

## Chapter 12

### Lecture Notes

- 1) Salary and Wages
  - a) Compensation paid to employees in the form of salary and wages has tax consequences to both employees and employers.
  - b) Employee considerations for salary and wages
    - i) Employees receiving salary generally earn a fixed amount of compensation for the year no matter how many hours they work.
    - ii) Salaried employees may be eligible for bonuses based on satisfying certain criteria.
    - iii) Employees receiving wages generally get paid by the hour.
    - iv) Salary, bonus, and wages are taxed to employees as ordinary income.
    - v) At the end of each year, employees receive a Form W-2 from their employers, summarizing their salary or wage compensation and the various withholding amounts during the year.
    - vi) Refer to Exhibit 12-1 for Form W-2.
    - vii) Form W-2
      - (1) Summarizes an employee's taxable salary and wages.
      - (2) Provides annual federal and state withholding information.
      - (3) Generated by employer on an annual basis.
    - viii) Tax withholding
      - (1) When employees begin employment with a firm, employees complete a Form W-4 to supply the information the firm needs to withhold the correct amount of tax from each paycheck.
      - (2) Employees use Form W-4 to indicate:
        - (a) Anticipated filing status,
        - (b) Whether the taxpayer has multiple jobs or a working spouse,
        - (c) The number of children qualifying for the child tax credit and other dependents, and
        - (d) Whether the employee has other adjustments (additional income or deductions) or wants extra withholding for each pay period.
  - c) Employer considerations for salary and wages
    - i) Deductibility of salary and wage payments
      - (1) Employers may generally deduct reasonable compensation paid to employees.
      - (2) Determining whether compensation is reasonable in amount is a facts and circumstances test that involves considering the duties of the employee, the complexities of the business, and the amount of salary compared with the income of the business, among other things.
      - (3) The amount of salary in excess of the amount considered reasonable is not deductible.
      - (4) Employers computing taxable income under the cash method of accounting generally deduct salary and wages when they pay the employee.
      - (5) Employers computing taxable income under the accrual method generally deduct wages payable to employees as the employees earn the wages.
        - (a) Compensation expense accrued at end of year is deductible in year accrued if:
          - (i) Paid to an unrelated party.
          - (ii) Paid within two and a half months of year-end.
        - (b) Compensation expense accrued at end of year is deductible when paid if:
          - (i) Paid to related party.
          - (ii) Related party if employee owns more than 50 percent of corporate employer.

- (6) Work through Example 12-1.
  - (a) The after-tax cost of providing this salary is generally much less than the before-tax cost, because the employer deducts the salary and associated FICA taxes paid.
  - (b) The formula for computing the after-tax cost of the salary:  $\text{Deductible expenditure} \times (1 - \text{Marginal tax rate})$ .
  - (c) Work through Example 12-3 on the timing of the compensation deduction.
  - (d) Work through Example 12-5. Limits on salary deductibility
    - (i) \$1,000,000 maximum annual compensation deduction per person.
    - (ii) Limited—applies to CEO, CFO, three other highest compensated officers, and all covered employees from prior years even after the employment relationship ends.
- 2) Equity-Based Compensation
  - a) Stock Options: Allows employees to purchase stock at a discount.
  - b) Restricted Stock: Form of compensation that provides actual stock ownership to employee after restrictions lapse.
  - c) It is used to motivate employees to take ownership in their companies.
  - d) Refer to Exhibit 12-2 for Excerpt from Adobe's Proxy Statement.
  - e) It helps in bringing cash flow benefits to employers as well.
  - f) Employers actually receive cash from their employees in the amount of the exercise price on the options exercised.
  - g) There are a couple of downsides to this benefit:
    - i) Employers experience the opportunity cost of selling shares at a discounted price to employees rather than selling the shares at fair market value on the open market.
    - ii) Because employers must issue new shares to satisfy option exercises and stock grants, the total number of shares outstanding increases, and therefore, earnings per share are diluted, which is a detriment to existing shareholders.
  - h) The only way for employers to mitigate this problem without increasing earnings is to use their cash reserves to acquire their own publicly traded shares to satisfy the options exercise.
  - i) Stock Options
    - i) Stock options differ from restricted stock in that employees must use cash to purchase employer stock once they are allowed to exercise the options, and there is a greater likelihood that options, which have expiration dates, will ultimately be worthless.
    - ii) When stock options vest, employees are legally entitled to buy or exercise employer stock at a stipulated price, referred to as the exercise price or strike price.
    - iii) The future value of stock option awards will depend on the exercise price, the company's future share price, the exercise date of the options, and the timing for selling the shares received from the option exercise.
  - iv) Work through Example 12-6.
  - v) Work through Example 12-7.
  - vi) Refer to Exhibit 12-3 for Sample Timeline for Nonqualified and Incentive Stock Options.
  - vii) Employee tax considerations for stock options
    - (1) The grant date is the date employees are initially allocated stock options.
    - (2) The exercise date is the date that employees purchase stock using their options.
    - (3) The exercise price is the amount paid to acquire shares with stock options.
    - (4) The bargain element is the difference between the fair market value of stock and the exercise price on the exercise date.
    - (5) The vesting date is the time when stock options granted can be exercised.
    - (6) Employees using NQOs to purchase employer stock are also in the same economic position as any other investor in that the value of the stock is subject to investment risk.
    - (7) To avoid overweighting their investment portfolios with a single stock, employees exercising nonqualified options often immediately sell all or a significant portion of the shares acquired on the exercise date, a practice referred to as a same-day sale.

