

Dividends and Dividend Equivalents

Restricted stock, which is issued at grant, is generally eligible for any dividend payments made to shareholders after its issuance (even those payments made before the stock has vested).

Restricted stock units are not eligible to receive dividend payments until they have been converted to stock (and distributed to employees). However, many companies provide payments on unvested restricted stock units that are equivalent to the dividends paid to shareholders; these payments are typically referred to as “dividend equivalents.” Units are designed to track the value of the company’s company stock; dividends paid to shareholders are part of that value, therefore, although units cannot receive actual dividends, it is reasonable (although not legally mandated) to provide an equivalent payment to unit holders.

Dividend Terminology

Illustration: Timeline of Dividend Payments



Below are four key dates to understand with respect to dividends paid by public companies:

- **Dividend Declared:** The company declares a dividend and announces it publicly, typically by issuing a press release and filing a Form 8-K with the SEC. The company will also set the record date for the dividend at this time.
- **Record Date:** This date typically occurs about two weeks after the dividend is declared. Only investors who own stock on the record date are entitled to the dividend.
- **Ex-Dividend Date:** Because open market transactions are subject to a two-day settlement period, when investors buy stock on the open market one day prior to the record date, their purchase transactions will not settle until after the record date. The ex-dividend date is always one trading day before the record date; investors who buy stock on the open market on or after the ex-dividend date will not be eligible for the dividend.

While it is helpful to understand what the ex-dividend date is, it is not generally relevant to dividends paid on awards.

- **Payable Date:** This is the date the dividend is paid to shareholders. It usually occurs about two weeks after the record date.

Types of Dividend and Equivalent Payments for Awards

For both restricted stock and units, dividends or dividend equivalents can be paid on either a current or a deferred basis and can be paid in cash or stock.

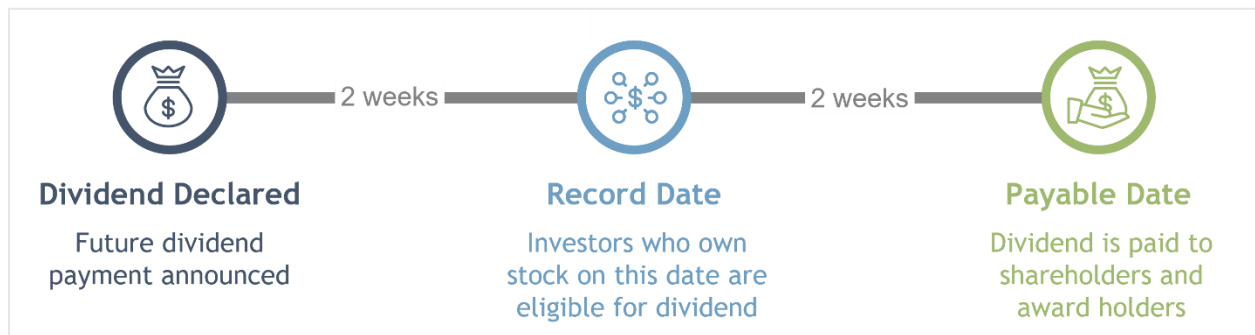
Current Basis

When dividends are paid on a current basis, award holders receive the dividend payment at the same time it is paid to shareholders (i.e., on the payable date).

When dividends/equivalents are paid on awards on a current basis, they are typically paid in cash (although companies can choose to pay them in stock, if desired).

For example, let's say that a company declares a dividend of \$.25 per share and an employee holds an unvested restricted stock award for 1,000 shares. The employee would receive a dividend payment of \$250 (less any required tax withholding). If paid on a current basis, the net dividend will be disbursed to the award holder on the dividend payable date (the same date that the dividend is disbursed to all other shareholders).

