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Developments in Tax Withholding for Equity Awards under Employer Stock Plans

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When an employee exercises or settles an award such as a stock option or restricted stock unit, there is often a measure of value that must be included in the employee's compensation income. Consequently, employers are required to withhold and remit payroll and income taxes with respect to that compensation, and employers will typically require employees to satisfy their portion of those taxes. Either the employee must come up with other sources of liquidity, or in some cases the taxes may be satisfied by “net settlement” – withholding some of the shares from the award. Two recent developments – one in the accounting arena and the second in securities law – affect how this withholding can be handled.

First, with respect to accounting, companies usually prefer to classify stock awards as equity rather than as a liability. For many years, the Financial Accounting Standards Board (FASB) allowed equity classification only if share withholding would not exceed the employer's minimum statutory tax withholding requirement. But in 2016, FASB issued an Accounting Standards Update that revised its position. Now, shares can be withheld up to the maximum individual tax rate in the applicable jurisdiction.

For companies that wish to allow share withholding up to FASB's increased amount, there are a few things to keep in mind. If the plan is drafted to permit net settlement only to the extent of FASB's previous standard (the minimum statutory required payment), the plan will have to be amended. Thankfully, both the NYSE and Nasdaq issued guidance making clear that such an amendment would not require shareholder approval. A company should also consider whether it will amend outstanding stock grants to allow additional withholding. FASB has clarified that doing so will not be considered a modification, but there may be other reasons to leave existing awards alone (such as the risk that such a revision might be viewed as a re-grant for purposes of Internal Revenue Code Section 409A's rules on deferred compensation).

The more favorable accounting rules have undoubtedly made net settlement much more useful and prevalent, and have led to the second development in the arena of securities regulation. Several companies have received shareholder letters or have been the target of shareholder lawsuits alleging that share withholding by an insider is exempt from Section 16b's short-swing profit rules only if the share withholding is required. In other words, the shareholders allege that if an insider has the discretion to choose to satisfy tax obligations either through net settlement or through other means, the insider's election is treated as a non-exempt sale subject to the Section 16b short-swing profit rule.

A recent federal court decision (Jordan v. Flexton, US District Court for the Southern District of Texas, April 26, 2017) dismissed a shareholder's lawsuit making this allegation, but the issue is not yet put to rest. The case has been appealed to the Fifth Circuit, and other courts could reach different results. Given the uncertainty in this area, public companies may wish to take action to make certain that net settlement will be exempt from Section 16b and avoid the hassle of shareholder challenges. Equity plan documents and/or award agreements could be amended to provide that share withholding is required. Or if not required, the documents could provide that share withholding is permitted only in the discretion of the board or the compensation committee.

All companies will want to keep these issues in mind throughout the year as equity awards are settled and exercised. And when the opportunity arises to amend or adopt a new equity plan, consideration should be given to plan language that relates to net settlement.

Contact a member of Holland & Hart's Benefits Law Group if you have questions or need assistance with an equity plan or any other employee benefits matter.