- (8) Nonqualified stock options (NQO)
  - (a) NQOs are any options that don't meet the requirements for being classified as incentive stock options.
  - (b) Employees experience no tax consequences on the grant date or vesting date.
  - (c) When employees exercise nonqualified stock options, they report ordinary income equal to the total bargain element on the shares of stock acquired—whether they hold the shares or sell them immediately.
  - (d) A taxpayer's basis in NQOs acquired is the fair market value on the date of exercise.
  - (e) The holding period for stock acquired begins on the exercise date.
  - (f) When taxpayers exercise incentive stock options, the bargain element is added to their alternative minimum taxable income, which increases the likelihood that taxpayers exercising incentive stock options will be required to pay the alternative minimum tax—this is almost always true if the bargain element is large.
  - (g) Employees who purchase stock with NQOs and retain the stock are in the same position for tax purposes as any other investor, their basis in the stock is the fair market value on the date they exercised the options (this is the exercise price of the stock plus the bargain element), and any future appreciation or depreciation of the stock will be treated for tax purposes as either short-term or long-term capital gain or loss depending on the holding period, which begins on the date of exercise.
  - (h) Work Example 12-8.
- (9) Incentive stock options (ISO)
  - (a) ISOs satisfy certain tax code requirements to provide favorable tax treatment to employees.
  - (b) Employees experience no tax consequences on the grant date or vesting date.
  - (c) When they exercise ISOs, employees don't report any income for regular tax purposes (as long as they don't immediately sell their shares).
  - (d) The holding period for stock acquired begins on the exercise date.
  - (e) Work through Example 12-9.
    - (i) Employees who acquire shares through the exercise of ISOs also have an additional tax benefit: if they hold such shares for at least two years after the grant date and one year after the exercise date, they will not be taxed until they sell the stock.
    - (ii) When they sell, employees will treat the difference between the sale proceeds and the adjusted basis (the exercise price) as a long-term capital gain in the year of disposition.
  - (f) Work through the Example 12-10.
    - (i) If the two-year and one-year requirements are not met, the premature sale of stock is classified as a disqualifying disposition, and the bargain element is taxed at the time of sale as if the option had been a nonqualified option.
- (10) See the Stock Options (Taxes in the Real World) information about the Elon Musk exercise of Tesla Stock.

viii) Employer tax considerations for stock options

- (1) Nonqualified options (NQOs)
  - (a) No tax consequences on grant date.
  - (b) On exercise date, bargain element is treated as ordinary (compensation) income to employee. See Example 12-11.
    - (i) Employee holds stock with holding period beginning on date of exercise.
  - (c) Employers deduct bargain element as compensation expense on exercise date.
- (2) Incentive stock options (ISOs)
  - (a) No tax consequences on grant date.

