

Multi-Disciplinary Facets of Net Withholding: It Ain't Boring

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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 2019 webinars:
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 - Employee Stock Purchase Plans: The Introductory Course (11/14/2019)
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Our Compensation Practice – What Sets Us Apart

- Compensation issues are complex, especially for publicly-traded issuers, 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 discussion is to cover:
 - Comparison of net withholding to broker-assisted sales in the open market;
 - How to increase net withholding rate without shareholder approval;
 - Coordinating net withholding and tax withholding;
 - Coordinating net withholding and federal deposit rules;
 - Net withholding as a cure to the blackout sniffles; and
 - Miscellaneous thoughts

Net Withholding Compared to Open Market Sales

- Advantages of net withholding provisions (compared to open market sales) include:
 - Assuming the equity plan document contains liberal share counting, the life expectancy of the share reserve should be longer because a lesser number of shares are actually issued;
 - Reduced shareholder dilution because only the net shares are considered issued and outstanding;
 - The holder receives the same economic benefit as a broker-assisted sale in the open market;
 - Broker fees are avoided;
 - Avoids blackout periods since there is no open market transaction (though check insider trading policy to ensure permissible during blackout period); and
 - More favorable treatment in calculating basic earnings per share

- Disadvantages of net withholding provisions (compared to open market sales) include:
 - Decreased cash flow for the company because the company has to remit its cash to the U.S. Treasury to satisfy the withholding obligation, and
 - ISS may assign a higher cost to the awards

Increase Net Withholding: No Shareholder Approval

- The Financial Accounting Standards Board (“**FASB**”) allows employers to effectuate tax withholding of equity awards up to the maximum individual statutory rate WITHOUT triggering liability classification for accounting purposes
 - Prior to the foregoing change, stock-based awards withheld at or less than the minimum statutory rate would be classified as equity awards (*i.e.*, accounting expenses is measured at the date of grant), and stock-based awards withheld at a rate above the minimum statutory rate would be classified as liability awards (*i.e.*, accounting expense is re-measured each reporting period settled)

Increase Net Withholding: No Shareholder Approval (cont.)

- And too, NYSE has amended its compensation FAQs to provide that (See FAQ Question C-1):
 - An amendment to allow for the maximum tax withholding (as opposed to the minimum tax rate) would NOT be a “material amendment” requiring stockholder approval
 - The shares forfeited that were never issued may revert back to replenish the equity plan’s share reserve (*i.e.*, the equity plan has liberal share counting)
 - However, if the amendment applies to issued and unvested shares (*e.g.*, restricted stock grants), then the amendment would be permitted as a non-material amendment (*i.e.*, an amendment not requiring shareholder approval) only if the withheld shares are forfeited (*i.e.*, no reversion to the equity plan)
- NASDAQ guidance is generally the same as the above, however, it did not specifically address the issue of “issued” shares
- In sum, the change creates a real solution to the problem of holding illiquid stock (either because the company is privately traded or because the recipient has material non-public information at the time of vesting or exercise of stock options)
 - The minimum federal supplement withholding rate is generally 22%, and
 - The maximum federal individual tax rate is 35%

Coordinating Net Withholding and Tax Withholding

- Important to remember is that accounting rules did not change tax rules
- Generally, there are only two types of wages with respect to employees
 - Regular wages (looking to the Form W-2 for the withholding amount), and
 - Supplemental wages
- Under the Treasury regulations, supplemental wages include:
 - Taxable income resulting from the lapse of a vesting schedule (*i.e.*, vested property),
 - Taxable income associated with the exercise of a non-statutory stock option (*i.e.*, a non-ISO), and
 - Taxable income resulting from non-qualified deferred compensation arrangements

Coordinating Net Withholding and Tax Withholding (cont.)

- According to the IRS, supplemental wages can only be withheld in accordance with one of the following:
 - The flat rate (*i.e.*, 22% for supplemental wages less than \$1mm, and highest marginal rate for supplement wages over \$1mm), or
 - The aggregate method
- The aggregate method involves the employer “aggregating” regular and supplemental wages, and then using the employee’s Form W-4 to determine the applicable withholding rate
 - To accomplish the desired goal of maximum withholding, the employee could file a revised Form W-4 and the employer could elect to use such immediately

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- Generally, employment taxes (*i.e.*, income taxes, FICA/FUTA) will attach at some point in the life cycle of an equity award
 - Attach at the time of vesting (or at the time of an 83(b) election) with respect to restricted stock and property, and
 - Attach at the time of exercise with respect to non-statutory stock options

- Federal deposit rules – Generally
 - Semi-weekly deposits are required if the employer reports total employment taxes exceeding \$50,000 on IRS Form 941 for a 4-quarter look-back period beginning July 1 and ending June 30
 - Monthly deposits are required if the employer reported \$50,000 or less in total employment taxes during the look-back period

- For a semi-weekly depositor, the deposit dates are:
 - For wages paid on Saturday, Sunday, Monday or Tuesday, the employer must deposit by the following Friday
 - For wages paid on Wednesday, Thursday or Friday, the employer must deposit by the following Wednesday

- Next day deposit rule
 - Under this rule, if an employer accumulates \$100,000 or more in employment taxes on any day during a deposit period, then it must deposit these taxes by the end of the next business day
 - This rule is often triggered due to vesting of equity awards, payouts of bonuses, regular wage payments, etc.

