Restricted stock: the tax impact on employers and employees

G. Edgar Adkins, Jr., and Jeffrey A. Martin
Restricted stock is growing in popularity as a method to compensate employees, primarily as a result of changes in generally accepted accounting principles (GAAP) that went into effect in 2006.

An important aspect of this compensation tool is the income tax treatment, from both a corporate (i.e., employer) and individual (i.e., employee) perspective. The discussion below addresses not only the direct tax treatment — i.e., the recognition of income by the employee and the deduction by the employer — but also related tax issues.

These include the effect of restricted stock on the $1 million deduction limit that applies to public companies under Section 162(m) and the treatment of restricted stock in determining eligibility for S corporation status.
Overview

“Restricted stock” refers to stock that is transferred to an employee as compensation for services, subject to a vesting schedule. The employee usually is not required to pay for the stock. If the employee does not remain with the employer until the end of the vesting period, the stock must be returned to the employer. If the employee has paid any amount for the restricted stock but then fails to become vested, the employer usually refunds the purchase price to the employee.

“Restricted stock” sometimes is used interchangeably with “restricted stock unit.” While similar, there is one major difference. With restricted stock, the stock itself is transferred to the employee, subject to a vesting schedule (as noted above). With restricted stock units, the stock is not transferred to the employee until the stock becomes vested. Thus, a restricted stock unit is a promise from the employer to transfer the stock on the vesting date. The tax treatment of restricted stock and restricted stock units, discussed below, is the same except where differences are specifically noted.

Until a change in accounting standards that went into effect in 2006, employers were permitted to use Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees (1972) (APB 25), to measure compensation cost reported in their income statements. APB 25 used the intrinsic value method to measure compensation cost associated with stock issued to employees. Stock options were particularly popular under APB 25, because the intrinsic value of most options was zero, resulting in no compensation cost recognized on the income statement. The following formula was used to measure the intrinsic value of stock options:

\[
\text{Intrinsic value of the option} = \frac{\text{Fair market value of the stock on the date the option was granted}}{\text{Exercise price of the option}} - 1
\]

Most employers issued options that had an exercise price equal to the fair market value (FMV) of the stock on the option’s grant date; thus, the intrinsic value was zero, and no compensation cost was recognized.

The same basic formula was used to measure the intrinsic value of restricted stock, as follows:

\[
\text{Intrinsic value of the stock} = \frac{\text{Fair market value of the stock on the date the restricted stock was granted}}{\text{Purchase price paid by the employer (often zero)}} - 1
\]

Since employees did not typically pay for restricted stock, the intrinsic value of restricted stock was generally the FMV of the stock on the grant date, resulting in compensation cost equal to the FMV. Consequently, restricted stock produced a less favorable accounting treatment than stock options, so stock options were considerably more popular than restricted stock.

In 1995, Statement of Financial Accounting Standards No. 123, Accounting for Stock-Based Compensation (SFAS 123), went into effect, requiring employers to disclose the value of equity-based compensation, such as stock options and restricted stock, in the footnotes of their financial statements. For this purpose, the value of stock options could no longer be measured by the intrinsic value; instead,
the value had to be calculated by using a stock option valuation model such as Black-Scholes. The value of restricted stock continued to be the stock’s FMV as of the grant date, reduced by any amount paid for the stock by the employee. Employers could voluntarily record the disclosed amounts associated with stock options as a compensation cost in the income statement but few chose to do so. Instead, on their income statements they continued to account for stock options and restricted stock under APB 25. As a result, stock options continued to be the most popular form of equity-based compensation.

A 2004 revision of SFAS 123, Share-Based Payment (SFAS 123(R)) went into effect in 2006. Under SFAS 123(R), companies must now record the value of stock options as a compensation cost on their income statements. Accordingly, stock options no longer enjoy the significant advantage over restricted stock of no cost recognition. This has caused many companies to take a closer look at restricted stock as a viable compensation tool. As a result, restricted stock has increased in popularity, while the popularity of stock options has declined.

Restricted stock serves several useful purposes as a compensation tool. First and foremost, the vesting schedule serves as an incentive for the employee to remain with the employer. In addition, the potential for future appreciation in the stock’s value serves as a powerful performance incentive.

More often than not, an employee is not required to pay for restricted stock. Thus, the full value of the shares accrues to the employee on vesting, and the shares have value even when the value declines between the grant date and the vesting date. This is very different from stock options, where there is no value to the employee unless the stock appreciates in value. As a result, a share of restricted stock has more value than a stock option. Accordingly, employers who issue restricted stock rather than stock options are able to use fewer shares to provide the same value to employees. The fact that restricted stock is less dilutive than stock options is very attractive to some employers and is one of the major driving forces in the growing popularity of restricted stock.

**Taxation to the employee**

The use of restricted stock as a compensation tool results in income recognition for the employee and a deduction for the employer. The timing and amount of the employee’s income recognition determines the timing and amount of the employer’s deduction. Thus, our discussion of the tax impact of restricted stock starts with the employee’s tax treatment. We begin with the basic tax rules, followed by a discussion of several issues that create complexity in applying those rules.

**The basics**

The taxation of restricted stock is governed by Section 83, which states that the value of property transferred in connection with the performance of services is included in gross income on the earlier of the following:

- Date on which the property is no longer subject to a substantial risk of forfeiture, or
- Date on which the property becomes transferable.

With respect to the first event above, restricted stock is no longer subject to a substantial risk of forfeiture when it becomes vested. With respect to the second event, restricted stock is transferable if
the employee can transfer the stock to another party on a fully vested basis. In practical terms, it is the vesting of the stock (the first event above) that will be the taxation trigger. It is unlikely that the transferability of the stock (the second event above) would occur first and be the taxation trigger, since that would happen only if the transfer of the stock resulted in the elimination of the vesting requirement. It is hard to imagine an employer’s rationale for designing a restricted stock arrangement in this manner. Thus, for purposes of clarity in the remainder of this discussion, we will assume that gross income is recognized on the vesting date.

The income recognized by the employee is compensation income, because the employee receives the restricted stock in return for services. Thus, the income is ordinary income. The amount of income is calculated as follows:

\[
\text{Fair market value of the stock on the vesting date} - \frac{\text{Amount the individual is required to pay for the stock (if any)}}{\text{Ordinary income}}
\]

Later, when the employee sells the stock, a capital gain is recognized if the value of the stock has appreciated. If the value of the stock has declined, a capital loss is recognized on the sale. The capital gain holding period, which determines whether the gain or loss is a long-term or short-term gain or loss, begins on the vesting date. Income recognition is illustrated as follows.

