

Tax Withholding on Restricted Stock and Unit Transactions

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Today's presenter...



Barbara Baksa

Executive Director for the National Association of Stock Plan Professionals (NASPP)

- › Frequent speaker on equity award topics
- › Authored numerous articles on stock compensation, contributed chapters to four books on equity compensation and co-authored the fifth edition of "Accounting for Equity Compensation," published in 2008 by the NCEO
- › Serves as editor of *The NASPP Advisor*, and contributes regularly to *The Corporate Executive*
- › Currently a member of the Advisory Board of the CEPI
- › Has a BA in English from the University of Iowa and is a Certified Equity Professional

Tax Withholding on Restricted Stock and Unit Transactions

› Agenda

- › Tax Treatment of Restricted Stock and Units
- › Tax Withholding and Reporting Requirements
- › Tax Payment Methods
- › International Considerations
- › Acceleration of Vesting on Retirement
- › Dividends
- › Best Practices



The Basics

› 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
- › 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 are reacquired by the company upon termination of employment



The Basics

- › 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
 - › Opportunity to defer taxation for U.S. income tax purposes



The Basics

› Taxation

› Grant

- › Restricted stock awards are generally not taxable at grant, unless Section 83(b) election is filed

› Vest

- › Taxable event normally occurs on the date the shares vest
- › Difference between purchase price (usually \$0) and market value at vesting is compensation income
- › Taxes withheld by company (with matching payments), unless non-employee

› Sale of shares

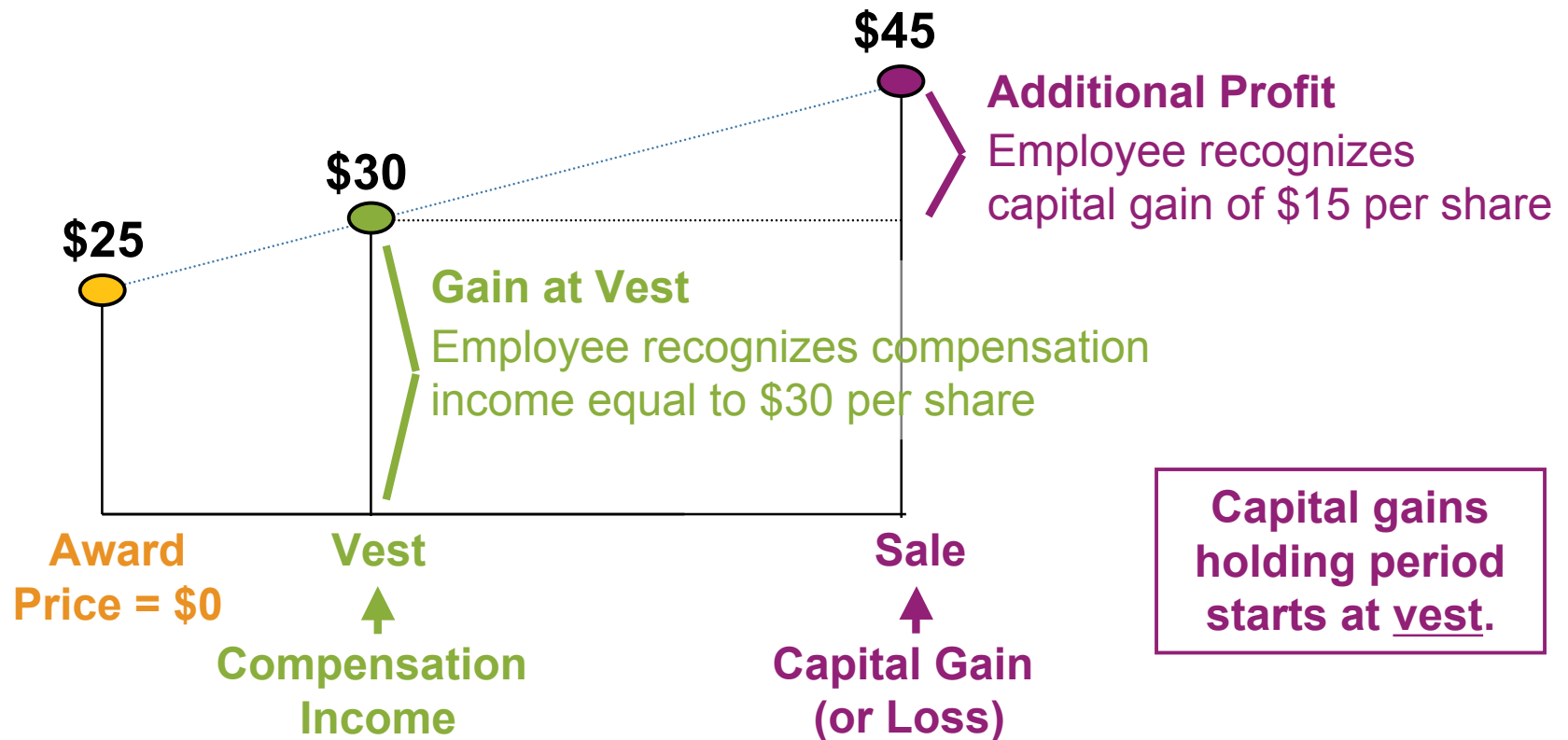
- › The employee recognizes either a capital gain or loss on the sale



