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## Stock Based Compensation Audit Techniques Guide (02-2005)

**NOTE:** This guide is current through the publication date. Since changes may have occurred after the publication date that would affect the accuracy of this document, no guarantees are made concerning the technical accuracy after the publication date.

Stock-based compensation generally consists of either the transferring of stock or the issuance of stock options to an employee or independent contractor. Generally, one place to start the audit is by reviewing the Securities and Exchange Commission (SEC) Form 10-K, Annual Report, including items 10, 11, and 12, to identify the 16b executives, as well as the Board of Directors, who may have received stock-based compensation. This report can be downloaded from the SEC website at [www.sec.gov](http://www.sec.gov); go to Filings and Forms, Search for Company Filings, then type in the name of the company to be researched. Although there are numerous documents filed with the SEC, the pertinent documents for compensation purposes are the 10-K, Def 14A, Other Definitive Proxy Statements, the Form 4, Statement of Changes in Beneficial Ownership, and the actual employment contracts for the 16b executives.

Once you've identified the 16b executives and the stock-based compensation arrangements, you will want to determine whether all compensation related to these various plans has been included in income (reported on the executive's W-2) and the appropriate employment taxes have been assessed. If the compensation awarded to the 16b executives has not been properly recognized, the audit scope may need to be expanded to other executives accordingly.

### SEC DOCUMENTS:

**The 10-K document** is the annual report filed with the SEC and provides a complete listing of the Directors and executive officers, executive compensation, and the security ownership of certain beneficial owners and management. There is also a description at the back of the 10-K containing additional exhibits filed with the SEC which may contain additional compensation plans for executives. Generally, these compensation plans include stock options and restricted stock and may discuss vesting of the options, especially if there is a change in control (i.e., a merger or buyout of the company).

**The 14A, Proxy Statement Pursuant to Section 14A of the SEC**, better known as the Definitive Proxy Statement, is sent to the shareholders of record prior to the Annual Meeting and contains information about specific stock options and compensation plans for the executives. It is more detailed than the 10-K and provides specific detail as to the number of options granted and the total exercise price.

**Form 4** 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.

**The employment contracts** contain additional information on the types of compensation awarded to employees including the right to participate in specific stock-based compensation such as the grant of options, phantom stock, stock

appreciation rights, and restricted stock. The information may be repetitive if you have read the prior documents first; however, there may be new information relating to compensation in the employment agreements.

#### **INTERNAL DOCUMENTS:**

The Board of Director's and Compensation Committee Minutes should be reviewed to identify activities relating to the grant or vesting of stock, options, or other stock-based compensation. Additionally, there may be reports issued by the compensation committee and presented to the Board of Directors. These reports should be requested because they may provide insight into any stock-based compensation.

Verify plan approval. Statutory stock option plans (i.e., for ISO's or options granted under an ESPP) require shareholder approval within 12 months before or after adoption by the board of directors. There are shareholder approval rules related to the deduction disallowance under §162(m). (See the ATG concerning 162(m) for more information.) There are no shareholder approval requirements for nonstatutory stock options, restricted stock, SAR's, or phantom stock plans under the Code.

Also verify that the taxpayer has not cancelled or reduced loans advanced to executives for them to exercise options or purchase restricted stock. Those cancellations or reductions are additional compensation, and thus, wages to the executive. See §1.83-4(c) and Rev. Rul. 2004-37.

#### **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 rights and dividend rights?
- 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 gain or loss based on the increase or decrease in the stock's value?

For example, if a service provider (i.e., an employee or independent contractor) pays for stock with a nonrecourse note (a note where the employee 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 in that the value of the property might decline substantially. Section 1.83-3(a) of the regulations contains several criteria and examples for deciding whether a transfer has occurred.

**Determine if there was transfer of stock options to a related person.** The transfer of compensatory stock options to related persons is now a Listed Transaction, thus making this a mandatory item that the audit team must address. Refer to Notice 2003-47, 2003-2 C.B. 132, and the ATG on the Transfer or Sale of Compensatory Stock Options to Related Persons for more specific information. Determine whether there has been a reduction in the purchase price of a note used to acquire employer stock. Due to the declining stock market, some employers and employees have reduced the outstanding balance of a recourse note issued by the employee to the employer 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 §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. Thus, the reduction of the outstanding balance of the note results in compensation income to the employee. Some taxpayers erroneously believe that is a purchase price adjustment under IRC §108(e)(5). If IRC §108(e)(5) were to apply, the employee would not recognize income upon the reduction of the outstanding balance of the note but instead would adjust the basis of the underlying property (the acquired stock). In this case, 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 to the employee from the discharge of indebtedness. Thus, IRC §108(e)(5) does not apply. See Rev. Rul. 2004-37.

