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# Restricted Stock Plans





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## What is it?

### *In general*

Under a restricted stock plan, you transfer shares of your company's stock to an employee, usually at little or no cost to the employee and subject to certain restrictions or limitations. Generally, the restrictions prevent the employee from selling or transferring the stock and require the employee to forfeit the stock if the employee fails to meet the terms of the restricted stock program (for example, the employee leaves employment within a certain number of years). As owners of the shares of restricted stock, employees have voting and dividend rights. However, the company is considered to be the owner of the restricted stock for federal income tax purposes until the stock becomes unrestricted (i.e., until the transfer and forfeiture restrictions have lapsed).

**Example(s):** XYZ Corporation transfers 8,000 shares of restricted stock to its employee, Bill Smith, for \$7 per share. The fair market value of XYZ's stock is \$40 per share. The restrictions on the stock indicate that Bill must resell the stock to XYZ Corporation for \$7 per share if he terminates his employment with XYZ within five years from the date XYZ transferred the 8,000 shares of stock to him. Therefore, Bill must work for XYZ for the next five years in order to gain ownership of stock that is unrestricted.

**Tip:** Once the stock vests, the income (equal to the then-current value of the shares minus the amount paid) your employee receives on the restricted stock is subject to tax and can move him or her into a higher tax bracket. To solve this problem, the terms of the stock agreement can call for the stock to vest over several years. Both your employee's income and your compensation deduction will take place as the vesting occurs during that time period.

**Tip:** In most cases, a restricted stock plan will not be considered a deferred compensation plan subject to Internal Revenue Code Section 409A.

## **What are the IRS requirements for implementing a restricted stock plan?**

In order for the IRS to recognize the stock as restricted, the stock must fulfill certain requirements. Stock is restricted when: (1) the stock is subject to a substantial risk of forfeiture (you condition ownership of the stock upon the employee's future performance of either substantial services or some other condition); and (2) the stock is not transferable (if the employee sells or assigns his or her interest in the stock, the transferee is subject to the same substantial risk of forfeiture as the employee). The stock certificates will indicate that there are restrictions on the stock. The certificate will thus serve as notice to subsequent stockholders that the stock carries such restrictions. For more information on the requirements for restricted stock, see Section 83 of the Internal Revenue Code.

## **Why would you want to provide your employees with restricted stock?**

You may want to provide your employees with the opportunity to participate in a restricted stock plan for a number of reasons.

First, restricted stock can help you to retain those employees who are crucial to your company's success. Some employees feel that you should reward them with ownership in a company as a result of hard work and dedication. A restricted stock plan would enable you to provide the employee with some indicia of ownership without handing over immediate and unrestricted ownership of the stock to the employee.

Second, you may want to use a restricted stock plan if your present cash flow is minimal but you anticipate future growth in the company's stock value. This would enable you to provide your employees with valuable noncash compensation without stretching your cash flow.

Third, restricted stock is an attractive benefit to many employees because it's tax deferrable. Your employee can choose to recognize the stock as income either upon receipt of the restricted stock--also known as a Section 83(b) election--or when the stock is no longer restricted (i.e., when the stock becomes vested). Note: because your employee can choose whether or not to make a Section 83(b) election (i.e., recognize the income upon receipt of the stock), you don't have control over when or how much to deduct.

Fourth, the restricted stock plan can serve as an incentive if the terms of the restrictions are based on the employee's



performance. The restricted stock plan can discourage certain conduct. For example, the terms of the plan can call for the employee's forfeiture of the stock if he or she leaves to work for a competitor.

Finally, restricted stock provides you with a compensation deduction equal to the amount of income included in your employee's wages. However, you can't deduct the compensation until your employee's stock becomes substantially vested (unrestricted) or your employee makes a Section 83(b) election. The timing of your compensation deduction is governed by the IRS rules for deferred compensation.

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