



Restricted Stock Fundamentals

Description

Restricted stock is an award of employer stock that is subject to vesting requirements and transferability restrictions (generally at no cost to the employee).

Key Features

Dividend and Voting Rights

Restricted shares typically have voting and dividend rights. Dividends may be paid currently or may be paid upon satisfaction of vesting requirements.

Vesting

- **Time-based.** Typically, restricted shares will vest upon the completion of a time-based service requirement (e.g., 3- to 5-year “cliff” service-based vesting).
- **Time-accelerated.** Under this vesting method, a restricted stock award is subject to a time-based service requirement, but vesting is accelerated if a predetermined performance condition or market condition is achieved prior to the completion of the time-based service requirement.
- **Performance-contingent.** Performance-based restricted shares are similar to performance shares, but with no upside above target. Performance measures fall into one of the following two categories: (i) performance conditions (e.g., EPS, ROE), or (ii) market conditions (e.g., stock price change or total shareholder return vs. peers).

Lapse of Restrictions

Upon vesting, generally the awarded shares will no longer be subject to transfer restrictions, at which point shares may be freely sold or transferred.

Shareholder Approval

- **NYSE and NASDAQ listing requirements.** An equity plan under which restricted shares may be granted must be approved by shareholders pursuant to stock exchange listing rules.
- **162(m) requirements—service-based awards.** Restricted stock awards subject solely to service-based vesting cannot qualify as “performance-based” compensation for purposes of IRC Section 162(m). However, through the use of a “162(m) pool” plan, service-based restricted awards may be able to qualify as “performance-based” compensation for purposes of IRC Section 162(m). Note: Additional requirements must be satisfied for performance units to qualify as “performance-based” compensation.

Federal Tax Considerations

To Employee

Restricted stock grants are automatically exempt from IRC Section 409A.

- **At grant.** No tax consequences (unless employee makes a Section 83(b) election).
- **At vesting.** The fair market value of stock on the vesting date (less any employee cost) is taxable as ordinary income; the timing of taxation changes if the employee made an 83(b) election.
- **At sale.** If shares received upon vesting are later sold, then any gain or loss on sale of shares (i.e., post-vesting share price appreciation or depreciation) is taxable as short- or long-term capital gain, depending on how long the stock has been held since vest.
- **Treatment of dividends.** Any dividends received during period of restriction or accrued and paid upon vesting are taxed as ordinary income, not dividend income.

To Employer

Restricted stock grants are automatically exempt from IRC Section 409A.

- **Deduction timing and amount.** The employer may take a tax deduction in the amount and at the time the employee realizes ordinary income. Dividends paid during the restriction period are also deductible as compensation.
- **Section 162(m) implications.** IRC Section 162(m) denies a deduction for compensation in excess of \$1 million paid to CEO and other three top paid executive officers (excluding CFO), unless “performance-based” (see discussion above regarding shareholder approval).

409A Considerations

- Restricted stock grants are automatically exempt from IRC Section 409A.

Accounting Treatment

Note: The following discussion ignores forfeiture rates and expected tax benefits and assumes that restricted stock is time-vested.

- Restricted stock grant date “fair value” is amortized over the grant’s requisite service period (e.g., typically the vesting period).
- “Fair value” is equal to the number of restricted shares granted multiplied by the grant date fair market value of a share of company stock.
- Dividends declared on restricted shares should be charged against retained earnings.

Impact on Earnings per Share

Basic EPS

Nonvested restricted shares are not included in the computation of the denominator of basic EPS. Vested restricted shares are considered outstanding for that purpose.

Diluted EPS

Nonvested restricted shares that vest based solely on continued employment are included in the computation of the denominator of diluted EPS using the treasury stock method if dilutive. Nonvested restricted shares with a performance or market condition are included in the computation of the denominator of diluted EPS if the restricted shares are dilutive and if their conditions (a) have been satisfied at the reporting date, or (b) would have been satisfied if the reporting date was the end of the performance period.