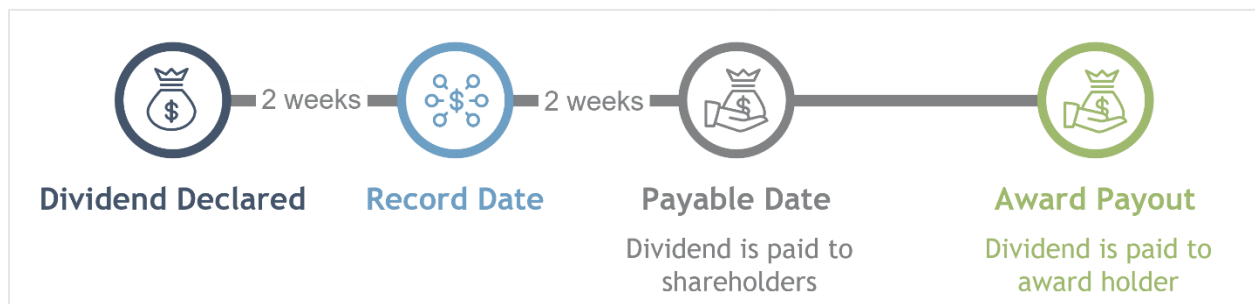
Illustration: Timeline of Dividends Paid on Awards on a Current Basis



Deferred Basis

When dividends are paid on a deferred basis, the dividend is accrued to the award on the record date, but award holders don't receive the dividend payment until the underlying award is paid out. In this case, the dividend payments are typically subject to the same vesting/forfeiture restrictions as the underlying award. This structure ensures that employees do not receive dividend payments until they have earned the award on which the dividends are paid.

Illustration: Timeline of Dividends Paid on Awards on a Deferred Basis



Dividends paid on a deferred basis can be accrued and paid in cash or stock/units; practices vary from company-to-company (data on current trends is discussed later in this article).

Example: Deferred Dividend Accrued in Cash

A US employee is granted an RSU that vests in full in three years (no portion of the award vests prior to the three-year anniversary of the grant). During the three-year vesting period, the company declares three dividends, each for \$.25 per share. As a result, when the award vests, the employee has accrued the right to \$750 in dividend payments (three payments of \$.25 per share each multiplied by 1,000 shares).

At the time the award is paid out, the employee will receive 1,000 shares and the \$750 in dividends accrued on the award. In most cases, the dividend payment is applied to the employee's tax withholding for the award. Thus, cash is only paid to the employee if the total amount of the accrued dividends exceeds the employee's tax withholding.

Note that some companies pay interest on accrued dividend amounts.

Example: Deferred Dividend Accrued in Stock/Units

Assume the same facts as in our previous example, but in this example the dividend will be accrued in the form of additional units, rather than a cash amount. Let's say that the FMV on each of the three dividend payable dates is \$30 per share, \$35 per share, and \$32 per share, respectively. The table below shows how many units will be accrued for each dividend.

	Dividend per Share		Units Subject to Dividend		Aggregate Dividend		Current FMV		Dividend Units Accrued
Dividend #1	\$.25	x	1,000	=	\$250	÷	\$30	=	8.3333
Dividend #2	\$.25	x	1,008.3333	=	\$252.0833	÷	\$35	=	7.2024
Dividend #3	\$.25	x	1,015.5357	=	\$253.8839	÷	\$32	=	7.9339

When the award is paid out, the employee will be entitled to a total of 1023.469587 units. Each individual dividend amount is typically accrued as a fractional amount. Over the life of the award, these fractions will combine to form whole units. Any remaining fraction left when the award is paid out is typically paid in cash (and applied to the employee's tax liability for the payout event).

In our example, we have assumed that each accrued dividend increases the number of units eligible to receive future dividends. This is the typical practice (and mimics broker-offered dividend reinvestment programs generally available to the public). In some cases, however, companies may choose to accrue dividends only on the underlying award (i.e., in our example, only on the 1,000 units initially granted).

Amounts in our example are rounded to four decimals due to space considerations. In practice, amounts can be carried out to additional decimals or may not need to be rounded at all. Practices are typically dictated by recordkeeping system limitations.