The Basics

Restricted Stock Award Example

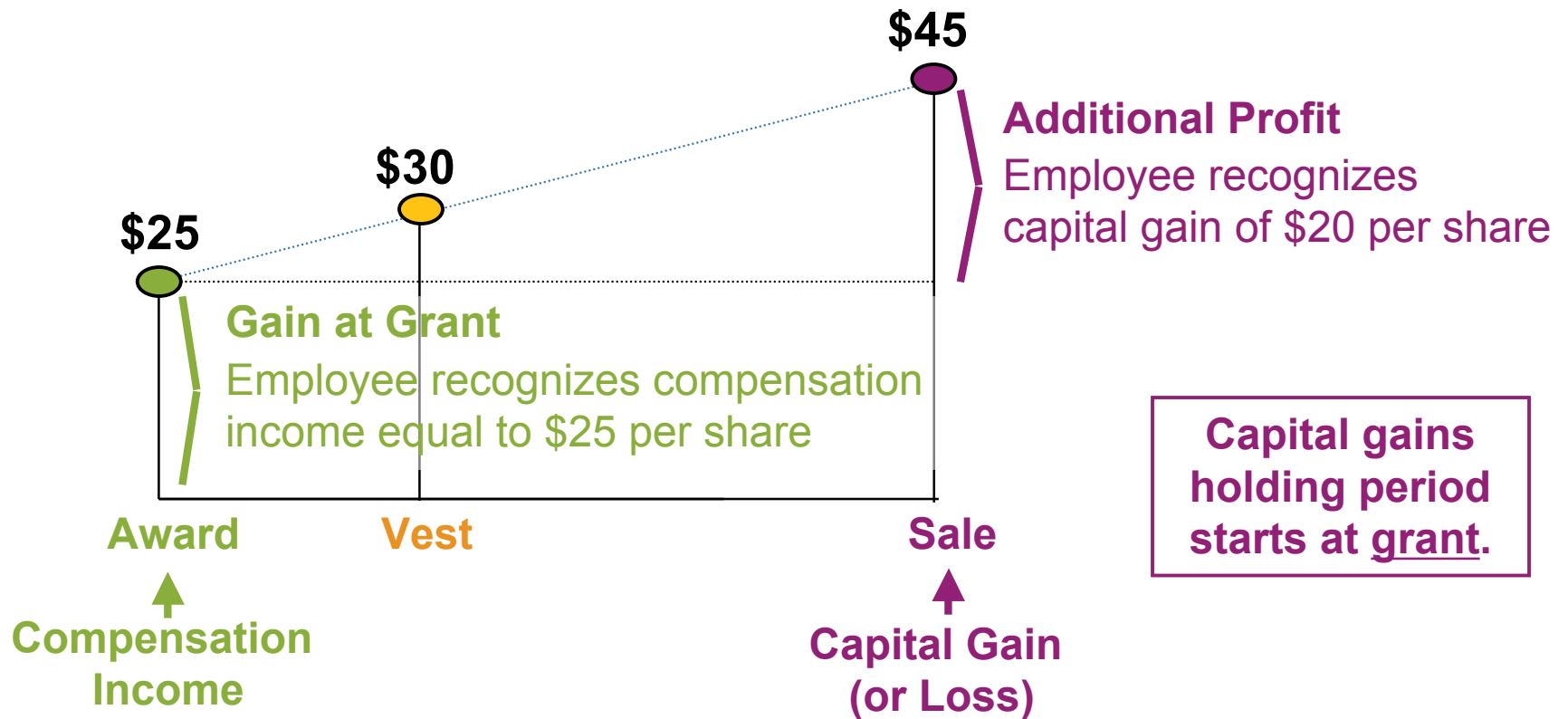
- › Most Likely Scenario: Section 83(b) election is NOT filed



