Restricted Stock Units in a Nonqualified Deferred Compensation Plan

An Effective Tax Planning Tool for Future Financial Needs

Restricted Stock and Restricted Stock Units:

An Overview, by William MacDonald, Managing Director, EBS-West

Restricted stock awards have become a popular planning tool for many corporations because stock options lost some of their luster when FASB began requiring expense recognition for stock options. A major advantage of utilizing restricted stock is that from a shareholder's perspective, it is an effective tool for motivating key employees to think and act like owners.

When a restricted stock award vests, the employee (or director) who received the restricted stock becomes an owner of the company.The employee or outside director has no further action to take to make it happen. The employee is now a shareholder and can vote at the annual meeting. But this comes at a stiff tax cost that will be discussed later.

The normal restrictions on the stock are time restrictions known as a vesting period. If an employee leaves the company before the vesting period lapses, the employee forfeits the stock. This is a good device to put a little glue in the seat to retain the company's key people. Once the vesting period is satisfied the employee owns the stock and can sell or hold it. If the stock price at time of grant is high and then at the time the grant vests the price is lower, the employee still has something of value.

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Any award of restricted stock comes with a tax cost:

1. The value of stock transferred to an employee is includible in employee's gross income in the first taxable year in which the risk of forfeiture lapses (when they vest).

2. Any grant of restricted stock is subject to an election to defer the income attributable to the grant until the employee's rights in the stock vest when the risk of forfeiture lapses. However, the employee may elect under IRC Section 83(b) to recognize income at the time the stock is granted (potentially the lower price). Most executives don't do this, as they are paying taxes on something they may never see (could leave the company before they vest).

3. The advantage of accelerating income under §83(b) is that any future appreciation in the stock won't be taxed to the employee until the stock is sold and is then subject to capital gain rates. However, as we mentioned above, most don't do this for fear for paying tax on something they may never see the value of.

4. If the §83(b) election is not made, on the date the restrictions lapse the employee will be treated as receiving taxable income equal to the fair market value of the stock (presumably higher in price).

Exhibit A:

Employee A is granted 1,000 shares in 2015 when the value is $100.00 a share and the restrictions on the stock lapse (they vest) in 2017 when the stock is worth $160.00 per share and the employee sells the shares in 2018 for $200.00 per share. If the §83(b) election is not made then the employee will be subject to ordinary income tax on $160,000 (1000 x $160.00 per share on the restriction lapse date) and capital gains tax on $40,000 when the stock is actually sold in 2018 (1000 x $200.00 with a tax basis of 1000 x $160.00 previously taxed). If the §83(b) election had been made at date of grant then the employee would have been taxed on $100,000 (1000 x $100.00) as ordinary income and $100,000 capital gains when the stock was actually sold (1000 x $200.00 with a tax basis of 1000 x $100.00 previously taxed income). Under the §83(b) election more of the gain is subject to capital gains, therefore the employee has greater value for making the earlier election.

By way of example, if the employee makes an §83(b) election then the employee will receive taxable income in the election year. The amount of income will be the fair market value of the stock on the date the restricted award is granted.

There are advantages to restricted stock but, as the examples illustrate, there are necessary steps an employee must take in order to avoid tax pitfalls and under IRC Section 83(b), the employee could be paying tax on an asset the employee may never receive, or on an asset with a lower value in the future if the stock price declines.

Restricted Stock and Restricted Stock Units — Deferred in a Nonqualified Plan:

A Better Alternative. In order to avoid the complexities of Restricted Stock, many companies are now using Restricted Stock Units (RSUs) with the potential for further tax deferral into their nonqualified deferred compensation (NQDC) plan. The units are not issued in the form of actual stock. Instead, the RSUs are measured and valued against the company's stock. Instead of issuing stock with restrictions, the company issues restricted stock units with similar restrictions but with one big advantage:The entire value and the taxation of the units may be deferred to a future date without an §83(b) election.

Rather than pay tax when the RSUs vest, any units issued to an employee at the time of issuance may be deferred to a NQDC Plan (subject to the guidelines under IRC §409A, not discussed herein). The units' value will grow inside the RSU plan and then later inside the deferred compensation plan without any current tax consequences to the employee.This method avoids the problem of an employee paying tax on phantom income under an §83(b) election, as well as avoids the potential problem of an employee paying tax currently on an asset the employee might not receive because of a forfeiture event. In addition, the employer may allow participants who defer RSUs to diversify some or all the units into a diversified portfolio of investment funds within the deferral plan.

