Frederic W. Cook & Co., Inc.

New York • Chicago • Los Angeles • San Francisco • Atlanta

July 14, 2008

Technical Issues Related to Accelerated Vesting of RSUs at Retirement

As with all types of equity compensation, companies must consider whether any special arrangements should apply to employees who retire before a grant is fully vested. A significant number of companies choose to provide for accelerated vesting of all or a portion of any unvested awards in the event of retirement (i.e., the executive retires after attaining a pre-determined retirement age).

A grant of restricted stock with this retirement vesting provision results in an adverse tax consequence to employees: an employee who is retirement-eligible at grant (or becomes retirement-eligible during the vesting period) must recognize federal income tax on the value of the restricted stock on grant (or when he or she becomes retirement-eligible), even though the shares will not be transferred to the employee until the end of the vesting period. To avoid the adverse tax consequence to retirement-eligible employees, many companies have switched their grants from restricted stock to restricted stock units (RSUs).

Problems solved? Well, not quite. The accelerated vesting of RSUs can make them a form of nonqualified deferred compensation, subject to a variety of tax issues. This letter discusses three tax issues arising from the accelerated vesting of RSUs of which employers should be aware.[1]

- Acceleration of Social Security and Medicare taxes (“FICA taxes”) due to retirement-age vesting

- Potential requirement to delay some distributions six-months from termination of employment

- Potential need to modify provisions accelerating payout upon a change-in-control

FICA Taxes

Normally, the employer must withhold FICA taxes when an executive is actually entitled to receive the shares underlying the RSUs. Often employers provide for this by withholding from the shares that would otherwise be paid to the executive a number of shares equal in value

[1] One accounting implication of accelerated vesting should also be noted—the full accounting expense under FAS 123R must be taken into account over the period from date of grant to retirement age. For example, if RSUs are granted with 25%-per-year vesting, the accounting expense is normally taken into account over four years. However, if the RSUs provide that vesting accelerates upon retirement, then if the executive has attained retirement age when the RSUs are granted, the entire RSU expense must be taken into account immediately at grant.

to any FICA taxes that the executive must pay. However, when an executive becomes vested in deferred compensation, FICA taxes (the 7.65% Social Security plus Medicare rate) are immediately due, whether or not the shares are then distributable. For example, when RSUs worth $10,000 become vested, the employer and the employee would each owe $765 in withholding taxes. Note that Social Security taxes are only due on wages up to $102,000; the tax rate drops to 1.45% (Medicare) on wages over $102,000[2].

If the RSU grant provides for full vesting at retirement age, the RSUs would be treated as fully-vested when the executive attains retirement age, regardless of whether the shares are delivered at that time. In the previous $10,000 RSU example, FICA withholding of $765 is due *when the executive becomes retirement-eligible*, even if the RSUs will be settled in shares at the original vesting dates assuming the executive does not actually retire.

The employer may take the withholding from other wages (e.g., salary) or may require the employee to write a check for the required amount. Alternatively, the employer can withhold RSUs equal to the required withholding. The amount to be withheld must be greater than the amount actually needed to cover the FICA taxes because the withholding of shares is treated as taxable income to the executive. Using the above example, if the required FICA withholding is $765 and the combined federal and state tax rate is 40%, shares worth $1,275[3] must be withheld.

A related issue is when the withholding must be taken. It may be permissible to make the required withholding on RSUs at one time during the calendar year (e.g., at the end of the year) for all executives attaining retirement age during the calendar year, based on IRS Announcement 85-113. This ruling permits employers to choose when to withhold on "taxable noncash fringe benefits," as long as the required withholding occurs during the year in which the benefits are taxable.

If FICA withholding is made when the shares vest at retirement age or upon grant if the employee is then retirement-eligible, there is no additional FICA withholding when the shares are distributed, regardless of any increases in value. If withholding does not occur at the required time, the employer may have to pay interest and penalties for late payment. Furthermore, if the taxes (plus any applicable interest and penalties) are not paid by the end of the statute of limitations period, the withholding will be calculated using the value of the shares when they are distributed.

