

THE POWER OF BEING UNDERSTOOD
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Equity and Deferred Compensation

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Incentive Stock Options (ISOs)

What is an ISO?

- A right granted by a company to an employee to purchase shares of the company's stock in the future at a predetermined purchase price and on favorable terms for income tax purposes. The option typically vests over a period of time.
- May be granted:
 - Only to employees;
 - For a term not exceeding 10 years; and
 - With an exercise price not less than 100% of the stock's fair market value at grant.

Incentive Stock Options (ISOs)

Special rules apply to employees owning more than 10% of all company stock:

- The ISO's exercise price must be at least 110% of stock's FMV at grant; and
- The ISO's term may not exceed five years.

Exercise provisions are:

- No more than \$100,000 worth of stock (valued at time of grant) may vest in any calendar year;
- An employee who disposes of stock earlier than one year after exercise and two years after grant of the ISO loses the favorable ISO treatment; and
- An option must be exercised while the option holder is an employee or within three months following termination (one year if termination if due to disability or death).

ISOs – Favorable Tax Treatment

- If an employee exercises an option under a qualified ISO plan and complies with the holding periods before selling the stock, no income is realized at the time the option is exercised and the income realized by the employee at the time of sale is generally not subject to federal income tax withholding or social security, Medicare, and FUTA taxes.
- If an employee buys stock under an ISO plan and sells it before the holding period ends, the ordinary income that is realized is not subject to federal income tax withholding or social security, Medicare, and FUTA taxes, although the income must be reported on the employee's Form W-2 in Box 1 (and possibly Boxes 16 and 18).

ISO - Reporting Requirements Federal Income Tax

Federal income tax (“FIT”):

- **Qualifying Disposition** - An employee does not recognize any taxable income at the time the ISO is granted or at the time it is exercised. When stock from an ISO is sold, the total increase in value is taxed as a capital gain. The excess value of the ISO at the time the stock option is exercised over the stock option exercise price may give rise to an alternative minimum tax liability to the employee.
- **Disqualifying Disposition** - A disqualifying disposition occurs when an employee sells stock acquired through an ISO prior to the expiration of the one-year (exercise) / two-year (grant) holding period requirement described previously. In this case, at the time of sale, a portion of any increase in the value of the stock is taxed as ordinary income. That portion is equal to the excess of the value of the stock when the ISO was exercised over the stock option exercise price (e.g., the price of the stock at the time the option was granted) or, if less, the entire increase.
- **Option Exercised After Employment Terminates.** An employee who exercises an ISO more than three months after termination of employment (except in the case of death or disability) is treated at the time of exercise as nonqualified stock options (NQSOs).

ISO - Reporting Requirements

Federal income tax withholding (“FITW”):

- **Qualifying Disposition** – No FITW is required at any time.
- **Disqualifying Disposition** – The amount treated as ordinary income by an employee is not treated as wages for FITW. *IRS Notice 87-49; Rev. Rul. 71-52, 1971-1 CB 278.*
- **Option Exercised After Employment Terminates** – Treated as NQSOs.

Social security, Medicare, and FUTA treatment:

- **Qualifying Disposition** – Any gain recognized by an employee through an ISO is not considered wages for FICA or FUTA purposes.
- **Disqualifying Disposition** – The amount treated as ordinary income by an employee is not treated as wages for FICA or FUTA purposes.
- **Option Exercised After Employment Terminates** – Treated as NQSOs.

ISO – Information Returns

Qualifying Disposition – No Form W-2 reporting is necessary. By January 31 of the year following the year an ISO is exercised, an employer must supply the employee with a statement (IRS Form 3921) containing information as to:

- The employer
- The person to whom the ISO shares are transferred
- The date the option was granted
- The date the shares were transferred to the employee
- The value of the shares on the date of transfer
- The number of shares transferred
- The total cost of the shares

Disqualifying Disposition – If the individual is an employee in the year of disposition, the amount treated as ordinary income should be reported on a Form W-2. If the individual is no longer an employee at any time in the year of disposition, it is the IRS' position that the amount be reported on the Form W-2.

Option Exercised After The Employee Terminates – Treated as NQSOs.

Nonqualified Stock Options (“NQSOs”)

- An NQSO is an offer by an employer to sell its stock to an employee for a specified price at any time during a specific period.
- An NQSO does not provide any favorable tax treatment, and, as a result, is not subject to any qualification requirements.
- When the option is exercised, the employee receives income equal to the excess of the value of the stock when the option is exercised over the price paid by the employee. This income is subject to federal income tax withholding and social security, Medicare, and FUTA taxes.
- When the stock is sold, any increase in the stock’s value over the value when the option was exercised is taxed as capital gains.