**Determine whether any 83(b) elections have been made and request records verifying these elections.** An 83(b) election allows the stock recipient, although not vested in the stock, to be taxed when the stock is transferred instead of when the stock actually vests. Generally, such elections are handled in payroll. The election must be made no later than 30 days from the date the stock is transferred to the service provider, with no extensions. See §83(b). Verify that employment taxes have been paid with respect to restricted property for which an 83(b) election was made.

**83(b) elections and options.** Note, on occasion, a service provider may try to make a §83(b) election on the receipt of options. An election with respect to a nonstatutory option is void because an 83(b) election may only be made with respect to property that has been transferred. Nonstatutory options, without a readily ascertainable fair market value, are not property subject to §83. Most nonstatutory options do not have a readily ascertainable fair market value, and thus, an 83(b) election cannot be made with respect to those options. Also, an 83(b) election is not effective with respect to stock transferred on exercise of a statutory (ISO or ESPP) option (although the election may be effective for AMT purposes).

**Lapse and Nonlapse Restrictions** should be examined. Determine whether sufficient incidents of ownership exist and/or what events must transpire to affect stock ownership. A lapse restriction impacts the timing of income recognition if it causes the property to be subject to a substantial risk of forfeiture, or in the case of a nonlapse restriction, the amount of income recognized. Lapse restrictions may or may not contain substantial risks of forfeiture. If a lapse restriction is not a substantial risk of forfeiture, it does not postpone the recognition of income or affect the value of the property.

**A substantial risk of forfeiture** exists when the rights to full enjoyment of the property are conditioned on the future performance of substantial services. See §1.83-3(c) for the definition and examples of substantial risks of forfeiture. Also, if certain executives receive stock that cannot be sold for six months after acquisition, taxation is delayed because under §83(c)(3) the stock acquired is subject to a substantial risk of forfeiture for up to six months. If there is a transfer of property, determine if there is a substantial risk of forfeiture, and if so, compensation should be recognized once the substantial risk of forfeiture has lapsed (if no 83(b) election was made). The corporation is entitled to a corresponding deduction unless disallowed by §§162(m) or 280G.

#### **STOCK OPTIONS:**

**Determine the type of stock option received by the individual.** Generally, the options received by executives are nonstatutory options meaning they are not statutory options. Statutory options include incentive stock options (ISO's) 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. The exercise of an ISO or option granted under an ESPP does not result in income tax, and the employer corporation may not take a compensation deduction. If the holding period requirements are met (2 years from the grant date and 1 year from the transfer of the stock), then there is capital gain on disposition of the stock and no deduction for the employer corporation. However, if the holding period requirements are not met, then there is a disqualifying disposition of the stock issued under the ISO or ESPP. Generally, the employee has compensation income on the date of the disqualifying disposition equal to the difference between the exercise price and fair market value on exercise, unless the stock was restricted (i.e., subject to a substantial risk of forfeiture) in which case the difference is between the exercise price and the fair market value on the date the restriction lapsed. The employer is entitled to a corresponding deduction. The compensation from a disqualifying disposition is reportable on box 1 of Form W-2 (F-W-2) per Regulation 1.6041-2(a)(1). However, the income being reported is not subject to the Federal Insurance Contributions (FICA) tax, Federal Unemployment Tax Act (FUTA) tax, or Federal income tax withholding (FITW). The income from these disqualifying dispositions is not subject to FICA, FUTA, or FITW due to a moratorium. In addition, the Service will not assert FICA taxes upon the exercise of a ISO or ESPP option. See Notice 2002-47, dated June 2002. Generally, executives will be participants in the company's ISO plan and in other stock plans as well.

**Incentive Stock Options**. Ascertain that the terms of the option don't allow for it to be treated any other way than as an incentive stock option (ISO). If the executive is allowed to convert it to something other than an ISO, then the option is considered a nonstatutory stock option, subject to FICA, FUTA and FITW at the time of exercise (Rev. Rul. 78-185, 1978-1 C.B. 304).

