

Equity Grants to U.S. Employees

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Key Drivers

- Business/compensation goals should control, not taxes
- Full-value vs. future upside benefits
- U.S. tax considerations
 - › Deferral of tax event
 - › Tax rate
 - Compensation income: ordinary tax rates (highest marginal bracket 37%) + employment taxes (12.4% Social Security up to taxable wage base (\$132,900 for 2019) + 2.9% Medicare + 0.9% “additional” Medicare)
 - › One-half of Social Security and Medicare taxes paid by employer and are deductible
 - Capital gain: 15% or 20% at highest marginal tax bracket + 3.8% net investment income tax
 - › Administrative burdens (including reporting and withholding obligations)

Key Drivers (cont'd)

- Full value awards
 - › Outright stock grants (restricted or unrestricted)
 - › Restricted stock units
 - › Phantom interests
- Future upside awards
 - › Options (different flavors)
 - › Stock appreciation rights
 - › Profits interests (partnerships only)

Options - Generally

- Two types
 - › “Nonqualified” options or “NSOs”
 - Difference between exercise price and value at exercise (the “spread”) is compensation income when option exercised; capital gain potential thereafter
 - Can be structured to be exempt from U.S. Internal Revenue Code Section 409A (maximum flexibility) or, alternatively, compliant with Section 409A
 - If subject to and noncompliant with Section 409A, U.S. tax disaster –
 - › 20% excise tax plus 1% premium interest tax and income inclusion as option vests (and thereafter), even if not yet (or never) exercised
 - › “Qualified” options or “Incentive Stock Options” or “ISOs”
 - Potential for capital gain treatment if numerous requirements satisfied
 - May or may not achieve this special tax treatment depending on personal tax position of the employee
 - Not subject to Section 409A, but must meet other strict U.S. tax rules
 - › If fail to meet other U.S. tax rules, option will be treated for tax purposes as an NSO that (hopefully) is exempt from Section 409A

Options – U.S. Tax Treatment

Tax comparison of NSOs vs. ISOs – if U.S. citizen or resident alien

	NSOs	ISOs
<i>Grant</i>	No tax event	No tax event
<i>Vesting</i>	No tax event (unless violate Section 409A)	No tax event
<i>Exercise</i>	“Spread” (FMV at exercise less exercise price) includable as compensation income; deductible by employer	Nontaxable for regular tax purposes; taxable for alternative minimum tax (AMT) purposes; no employer deduction
<i>Sale of stock</i>	Capital gain/loss on difference between amount paid plus compensation income recognized on exercise and FMV of stock on sale	If sale w/in 2 years of grant and 1 year of exercise - spread taxed at ordinary income tax rates (no employment taxes); if held for qualifying period, spread taxed at capital gains rates

Options – U.S. Tax Treatment

- Tax comparison of NSOs vs. ISOs – if U.S. nonresident
 - › If worked in U.S. during vesting period, portion of income on exercise of an NSO will be subject to U.S. tax based on the number of working days in the U.S. during vesting period – even if not in the U.S. on date of exercise
 - Some states use a different “lookback” period (between grant and exercise date)
 - Requires tracking days in and days out of the U.S.
 - › For ISOs – if held for qualifying period then option gain not taxed in U.S.
- Withholding rules
 - › Foreign employers generally subject to U.S. income tax withholding for services performed in the U.S., unless treaty exception applies
 - › Also generally subject to Social Security/Medicare tax withholding for services performed in the U.S. or outside the U.S. by a U.S. citizen or resident

Section 409A Exempt NSOs

- Requirements

- › Must be granted by the employer or any entity up the chain with at least 50% common ownership
- › Stock generally cannot be subject to put/call rights or mandatory repurchase rights
 - Formula prices can cause problems
- › Must be common stock
- › Must be granted with an exercise price at least equal to FMV on the “date of grant”
 - “Date of grant” has technical meaning – generally date of Board resolution, even if shareholder vote required
 - Market practice is to get a third-party valuation for private companies
 - › Valuation only good for 12 months, as of a date that is not earlier than 12 months from date of grant
 - › Board still must consider material factors arising after valuation
- › No deferral features
 - Cannot later extend exercise period beyond term of original option
 - Repriced option viewed as a grant of a new option