Tax Treatment of Dividend Payments

Dividends and dividend equivalents paid on restricted stock and units are subject to tax at the time they are paid out to the employee. Where the dividend is paid in cash, the employee recognizes income equal to the cash received; where a dividend is paid in stock, the employee recognizes income equal to value of the stock on the date it is subject to taxation.

Dividend payments on restricted stock are treated as compensation income, subject to all of the withholding described in the following section on "Employee Tax Withholding," and are reported on Form W-2 unless a Section 83(b) election was filed on the award. Where a Section 83(b) election was filed on the award, the payment is treated as dividend income, reported on Form 1099-DIV, and is not subject to withholding (note that there is some uncertainty as to whether this treatment applies when the dividends are not paid until the underlying award vests).

Dividend equivalents paid on restricted stock units are always treated as compensation income and will be subject to federal income tax when paid out to employees. In most cases, dividend equivalents are paid on a deferred basis and paid only when the underlying award is paid out. If so, the dividend equivalents are subject to federal income tax when they are paid out, along with the shares underlying the award. Where dividend equivalents are paid on a current basis, they are subject to federal income tax at that time.

The FICA/FUTA treatment of dividend equivalents paid on restricted stock units may depend on whether the underlying award has been taken into the employee's income for FICA/FUTA purposes. If the restricted stock unit award has not yet been subject to FICA/FUTA, i.e., is not yet vested or is subject to a substantial risk of forfeiture, the dividend equivalents accrued on the award are clearly subject to FICA/FUTA when they are no longer subject to a substantial risk of forfeiture.

The treatment of the dividend equivalents is less clear when the underlying award has already been subject to FICA/FUTA. Under §31.3121(v)(2)-(1)(a)(2)(iii), often referred to as the "non-duplication rule," once an award has been included in income for FICA/FUTA purposes, no further income attributable to the award is subject to FICA/FUTA. The term "income" most certainly includes any additional appreciation in the underlying shares; this rule is the reason why restricted stock units are subject to FICA/FUTA at vest only and not again when paid out. Most practitioners believe that dividend equivalents paid on the award are also covered under this rule as additional income attributable to the underlying stock (akin to dividends paid on common stock)—thus, dividend equivalents paid after a restricted stock unit award has been subject to FICA/FUTA (e.g., in a situation where a unit award is subject to deferred distribution, those dividend equivalents accrued after the award has vested but before it is paid out) would not be subject to FICA/FUTA.

Note, however, that the non-duplication rule doesn't specifically address dividend equivalents, which can be viewed as additional compensation (i.e., an additional award) rather than earnings on the underlying shares, since, technically, they aren't a dividend payment. Of particular concern is Chief Counsel Advice 201414018, issued in April 2014, which addresses a specific scenario in which the IRS staff determined that dividend equivalents paid on vested but deferred RSUs are treated as additional compensation and are subject to FICA when paid. The CCA addresses a situation in which a privately-held company pays dividend equivalents on restricted stock units that are subject to deferred payout. The dividend equivalents are paid out to award holders at the same time dividends are paid to shareholders, rather than with the underlying award. In addition, the underlying award is paid out solely in cash. The CCA thus distinguishes the dividend equivalents from earnings on publicly held stock that would be exempt from FICA taxation under the non-duplication rule. While this CCA should be considered when determining the FICA tax treatment of dividends paid on RSUs that have already been taken into income for FICA purposes, it is not clear that it applies to the more common situation where the dividend equivalents will be paid out with the underlying award. Readers should consult their tax advisors on this matter.

Global Considerations

Dividends and equivalents paid on awards held by employees outside the United States will be subject to tax based on the laws of the applicable jurisdiction. Consequently, the tax status may differ from that of the treatment in the United States.

In some jurisdictions, dividends paid on restricted stock may qualify for preferable tax rates that aren't available for dividend equivalents paid on RSUs.

In some jurisdictions, paying dividends on a current basis (i.e., before the award has vested) could change the tax treatment that applies to the underlying award because the employee will have realized a benefit on the award.

Finally, entitlement rights and other legal considerations may also apply to dividend and equivalent payments.