There is also a \$100,000 limit with regard to ISO's. To the extent the fair market value to which an ISO is exercisable for the first time during any calendar year exceeds \$100,000, the excess is treated as a nonstatutory option. This limit is determined by looking at the fair market value of the stock at the time the option is granted—not at the time the option vests. If the \$100,000 limit is surpassed, the options exceeding the limit are considered nonstatutory options, subject to all employment tax rules governing those options. See 1.422-4 for rules related to the \$100,000 rule.

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 fair market value of the stock (determined with the options are granted) for each calendar year in which the option is outstanding. See 423(b)(3) and 1.423-2(i).

**Same Day Sales of ISO's or ESPP Stock** should be reviewed. Determine if stock was actually issued. This occurs when, rather than holding the shares of stock acquired through an ISO or ESPP exercise, an employee sells the stock immediately after exercising the option, commonly known as a same day sale. In order for a same day sale to be exempt from all employment taxes, the corporation must issue stock pursuant to an actual exercise of the statutory stock option. If the employee merely forfeits the option in return for the spread amount (what the employee would have received if the employee exercised the stock and immediately sold it), this is essentially a sale of an option and the amount received would be a wage payment subject to employment taxes. Additionally, the sale of the option results in compensation income for the employee and corresponding deduction for the employer.

**Nonstatutory Stock Options** generally result in compensation income and wages on the date of exercise (or other disposition) (Rev. Rul. 78-185), and the corporation is generally entitled to a corresponding deduction. (Again, note the rules under §§162(m) and 280G.) Nonstatutory options are generally excepted from the application of §409A, however, an option with an exercise price less than the FMV on the date of grant (discounted option) may be within the scope of §409A. See Notice 2005-1, 2005-2 I.R.B. \_\_\_ (January 10, 2005).

These options do not come under the wage exclusions provided under §§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 fair market value. Generally, the company can provide a nonstatutory stock option report which should show, by employee, the option grant date, exercise date, employment taxes withheld and the type of information return furnished. Former employee's compensation is still reported on a Form W-2, not a Form 1099. Request a reconciliation of some of the larger exercises to the employee's reported option income in Box 1. If the options are offered to Directors, ascertain that a 1099 was issued. Request a RTVUE to ascertain that the option income was reported on line 21, Other Income, and that self-employment tax was paid on the exercise or other disposition.

Determine that all appropriate FICA tax, FUTA tax, 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 semiweekly depositor. If there are large M-1 option exercises, review the 650 deposit notations on the 941 BMFOLT and look for variances in the company's depositing schedule. If the deposit schedule doesn't vary and there were large M-1 adjustments for option exercises, contact the LMSB Field Specialist Employment Tax team manager having responsibility for your area for guidance on pursuing a possible Failure to Deposit Penalty under IRC 6656.

**Phantom Stock** arrangements involve the crediting of shares of stock to a service provider's account without ever issuing the actual shares to the employee. Despite their name, phantom stock plans are NQDC arrangements, not stock arrangements. Typically, upon termination of employment, the individual is entitled to receive the cash value of the number of phantom shares that have been credited to the individual's account. Determine if the company engages in such practices and if so, the terms of the arrangement. See Notice 2005-1.

Phantom stock is considered nonqualified deferred compensation for purposes of § 3121(v)(2) 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.

Reg. § 31.3121(v)(2)-1(b)(4)(ii), and -1(b)(5) Ex. 8. Section 3121(v)(2) provides a special timing rule for nonqualified deferred compensation. If phantom stock is nonqualified deferred compensation within the meaning of § 3121(v)(2), then under the special timing rule the value of the phantom stock is wages at the time credited to the employee's account. The amount of FICA wages is the fair market value of the phantom stock when credited to the employee's account. If the phantom stock is nonqualified deferred compensation, and the value of the phantom stock was included in FICA wages 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. When the executive cashes out, any appreciation is gross income to the employee subject to FITW.

**Stock Appreciation Rights** are another method of compensating employees or independent contractors. Determine that at the time of exercise, the appreciation attributable to the shares and/or cash received were included as compensation, subject to FICA/FITW. Stock appreciation rights are not subject to the special timing rule under § 3121(v)(2). Reg. § 31.3121(v)(2)-1(b)(4)(ii). See Notice 2005-1.