



Tax considerations for public company equity incentive awards

This is the third part of a series covering certain securities law, corporate governance, and tax considerations related to stock options and restricted stock unit (RSU) awards granted by public companies.

Overview

This alert provides an overview of key aspects and tax considerations related to stock options and RSUs granted by publicly traded companies (referred to as “employers” or “companies”).

We also discuss issues that public companies and compensation committees of their boards of directors may consider in addressing tax withholding obligations related to the exercise and settlement of stock options and RSUs. These obligations are often particularly complex for RSUs. While an option holder generally has the flexibility to choose the date of exercise and the resulting tax recognition timing, the RSU holder does not have control over the timing of share settlement and tax recognition.

Satisfying employer tax withholding responsibilities

Methods for payment of tax withholding

Employers have a tax withholding obligation in connection with the exercise of nonqualified stock options (NSOs) and the settlement of RSUs held by current or former employees. Specifically, the employer is required to withhold and remit applicable Federal Insurance Contributions Act (FICA) taxes (ie, taxes with respect to Social Security and Medicare) and federal and state income taxes on the income recognized by the award holder. For exercised NSOs or stock-settled RSUs, the income amount corresponds to the value of the underlying issued shares rather than cash. However, the employer must remit the tax withholding to the Internal Revenue Service (IRS) and state and local tax authorities in cash. As a result, employers are encouraged to plan ahead and utilize a strategy that ensures

sufficient cash will be available to satisfy the tax withholding obligations.

The most common strategies used by publicly traded companies include:

- **Sell-to-cover:** The issuer or the award holder provides instructions for a third-party broker to sell (in connection with the issuance of the shares) a number of shares sufficient to generate enough cash to satisfy the tax withholding obligation.
- **Net share issuance:** The number of shares delivered to the award holder by the issuer is reduced by a number of whole shares that have an aggregate fair market value equal to the tax withholding obligation. Any remaining incremental tax due that is less than the current value

of a share is deducted from payroll. The company must then use its cash reserves to remit applicable taxes to the IRS and other tax authorities. As a result, this approach is generally reserved for companies that have sufficient cash reserves to utilize the strategy consistently across their entire employee populations.

- **Cash payment by employee:** As a condition to exercising an NSO or settling an RSU, the award holder is required to remit to the employer an amount of cash that is sufficient to satisfy the tax withholding obligation. The employer may also withhold cash from an employee's other earned and payable after-tax compensation. In practice, this option is not an attractive alternative to holders who incur a significant tax liability, and it may be difficult to utilize across a large employee population. Requiring the payment of taxes in cash is difficult to implement and is rarely used, particularly with respect to RSU settlement, because the holder does not control the timing of settlement and the timing of tax recognition. However, this approach allows the award holder to retain the largest number of shares.

Prior to utilizing one of these approaches, companies are encouraged to review the controlling equity plan and award agreement under which the equity award was granted. Equity incentive plans typically include broad authority for the compensation committee or board to determine the method of tax withholding used by the company. However, if a certain approach is not permitted under the terms of the governing documents, action by the compensation committee or the board might be required in order to approve the new withholding method, and the holder's consent may also be required for previously granted awards.

Securities law considerations related to tax withholding

- **Section 16 reporting:** Issuers are advised to consider reporting requirements for Section 16 officers that apply to the sell-to-cover and net share issuance methods for satisfying tax withholding. When the Section 16 officer sells shares, or shares are withheld to cover the withholding taxes due, a Form 4 must be filed, reporting the transaction within two business days following the sale or disposition.
- **Compensation committee approval of net share issuance:** If net share issuance is used for Section 16 officers, the compensation committee or the full board should approve the share withholding method in advance. Alternatively, the form of award agreement previously approved by the compensation committee or the full board may permit the use of net share issuance without further approval. In either case, management should not be delegated the discretion, explicitly or effectively, regarding whether to use net share issuance to ensure that the disposition of shares to the company is exempt from Section 16(b) short-swing profit liability pursuant to Rule 16b3(e). It is possible, however, for the compensation committee or board approval to provide

that the Section 16 officer may elect whether net share issuance will be utilized.

