Nifty Past 60: Dealing with Retirement Eligibility in Stock Plans

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Materials Slides

http://www.sos-team.com/pdfs/retirement_eligibility.pdf

Agenda

General Concept of Retirement Provisions

Issues for the Administrator

Expense Impacts

Tax Implications

409A Issues

What are companies doing?

What are the experts saying?

Winning Solutions

Q&A

Retirement Provisions

- What happens to unvested Stock Options at retirement?
  - Cancelled at retirement date
  - Continue to vest under original terms
  - Acceleration of all or a prorated portion of unvested shares and exercisability for some period
  - Remaining term of vested options may be truncated

- What happens to unvested Awards (RSA, RSU or PSA, PSU)?
  - Cancelled at retirement date
  - Continue to vest under original terms – with restrictive covenants, no longer subject to service requirements
  - Acceleration of all or a prorated portion of unvested shares and immediate release of shares
  - Acceleration of all or a prorated portion of unvested shares with the release at some future date
  - Pay-out of performance-based awards may be based on target (but watch 162(m)), actual performance to date of retirement, or actual performance for full performance-period

What do these provisions mean for the company?

- Cancellation of unvested….
  - True up expense for unvested shares
  - Shares may go back to the available share pool
  - Administrative burden of continued relationship with retiree may be reduced
    - Payroll
    - Equity system updates
- Continued vesting or accelerated vesting…
  - Immediate Expense!
    - At retirement eligibility date must be fully expensed
  - Taxes for the employee on Awards
    - No longer any risk of forfeiture - a taxable event
  - Shares do not go back into the available share pool
  - Administrative burden to keep retiree connected
- Technicalities of continued vesting when there is no longer any risk of forfeiture

Quick note on vesting without substantial risk of forfeiture

- Under applicable tax law, an award does not continue to “vest” after the retirement eligibility date if the employee is not required to continuing working in order to earn his or her award
- In limited circumstances, vesting may continue if a restrictive covenant is in place (such as a non-compete agreement)
- Any delayed distribution after the vesting date (and after the lapse of any substantial risk of forfeiture) is not continued vesting
- A substantial risk of forfeiture is
  - Right to receive the award is conditioned on the future performance of substantial services or the occurrence of a condition related to the award (performance)
  - A noncompete agreement will not ordinarily be considered a substantial risk of forfeiture unless the facts and circumstances suggest otherwise (Code Section 83)
  - An amount is not subject to a substantial risk of forfeiture merely because the right is conditioned upon refraining from the performance of services (Code Section 409A)

Expense

- ASC 718
  - Basic premise – expense for all vested portions of grant/award must be booked by final vest date
    - Accelerated vesting of all or a prorated portion of grant at retirement eligibility date, all expense must be booked by that date!
  - Systematic vs. Manual tracking
    - Retirement eligibility date
      - Who tracks this and where is it maintained?
      - Is it a date or a formula?
    - Effective date for the expense
      - Catching up your expense in the current period
    - Acceleration and/or Proration

Tax Implications

- Risk of forfeiture no longer exists…tax obligation created for Awards
  - Federal Income Tax due on RSA value at vest
  - FICA/Medicare tax due on value of RSU at vest; federal income tax due on RSU at time of settlement in shares
    - What is the price tag?
    - Can the employee write a check?
    - Can you determined this under the Rule of Administrative Convenience - Reg. §31.3121(v)(2)-1(e)(5)….collect the tax later in the year when FICA may be fully met and only Medicare may be payable?
- Does the plan allow for share withholding for the tax obligation?
  - If vesting and release is the same day, easy calculation and shares withheld for all taxes under normal processes
  - If vesting and release are different dates, shares you withhold for FICA/Medicare have a pyramid effect attached as those shares now are subject to Federal, State and Local tax too. Let's take a look…
  - Not all systems can handle the calculation and tracking of non-payroll tax payment methods which may lead to manual calculations and spreadsheets

Pyramid Tax example

Over 120 shares will need to be withheld in the end…complex to explain to employee and must be calculated outside any system.

