Restricted Stock: Basics

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Why You'll Learn To Like Restricted Stock Grants

Richard Friedman

Your company is no longer granting you stock options, or at least fewer than before. Instead, you're receiving restricted stock (or restricted stock units, commonly called RSUs). While these grants don't give you the same potentially life-altering, wealth-building upside as stock options, they have benefits you will grow to appreciate.

Less Risk And Clearer Value

The value of stock options depends on how much (or whether) your company's stock price rises above the price on the grant date. By contrast, restricted stock has value at vesting even if the stock price has not moved since grant (or even if it has dropped).

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Depending on your attitude toward risk and your experience with swings in your company's stock price, the certainty that restricted stock will have value can be an attractive advantage over stock options, which have great upside potential but can be "underwater" (i.e., having a market price lower than the exercise price). This is why restricted stock is often granted to a newly hired executive either as a hiring bonus or to make up for compensation and benefits, including in-the-money options and nonqualified retirement benefits, forfeited by leaving a
prior employer.

You also may find it easier to appreciate a restricted stock grant because its monetary value in your pocket (i.e., your company’s stock price) is easier to figure out than a stock option's value, which is theoretical. A stock option grant involves more shares than a comparable restricted stock grant (an FAQ on this website discusses typical share ratios of restricted stock grants to comparable option grants). However, stock options may never be worth anything: in the worst case, they may be underwater after vesting and for the remainder of the option term.

Of course, the very essence of restricted stock is that you must remain employed until it vests to receive its value. While you may have between 30 and 90 days to exercise stock options after voluntary termination, unvested grants of restricted stock are often forfeited immediately. Thus, it is an extremely effective golden handcuff to keep you at your company.

**Fewer Decisions**

Unlike a stock option, which requires you to decide when to exercise and what exercise method to use, restricted stock involves fewer and simpler decisions. At vesting, when you receive the shares, you may have a choice of tax-withholding methods (e.g., cash, sell shares for taxes), or your company may automatically withhold enough vested shares to cover the tax withholding (see the detailed FAQ on methods of withholding). Restricted stock is considered "supplemental" wages, following the same tax rules that apply to grants of nonqualified stock options.

**Lower Your Potential Tax**

The most meaningful decision with restricted stock grants is whether to make a Section 83(b) election to be taxed on the value of the shares (i.e., “property”) at grant instead of at vesting. Whether to make this election, named after the section of the Internal Revenue Code that authorizes it, is up to...
you. (It is not available for RSUs, which are not “property” within the meaning of Internal Revenue Code Section 83. See the FAQ on the main differences between restricted stock and RSUs.)

If a valid 83(b) election is made within 30 days from the date of grant, you report ordinary income based on the value of the stock at grant rather than at vesting. As a result, any appreciation in the stock price above the grant date is taxed at capital gains rates when you sell the stock after vesting.

While this can appear to provide an advantage, you face significant disadvantages should the stock never vest and you forfeit it because of job loss or other reasons (see a related article on the risks of the 83(b) election). You cannot recover the taxes you paid on the forfeited stock. For this reason, and the earlier payment date of required taxes on the grant date value, you usually do better by not making the election. However, this election does provide one of the few opportunities for compensation to be taxed at capital gains rates.

**Dividends**

Unlike stock options, which rarely carry dividend equivalent rights, restricted stock typically entitles you to receive dividends when they are paid to shareholders. With RSUs, your company decides whether to pay dividend equivalents.

Unlike actual dividends, the dividends on restricted stock are reported on your W-2 as wages (unless you made a Section 83 (b) election at grant) and are not eligible for the lower tax rate on qualified dividends until after vesting. (A related FAQ gives details on the tax treatment of dividends.)

**Financial Planning**
When you receive restricted stock in place of some or all of the stock options that were granted in prior years, you should adjust your financial and tax planning. While both awards provide an exposure to the value of company stock, they do so in different amounts and in different ways. Moreover, because options give you greater leverage, they carry more risk too. Executives, especially those who are close to retirement, may need to change their stock option exercise strategy for outstanding awards. For details, see another article.

**Estate Planning**

In most cases, death either fully accelerates vesting or triggers *pro rata* acceleration, depending on length of service through the date of death. In some cases, your company has the discretion to vest all or just a portion of the award. Many plans or grant agreements allow you to designate a beneficiary who would be entitled to receive the shares upon your death. Otherwise, the shares would pass through the decedent's estate.

The value of restricted stock shares at death may be clearer than the value of stock option shares. The IRS requires the use of a valuation formula, such as Black-Scholes, to estimate the value of the options at the date of the optionholder's death. (See the section Life Events: Death Taxes.)

**Stock Ownership Requirements**

A majority of large companies now have stock ownership guidelines for key executives. Typically, only your vested restricted stock counts toward ownership requirements, though unvested restricted stock can count as well (unexercised stock options are rarely counted). Check your program for details.

**Tax Deferral**

If you are an executive, some RSU plans will let you defer taxation from vesting to a date you choose to receive the shares on (see the detailed FAQ on deferred delivery of shares with restricted stock units). You're then taxed on the value of the shares at that point. These plans are considered deferred
compensation, so to avoid penalties you and your company must comply with the deferred compensation rules of the American Jobs Creation Act.

Securities Law

Senior executives and directors need to make Section 16 filings (Form 4 and/or Form 5) with restricted stock. You may also want to consider setting up a Rule 10b5-1 trading plan to cover the shares you plan to sell at vesting. Rules that the SEC proposed in January 2006 on enhanced disclosure of executive compensation require more detailed proxy reporting for restricted stock and RSU grants than prior regulations.

Future

Restricted stock is no longer maligned as merely "pay for a pulse," particularly as companies add performance features that trigger grant or vesting. Although experts predict that stock options will continue as the primary long-term incentive award to attract, motivate, and retain key employees and executives, the role of restricted stock is growing. Surveys show that it is the primary replacement for stock options. Appreciating its benefits and understanding the details of related tax and financial planning will help you maximize its value.

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