Workers' Compensation Insurance Rating Bureau of California

Report on Payroll – Remuneration: Equity-Based Compensation Plans Study

Excerpt from the WCIRB Classification and Rating Committee Minutes
March 20, 2018

About this Report

The WCIRB prepares and presents reports to the WCIRB's Classification and Rating Committee to assist in the formulation of proposed changes to the Insurance Commissioner's regulations. Once adopted by the Classification and Rating Committee, the recommendations contained in the report are provided to the WCIRB Governing Committee and may be included in a WCIRB regulatory filing that is submitted to the Insurance Commissioner for approval.

About the WCIRB

The WCIRB is California's trusted, objective provider of actuarially-based information and research, advisory pure premium rates, and educational services integral to a healthy workers' compensation system. Learn more at www.wcirb.com.

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Notice

This Report was developed by the Workers' Compensation Insurance Rating Bureau of California (WCIRB) to assist in the formulation of proposed changes to the Insurance Commissioner's regulations. The WCIRB has made reasonable efforts to ensure the accuracy of this Report. You must make an independent assessment regarding the use of this Report based upon your particular facts and circumstances.

Payroll — Remuneration: Equity-Based Compensation Plans Study

California Workers' Compensation Uniform Statistical Reporting Plan—1995
Part 3, *Standard Classification System*, Section V, *Payroll – Remuneration*, Rule 1, *Payroll – Remuneration,* and Appendix II, *Payroll/Remuneration Table*

Executive Summary

Objective

The *California Workers' Compensation Uniform Statistical Reporting Plan—1995* (USRP)[1] defines reportable remuneration and includes numerous provisions for adjusting, limiting or excluding specific forms of compensation.

WCIRB staff led a multi-jurisdictional working group, including the National Council on Compensation Insurance (NCCI) and the other independent rating organizations, to review payroll as the basis of premium for workers' compensation insurance. The goals of this group were to ensure that the payroll reported for workers' compensation purposes (1) provides a basis of exposure that is reasonably correlated with the losses expected to emerge, (2) mitigates the risk of potential manipulation and (3) can be reasonably and efficiently audited by insurers. As part of this review, the WCIRB performed a comprehensive study of equity-based compensation[2] to help assure consistency in the data submitted to the WCIRB and used in experience rating and pure premium ratemaking.

Equity-based compensation is defined by the Internal Revenue Service as any compensation paid that is based on the value of ownership shares or specified stock, regardless of whether there is an actual transfer of equity. Examples of equity-based compensation include but are not limited to Stock Transfers, Stock Options, Stock Warrants, Restricted Stock, Restricted Stock Units, Phantom Stock Plans and Stock Appreciation Rights. Equity-based compensation plans are increasingly common forms of compensation in certain industries in California and can result in significant fluctuations in an employee's payroll from year-to-year that may not necessarily correlate with fluctuations in the underlying exposure for workers' compensation losses. The USRP currently provides limited information regarding the reporting of equity-based compensation. Although the USRP currently references Profit Sharing and Stock Option and Stock Purchase Plans, it does not specifically address other forms of equity-based compensation.

The recommendations in this Study reflect the consensus of the multi-jurisdictional working group as to the most appropriate treatment of equity-based compensation plans from a national perspective.

Findings

Based on its review of the characteristics of equity-based compensation plans, WCIRB staff determined:

1. The USRP currently provides limited information regarding the reporting of equity-based compensation. Clear and uniform rules regarding the reporting of equity-based compensation based on a consensus view developed by the multi-jurisdictional working group can provide clarity to all stakeholders and promote consistent reporting practices nationwide.

2. Equity-based compensation that is paid on a scheduled or annual basis, or based on the achievement of performance goals or milestone anniversaries, can represent a recurring portion of an employee's overall compensation and is therefore a reasonable proxy for workers' compensation exposure and should be included as reportable remuneration.

3. Payment of equity-based compensation due to accelerated cliff vesting an Initial Public Offering (IPO) of stock, or a change in majority ownership, is caused by typically non-recurring infrequent

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[1] See Part 3, *Standard Classification System*, Section V, *Payroll – Remuneration*, Rule 1, *Payroll – Remuneration,* and Appendix II, *Payroll/Remuneration Table*, of the USRP ("Rule 1" and "Appendix II").

[2] Also known as share-based compensation or stock compensation.

events that can produce very large increases in payroll that can result in volatility in reported payrolls from year to year without similar shifts in underlying loss exposure. These amounts are not a regular or recurring portion of an employee's overall compensation and are therefore not a reasonable proxy for workers' compensation exposure during an individual policy period and should not be included as reportable remuneration.

4. Employee payroll-based contributions to fund equity-based compensation plans are similar to employee payroll-based contributions to fund pensions or deferred compensation plans and should be included as reportable remuneration.

5. Employer contributions to stock purchase plans and discounts on the purchase of stock are currently excluded from reportable remuneration. The existing rules do not address payments by the employer in connection with an employee's cashless exercise of stock options, which are taxable income and should be included as reportable remuneration. The existing rules could also be clarified to specifically reference employer contributions to Qualified or Non-Qualified Employee Stock Purchase Plans (ESPP).

6. Employee contributions to qualified or non-qualified deferred compensation plans are currently included as reportable remuneration when earned, and employer contributions to such plans are excluded. The existing rules do not address payments of previously deferred compensation. Amounts paid to current employees from an employer's previous contributions to deferred compensation should be included as reportable remuneration when paid. Payout of deferred compensation to retired or terminated employees who are not employed during the current policy period should not be included as reportable remuneration, provided the employer maintains records that segregate such payments.