**Example 1:** In year 1, an employee receives 5,000 shares of restricted stock. The employee pays nothing for the stock. The shares vest in year 5. On the vesting date, the FMV is $30 per share. The employee sells the stock in year 8, when the FMV is $40 per share. The employee will report $150,000 of ordinary income when she vests in year 5, calculated by multiplying the FMV per share at the vesting date, $30, by the number of shares, 5,000. When the employee sells the stock in year 8, she will report a capital gain of $50,000, calculated as follows:

<table>
<thead>
<tr>
<th>Sales price per share</th>
<th>$40</th>
</tr>
</thead>
<tbody>
<tr>
<td>Ordinary income per share previously recognized (i.e., basis in the stock)</td>
<td>$30</td>
</tr>
<tr>
<td>Capital gain per share</td>
<td>$10</td>
</tr>
<tr>
<td>Number of shares sold</td>
<td>x 5,000</td>
</tr>
<tr>
<td>Total capital gain</td>
<td>$50,000</td>
</tr>
</tbody>
</table>

The gain is a long-term capital gain, because the employee held the stock for more than one year.

**Section 83(b) election**

An employee can report the gross income associated with restricted stock in the year the stock is granted (i.e., transferred), rather than waiting until the year in which the stock vests. This Section 83(b) election is available for restricted stock but not for restricted stock units, because typically the stock is not transferred until it vests.

When a Section 83(b) election is made, the income that is recognized is based on the stock’s FMV on the grant date, rather than the FMV on the vesting date. The gross income recognized in connection with a Section 83(b) election is ordinary income. There is no further income recognition until the stock is sold, when a capital gain or loss is recognized. For purposes of determining whether the capital gain
is a short-term or long-term gain, the holding period begins on the date the stock is transferred, rather than the vesting date.

Example 2: The facts are the same as in Example 1 above. The FMV of the stock on the date of grant in year 1 is $10 per share. The employee makes a Section 83(b) election to recognize income on the grant of the restricted stock. As a result, the employee will report $50,000 of ordinary income in year 1, calculated by multiplying the $10 FMV per share at grant date by the number of shares, 5,000. When the employee vests in the stock in year 5, there is no income recognition, due to the fact that the employee chose to recognize income in year 1.

When the employee sells the stock in year 8, she will report a capital gain of $150,000, calculated as follows:

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The gain is a long-term capital gain, because the employee held the stock for more than one year.

Exhibit 1 summarizes the income recognition from the two examples above (i.e., with and without a Section 83(b) election). Under both scenarios, the total income recognized is $200,000. The two scenarios vary significantly, however, in the composition of the income. When the employee makes a Section 83(b) election, a large portion of the appreciation in the stock’s value is taxed at the more favorable capital gains rate of 15%. In contrast, if the employee does not make a Section 83(b) election, most of the gain is taxed at the ordinary income tax rate (a rate as high as 35%).

<table>
<thead>
<tr>
<th>Exhibit 1</th>
<th>Impact of the 83(b) election in Examples 1 and 2</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>No section 83(b) election</td>
</tr>
<tr>
<td>Ordinary income</td>
<td>$150,000</td>
</tr>
<tr>
<td>Capital gain</td>
<td>50,000</td>
</tr>
</tbody>
</table>

While a Section 83(b) election may minimize the total income tax liability, the decision to make the election should not be taken lightly. In Example 2, the employee reports $50,000 of ordinary income in year 1, even though the stock does not vest until year 5. Suppose the employee leaves the employer in year 3 and, as a result, she does not become vested in the stock. The law does not permit the employee to recover the income taxes she paid in year 1. She has paid taxes on $50,000 of income that she never actually received. This is one of the risks associated with a Section 83(b) election. Another risk is the possibility that the stock will decline in value, causing the employee to recognize a higher amount of ordinary income than she would have without a Section 83(b) election.

Restricted stock plans are sometimes designed so that the employee is required to pay some amount for the stock. When an employee makes a Section 83(b) election and later forfeits the stock, a capital loss is recognized equal to the amount paid for the stock (but only if the employer does not refund the purchase price to the employee). In Example 2, if the employer had required the employee to pay $1
per share for the stock in year 1, for a total of $5,000, she would report a capital loss of $5,000 on her income tax return for year 3 when she forfeited the stock.

The discussion above highlights the considerable risks associated with a Section 83(b) election. When the stock has little or no value on the grant date, however, little or no income will be reported as a result of the election, resulting in little to no risk in making the election. Also, if the employee is required to pay a significant amount for the restricted stock, the income reported as a result of the election may be relatively small. For example, if the employee is required to pay the full FMV for the stock, the income reported in connection with the Section 83(b) election would be zero. The regulations specifically allow the election to be made, even when the employee has paid the full value for the stock.\(^8\)

As an employee considers whether to make a Section 83(b) election, she should take into account the various advantages and disadvantages of the election. The major advantages and disadvantages are summarized in Exhibit 2.

<table>
<thead>
<tr>
<th>Exhibit 2</th>
<th>Section 83(b) elections: major advantages and disadvantages</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Advantages</strong></td>
<td><strong>Disadvantages</strong></td>
</tr>
<tr>
<td>If the stock increases, more of the appreciation is capital gain rather than ordinary income</td>
<td>Accelerates the payment of taxes (an issue particularly if the stock has high value on the transfer date)</td>
</tr>
<tr>
<td>Capital gain holding period begins at grant date rather than at vesting date</td>
<td>If the stock value decreases between the grant date and vesting date, the election results in a larger amount of ordinary income than would have been the case without the election</td>
</tr>
<tr>
<td></td>
<td>If the stock is forfeited, there is no loss deduction (except for the amount, if any, paid by the employee for the stock and not refunded by the employer)</td>
</tr>
</tbody>
</table>

Reg. 1.83-2 sets forth certain procedures that must be followed and information that must be supplied to make a valid Section 83(b) election; there is no IRS form for this purpose. The information includes the date the stock is transferred, the nature of the restrictions on the stock and the FMV of the stock on the transfer date.\(^9\) The procedures for filing the election include the following:

- The election must be filed with the IRS office where the individual files the 1040 return;
- The deadline for filing the election with the IRS is 30 days after the stock’s transfer;
- A copy of the election must be given to the employer; and
- The election must be attached to the individual's income tax return for the year in which the election is made.

The most important of these is the requirement to file the election with the IRS within the 30-day deadline. If this deadline is missed, an election cannot be made. The other requirements are less important, and a valid election will probably exist even if these requirements are not met. For example, the IRS has held that an election is valid even though the employee fails to attach it to the tax return.\(^10\)
Given the risks associated with a Section 83(b) election, a common question is whether the election can be revoked. An election cannot be revoked without the IRS’s approval. The IRS has issued specific guidance and procedures for seeking a revocation. If the employee seeks the revocation within the first 30 days after the stock is granted, the revocation will be approved. After that, the IRS will approve a revocation only when the employee made the election under a “mistake of fact,” which is “an unconscious ignorance of a fact that is material to the transaction.” A Section 83(b) election that is properly revoked is given no effect.

The failure of the employee to understand the substantial risk of forfeiture associated with the restricted stock is not a mistake of fact. In addition, the failure of the employee to understand the tax consequences of making the Section 83(b) election is not a mistake of fact. A mistake as to the value of the stock also is not considered a mistake of fact. Even when there has been a mistake of fact, the IRS will not approve a revocation unless the request is made within 60 days of the date on which the mistake of fact first became known to the employee.