- (b) No tax consequences on exercise date if employee holds for two years after grant date and one year after exercise date.
    - (i) If holding requirements are not met (if there is a disqualifying disposition), option becomes an NQO.
  - (c) When employee sells stock, employee recognizes long-term capital gain on difference between selling price and exercise price.
  - (d) No deduction for employers unless employee doesn't meet holding requirements
- (3) Accounting issues
  - (a) To increase the comparability of financial statements as well as to ensure that the true cost of stock options would be reflected in the financial statements, FASB mandated the expensing of stock options for financial accounting purposes for years beginning on or after January 1, 2006.
  - (b) Work through the Example 12-12.
- ix) Stock option expense: GAAP versus tax
  - (1) For tax purposes, employer deducts bargain element on exercise date.
  - (2) For GAAP purposes, employer expenses the estimated value of the option pro rata over the vesting period.
  - (3) Refer to Exhibit 12-4 for TPI's Tax Deductions and Book Expense from Stock Option Grant to Julie.
- j) Restricted Stock
  - i) Restricted stock can't be sold or otherwise treated as owned by employees until they legally have the right to sell the shares on the vesting date.
  - ii) Unlike the stock acquired through options exercises, employees receive restricted stock on the vesting date without having to pay for it, after which they can either sell it immediately or retain it.
  - iii) Refer to Exhibit 12-5 for Sample Timeline for Restricted Stock.
  - iv) Work through Example 12-13.
  - v) Employee tax considerations for restricted stock
    - (1) Restricted stock is taxed like nonqualified stock options with two important distinctions:
      - (a) While employees receiving NQOs are taxed at ordinary rates on the bargain element of the shares when they exercise their options,
      - (b) Employees receiving restricted stock are taxed on the full fair market value of the shares on the date the restricted stock vests.
    - (2) Work through Example 12-14.
    - (3) 83(b) election
      - (a) The tax laws allow employees who receive restricted stock to make a tax election that can significantly change the tax consequences by treating the stock nearly the same as vested stock.
      - (b) Work through the Example 12-15.
      - (c) Restricted stock without a section 83(b) election
        - (i) No tax consequences on grant date.
        - (ii) Employee recognizes ordinary income on value of stock on vesting date.
        - (iii) Holding period for stock begins on vesting date.
        - (iv) Employer deducts value of stock on vesting date.
      - (d) Restricted stock with a section 83(b) election
        - (i) On grant date, employee recognizes market value of stock as ordinary income.
        - (ii) Employee takes fair market value basis in stock.
        - (iii) Holding period for stock begins on grant date.
        - (iv) If employee never vests, no deduction for basis in stock.
        - (v) Employer deducts value of stock on grant date.

