Net Settlement of Shares for Tax Withholding Purposes

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When certain types of equity awards vest, employers must withhold applicable payroll and income taxes on behalf of the employee. One common way to handle this tax obligation is through a “Net Settlement,” which allows the employer to withhold a portion of the shares otherwise deliverable to the employee to satisfy applicable tax withholding obligations.

Generally, when certain equity awards vest, the fair market value of the vested shares (less any amount previously paid by the employee for the shares) is included in the employee’s ordinary income for the applicable taxable year. To effect a Net Settlement, the employer calculates the total taxes owed on that amount, withholds enough shares to cover those taxes, and delivers the remaining shares to the employee. The employer then sends the cash equivalent of the withheld shares to the IRS and any applicable state or local tax authorities.

Prior to considering a Net Settlement, employers should consider:

- **Cash Flow:** The company needs enough cash on hand to pay the tax authorities directly.
- **Section 16 Officers:** For a Section 16 officer, a Net Settlement must be structured to qualify as an exempt transaction under SEC Rule 16b-3 so it does not create short-swing profit liability, which generally requires advance approval by the board of directors or a compensation committee. Many companies either hardwire an automatic Net Settlement into the award agreements or limit the timing of Net Settlements to open trading windows or pre-approved Rule 10b5-1 plans to help avoid insider trading concerns.
- **Plan Documents:** The company’s equity plan must authorize Net Settlements, typically with the approval of the plan administrator, and the underlying award agreement should also provide for Net Settlement as a way to satisfy the employee’s tax obligation.

It is important to note that the foregoing applies to equity awards that are not subject to a valid election under Section 83(b) of the Internal Revenue Code. Where such an election has been timely filed, the taxable event is accelerated to the date of grant rather than the date of vesting and Net Settlement would not be available since the shares have not yet vested.

Although a Net Settlement is a common mechanism that employers use for satisfying employee tax withholding obligations for equity awards, employers should be aware of the considerations summarized above when implementing such a practice.