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Comp Talks

The Latest re: RSU Design, Implementation and Administration

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“Now...what shall we talk about?”

- RSU Basics
- Latest in RSU Grant Practices and Design
- Practical Issues in Implementation and Administration
- We will not discuss additional RSU considerations applicable to private entities





Remind me, what exactly are RSUs?

- RSUs represent an unsecured right to receive a specified number of shares of stock at a later date
- No shares are issued at grant
- Typically granted solely in consideration for services with no purchase price
- Can be subject to vesting – time and/or performance based
- On vesting, or a qualifying deferred delivery date, shares are issued, typically without cost to the recipient (other than tax obligations)
- No shareholder rights prior to issuance of shares

Keeping Up With General RSU Trends (Not Keeping Up With the Kardashians)

- Use of RSUs has increased as use of options has correspondingly declined
- Generally “value based” determination of the size of RSU awards
- More use of performance based vesting criteria and multi-year performance periods
- Relative TSR and revenue are the most prevalent performance metrics utilized by technology companies

What About Taxes?

- No taxable income at grant of RSU
 - Tip: Section 83(b) elections are not applicable/possible because there is no transfer of property at grant
- Ordinary income generally recognized upon issuance of shares
- Income equal to the FMV of shares on date of issuance

Ordinary Income and FICA/FUTA Disconnect



The Internal Revenue Code is absurdly complex or, as we lawyers say, a goldmine.

- Ordinary income triggered at issuance – not vesting
- However - FICA & FUTA is triggered at vesting... why not mix things up just to keep it interesting?
 - Tips:
 - If special retirement vesting provisions apply – FICA & FUTA may be owed when employee is retirement eligible
 - Watch out for “pro-rata” vesting upon any termination of employment for awards that otherwise would vest annually or quarterly

Collecting Withholding Taxes

- Withholding taxes that apply upon vesting and issuance can be satisfied, in many different ways:
 - Cash/check
 - Withhold from cash compensation
 - Withholding issuance of shares to cover minimum tax obligations
 - Sale on open market

Share Withholding Tips

- Be sure to limit use to covering minimum statutory tax obligations (until new accounting rules are applicable)
- Do you have the cash on hand to cover the payments to the taxing authorities?
- Do you have a consistent policy for how to determine FMV for purposes of tax reporting on the applicable date?
- For Section 16 insiders, choice to use share withholding shouldn't be left to the discretion of management

RSU Design Trends—Mandatory Sell to Cover



We are seeing more RSUs with terms that mandate a sale of shares on the open market in order to satisfy withholding taxes

Sell to Cover



- Must be at a time when individual is not in possession of material non-public information
- Can enter into 10b5-1 trading plan in advance of vesting and issuance
- Mandatory or permissive?
- Company's role vs broker's role
 - Each broker usually requires use of its own form
 - Company approval of the form
- Consider complexity if having to explain to a broad based employee group

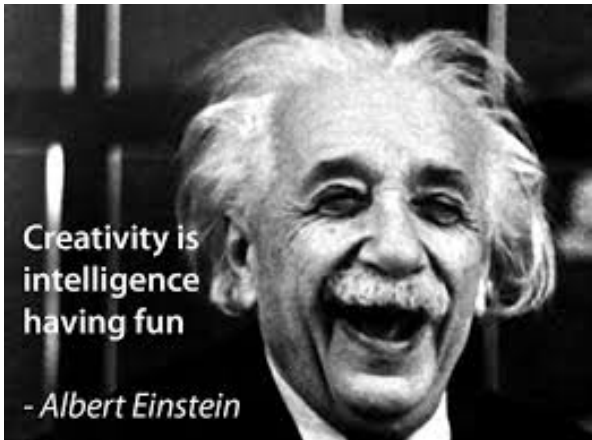
Sell to Cover—Continued ...



- Can you get sale completed and proceeds remitted within required withholding time frame?
 - May not be able to delay payment until next scheduled payroll date - i.e., if you are subject to the “next day deposit” rule
 - \$100K of aggregate tax withholdings on any day
 - If “next day deposit” rule applies, vesting + 3 days is informal convention
 - Not an official guideline for full value awards – interpretation of option rule to accommodate sell to cover
- Does the issuance of shares to the employee prior to payment of taxes constitute an impermissible SOX loan?