And so on until 0 additional shares required

Value of 27 shares withheld is $540 (27 x $20) subject to Income tax rate 35% = $189

Or additional 10 shares

Value of 77 shares withheld is $1,540 (77 x $20) subject to Federal and State Income Tax assumed 35% = $539 ÷ $20 = 26.95 shares

Or **additional 27 shares withheld**

1,000 vested shares @ $20 stock price = $20,000 value

Subject to FICA/FUTA rate of 7.65% = $1,530 tax

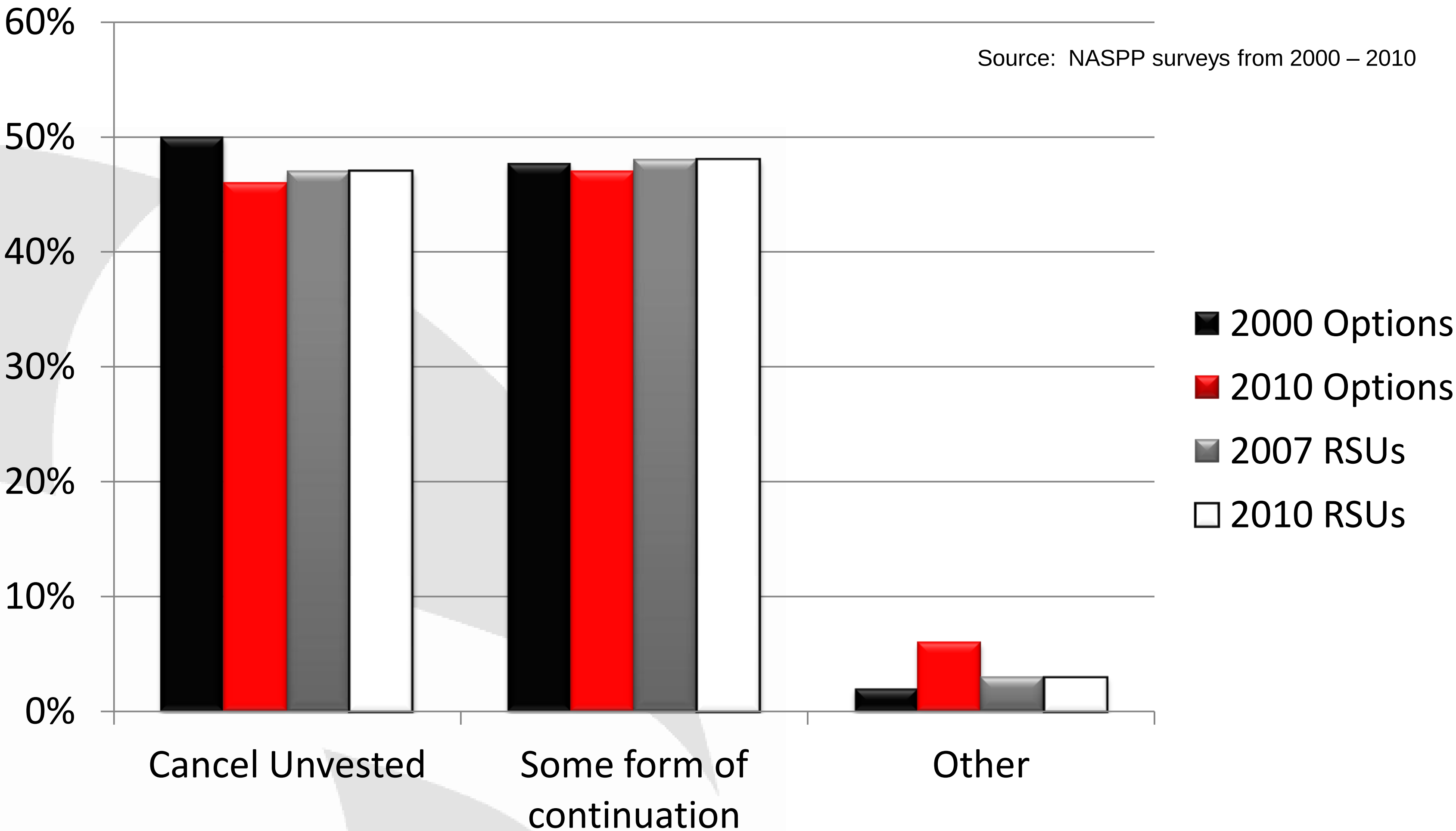
Divided by $20 price = 76.5 shares

Rounded up to **77 shares withheld**

409A and other Legal Issues

- The vesting of an RSU with a release date in the future is deferred compensation under Section 409A