- **MNPI considerations and blackout periods:** Issuers are encouraged to have in place pre-clearance procedures under their insider trading policies for any public trading of issuer shares by Section 16 officers to ensure that the insider does not have any material nonpublic information (MNPI), and that the issuer does not have a regularly scheduled blackout period in place at the time any shares will be sold on the open market to cover withholding taxes, unless these sales are covered under a 10b5-1 trading plan.

Blackout periods

Another key withholding challenge may arise in connection with blackout periods. During a blackout period the trading of a company's shares is restricted to prevent employees from trading while in possession of MNPI. Blackout periods typically occur prior to significant events, such as material corporate transactions or quarterly earnings releases.

From a withholding perspective, issues arise if an employee attempts to exercise an NSO, or if a vested RSU is scheduled to be settled during a blackout period. While the exercise of an NSO itself does not involve any open market sale, the employee would not be able to sell shares into the market during the blackout period to cover the option exercise price or any withholding taxes, thereby restricting the ability to utilize the sell-to-cover withholding tax strategy noted above. Typically, the holder of an NSO will simply wait until an open trading window to exercise.

However, to address this challenge for RSU awards, where the timing of settlement is not elected by the holder, companies typically utilize one of the following strategies:

- **Automatic delayed settlement:** The RSU award agreement may provide for automatically delaying the settlement of an RSU until a trading window opens if net share withholding is not utilized. Generally, if the RSU is not "deferred compensation" for purposes of Section 409A of the Internal Revenue Code, it must be settled no later than two and a half months following the end of the calendar year in which the RSU vests to avoid adverse consequences under Section 409A. This approach has limitations, as a blackout period might not end after the vesting date and before the delayed settlement date. In such circumstances, issuers with sufficient cash reserves often fall back on net share settlement as a failsafe method to cover tax withholding if shares cannot otherwise be sold on the open market in time to avoid adverse tax consequences under Section 409A.
- **Coordinating vesting dates with open windows:** Many companies structure RSU vesting schedules so that awards vest and settle during expected open trading windows. For instance, a company might schedule vesting of awards

to occur far from the expected date of quarterly earnings releases and during an open trading window. While this strategy may mitigate the blackout period risk discussed above, unexpected blackout periods can occur, and Section 16 officers may be exposed to MNPI during scheduled open trading windows, which may limit the effectiveness of this approach.

- **“Mandatory” sell-to-cover:** Some issuers have taken the position that, if the terms of the RSU award agreement provide that shares will automatically be sold on the open market to cover withholding taxes, there is no effective trading election by the insider because the sale is mandatory, and thus no potential insider trading violation where such sale occurs on a date that the insider could not otherwise elect to sell the shares. While administratively easy, this approach carries significant risk that the Securities and Exchange Commission (SEC) would view such an arrangement as an effective sale election made by the Section 16 officer on the date the RSU award is accepted. Issuers taking this approach have implemented a number of strategies to mitigate this risk.
- Many employers require that their Section 16 officers make a separate written election agreeing to sell-to-cover for all of their RSU grants, including future grants, during an open trading window when the insider could otherwise elect to sell shares and remain consistent with the timing requirements for establishing a Rule 10b5-1 trading plan, including satisfying the applicable required “cooling off” periods prior to sale.
- Some employers require that RSU awards be accepted by the recipient during a limited period corresponding to an open trading window while the RSUs have not vested, or the RSU award will otherwise be automatically forfeited. This approach is not administratively practicable to implement for employers who grant RSUs broadly to their workforce. Even for employers limiting this requirement to their Section 16 officers, tracking and enforcing acceptances may be administratively burdensome and may result in inadvertent forfeitures of awards. This could be particularly troublesome for named executive officer grants as the forfeiture and new grants would need to be reported in the employer’s executive compensation disclosure included in its Form 10-K or proxy statement.
- Other employers position that the RSU award is by default “automatically accepted” on a date scheduled during an open trading window, unless the insider timely rejects the RSU award within a specified period. The SEC has not provided guidance or expressed any views as to whether such a default “deemed acceptance” during an open-window approach would or would not be viewed as permissible under the amended 10b5-1 rules.