Sell to Cover Design Tip

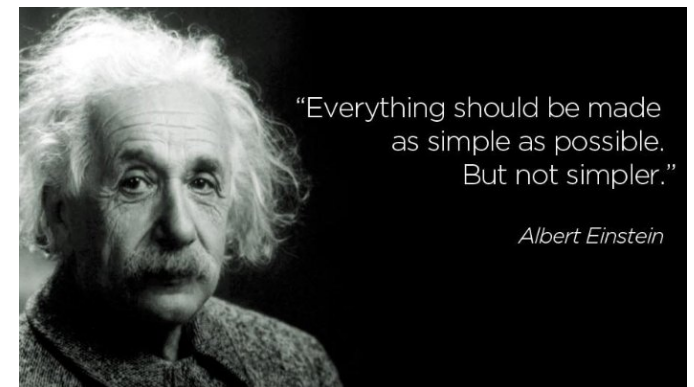
- Delay issuance of shares – and taxation and withholding event – until trading window first opens after the vesting date to facilitate sale on open market



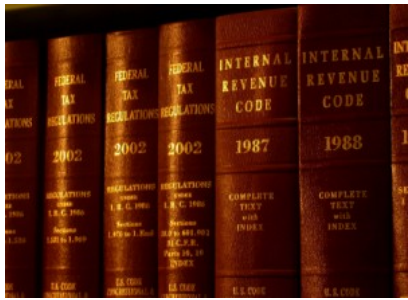
- ▶ Maximum delay = March 15 of following year ... or else 409A violation and penalties
- ▶ Need to bake this delay into the form of RSU award agreement at the time of grant
- ▶ Potential exception for FICA/FUTA taxation allows FICA/FUTA to be applied at time of *issuance* of shares subject to certain deadlines

Time Based Vesting Schedules Tips

- Many vesting dates potentially means many withholding dates
- Try to coordinate vesting and/or issuance dates with open trading windows
- Consider annual or quarterly vesting
- Beware of triggering vesting date off service date, unless you will have difference issuance dates that are consistent



What about Section 409A?



- RSU is generally not subject to Section 409A rules if short-term deferral exception to 409A is available (e.g., shares are required to be issued no later than March 15 of year following year of vesting of the RSU)
- RSUs subject to Section 409A rules – need adequate 409A compliant documentation and administration, including required 6 month delay on issuance of shares upon separation of service of “specified employees” of publicly traded entities to avoid adverse tax consequences

RSUs—Section 409A Compliance Traps and Tips

- Watch out for accelerated vesting provisions in separate agreements. If the acceleration triggers are not sufficiently rigorous, RSU award may be deemed “vested” at grant for 409A purposes
- Watch out for performance awards where continued service through the achievement of the performance goal is not required (e.g., termination without cause, death, disability, change in control)
- Include Section 409A “savings clauses” into the form of RSU agreement
- Check with counsel familiar with Section 409A rules before making any changes to vesting terms of RSUs



Deferred RSU Design



- At grant, structure RSU to defer delivery of shares – and therefore ordinary income tax – on vested RSUs until one of Section 409A permitted payment events:
 - 409A “Separation From Service”
 - Fixed date(s) or calendar year – e.g., February 15, 2018, or calendar year 2018
 - 409A “Change in Control”
 - 409A “Disability”
 - Death (see IRS Notice 2007-90)
 - The “undead regulations”



Deferred RSUs—Participant Deferral Elections

- If RSU grantee is given opportunity to make deferral election, special timing rules apply to the election
 - General rule: must be made no later than December 31st of year preceding RSU grant
 - May be made in year of grant if made no later than 30 days following grant, and RSU cannot potentially vest any earlier than 12 months following latest permitted date for making the election (i.e., the “13 month vesting” rule)



Deferred Issuance RSUs—Pros and Cons

- Pros:
 - Defer ordinary income tax until issuance date
- Cons:
 - Subject to 409A rules
 - very difficult to revise terms after grant
 - For employees, the employer plus employee portions of FICA/FUTA taxes will be due on vesting



What is the tax treatment for the company?

- Company receives tax deduction in the same amount and at the same time as the individual recognizes ordinary income (date shares are issued)
- For executive officers subject to the \$1 million deduction limitation under Internal Revenue Code Section 162(m), deductibility may be limited or eliminated, unless the RSU qualifies as “performance-based compensation”



Administration—Securities issues

- File Form S-8 prior to grant unless other registration or exemption from registration – e.g., “no sale” doctrine – is available
- S-8 prospectus must address terms of RSUs and be delivered to recipient at time of grant
- Value and size of award disclosed in proxy based on fair value measurement on date of grant
- Ensure Form 4 reporting is timely completed (different rules apply depending on structure of RSU)



What is the Accounting Treatment?

- Compensation expense measured at the grant date and is equal to the FMV on that date
 - Additional expense for RSUs that contain dividend equivalent rights is measured at the time of the dividend payment
- Expense is generally recognized over vesting period
 - Expense for performance-vesting awards is recognized based on likelihood of achievement



RSUs—Equity Plan Administration

- Same as options- RSUs are *notionally* counted against the authorized share pool when granted
- Tip: RSUs are “full value” awards (same as restricted stock)
 - If equity plan has a fungible reserve, 1 share granted as RSU counts as more than 1 share against the share reserve (e.g. 1.5 shares are deducted from share reserve for each 1 RSU)
 - ISS also applies multiplier to RSUs as full value awards when doing its burn rate calculations (different multiplier than fungible share reserve multiplier)
- Shares underlying RSUs that fail to vest are generally available to be granted again under new awards under the plan

Questions????

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