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Forfeiture of Stock Awards (by the Book)

By Trudie D. Kanter, CPA, and Kevin F. Powers, CPA

Financial institutions long have offered stock-based compensation plans, and many are expanding those plans as share prices have risen and the overall stock market has improved. Such plans play a critical role in attracting and retaining quality employees, but they must comply with a variety of sometimes complicated rules, including the income tax accounting rules for stock award forfeitures.

Forfeitures and Book Compensation Expense

Forfeiture of a stock award occurs when the grantee of the award separates from service before the stock award vests (such as when the employee terminates employment prior to vesting) or when a performance condition is not met. Forfeiture could occur with restricted stock awards, nonstatutory stock options, or incentive stock options, among others.

An employer's book compensation expense reflects an expected forfeiture rate that is adjusted on a regular (for example, annual) basis to account for actual forfeitures. In effect, when forfeiture actually occurs, the prior book compensation expense that was recorded is reversed. Thus, from an income tax accounting perspective, the forfeiture generally doesn't give rise to an excess tax benefit or a tax deficiency (perhaps with one exception that is discussed later). The excess tax benefits pool (commonly referred to as the additional paid in capital (APIC) pool) isn't affected because, as the awards never vest, no tax deduction arises.

Accounting for Restricted Stock and Nonstatutory Stock Options

For restricted stock and nonstatutory stock options, a deferred tax asset is recorded during the period over which the stock awards vest. This deferred tax asset represents the future tax deduction expected either when the restricted stock vests or when the stock options are exercised subsequent to vesting. When restricted stock or nonstatutory stock options are forfeited, the deferred tax asset will be adjusted automatically as a function of adjustments to the book compensation expense, which will be reflected in the temporary component of the book-to-tax return adjustments.

An exception applies to restricted stock for which the employee made an election under Section 83(b) of the Internal Revenue Code. A Section 83(b) election effectively treats the stock as if there is no longer any risk of forfeiture for income tax purposes, and the employee is taxed based on the fair market value of the stock on the date of grant. This situation creates a tax deduction for the employer when the stock is granted as opposed to when it vests. However, the book compensation expense still is recorded over the applicable vesting period.

In such cases, the tax deduction is accelerated in relation to the book compensation expense, resulting in a deferred tax liability on the books. If the employee terminates employment prior to the end of the vesting period or a performance goal is not met, the stock is forfeited. However, the employer still is entitled to the tax return deduction it claimed when the employee made the Section 83(b) election, which results in an excess tax benefit being recorded for income tax accounting purposes.

Accounting for Incentive Stock Options

Incentive stock options are subject to an assumption that they will not create a tax return deduction for the employer, so any book compensation expense will be reflected as a nondeductible expense in the permanent component of the book-to-tax return adjustments. Any impact of forfeitures will be adjusted through book compensation expense and reflected in this permanent component.