A full discussion of all the global considerations is beyond the scope of this article. Companies paying dividends or equivalents on awards issued to non-US employees should review the treatment of the payments with their global stock plan advisors.

Accounting for Dividend Payments

Under ASC 718, dividends and dividend equivalents paid on restricted stock and units are charged to retained earnings. This applies regardless of whether the dividends are paid on a current basis (i.e., at the same time the dividend is paid to other shareholders) or on a deferred basis (i.e., not until the underlying award is paid out). It also applies whether the dividends are paid in cash or stock and whether they are paid on restricted stock or restricted stock units.

When the award is granted, the fair market value of the underlying stock already includes the value of the future dividend payments (i.e., when investors are buying and selling the stock, the prices they agree on should take into account the future dividend stream that the buyer will be entitled to and that the seller is giving up). Since the expense the company recognizes is based on this fair market value, when the dividends are actually paid there is no need for the company to recognize any further expense.

As mentioned earlier, for restricted stock arrangements that are not entitled to dividends before vesting but where the company does pay dividends on the underlying stock, the fair value of the award is reduced by the present value of the dividends that will be paid over the vesting period of the award. For example, assume that restricted stock units are granted when the fair market value is \$40 per share and that the present value of the dividends the company expects to pay over the vesting period of the award is \$2 per share. If the company pays dividend equivalents on the unvested restricted stock units, the fair value of the unit award is \$40 per share (the fair market value on the date the award is granted). If the company does not pay dividend equivalents on the unvested units, the fair value of the award is reduced by the present value of the future dividend stream, to \$38 per share.

Note, however, that where dividends are paid on awards that are ultimately forfeited, the company will recognize compensation expense for the dividends. In this situation, because of the forfeiture, the company won't recognize any expense for the award itself. But the employee has received some compensation in the form of the dividend payment; that compensation should be recognized as an expense. Another way to think of it is that the original award encompassed both the underlying shares and the future dividend stream that would be paid on them; both of these components contributed to the award's fair value. Now that the underlying shares have been forfeited but the employee retains the dividend payments, the company still has to recognize expense for the portion of the award that

wasn't forfeited, i.e., the dividend payments. Thus, the portion of the award's fair value that is attributable to the dividends is recognized as compensation expense.

This scenario is much more likely to occur with dividends that are paid on a current basis. For example, assume that on January 1, 2018, a company grants a restricted stock award that cliff vests in four years. The company pays a dividend to the grantee in 2019, and then the grantee terminates in 2020, forfeiting the award. In 2019, when the dividend is paid, it is charged to retained earnings. But in 2020, when the award is forfeited, unless the company forces the employee to pay back the dividend (highly unlikely), the company will recognize compensation expense equal to the amount of the dividend.

Where the company applies an estimated forfeiture rate to expense recorded for awards under ASC 718, the company would have to estimate forfeitures up front and record expense for dividend payments based on the estimate, truing up for actual outcome. Or rather, the "haircut" that the company applies to its overall expense for estimated forfeitures is reduced by the amount of the dividends that are expected to be paid out on awards that ultimately will be forfeited.

This is less likely to be a concern with dividends that are paid on a deferred basis because they are typically subject to forfeiture if the vesting conditions of the underlying award are not met.

Where performance-based awards are eligible for dividends prior to vesting, the dividend payments should be subject to the same performance conditions as the underlying award. If any portion of a performance award is forfeited and the dividends accrued on the award are not commensurately adjusted for the forfeiture, this results in a situation in which dividends have been paid on an award that was forfeited, causing the company to recognize expense for the dividends as described above.

For example, say that a company accrues a dividend of \$.10 a share on an award with a target payout of 1,000 shares. The company accrues the dividend on the target amount of the award, resulting in an accrued dividend of \$100. At the end of the performance cycle, performance level achieved is sufficient to secure a payout of only 80% of the target, or 800 shares, resulting in a forfeiture of 20% of the award. This should also result in a forfeiture of \$20 of the \$100 dividend (20% of the dividend). If the dividend is paid out at \$100, despite the forfeiture of 20% of the award, the company will have to recognize \$20 of compensation expense for the dividend.

