Performance Awards Through Employee Stock Compensation Plans

TAX AND DIVORCE ISSUES

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Many companies favor stock-based compensation plans to entice, retain, motivate, and attract their employees. These stock- and performance-based plans have remained a key component of executive pay. The plans allow employees to benefit from the potential upside of an equity investment while they participate in the downside risk. Such plans provide value for the investor/owners as they align pay, performance, and overall company value. They may give employees the option to buy stock at a discounted price, be directly granted company shares, or receive dividends or increases in the value of shares.

To help clarify the differences in these plans, an explanation of what a performance share is, and the differences between a stock option and a stock grant, is necessary.

A performance share is a share of equity that has been awarded and will be earned/vested based on the financial performance of the company and/or the employee. Almost all share awards have some sort of performance metric built in.

A stock option is the right granted to an employee to purchase a fixed number of shares at a set exercise price within a specified time frame. The employee has the right to purchase the stock at a price that is the same or less than the grant-date market price. The option has a period during which it can be exercised. Furthermore, options will be exercised only when the stock price exceeds the option price ("in the money" options). While there is not a requirement or a designated vesting period, when an option is "in the money," the employee must decide when to exercise and buy the stock. During this period, the option may be "underwater" (when the exercise price exceeds the fair market value of the underlying stock), or worthless. Most of the time, when the option is exercised, the employee will simultaneously sell the stock. The funds provided from the sale allow the employee to purchase the option stocks at the exercise price, pay the withholding tax on the compensation element (current value less exercise price), and realize any excess as the net return (gain).

Stock grants are an employee retention mechanism, as they contain vesting features that are triggered during a period set by the employer. The vesting date, the date on which the employee has the right to receive stock (which triggers compensation income), is often based on the employee's longevity and/or specific performance. An employee may receive annual grants only a portion of which vest (and are then available for sale) when the employee achieves certain goals. Stock grants have more value to an employee because their outflow (cost) is equal to the tax on the value of the stock.

There are many variations of option and grant plans, and they can be confusing. And many employees, never mind their spouses, have a difficult time understanding the intricacies of these plans. One would hope that because of that great complexity, companies would devote significant resources to communicating the terms of their equity compensation to employees. However, since this is not usually the case, an employee must ask questions of the company providing the benefits and of financial planners and advisors.

The most common stock performance awards are incentive stock options (ISOs), nonqualified stock options (NSOs), and restricted stock units (RSUs); however, there are also phantom stock, stock appreciation rights (SARs), restricted stock, and reload/replacement options. Each of

these plans has different taxable outcomes, reporting conditions, and basis considerations.

When an employee is participating in such plans and files for divorce, tracking the plans can become burdensome. It is important to get the employee benefits plan documents and copies of any grant schedules so as to track plans and shares/units. These are frequently available only online, so access can be difficult. It will need to be determined when the shares were granted and when they vest, if they are transferrable, and then whether they are marital or nonmarital (grant dates are important). It is also critical to understand the tax consequences of each type of option. Below is a discussion of the definition and taxation of each of these types of stock-based compensation plans.

Phantom Stock

Phantom stock (also called "synthetic equity") allows an employee to participate in the upside of company stock ownership without actually owning the company stock. The stock is called phantom stock because there is no actual stock. Even though the stock is not real, the phantom stock is tracked as if it were company stock and therefore may provide dividends, stock splits, and price changes all as if real stock was held.

Essentially, phantom stock is a promise to pay an employee a bonus either at a specific time (based on the value of the company shares deemed held), over a period of time, or at a certain event (such as the sale of the company). The taxation of the payments on the phantom stock is like any other cash bonus and is subject to ordinary income tax rates at the time of receipt. However, if consideration was paid to receive the phantom shares, the amount taxed is net of the consideration paid.

Phantom stock plans can, but usually do not, cover a broad range of employees or groups and are not subject to ESOP, 401(k), ERISA, and tax-qualified plan rules, but they are considered deferred compensation plans. Even though the phantom stock plan must meet the requirements under Internal Revenue Code (I.R.C.) § 409(a) and have written policies, the particulars of the value of the benefit can change at the discretion of the employer. Phantom stock typically cannot be transferred to a spouse during a divorce, and the value of these shares is often unknown and would likely be divided "if and when received" net of tax.

Stock Appreciation Right

A stock appreciation right (SAR) is a cash bonus given to an employee (usually upper management) that is equal to the appreciation of the company stock over time. Although it seems similar to a phantom stock-based program, no stock is deemed received by the employee, but the value is provided as a marker to calculate the increase in stock price. The ultimate payment to the employee is taxed as ordinary income because it is a cash bonus payment. Employees do not have to pay an exercise price and therefore have no out-of-pocket expense. But, like any stock-related benefit, when the company is not performing, these bonuses may be reduced or not received at all. However, when the company is doing well and if the stock prices rise, the employee participates in that achievement. SARs can also be part of a retirement plan. These plans can be designed in many ways and there is much flexibility, but a plan document is needed.