In addition to a proper revocation, a Section 83(b) election may be given no effect when the restricted stock transaction is rescinded. In Ltr. Rul. 9104039, the IRS held that a Section 83(b) election would be ignored when the employer rescinded its transfer of restricted stock to the employees. In this ruling, the rescission action was taken in the same tax year as the grant, and the IRS made it clear that this was an important fact in reaching its conclusion.

**Substantial risk of forfeiture**

As discussed above, the value of restricted stock is included in the employee’s income when it is no longer subject to a substantial risk of forfeiture (unless a Section 83(b) election is made). Thus, it is important to determine when a substantial risk of forfeiture lapses so that income is reported at the proper time.

Section 83(c)(1) provides that “substantial risk of forfeiture” means the “future performance of substantial services.” In addition, a substantial risk of forfeiture exists when vesting is contingent on the “occurrence of a condition related to the purpose of the transfer.”

In the past, employers commonly used relatively simple vesting conditions, based only on continued employment. For example, an employee would vest in restricted stock if she remained with the employer for three years beyond the grant date. Currently, there is a growing interest in vesting conditions that involve conditions beyond that of mere continued employment. An example of this is restricted stock that becomes vested if the employer’s revenues increase by 10% each year for the next two years.

These conditions are commonly referred to as “performance” conditions, and can qualify as a valid substantial risk of forfeiture because they are a “condition related to the purpose of the transfer,” as mentioned above. Additional examples of performance-based vesting conditions include the following:
• Achievement of specified net income growth of the employer or a division of the employer;
• An EBITDA (earnings before interest, taxes, depreciation and amortization) target; and
• An initial public offering.

These types of vesting conditions give employees an incentive to perform at a high level in addition to simply remaining with the employer. The accounting rules under APB 25 made performance conditions undesirable, because the compensation cost had to be adjusted each reporting period based on the current value of the stock (variable accounting, which generally is viewed as undesirable due to the potential volatility in cost). Under SFAS 123(R), performance conditions no longer result in variable accounting. Consequently, performance vesting conditions are increasing in popularity.

Another vesting condition that is sometimes used involves a noncompetition requirement (e.g., stock must be returned to the employer if the employee accepts a job with a competing firm). This type of condition ordinarily will not be treated as a substantial risk of forfeiture for Section 83 purposes. Factors that may be taken into account in determining whether a covenant not to compete constitutes a substantial risk of forfeiture are the age of the employee, the availability of alternative employment opportunities, the likelihood of the employee’s obtaining other employment, the degree of skill possessed by the employee, the employee’s health and the practice of the employer to enforce noncompete covenants.

The regulations address yet another situation in which a substantial risk of forfeiture may exist. Specifically, Reg. 1.83-3(c)(1) states that “[p]roperty is not transferred subject to a substantial risk of forfeiture to the extent that the employer is required to pay the fair market value of a portion of such property to the employee upon the return of such property.” This statement implies that the converse would be true, that is, stock is subject to a substantial risk of forfeiture if the employer is required to pay a value other than the FMV (presumably, a lower value) to the employee on the return of the stock to the employer. Rev. Rul. 2007-49, 2007-31 IRB 237, sheds light on this concept by providing examples where an employee who terminates his employment within a specified period of years must sell the shares back to the employer at the lesser of a stated amount or the FMV at the time the employment is terminated. In these examples, the IRS treats the stock as subject to a substantial risk of forfeiture. Reg. 1.83-3(c)(1), however, specifically provides that a nonlapse restriction (a permanent requirement to sell the stock to the employer at a formula value, as discussed later in connection with the determination of FMV) is not a substantial risk of forfeiture.

Regardless of the specific vesting conditions chosen, the conditions must be “substantial.” A risk of forfeiture that is not substantial will be disregarded, and the employee must include the value of the restricted stock in gross income on grant. The determination of whether a risk of forfeiture is substantial is based on all of the surrounding facts and circumstances.

One common question relates to how long the vesting period must be in order for the risk of forfeiture to be substantial. There is no clear answer to this. The regulations include an example, however, in which two years is treated as a substantial risk of forfeiture. Thus, some tax practitioners take the position that a two-year vesting period is adequate to create a substantial risk of forfeiture, and that any period less than two years is somewhat risky (i.e., it may be treated by the IRS as insubstantial, resulting in immediate taxation on the grant of the stock).
Special care must be taken in determining whether there is a substantial risk of forfeiture on the part of an employee who owns a significant amount of the total combined voting power or value of all classes of stock of the employer. The concern is that the employee may have so much influence and authority that she can waive her risk of forfeiture, resulting in an insubstantial risk of forfeiture.

Reg. 1.83-3(c)(3) provides general guidelines for this situation, including two examples. The guidelines focus on the employee’s relationship with (and degree of control over) the other shareholders, the employee’s relationship with officers and directors, and the employee’s role in the company. The corporation’s prior history in enforcing vesting requirements is also taken into account. In the first example, the employee owns 20% of the employer’s stock, with the remaining 80% owned by unrelated individuals. In this example, the regulations conclude there is a substantial risk of forfeiture because the possibility of the corporation enforcing a restriction is substantial. In the second example, however, the employee (the company president) holds 4% of the voting power of all of the employer’s stock, with the remaining stock held “diversely” by the public. In this example, there is not a substantial risk of forfeiture because the president effectively controls the corporation.

A special rule under Section 83 relates to section 16(b) of the Securities Exchange Act of 1934. That Act restricts the sale of stock at a profit within six months after the purchase of the stock. Under the special rule, the stock is treated as both subject to a substantial risk of forfeiture and not transferable during this six-month period. Thus, there is no taxable event until the section 16(b) restriction period ends. Restrictions on transferability that apply under any other securities laws are not accorded this same treatment; thus, stock that otherwise is vested is subject to tax, despite these restrictions. Similarly, stock issued by a private company that is subject to restrictions on its transferability is taxed on vesting, despite the restrictions.

**Fair market value**

In addition to the vesting date, the FMV of restricted stock must be accurately determined to ensure that the proper amount is included in an employee’s gross income. If the employee makes a Section 83(b) election, this value must be determined as of the date the restricted stock is granted to the employee. If the employee does not make a Section 83(b) election, the value must be determined as of the date the substantial risk of forfeiture lapses (i.e., the vesting date). The accurate identification of these dates is of paramount importance, especially when the value of the stock is volatile and can change dramatically from one day to another.

Section 83 provides no guidance for determining the grant date in connection with a Section 83(b) election. The IRS, however, has addressed the determination of the grant date in connection with stock options. It seems reasonable to apply the same principles for determining the grant date for restricted stock, since the inherent differences between stock options and restricted stock do not have any effect on this determination.