The Basics

Restricted Stock Award Example

- › Least Likely Scenario : Section 83(b) election IS filed



The Basics

- › Advantages of Section 83(b) Election
 - › Close out compensatory portion of award at grant
 - › If stock continues to appreciate after the grant date, results in a lower amount of compensation income
 - › Starts long-term capital gains holding period

The Basics

- › Disadvantages of Section 83(b) Election
 - › When filed for restricted stock awards, the election always results in some amount of compensation income
 - › If shares are forfeited, taxes paid are also forfeited
 - › Stock could decline in value
 - › Employee cannot claim a loss for decline in value at vest, unless shares are sold at that time
 - › Taxes must be paid in cash
 - › Alternative tax payment methods are not available until the shares have been earned
 - › Generally preferable to pay taxes later rather than sooner

The Basics

› Taxation

› Grant

- › Restricted stock units are not taxable at grant
- › Section 83(b) election is not available

› Vest

- › FICA/FUTA taxes are due upon vest
- › Difference between purchase price (usually \$0) and market value at vesting is FICA/FUTA income
- › Taxes withheld by company (with matching payments), unless non-employee



The Basics

› Taxation

› Release

- › Compensation income recognized when shares are released (e.g., when employee has constructive receipt)
- › Difference between purchase price (usually \$0) and market value at release is compensation income
- › Taxes withheld by company, unless non-employee