In addition to the expense considerations, where dividends are paid on unvested awards and the dividends are not subject to forfeiture, the company is required to use the two-class method when reporting earnings per share. The two-class method is typically used by companies with multiple classes of common stock or with other securities that participate in dividends paid to common stockholders. The method uses a formula to allocate earnings (the numerator of the EPS equation) to each security. Thus, separate EPS calculations would be required for the company's unvested awards vs. the rest of its common stock. A full discussion of the two-class method of reporting EPS is beyond the scope of this article.

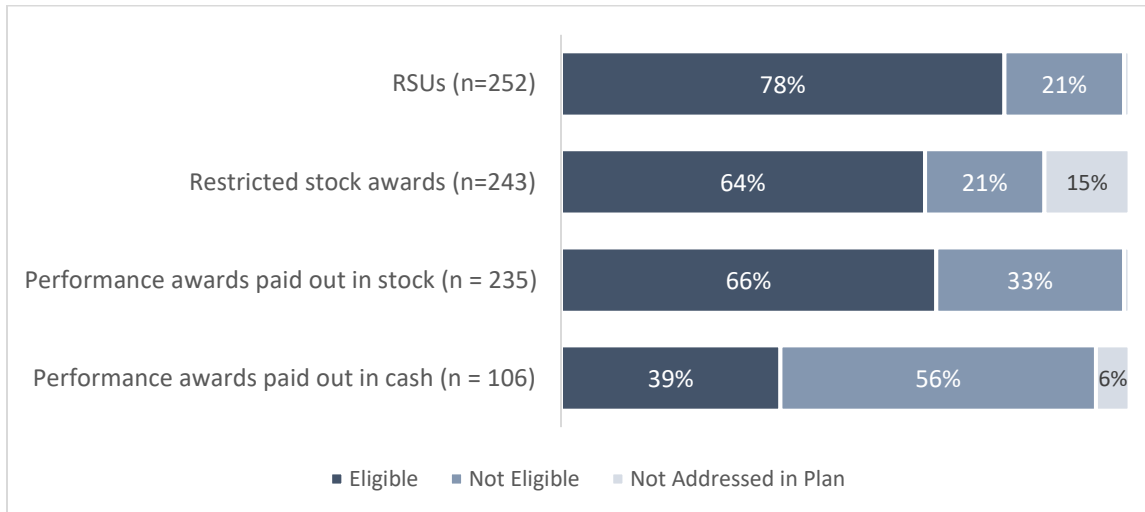
Accounting for Tax Effects of Dividend Payments

Where employees receive dividends on unvested restricted stock arrangements that are not subject to a Section 83(b) election, as mentioned earlier, the dividend is treated as compensation income. Consequently, the company recognizes a tax deduction equal to the amount of income reported for the dividend; the tax savings attributable to this deduction are recorded to tax expense.

Trends in the Payment of Dividends/Equivalents on Awards

It is common to pay dividends on service-based equity awards. Companies are less likely to pay dividends on performance-based awards, particularly awards that will be settled in cash.