The IRS has defined the grant date of an incentive stock option as the “date or time when the granting corporation completes the corporate action constituting an offer of stock for sale to an individual under the terms and conditions of a statutory option. A corporate action constituting an offer of stock for sale is not considered complete until the date on which the maximum number of shares that can be purchased under the option and the minimum option price are fixed or determinable.” The IRS also
has addressed the determination of grant date under Section 409A’s rules for nonqualified deferred compensation in connection with stock options and stock appreciation rights. The regulations under Section 409A provide the same definition of grant date as for incentive stock options, with two additional requirements. First, the class of stock must be designated; second, the identity of the employee must be designated.20

The application of this guidance to restricted stock is not altogether clear, so it is subject to interpretation and differing views. Nevertheless, it seems clear that the grant date of restricted stock is the date when the granting corporation completes the corporate action constituting a transfer of stock to an individual under the terms and conditions of the restricted stock agreement. Thus, a careful analysis of the restricted stock agreement is important in determining the grant date. If a fuller analogy to the IRS guidance for options and stock appreciation rights is applied, the grant date for restricted stock does not occur until the date on which the number of shares that are transferred and the purchase price (if any) are fixed or determinable, and the class of stock and the employee have been identified.

Several practical issues arise in determining the grant date. Once again, the IRS’s guidance for incentive stock options, and for stock options and stock appreciation rights under Section 409A, proves helpful. For example, the grant date can occur before the employee is notified of the grant, as long as there is not an unreasonable delay in notifying the employee after the corporate action is completed. Also, the grant date can occur before shareholders have approved the grant. Finally, the grant date can occur before the approval of, or registration with, a regulatory or government agency, such as the Securities and Exchange Commission, unless the corporate action clearly indicates that this is a condition of the grant.21

In determining the vesting date (i.e., when a Section 83(b) election has not been made), the specific provisions of the restricted stock agreement should be carefully reviewed. Under most circumstances, this determination will be relatively straightforward. When complex vesting provisions are used, however — such as some of the performance condition examples discussed above — it follows that the determination of the specific date on which vesting occurs also may be complex.

Once the appropriate date has been determined, attention must be turned to measuring the stock’s FMV on that date. Any discussion of FMV must necessarily distinguish between public and private companies. The determination of FMV, a relatively easy process for public companies, is a significant challenge for private companies. Thus, it comes as no surprise that the available guidance focuses largely on private companies.

Despite the importance of measuring FMV, the statute deals with only one relatively narrow aspect of this determination. Specifically, Section 83(a)(1) states that the FMV should be “determined without regard to any restriction other than a restriction which by its terms will never lapse.” The regulations refer to this as a “nonlapse” restriction and define it as a permanent restriction that requires the use of a specified formula to determine the value at which the stock is sold.22

The examples of such a formula in the regulations include the use of book value and a multiple of earnings per share. Whatever the formula, the employee can sell the stock only at the value that is
calculated under the formula. Likewise, a party who purchases stock from the employee must sell the stock at the formula value, because the formula must apply to all subsequent holders of the stock.\textsuperscript{23}

This type of restriction truly has the effect of establishing the FMV of the stock, because the stock cannot be sold at any value other than the formula value. The regulations state that the formula value will be considered the FMV unless another value is established to the contrary by the IRS. In this instance, the burden of proof with respect to the value is on the IRS.\textsuperscript{24}

Reg. 1.83-5(a) contains a special provision for a formula price based on book value, or a multiple of earnings, or a combination of these two measures. The regulation states that the price “will ordinarily be regarded as determinative of the fair market value.” The formula price will not be treated as the FMV “in certain circumstances,” however. There is no elaboration on these circumstances, other than the following statement: “For example, where the formula price is the current book value of stock, the book value of the stock at some time in the future may be a more accurate measure of the value of the stock than the current book value of the stock for purposes of determining the fair market value of the stock at the time the stock becomes substantially vested.”

The regulations then provide an illustration that is helpful in understanding the intent of this provision. Reg. 1.83-5(c), Example 4, implies that this provision has the most applicability where the employee makes a Section 83(b) election. In the example, an independent contractor agrees to provide services in the construction of an office building in exchange for common stock. The stock is subject to a substantial risk of forfeiture until the services are completed. The contractor makes a Section 83(b) election. The stock is subject to a nonlapse restriction that uses book value.

In the example, there is outstanding preferred stock with a liquidation value. The liquidation value is so great that there is no remaining book value attributable to the common stock on the grant date. The example points out that the independent contractor must believe that the common stock has value; otherwise, he would not be willing to perform the services in exchange for the stock. Under these circumstances, according to the example, “[i]n determining the fair market value of the stock, the expected book value after construction of the office building would be given great weight.” Thus, it is not always appropriate to simply apply the formula using values as of the measurement date.

Any restrictions that do not meet the relatively narrow definition of a nonlapse restriction are referred to in the regulations as a “lapse” restriction.\textsuperscript{25} A lapse restriction is not taken into account in measuring the FMV of stock. Thus, a formula value that is to be used only for a limited period should not be considered in determining the stock’s FMV.

There is no further help under Section 83 with respect to determining the FMV of stock. As in the determination of the grant date, the IRS has provided guidance on determining the FMV of stock in connection with incentive stock options under Section 421, as well as under Section 409A with respect to stock options and stock appreciation rights. Presumably, the IRS has chosen to provide the guidance under these sections due to the importance of accurately determining the FMV. Specifically, an option cannot qualify as an incentive stock option unless the exercise price is equal to or greater than the FMV of the stock on the grant date.\textsuperscript{26} A stock option or stock appreciation right is subject to the restrictions...
on nonqualified deferred compensation plans under Section 409A if the exercise price is less than the FMV of the stock as of the grant date.\textsuperscript{27}

The approach chosen by the IRS under these sections is to provide very general guidance, rather than to require the use of specific rules for determining FMV. The incentive stock option rules require only a “reasonable valuation method,” and in a similar fashion, the nonqualified deferred compensation rules require only the “reasonable application of a reasonable valuation method.”\textsuperscript{28}

The incentive stock options regulations have little to say beyond the requirement that a reasonable valuation method must be used. In fact, the additional guidance is limited to a statement that majority or minority stockholder status may be taken into account, and that the valuation method described in the estate tax regulations is an example of a reasonable valuation method.\textsuperscript{29} The estate tax regulations, in turn, list factors that must be taken into account in a valuation, such as the company’s net worth, prospective earnings power, goodwill and the economic outlook of the industry.\textsuperscript{30} In addressing whether a good faith attempt has been made to determine FMV, the regulations provide only one example, which is the determination of FMV based on an average of the FMVs determined by “independent and well-qualified experts.”\textsuperscript{31} Nevertheless, the averaging approach is simply an example of good faith; it is not a requirement.