- Short term deferral rule may still be available if RSU is settled within two and one-half months following the end of the year in which the RSU vests
- If the RSU is deferred compensation, then the Agreement (or plan) document must be in compliance with Code Section 409A
  - Six month delayed distribution for key employees of public companies
  - Definition of “separation from service” “change of control” “disability”
  - Permissible payment dates
  - Specified time and form of payment
- Consider the implications if the award is vested on the date of grant
- Is vesting on retirement discriminatory?

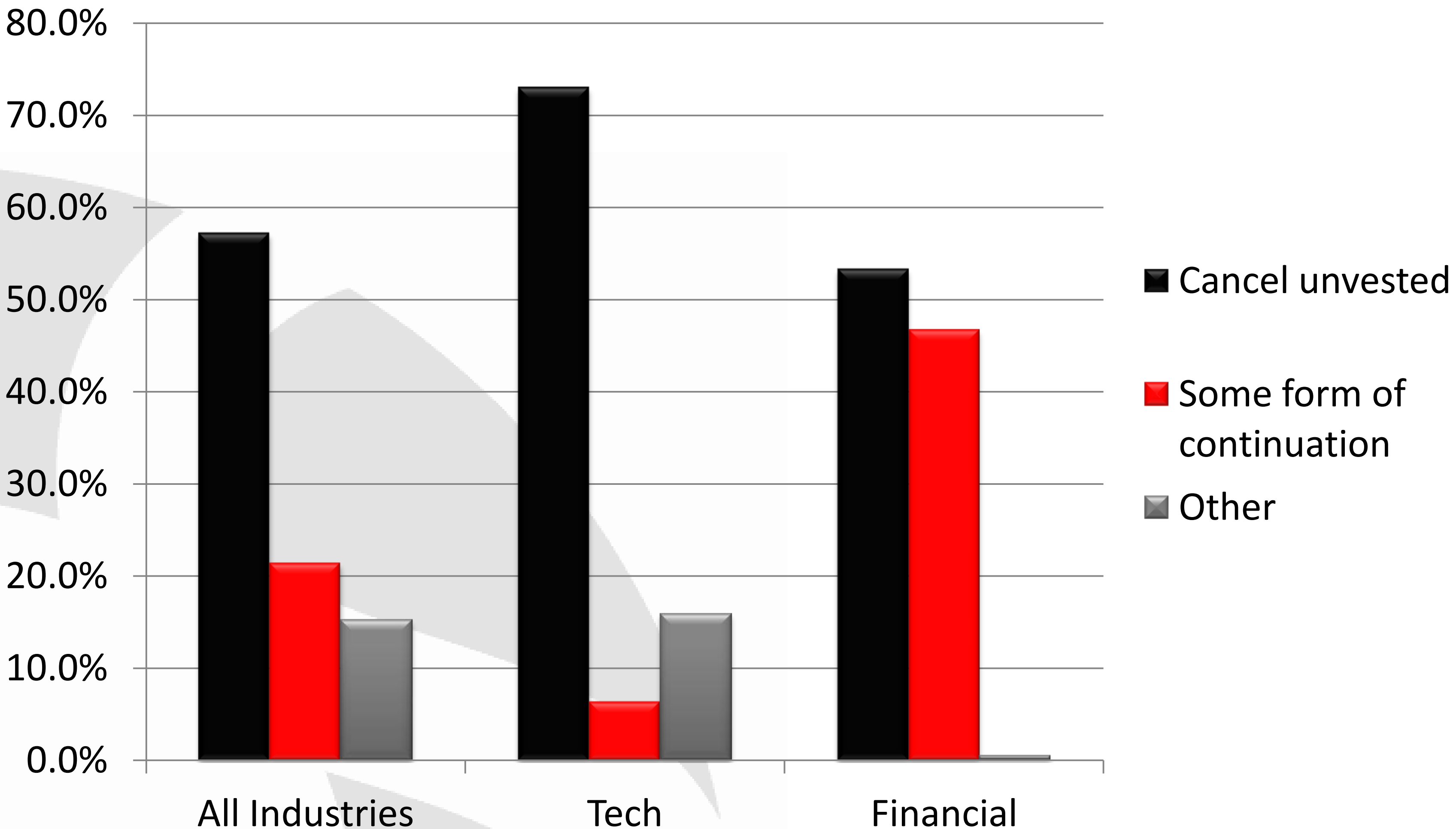
What are companies doing?