When an employee is given a set number of SARs that can be tracked, the company either pays out the increase in value at a given time or issues shares of stock. The bonus portion is almost always paid in cash, but the company sometimes issues shares instead. Usually (but based on the SAR's policy agreement), the SARs can be exercised directly after they vest. The SAR in share form is not seen very often, as companies often have both a SAR and stock option/unit policy so that the SAR can be paid out in cash and then the other stock award can be used as a way for employees to be vested in the company. Sometimes companies issue "tandem SARs," which are the cash awards that are issued only to help fund the purchase of options or to pay off taxes due at the time the shares are exercised.

Because the employee is taxed when the benefit is exercised, the value of the award, minus any consideration (there usually is none), is taxed as ordinary income. If the award is settled in shares, the amount of the gain is taxable at exercise if the shares are not sold. Any subsequent gain on the shares is taxable as a capital gain.

As part of a divorce, a SAR treated as a bonus cannot be transferred. It would be treated as a marital asset, net of tax, if it were earned during the marriage. However, if it is not a marital asset, it would be treated as income and as part of the net income available for support, net of any taxes due. If the SAR is in the form of stock, it too may be marital or nonmarital depending on when it is earned. The stocks, if received and vested, can be transferred to the spouse with the same basis as the working spouse. Any gain on the sale of stock is taxable to the nonemployee spouse at the capital gains rate. If sold prior to the required holding period, any gain is considered short term and would be treated as ordinary income.

Restricted Stock

Restricted stock is similar to restricted stock units (discussed below), but there are a few important distinctions. With restricted stock, the owner may elect to pay taxes at the time of grant with an I.R.C. § 83(b) election. This is a tax treatment choice that will allow the owner to treat capital

appreciation as a capital gain, as opposed to ordinary income. The employee must file a form with the IRS when the stock is received, and the capital gains holding period starts when the unit is issued. The hope is that the amount taxes are paid on is much lower than the price will be when it is sold; however, the risk in doing this is that, if the stock ends up being worthless, you will have paid tax when you otherwise would not have.

Effective for stock settled after December 31, 2017, a qualified employee can elect to defer income attributable to qualified stock for up to five years for income tax purposes (but not for Social Security (FICA) or unemployment tax (FUTA) purposes). This election under I.R.C. § 83(i) must be made no later than thirty days after the employee's interest has vested or the stock is transferable, whichever is earlier. In addition, the corporation's stock must not be publicly traded, and the corporation must have a written plan under which eighty percent of U.S. employees are granted options. The five-year period is referred to as the deferral period, and this period ends under a few trigger points, including: (1) the first date the qualified stock becomes transferable from the employee, (2) the date the employee becomes an excluded employee, (3) the date at which the stock becomes publicly traded, and (4) the date the employee revokes the § 83(i) election. In all likelihood, the ability to transfer the stock (the first trigger point) causes most individuals to not be able to make this election because most stock (if not all, in our experience) is able to be transferred (to an individual or entity) upon vesting.

The plan document would need to be reviewed, but restricted stock may not be transferable to a spouse even in divorce. Because of the speculative nature of the longer-term ownership, a division as "if and when received" net of tax is warranted.

Restricted Stock Units

Restricted stock units (RSUs) are different from restricted stock, as they are not an "option" to purchase stock at a discounted value but a grant of shares that typically become available upon a company-specific vesting schedule. The tax trigger is the date the shares are delivered to the employee, which is often the vesting date. The taxable income is the market value of those units at the vesting date, and it is taxed at ordinary rates and subject to Social Security and Medicare taxes.

As with restricted stock options, effective for stock settlements after December 31, 2017, the employee can elect to defer recognizing taxable income on the transfer for up to five years. Again, the trigger points listed above apply and in most circumstances, as with the restricted stock above, this election will not be allowed because usually, when the RSU vests, the employee receives the transferable stock, and that will eliminate the election or the possibility for the election.

RSUs, depending on the state where the divorce is filed, may be a marital asset based on date granted (for services performed during the marriage), or they may be a marital asset that requires additional time for the stock to vest. RSUs usually cannot be transferred until they are vested and received in stock. The basis of the RSUs is the taxable amount of income (compensation) at vesting. This basis carries over as the basis to the nonemployee spouse. Calculation of the value of the shares transferred to the nonemployee spouse should include a consideration of the amount of tax paid to purchase the shares at vesting.

Incentive Stock Options

There are no tax consequences when a taxpayer is granted an incentive stock option (ISO). ISOs typically come with a required holding period to qualify for the most optimal tax treatment. If ISOs are exercised and sold before that date, they will be taxable as ordinary income and subject to ordinary rates. If they are held for the required two-year period, the gain is treated as capital and taxable at the preferred capital gain rates.