In a fashion similar to the estate tax regulations, the regulations under Section 409A set forth factors that must be taken into account in determining FMV. These factors include the value of assets (both tangible and intangible), the present value of anticipated future cash flows, the market value of stock or equity interests in similar corporations or equity interests in similar corporations or other entities engaged in substantially similar trades or businesses. In addition, the valuation may reflect control premiums or discounts for lack of marketability. The valuation may be used for up to 12 months, but must be updated to reflect information that materially affects the value of the corporation, such as the resolution of litigation or the issuance of a patent.\textsuperscript{32}

The Section 409A regulations go a step beyond any other guidance by providing safe harbor valuation methods. When one of these safe harbors is used in lieu of the general valuation approach, the valuation is presumed to be reasonable. The IRS may rebut the presumption only if the valuation is “grossly unreasonable.”\textsuperscript{33}

There are three safe harbor methods:

- Appraisal by an independent party,\textsuperscript{34}
- Appraisal by a qualified individual who does not have to be independent (available only for “start-up” companies),\textsuperscript{35} and
- Formula value.\textsuperscript{36}

\textbf{Independent appraisal.} The first safe harbor is largely self-explanatory. The regulations provide that in applying this safe harbor, the standards for the appraisal of stock held by an employee stock ownership plan under Section 401(a)(28)(C) and its accompanying regulations should be used. Section 401(a)(28)(C), however, simply states that the valuation must be performed by an independent appraiser, and the regulations provide no additional guidance. Thus, this safe harbor appears to rest
solely on having an appraiser who is independent. The only additional guidance on this safe harbor is a requirement that in order for the valuation to be used, it must be as of a date within the past 12 months.

Non-independent appraisal. Under the second safe harbor, an appraisal is required, but the party performing the valuation need not be independent. The appraisal must take into account all of the factors described above in the discussion of general valuation principles. This safe harbor is available only for a corporation that has conducted its trade or business for less than ten years (a so-called “start-up” corporation). Thus, this safe harbor exists so that a newer corporation can avoid the cost of an independent appraisal.

The second safe harbor is not available if either the employer or employee reasonably anticipates that the corporation will undergo a change in control event in the next 90 days or an initial public offering within the next 180 days. The rationale for this appears to be that such events have the potential to cause a major change in the value of the corporation (most likely an upswing in value). In addition, this safe harbor may not be used if the stock is subject to any put, call or other right to purchase the stock, other than a right of first refusal upon an offer to purchase by an unrelated third party, or a non-permanent right to sell the stock or buy the stock at a formula value.

Although the individual who performs the valuation does not have to be independent, he or she must be qualified to perform the valuation. The individual’s qualifications are based on his or her knowledge, experience, education or training. “Experience” generally means at least five years of relevant experience in valuations, financial accounting, investment banking, private equity, secured lending or other comparable experience in the line of business or industry in which the corporation operates.

Formula. The final safe harbor is the use of a formula value. At first, this may appear to be a very useful safe harbor, especially in light of the fact that many private companies have typically used a formula to determine FMV. In developing this safe harbor, however, the IRS looked to the principles adopted in the Section 83 regulations, because the safe harbor may be used only when the formula is a nonlapse restriction, defined in the same manner as under Section 83 (as discussed above). Thus, it is not intended to simply make the determination of FMV an easy task, as many private companies might hope. It is available only when the formula value is the value at which the stock must always be purchased and sold, and only when the formula applies to all parties on a permanent basis. The regulations provide one very notable exception to these otherwise relatively rigid conditions: The safe harbor may be used even though the formula value restriction is lifted in connection with the sale of all or substantially all of the outstanding stock of the corporation in an arm’s-length transaction.

Public companies. As noted above, it is relatively easy for public companies to determine the FMV of their stock — it is the price at which its stock is traded. Nevertheless, it is not clear as to which particular transaction should be used to set the value. For example, should the value be determined based on the opening price on the grant date or the closing price on the grant date? As noted earlier, there is no detailed guidance under Section 83.

The regulations under Section 409A do provide detailed guidance on this issue, however, and set forth the range of alternatives acceptable to the IRS. Any practices that fall outside the parameters of this
guidance might be of concern to the IRS, even with respect to compensatory practices that do not
directly fall under Section 409A (such as the granting and vesting of restricted stock under Section 83).
Thus, it is advisable for public companies to evaluate this guidance to determine whether their
approach to determining FMV in connection with restricted stock may be acceptable to the IRS.

In reviewing this guidance, it is important to keep in mind that it relates to determining the exercise
price of stock options, as well as determining the base price of stock appreciation rights. Thus, the
methods for determining FMV all make reference to the grant date of the stock option or stock
appreciation right. The regulations permit any of the following values to be used:

- The price in a specific transaction, using either (1) the last sale before the grant or (2) the first sale
  after the grant;
- The closing price on either (1) the trading day before the grant or (2) the trading day of the grant;
- An average price (1) of the high and low prices on the trading day before the grant, (2) of the high
  and low prices on the trading day of the grant or (3) during a specified period that is within 30 days
  before or after the grant; or
- A price derived using any other reasonable method using actual transactions.

Some of these alternatives are easier to apply to restricted stock than others. For example, the use of
the closing price on the trading day before the grant or on the trading day of the grant works without
difficulty in determining the stock’s value on the grant date (i.e., when a Section 83(b) election is made).
When a Section 83(b) election is not made, then the relevant date for measuring the FMV is the vesting
date. Thus, the FMV could be determined as of the closing price on the trading day before vesting, or
on the trading day that the stock vests. The “specific transaction” alternatives listed above also could be
applied in a similar manner.

The “average price” alternative may not be appropriate, however. While it makes sense to set the
exercise price of an option based on an average price (in order to minimize the effect on the exercise
price of large increases or decreases in trading values), an average price does not seem appropriate for
measuring the FMV of stock at a given point (i.e., on the grant date when a Section 83(b) election is
made and otherwise on the vesting date).

**Dividends**

Some employers choose to pay dividends on restricted stock. In that event, income must be recognized
by the employee. The question is whether it is compensation income (i.e., subject to ordinary income
tax rates) or dividend income (i.e., subject to the favorable tax treatment of qualified dividends under
Section 1(h)(11)). The answer depends on whether a Section 83(b) election has been made. If no
Section 83(b) election has been made, then the dividend is compensation income (i.e., ordinary income)
and is deductible by the employer as compensation expense.\footnote{37} If a Section 83(b) election has been
made, however, the dividends are treated as dividend income rather than compensation.\footnote{38}

**Withholding and employment taxes**

The income derived by an employee from restricted stock is treated as compensation. Thus, income tax
withholding is required, as well as the payment of FICA and FUTA taxes. These obligations occur at
the same time that the employee recognizes income. Thus, for restricted stock, the obligations arise
when the stock becomes vested. If, however, a Section 83(b) election is made, the obligations arise when the election is made rather than on the vesting date.

For purposes of determining the amount of income tax withholding, the employer may treat the income associated with restricted stock as regular wages. If the income associated with the restricted stock is a relatively large amount, however, this treatment may result in a large amount of withholding. Employees may find the withholding amount excessive. As an alternative to treating the restricted stock income as regular wages, the employer may treat the income as supplemental wages, subject to a flat (and perhaps lower) withholding rate.40

The withholding rate for supplemental wages is 25% on the first $1 million paid to the employee during the calendar year, and 35% on the amounts in excess of $1 million.41 All supplemental wages paid to the employee by the employer and related employers during the calendar year must be aggregated in order to determine whether the $1 million threshold has been reached. The flat rates are applied without regard to the number of withholding allowances claimed by the employee on Form W-4.42

The total FICA tax rate is 7.65%, payable by both the employer and the employee (i.e., a combined tax rate of 15.3%).43 Of this amount, 6.2% is paid on a limited amount of inflation-adjusted income ($97,500 in 2007), and many employees will reach this limit without regard to any income attributable to restricted stock. The remaining 1.45% is applied to total income with no limitation and can be a significant amount with respect to restricted stock.