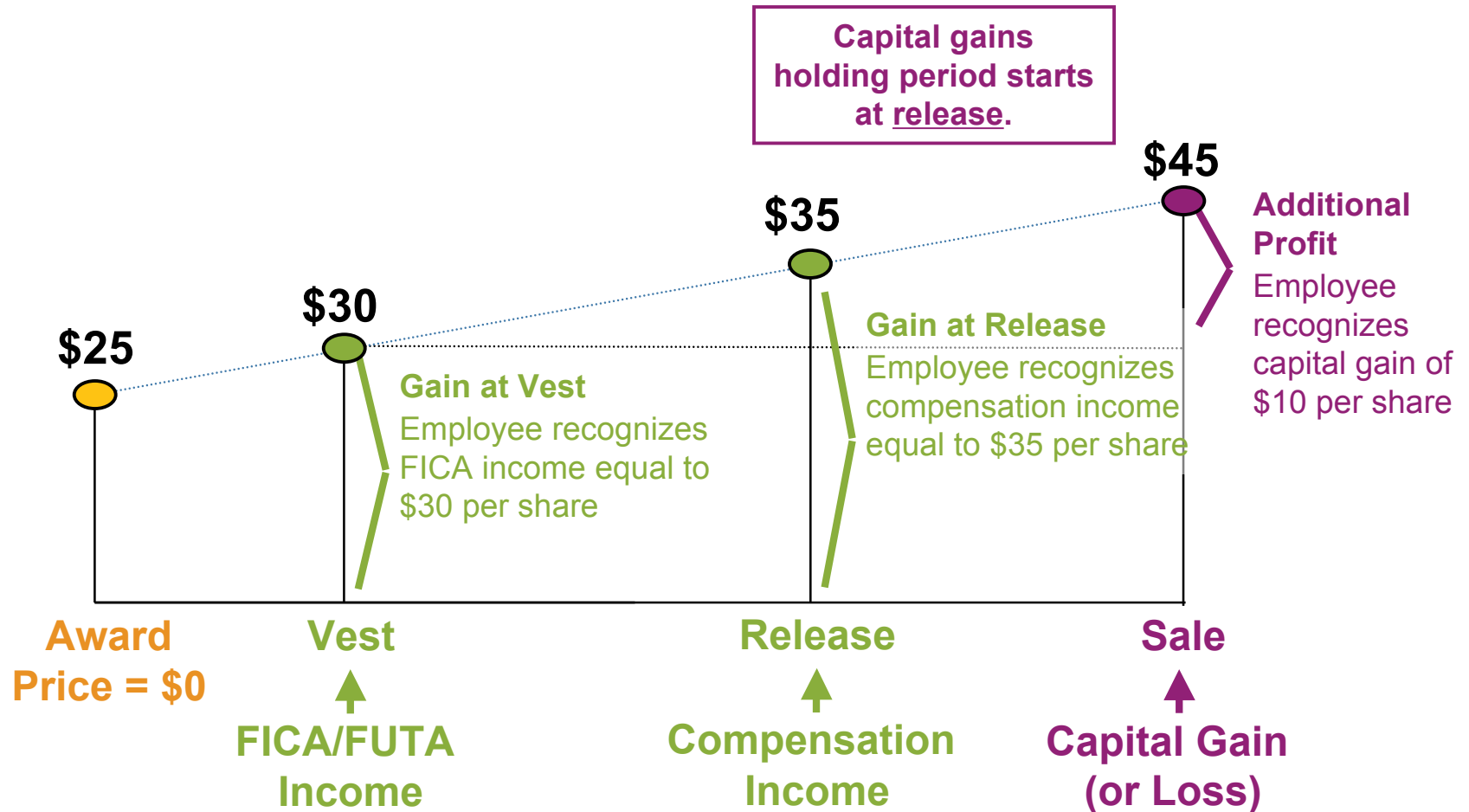
› Sale of shares

- › The employee recognizes either a capital gain or loss on the sale

Note: Vest, release, and sale may all occur on the same date. If so, the employee's FICA and compensation income will be the same amount. The employee will have a nominal capital gain or loss equal to the difference between the amount realized on the sale (the sale proceeds less any transaction fees) and the market value of the stock.

The Basics

Restricted Stock Unit Example



Beyond the Basics

- › 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 release
 - › FICA taxation still occurs at vest
 - › Shares can be used to cover FICA, but will result in income taxation on shares sold/withheld



Beyond the Basics

› Deferral Elections

› Service-based awards

› Within 30 days of grant, provided that:

- › Award does not vest for at least one year, and

- › Election is made one year before deferred shares will vest

- › Up to one year before vest if deferral is for at least five years

› Performance-based awards

- › Up to six months before vest



Tax Treatment Summary

Event	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
Release	No taxable income	Income taxation on current value
Sale	Capital gain/loss	Capital gain/loss

Mechanics and Practical Considerations

› Withholding

- › Federal income tax generally withheld at flat rate
 - › W-4 rate is also permissible
 - › Maximum individual rate (35%) if supplemental payments exceed \$1 million
- › Social Security and Medicare
- › State taxes and local taxes, if applicable
 - › In CA, restricted stock is subject to withholding at maximum individual rate (as applicable to stock options and bonuses)



Mechanics and Practical Considerations

- › Depositing taxes with the IRS
 - › If cumulative liability for all employees is less than \$100,000
 - › Withholding taxes are deposited according to regular deposit schedule
 - › When company's cumulative deposit liability exceeds \$100,000
 - › Withholding taxes must be deposited by next business day
 - › Liability for entire company, not just one employee or one award



Mechanics and Practical Considerations

› Depositing Taxes with the IRS

› When does deposit liability accrue?

