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Stock Compensation Can Add Zing to Your Benefits Package

Federal Law Compliance Headaches To Keep In Mind

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Recently the headlines are full of statistics and anecdotes about the difficulty employers face finding and retaining employees. In this competitive market, employers want to be sure they are offering the most competitive benefits package they can. Aside from the traditional retirement plan and medical benefit offerings, some employers may find value in offering creative stock bonus and compensation programs like stock options, restricted stock, and other equity-type arrangements. Stock compensation can often provide both short-term and long-term incentives to employees. But, just like every other compensation and benefits program, stock programs trigger a multitude of legal rules and restrictions. This article addresses three sources of federal law that must be kept in mind when designing and implementing a stock compensation program – the Internal Revenue Code, ERISA, and securities laws.

Income and Payroll Tax Considerations

Employers offering stock compensation will want to make sure they understand when and how the benefits will be taxable to their employees. Income and payroll taxes are usually due when awards vest. Sometimes this can have surprising results. For example, restricted stock units are often structured to vest at retirement age, which means payroll tax obligations might be triggered even before the awards are due to be paid. Stock options, on the other hand, are not included in an employee's income unless and until they are exercised. And if shares of restricted stock are granted, they are not included in income until vesting, *unless* the employee follows the requirements of Internal Revenue Code Section 83(b) (including submitting a written election to the IRS within 30 days of the grant) to have them taxed at the time of grant.

Deferred Compensation Minefields

In addition to income and payroll tax issues, the Internal Revenue Code also includes a formidable provision affecting all “deferred compensation” – Section 409A. Because of the broad definition of this term, Section 409A is a force to be reckoned with when structuring stock compensation. Stock options and stock appreciation rights are usually structured to be exempt from 409A, but the exemption doesn't come easily – there are strict rules regarding how the base value of the awards must be set and other conditions that must be monitored. Other stock compensation like restricted stock units and phantom stock are often subject to Section 409A. To avoid hefty penalties, they must comply with 409A's detailed rules on payment triggers (only certain events and dates will suffice), and bans (with very limited exceptions) on subsequent deferrals or accelerations.

Stock Compensation Programs *Can* Trigger ERISA

The counterpart to the Internal Revenue Code for many benefit programs is ERISA, and this is true for stock compensation, as well. Employers may be surprised to learn that stock compensation programs can fall within the reach of ERISA. If a stock compensation program operates like a bonus plan, where benefits are payable at various times and events, it will most likely not be subject to ERISA. For example, restricted stock units that settle after a short vesting period are clearly just a bonus program. But if, for example, a phantom stock program is intended to or has the effect of deferring benefits until retirement age or termination of employment, it could very well be viewed as a “pension plan” by the Department of Labor. This is usually a death-knell for a stock or bonus program, since ERISA's myriad of rules (starting with eligibility, vesting, trust, fiduciary, etc.) are essentially incompatible with stock programs. Luckily, many of those ERISA rules can be avoided by making the program a “top hat” plan, where eligibility is limited to executive and management employees. But even if a stock compensation program is limited to executives, the employer should make sure that the necessary one-time filing with the DOL is made, and that the plan complies with the provisions of ERISA for which there is no exemption (such as, for example, the ERISA claims procedures).

Does SEC Registration Exemption Apply?

Securities laws are a third source of federal law that applies to stock compensation programs. The Securities Act of 1933 requires that every “offer and sale” of a “security” must be registered or exempt from registration requirements. While these terms are, of course, subject to nuanced interpretation and application, they generally apply to employer equity compensation plans. Rule 701 provides an exemption from such registration requirements for companies not subject to reporting requirements under the Securities Exchange Act of 1934 (non-reporting companies) to issue securities (including securities issuable under stock options and restricted stock units) for compensatory purposes to employees, directors and certain service providers of the company.

Rule 701 covers securities issued under a written compensatory benefit plan or written agreement relating to compensation. Among the many requirements of the exemption are the following:

- *Eligible Service Providers.* It's no surprise that under this exemption, securities can be issued to employees, officers and directors. It is also possible to use it for programs that benefit consultants and advisors, provided that they are natural persons, they provide *bona fide* services to the issuer or its affiliates and the services are not in connection with the offer or sale of securities in a capital-raising transaction.
- *Offering Limits.* Under the Rule 701 exemption, the aggregate sales price or amount of securities sold during any 12-month period cannot exceed the greater of three benchmarks: \$1 million; 15% of the issuer's total assets; and 15% of the outstanding securities of

the class being offered.

- *Disclosure Requirements.* Although Rule 701 does not require any notices, reports or filings with the SEC, issuers relying on the exemption do have to provide employees in the program with a copy of the program documents. And if the program will exceed \$10 million in any 12-month period there are additional disclosure requirements, including risk factors and financial statements. This threshold for enhanced disclosure was much lower (\$5 million) until a rule change on July 24, 2018. If an employer was deterred from offering a stock compensation program due to the burden of disclosure, it may be worth revisiting the issue now that the burden has been lightened. Keep in mind, too, that regardless of whether the enhanced disclosure rules apply or not, there is always a duty to comply with securities law antifraud requirements.

This article has only touched on some of the basic principles of tax, ERISA, and securities laws that might apply to an employer's stock compensation program. For a more thorough analysis of how these and other laws (including corporate governance and state securities laws) might apply to your business's stock compensation program, consult with a benefits professional.

For more information, contact a member of Holland & Hart's Benefits Law Group or Corporate Group.

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