Utilizing a NQDC plan will alleviate the tax-related complexities associated with restricted stock. The risk the employee faces with restricted stock units in a NQDC plan is that if the company fails the plan could be subject to creditor claims. However, the employee would be in an even worse position with restricted stock because the employee would have already paid tax on a worthless asset.

In today's environment where companies must retain key employees, a NQDC plan with restricted stock units solves the compensation goals of an employer to provide stock-related financial rewards and enhances retention while avoiding unexpected and untoward tax consequences for the employee.

The value of the RSUs can be tracked through the normal operation of the employer's NQDC plan recordkeeping service. These deferred stock awards may become the cornerstone of the employee's retirement plan and because of that may become even more valuable as a recruiting and retention vehicle.

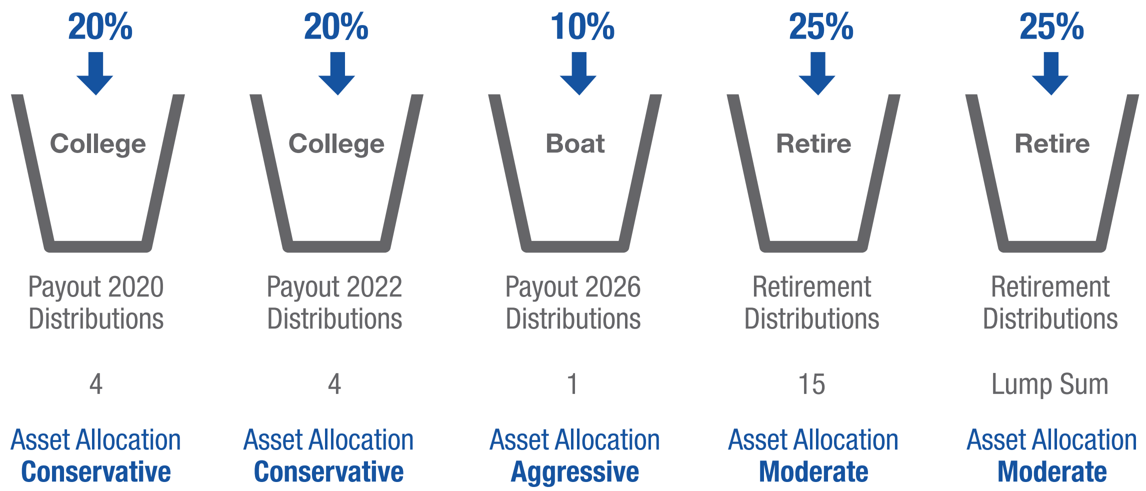
In addition, RSU's held in the NQDC plan could count toward shareholding requirments for senior executives. When the employee first makes their election, which is required within a 30 day period of the grant being made, he or she can defer the award beyond the vesting period and take distribution many years in the future. With most NQDC plans, they can plan for their life events and defer the shares to help finance many of their life's financial goals.

Chart I illustrates an example of a 45 year old executive who has two children age 13 and 11. In 2015, he was issued 50,000 RSUs, with a three year vesting period (1/3, 1/3, 1/3). By making his election within 30 days of grant, he deferred 20% of the shares (10,000) for his sons college education starting in 2020 (first bucket) and 20% (10,000) to his daughters education starting in 2022 (second bucket). He also made the election to take each bucket in four (4) equal installments, as he anticipates a four year college education for both his children. The advantage, he is not paying taxes when he vests on the un-distributed shares and has the ability to continue to grow them tax deferred.



Now continuing with our chart, he sets up another life event by deferring 10% (5,000 shares) into his “boat account” (third bucket). When the kids are out of school, he and his wife want to enjoy life a little. And finally, he makes two elections with the final shares and defers the balance until retirement, setting up two buckets. The first, he decided to take a lump sum so he can take a little money off the table at retirement and the second, he takes over a 15 year period with the growth of the stock appreciating tax deferred.

