Equity (Stock) - Based Compensation Audit Technique Guide

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The taxpayer names and addresses shown in this publication are hypothetical.

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I. Overview

A. What is Equity-Based Compensation

The term "equity-based compensation" includes any compensation paid to an employee, director, or independent contractor that is based on the value of specified stock (generally, the stock of the employer, which may be a corporation or a partnership). Examples of equity-based compensation include Stock Transfers, Stock Options, 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.

B. Where to Find Information on Equity-Based Compensation

(1) During the initial examination process, a review of relevant filings with the Securities and Exchange Commission (SEC) and the taxpayer's internal documents is a good place to start. The review of these documents may assist in identifying individuals who may have received equity-based compensation.

(2) Pertinent documents for compensation purposes filed with the SEC include Form 10-K (Annual Report), DEF 14A (Definitive Proxy Statement), and Form 4 (Statement of Changes in Beneficial Ownership). The individuals identified in the SEC reports are considered executives and directors under Security Exchange Act section 16(b). Once the section 16(b) executives and directors with equity-based compensation arrangements have been identified, confirmation should be made on whether all compensation related to various compensation plans have been reported to the recipient (on the individual's Form W-2 or Form 1099-MISC) and that the appropriate employment taxes have been withheld and paid. If the compensation awarded to the section 16(b) executives has not been properly recognized, the audit scope may need to be expanded to other executives, directors, and employees accordingly. The assistance of an Employment Tax Specialist and a review of the Compensation & Benefits (CAB) Practice Network website should be considered.

(3) SEC filings can be downloaded from the SEC website.

(4) The suggested SEC filings and possible taxpayer's internal documents are further discussed below.

C. SEC Documents

Form 10-K is the annual report filed with the SEC and provides a complete listing of section 16(b) executives and directors, executive compensation, and the security ownership of certain beneficial owners and management. Items 10, 11, and 12 of the Form 10-K and references to supplementary exhibits filed with the SEC may contain additional compensation plans for executives. These compensation plans may include stock options, restricted stock, and other types of equity-based compensation. The plans may discuss vesting of options and vesting in the event of a change in control (i.e., a merger or buyout of the company). A change in control provision may also apply to publicly-traded partnerships that offer equity to employees.

DEF 14A (Proxy Statement Pursuant to Section 14A of the SEC), better known as the Definitive Proxy Statement or the annual proxy statement, is the easiest place to look up information on executive compensation. This proxy statement is sent to the shareholders of record prior to the Annual Meeting and may contain information about specific stock options and compensation plans for executives. It is more detailed than Form 10-K and provides specific detail on the number of options granted and the total exercise price under the various plans.

The Summary Compensation Table, found in the Definitive Proxy Statement, is the cornerstone of the SEC's required disclosures on executive compensation. The Summary Compensation Table provides a comprehensive overview of the company's executive pay practices. The Summary Compensation Table is followed by other tables and disclosures containing more specific information on the components of compensation for the last completed year. This disclosure includes information about grants of stock options, stock appreciation rights, long-term incentive plan awards, pension plans, employment contracts, and related arrangements.

The Definitive Proxy Statement also contains the Compensation Discussion and Analysis (CD&A), which explains all material elements of the company's executive compensation programs.

To comply with its financial reporting requirements, the company must estimate the value of the equity-based compensation at the time of grant. For tax purposes, the equity-based compensation is not reported as compensation until the vest date or exercise date (depending on the type of equity-based compensation at issue). Large discrepancies are common between the GAAP expense and the amount deductible for federal income tax purposes. The tables for Outstanding Equity at Year End and Option Exercises and Stock Vested may provide insight on where the discrepancies arise.

Stock options and other equity-based incentive plans are often included as exhibits attached to the SEC filings in the year the plan went into effect. These plans are generally included in the DEF 14A filing. For example, a "2004 Stock and Incentive Plan" is often available in the 2004 DEF 14A. For fiscal year companies, the plans may be attached to the DEF 14A for the prior calendar year. The term "Incentive Stock Options" (ISOs) may indicate the company offers equity compensation intended to comply with IRC § 422. The term "Employee Stock Purchase Plan" may indicate the company offers equity compensation intended to comply with IRC § 423. See the section on Statutory Stock Options for more information.

Form S-3 (Registration Statement) is a simplified security registration under the Securities Act of 1933. The Registration Statement requires disclosure of important financial information including information related to equity-based compensation.