- (e) The 83(b) election is advisable when the potential for growth in the stock value is high and the amount of additional current tax is manageable.
    - (f) If an employee makes a section 83(b) election and then forfeits the stock for any reason, the employee cannot deduct the loss on the forfeiture.
    - (g) The risk of making the election is that if the stock value declines, the employee would have paid taxes on value that the employee never receives.
  - vi) Employer tax considerations for restricted stock
    - (1) The employer's deduction for restricted stock equals the amount of ordinary income reported by its employees.
    - (2) The timing of the deduction is determined by the employee's decisions regarding the 83(b) election.
    - (3) If the employee makes a section 83(b) election, the employer claims the deduction in the year the restricted stock is granted. Otherwise, the employer claims a deduction when the restrictions lapse.
    - (4) Refer to Exhibit 12-6 for Excerpt from Apple Inc.'s Proxy Statement.
    - (5) Work through Example 12-16.
    - (6) Give a brief overview of RSUs and Qualified Equity Grants (some instructors skip the latter).
  - k) Equity-Based Compensation Summary
    - i) Refer to Exhibit 12-7 for Reportable Income and Deductions from Equity-Based Compensation (for given time frame and stock prices).
- 3) Fringe Benefits
  - a) Taxable Fringe Benefits
    - i) Employees recognize compensation income on all benefits received unless specifically excluded by tax laws.
    - ii) Employee considerations for fringe benefits
      - (1) Employees treat benefits received like taxable cash compensation.
      - (2) Employees recognize ordinary compensation income when they receive taxable benefits and, just as they do with salary, pay FICA taxes on the value of the benefit.
      - (3) As a result, taxable fringe benefits cost employees the amount of tax they must pay on the benefits.
      - (4) Work through Example 12-17.
      - (5) Employees may prefer a taxable benefit to an equivalent amount of cash when they benefit from employer-provided quantity or group discounts associated with the benefit.
      - (6) To compute the annual taxable benefit, taxpayers use the following steps:
        - (a) Subtract \$50,000 from the death benefit of their employer-provided group-term life insurance policy.
        - (b) Divide the Step 1 result by \$1,000.
        - (c) Multiply the result from Step 2 by the cost per \$1,000 of protection for one month from the table based on the taxpayer's age.
        - (d) Multiply the outcome of Step 3 by the number of months the benefit was received during the taxable year.
      - (7) Refer to Exhibit 12-8 for Uniform Premiums for \$1,000 of Group-Term Life Insurance Protection.
      - (8) Work through Example 12-18.
      - (9) When corporations provide taxable fringe benefits to senior executives, they also provide the executives enough cash to cover the taxes so the benefit costs the executive nothing. This is commonly referred to as a gross-up.
    - iii) Employer considerations for taxable fringe benefits
      - (1) Employer deducts cost.
      - (2) Work through Example 12-29.

- (3) Refer to Exhibit 12-9 for Excerpt from Wal-Mart's Proxy Statement.
- b) Nontaxable Fringe Benefits
- i) Refer to Exhibit 12-10 for Common Forms of Nontaxable Fringe Benefits.
  - ii) Group-term life insurance
    - (1) Employees may exclude from income the employer-provided benefit for the first \$50,000 of group-term life insurance.
    - (2) Any remaining group-term life insurance benefit is taxable.
    - (3) An employer may not discriminate between employees in providing nontaxable group-term life insurance benefits.
  - iii) Health and accident insurance and benefits
    - (1) When employers pay for health and accident insurance for an employee and the employee's spouse and dependents, the employee excludes the benefit from her gross income.
    - (2) Employers may not discriminate between employees when providing health and accident insurance benefits.
  - iv) Meals and lodging for the convenience of the employer
    - (1) The value of certain meals and lodging the employer provides to an employee may be excluded from an employee's gross income if the benefit meets two criteria:
      - (a) The meals and lodging are provided on the employer's business premises to the employee (and the employee's spouse and dependents, if any), and
      - (b) The meals and lodging are provided for the convenience of the employer.
    - (2) Employers are allowed to deduct 50 percent of meals provided to employees for the convenience of the employer.
    - (3) The cost is not subject to the 50 percent deductibility limitation on meals.
    - (4) Employers may generally discriminate between employees for the convenience of the employer benefits.
    - (5) Work through Example 12-20.
    - (6) Employees may exclude the value of the lodging from gross income.
  - v) Employee educational assistance
    - (1) Employees can exclude from income up to \$5,250 of employee educational assistance benefits covering tuition, books, and fees.
    - (2) Amounts excluded from income cannot qualify for educational deductions or credits (such as the American opportunity tax credit and lifetime learning credit).
  - vi) Dependent care benefits
    - (1) Employees can exclude up to \$5,000 for benefits paid or reimbursed by employers for caring for children under age 13 or dependents or spouses who are physically or mentally unable to care for themselves.
  - vii) No-additional-cost services
    - (1) Employees can exclude the value of no-additional-cost services.
    - (2) These are any services employers provide to employees in the ordinary course of business that generate no substantial costs to the employer.
    - (3) Refer to Exhibit 12-11 for Flight Benefits.
    - (4) Work through Example 12-22.
  - viii) Qualified employee discounts
    - (1) Employers frequently allow employees to purchase their goods and services at a discount.
    - (2) Employees may exclude qualified employee discounts from income as long as they don't acquire goods at a discount greater than the average gross profit percentage for the employer's goods.
    - (3) This can be a fairly significant nontaxable benefit to employees, particularly for higher-priced products.
    - (4) Refer to Exhibit 12-11 for Excerpt from United Airline's Website.