Recommendations

In view of the above, the WCIRB recommends the following:

1. Establish a new Subrule in Part 3, Section V, Rule 1, *Payroll – Remuneration*, (Rule 1) to reference equity-based compensation plans (other than stock options and stock purchase plans); direct that the amount by which an employee's salary is reduced to contribute to an equity-based compensation plan be included as reportable remuneration; and direct that equity-based compensation payments be included as reportable remuneration at the time of vesting, except for payments made due to accelerated cliff vesting triggered by an Initial Public Offering (IPO) of stock, or a change in majority (greater than 50%) ownership such as that which might result from a merger or acquisition.

2. Amend the USRP, Appendix II, *Payroll/Remuneration* Table, to add an entry for reporting payroll for equity-based compensation plans (other than stock options and stock purchase plans); direct that the amount by which an employee's salary is reduced to contribute to an equity-based compensation plan be included as reportable remuneration; and direct that equity-based compensation payments be included as reportable remuneration at the time of vesting, except for payments made due to accelerated cliff vesting triggered by an Initial Public Offering (IPO) of stock, or a change in majority (greater than 50%) ownership such as that which might result from a merger or acquisition.

3. Amend Part 3, Section V, *Payroll – Remuneration*, Rule 1, *Payroll – Remuneration*, Rule 1, Subrule f, *Employer Contributory Payments*, to direct that employer payments in connection with an employee's cashless exercise of stock options are included as reportable remuneration, provide direction regarding when the payout of deferred compensation from an employer's contributions to previously deferred payroll should be included as reportable remuneration and for consistency with other remuneration reporting rules.

4. Amend Part 3, Section V, *Payroll – Remuneration*, Rule 1, Subrule g, *Salary Reduction and Cafeteria Benefit Plans*, to include stock options, Qualified or Non-Qualified Employee Stock Purchase Plans (ESPP) and equity-based compensation plans, and clarify that an employee's elected deferrals or

payroll-based contributions to employee-elected deferral plans are included as remuneration when earned.

5. Establish a new Subrule in Part 3, Section V, Rule 1, *Payroll – Remuneration*, to direct that the amount by which an employee's salary is reduced to contribute to the purchase of stock options or Qualified or Non-Qualified Employee Stock Purchase Plans (ESPP) be included as reportable remuneration when earned, employer contributions or stock discount amounts not be included as reportable remuneration, and payments by an employer in connection with an employee's cashless exercise of stock options be included as reportable remuneration.

6. Amend the *Stock Option Plans* entry in Appendix II, *Payroll/Remuneration Table*, to clarify that the amount by which an employee's salary is reduced to contribute to the purchase of stock be included as reportable remuneration, employer contributions or stock discount amounts not be included as reportable remuneration, and payments by an employer in connection with an employee's cashless exercise of stock options be included as reportable remuneration.

7. Amend the *Deferred Compensation – 401K* entry in Appendix II, *Payroll/Remuneration Table*, to provide direction regarding when an employee's contributions or deferrals of compensation to employee-elected deferral plans should be included as reportable remuneration, and when the payout of deferred compensation from an employer's contributions to previously deferred payroll should be included as reportable remuneration.

8. Amend the *Stock Purchase Plans* entry in Appendix II, *Payroll/Remuneration Table*, to clarify that the amount by which an employee's salary is reduced to contribute to the purchase of Qualified or Non-Qualified Employee Stock Purchase Plans (ESPP) be included as reportable remuneration and for consistency with other remuneration reporting rules.

9. Amend the *Profit Sharing* entry in Appendix II, Payroll/Remuneration Table, to clarify that employer contributions to purchase a qualified or non-qualified Employee Stock Purchase Plan (ESPP) not be included as reportable remuneration.

Introduction

Payroll, also referred to as remuneration, has historically been used as a proxy for determining exposure to losses for ratemaking and experience rating purposes. Remuneration is reasonably correlated with losses and can be audited and validated against other documents that are reported to state or federal government agencies. For certain classifications with great variability in remuneration without a corresponding variability in exposure to loss (e.g., classifications pertaining to highly compensated athletes and entertainers), the remuneration for individual employees is limited in the USRP for purposes of premium computation. Remuneration is also limited for executive officers, partners, individual employers and members of limited liability companies for reporting purposes and premium computation.

The advisory pure premium rate for each classification represents the ratio of reported losses relative to reported remuneration, and the expected losses that are compared to actual losses in the experience rating calculation are also based on reportable remuneration. As such, it is imperative for accurate ratemaking and experience rating that reportable remuneration is clearly defined, auditable, resistant to manipulation and reasonably well-correlated to the expected exposure to losses.

This Study examined equity-based compensation plans and determined that the treatment of such compensation can result in great variability in reported remuneration without necessarily a commensurate change in exposure to loss. The USRP currently provides limited information regarding the reporting of equity-based compensation. A goal of this Study was to develop rules that would apply broadly to evolving equity-based compensation plans.

Historical Background

Historically, the basis used to calculate premium for workers' compensation insurance has, with few exceptions, been an employee's remuneration.[3] Rule 1 and Appendix II are a compilation of rules that establish the types of compensation that are included in or excluded from the reportable remuneration for statistical reporting purposes. Rule 1 starts with the following broad definition of Payroll – Remuneration:

> As used in this Plan, payroll and remuneration are synonymous and mean the monetary value at which service is recompensed. Except as provided herein, remuneration includes: gross wages, salaries, commissions, bonuses, vacation, holiday and sick pay, overtime payments, the market value of gifts, and all substitutes for money earned during the policy period by employees and officers of the employer, and any other persons for whom voluntary coverage is provided under the policy.