Form 4 (Statement of Changes in Beneficial Ownership) provides information about the disposition of stock either by sale or transfer. This information may indicate whether the shares have been transferred to a family partnership or other entity controlled by the shareholders, officers, and/or directors.

D. Internal Taxpayer Documents

Employment contracts may contain additional information on the types of compensation awarded to employees, including the right to participate in specific equity-based compensation plans such as the grant of stock options, phantom stock, stock appreciation rights, restricted stock, restricted stock units/awards, or other items based on the value of specified stock. It is important to review these contracts, even if the contents are duplicative of information contained in the SEC filings.

Board of directors and compensation committee minutes should be reviewed to identify activities relating to the adoption of incentive compensation plans and the grant or vesting of stock, options, or other equity-based compensation. Reports issued by the compensation committee and presented to the board of directors should be requested and reviewed to provide insight into any equity-based compensation.

The examiner should verify that plans under which statutory options may be granted were approved by the board of directors and the shareholders. Statutory Stock Option Plans require shareholder approval within 12 months before or after adoption by the board of directors. Statutory options include Incentive Stock Options (ISOs) and options granted under an Employee Stock Purchase Plan (ESPP). There are also shareholder approval rules related to the deduction limitation under IRC §162(m). There are no shareholder approval requirements under the Internal Revenue Code for non-statutory stock options, restricted stock, Stock Appreciation Rights (SARs), or phantom stock plans, except as provided in the regulations under IRC §162(m). See the Audit Technique Guide (ATG) for more information concerning IRC §162(m).

The examiner should also verify that the taxpayer has not cancelled or reduced loans advanced to executives as a condition to exercise options or purchase restricted stock. Loan cancellations or reductions are acceptable to the extent they were included as additional compensation and are subject to Federal Insurance Contributions Act (FICA) taxes, Federal Unemployment Tax Act (FUTA), and Federal Income Tax Withholding (FITW). See Treasury Regulation (Treas. Reg.) §1.83-4(c) and Revenue Ruling (Rev. Rul.) 2004-37. Without an inclusion in the executives' wages, the examiner should consider whether the corporate deduction is allowable. See IRC § 83(h). Penalties may also be applicable for incorrect filing and furnishing of Form W-2 under IRC §§ 6721, 6722, and/or 6674. Additional discussion of reduced loans used to acquire employer stock is found below under potential issues.

E. Stock Transfers and Awards

Determine if stock was actually transferred. Stock is considered "transferred" only if the employee has the risks and benefits of an owner. Transfer does not hinge solely on receipt of the stock.

Determine if the following conditions exist:

- Does the employee or independent contractor have voting and dividend rights?
- Are restrictions placed upon the stock in the employment contracts, stock plans or other documents? There are many types of restrictions, but one example would be a restriction on the sale or transfer of the stock by the employee.
- If the corporation were liquidated, does the employee or independent contractor have a right to a liquidation distribution?
- Does the employee or independent contractor have the right to a gain or loss based on the increase or decrease in the stock's value?

Treas. Reg. §1.83-3(a) contains several criteria and examples for deciding whether a transfer has occurred. For example, if a service provider (i.e., an employee or independent contractor) pays for stock with a nonrecourse note (a note where the service provider has no personal liability), the transaction may not be a transfer of the stock, but instead, may be considered an option to buy stock in the future because the service provider has made no investment and has no risk of loss. If the stock declines in value, the service provider can decide not to pay the note and forfeit the stock. In these circumstances, the service provider has not incurred the risk of a beneficial owner if the value of the property declines substantially.

Determine if there was transfer of stock options to a related person. The transfer of compensatory stock options to related persons (of the service provider) is a "listed transaction." The examiner should consider issuing the Information Document Request for Tax Shelters and review Notice 2003-47, 2003-2 C.B. 132 for additional information on this type of listed transaction.

Determine whether there has been a reduction in the purchase price of a note used to acquire employer stock. Historically, in declining stock markets, some employers have reduced the outstanding balance of a recourse note (a note where the creditor has the ability to hold the debtor personally responsible to repay) issued by the employer to the employee in satisfaction of the exercise price of an option to acquire the employer's stock. Under Treas. Reg. §1.83-4(c), if an indebtedness that has been treated as an "amount paid" (for purposes of IRC § 83 is subsequently cancelled, forgiven, or satisfied) for an amount less than the amount of such indebtedness, the amount that is not in fact paid is includible in the gross income of the service provider for the taxable year in which such cancellation, forgiveness, or satisfaction occurs. The reduction of the outstanding balance of the note results in compensation income to the employee and wages are subject to FICA, FUTA, and FITW.

