



# RSUs and Restricted Stock for Retirement-Eligible Employees -- Tax Surprises under Section 162(m)

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Many companies offer employees restricted stock and restricted stock units (RSUs). Grants typically vest and pay after three or more years of service. New IRS guidance throws a spotlight on the many tax issues raised when these shares vest early.

An often overlooked wrinkle is that the employee who attains retirement eligibility is typically entitled to a pro-rata piece of his grant if he terminates before the originally scheduled three-year payout date. The IRS position is that for tax purposes the retirement-eligible employee is **vested** in this pro rata piece at retirement eligibility whether or not the employee actually retires. See, e.g., TAM 199903032 (1/25/99). For retirement-eligible employees who continue to work, this early vesting date may have unpleasant consequences for purposes of FICA taxes, Section 83, and Section 409A. And now new IRS guidance under Code section 162(m) overturns the longstanding "performance based" exception for certain performance-based shares and RSUs that earn or vest on retirement eligibility and certain other events. PLR 200804004 (1/25/08).

**Section 162(m) New Guidance Overturns Old Rulings.** Some RSUs and restricted stock have performance-based earning or vesting criteria, so that shares are earned or vested only if the company meets certain financial targets. Such grants are treated by employers as "performance based compensation" for purposes of Section 162(m). For some of these grants, however, the performance targets have an override for retirement. If the employee terminates after reaching retirement eligibility, his shares or RSUs are **deemed** to have met the performance targets, and are earned or vested on a pro-rata basis. (Some grants have a similar override for involuntary terminations and voluntary/good-reason quits). Until now, employers have taken comfort



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from PLRs 200613012 and 199949014, in which the IRS held that the retirement (or involuntary termination) override did not disqualify a grant as performance-based. Now the IRS has reversed this position in PLR 2008404004 (January 25, 2008). The IRS's new position is that grants with a performance override for early retirement, or involuntary or voluntary/good-reason termination, are **not performance-based compensation** for purposes of section 162(m).

**FICA.** When a restricted stock or RSU grant vests because of retirement-eligibility, its value is includable in FICA-taxable wages. For an RSU grant, the participant may have earned only a pro-rata piece of the full 3-year grant when he first hits retirement eligibility; only this piece is immediately subject to FICA tax. But as he continues to perform services, any later-earned shares are vested and FICA-taxable in the year earned.

**Restricted Stock Income Tax.** Grants of restricted stock are taxed under Section 83 when they vest. This means that restricted stock is subject to income tax as well as FICA as soon as the employee hits the retirement-eligibility mark, whether or not he retires.

To the extent the stock is vested, any dividends paid must be treated as dividend income, rather than additional compensation. This means the employer may not claim a compensation deduction for dividends paid on the restricted stock held by a retirement-eligible employee. On the plus side, the employee may be entitled to the lower income tax rate on dividends.

**RSUs Section 409A.** RSUs with delayed vesting normally fall outside of Section 409A because of the "short-term" deferral exception. But RSUs that vest upon retirement eligibility and that are payable in a year after the vesting year are "deferred compensation" under Section 409A, and must meet the 409A payout rules.

It is acceptable to structure RSU payouts to begin at the earlier of retirement or a date certain after the end of the performance period. Many RSUs, however, also accelerate payout upon changes in control. Accelerated payout in this case is **not** permitted under Section 409A unless the RSU "change in control" trigger satisfies the Section 409A definition. Many RSUs have a broader "change in control" definition that would cause a Section 409A failure. An alternative way to satisfy section 409A is a "double trigger" payout provision, providing that the RSU vests upon a change in control, however broadly defined, but pays when the employee terminates thereafter.

Falling under Section 409A also means that any payment triggered by retirement or other termination must delay payment for six months if the payee is a "specified employee."

### Conclusion



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The IRS's new 162(m) guidance only adds a new issue to older ones that some employers may not have addressed in the case of RSUs and restricted stock whether or not performancebased.

Some employers have not focused on the FICA tax, Section 83, and other income tax consequences of early vesting for retirement-eligible employees who continue to work. As the IRS moves into 409A-enforcement mode, it is to be expected the IRS will scrutinize all executive compensation arrangements more closely for compliance with FICA and income tax laws. Employers should be looking at their RSUs and restricted stock plans now, to see if these commonly overlooked wrinkles are a problem needing fixing. In addition, employers with performance-based RSUs and shares may want to confirm that the shares meet the IRS's new conditions under section 162(m), or alternatively, consider whether they want to modify their return position.