Rule 1 contains 16 Subrules, a through p, each directing the inclusion, exclusion, computation or limitation of various forms of remuneration for reporting purposes. More than 50 additional directives are provided in Appendix II, and many of the table entries reference specific provisions of Rule 1.

The intent of each directive must be consistent with the concept that remuneration is the monetary value at which an employee's service is recompensed and the objective that remuneration is a reasonable proxy for the insurer's exposure resulting from the work performed by the employee during the policy period.

Equity-based compensation plans are an evolving component of remuneration. Prior to 2007, start-up and technology companies frequently used equity-based compensation plans such as stock options and stock purchase plans to recruit and retain staff. Stock options are awarded as an option for the employee to purchase stock in the company at a specified price at a future date. Stock options have value to the extent the option price is lower than the market price for the stock. Stock options can become worthless if the stock's market price falls below the option price; these are often described as "underwater" stock options. Stock purchase plans, also referred to as Employee Stock Purchase Plans (ESPP), are similar to stock options in that employees are provided the right to purchase company stock. However, with ESPPs, employers may contribute to the stock purchase plan by offering a discounted price to employees that is typically 10-15% below market value. The amount of the discount represents the employer's contribution.

Many employers, including but not limited to employers in technology-related industries, have shifted from stock options and stock purchase plans to other forms of equity-based compensation plans. Around 2007, a version of equity-based compensation called Restricted Stock Units (RSUs) became popular with many technology and start-up employers. RSUs allow employers to plan to issue shares of common stock to an employee at a future date, subject to the employee satisfying vesting requirements. This deferred stock issuance avoids equity dilution until the RSUs vest. Other equity-based compensation plans that are essentially bonuses indexed to the value of company stock or ownership shares that do not transfer actual equity to the recipient also avoid equity dilution. Multiple forms of equity-based compensation remain in use and new forms may emerge.

Analysis

Equity-based compensation plans are increasingly common forms of compensation in certain industries in California and can result in significant fluctuations in an employee's reported remuneration from year-to-year. Equity-based compensation is defined by the Internal Revenue Service (IRS) as any compensation paid that is based on the value of equity which is, generally, the stock of the employer,[4] whether or not stock ownership is actually transferred to the employee. Examples of equity-based compensation include

[3] There are currently four classifications that use a basis of exposure other than remuneration:

Code No.	Standard Classification	Unit of Exposure
8278	Jockeys or Harness Drivers	Per Race
7707	Firefighting Operations, Volunteers	Per Capita, Per Year
7722	Police, etc., Volunteers	Per Capita, Per Year
8631	Racing Stables	Per Occupied Stall, Per Day

[4] See https://www.irs.gov/businesses/corporations/equity-stock-based-compensation-audit-techniques-guide.

but are not limited to Stock Options, Stock Purchase Plans, Stock Transfers, Stock Warrants, Restricted Stock, Restricted Stock Units, Phantom Stock Plans and Stock Appreciation Rights.[5]

Because new forms of equity-based compensation plans are expected to continue to emerge, proposed changes to Rule 1 and Appendix II should not be limited to specific equity-based compensation plans, as such provisions could become quickly outdated. Instead, this Study identifies characteristics of equity-based compensation plans that should be included or excluded as remuneration for reporting purposes. Proposed changes to Rule 1 and Appendix II have been developed based on these identified characteristics so that they can be uniformly applied to any equity-based compensation plan.

Characteristics of Various Types of Equity-Based Compensation

Many equity-based compensation plans are structured with a multi-year vesting plan and distribution schedule; this acts as a form of retention bonus to encourage an employee to stay with an employer in order to receive the future scheduled payment when a vesting date or performance goal is reached. Although the final value of the scheduled payment is not known at the time it is awarded, the annual scheduled vesting amounts can form a significant portion of an employee's yearly compensation. In some industries, employees may agree to accept a reduced salary in exchange for participation in equity-based compensation plans. A currently popular form of equity-based compensation plan is an RSU. Staff reviewed audited payroll and RSU amounts for 17 large technology employers, and RSUs ranged from 5% to 53% of each employer's reported California remuneration for the year. Equity-based payments made according to a regular vesting schedule are an integral and recurring part of annual compensation for many employers and are, therefore, a reasonable proxy for workers' compensation exposure and should be included as reportable remuneration.

In addition to scheduled vesting, some equity-based compensation plan agreements include provisions for immediate or "cliff" vesting upon the occurrence of a specific event, at which time employees earn the right to receive the full value of their equity-based compensation plan. For example, cliff vesting can occur when an employee reaches a milestone anniversary or achieves a performance goal. These cliff vesting payments are a form of bonus that is calculated based on equity valuation and therefore, like other bonuses, should be included as reported remuneration.

Some cliff vesting can result in extraordinarily large payroll increases due to a single payout of equity-based compensation. Such large payouts are usually due to accelerated cliff vesting triggered by a change in majority ownership such as that which might result from a merger[6] or acquisition[7], or when a company makes an Initial Public Offering (IPO) of stock. When a company undergoes an IPO, it is common to accelerate the cliff vesting of outstanding restricted stock units (RSUs). If the IPO results in the stock price rapidly increasing, the RSU values can increase greatly with no corresponding increase in workers' compensation loss exposure. When a company undergoes a change in majority ownership, including but not limited to a merger or acquisition, it is common for the acquiring company to accelerate the cliff vesting of outstanding equity compensation obligations that had been issued by the acquired company. The significant increase in remuneration caused by these typically non-recurring events is not a regular or recurring portion of an employee's overall compensation. For this reason, the payments made to employees as a result of accelerated cliff vesting triggered by these ownership changes or IPOs is not a strong proxy for the insurer's exposure in the year they are paid. Accordingly, these payments should not be included as reportable remuneration.