› Income taxes

› Vest date for restricted stock

› Constructive receipt for restricted stock units

› Shares/payment are available to the employee and the employee has control over receipt of payment

› Probably not deferred due to administrative delay in issuing shares

› FICA

› Vest date for both restricted stock and units

› IRS regs allow company to treat payment as occurring on any day during the same calendar year*



* IRC §31.3121(v)(2)-1(e)(5)

Mechanics and Practical Considerations

› Reporting

- › Income at vest/release 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
 - › Boxes 1, 3, and 5
 - › State and local boxes, if applicable
 - › Withholding also reported in appropriate boxes
 - › Income can be reported voluntarily in box 14 (other)



Mechanics and Practical Considerations

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



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

- › May be viable if amounts to be withheld are very small (less than paychecks)

- › Considerable employee education required

- › Withholding may equal employees' entire paychecks



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 FAS 123(R)
 - › Rounding issues
 - › A problem for overseas employees, where it can be difficult to determine the required tax withholding rate
- › Form 1099-B question
- › IFRS requires liability treatment



Tax Payment Methods

- › Dealing with the fractional share
 - › To round up or round down, that is the question...
 - › Conservative reading of FAS 123(R) 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 shortfall
 - › Round down and collect shortfall 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



Tax Payment Methods

› Shares

› Sale of shares

- › Shares sold on open market and sale proceeds forwarded to company to cover taxes
- › Volume of sales
- › Black-out periods
- › IRS deposit requirements
- › Employees must pay brokerage fee
- › Results in flow of shares into the market place
- › If employees are required to sell to cover taxes, additional Form S-8 registration may be required