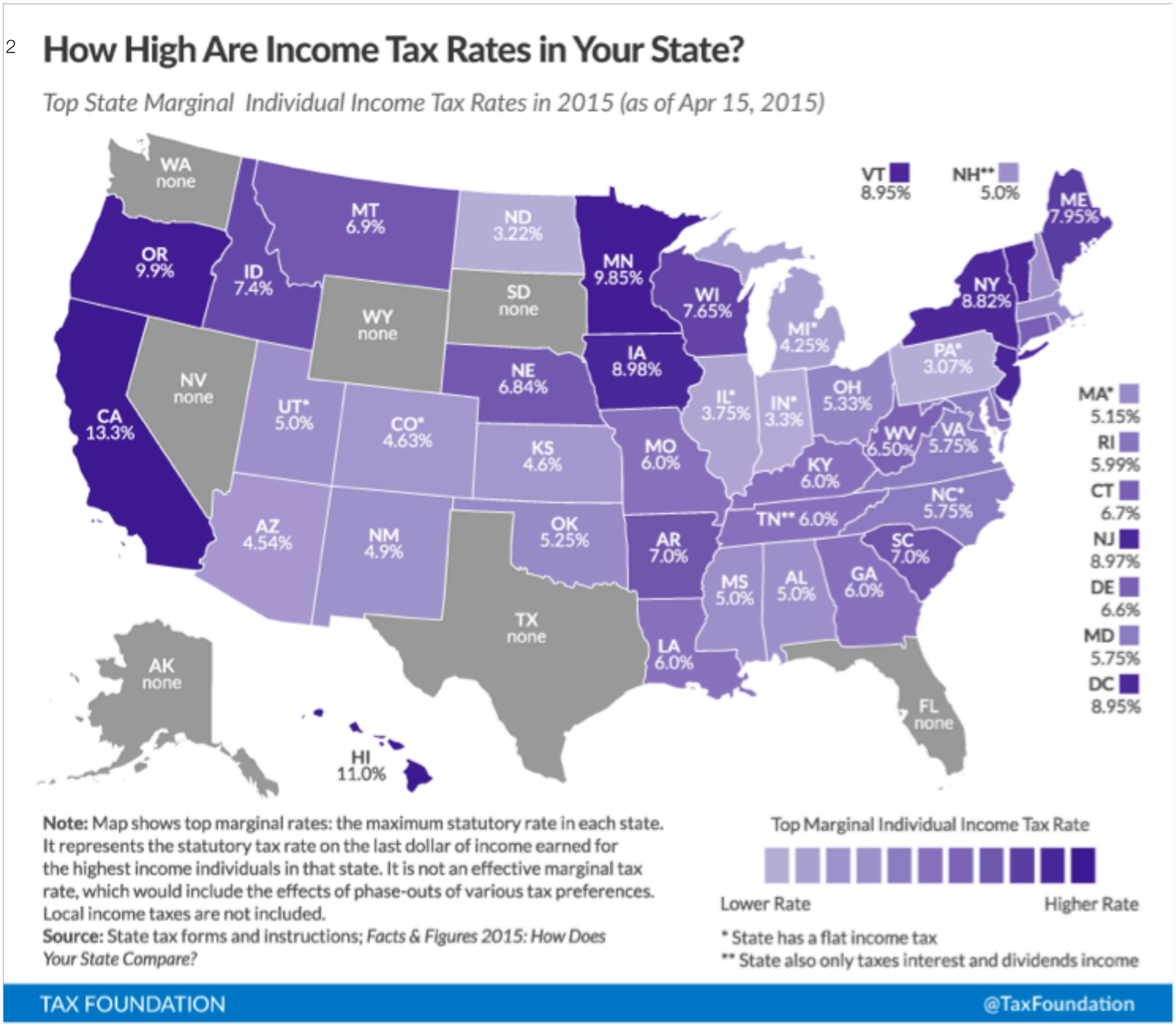
Chart I



By taking the last bucket over 15 years, he is taking advantage of some additional tax benefits.There may be state tax advantages for taking a distribution over ten years or longer, called the source tax provision. This provision allows the executive to defer while living in a high income tax state like California or New York, and taking their distribution (10 years or longer) while living in a state without income tax, like Nevada or Florida. This could make a huge difference on the income you receive at retirement. It will be very important at retirement to plan your distributions not only in the form you take them, but where you take them.

Under the new §409A regulations for deferred compensation, the participant could even“re-defer” the previous election. As an example, if their child decides to not go to college immediately, or better yet she gets a scholarship, you can re-defer those dollars to later years.

Chart 2



The rules are quite clear: You need to elect to re-defer at least one year prior to distribution, and your re-deferral must be for at least five years.There is no restriction on how many buckets you can establish or how many times you re-defer. You could set up 5, 10, 15, or more distribution buckets, and have a cascading effect, rolling those RSUs to later dates while having the option to take them while you're working to help settle life's financial needs. You will have the same opportunities with future grants of RSUs, by adding the to the existing buckets, or setting up new ones.