When evaluating the various forms of equity-based compensation, the multi-jurisdictional working group considered whether certain types should be excluded from reported remuneration in light of the objective that any exclusion allowance should be resistant to manipulation. There was consensus, however, that the extraordinarily large amounts that may potentially be paid at accelerated cliff vesting triggered by changes in majority (greater than 50%) ownership could be excluded from reported remuneration

[5] See Appendix I for descriptions of common types of equity-based compensation plans.

[6] A merger is a deal to unite two existing companies into one new company. After the merger, the acquired company ceases to exist and becomes part of the acquiring company, or the merged companies become a new company.

[7] An acquisition occurs when the purchasing company obtains more than 50% ownership in a target company.

provided the qualifying ownership change is significant, and not a minor ownership change that could be orchestrated to reduce remuneration. In order to have an objective and uniform standard for determining what constitutes a significant change in ownership for this purpose, the WCIRB proposes defining a change in majority ownership as a change in ownership where the owner(s) prior to the change own less than a one-half interest after the change.

The WCIRB also considered the need to adjust advisory pure premium rates resulting from the exclusion of accelerated cliff vesting payments triggered by a majority change in ownership or an IPO. Cliff vesting triggered by an IPO or majority change in ownership occur infrequently within a company and are unpredictable. These characteristics make locating and isolating the payments to employees difficult. Additionally, it is unclear to what extent these payments have been included or excluded from reported remuneration by insurers. For these reasons, the WCIRB does not recommend any pure premium rate adjustments at this time to reflect the exclusion of accelerated cliff vesting payments triggered by an IPO or majority change in ownership.

<u>Current USRP Provisions</u>

Rule 1, Subrule f, *Employer Contributory Payments*, addresses employer contributions to specific forms of equity-based compensation plans, including stock purchase plans and the exercise of stock options:

> f. Employer Contributory Payments
>
> Contributory payments made by the employer in connection with group insurance, stock purchase plans or qualified retirement plans, the exercise of stock options and deferred compensation plans are not to be included in the payroll.
>
> Payments by an employer of amounts otherwise required by law to be paid by employees to statutory insurance or pension plans, such as the Federal Social Security Act, are to be included in the payroll.

In addition, equity-based compensation payments based on the valuation of stock or ownership shares, while not specifically addressed in the USRP, have been considered a form of bonus. Since Rule 1 specifically includes bonuses as reportable remuneration, equity-based compensation payments based on the valuation of stock are currently intended to be included as remuneration at the fair market value at the time of vesting or payment.

<u>Evaluation</u>

Appendix II references three types of equity-based compensation, Profit Sharing, Stock Option Plans and Stock Purchase Plans, and identifies whether each should be included or excluded from remuneration.[8] The reference to Stock Purchase Plans does not use the current terminology, which is Qualified or Non-Qualified ESPP. With regard to Stock Option Plans, Appendix II directs that when the option is exercised and the employee purchases stock at a price that is lower than the market value, the difference between the market value and the lower option price is not included as payroll. These amounts are generally not recorded as payroll by the employer and auditing these amounts is impractical. However, in some cases, an employee may receive stock or money from the employer due to a cashless exercise of a stock option. In these cases, the employee does not pay to acquire stock, but instead receives an adjusted settlement from the employer net of the option price that the employee otherwise would have paid. These amounts are considered taxable income, are recorded by the employer as payroll,[9] and should be included as reported payroll for workers' compensation purposes.

Equity-based compensation plans can include contributions made by employees and employers. Appendix II directs that the amount by which an employee's salary is reduced to fund a deferred compensation

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[8] See Appendix II of this Study for the current provisions in Appendix II of the USRP that address equity-based compensation.

[9] Cashless exercise of stock options can also be achieved by borrowing funds from a broker, purchasing stock through the broker at the option price, and selling stock to immediately repay the loan. These transactions are not recorded by the employer as payroll and auditing these amounts is impractical, so such transactions should not be included as reported payroll for workers' compensation purposes.

plan[10] is included as reported payroll. In addition, entries in Appendix II direct that employee payroll-based contributions to Pension/Retirement Plans and Stock Purchase Plans are included as reported payroll. Employee payroll-based contributions to any other form of equity-based compensation plan are similar to contributions made to pension, deferred compensation or stock purchase plans. Accordingly, employee payroll-based contributions to equity-based compensation plans should also be included as reportable remuneration at the time they are earned and contributed.

Entries in Appendix II direct that employer contributory payments for qualified Pension/Retirement Plans and Stock Purchase Plans are not to be included as reported payroll. With stock purchase plans, employers may contribute to equity-based compensation plans by offering a discounted purchase price to employees that is typically 10-15% below market value. The amount of the discount, representing the employer's contribution, is currently excluded from reported remuneration. For other equity-based compensation plans, the entire value of the equity-based compensation plan may be provided by the employer, equating to a bonus that is therefore included as remuneration.