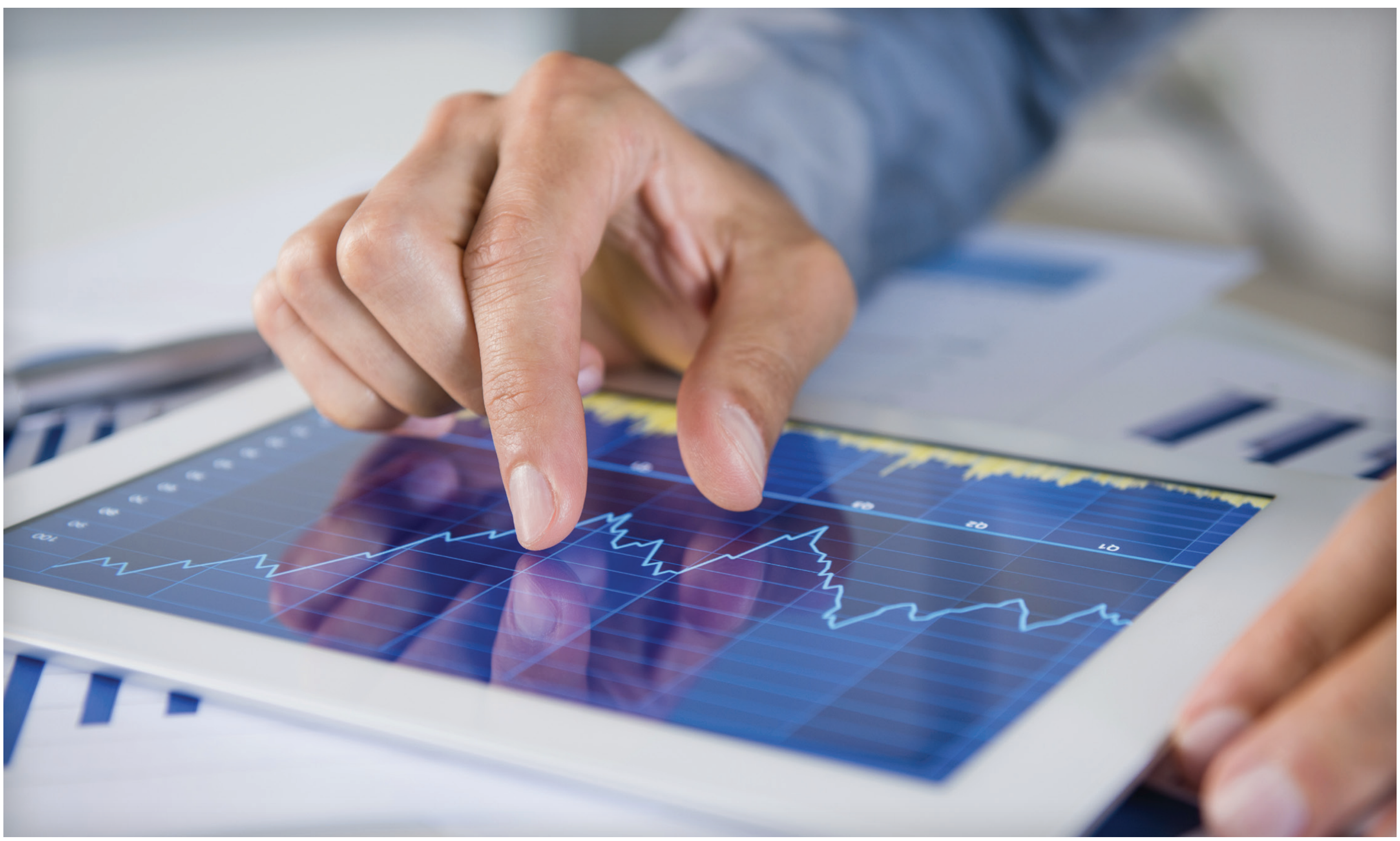
Separation of Service Without Forfeiture

It’s possible that forfeiture will not occur immediately upon an employee terminating employment. For example, an employee could resign but, under the applicable terms of a restricted stock award plan, have a 180-day window after the resignation in which stock could yet vest based on hitting a performance condition. In such circumstances, the deferred tax asset is reversed when the window expires – unless the performance condition is achieved and the stock vests – regardless of the likelihood of the performance condition being achieved during the 180-day window.

Stock Option Expirations

An expiration of a stock option is different from a forfeiture. With an expiration, the stock option generally already has vested but the employee either terminates employment after vesting or the period for which the option could be exercised has expired (for example, the option is "underwater," and thus the employee never exercises the option). As the award did vest, book compensation expense is not reversed for expirations.

With an expiration of a nonstatutory stock option, the "tax event" results in a zero tax deduction for the employer, producing a tax deficiency for income tax accounting purposes. An expiration of an incentive stock option has no impact for income tax accounting purposes, as a deferred tax asset never was established.



Contact Information

Trudie Kanter is with Crowe Horwath LLP in the Oak Brook, Ill., office. She can be reached at 630.586.5126 or trudie.kanter@crowehorwath.com.

Kevin Powers is a partner with Crowe in the Oak Brook office. He can be reached at 630.586.5140 or kevin.powers@crowehorwath.com.

Proceed With Caution

The income tax accounting for stock-based compensation awards can prove tricky. The key is that forfeitures generally don't result in a taxable event. Instead, the effects of the forfeitures essentially are reversed back through book compensation expense.

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