The FUTA tax rate is generally only 0.8% and is payable on a limited amount of inflation-adjusted income ($7,000 in 2007).44 Thus, FUTA taxes rarely will have any impact on employees with respect to restricted stock.

Tax withholding may be a challenge, since the compensation related to restricted stock is not paid in cash. This raises the issue of how the withholding obligation from the employee will be satisfied. The easiest approach is for the employer to withhold from the employer’s regular cash compensation. Where there is a relatively large amount of income related to the restricted stock, however, the employee’s regular compensation may not be adequate to meet the withholding obligation. In that event, the employee and employer must make other arrangements to meet the withholding obligation. One approach is for the employee to provide the cash to the employer to satisfy the withholding obligation. This approach may be burdensome for the employee, who may not have the cash on hand to make the payment.

Another approach involves the employee’s transferring some of the stock to the employer in order to satisfy the withholding obligation. Presumably, an employer would permit this only for stock that is vested. The transfer of the stock would be treated as a sale by the employee, which itself would generate an additional income tax liability; the additional income is not compensation income, so it would not be subject to withholding. Yet another approach is for the employer to gross-up the employee for the taxes. This is expensive for the employer, because the gross-up itself is taxable to the employee, which in turn leads to an additional income tax liability. Thus, gross-ups have a pyramiding effect. For example, at a 35% rate the gross-up for $1,000 of income is $538.45
A Section 83(b) election can create interesting timing issues with respect to withholding and employment taxes, as illustrated below.

**Example 3:** An employee receives restricted stock on Dec. 15, 2007. The employee submits a Section 83(b) election to the employer on Jan. 12, 2008 (i.e., within the 30-day election period). The employee will recognize income as of the grant date, which occurred in 2007. Thus, if the employer has already prepared the employee’s Form W-2, a corrected form (i.e., Form W-2C) will have to be prepared. Nevertheless, it will be too late to withhold and pay taxes in 2007.

There is no IRS guidance on how to handle this particular situation, and employers have taken various approaches. Regardless of the specific approach taken, the income to the employee must be reported in the proper year, and the FICA taxes ultimately must be paid. Some employers argue that the withholding of income taxes is less important in this situation, since the employee ultimately will pay the income taxes on filing the income tax return.

**Tax treatment when vested stock becomes nonvested**

It is possible that vested stock may become nonvested at some point in the future (i.e., the opposite of what usually happens with respect to restricted stock). This is most likely to occur in connection with a corporate transaction. In Rev. Rul. 2007-49, the IRS recently addressed the tax impact of three specific situations where this occurs.

In the first situation, new investors in a corporation reach an agreement with an employee under which vested stock that the employee previously received in connection with his services will become nonvested for a period of two years (as an incentive for the employee to remain with the company). The IRS concluded that neither the agreement to change the vested status of the stock nor the subsequent vesting of the stock in two years will have any tax effect, since for tax purposes the employee already has recognized income with respect to the stock and is treated as the owner of the stock for tax purposes.

In the second situation, the employer is acquired by another corporation in a Section 368(a) tax-free reorganization. The employee exchanges his vested stock in the employer for nonvested stock in the acquiring corporation. The employee timely files a Section 83(b) election in connection with the nonvested stock. The IRS concluded that the Section 83(b) election is valid, and that for purposes of the election, the amount paid by the employee for the nonvested stock is the FMV of the employer’s vested stock that was exchanged for the acquiring corporation’s nonvested stock. Since the FMV of the acquiring corporation’s stock and the employer’s stock is the same at the time of the exchange, the amount of gross income recognition in connection with the Section 83(b) election is zero. The employee’s basis in the new stock is his basis in the original employer stock.

In the third situation, the facts are the same as in the second situation except that the employer is acquired by another corporation in a fully taxable transaction. The employee recognizes a capital gain equal to the difference between the value of the acquiring corporation’s stock and his basis in the employer stock, despite the fact that his stock in the acquiring corporation is not vested. The employee’s basis in the acquiring corporation’s stock will be equal to the FMV of the employer’s stock on the exchange date. The employee will recognize compensation income when he vests in the

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acquiring corporation’s stock, in an amount equal to the appreciation in the stock value between the
date it was issued and the vesting date. The employee may make a Section 83(b) election in connection
with the nonvested stock of the acquiring corporation. If he does so, there will be no income
recognized on making the election, for the same reasons as described above for the second situation. In
addition, there will be no income recognized on the vesting of the stock, due to the fact that the
Section 83(b) election was made.

**Deduction by the employer**

Section 83(h) provides that the employer receives an income tax deduction with respect to restricted
stock in “an amount equal to the amount included” in income by the employee. Thus, the employer
receives a deduction on the vesting of the stock, unless the employee makes a Section 83(b) election. In
the latter instance, the employer obtains a deduction on the granting of the stock.

Some employers choose to issue restricted stock units rather than restricted stock, because employees
cannot make a Section 83(b) election in connection with restricted stock units. Employers who make
this choice typically do so because they do not want to keep track of whether employees have made the
election, and they do not want the employees’ decisions to determine the timing and amount of their
tax deduction (especially when they believe that the value of the stock will increase significantly in the
future).

The statute uses “included” rather than “includable.” Tax practitioners generally interpret this to mean
that the employee must actually include the amount in income in order for the employer to obtain a
deduction. Of course, the employer is usually in no position to know whether the employee actually
includes the amount in income. Fortunately, the regulations provide that if the employer reports the
income on the employee’s Form W-2, then the employee is deemed to have included the amount in
income.46

The Federal Circuit has held that “included” means that the employee was legally required to report an
amount in income.47 Thus, according to the court, the employee’s actual inclusion of an amount in
income is not required in order for the employer to obtain a deduction. Despite this interpretation, it
seems prudent for employers to issue a Form W-2 to employees to report the income, in order to
ensure a proper deduction, regardless of how the word “included” is interpreted.

If the employer’s and employee’s tax years coincide (i.e., a calendar year), the employer obtains the
deduction in the same tax year that the employee includes the amount in income. If the employer’s and
employee’s tax years do not coincide, the employer obtains the deduction in the tax year in which the
employee’s tax year ends.