Although the USRP discusses how to report remuneration for employee and employer contributions to deferred compensation plans, it does not address how to report remuneration when deferred compensation is paid. Under the current rules, when an employee elects to defer receiving a portion of his or her compensation until a later date, such compensation is included as remuneration when earned, and when an employer makes contributions to a deferred compensation plan, such contributions are not included as remuneration. Payout of deferred compensation to current employees from an employer's contributions to previously deferred payroll should be included as reportable remuneration when paid as it is considered additional income. However, any deferred amounts paid to retired or terminated employees who are not employed during the current policy period should not be included as reportable remuneration, provided the employer maintains records that segregate such payments. Since the employee is no longer employed, such amounts are likely not a reasonable proxy for workers' compensation exposure, and it could be difficult to determine the correct classification under which such amounts should be reported.

Findings

Based on its review of the characteristics of equity-based compensation plans, WCIRB staff determined:

1. The USRP currently provides limited information regarding the reporting of equity-based compensation. Clear and uniform rules regarding the reporting of equity-based compensation based on a consensus view developed by the multi-jurisdictional working group can provide clarity to all stakeholders and promote consistent reporting practices nationwide.

2. Equity-based compensation that is paid on a scheduled or annual basis, or based on the achievement of performance goals or milestone anniversaries, can represent a recurring portion of an employee's overall compensation and is therefore a reasonable proxy for workers' compensation exposure and should be included as reportable remuneration.

3. Payment of equity-based compensation due to accelerated cliff vesting triggered by an Initial Public Offering (IPO) of stock, or a change in majority ownership, is caused by typically non-recurring infrequent events that can produce very large increases in payroll that can result in volatility in reported payrolls from year to year without similar shifts in underlying loss exposure. These amounts are not a regular or recurring portion of an employee's overall compensation and are therefore not a reasonable proxy for workers' compensation exposure during an individual policy period and should not be included as reportable remuneration.

4. Employee payroll-based contributions to fund equity-based compensation plans are similar to employee payroll-based contributions to fund pensions or deferred compensation plans and should be included as reportable remuneration.

[10] See the entry for *Deferred Compensation – 401K* in Appendix II of the USRP.

5. Employer contributions to stock purchase plans and discounts on the purchase of stock are currently excluded from reportable remuneration. The existing rules do not address payments by the employer in connection with an employee's cashless exercise of stock options, which are taxable income and should be included as reportable remuneration. The existing rules could also be clarified to specifically reference employer contributions to Qualified or Non-Qualified Employee Stock Purchase Plans (ESPP).

6. Employee contributions to qualified or non-qualified deferred compensation plans are currently included as reportable remuneration when earned, and employer contributions to such plans are excluded. The existing rules do not address payments of previously deferred compensation. Amounts paid to current employees from an employer's previous contributions to deferred compensation should be included as reportable remuneration when paid. Payout of deferred compensation to retired or terminated employees who are not employed during the current policy period should not be included as reportable remuneration, provided the employer maintains records that segregate such payments.

Recommendations
In view of the above, the WCIRB recommends the following:

1. Establish a new Subrule in Part 3, Section V, Rule 1, *Payroll – Remuneration*, (Rule 1) to reference equity-based compensation plans (other than stock options and stock purchase plans); direct that the amount by which an employee's salary is reduced to contribute to an equity-based compensation plan be included as reportable remuneration; direct that equity-based compensation payments be included as reportable remuneration at the time of vesting, except for payments made due to accelerated cliff vesting events triggered by an Initial Public Offering (IPO) of stock, or a change in majority (greater than 50%) ownership such as that which might result from a merger or acquisition.

2. Amend the USRP, Appendix II, *Payroll/Remuneration* Table, to add an entry for reporting payroll for equity-based compensation plans (other than stock options and stock purchase plans); direct that the amount by which an employee's salary is reduced to contribute to an equity-based compensation plan be included as reportable remuneration; and direct that equity-based compensation payments be included as reportable remuneration at the time of vesting, except for payments made due to accelerated cliff vesting events triggered by an Initial Public Offering (IPO) of stock, or a change in majority (greater than 50%) ownership such as that which might result from a merger or acquisition.

3. Amend Part 3, Section V, *Payroll – Remuneration*, Rule 1, *Payroll – Remuneration*, Rule 1, Subrule f, *Employer Contributory Payments*, to direct that employer payments in connection with an employee's cashless exercise of stock options are included as reportable remuneration, provide direction regarding when the payout of deferred compensation from an employer's contributions to previously deferred payroll should be included as reportable remuneration and for consistency with other remuneration reporting rules.

4. Amend Part 3, Section V, *Payroll – Remuneration*, Rule 1, Subrule g, *Salary Reduction and Cafeteria Benefit Plans*, to include stock options, Qualified or Non-Qualified Employee Stock Purchase Plans (ESPP) and equity-based compensation plans and clarify that an employee's elected deferrals or payroll-based contributions to employee-elected deferral plans are included as remuneration when earned.

5. Establish a new Subrule in Part 3, Section V, Rule 1, *Payroll – Remuneration*, to direct that the amount by which an employee's salary is reduced to contribute to the purchase of stock options or Qualified or Non-Qualified Employee Stock Purchase Plans (ESPP) be included as reportable remuneration when earned, employer contributions or stock discount amounts not be included as reportable remuneration, and payments by an employer in connection with an employee's cashless exercise of stock options be included as reportable remuneration.

6. Amend the *Stock Option Plans* entry in Appendix II, *Payroll/Remuneration Table*, to clarify that the amount by which an employee's salary is reduced to contribute to the purchase of stock be included as reportable remuneration, employer contributions or stock discount amounts not be included as reportable remuneration, and payments by an employer in connection with an employee's cashless exercise of stock options be included as reportable remuneration.