Section 409A and RSUs—the Six-Month Delay for Key Employees

Section 409A imposes numerous conditions that deferred compensation must meet in order to avoid immediate taxation as well as a 20% additional tax. One of these conditions is that deferred compensation payable upon termination of employment must be delayed until six months following termination in the case of "key employees" (generally the company's 50 highest-paid officers).

---

[2] This dollar limit increases annually with increases in the Social Security wage index.

[3] The formula in this example is $765 ÷ (1-40%) = $1,275. 40% of $1,275 = $510; the remainder is $765, the required FICA withholding.

Section 409A does not apply to amounts that are payable shortly after vesting, so RSUs settled in shares (or cash) upon vesting are also normally not subject to 409A. Adding vesting acceleration on account of attaining retirement age to RSUs may, however, result in all or a portion of the RSUs credited to an executive becoming subject to Section 409A if the executive attains retirement age before the RSUs would normally have become completely vested and the underlying shares are not transferred to the executive until the applicable vesting dates.

For example, assume the executive is granted 10,000 RSUs on January 1, 2009, at which point he or she has already attained normal retirement age and that the RSUs were scheduled to vest at the rate of 25% a year. Under these circumstances, it is likely that the RSU tranches vesting on January 1, 2011, January 1, 2012, and January 1, 2013 would be subject to Section 409A.[4] As a result, to the extent these tranches become payable at retirement, payment must be delayed for at least six months after termination.

Because of the punitive 20% additional tax imposed by Section 409A, it is imperative that payment of RSUs not violate Section 409A. One way to comply is to provide that RSUs for key employees continue to be paid out under the original vesting schedule, regardless of employment status. In other words, the RSUs are not paid at retirement prior to the applicable vesting dates, but at the times that they would have been paid if the retired executive had continued in employment. Alternatively, the RSU grant can provide that RSUs subject to 409A will not be paid on retirement prior to the applicable vesting dates until six months after termination of employment.

Section 409A and RSUs—Acceleration of Payments in the Event of a Change in Control

Provisions accelerating RSU vesting in the event of retirement may be problematic if the payout accelerates in the event of a change in control and "change in control" is defined more broadly than the definition in the final regulations.[5] It is generally impermissible under Section 409A to accelerate payment of deferred compensation (e.g., RSUs held by retirement-eligible employees in the example above) on account of a change in control unless it is defined at least as narrowly as the definition in the final regulations. For example, the regulations generally provide that a change in control may be considered triggered if a third person purchases more than 30% of the employer's stock. Therefore, a plan provision defining a change in control as occurring when a third person purchases at least 25% of the employer's stock would not be a compliant definition, and payout of deferred compensation upon this type of change in control would be impermissible under Section 409A.

Another issue arises if, in the event of a change in control, vesting and payment of equity awards accelerate unless they are assumed by the acquiring employer. Some legal counsel have suggested that for RSUs subject to 409A, this may be treated as an impermissible form of

---

4 The tranche scheduled to vest January 1, 2010 should not be subject to Section 409A under the exception for "short-term deferrals" (amounts that will be paid in all events by March 15 of the year following the year in which vesting first occurs).

5 This issue only arises because, as noted in the previous discussion, the RSUs may be subject to Section 409A. Accordingly, the potential change in control issue should not normally apply to RSUs held by executives who are not retirement-eligible.

discretion, because there is a choice whether the acquirer assumes the RSUs. Under this scenario, payout of RSUs to retirement-eligible employees could result in the punitive 20% additional tax imposed by Section 409A.

One solution to this potential problem would be to have the plan provide that, if the change in control is a stock-for-stock transaction, then unvested equity awards will be automatically converted to the acquirer's equity in an equitable fashion. If the acquisition is a stock-for-cash transaction, the unvested awards will be converted into a promise to pay cash (at the deal price) on the original payment dates or earlier, if applicable, on a qualifying termination.

* * * * * * * *

This letter is intended to alert compensation professionals about issues that may affect their companies, and should not be considered or relied upon as legal advice. Specific questions about the tax issues addressed in this letter should be discussed with appropriate legal counsel. General questions about the subjects in this letter may be directed to David Gordon in our Los Angeles office at (310) 277-5070 or Cimi Silverberg in our Chicago office at (312) 332-0910.