- **Rule 10b5-1 trading plans:** Rule 10b5-1 plans are pre-established trading plans that allow company insiders and employees to pre-schedule sales of company stock at a future date, including during blackout periods. Rule 10b5-1 of the Securities Exchange Act of 1934, as amended (Exchange Act), sets forth specific requirements for establishing a Rule 10b5-1 trading plan, including adopting a plan during an open trading window or on a date the insider has no MNPI and a required waiting or “cooling off” period before any trades under such plan can commence. If a valid Rule 10b5-1 plan is timely established, company employees may utilize the sell-to-cover withholding method to sell shares during a blackout period. While the SEC rules as amended generally limit having “overlapping” 10b5-1 trading plans, any sell-to-cover transactions are generally excepted from such limitation.

T+1 rule settlement and next-day deposit rules

On May 28, 2024, a new SEC rule went into effect requiring most securities transactions effected by a broker-dealer to be settled within one business day after the trade date (referred to as the T+1 rule). For the exercise of NSOs and the settlement of RSU awards, this rule requires a broker supporting a sell-to-cover transaction to ensure the shares of stock are delivered to the purchaser (which requires the shares to have been first deposited in the selling employee’s account) within one business day following the exercise or settlement date.

Separately, the IRS has its own set of rules requiring an employer who accumulates more than \$100,000 in employment taxes on any day to deposit the employment taxes with the IRS by the following business day. Failure to timely deposit taxes in accordance with these rules may result in significant penalties to the employer. For example, if an RSU vests and is settled on a Monday, the shares must be deposited in the employee’s account by Tuesday, and tax withholding must be transmitted to the IRS by Tuesday based on the value of the shares at settlement.

Given that employer tax withholding is tied to the date a stock transaction is settled, the application of the T+1 rule means that employers who historically used a longer settlement cycle to prepare for the logistics of paying withholding taxes may feel pressed for time. In order to remit the withholding obligation in a timely manner, companies should consider the method used to determine the fair market value of shares on an exercise or settlement date.

Typically, an equity plan will have a definition of fair market value that is most commonly applied for purposes of establishing the value of the company’s shares on the grant date of an award; however, this definition is not necessarily required for determining a tax withholding obligation. As a result, employers are encouraged to fix in advance a consistent

method that will be used for determining fair market value for tax withholding purposes. Often, this is the closing price per share on the trading day prior to the exercise or settlement date. Companies that previously used the closing price on the date of issuance may consider using a valuation method tied to the closing price on the prior trading day in order to provide more time to calculate and remit tax withholding.

Companies are encouraged to consistently use the method determined by its compensation committee as to avoid the appearance that the company uses different valuation methods for different participants, or in light of different market conditions and events that may affect the stock price for the purpose of avoiding taxes.

Deferred settlement of RSUs and FICA taxes

In some cases, RSUs are structured with deferred settlement dates following vesting, allowing the RSU holder to generally defer taxation with respect to the RSU to a taxable year following the RSU vesting year. For example, the RSU agreement might provide that, upon vesting, the RSU is not settled, and the issuance of shares will be deferred until the earlier of a fixed future date, termination of service, or an earlier change in control of the company. While the delayed settlement defers income tax, it does not defer FICA taxes.

Under the FICA tax regulations, deferred compensation is subject to FICA taxation when the award is no longer subject to a substantial risk of forfeiture, generally meaning that the award is vested. If RSUs vest but are not settled until a future date or event, the award may be considered deferred compensation subject to FICA taxes and related FICA withholding upon vesting. The value of the shares issued on the later settlement date is not subject to FICA taxes at that time.