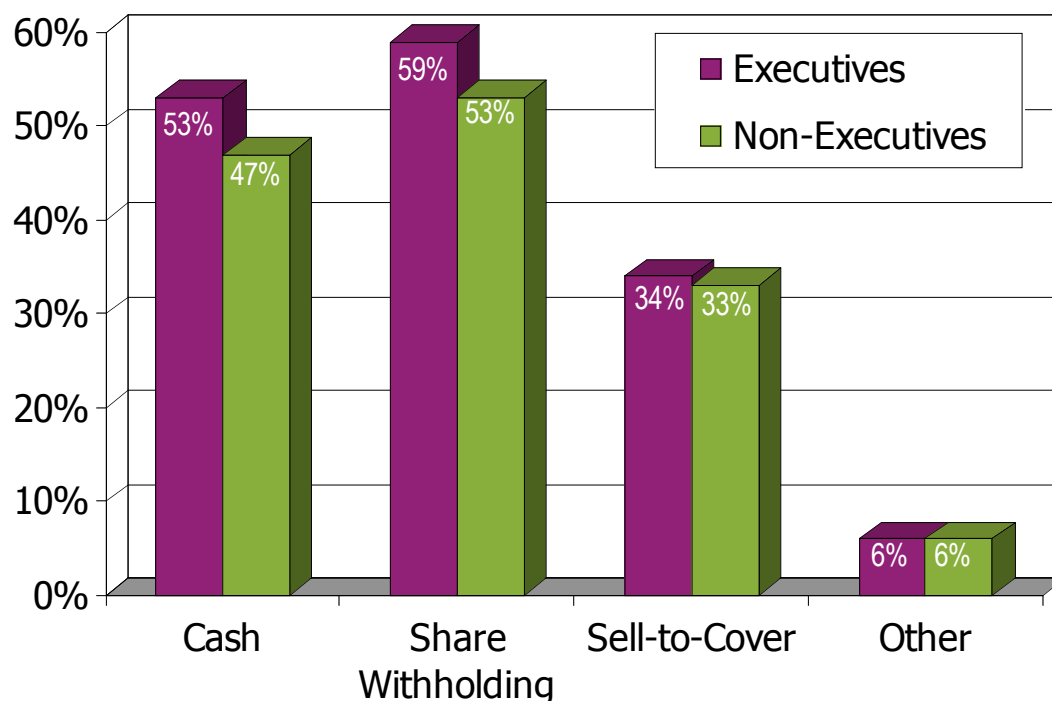
Tax Payment Methods

› Rule 10b5-1 Plans

- › Used to facilitate sell-to-cover and, for some companies, share withholding
 - › Written into grant agreement or separate agreement
 - › Employee commits to sell shares or share withholding while not in possession of material, non-public information
 - › Actual sale or share withholding transaction can then take place during a closed window period
- › For more information see “Keeping Up with the Joneses: The Hottest Equity Compensation Issues Today” in the NASPP Document Library

Tax Payment Methods

- › Percentage of companies permitting each tax payment method
 - › Data from the 2007 Domestic Stock Plan Design and Administration Survey



* Co-sponsored by the NASPP and Deloitte Tax.

Tax Payment Methods

- Percentage of award releases in the past year using the specified tax payment method:

	None	1-10%	11-25%	26-50%	51-75%	>75%
Share Withholding - Executives	11%	7%	2%	4%	3%	73%
Share Withholding – Non-Executives	11%	6%	2%	4%	2%	75%
Cash - Executives	26%	49%	7%	4%	1%	13%
Cash – Non-Executives	25%	54%	7%	3%	3%	8%
Sell-to-Cover - Executives	38%	20%	5%	6%	3%	28%
Sell-to-Cover – Non-Executives	32%	16%	14%	2%	4%	33%
Other - Executives	54%	13%	7%	0%	13%	13%
Other – Non-Executives	31%	25%	6%	0%	25%	13%

Data from the 2006 International Stock Plan Design and Administration Survey, co-sponsored by the NASPP and Deloitte Tax.

Tax Payment Methods

› Rounding for Share Withholding

- › If the company's plan allows share withholding, the company treats the resulting fractional shares in the following way:
 - › 15% - round down to the nearest whole share and collect additional cash from employees
 - › 10% - round down to the nearest whole share and deduct additional payment from employee's next paycheck
 - › 21% - round up to the nearest whole share and refund excess cash to employees
 - › 51% - round up to the nearest whole share and include excess with tax payment
 - › 3% - other

› 1099-B

- › 78% of respondents do NOT issue Form 1099-B for share withholding

Data from the 2006 International Stock Plan Design and Administration Survey, co-sponsored by the NASPP and Deloitte Tax.

Offering Full Value Awards Outside the U.S.

› International Considerations

› Taxation can be problematic

- › Taxation of full value awards is often less defined than taxation of stock options
- › Restricted stock is sometimes taxed at grant
 - › Restricted stock units can resolve this, but be careful about paying dividend equivalents
 - › Where restricted stock won't be taxed at grant and employees will receive dividends/dividend equivalents, restricted stock may be preferable to units
- › Taxation of units that are subject to deferral varies by country



Offering Full Value Awards Outside the U.S.

› International Considerations

› Taxation can be problematic

› Countries that offer tax-qualified option plans rarely offer tax-qualified restricted stock plans

- › Considerable social taxes can apply to both the company and the employee
- › France offers qualified restricted stock program
- › U.K. allows employees to elect taxation at grant
- › A few other planning opportunities exist



Offering Full Value Awards Outside the U.S.

