: A large majority of companies 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 2018 *Digest* for our last survey on Executive 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, most companies have now replaced any single-trigger acceleration in vesting with a double-trigger requirement (CIC plus a separation from service). This can help reduce or minimize any excess parachute excise tax potential.

- *Impact of IRC §409A*: While restricted stock is not subject to §409A, RSUs, phantom stock or similar awards payable in stock (or cash) at a future date are. The most significant impact of this can be the necessity of a six-month delay in payments triggered by a separation from service made to "specified employees" at U.S. public companies, unless an exception applies. A plan that provides for the automatic acceleration in vesting upon retirement eligibility with payout delayed until after actual retirement could create the need for a six-month delay in payment. 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 <u>after</u> grant. While this timing rule resulted in fewer companies allowing a deferral election for RSUs 10 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. If there is a choice involving restricted stock units, any election must meet the §409A timing rules.

- *§162(m) Changes*: The Tax Cuts and Jobs Act of 2017 eliminated the performance exception under IRC §162(m), subject to certain grandfathering of existing awards. It also expanded the definition of a "covered employee" subject to the $1 million corporate deduction limit on compensation paid annually. There had been speculation that this could lead to a shift away from performance-based pay for the highest paid executives at public companies. We haven't seen this take shape yet. Perhaps one factor is that ISS considers any shift away from performance-based pay to discretionary or fixed pay elements to be a problematic pay practice.

  Time-vesting restricted stock and RSUs do provide companies more control as to when compensation will be paid and corporate deduction earned compared to other LTI awards, including stock options.

- *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. When stock options are transferred pursuant to a state divorce order, FICA is payable by the employee on all of the options, including those transferred to the former spouse, according to IRS guidance. There should be a similar result upon the vesting of restricted stock or RSUs.

- *Cost Basis Reporting*: Both restricted stock and RSUs granted on or after 2013 are characterized as "non-covered securities". As a result, recipients are to calculate any gain or loss on the sale of shares by adding the compensation element reported on Form W-2 to basis (if any) reported on Form 1099-B (a rare occurrence). Brokers should not be reporting the compensation element as part of the stock's basis on Form 1099's issued.

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

Could share withholding trigger a SEC §16(b) violation resulting in a recoupment of any "profit" if an insider has an open market purchase within six months? Two federal appeals courts recently concluded the answer was no (*Olorgues v. Muncrief; Jordan v. Flenton*). Assuming a plan or award is approved pursuant to SEC Rule 16(b)3, any share withholding should be treated as an exempt transaction, and a matchable "sale".

# Final IRS Regulations on Hardship Distributions

Last year, the IRS issued new proposed regulations regarding hardship distributions from §401(k) plans and §403(b) plans. Generally, when the IRS issues proposed regulations, it requests comments from practitioners regarding any modifications or changes they recommend before the rules are finalized. The IRS did receive a number of comments on its hardship distribution rules and has now issued final regulations regarding such distributions.

Here is a brief summary of these final rules, including steps that employers with plans that allow for hardship distributions will need to take.

- ***Elimination of Six-Month Suspension of Contributions***: Effective for hardship distributions requested after 2019, plans cannot impose a six-month suspension of employee contributions following a hardship withdrawal. The final regulations clarify that this applies only to qualified plans and does not apply to nonqualified plans subject to §409A that have a hardship withdrawal provision.

- ***Elimination of Requirement to Take Plan Loans***: Effective as of January 1, 2019, employees are not required to take plan loans before receiving a hardship distribution from the plan.

- ***Related Employee Representation Requirement***: The proposed regulations required that a participant make a representation that he/she has insufficient cash or other liquid assets to cover expenses resulting from a hardship. The final regulations relax this requirement by providing that the participant must represent only that he or she has insufficient cash or other liquid assets *reasonably available* to cover expenses resulting from a hardship.

- ***Changes to Definition of "Immediate and Heavy Financial Need"***: The list of distributions deemed to be made on account of an immediate and heavy financial need have been modified. They now include:

  - *Expenses for Employee and Primary Beneficiaries*: Medical, educational, and burial/funeral expenses, including those incurred for the participant's primary beneficiary under the plan.
  - *Expenses Incurred as a Result of Certain Disasters*: Expenses and losses (including loss of income) incurred by the employee on account of a disaster declared by the Federal Emergency Management Agency ("FEMA"), if the employee's principal place of residence or employment at the time of the disaster was located within an area designated by FEMA for individual assistance.
  - *Casualty Loss*: Damage to a principal residence that would qualify for a casualty deduction is no longer required to be in a federally declared disaster area.

  These new safe harbor events may be applied to hardship distributions received as early as last year (but would require plan amendment this year).