- (5) Work through Example 12-21.
- ix) Working condition fringe benefits
  - (1) Employees may exclude from income any benefit or reimbursement of a benefit provided by an employer that would be deductible as an ordinary and necessary expense by the employee if the employee rather than the employer paid the expense (or the employer did not reimburse the employee).
  - (2) Additionally, telephones or computers provided to employees for business use may be excluded.
  - (3) Employers may discriminate between employees with respect to working condition fringe benefits.
  - (4) Work through Example 12-23.
- x) *De minimis* fringe benefits
  - (1) Employees can also exclude from income occasional or incidental *de minimis* fringe benefits (very small).
  - (2) These include occasional personal use of a copy machine, company-sponsored picnics, noncash traditional holiday gifts, and occasional tickets to sporting or theatrical events.
  - (3) Employers are allowed to discriminate between employees when providing *de minimis* fringe benefits.
- xi) Qualified transportation fringe benefits
  - (1) Employees may exclude from income the value of certain transportation benefits they receive from employers, whether employers pay for these benefits directly or reimburse employees for the transportation costs.
  - (2) These include the value of company-owned car pool vehicles for commuting to and from work, the cost of mass transit passes, and the cost of qualified parking near the work place.
  - (3) In 2025, the maximum exclusion for the car pool vehicle and mass transit pass is \$325 per month and the maximum exclusion for the qualified parking benefit is \$325 per month.
- xii) Cafeteria plans and flexible spending accounts
  - (1) Cafeteria plans
    - (a) Employers determine the total cost of benefits they are willing to provide for each employee.
    - (b) Each employee then either chooses (or buys) benefits up to the determined amount from a menu of nontaxable fringe benefits or may receive a cash equivalent in lieu of forgone benefits.
    - (c) Cash received from a cafeteria plan is taxable compensation to employees.
    - (d) Cafeteria plans are popular because each employee may desire different types of nontaxable fringe benefits.
    - (e) Through this plan, employees can select the benefits best suited to their needs.
  - (2) Flexible spending accounts (FSAs)
    - (a) It allows employees to set aside a portion of their before-tax salary for payment of either health and/or dependent-care benefits.
    - (b) These plans allow employees to set aside either employee contributions (on a before-tax basis) or employer contributions (a leftover cafeteria plan amount) to pay for medical-related expenses (such as co-payments and prescriptions) or dependent care.
    - (c) Taxpayers must use amounts placed in flexible spending accounts to pay for qualified benefits they expend funds on during the FSA plan year (which is often the calendar year), or they forfeit the remaining balance of the account.
    - (d) Employers may no longer allow employees to use the remaining balance from one year within the first two and a half months of the next FSA plan year.
- xiii) Employee and employer considerations for nontaxable fringe benefits

- (1) Nontaxable fringe benefits are very attractive to employees because their after-tax cost of these benefits is zero.
  - (2) They do not pay for the benefits and they are not taxed on the value of the benefits they receive.
  - (3) Employers deduct the cost of providing the benefits, which (thanks to group or quantity discounts) can be considerably lower than the cost to the employee of purchasing the benefit(s) separately.
- c) Tax Planning with Fringe Benefits
- i) The fact that employees can exclude nontaxable fringe benefits from gross income, while employers can deduct the cost of providing them (just as they deduct the cost of taxable fringe benefits), gives rise to compensation-related tax planning opportunities that may benefit both employee and employer.
  - ii) Work through Example 12-24.
  - iii) Work through Example 12-25.
  - iv) Work through Example 12-26.
- d) Fringe Benefits Summary
- i) Refer to Exhibit 12-12 for Excerpt from Disney Company's Proxy Statement Dealing with Fringe Benefits.
  - ii) Refer to Exhibit 12-13 for Summary of Julie's Nonsalary Benefits from TPI.