7. Amend the *Deferred Compensation – 401K* entry in Appendix II, *Payroll/Remuneration Table*, to provide direction regarding when an employee's voluntary contributions or deferrals of compensation to employee-elected deferral plans should be included as reportable remuneration, and when the payout of deferred compensation from an employer's contributions to previously deferred payroll should be included as reportable remuneration.

8. Amend the *Stock Purchase Plans* entry in Appendix II, *Payroll/Remuneration Table*, to clarify that the amount by which an employee's salary is reduced to contribute to the purchase of Qualified or Non-Qualified Employee Stock Purchase Plans (ESPP) be included as reportable remuneration and for consistency with other remuneration reporting rules.

9. Amend the *Profit Sharing* entry in Appendix II, *Payroll/Remuneration Table*, to clarify that employer contributions to purchase a qualified or non-qualified Employee Stock Purchase Plan (ESPP) not be included as reportable remuneration.

Appendix I

Types of Equity-Based Compensation

Examples of equity-based compensation include Stock Options, Stock Transfers, Stock Warrants, Restricted Stock, Restricted Stock Units, Phantom Stock Plans, Stock Appreciation Rights, and other awards whose value is based on the value of specified stock.

Stock Options
Contracts between a company and its employees that give employees the right to buy a specific number of the company's shares at a fixed price within a certain period of time. The fixed price is often called the grant or exercise price. Employees who are granted stock options hope to profit by exercising their options to buy shares at the exercise price when the shares are trading at a price that is higher than the exercise price.[11]

Employee Stock Purchase Plan (ESPP)
An employer-sponsored program that allows employees to make planned, periodic purchases of company stock through payroll deductions.[12]

Stock Transfers
The transfer of compensatory stock options using programs instituted by the employer that permit employees the opportunity to transfer any outstanding forms of equity compensation to a financial institution or other person or entity approved by the employer.[13]

Stock Warrants
Similar to stock options, they are certificates that allow the owner to purchase a specified number of shares, at a specified time, for a specified price. Stock options are normally granted to employees and other service providers, whereas warrants are typically granted to non-employees (including outside investors). They are typically options to purchase stock over a long period and are freely transferable instruments.

Restricted Stock
Stock that has been granted to an executive that is nontransferable and subject to forfeiture under certain conditions, such as termination of employment or failure to meet either corporate or personal performance benchmarks. Restricted stock also generally becomes available to the recipient under a graded vesting schedule that lasts for several years.[14]

Restricted Stock Units
Unsecured, unfunded promises to pay cash or stock in the future that are considered nonqualified deferred compensation subject to IRC §§ 3121(v)(2), 451 and 409A. Typically, one Restricted Stock Unit represents one share of actual stock. Restricted Stock Units generally are not taxable at grant if they meet the requirements of, or otherwise are exempt from, IRC §§ 451 and 409A. Generally, a taxable event does not take place until the vesting of the Restricted Stock Unit. In addition, Restricted Stock Units are not considered property for purposes of IRC §83 since no actual property has been transferred, and therefore an IRC §83(b) election cannot be made with respect to the grant of a Restricted Stock Unit.

Restricted Stock Units Settled with Stock

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[11] https://www.sec.gov/fast-answers/answers-empopthtm.html

[12] http://www.morganstanleyfa.com/public/facilityfiles/sb090312151937/dcb41be8-fe11-4aad-8615-e117c01e92f0.pdf

[13] https://www.sec.gov/Archives/edgar/data/1382821/000119312517228856/d325499dex103.htm

[14] http://www.investopedia.com/articles/tax/09/restricted-stock-tax.asp

A Restricted Stock Unit payable in stock is similar to a Restricted Stock Award, except that the employer does not transfer the stock to the employee until the Restricted Stock Unit vests. Restricted Stock Units settled in stock are subject to IRC §§ 451 and 409A (unless they satisfy an exception) but are not subject to IRC §83 at grant. Restricted Stock Units settled in stock are subject to IRC §83 only when the stock is actually transferred to the employee. Typically, the value of the stock transferred is includable in the income of the service provider and a corresponding deduction allowed to the service recipient.

Restricted Stock Units Settled With Cash
A Restricted Stock Unit payable in cash is an arrangement under which the employee has the right to receive the value of the unit on the date the unit vests. Restricted Stock Units payable in cash are never subject to IRC §83 because no property is ever transferred. The amount of cash received upon vesting of the Restricted Stock Unit is includible in income of the service provider and a corresponding deduction is allowed to the service recipient.

Phantom Stock Plans
An arrangement under which deferred amounts are determined by a reference to hypothetical "phantom" shares of the employer's stock without ever issuing the actual shares to the employee. Depending on the terms of the arrangement, the employee may be entitled to receive only the growth in the value of the stock between the time the employer awards the phantom shares and the time the employee cashes out the shares. Alternatively, the employee may be entitled to receive the entire value of the stock as well as any dividends paid from the time the employer grants the phantom shares. The employer does not hold actual shares of stock for the employee, but depending on the terms of the plan, the employee may be paid in actual shares or in cash at the time of the cash-out.