Section 409A Compliant NSOs

- If option fails to meet any of the above-requirements, it may be possible to structure the NSO as Section 409A compliant
 - › Exercise only on certain pre-specified and authorized events (example: exercisable only on the earlier of death, “separation from service” or a “change in control”)
 - › Avoids need for Section 409A valuations
- Pre-specified events must meet Section 409A requirements
 - › “Change in control” generally limited to a sale of 40% or more of gross value of assets or more than 50% (by vote or value) of the equity
 - › “Separation from service” will not occur if continue to provide services as a consultant or transfer to certain affiliates

NSOs that Violate Section 409A

- Income inclusion each year as the option vests (and thereafter), measured generally using the December 31 value over prior year's December 31 value, until option is exercised
 - › Amount is taxable as compensation income
 - › Also subject to additional 20% excise tax and premium interest penalty under Section 409A
- Problems with Section 409A in international context

Example: U.S. citizen has vested options with spread income of \$50,000. Under foreign law options are not subject to tax until exercise. Because option does not comply with Section 409A, U.S. citizen has \$50,000 of income inclusion in year of vesting, plus a 20% excise tax and premium interest tax. U.S. citizen is in highest marginal tax bracket and so income is taxed at nearly 60% to 70% (37% federal income tax + state tax + employment taxes + 20% excise tax + premium interest tax). If foreign country tax rate is 30% to 40% could have a nearly 100% tax rate, and if U.S. citizen exercises many years after vesting, may not be able to credit U.S. tax against foreign tax.

ISO Requirements

- Granted only by a corporation, not a partnership (including an LLC taxed as a partnership)
- Can only be granted to employees (not directors or independent contractors)
- Grants must be made under a written plan document approved by shareholders of issuing corporation (re-approval every 10 years)
- Exercise price must be at least equal to fair market value on the date of grant (“good faith” determination by Board)
- No more than 10-year option term
- No more than \$100,000 worth of stock can first become exercisable (vest) in any given year
 - › “Shadow rule” – if reprice, original option grant may remain outstanding for year of repricing

Profits Interests

- Profits interest is a right to receive a portion of the profits of a partnership
 - › Typically, right accrues as profits are earned
- No tax on grant of interest, capital gain on sale of interests
 - › Distributive share of profits of partnership retain character from partnership
- Key issue – treated as a partner, not employee
 - › No income tax withholding (must pay estimated taxes)
 - › Subject to self-employment taxes on income
 - › Some minor benefits differences

Restricted Stock

- Restricted stock
 - › Transfer of stock, subject to forfeiture if certain vesting requirements not made
 - › General rule – subject to tax when vests
 - › Section 83(b) election to accelerate income inclusion to year of grant
 - Must be made within 30 days of grant; irrevocable
 - If stock is forfeited, no loss available
 - If value goes down, no ordinary loss is possible when shares are disposed
 - Nonresidents – may want to consider if anticipate working in U.S. in year of vesting
 - › For corporate law purposes, considered a shareholder
 - Dividends paid during vesting period are taxable as compensation income (unless Section 83(b) election made)

Restricted Stock Units

- Restricted Stock Units (“RSUs”)
 - › RSUs are a promise to deliver stock in future if certain vesting conditions satisfied
 - › Must be designed to be exempt from or compliant with Section 409A
 - › For corporate law purposes not treated as a shareholder during vesting period
 - Can issue “dividend equivalent rights” that are exempt from or compliant with Section 409A

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Amy concentrates her practice in the employee benefits and executive compensation area and is experienced in addressing documentation and compliance issues for welfare plans (including federal health care reform and HIPAA privacy and security requirements), qualified retirement plans and individual retirement accounts. She designs and reviews nonqualified deferred compensation arrangements, including for compliance with Internal Revenue Code Sections 409A and 457A. Amy is also experienced in analyzing ERISA prohibited transaction, fiduciary and reporting issues.

Bar & Court Admissions

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Education

- LL.M., Taxation, Boston University School of Law
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