Restricted Stock & Restricted Stock Units

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Restricted stock grant v. stock options

- Often has been part of senior executives’ comp. with options.
- Popularity with institutional investors runs in cycles: “Pay for pulse.”
- Historically most useful in employee recruitment/retention when leaving behind valuable options or when stock price flat.
- Big increases in grants at levels below senior management, although not as broadly granted as options.
- Now the top alternative to stock options, whether granted instead of or in combination with options.
- Accounting treatment becomes similar between types of equity compensation: “level playing field.”
- Less dilution than with options because fewer granted.
- Value in down and volatile markets: never underwater, gets dividends, but less upside compared with options.
Bill Gates on the move from options to restricted stock at Microsoft: less risk for you than stock options

- “When you win [with options], you win the lottery. And when you don't win, you still want it. The fact is that the variation in the value of an option is just too great.”

- “I can imagine an employee going home at night and considering two wildly different possibilities with his compensation program. Either he can buy six summer homes or no summer homes. Either he can send his kids to college 50 times, or no times.”

- “The variation is huge; much greater than most employees have an appetite for. And so as soon as they saw that options could go both ways, we proposed an economic equivalent. So what we do now is give shares, not options.”
What’s the restriction?

- Confused with restricted securities (i.e. unregistered stock), performance shares, or outright grants. Better term is “unvested stock grants” or “full value shares.”
- Restricted because you cannot sell stock until it has vested. Not yet fully “owned” in the traditional sense.
- Vested: when sale restrictions lapse.
- Lapse: no longer subject to “substantial risk of forfeiture.”
- Private companies: presentation not on early-exercise, pre-IPO options in which you get restricted stock at exercise. (See the section Pre-IPO: Early Exercise Options by myStockOptions.com.)
Vesting: key concept

- No money paid to company (no exercise). Not exercising to own stock, as with options (unless pre-IPO early-exercise options/paying money).
- Unfettered ownership at vesting like any stock you own. Taxes triggered when shares vest.
- Time-based most popular. Not eligible for performance-based exception under rules that limit deduction for compensation over $1 million [Section 162(m)].
- Performance targets: can trigger or accelerate vesting, and performance goal must be related to company.
- Termination: forfeit unvested shares.
Free e-learning quizzes on restricted stock/RSUs
Grant size: tradeoffs

Full value of shares at vesting (not spread since grant), so fewer shares than in an option grant. The volatility of your company's stock and any dividend affect the value of restricted stock in comparison with stock options. Observations by consultants about the tradeoff ratios:

<table>
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<tr>
<th>Type of company</th>
<th>Ratio</th>
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<tr>
<td>High volatility / no dividends (e.g., technology)</td>
<td>1 restricted share for 3 or 4 option shares</td>
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<tr>
<td>Moderate volatility / moderate dividend yield</td>
<td>1 restricted share for 4 or 5 option shares</td>
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<tr>
<td>Low volatility / high dividend yield</td>
<td>1 restricted share for 6 or 7 option shares</td>
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Tax treatment different from that of options: two alternatives

**Standard: Pay Tax At Vesting**
- Taxed as ordinary income at vesting when forfeiture risk removed (with options not taxed at vest).
- Taxable income is the value of the stock when each slice vests. Stock price at grant does not matter unless second tax treatment alternative.
- If you sell the stock, you have capital gains or losses as with the sale of any shares.
- Tax basis is the amount you included in income as compensation.
- Capital gains holding period begins at the time of vesting.
Example: let shares vest

4,000 shares of restricted stock that vest at a rate of 25% a year; grant market price at $18.

- **year one:** $20 (1,000 \times $20 = $20,000 of ordinary income)
- **year two:** $25 ($25,000)
- **year three:** $30 ($30,000)
- **year four:** $33 ($33,000)
- **total:** $108,000

- Each increment is taxable on its vesting date.
- Sell all the stock two years after the last shares vest, when the price is $50 ($200,000 for the 4,000 shares).
- Capital gain is $92,000 ($200,000 minus $108,000).
Second tax treatment: 83(b) elections

- Make a Section 83(b) election with the IRS within 30 days of the grant. Not available for RSUs.
- No special tax form for a Section 83(b) election.
- You send the local IRS office your election with information that identifies you and the property you include in your income. Still attach a copy of the election when you file your return.
- Pay taxes on the value of all the stock at grant.
- Remember: you cannot sell any shares until they vest.
- Almost impossible to rescind election.
- Advantage: tax for compensation income will (hopefully) be lower and start capital gains holding period.
Example with 83(b) election

Same facts of the previous example for appreciating stock.
You make a timely 83(b) election at grant:

- Compensation income of $72,000 (4,000 x $18).
- Capital gain of $128,000 at sale ($200,000 minus $72,000).
- Election allowed you to convert $36,000 of ordinary income to the lower-taxed capital gains ($128,000 = $92,000 of capital gain in the prior example plus $36,000 that was ordinary income without the 83(b) election).
Risk with election

- You left the company: restricted stock never vested.

- You cannot rescind your election or recover the taxes you paid.

- Stock price dropped by vesting: you cannot recover taxes paid with 83(b) election.