**Example 4:** The employer’s tax year ends on June 30. The employee’s restricted stock vests on May 31,
2008. The employee will recognize the amount in income in the tax year that ends on Dec. 31, 2008.
The December 31 date falls within the employer’s tax year that ends on June 30, 2009, which thus is the
year in which the employer takes the deduction.
Parent stock. An issue that arises when restricted stock in a parent corporation is granted to employees of a subsidiary corporation is who gets the deduction, the parent or the subsidiary? This is important when the parent and subsidiary do not file a consolidated income tax return (e.g., a foreign parent and a U.S. domestic subsidiary). The transfer of the stock is treated as a two-step transaction, as follows:

1. A contribution of the stock by the parent to the capital of the subsidiary, and
2. A transfer of the stock by the subsidiary to the employee.

Thus, the subsidiary is entitled to the deduction, because it is the subsidiary that has transferred the stock to the employee.48

Impact on other areas of tax law

The primary tax impact of restricted stock relates to the employee’s inclusion of the value in gross income and the employer’s deduction. Restricted stock also affects other areas of tax law, including the Section 162(m) deduction limit on compensation, the Section 280G golden parachute rules, the Section 409A nonqualified deferred compensation plan rules and special considerations related to S corporations.

$1 million deduction limitation

A public company’s deduction for compensation paid to a “covered employee” is limited to $1 million per year under Section 162(m)(1). “Covered employee” includes the company’s chief executive officer (CEO) and its three highest-paid officers other than the CEO and chief financial officer.49 Equity-based compensation, including restricted stock, may significantly contribute to a covered employee’s compensation, causing it to exceed $1 million. Performance-based compensation (e.g., a bonus that meets certain conditions) is deductible without regard to the $1 million limit.50

Restricted stock is not performance-based compensation, however. Reg. 1.162-27(e)(2)(vi)(A) provides that “if the amount of compensation the employee will receive under the grant or award is not based solely on an increase in the value of the stock after the date of grant or award (e.g., in the case of restricted stock ...), none of the compensation attributable to the grant or award is qualified performance-based compensation...” (Emphasis added.)

Fortunately, the regulation provides a clear way for restricted stock to qualify as performance-based compensation. Specifically, if the restricted stock is granted or becomes vested as a result of the attainment of a performance goal, then the restricted stock qualifies as performance-based compensation. Several requirements must be met in order for compensation to be treated as performance-based compensation:

- The grant or vesting must be contingent on attaining pre-established performance goals determined by the compensation committee;
- The compensation committee must be made up solely of two or more outside directors;
- The material terms of the restricted stock plan must be disclosed and approved by a shareholder vote; and
• The compensation committee must certify that the performance goals were met before the restricted stock is granted or vested.

**Golden parachute payments**

Restricted stock also can affect the application of the golden parachute rules under Section 280G. These rules apply to corporations that undergo a change in ownership or effective control of the corporation or in the ownership of a substantial portion of the corporation's assets, except for corporations that qualify as a “small business corporation” under Section 1361.\(^{51}\) If payments made to certain individuals in connection with a change in control exceed three times the average of their annual compensation for the prior five years, the payments are “excess parachute payments.” Payments made by a private company that have been approved by more than 75% of the shareholders are not treated as parachute payments.\(^{52}\) The excess parachute payments are nondeductible by the employer and are subject to a 20% excise tax on the part of the individual.\(^{53}\)

These rules apply to payments that are contingent on a change in control and are known as parachute payments.\(^{54}\) Restricted stock agreements often provide for accelerated vesting on a change in control. This accelerated vesting causes the restricted stock to be treated as a parachute payment. The amount of the parachute payment consists of two components.

The first component measures the time-value difference between receiving money at the time of the change in control vs. receiving it later (on the normal vesting date).\(^{55}\) The second component places a somewhat arbitrary value on the fact that the vesting period has been cut short; the value attributable to this component is equal to 1% of the stock’s value for each month that the vesting is accelerated.\(^{56}\) This second component can be a significant amount when the change in control occurs long before the regular vesting date. If the vesting conditions associated with the restricted stock involve more than simply continued employment, such as the satisfaction of performance conditions discussed above, then the two components described above are ignored and the entire value of the stock is treated as a parachute payment.\(^{57}\)

A question arises when the stock for which vesting is accelerated on a change in control already has been included in income due to a Section 83(b) election in a tax year prior to the change in control. Logically, one might conclude that this stock is not a parachute payment because it has already been included in the employee’s income. The regulations provide, however, that the restricted stock will be treated as a parachute payment when the stock actually vests, rather than when the Section 83(b) election was made.\(^{58}\) Thus, the calculations described above for determining the parachute payment amount apply even when a Section 83(b) election has been made.

For purposes of the Section 280G rules, a change in ownership or control occurs when a person, or group of persons acting as a group, acquires stock that, together with stock already held by the person or group, causes them to possess more than 50% of the total FMV or voting power of the stock.\(^{59}\) A change in control also occurs if a person, or a group of persons acting as a group, acquires ownership of stock within the last 12 months possessing 20% or more of the total voting power of the corporation.\(^ {60}\) Restricted stock is generally not treated as outstanding stock for purposes of determining whether a change in control has occurred. If an employee has made a Section 83(b) election, however, the stock is treated as outstanding.\(^{61}\)
The individuals to whom the golden parachute rules apply are known as “disqualified individuals.” The term includes officers, shareholders who own stock with an FMV in excess of 1% of the value of all outstanding shares of the employer and individuals who are among the highest paid 1% of the employer’s employees. When determining whether an employee-shareholder has reached the 1% ownership threshold, restricted stock generally is not taken into account. If the individual has made a Section 83(b) election with respect to her restricted stock, however, those shares are treated as outstanding and are included in the employee’s total shares owned.

Nonqualified deferred compensation plans

Section 409A places restrictions on arrangements that defer compensation. These restrictions apply to elections to defer compensation, the funding of the deferred compensation and distributions of the deferred compensation. If the arrangement fails to comply with these restrictions, the deferred compensation is subject to income tax immediately on vesting, along with a 20% additional tax and interest.

Restricted stock is specifically exempt from Section 409A. Some types of restricted stock units, however, are subject to Section 409A. Specifically, if the stock that will be transferred in connection with the restricted stock unit is vested at the time of the transfer, then the restricted stock unit is subject to Section 409A. In contrast, a restricted stock unit that will result in the transfer of nonvested stock is not subject to Section 409A (presumably because this is equivalent to a transfer of restricted stock, and restricted stock is exempt from Section 409A). For a restricted stock unit that is subject to Section 409A, the primary impact is that the stock’s transfer date or triggering event (such as on a change of control) must be specified at the time the restricted stock unit is granted. (A further discussion of the impact of the Section 409A requirements on restricted stock units is beyond the scope of this article.)

S corporations

Several requirements must be met in order for S corporation status to be available. Two of these warrant special attention when the corporation issues restricted stock, i.e., the corporation (1) may have no more than 100 shareholders and (2) may have only one class of stock.

Restricted stock is ignored for S corporation purposes until it becomes vested. Thus, the individuals who hold restricted stock are not counted towards the 100-shareholder limit, and the restricted stock is ignored for purposes of determining whether there is more than one class of stock. When the restricted stock vests, however, the individuals who hold the stock will count towards the 100-shareholder limit and the restricted stock will be taken into account in determining whether there is more than one class of stock. Thus, if there is a desire to preserve S corporation treatment, care must be taken to limit the number of individuals to whom restricted stock is granted and to ensure that the characteristics of the stock do not create an additional class of stock.