- ***Expansion of Plan Sources for Hardship Distributions***: The regulations permit, but do not require, 401(k) plans to allow participants to take hardship distributions from participant elective deferrals, qualified nonelective deferrals, qualified matching contributions, and/or the earnings on those contributions. Qualified nonelective contributions and qualified matching contributions held in a 403(b) custodial account continue to be ineligible for hardship distributions.

- ***Elimination of Facts and Circumstances Test***: Under existing regulations, if a plan does not rely on the safe harbor rules in the regulations, the plan administrator must determine whether the claimed need is "immediate and heavy" and "necessary" based on individual facts and circumstances.

  The regulations eliminate this fact and circumstances test and replace it with a three-part test that requires:

  - The distribution is not in excess of need;
  - Other available distributions obtained;
  - Insufficient liquid assets reasonably available.

- ***Plan Amendments***: 401(k) plans that currently permit hardship distributions will need to be amended to reflect the new rules by December 31, 2021. Operational changes to comply with the new rules are to be in effect by January 1, 2020. If an employer chooses to adopt any of these changes for 2019, plans must be amended by December 31, 2019.

  Employers will need to work with their plan administrator to adopt these new rules and communicate the changes in hardship distributions to plan participants in a timely manner.

## Can Arbitration Be Mandated In 401(k) Plan/ERISA Litigation?

If an employee or former employee seeks to sue his/her employer relating to an ERISA plan, can the employer force the potential litigant into individual arbitration prior to commencing litigation in federal court? The Federal Arbitration Act was enacted nearly 100 years ago and the U.S. Supreme Court has repeatedly ruled in favor of arbitration clauses.

The answer to this question has been somewhat murky since ERISA was enacted in 1974. Recently, the 9th Circuit U.S. Court of Appeals issued two opinions expressly overruling its previous decisions that ERISA disputes were not arbitrable (*Dorman v. Charles Schwab Corp.*). This could lead to a greater consistency and utilization if there are individual arbitration clauses in plans or individual agreements.

In this case, Michael Dorman participated in a 401(k) plan throughout his employment from 2009 through 2015. During his term of employment with Charles Schwab Corp., the 401(k) plan was amended to include an arbitration provision and a class action waiver that required individual arbitration. After employment termination, Dorman filed a class action complaint alleging that his employer breached its fiduciary duties of loyalty and prudence by including in the 401(k) plan certain investment funds that were affiliated with the plan sponsor. The former employee claimed that these funds performed poorly, but were kept in the plan's mix to generate fees for the plan sponsor. In response to this action, the company moved to compel arbitration based on provisions in the plan. A lower federal court concluded that the arbitration provisions were unenforceable based, in part, on a prior 9th Circuit federal court opinion from 1984 that ERISA claims could not be subject to arbitration. Now however, that conclusion has been overturned and the arbitration clause in the plan can be the basis of trying to resolve the parties' differences prior to engaging in ongoing and likely costly litigation.

Arbitration has become much more common and often a less time consuming mechanism to resolve disputes in recent years. In fact, a U.S. Supreme Court decision in 1953 stated that arbitration was an inferior and disadvantageous forum for determining a plaintiff's statutory rights. That conclusion was later overruled and arbitration became an acceptable resolution in many, but not all, federal forums. Now, many employment contracts contain an arbitration clause and it appears that they are also becoming more common in ERISA plans. This latest federal decision seems to indicate that if such a clause is in a plan or agreement, it can generally be enforced, if the rules and procedures are properly followed. Does your company have arbitration provisions?

## Did You Know…

- According to data supplied by the Congressional Budget Office, from 1995 to 2018, the share of Americans age 55 to 79 who were employed increased from 33% to 44%. For those between the ages of 62 to 69, the increase was 22% to 36%.

- The 19th annual retirement survey conducted by Transamerica Center for Retirement Studies reported that while 75% of employers consider themselves to be "aging friendly" to their employees (including having flexible work arrangements), just 54% of workers think their employers have adopted sufficient policy options.

- Over half of corporate participants in the 2019 EBRI Employer Approaches to Financial Wellbeing Solutions Survey reported currently offering financial wellness initiatives to their employees, while another 20% are actively implementing a program and 29% were interested or considering such an initiative.

- The IRS recently released PLR 201933005 indicating that portions of the cost of a genetic testing service may be considered as a medical expense that is reimbursable from a flexible spending account.

- According to a poll recently conducted for the AICPA, over 90% of American parents say it is very important that their children understand how to manage their money, including their allowance. Eight in ten parents require their children to do chores in exchange for an allowance. The average allowance for all children under age 25 living at home was reported as $120 per month. (Wow! How much did you receive?)

### About This Newsletter

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