Some taxpayers erroneously believe such a reduction is a purchase price adjustment under IRC §108(e)(5). If IRC §108(e)(5) applies, the employee does not recognize income upon the reduction of the outstanding balance of the note, but instead adjusts the basis of the underlying property (the acquired stock). However, in this case, IRC §108(e)(5) does not apply because the reduction of the outstanding balance of the note is a medium for payment of compensation by the employer to the employee, and any income resulting from the reduction is not income from the discharge of indebtedness to the employee. See Rev. Rul. 2004-37.

Determine whether any elections pursuant to IRC §83(b) have been made and request records to verify these elections. An election pursuant to IRC §83(b) allows a recipient of restricted property to be taxed when the property is transferred instead of when the property actually vests (at a later date when the value may be higher). The election must be made no later than 30 days from the date the property is transferred to the service provider, with no extensions. Generally, such elections are handled through the employer's payroll department. Elections pursuant to IRC §83(b) are also common when an individual receives an interest in a partnership or receives equity before an entity makes an Initial Public Offering (IPO). See Rev. Proc. 2012-29 for a model election pursuant to IRC §83(b).

Determine whether any elections pursuant to IRC § 83(i) have been made and request records to verify these elections. For stock options exercised or Restricted Stock Units (RSUs) settled after December 31, 2017, employees of startup companies can make an election under IRC § 83(i) so that no amount will be included in income of the employee for the first taxable year in which the rights of the employee in such stock are transferable or are not subject to a substantial risk of forfeiture, whichever is applicable. Under IRC § 83(i), income taxation is deferred by the employee until the earlier of (1) five years after the first date the rights of the employee in such stock are transferable or are not subject to a substantial risk of forfeiture, whichever occurs earlier; (2) the first date any qualified stock becomes transferable (including becoming transferable to the employer); (3) the date the employee first becomes an “excluded employee;” (4) the first date on which any stock of the corporation that issued the qualified stock becomes readily tradable on an established securities market; or (5) the date on which the employee revokes an election to treat a grant as a qualified equity grant under IRC § 83(i). An election under IRC § 83(i) may be made only if no stock of the corporation is readily tradable on an established securities market, and the corporation has a written plan under which not less than 80% of all employees who are granted stock options or RSUs with the same rights and privileges to receive qualified stock. An election with respect to qualified stock must be made no later than 30 days after the first date the rights of the employee in such stock are transferable or are not subject to a substantial risk of forfeiture, whichever occurs earlier. An election under IRC § 83(i) is made in a manner similar to an election made under IRC § 83(b). Please see Notice 2018-97 for additional guidance on the application of IRC § 83(i).

The examiner should verify that employment taxes have been properly withheld with respect to restricted property for which an IRC §83(b) election was made, if applicable. In addition, the examiner should verify that the corporate deduction matches the amount included (if any) in the service provider's income.

Elections pursuant to IRC §83(b) and stock options. On occasion, a service provider may try to make an election pursuant to IRC §83(b) on the receipt of stock options. An election with respect to an option is usually void because an election pursuant to IRC §83(b) may be made only with respect to property that has been transferred. Options without a readily ascertainable fair market value (FMV) are not property within the meaning of IRC §83. However, if the stock purchased pursuant to the exercise of an option is subject to a substantial risk of forfeiture, the service provider may make an IRC §83(b) election with respect to the stock received pursuant to the exercise of the option.

Determining whether a substantial risk of forfeiture exists depends on the facts and circumstances. Generally, a substantial risk of forfeiture exists only if rights in property that are transferred are conditioned, directly or indirectly, upon the future performance (or refraining from performance) of substantial services by any person, or upon the occurrence of a condition related to a purpose of the transfer. Property is not considered transferred if it is subject to a substantial risk of forfeiture, and at the time of transfer, the facts and circumstances demonstrate that the forfeiture condition is unlikely to be enforced. See Treas. Reg. §1.83-3(c) for the definition and examples of substantial risks of forfeiture.