› International Considerations

› Tax withholding can be a challenge

› Share withholding is especially problematic

- › Very few countries offer a flat rate

- › Share withholding for more than the minimum required rate triggers liability accounting under 123(R)

- › More than just a rounding issue

› Alternatives to share withholding

- › Sell-to-cover

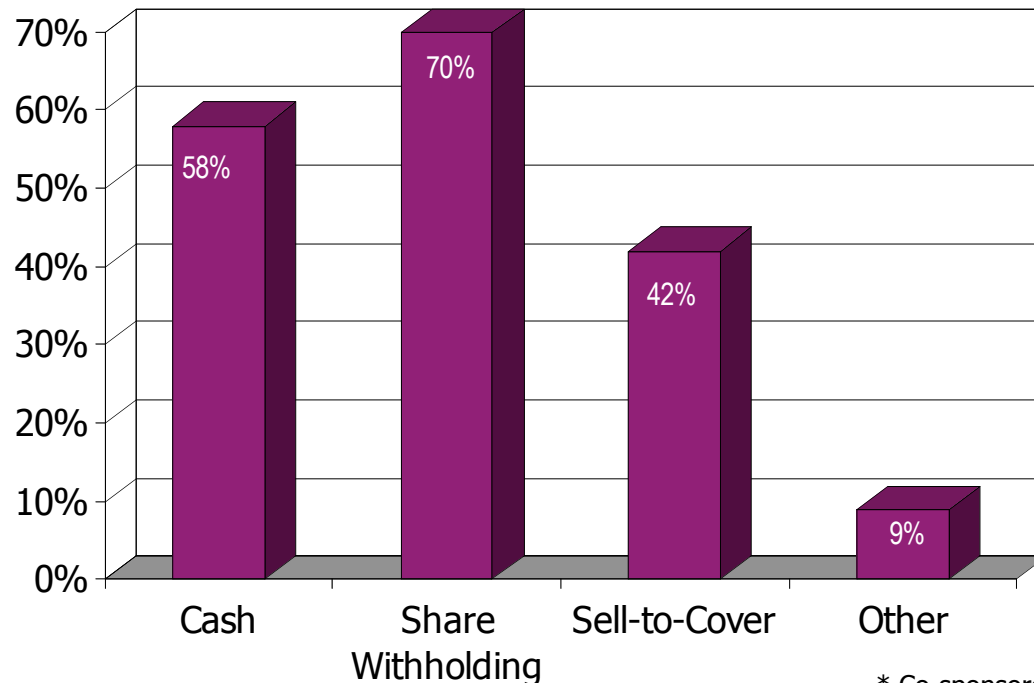
- › Collect cash from employees

- › Deduct through payroll



Offering Full Value Awards Outside the U.S.

- › Types of tax payment methods permitted for non-U.S. employees
 - › From the 2006 International Stock Plan Design and Administration Survey*



* Co-sponsored by the NASPP and Deloitte Tax.

Offering Full Value Awards Outside the U.S.

- › How tax withholding is determined for non-US employees
 - › Companies determine tax withholding for non-US based participants in the follow ways:

Withholding Method	% of Respondents
Flat rate is established for each country and local payroll collects additional withholding or refunds excess withholding	31%
Minimum required rate for each country is used and local payroll collects additional withholding	12%
Local payroll determines tax rate and communicates to US	34%
Local payroll collects withholding	38%
Do not withhold	15%

Data from the 2006 International Stock Plan Design and Administration Survey, co-sponsored by the NASPP and Deloitte Tax.

A Few More Complications

- › Acceleration of vesting on retirement
 - › Full value awards are taxed when they are no longer subject to forfeiture
 - › Restricted stock: Income and FICA taxes
 - › Restricted stock units: FICA taxes only
 - › Income tax isn't triggered until shares are released
- › Problem
 - › When the following two conditions exist:
 - › Employee holding award is eligible to retire, AND
 - › Award terms provide for acceleration (or continued) vesting on retirement
 - › Award is no longer subject to forfeiture and is taxable as described above



A Few More Complications

- › Acceleration of vesting on retirement
 - › Application of rule
 - › Employees already eligible to retire
 - › Awards are taxable at grant
 - › Employees that become eligible to retire prior to award vest dates
 - › Awards are taxable when employees become eligible to retire
- › Consider using restricted stock units instead of restricted stock
 - › Only FICA taxes
 - › Rule for administrative convenience allows company to consider payment date to be a date at the end of the calendar year
 - › Some employees will have maxed out on Social Security, so only Medicare will apply



