Comparing equity awards (stock) and deferred comp

Companies seeking to attract, retain, and reward key executives have choices to make regarding the form of compensation paid to those executives. Company contributions to various benefit programs may have a significant impact on the financial results of the company, as well as having a significant tax impact on both the company and the employee.

Many companies have been accounting for stock-option grants under FAS 123R (Accounting for Compensation – Stock Compensation ASC718-30), which requires expensing of stock options. With the issuance of ASU 2017-09, companies may be able to use the Intrinsic Value Method under APB 25 in accounting for stock options.

Accounting treatment-income statement impact

Stock options. Under ASC 718-30 (FAS 123R), the **Fair Value Based Method** determines a fair value of the option as of the date of the grant and then requires expensing of this value over the vesting period of the option. The fair value is determined using a number of factors, including the strike price, the market value as of the date of the grant, the life of the grant, and the expected volatility of the stock. Under ASC 718-30 (FAS 123R), this treatment may be required, and most stock-option programs will result in the company booking an expense.

Restricted stock. Restricted stock grants are accounted for under ASC 718-30 (FAS 123R). The value of a restricted stock grant is measured using the market value of the stock as of the date of the grant. This amount is then expensed over the vesting period of the grant.

Nonqualified deferred compensation. Company contributions to deferred comp plans are accounted for under Compensation – General ASC 710-10-25 (APB 12). Amounts are expensed over the period the contributions vest. Also, any gains or losses credited to the participant's account need to be taken into consideration in determining the amount to be expensed.

Accounting treatment-earnings per share impact

Stock options and restricted stock. Under Earnings Per Share ASC 260-10 (FAS 128), companies are required to include all forms of stock compensation in the calculation of "fully diluted" earnings per share. This means that stock options and restricted stock grants will cause dilution of the company's earnings per share.

Nonqualified deferred compensation. There's no effect on the number of shares in the earnings per share calculation if company stock is offered as an investment alternative in a nonqualified deferred compensation plan.

The calculation of the value of the account is dependent on share value, but since no shares are actually issued or available for issue under the plan, there's no dilution.

Tax treatment-for the employee

Stock options. The employee recognizes income in the year in which the option is exercised. The income is the difference between the strike price and the exercise price on the date of exercise. The income is subject to both income and Social Security and Medicare withholding (FICA) taxes and is reported on the employee's Form W-2. The employee pays tax regardless of whether they keep the stock or immediately sell it. If they keep the stock, their basis is the FMV of the stock (exercise price plus amount taxed), and the capital gains holding period is calculated from the date of exercise.

Restricted stock. The employee recognizes income in the year in which the restricted stock grant vests. The income is calculated using the value of the stock on the date the grant vests (not the original grant date). The income is subject to both income and FICA taxes and is reported on the employee's Form W-2. The holding period for capital gains treatment begins on the date the grant vests. (**Note:** The employee may also elect to recognize the full value of the grant as of the date the grant is issued (Internal Revenue Code Section 83(b) election). Their basis in the stock is fixed at that point, and the holding period for capital gains treatment also begins on the date the grant is issued (when the property is transferred.))

Nonqualified deferred compensation. The employee pays FICA taxes on the change in the vested value of their account each year. The employee only pays income taxes in the year of distribution. These amounts are reported on the employee's Form W-2.

Tax treatment-for the company

For all types of compensation, the tax treatment for the company mirrors the treatment for the employee. The company receives a tax deduction for the compensation in the year the employee recognizes the income. The company owes the FICA match at the time the employee pays his or her portion.

Summary

Each of the three methods (stock options, restricted stock, and deferred comp) has benefits and things for the company to consider in terms of financial statement and tax impact. For the employee, the tax timing and treatment of each type of benefit can vary substantially. The company needs to carefully evaluate each method before deciding on the most appropriate benefit program for their key employees.

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