If there is a transfer of property, the examiner must determine if there is a substantial risk of forfeiture, and if so, compensation should be recognized once the substantial risk of forfeiture has lapsed (assuming no election pursuant to IRC §83(b) was made). The corporation is entitled to a corresponding deduction unless disallowed by IRC §§ 162(m) or 280G. (see IRC §83(h).

- Section 16b Executives. Individual(s) that qualify as an executive under section 16(b) of the Securities Exchange Act of 1934 may be subject to suit if the executive sells the stock at a profit within six months after the purchase of the stock. These individual's rights in the property are treated as subject to a substantial risk of forfeiture and is not transferable until the earlier of (i) the expiration of such six-month period, or (ii) the first day on which the sale of such property at a profit will not subject the individual to suit under section 16(b) of the Securities Exchange Act of 1934.
- Lapse Restrictions. Lapse Restrictions are restrictions other than non-lapse restrictions (see below) and include restrictions that carry a substantial risk of forfeiture. A "lapse" restriction prevents the transfer of

restricted stock until a specific date after which the stock may be sold outright such as a requirement that the employee perform services for one year. See Treas. Reg. §1.83-3(i).

- Non-Lapse Restrictions. Non-Lapse Restrictions will never lapse and requires the holder of the stock to sell, or offer to sell, the stock at a price determined under a formula. Non-Lapse Restrictions are not considered substantial risks of forfeiture and never postpone the recognition of income. Therefore, the service provider recognizes income immediately upon grant and the company is allowed a deduction. A Non-Lapse Restriction is not dependent upon the service provider performing services for a specified number of years. Rather, the restriction will terminate upon the occurrence of a specific event such as a change in control, termination of employment, or death of the service provider. A common Non-Lapse Restriction (generally with a non-public employer) is when an employer requires the employee to sell the stock back to the employer at book value whenever the employee wishes to dispose of it for any reason. In this case, book value will be considered FMV when determining the amount included as compensation in the service provider's gross income. The employee will recognize as compensation the difference between book value and any amount paid for the stock. See IRC §83(d) and Treas. Reg. §§ 1.83-3(h) and 1.83-5.

Dividends from restricted stock. If an employee or independent contractor receives dividends or other income from substantially non-vested restricted stock, the amounts are (1) considered additional compensation to the individual and must be included in income, (2) are subject to employment taxes, and (3) may be deductible by the corporation. See Treas. Reg. §§ 1.83-1(a)(1) and 1.83-1(f), Example (1). However, if the employee makes an election pursuant to IRC §83(b), the dividends are treated as dividend income rather than compensation. Once the restricted stock award vests, the dividends are treated as dividend income rather than compensation.

F. Potential Issues Involving Stock Options

To determine if there is an issue with stock options, the examiner must determine the type of stock option received by the individual. Generally, the options received by executives are called "Non-Statutory Options." Employers have much more discretion in granting Non-Statutory Options as compared to Statutory Options. Statutory Options include Incentive Stock Options (ISOs) as described in IRC § 422 and options granted under an Employee Stock Purchase Plan (ESPP) as described in IRC § 423.

Statutory Stock Options include ISO's and options granted under an ESPP that can only be granted to employees. The exercise of Statutory Options does not result in income (compensation) or income tax to the employee, and the employer may not take a compensation deduction. Employment taxes such as FICA, FUTA, and FITW do not apply upon the exercise of an ISO or ESPP option. See Notice 2002-47, 2002-2 C.B. 97 (this notice was provided for a moratorium on the assessment of FICA, FUTA, and FITW on either the exercise of a statutory stock option or the disposition of stock acquired by an employee pursuant to the exercise of a statutory stock option), IRC §§3121(a)(22), 3306(b)(19), and 421(b). For information regarding employment taxes, see Notice 2002-47.

The examiner should review the terms of a Statutory Stock Option and verify that it is not allowable for it to be treated any other way than as a Statutory Stock Option. If the executive is allowed to convert it to something other than a Statutory Stock Option, then the option is considered a Non-Statutory Stock Option, subject to FICA, FUTA and FITW at the time of exercise (Rev. Rul. 78-185, 1978-1 C.B. 304).

F.1. Qualifying Dispositions

A qualifying disposition occurs when the employee holds the stock for at least two years from the date of grant and one year from the date of exercise. If the specific holding period requirements are met, then the employee recognizes capital gain (or loss) on disposition of the stock (but there is still no deduction for the employer).