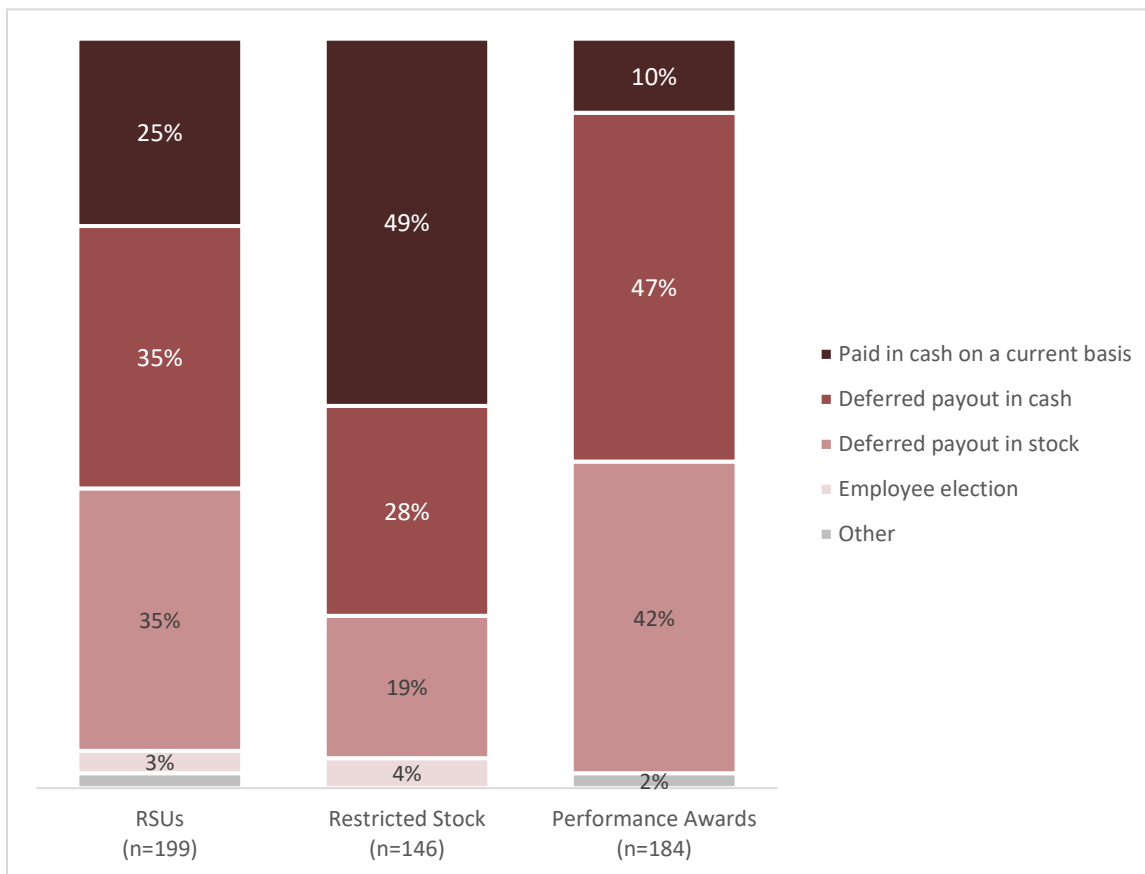
Are Awards Eligible for Dividend/Equivalent Payments?



Where dividends are paid on service-based RSUs and performance awards, the most common practice is to pay the dividends on a deferred basis (i.e., the dividend is paid out with the underlying award). In the case of restricted stock, companies are split between paying the dividends on a current basis or a deferred basis.

Where dividends are paid on a deferred basis, companies are generally split between paying the dividends in cash and reinvesting them in additional stock or units.

How are dividends/equivalents paid on awards?