Accounting for the Deferral of RSUs

One of the most attractive aspects of this concept is no additional cost to the company. If the employee defers RSUs and the company settles in stock, they can take advantage of favorable fixed accounting, making this plan attractive to both participants and shareholders.This opportunity is spelled out in EITF 97-14.

EITF 97-14 provides special rules for how Employer Stock is to be handled for purposes of both the NQDC plan and its funding. If such stock is used as a NQDC plan measurement fund, its accounting is the same as that for any other NQDC plan investment option using variable accounting, however, if the plan provides that (i) a participant may not allocate his or her account balance in and out of the NQDC plan Employer Stock account and (ii) the portion of his or her account balance that is allocated to Employer Stock can only be paid out in employer stock, then the Employer Stock is held at basis, without any increase or decrease in value due to gains or losses ("Fixed Accounting"). This Fixed Accounting is shown below. If Employer Stock is used to informally fund the NQDC plan liability through a Rabbi Trust, EITF 97-17 provides that such stock will be treated as treasury stock and held at basis.

A. Initial Investment

The initial investment in Employer Stock in the NQDC plan is shown in Example 1 and in the Rabbi Trust in Example 2.

Example 1: Initial Investment NQDC PLAN (Assuming $100,000 initial investment)			
Journal Account	**Financial Statement**	**Debit**	**Credit**
Deferred Comp. Expense	Income Statement	$100,000	
Deferred Comp. Liability	Balance Sheet		$100,000

Example 2: Initial Investment Rabbi Trust (Assuming $100,000 initial investment)			
Journal Account	**Financial Statement**	**Debit**	**Credit**
Employer Stock	Balance Sheet	$100,000	
Cash	Balance Sheet		$100,000

B. Earnings

Assuming that liabilities are booked using the Fixed Accounting method, Example 3 shows sample entries for the NQDC plan. Example 4 shows sample entries for Employer Stock held in the Rabbi Trust. In both instances, no gain or loss is booked.

Example 3: Investment Gains/Losses NQDC PLAN (Assuming $10,000 gain or loss)			
Journal Account	**Financial Statement**	**Debit**	**Credit**
Deferred Comp. Expense	Income Statement	$0	$0
Deferred Comp. Liability	Balance Sheet	$0	$0
Deferred Comp. Liability	Balance Sheet	$0	$0
Deferred Comp. Expense	Income Statement	$0	$0

Example 4: Investment Gains/Losses Rabbi Trust (Assuming $10,000 gain or loss)			
Journal Account	**Financial Statement**	**Debit**	**Credit**
Employer Stock	Shareholders Equity	$0	$0
Gain	Income Statement	$0	$0
Loss	Income Statement	$0	$0
Employer Stock	Shareholders Equity	$0	$0

C. Payment of Benefit

When Employer Stock is distributed and the Fixed Accounting method is used, no realized gain or loss is recognized as shown in example 5.

Example 5: Payment of NQDC PLAN Liability From Stock In Rabbi Trust (Assuming $100,000 initial investment)			
Journal Account	**Financial Statement**	**Debit**	**Credit**
Deferred Comp. Liability	Balance Sheet	$100,000	
Employer Stock	Shareholders Equity		$100,000

Summary

With the issuance of RSUs as part of a total rewards program and the need for advanced tax planning in these uncertain times, NQDC plans with this feature, as well as the flexibility discussed above in Chart I, should be a win-win for executives, outside directors, and the company shareholders. Favorable accounting also makes this an attractive benefit for shareholders to attract, retain and reward the key people who can make a difference in the organization. And finally, having the right administrator to manage and communicate this feature could be the key in your success.

About the Author

William L. MacDonald founded three leading firms in the executive compensation and benefits Industry; notably, Compensation Resources Group, Inc. (CRG); Retirement Capital Group, Inc. (RCG); and the Merrill Lynch Executive Compensation Group. Clark Consulting, a NYSE firm, acquired CRG, and Bill continued to lead its executive benefits practice as president. He now serves as Managing Director for EBS, and is Chief Marketing Officer for the organization.

Mr. MacDonald has consulted on executive compensation and benefit issues for more than 20 years for numerous public and privately-held firms across a variety of industries, including a large number of Fortune 500 companies. He wrote a book Retain Key Executives published by CCH, and has authored numerous articles on the subject of executive compensation and benefits. In addition, Mr. MacDonald has been quoted frequently in The Wall Street Journal, The New York Times, and Bloomberg, as well as in a number of industry trade journals.

www.executivebenefitsolutions.com Contact Bill MacDonald: 760-340-4277

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