Special rules apply to a qualifying disposition of stock acquired under an ESPP if the option's exercise price was less than the share's FMV when the option was granted. Per IRC § 423(c), the employee recognizes compensation income equal to the lesser of:

- the excess of the FMV of the share on the date of its disposition over the amount paid for the share, or
- The excess of the share on the option’s grant date over the exercise price.

If the option price is not fixed and determinable at the time the option is granted, the option price will be computed as if the option had been exercised on the grant date. See Treas. Reg. § 1.423-2(k)(1)(ii). This compensation income is not subject to FICA, FUTA or FITW. See Notice 2002-47. Any additional gain on the disposition of the stock is characterized as capital gain. See IRC § 423(c). The employer receives no tax deduction for the compensation recognized by the employee under this special rule. See Treas. Reg. § 1.423-2(k)(1)(iii).

F.2. Disqualifying Dispositions

A failure to meet the holding period requirements results in a disqualifying disposition of the stock purchased by exercising a Statutory Stock Option. In that event, the employee has compensation (ordinary income) on the date of the disqualifying disposition equal to the difference between the exercise price and FMV of the underlying stock on the date of exercise. If the stock at issue was restricted (i.e., subject to a substantial risk of forfeiture) the income is the difference between the exercise price and the FMV on the date the restriction lapsed. In the event of a disqualifying disposition, the employer is entitled to a corresponding wage deduction.

Pursuant to Treas. Reg. § 1.6041-2(a)(1), the compensation from a disqualifying disposition is considered wages, should be reported on the employee's Form W-2, and is deductible on the employer's income tax return. However, the income from disqualifying dispositions is not subject to FICA, FUTA or FITW. For information regarding employment taxes, see Notice 2002-47.

F.3. Annual Limitations

There is a $100,000 annual limitation on the value of an employee's ISO that may become exercisable for the first time during any calendar year. See IRC § 422(d). This limit is determined based on the FMV of the stock at the time the option is granted and not at the time the option vests. To the extent in which an ISO is exercisable for the first time (first day the FMV exceeds $100,000), the excess amount over $100,000 is treated as a Non-Statutory Option, subject to all employment tax rules governing those options. At the time of exercise, this results in ordinary income to the employee and a wage deduction to the employer. See Treas. Reg. § 1.422-4 for rules related to the $100,000 rule. See IRC § 422(c)(5) for the special rules for a 10% owner.

For options granted under an ESPP, no employee is permitted to accrue the right to purchase stock of the employer that exceeds $25,000 of the FMV of the stock (determined when the options are granted) for each calendar year in which the option is outstanding. See IRC § 423(b) (8) and Treas. Reg. §1.423-2(i).

F.4. Reporting and Filing Rules

In addition to issuing a Form W-2, an employer has an information reporting requirement under IRC § 6039 following the exercise of a statutory option. IRC § 6039 requires corporations to furnish a written statement to each employee on or before January 31 of the year following the year for which the statement is required regarding:

- The transfer of stock to the employee pursuant to the exercise of an ISO after December 31, 2009, shall be reported on Form 3921. With respect to the exercise of an option under an ESPP after December 31, 2009, the transfer of stock to the employee is reported on Form 3922. IRC § 6039 also requires corporations to file an information return with the IRS.
- The corporation's transfer of stock pursuant to the employee's exercise of an ISO; and

- The corporation's (or its agent's) recording the first transfer of the legal title of a share of stock acquired by the employee pursuant to the exercise of an ESPP option described in IRC § 423(c).

Non-Statutory Stock Options generally result in ordinary income and wages on the date of exercise or other disposition (Rev. Rul. 78-185). The corporation is generally entitled to a corresponding deduction under IRC § 83(h), unless disallowed under IRC §§ 162(m) and 280G. Non-statutory options with an exercise price less than the FMV on the date of grant (a "discounted option") may be subject to IRC § 409A. See final regulations under IRC § 409A.