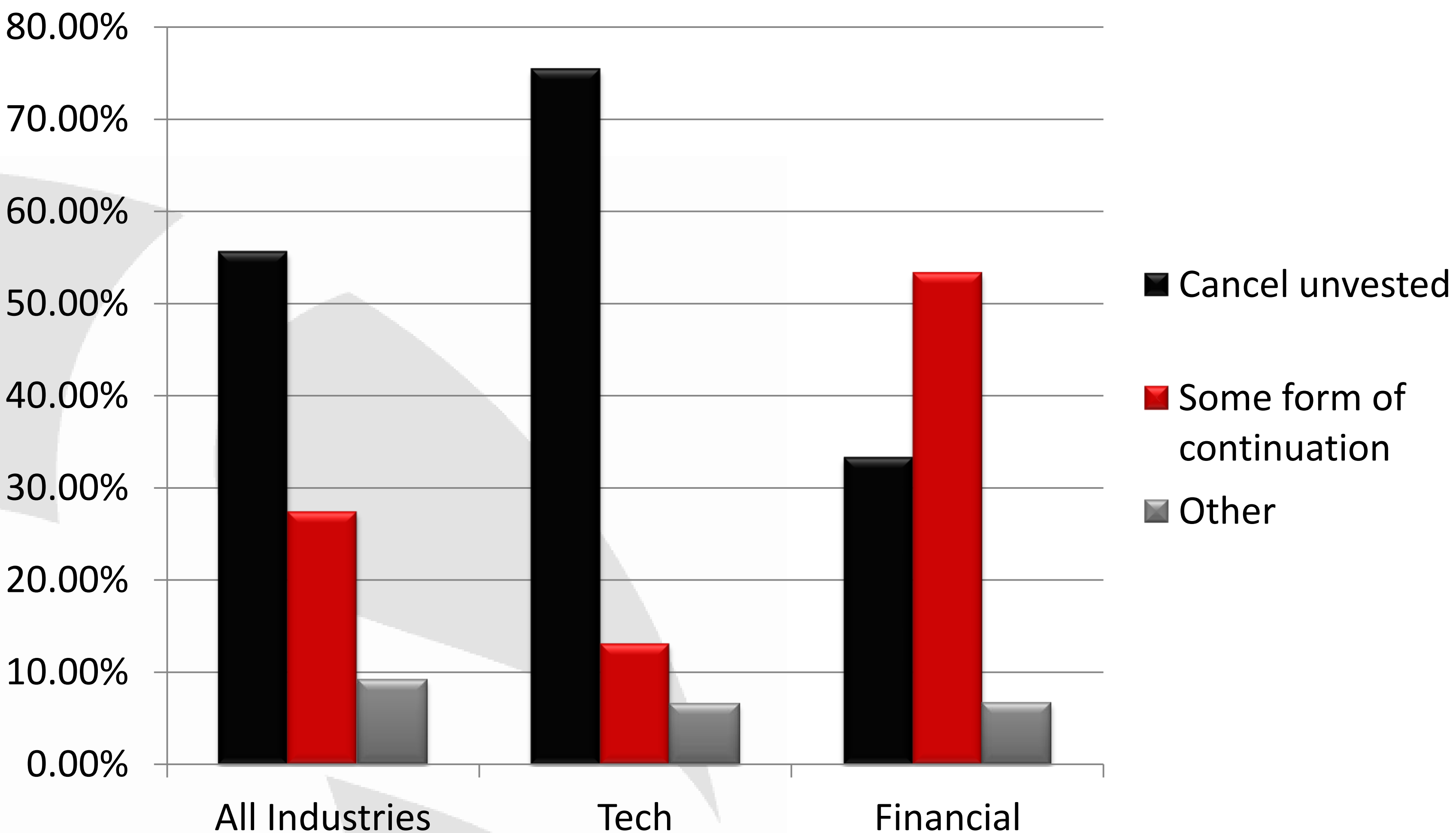
Recent SOS Survey - 2013

- Common practice
  - cancel unvested stock options with standard grace period to exercise vested
  - Cancel unvested awards
- Varies by industry
  - Technology companies tend **not** to provide for any ongoing vesting, more of a “use it or lose it” approach
  - Financial Services tend to allow for some continuation, equity granted in lieu of cash, can’t take away

SOS Survey in 2013…stock options



SOS Survey in 2013…RSUs



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What are the experts saying?

Optimal approach needs to balance retention and succession planning objectives, and depends on the company's long-term incentive strategy.

- Ideal approach balances the following objectives:
  - Is fair to both employees and the Company
  - Supports the objectives of the Company's equity compensation program by providing the intended pay opportunities and retention hooks
  - Facilitates succession planning and orderly transitions
  - Protects the Company from competitive harm
- To achieve these objectives, **avoid windfalls and shortfalls**
  - Avoid windfalls: If vesting accelerates 100% at retirement, retirees might have a windfall compared to ongoing employees.
  - Avoid shortfalls: If unvested awards are canceled at retirement, employees total pay opportunity shrinks in each year approaching retirement.

What are the experts saying?

Ideally, the retirement decision can be independent from compensation issues. Consider the following approach:

- Continued rather than accelerated vesting
  - Retiree gets shares at same time (and price) as ongoing employees get theirs.
  - Earn-out of performance-based awards can be based on actual performance and paid at same time ongoing employees are paid
  - Enables enforcement of restrictive covenants (e.g., non-competition, non-solicitation, etc.); breach of restrictive covenants results in forfeiture of unvested awards
- Prorate most recent annual grant over <u>one-year</u>; do not prorate prior year's grants
  - If long-term incentive (LTI) grants are made annually, LTI is part of ongoing pay opportunity. Participant earns the right to continue vesting in the grant over the compensation year, similar to the way in which they earn salary and (sometimes) the right to a pro-rated annual bonus in year of retirement.
- Special retention/incentive awards may be treated differently

Winning Solutions

- Cancel all unvested at termination due to retirement!
  - Is this the right thing for your company?
  - Easy to administer
- Accelerate unvested at termination but with immediate release of RSA/RSU shares
  - Easy to administer
  - Tax burden can be handled with share withholding
  - Watch out for issues related to substantial risk of forfeiture
  - Still need to consider the expense
  - Is this the right thing to do?
- Continue vesting
  - Fairest to retirees and ongoing employees
  - More complex to administer
  - Need to consider tax issues to participant
  - Expense is same as for acceleration

Q&A

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