Nonqualified Stock Options

- **Federal Income Tax** - An employee does not recognize any taxable income when the stock option is granted. When the stock option is exercised, the excess of the value of the stock at that time over the exercise price specified in the NQSO is treated as ordinary income to the employee. Any increase in the value of the stock after the date of exercise is taxed as a capital gain when the stock is ultimately sold.
- **Federal Income Tax Withholding** - When an NQSO is exercised, the excess of the value of the stock over the exercise price specified in the NQSO is treated as wages for withholding purposes.
- **State Income Tax Withholding** - Most states treat the spread income (the excess of the fair market value of the stock over the exercise price) as wages for state income withholding purposes.

Nonqualified Stock Options

- The income realized is a supplemental wage payment. Withholding may be accomplished with respect to other cash compensation being paid to the employee or by holding back a number of shares equal in value to the amount required to be withheld or by accepting a cash payment from the employee.
- **FICA and FUTA treatment** - The amount treated as wages for federal income tax withholding purposes is also treated as FICA and FUTA wages.
- **Information Returns** - The amount treated as wages for employment tax purposes should be reported on the Form W-2 in Boxes 1, 3, 5, and 12 denoted by Code V. Code V is used for income from the exercise of nonstatutory stock options. Enter the spread (i.e., the fair market value minus the exercise price) from your employees' (or former employees') exercise of nonstatutory stock options. Boxes 16 and 18 may also be applicable.

Polling Question 1

Can income realized from the disposition of an ISO ever be subject to social security, Medicare, or FUTA taxes?

- A. True
- B. False

Restricted Stock Awards (RSAs)

- Under RSA plans, an employer awards shares of stock to employees outright.
- Unlike stock options, employees do not contribute to the cost of the stock.
- Typically, the employee only is able to retain the stock if certain conditions are met (e.g., the employee does not terminate employment for a prescribed number of years or certain company financial targets are achieved). This contingent vesting gives rise to the term "restricted" in connection with such an award.
- Contingent vesting is not required, and an employer may award stock to employees that are fully vested.
- There are no qualification requirements under the IRC that affect the design of these plans.

RSA Taxation & Reporting

- **FIT** - An employee is taxed on the value of the shares when they become vested. Alternatively, the employee may elect to be taxed on the value of the stock as soon as it is awarded. This is known as an IRC § 83(b) election. Amounts recognized as income by the employee are taxed at ordinary rates, not at capital gains tax rate. If the shares are forfeited, the employee will not recognize any income, unless the employee previously made an IRC § 83(b) election. In this case, the employee is not entitled to a deduction despite the loss of the stock.
- **FITW** - Restricted stock is treated as wages for FITW purposes at the time it is subject to federal income tax. The amount of wages is the fair market value of the shares at the time the stock is awarded (IRC § 83(b) election) or when the stock is vested - whichever the employee chooses. This is a supplemental wage payment. Withholding may be accomplished with respect to other cash compensation being paid to the employee, by holding back a number of shares equal in value to the amount required to be withheld or by accepting a cash payment from the employee.
- **FICA & FUTA** - Restricted stock is treated as wages for FICA and FUTA purposes at the time that it is subject to FITW. The amount of wages is the fair market value of the stock at the time it is awarded or vested, whichever the employee chooses.
- **Information Returns** - The amount of taxable income generated by a grant of restricted stock is reported on Form W-2 in Boxes 1, 3, and 5. Boxes 16 and 18 may be applicable as well. There is no special Box 12 coding.

IRC § 83(b) Election

- Election is a written statement should contain the following:
 - Name, address, and taxpayer ID of the employee
 - Description of property to which the election relates
 - Date(s) property is transferred and taxable year for which election is made
 - Nature of restrictions to which the property is subject
 - FMV of property at the time transferred
 - Amount paid (if any) for the restricted property
 - Statement that copies have been furnished to other people (e.g., employer)
- Must be filed with IRS Service Center (where return is filed) no later than 30 days after the date the shares were transferred to the employee
- Copies of the election should be provided to
 - IRS with applicable individual income tax return
 - Employer

Restricted Stock Units (“RSUs”)

- The grant of a restricted stock unit (“RSU”) is a promise to pay property in the future, rather than a transfer of property.
- If property is transferred to an employee in connection with the performance of services, the employee is taxed on the fair market value of the property (less any amount paid), at the time the property is either transferable or no longer subject to a substantial risk of forfeiture (i.e., when it is “substantially vested”).
- “Property” for this purpose includes real and personal property other than either money or an unfunded and unsecured promise to pay money or property in the future.
- Because the grant of the RSUs is a promise to pay property (stock) in the future, rather than a transfer of property, the RSUs are treated as deferred compensation, rather than the transfer of property in connection with the performance of services under IRC § 83.