- Generally, the penalty for late deposits are as follows:
 - 2% of the underpayment if the deposit is 1-5 days late,
 - 5% of the underpayment if the deposit is 6-15 days late,
 - 10% of the underpayment if the deposit is 16 or more days late
 - 15% in certain situations where the employer received notice from the IRS

- How the next day deposit rule applies to the administration of equity awards is contained on the next few slides

- Non-statutory stock options (“**NSOs**”)
 - Generally, employment taxes are triggered due to the exercise of an NSO
 - A technical issue is whether taxes arise on the date of exercise or whether they arise on the date the employee receives the underlying stock (which could be a few days later)
 - According to an IRS field directive (found here: <https://www.irs.gov/businesses/assertion-of-the-penalty-for-failure-to-deposit-employment-taxes>) IRS examiners are instructed to NOT challenge the timeliness of deposits relating to NSOs if:
 - The employer deposits the taxes within one day from the date the employee received the underlying stock, AND
 - The date the employee received the underlying stock is not more than 3 days from the date the stock option was exercised
- Restricted stock
 - Employment taxes are due at vesting (or upon filing an 83(b) election, if earlier)
 - The above field directive does not apply to restricted stock grants
- Deferred RSUs and phantom awards
 - The award is subject to FICA taxes at vesting, even if income taxes are deferred under Section 409A to a later date
 - However, due to a rule of administrative convenience, the employer is permitted to withhold FICA taxes at the same time it withholds income taxes if vesting and settlement of the award are in the same calendar year

- How is the next day deposit rule satisfied in situations where the employer is waiting for the employee to remit his/her withholding dollars to the employer?

- Solutions include:
 - Over withhold on other cash compensation due to the employee (assuming the next day deposit rule coincides with payroll and there is sufficient payroll to satisfy the deposit obligation)
 - Subject to satisfying Section 402 of SOX, the employer could estimate the probable withholding and deposit the amounts early to the IRS, then on the required due date the employer could then direct the IRS as to how that early deposit should be allocated
 - The employer could require the employee to transfer to the employer, in advance of the deposit due date, the estimated withholding obligation (and when the actual deposit is calculated, any overage can then be returned to the employee)
 - Implement a “net withholding” whereby the employer withholds a sufficient number of shares of stock equal in FMV to the employee’s portion of the withholding obligation

Cure to the Blackout Sniffles

- Quick background:

- Short-swing profit liability
 - Under Section 16(b) of the Exchange Act, any profits realized by insiders from the purchase and sale of any equity security of the issuer within a 6-month period may be disgorged by the issuer or other holders of the issuer’s securities (the “**Short-Swing Profit Rule**”)
 - The Short-Swing Profit Rule creates a strict liability cause of action and does not require proof of any insider information
 - Disgorged “profits” is computed by matching the highest sales price to the lowest purchase price during the period, irrespective of the dates on which the transactions occurred
 - This means it is possible to have a “profit” even though the transactions resulted in a net loss to the insider

- 10b5-1 trading plans
 - 10b5-1 provides an affirmative defense against allegations of Rule 10b5-1 and Section 10(b) violation
 - This allows an insider to enter into a transaction for the purchase or sale of a security while possessing material non-public information about the issuer’s securities, but only if the transaction was pre-planned and subject to a written plan that was entered into in good faith at a time when the person was unaware of material non-public information

Cure to the Blackout Sniffles (cont.)

- Some companies adopt 10b5-1 trading plans to facilitate tax withholding obligations during blackout periods
 - For example, consider a company that continuously has blackouts, and as a result, the executive cannot otherwise sell shares in the open market to offset his/her personal income tax obligations that were triggered when such shares vested
 - A 10b5-1 trading plan can solve the above issue
 - However, if that same executive is conducting open market purchases of the employer's stock, then careful planning should be considered so as to avoid application of the Short-Swing Profit Rule (*e.g.*, a sale and a purchase within a 6-month period)
- A benefit of the 10b5-1 trading plan (compared to net withholding provisions) is that the “market” finances the withholding obligation (as opposed to the employer financing the withholding obligation)
- However, if the company can finance the net withholding obligation (*i.e.*, remitting employer cash to the U.S. Treasury to satisfy the withholding obligation), then net withholding could be a more viable alternative for those companies that otherwise are encouraging their insiders to purchase employer stock on the open market

Miscellaneous Thoughts

- Remember that Section 402 of SOX prohibits personal loans from a public company to any of its directors or executive officers
 - This issue should be vetted any time the employer “advances” such employee’s tax withholding obligation to the IRS

- Counting mechanisms – net basis v. gross basis
 - Equity incentive plans with liberal share counting (e.g., forfeited shares that were subject to an outstanding award revert to and work towards replenishing the share reserve) are counted/depleted on a net basis
 - In contrast, shares registered pursuant to a Form S-8 are counted/depleted on a gross basis (*i.e.*, forfeited shares would count towards and deplete the remaining share reserve subject to the Form S-8)
 - This means . . .
 - Do not rely upon your equity incentive plan capitalization table to determine how many shares remain available under the Form S-8
 - When determining how many shares to register under a Form S-8, always register more than are then available under the equity incentive plan

Miscellaneous Thoughts (cont.)

- With respect to any equity plan amendments to increase the tax withholding rate, such an amendment would be viewed by ISS as administrative
 - However, for those equity plans with liberal share counting, the foregoing applies only if the amendment stipulates that only the shares netted/withheld up to the minimum tax withholding rate may be recycled (*i.e.*, those shares netted/withheld on the spread between the minimum rate and the maximum rate could not be recycled and must be forfeited)

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- Title:
 - Everything Perquisites: The 101 Training Course

- When:
 - 10:00 am to 11:00 am Central
 - August 8, 2019