The general rule is that a corporation is treated as having only one class of stock if all outstanding shares of the corporation confer identical rights to distribution and liquidation proceeds. It is, however, acceptable for the stock to have differences in voting rights and still qualify as an S corporation. This is particularly useful for employers who wish to grant stock to employees, but who do not wish to convey any voting rights.
On making a Section 83(b) election, the employee is treated as an actual shareholder. Thus, the employee is counted as a shareholder for purposes of the 100-shareholder limit, and the stock is treated as outstanding stock for purposes of the single class of stock requirement. The fact that the stock is subject to a vesting schedule does not cause it to be treated as a second class of stock. The employee will be taxed on her share of the corporation’s income, based on relative stock ownership. Thus, an employee who is contemplating a Section 83(b) election should inquire as to whether distributions will be made each year to fund the taxes on this income.

S corporations that maintain an employee stock ownership plan (ESOP) should be aware of the impact that restricted stock may have on the ESOP. Under Section 409(p), employees who own at least 10% of the S corporation’s stock held by the ESOP (or 20% with family members) may not receive a contribution allocation under the ESOP when these employees own 50% or more of the S corporation shares. Restricted stock is taken into account when determining this ownership threshold.

**Conclusion**

The rules regarding the taxation of restricted stock are relatively straightforward. Several complex issues may arise, however, in some situations, such as the appropriate determination of the grant date and the vesting date. The determination of the stock’s FMV is a particularly challenging task for private companies.

Before restricted stock is issued, care should be taken to understand the full impact of the stock on various aspects of the tax law, such as the $1 million deduction limit under Section 162(m) and the golden parachute rules under Section 280G. Despite these complexities, restricted stock serves as a valuable compensation tool, and its popularity is likely to continue and perhaps even grow in the future.

**Practice notes**

In order to determine the proper timing and amount of the employee’s income and the employer’s deduction, care must be taken to accurately determine the grant date, vesting date and FMV. An employee includes the FMV of the restricted stock in income on vesting. If a Section 83(b) election is made, then the employee recognizes income earlier — on the grant of the stock. The employer obtains a deduction at the same time, and in the amount, as the employee includes the income.

The Federal Circuit has held that “includes” means that the employee was legally required to report an amount in income. Thus, according to the court, the employee’s actual inclusion of an amount in income is not required in order for the employer to obtain a deduction. Despite this interpretation, it seems prudent for employers to issue a Form W-2 to employees to report the income, in order to ensure a proper deduction, regardless of how the word “included” is interpreted.

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1 Restricted stock also may be issued to compensate non-employees, such as independent contractors and directors. The tax treatment for non-employees generally is the same as for employees.

2 APB 25, ¶10.
3 Large public employers were required to adopt SFAS 123(R) in the first quarter of fiscal years beginning after June 15, 2005. Small public employers (annual revenues or market capitalization less than $25 million) were required to adopt in the first quarter of fiscal years beginning after Dec. 15, 2005. Privately held employers were required to adopt in the first fiscal year beginning after Dec. 15, 2005.

4 Some compensation planners argue that restricted stock is a less effective incentive for employees than stock options, because employees typically make no investment in the stock, and the stock has value to them even if the stock value goes down after the grant date.

5 Section 83(c)(2).

6 Reg. 1.83-3(b) states that property, e.g., stock, is “vested” when it is either transferable or not subject to a substantial risk of forfeiture. The term “vested” is commonly used in practice, however, in a manner that means simply that there is no substantial risk of forfeiture.


8 Id. See also Alves, 54 AFTR 2d 84-5281, 734 F2d 478 (CA-9, 1984), aff’g 79 TC 864 (1982).

9 Reg. 1.83-2(e).

10 See, e.g., Ltr. Ruls. 8452116 and 8833015.

11 Section 83(b)(2).


13 Reg. 1.83-3(c)(1).

14 Reg. 1.83-3(c)(2).

15 Reg. 1.83-3(c)(1).


17 Section 83(c)(3).


19 Reg. 1.421-1(c)(1).


22 Reg. 1.83-5 contemplates the possibility that a restriction that was intended to be permanent may be cancelled in the future and provides that compensation income will arise as a result of the cancellation.

23 Reg. 1.83-3(h).


25 Reg. 1.83-3(i).

26 Section 422(b)(4).


28 Regs. 1.421-1(e) and 1.409A-1(b)(5)(iv)(B)(1).

29 Regs. 1.422-2(e)(2)(iii) and 1.421-1(e)(2).

30 Reg. 20.2031-2.

31 Reg. 1.422-2(e)(2)(iii).

Restricted stock: the tax impact on employers and employees

37 Reg. 1.83-1(f), Example 1.
40 Reg. 31.3402(g)-1(a) defines supplemental wages to include “wage income recognized on the lapse of a restriction on restricted property transferred from an employer to an employee.”
41 Regs. 31.3402(g)-1(a)(2) and (a)(7)(iii)(F).
42 Reg. 31.3402(g)-1(a)(2).
43 Section 3101.
44 Sections 3301 and 3302.
45 The income tax liability on $1,000 of income at a 35% rate is $350. The gross-up calculation is as follows: $350 × [1 ÷ (1 − .35)].
46 Reg. 1.83-6(a)(2).
48 Reg. 1.83-6(d).
49 Notice 2007-49, 2007-25 IRB 1429. Due to the interaction between the statutory language of Section 162(m) and the recently changed SEC rules, the chief financial officer is not a covered employee.
50 Section 162(m)(4)(C).
51 Section 280G(b)(2).
52 Section 280G(b)(5)(B).
53 Sections 280G and 4999.
54 Section 280G(b)(2)(A).
55 Reg. 1.280G-1, Q&A-22(c) and -24(c)(1).
56 Id., Q&A-24(c)(4).
57 Id., Q&A-24(d)(3).
58 Id., Q&A-12(b).
59 Id., Q&A-27(a).
60 Id., Q&A-28(a)(1). There are other circumstances under which a change in control may occur, but restricted stock has no impact on these circumstances.
62 Section 280G(c); Reg. 1.280G-1, Q&A-15 through -19.
64 Sections 409A(a)(2), (a)(4), and (b).
65 Section 409A(a)(1).
66 Reg. 1.409A-1(b)(6).
68 Id.
69 Sections 1361(b)(1)(A) and (D).
70 Reg. 1.1361-1(b)(3). Stock existing on the effective date of the regulations (tax years beginning after May 27, 1992) that has been treated as outstanding by the corporation, even though it is substantially nonvested, continues to be treated as outstanding for purposes of Subchapter S. A history of issuing a Schedule K-1 with respect to the stock is evidence that the corporation has treated the nonvested stock as outstanding.
71 Reg. 1.1361-1(l)(1).
72 Reg. 1.1361-1(b)(3).

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