Restricted Stock Units

- Under the doctrine of constructive receipt, the mere right to receive money or property does not constitute the receipt of such money or property unless it is set apart or made available so that the recipient could claim it at any time without limitation or restriction.
- Income, although not actually reduced to a taxpayer's possession, is constructively received if it is credited to his account, set apart for him, or otherwise made available so that he may draw upon it at any time, or if he could have drawn upon it if notice of intent to withdraw had been given.
- However, income is not constructively received if the taxpayer's control of its receipt is subject to substantial limitations or restrictions.

RSUs – Inclusion in Income

- Deferred compensation amounts are not includible in income by the employee until the money or property is paid or made available to the recipient. Vesting by itself does not result in the receipt of income with respect to deferred compensation. When the RSUs are converted to shares of stock and actual shares are paid or made available to the employee, the value of the shares at such time will be includible as compensation income by the employee.
- Payments from a nonqualified deferred compensation plan are wages subject to the general income tax withholding requirements of IRC § 3402 in the year actually or constructively received. The employer must deduct and withhold income tax on the value of the shares at the time the shares are paid or made available to the employee. The value of the shares should be reported to employees on Form W-2 in Boxes 1, 3, and 5. Boxes 16 and 18 may also apply. There is no Box 12 reporting requirement.
- In addition, deferred compensation amounts are subject to employment tax (FICA) as of the later of when the related services are performed by the employee or when the compensation is vested (not subject to a “substantial risk of forfeiture”).

Polling Question 2

When can an employee make an IRC § 83 election for RSUs?

- A. At grant
- B. At vesting
- C. At exercise
- D. Never

Nonqualified Deferred Compensation

- Monies otherwise payable to executives (e.g., salary, bonus) are withheld by the company until payment upon retirement or another specified future date. Voluntary employee deferrals may be augmented by an additional company contributions or matches. Employee deferrals, company contributions, and any subsequent earnings are taxable for income tax to executives when distributed in the future, allowing for the pre-tax buildup of employee accounts.
- There is a very clear difference in the timing of income recognitions on nonqualified deferred compensation benefits for federal income tax withholding purposes and for FICA tax purposes. Amounts deferred under an unfunded nonqualified deferred compensation agreement are includible in the recipient's gross income for income tax purposes when paid or made available under the general timing rule of IRC § 1.451-1(a) and Rev. Rul. 60-31, 1960-1 C.B. 174. The plan is not in any way secured or funded (meaning assets irrevocably set aside solely for this purpose) beyond the employer's promise to pay and therefore, the employee will not have income based merely on the employer's promise. The income results from actual or constructive receipt of the payments.

NQDC – FITW

Federal Income Tax Withholding

- The rules that govern NQDC plans for federal income tax withholding are set forth in Treas. Regulation § 1.451-2, the constructive receipt doctrine. Under the constructive receipt doctrine, payments to employees generally are taxable when they are set aside for, and are accessible by the employee, without significant restrictions. Income has not been constructively received; however, if it is subject to substantial limitations or restrictions.
- According to the constructive receipt doctrine, if the payments are not available to the employee immediately, then such payments have not been constructively received. Since payments are not taxable as income until constructively received, the contributions and interest component of a NQDC plan are not subject to federal income tax withholding until the distribution date.

NQDC – FICA & FUTA Taxation

FICA and FUTA Taxation Methods

- For FICA purposes, the tests that govern taxability are different than those that govern federal income tax. The FICA timing rules look to forfeitability of the benefit. IRC § 3121(v)(2) sets forth the general FICA taxation methods for NQDC plans.
- Treas. Regulation § 31.3121(v)(2)-1 specifically governs the taxability for FICA purposes of deferred amounts under NQDC plans. For FICA purposes, the contributions become taxable on the later of:
 - Date services are performed; or
 - When there is no substantial risk of forfeiture of the employees' interest in the funds.
- Under the nonduplication rule, NQDC is subject to FICA and FUTA taxes only once

Stock Appreciation Rights (SARs)

- Right granted an employee to receive, either in cash or employer stock, the appreciation in the value of a share of employer stock over a certain period of time
- Employee is not required to buy the stock
- SARs are taxable for FITW, FICA, and FUTA on the date of exercise of the SAR since it will not otherwise be constructively received until that date due to the potential for future appreciation.

Polling Question 3

Can NQDC be subject to FITA, FICA, and FUTA all at the same time?

- A. True
- B. False



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