Stock Appreciation Rights (SAR)
An arrangement, during a specified period, wherein the employee has the right to receive the increased value of the employer's stock by cashing out or exercising the SAR. The employee can only benefit from the appreciation in the value of the stock; therefore, a taxable event does not take place until the exercise of a SAR. The amount received upon exercise of the SAR is includible in the employee's income, constitutes wages, and creates a deduction to the employer at that time. Stock appreciation rights are not deferred compensation subject to the special timing rule under IRC §3121(v)(2). See Treas. Reg. §31.3121(v)(2)-1(b)(4)(ii) and Notice 2005-1. However, if the terms of the SAR limit the amount that an employee may receive upon exercise, the IRS has ruled income has been constructively received in the tax year in which the maximum limit has been attained.

Appendix II
Following are the current provisions in Appendix II of the USRP that address equity-based compensation.

Payroll/Remuneration Table

Type of Compensation	Is Payment Included as Payroll?	Exception or Comment
• • •		
Profit Sharing		
Annual distribution	Yes	Similar to a bonus
Employer contribution to a stock purchase plan or fund that is held by the employer until the employee's termination, and distribution is not made through the regular payroll	No	
• • •		
Stock Option Plans	No	Employees may be granted an option to purchase stock in the company at a specified price. Typically when the option is exercised, the employee purchases stock at a price that is lower than the market value. The difference between the market value and the lower option price is not included as payroll.
Stock Purchase Plans		
Employee's contribution	Yes	
Employer's contribution	No	
• • •		

Recommendation
Amend Part 3, *Standard Classification System*, Section V, *Payroll – Remuneration*, Rule 1, *Payroll – Remuneration*, Subrule f, *Employer Contributory Payments,* to direct that employer payments in connection with an employee's cashless exercise of stock options are included as reportable remuneration, provide direction regarding when the payout of deferred compensation from an employer's contributions to previously deferred payroll should be included as reportable remuneration and for consistency with other remuneration reporting rules.

PROPOSED

Section V – Payroll – Remuneration

1. Payroll – Remuneration[1]

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f. Employer Contributory Payments

Contributory payments made by the employer in connection with group insurance, Qualified or Non-Qualified Employee ~~s~~Stock ~~p~~Purchase ~~p~~Plans (ESPP), ~~or~~ qualified retirement plans, the exercise of stock options other than the cashless exercise of stock options, and deferred compensation plans ~~are~~shall not ~~to~~ be included ~~in the payroll~~as remuneration.

Payout of deferred compensation to current employees from an employer's contributions to previously deferred payroll shall be included as remuneration. Payout of deferred compensation to retired or terminated employees who are not employed during the current policy period shall not be included as remuneration provided the employer maintains records that segregate such payments.

Payments by an employer in connection with an employee's cashless exercise of stock options shall be included as remuneration.

Payments by an employer of amounts otherwise required by law to be paid by employees to statutory insurance or pension plans, such as the Federal Social Security Act, ~~are to~~shall be included ~~in the payroll~~as remuneration.

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Recommendation
Amend Part 3, Section V, Rule 1, Subrule g, *Salary Reduction and Cafeteria Benefit Plans,* to include stock options, Qualified or Non-Qualified Employee Stock Purchase Plans (ESPP) and equity-based compensation plans and clarify that an employee's elected deferrals or payroll-based contributions to employee-elected deferral plans are included as remuneration when earned, and to provide direction regarding when the payout of deferred compensation from an employer's contributions to previously deferred payroll should be included as reportable remuneration.

PROPOSED

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g. Salary Reduction and Cafeteria Benefit Plans

The amount by which an employee's salary is reduced to fund a pension, ~~or~~ deferred compensation plan, equity-based compensation plan, Qualified or Non-Qualified Employee Stock Purchase Plan (ESPP), stock options or other employee-elected deferral plan shall be included as remuneration when earned even though such plan is a portion of a cafeteria plan. The amount by which an employee's salary is reduced to fund the welfare or fringe benefit portion of a cafeteria plan qualified under Section 125 of the Internal Revenue Code shall not be included as remuneration provided the employer's books and records are maintained to show separately such amounts by employee and in summary by type of operation performed.

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Recommendation
Establish Part 3, Section V, Rule 1, Subrule q, *Stock Options and Stock Purchase Plans,* to provide direction regarding the inclusion of stock options and Qualified or Non-Qualified Employee Stock Purchase Plans (ESPP) as reportable remuneration.

PROPOSED

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q. Stock Options and Stock Purchase Plans

The amount by which an employee's salary is reduced to contribute to the purchase of stock options or Qualified or Non-Qualified Employee Stock Purchase Plans (ESPP) shall be included as remuneration when earned. The difference between the market price of stock and any discounted price paid by the employee to purchase the stock shall not be included as remuneration. Contributory payments made by the employer in connection with the exercise of stock options or Qualified or Non-Qualified Employee Stock Purchase Plans (ESPP), other than the cashless exercise of stock options, shall not be included as remuneration (see Subrule f, *Employer Contributory Payments*).

Payments by an employer in connection with an employee's cashless exercise of stock options shall be included as remuneration.

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Recommendation
Establish Part 3, Section V, Rule 1, Subrule r, *Equity-Based Compensation Plans (Other Than Stock Options and Stock Purchase Plans),* to provide direction regarding the inclusion of equity-based compensation (other than stock options and stock purchase plans) as reportable remuneration.