When the ISOs are exercised, it is not a taxable event for regular tax purposes. However, it is a taxable event for alternative minimum tax (AMT) and possibly state tax purposes. The AMT (and state) gain on the exercise is the difference between the option price and the fair market value (FMV) at the date of exercise. When the shares are ultimately sold, the gain is recognized for regular federal income tax purposes. The gain is the difference between the option price and the FMV at the date of the sale. When stock options are sold, the amount is also separately reported as a disclosure on the employee's W-2 in box twelve, usually with a code "V."

The sale should also be reported through an IRS Form1099-B, and the federal gain is considered a capital gain subject to preferential rates. Upon the actual sale, since the AMT gain has already been recognized and in some cases an AMT tax has been paid, which creates an AMT credit, the AMT gain is much smaller upon the final disposition. The AMT credit in many cases is then available to offset the tax on the regular gain. Because of other recent changes in the tax code, many individuals will be less likely to qualify for the AMT, so, in turn, there will likely be less AMT tax for these types of transactions as well.

If an employee were to transfer the options to a spouse incident to a divorce, no gain is recognized by either spouse at the time of the transfer. Income is recognized by the nonemployee spouse just as for the employee spouse upon exercise of the options, as discussed previously. Any subsequent gain on the sale of stock is taxable to the nonemployee spouse at the capital gains rate, as noted. If sold prior to the required holding period, any gain is considered short term and would be treated as ordinary income. Many plan documents do not allow for the transfer of the stock option to a nonemployee spouse. Further, if the employee spouse has stock ownership requirement restrictions on the number of shares required to be held if the employee is a high-level executive, the employee often cannot transfer the shares to the nonemployee spouse, even if the plan allows it.

Nonqualified Stock Options

Nonqualified stock options (NSOs) are options that do not qualify for the preferred capital gains rates afforded to incentive stock options. The granting and vesting of NSOs does not create a taxable event. The taxable event occurs upon exercise. When exercised, the taxable amount is the difference between the exercise price and the FMV of the stock on that date. This difference is reported on the employee's W-2 as compensation income and taxed at ordinary income rates. If an employee exercises his or her option to purchase the stock and then holds on to the stock before selling it, short-term/long-term capital gain rules apply for the difference between the amount reported on the W-2 and the value when sold.

According to Revenue Ruling 2002-22, during a divorce, if a nonemployee spouse has been issued NSOs, the transfer itself is not a triggering tax event, and the recipient spouse receives his or her pro rata share of the carryover basis in the options for tax purposes. Each spouse is then separately responsible for the income tax consequences when the stock is sold, and if one spouse exercises the option, that has no taxable effect for the other spouse. The company will issue an IRS Form 1099-MISC to the nonemployee spouse when the taxable event is triggered. NSOs are a marital asset at the date of grant.

Reload/Replacement Options for Underwater/Expired Awards

As mentioned above, when a stock option's exercise price exceeds the FMV of the stock, the option is said to be "under water." When this happens in down markets, companies consider "repricing" their stock options as a way to make their stock options more valuable to employees. Traditionally, repricing simply involved canceling the existing stock options and granting new stock options with a price equal to the current fair market value of the underlying stock. Tax concerns weigh heavily in repricing decisions if the stock options being repriced are ISOs under I.R.C. § 422. In order to preserve the favorable ISO tax treatment, the new stock options must be granted at the current FMV of the underlying stock. Assessing the current FMV of a privately held company will require the board to set a new value on the common stock of the company.

Additional alternative approaches to traditional repricing have been developed to avoid difficulties in the company's accounting of a repricing and to avoid the animosity from nonemployee shareholders who will not enjoy the same treatment of repricing. The cancellation of an existing option and the grant of a new option is not a "repricing" if the cancellation and repricing are more than six months apart. To avoid repricing, a company may cancel the underwater stock option and then offer the employee the grant of a replacement option, six months and one day later, with an exercise price equal to the then-FMV of the underlying stock, whatever that may be at the time. With this approach, there is risk to the employee that the FMV will rise as of the reissuance date. A second approach is for the company to cancel the underwater stock options and replace them with an outright restricted stock award. But if there are any tax consequences or if there is a price differential from the first award, the employee will need to have the cash available to pay for these items. The last alternative is for a company to grant additional stock options at the lower stock price on top of the old underwater options without canceling the old underwater options. However, with this option, there is the potential for dilution to existing shareholders.

The implication in a divorce for underwater and expired awards is that the parties should obtain an accurate and up-to-date schedule of the assets that remain and receive the documents for any change in types of awards.

Summary

Stock plans and stock ownership can be very complicated. When they are being analyzed for divorce purposes, a clear understanding of the shares and the company-specific plan is critical. It is also important to understand, for points of discussion about division, the state rules on certain factors such as dates of grant, vesting periods and requirements, and income tax implications. Often with highly compensated executives or officers, there are share ownership requirements that dictate the restriction on how much of these assets can be divided and when. Discussing the plan with the benefits specialist at the issuing company may help clarify any specific plan questions. FA

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