- You might be better off with using the tax dollars to buy stock on open market. Need to run the numbers with your advisor.
Restricted Stock: Section 83(b)

Decisions At Grant With Restricted Stock (Part 2): The 83(b) Election Risks

Tom Davison

In Part 1, we examined the basic facts of restricted stock and the decisions you need to make at grant. One of the biggest decisions is the choice to be taxed at grant or at vesting. You can choose to be taxed at grant with a Section 83(b) election (this choice is unavailable with RSU grants). This article explains the risks of the election.

Decision Alternatives At Grant

You have three alternatives when the grant is made:

1. Make an 83(b) election for all or part of the grant, paying taxes up front.
2. Take the up-front cash that you would otherwise use to pay the taxes and invest in a diversified portfolio.
3. Take the up-front cash that you would otherwise use to pay the taxes and invest in more shares of your company stock.

Risks Of The 83(b) Election

Can I make a Section 83(b) election for a grant of restricted stock units (RSUs)?

Most experts say that you cannot...

Can I make a Section 83(b) election for just part of my restricted stock grant?

Yes, according to most experts. There is nothing in Section 83 of the Internal Revenue Code that states or implies that a grant of restricted stock is a single piece of property...

Is a Section 83(b) election that taxes you on the value at grant of restricted stock ever revocable or rescinded?

The Section 83(b) election is irrevocable unless you show a mistake of fact...

More Related FAQs

Related Articles

Decisions At Grant With Restricted Stock (Part 3): Analyze Your Alternatives
Withholding taxes on restricted stock

- Subject to tax withholding at vesting or 83(b) filing.
- Compensation income similar to NQSO treatment on spread at exercise. Familiar W-2 reporting.
- Amount is withheld from salary, cash payment made, or sell-to-cover taxes, or the company may allow (or require) share withholding.
- Company needs to have the cash to use automatic share withholding/surrender, as no shares sold to generate funds need to pay IRS.
- With share withholding/surrender, employees may have additional reporting for securities sale on Schedule D of tax return. At the least, do not withhold shares in Schedule D reporting when remaining shares sold (see FAQ in the Tax Center on myStockOptions.com).
Withholding taxes on restricted stock

- Clear dates where actions and transactions will be occurring. Company needs to make decisions on: communications about 83(b) election at grant; withholding/lapse election process at vesting; timing for notifications on choices for withholding; what to do if no election made; elections on what to do with stock and cash

- Senior executives and directors Form 4 filing if share withholding at vesting even though no shares are “sold” into market. Normally file form 4 with grant and then with stock sale, not at vesting.

- Companies considering Rule 10b5-1 trading plans to cover share withholding.

- **ALERT:** Companies can no longer lend senior executives or directors the necessary funds for tax withholding or for buying restricted stock.
Restricted stock accounting

- Earnings charge fixed according to grant date value spread out over vesting/restriction lapse dates, unless 83(b) election made. No use of option valuation models.
- Timing for tax deduction and earnings charge match taxable compensation to employee when yearly vesting.
- More complex areas: estimates on forfeitures; deferred tax accounting; performance-vesting provisions (e.g., shares that may never vest).
Accounting example

4,000 shares of restricted stock vest at 25% a year (1,000 shares yearly); grant market price at $18 and no 83(b) election.

- year one: stock price $20 (1,000 x $18 = $18,000 earning charge and $20,000 tax deduction)
- year two: $25 ($18,000 charge, $25,000 deduction)
- year three: $30 ($18,000 charge, $30,000 deduction)
- year four: $33 ($18,000 charge, $33,000 deduction)
- 83(b) election to be taxed at grant: $72,000 earnings charge and tax deduction
Dividends on restricted stock

- Dividends on unvested shares are compensation income reported on W-2. They are not “qualified dividends,” which are taxed at lower rates until vested.

- Dividends on 83(b) election are reported on 1099-DIV.

- Approximately 10% pay dividends in more shares, although not received until underlying shares vest.
Restricted stock units: used by Amazon, Microsoft, and GE

- Stock itself is not issued or outstanding until the actual release of the shares at vesting.
- Holders of RSUs have no voting rights.
- Dividends (i.e., equivalents) not required as RSU-holders are not shareholders. May be dividend equivalents based on the plan details.
- Microsoft does not pay dividends on RSUs. Made adjustments with large dividend payment. General Electric does pay dividends.
Restricted stock units: used by Amazon, Microsoft, and GE

- Share delivery occurs at vesting in broad-based plans, with share withholding for the taxes.
- Specialized RSU plans have a deferral feature that lets you select a date for share delivery, or one is specified by the company (e.g., retirement). Ordinary income tax, delayed until delivery of shares.
- With these deferral elections, you must follow all the guidance on timing and the procedures under Section 409A (on deferred compensation) of the American Jobs Creation Act.
- Social Security and Medicare at vesting with deferrals.
Why use RSUs instead of restricted stock for grants?

- Eliminates 83(b) election. No administrative burdens for company and employee risks.
- Can avoid paying cash dividends during the vesting period.
- Avoids tax at grant in countries where tax not delayed until vesting.
- RSUs do not avoid the administrative issues for withholding taxes at vesting.
- Specialized RSU plans defer delivery of the shares (not at vesting) until date specified by executives or termination of employment.
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