Companies granting RSUs with deferred settlement dates (ie, later than March 15th of the year following vesting) should be aware of the obligation to withhold FICA taxes during the year in which the RSUs vest. This tax obligation may occur even with a de facto deferral feature, such as when RSUs are eligible to vest upon “retirement,” but the tax obligation arises when the RSU holder has become retirement eligible (even if the holder has not elected to retire).

Conclusion

The tax implications and withholding obligations related to equity incentive awards present key challenges to public companies and compensation committees. By carefully considering these issues, compensation committees can plan ahead and develop strategies that comply with applicable regulatory requirements, while also providing solutions that can benefit the company and employees.

Appendix A

Overview of taxation of equity awards

Companies should keep in mind how and when stock options and RSUs are subject to taxation and tax withholding when considering the methods they will use to fulfill tax withholding obligations.

Stock options

Stock options give recipients the right to buy a certain number of shares of the company's stock at a predetermined exercise price within the specified term of the option, often subject to applicable vesting requirements. There are two types of stock options: non-qualified stock options (NSOs) and incentive stock options (ISOs). Generally, NSOs are subject to ordinary income tax treatment, whereas ISOs may qualify for more favorable capital gains tax treatment if certain requirements under the Internal Revenue Code are satisfied. Stock options are taxed as follows:

- **At grant and vesting:** The grant of stock options does not trigger any tax consequences for the recipient, regardless of whether the options are NSOs or ISOs. Similarly, there are no tax consequences at vesting.
- **At exercise:**
 - **NSOs:** When NSOs are exercised, the holder recognizes ordinary income tax on the difference between the fair market value at the time of exercise of the shares being exercised, and the applicable exercise price (referred to as the spread value). An issuer is required to withhold taxes on the spread value at the time of exercise and report the compensation income on Form W-2 if the holder is or was an employee while holding the NSO. The issuer is not required to withhold taxes if the holder is or was a director or consultant, but the issuer must report the spread value on Form 1099.
 - **ISOs:** When ISOs are exercised, the holder is not subject to ordinary income tax. However, the spread value of the shares being exercised is included in the holder's alternative minimum tax calculation (a parallel tax system that applies to certain taxpayers with specific preferences and adjustments). No employment tax withholding is required in connection with an ISO.
- **At sale:**
 - **NSOs:** Any gain or loss from the sale of the shares acquired from the exercise of an NSO is treated as capital gain or loss – either as long-term or short-term, depending on whether the shares have been held for at least 12 months prior to such sale.
 - **ISOs:** If shares acquired from the exercise of an ISO are held for at least one year after exercise, and two years after the date of grant of the ISO, the sale of such

shares is subject to long-term capital gains treatment. If the holding period requirements are not satisfied, the difference between the exercise price and the lesser of the fair market value of the shares at the time of exercise or the sales price is taxed as ordinary income. Any additional gain is taxed as a capital gain.

RSUs

RSUs represent the right to receive a certain number of shares of the company's stock or a cash equivalent, subject to applicable vesting requirements. Unlike actual shares of a company, RSUs generally do not give employees any ownership or voting rights until the RSUs are settled and corresponding shares are actually issued. RSUs are taxed as follows:

- **At grant:** The grant of RSUs does not trigger any tax consequences for the recipient.
- **At settlement:** Upon settlement of RSUs into shares (or a cash equivalent), the holder recognizes ordinary income tax on the fair market value of the shares (or the cash equivalent) as of the settlement date. Settlement often occurs in connection with the vesting of an RSU, or within a short period of time thereafter. An employer is required to withhold taxes on the value of the shares (or cash payment) at the time of settlement and report the compensation income on Form W-2 if the holder is or was an employee. The employer is not required to withhold taxes if the holder is or was a director or consultant, but the employer must report the value of the shares (or cash payment) on Form 1099.
- **At sale:** Any gain or loss from the sale of the shares obtained upon settlement of RSUs is treated as capital gain or loss – either long-term or short-term, depending on whether the shares have been held for at least 12 months prior to the sale.

For more information

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