PROPOSED

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r. Equity-Based Compensation Plans (Other Than Stock Options and Stock Purchase Plans)

The value of equity-based compensation plans (other than Stock Options and Stock Purchase Plans), including but not limited to Stock Transfers, Stock Warrants, Restricted Stock, Restricted Stock Units, Phantom Stock Plans and Stock Appreciation Rights, shall be included as remuneration at the time of vesting when vesting is on a scheduled or annual basis, such as graded vesting or scheduled cliff vesting, or when the vesting is based on the achievement of performance goals or milestone anniversaries. The amount by which an employee's salary is reduced to contribute to an equity-based compensation plan shall be included as remuneration. The market value of equity-based compensation plans shall not be included as remuneration when accelerated cliff vesting is triggered by (1) an Initial Public Offering (IPO) of stock, or (2) a change in majority ownership where the owner(s) prior to the change own less than a one-half interest after the change.

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Recommendation
Amend the *Deferred Compensation – 401K* entry in Appendix II, *Payroll/Remuneration Table,* to provide direction regarding when an employee's voluntary contributions or deferrals of compensation to employee-elected deferral plans should be included as reportable remuneration, and when the payout of deferred compensation from an employer's contributions to previously deferred payroll should be included as reportable remuneration.

PROPOSED

Type of Compensation	Is Payment Included as Payroll?	Exception or Comment
• • •		
Deferred Compensation~~–~~ ~~401K~~		See USRP, Part 3, Section V, Rule 1f and 1g
Employee's contribution – qualified or non-qualified plan – including "Cafeteria" and 401K plans or other employee-elected deferral plans	Yes	Employee's voluntary contributions or deferrals made through regular payroll deductions are included even when the contribution is part of a "Cafeteria" plan qualified under Section 125 of the Internal Revenue Code

Employer's contribution – qualified or non-qualified supplemental plan – including "Cafeteria" and 401K plans or other employee-elected deferral plans	No	Exclude ~~if~~ contributions to ~~a~~ "qualified" and "non-qualified" plans
Payout to current employees	Yes	Payout of deferred compensation to current employees from employer's contributions to previously deferred payroll is considered additional income.
Payout to retired/terminated employees	No	Exclude amounts paid to retired/terminated employees who are not employed during the current policy period, provided the employer maintains records that segregate such payments. NOTE: Include payments to employees employed for any portion of the current policy period.

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Recommendation
Amend Appendix II, *Payroll/Remuneration Table,* to add an entry for reporting payroll for Equity-Based Compensation Plans (Other Than Stock Options and Stock Purchase Plans).

PROPOSED

Type of Compensation	Is Payment Included as Payroll?	Exception or Comment
• • •		
Equity-Based Compensation Plans (Other Than Stock Options and Stock Purchase Plans)		See USRP, Part 3, Section V, Rule 1r
Employee Contribution	Yes	Include the amount by which an employee's salary is reduced to contribute to an equity-based compensation plan
Payment at time of vesting (graded vesting or scheduled cliff vesting)	Yes	Include amounts paid on a graded vesting schedule or a scheduled cliff vesting date

Type of Compensation	Is Payment Included as Payroll?	Exception or Comment
Payment at time of an accelerated cliff vesting event that is triggered by (1) an Initial Public Offering (IPO) of stock, or (2) a change in majority ownership where the owner(s) prior to the change own less than a one-half interest after the change	No	Cliff vesting may be accelerated based on changes in company ownership. Exclude amounts paid at time of accelerated cliff vesting due to (1) an IPO, or (2) a change in majority ownership where the owner(s) prior to the change own less than a one-half interest after the change. A change in majority ownership could include a merger or acquisition if the owner(s) prior to the change own less than a one-half interest after the change
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Recommendation

Amend the *Profit Sharing* entry in Appendix II, *Payroll/Remuneration Table,* to update the terminology to refer to a "stock purchase plan" as a "Qualified or Non-Qualified Employee Stock Purchase Plan (ESPP)."

PROPOSED

Type of Compensation	Is Payment Included as Payroll?	Exception or Comment
• • •		
Profit Sharing		
Annual distribution	Yes	Similar to a bonus
Employer contribution to a Qualified or Non-Qualified Employee ~~s~~Stock ~~p~~Purchase ~~p~~Plan (ESPP) or fund that is held by the employer until the employee's termination and distribution is not made through the regular payroll	No	
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Recommendation
Amend the *Stock Option Plans* entry in Appendix II, *Payroll/Remuneration Table,* to include the rules for reporting payroll for Stock Options.

PROPOSED

Type of Compensation	Is Payment Included as Payroll?	Exception or Comment
• • •		
Stock Option ~~Plans~~		See USRP, Part 3, Section V, Rule 1q
Employee's Contribution	Yes	Include the amount by which an employee's salary is reduced to contribute to the purchase of stock
Employer's Contribution (other than the cashless exercise of stock options)	No	See USRP, Part 3, Section V, Rule 1f
Employer's Contribution for cashless exercise of stock options	Yes	Taxable amounts paid by the employer when an employee completes a cashless exercise of stock options are included as payroll.
Difference between the stock's market price and the exercise price	No	~~Employees may be granted an option to purchase stock in the company at a specified price.~~ Typically when the option is exercised, the employee purchases stock at a price that is lower than the market value. The difference between the market value and the lower option price is not included as payroll.
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Recommendation
Amend the *Stock Purchase Plans* entry in Appendix II, *Payroll/Remuneration Table,* to clarify that employee payroll-based contributions be included as reportable remuneration and for consistency with other remuneration reporting rules.

PROPOSED

Type of Compensation	Is Payment Included as Payroll?	Exception or Comment
• • •		
Employee Stock Purchase Plans (ESPP) – Qualified or Non-Qualified		See USRP, Part 3, Section V, Rule 1q
Employee's contribution	Yes	Include the amount by which an employee's salary is reduced to contribute to the purchase of stock purchase plans
Employer's contribution	No	
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