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DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, DC 20224

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The Honorable Jimmy Panetta
Member, U.S. House of Representatives
701 Ocean Street, Room 318-C
Santa Cruz, CA 95060

Attention:

Dear Representative Panetta:

I'm responding to your April 23, 2024, inquiry from your constituent, . He asked for clarification about inclusion in income for certain stock awards. He wants to know why his employer included the value of stock he describes as "unvested" in Box 5 of his 2023 Form W-2 following his resignation in 2023. His employer offered to continue vesting his stock (scheduled to vest between 2024 and 2027) if he signed a release waiving potential claims against his employer.

Generally, we can't provide binding legal advice to except through the private letter ruling process. In addition, we don't have enough information to determine the specifics of his awards and the resulting taxation thereof. However, we can provide general information we believe is relevant to his inquiry.

Timing of Income Taxation of Equity Compensation

stock award is a type of equity compensation. There are many different types of equity compensation. However, based on the language of the inquiry, we assume that his stock award is either a restricted stock award ("restricted stock") or restricted stock units ("RSUs"). In general, equity compensation such as restricted stock and RSUs are wages subject to federal income tax withholding.

Restricted stock is stock transferred to a service provider in connection with the performance of services. The stock is subject to taxation under Internal Revenue Code (IRC) Section 83. Generally, restricted stock is included in the gross income of the service provider in the first taxable year in which the stock is "substantially vested." Stock is substantially vested when it is transferable or is not subject to a substantial risk of forfeiture. Generally, under IRC Section 83 regulations, a substantial risk of forfeiture exists if continued employment through a certain date or event is required. A substantial risk of forfeiture also exists if there is a condition related to a purpose of the transfer and the possibility of forfeiture is substantial, an example of such a condition is the achievement of certain performance metrics. Whether or not restricted stock has vested (*i.e.*, is not subject to a substantial risk of forfeiture) for purposes of IRC Section 83 depends on all the facts and circumstances. Restricted stock subject to a vesting condition requiring continued employment through a certain date is generally treated as substantially vested when the requirement to perform substantial future services has lapsed. The value of restricted stock included in gross income is generally the fair market value of the stock at the time of vesting over any amount paid for the stock.

RSUs are a different type of award. An RSU is an unsecured and unfunded promise of the service recipient to either transfer one or more shares of stock to the service provider or pay the fair market value of the stock in cash. The service recipient will pay the service provider at a future date after the service provider meets a specified vesting condition. After the vesting condition is met, the RSU is "settled" either through the transfer of stock or the payment of cash. Generally, under IRC Section 83, the fair market value of the stock is included in the service provider's gross income in the year the transfer occurs. If the service recipient settles the RSU in cash, then the amount is included in gross income the year the cash is paid to the service provider.

Regardless of whether the award is restricted stock or an RSU, the amount included in gross income is reported in Box 1 of the employee's Form W-2.

Social Security and Medicare Taxation of Equity Compensation

In general, equity compensation such as restricted stock and RSUs are wages. They are subject to social security and Medicare (FICA) taxes, and, if applicable, the Additional Medicare Tax. Restricted stock is normally subject to FICA when it is no longer subject to a substantial risk of forfeiture and is includible in income under IRC Section 83. See Rev. Rul. 79-305, 1979-2 C.B. 350.

An RSU granted in one year and which will vest and become payable in a later year will generally be treated as nonqualified deferred compensation (NQDC) for FICA purposes. Under IRC Section 3121(v)(2), any amount deferred under a NQDC plan is considered as wages for FICA tax purposes as of the later of (1) when the services are performed, or (2) when there is no substantial risk of forfeiture of the rights to such amount. This is referred to as the special timing rule. The determination of whether a substantial risk of forfeiture exists is made in accordance with IRC Section 83.

Wages for social security tax purposes are reported in Box 3 of the Form W-2. This amount when combined with “Box 7 – Social security tips” shouldn’t exceed the social security wage base of $160,200 for tax year 2023. Wages for Medicare taxes are reported in Box 5 of the Form W-2. The wage base doesn’t apply to Medicare wages.

I only provided certain general principles of law within this letter. This explanation is intended for informational purposes only and does not constitute a ruling. See Rev. Proc. 2024-1, Section 2.04, 2024-1 I.R.B. 1 (January 2, 2024).

I hope this information is helpful. If you have any questions, you can contact me at or , general attorney, at .

Sincerely,

Rachel D. Leiser Levy
Associate Chief Counsel
Employee Benefits, Exempt Organizations,
and Employment Taxes