A Few More Complications

› Dividends

› Paid out on current basis

- › Paid out to employees at same time dividend is paid to shareholders

› Taxed as compensation income

- › Income is equal to amount of dividend payment

- › Subject to withholding and Form W-2 reporting for employees

- › No withholding and Form 1099-MISC reporting for non-employees

- › Only exception is for restricted stock subject to 83(b) election



A Few More Complications

› Dividends

› Paid out on deferred basis

› Dividends are subject to forfeiture until underlying award vests

› Taxed as compensation income

› Income is equal to cash paid or value of stock when paid out

› Subject to withholding and Form W-2 reporting for employees

› No withholding and Form 1099-MISC reporting for non-employees

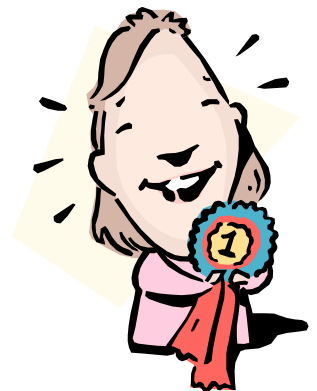
› Possible exception is for restricted stock subject to 83(b) election?



Best Practices

› Recommendations

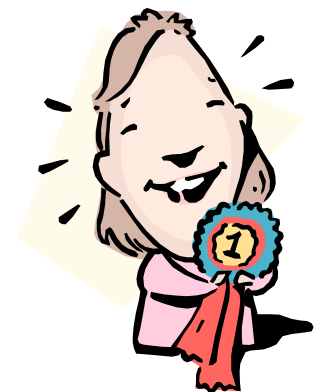
- › Require share withholding to cover taxes
 - › If cash flow isn't a concern
 - › May not work for non-U.S. employees
- › If employees can elect a tax payment method
 - › Distribute election notices in advance of vesting
 - › Save a tree! Distribute notices and collect elections online
 - › Stipulate share withholding or sell-to-cover as default if election isn't submitted on time
 - › Where employees elect cash, revert to default if cash isn't received within a very short period (one to two days)



Best Practices

› Recommendations

- › Consider using restricted stock units instead of restricted stock
 - › Don't have to explain 83(b) elections
 - › Flexibility of tax deferral
 - › Don't have to pay dividends on unvested awards
 - › Better solution if vesting is accelerated or continues upon retirement
 - › Often a better solution internationally
- › Consider disallowing 83(b) election on restricted stock
 - › Especially for rank-and-file
 - › Better yet, grant restricted stock units



Best Practices

› Recommendations

- › Review taxation in each country BEFORE granting any awards
 - › Forecast company matching payments for social taxes
 - › Verify taxation of dividend payments as well as award itself
- › Don't forget to tax dividends
- › Plan on significant employee education
 - › New arrangement that employees aren't familiar with
 - › Compare to stock options, but don't overdo it



More Information

- › Additional resources on restricted stock and units
 - › Restricted Stock Essentials
 - › Intensive one-day course covering everything you need to know about restricted stock and units, from regulatory considerations to day-to-day administrative procedures
 - › Offered by the NASPP on October 20, in advance of the 2008 NASPP Annual Conference in New Orleans
 - › Attend this course then stay on for the NASPP Conference, which includes additional sessions on restricted stock and units
 - › Register at Naspp.com

More Information

- › Additional resources on restricted stock and units
 - › Online Resources
 - › Restricted Stock Portal on Naspp.com
 - › Articles and other resources on restricted stock and units
 - › Sample program materials
 - › “Restricted Stock Plans” by Barbara Baksa
 - › Article covering the tax, accounting, securities law, and administrative considerations for awards and purchases of restricted stock and units
 - › Available on Naspp.com and also published in the book “Beyond Stock Options” by the NCEO (nceo.org)

Questions?

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