Non-Statutory Stock Options do not fall under the wage exclusions provided under IRC §§ 3121(a)(22) or 3306(b)(19) and are not subject to the moratorium under Notice 2002-47. Special rules apply to an option with a readily ascertainable FMV. Generally, the company can provide a Non-Statutory Stock Option report which should show, by employee, the option grant date, exercise date, employment taxes withheld, and the type of information return furnished. This report may be used to reconcile the tax deduction on the company's tax return Schedule M-3 to the Forms W-2 issued to the employees. Former employees' compensation should be reported on Form W-2. A reconciliation should be requested for some of the larger exercises to the employee's reported option income in Box 1 and Box 12, code V of Form W-2. Extra steps must be taken to reconcile deductions to the proper year for companies with a fiscal year end. Discrepancies in the reconciliations may indicate an income or employment tax issue.

Income from qualified equity grants under IRC § 83(i) should be reported on Form W-2, box 12 with code GG. Aggregate deferrals under IRC § 83(i) elections as of the close of the calendar year should be reported on Form W-2, box 12 with code HH.

If the options are offered to directors, ascertain whether a Form 1099 was issued. This option income should be reported on the director's individual tax return (e.g. Schedule C or on Form 1040, line 8, Other Income and on Schedule 1, line 8k), along with self-employment tax upon exercise or other disposition.

Determine that all appropriate FICA, FUTA, and FITW are deposited. If the employment taxes equal or exceed $100,000 on any day during a deposit period, the company is required to deposit the tax by the next banking day, regardless of whether they are a monthly or semi-weekly depositor. If there are large Schedule M-3 adjustments for options exercised and if the deposit schedule doesn't vary, consult with an Employment Tax Specialist for guidance on pursuing a possible Failure to Deposit Penalty under IRC § 6656.

G. Other Types of Equity-Based Compensation

G.1. Phantom Stock Plan

A Phantom Stock Plan is 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.

Despite their name, Phantom Stock Plans are Non-Qualified Deferred Compensation (NQDC) arrangements, not stock arrangements. IRC § 3121(v)(2) provides that an arrangement is a NQDC if the employee has a legally binding right in a calendar year to the cash value of a certain number of shares that is to be paid in a later calendar year. Typically, the individual is entitled to receive the cash value of the number of phantom shares that have been credited to the individual's account upon termination of employment. The examiner should determine if the company engages in such practices and if so, obtain an understanding of the terms of the arrangement. See the final regulations under IRC § 409A, which are applicable to NQDC arrangements.

IRC § 3121(v)(2) deals with treatment of certain deferred compensation & salary reduction arrangements specifically the treatment of certain nonqualified deferred compensation plans. Treas. Reg. § 31.3121(v)(2)-1(b)(4)(ii) discusses plans, arrangements, and benefits that do not provide for the deferral of compensation such as stock options, stock appreciation rights, and other stock value rights. Treas. Reg. § 31.3121(v)(2)-1(b)(5) example 8 provides a special timing rule for nonqualified deferred compensation, which may include phantom stock. Under the special timing rule the FMV of the phantom stock is wages at the time credited to the employee's account (when it is vested). If "taken into account" when credited to the employee's account, then any appreciation in the value of the stock is not FICA wages when the executive cashes-out the phantom stock. However, such appreciation is income to the employee and subject to FITW.

G.2. Stock Appreciation Rights

Stock Appreciation Rights are another method of compensating employees or independent contractors. A Stock Appreciation Right (SAR) is an arrangement, during a specified period, which 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. See Rev. Rul. 80-300, 1980-2 C.B. 165, Rev. Rul. 82-121, 1982-1 C.B. 79, and Treas. Reg. § 1.451-2(a). 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). 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. See Private Letter Ruling (PLR) 8104119. In addition, an employee who fails to exercise a SAR has constructively received the value of stock at the end of its term. See PLR 8120103.

G.3. Restricted Stock Units

Restricted Stock Units are unsecured, unfunded promises to pay cash or stock in the future and 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. 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.

G.4. Stock Warrants

Stock Warrants are 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. See Black's Law Dictionary 1617 (8th ed. 2004). Generally, warrants are not compensatory for tax purposes; however, some options may be incorrectly referred to as "warrants." Depending upon the facts and circumstances, the warrants that are actually issued in exchange for, or in connection with, performance of services should be subject to taxation under IRC § 83. To determine if proper tax treatment and consideration was given, a copy of the stock warrant agreement and underlying plan documentation (if any) should be obtained.

H. Additional Resources

Technical questions may be submitted to the Compensation & Benefits Practice Network on the CAB PN SharePoint site. Please use the “Submit an Inquiry” link to submit a formal request for assistance.