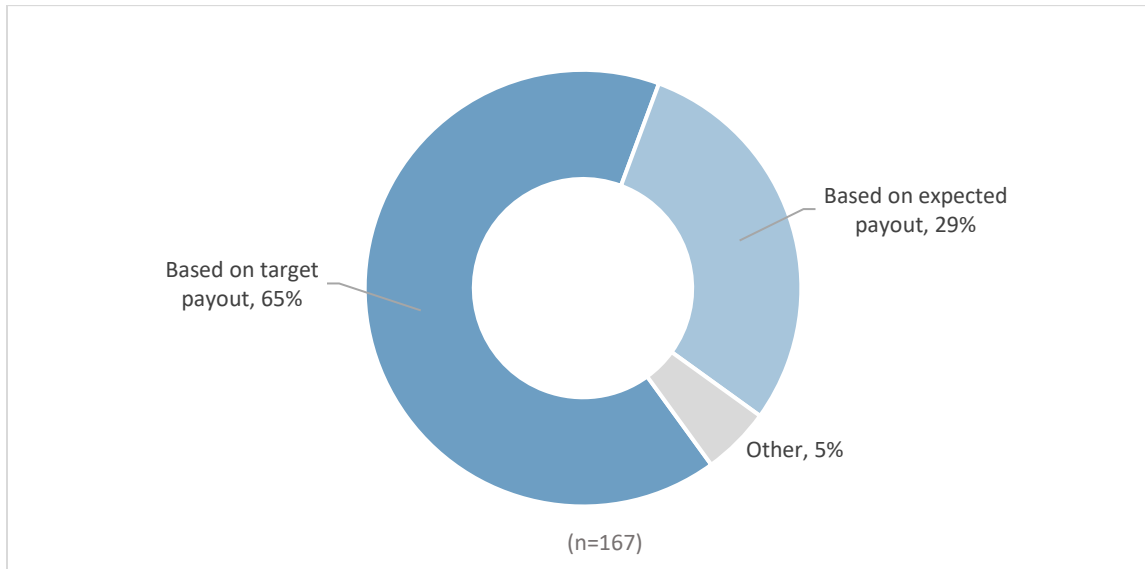


When dividends are paid performance awards, companies are faced with the question of determining how many units or shares to accrue the dividend on. For example, say that an award offers a payout range of 1,000 to 2,000 shares, with a target payout of 1,500 shares—should the dividend be accrued on 1,000 shares, 1,500 shares, 2,000 shares or some number in between? Two-thirds of companies choose to accrue dividends on the target payout under the award (in our example, 1,500 shares).

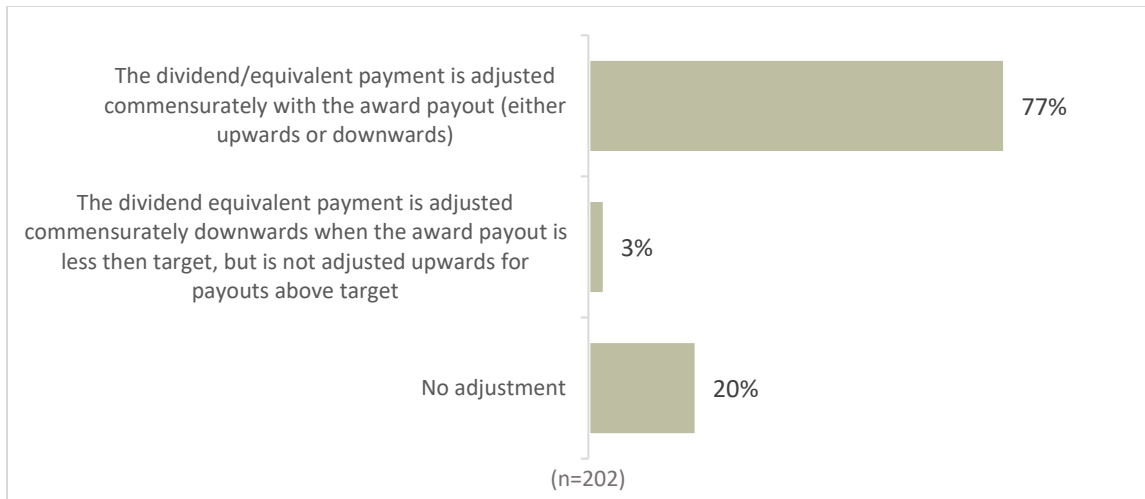
Companies also must decide whether to adjust the dividends they are ultimately paid out under the award for the performance level achieved under the award. Just over two-thirds of companies adjust the dividends to align with the portion of the award that is paid out. This adjustment could increase or decrease the amount of dividend paid out.

Note that failure to reduce dividend payments commensurately with the performance achieved under the award can increase the compensation expense recognized for the award.

For performance awards, how is the amount of the dividend equivalent calculated at the time the dividend is accrued?



If dividends equivalents are paid out when the underlying performance award is paid out, is the dividend/equivalent amount adjusted based on the award payout?



All data reported is from the NASPP/Deloitte Consulting 2019 Domestic Stock Plan Design Survey.