How Restricted Stock and Restricted Stock Units Are Taxed

by Mark Cussen

Employee compensation is a major expenditure for most corporations; therefore, many firms find it easier to pay at least a portion of their employees' compensation in the form of stock. This type of compensation has two advantages: it reduces the amount of cash compensation that employers must pay out, and also serves as an incentive for employee productivity. There are many types of stock compensation, and each has its own set of rules and regulations. Executives that receive stock options face a special set of rules that restrict the circumstances under which they may exercise and sell them. This article will examine the nature of restricted stock and restricted stock units (RSUs) and how they are taxed.

What Is Restricted Stock?

Restricted stock is, by definition, stock that has been granted to an executive that is nontransferable and subject to forfeiture under certain conditions, such as termination of employment or failure to meet either corporate or personal performance benchmarks. Restricted stock also generally becomes available to the recipient under a graded vesting schedule that lasts for several years.

Although there are some exceptions, most restricted stock is granted to executives that are considered to have "insider" knowledge of a corporation, thus making it subject to the insider trading regulations under SEC Rule 144. Failure to adhere to these regulations can also result in forfeiture. Restricted stockholders have voting rights, the same as any other type of shareholder. Restricted stock grants have become more popular since the mid-2000s, when companies were required to expense stock option grants. (For more, read *Mapping Out The Stock Options Landscape*.)

What Are Restricted Stock Units?

RSUs resemble restricted stock options conceptually, but differ in some key respects. RSUs represent an unsecured promise by the employer to grant a set number of shares of stock to the employee upon the completion of the vesting schedule. Some types of plans allow for a cash payment to be made in lieu of the stock, but this type of plan is in the minority. Most plans mandate that actual shares of the stock are not to be issued until the underlying covenants are met.

Therefore, the shares of stock cannot be delivered until vesting and forfeiture requirements have been satisfied and release is granted. Some RSU plans allow the employee to decide within certain limits exactly when he or she would like to receive the shares, which can assist in tax planning. However, unlike standard restricted stockholders, RSU participants have no voting rights on the stock during the vesting period, because no stock has actually been issued. The rules of each plan will determine whether RSU holders receive dividend equivalents.

How Are Restricted Stock and RSUs Taxed?

Restricted stock and RSUs are taxed differently than other kinds of stock options, such as statutory or nonstatutory employee stock purchase plans (ESPPs). Those plans generally have tax consequences at the date of exercise or sale, whereas restricted stock usually becomes taxable upon the completion of the vesting schedule. Restricted stock plans are not eligible for capital gains treatment, and the entire amount of the vested stock must be counted as ordinary income in the year of vesting. (To learn more, check out *Getting The Most Out of Employee Stock Options*.)

The amount that must be declared is determined by subtracting the original purchase or exercise price of the stock (which may be zero) from the fair market value of the stock as of the date that the stock becomes fully vested. The difference must be reported by the shareholder as ordinary income. However, if the shareholder does not sell the stock at vesting and sells it at a later time, any difference between the sale price and the fair market value on the date of vesting is reported as a capital gain or loss.

Section 83(b) Election

Shareholders of restricted stock are allowed to report the fair market value of their shares as ordinary income on the date that they are granted, instead of when they become vested, if they so desire. This election can greatly reduce the amount of taxes that are paid upon the plan, because the stock price at the time of grant is often much lower than at the time of vesting. Therefore, capital gains treatment begins at the time of grant and not at vesting. This type of election can be especially useful when longer periods of time exist between when shares are granted and when they vest (five years or more).

Example - Reporting Restricted Stock

John and Frank are both key executives in a large corporation. They each receive restricted stock grants of 10,000 shares. The company stock is trading at $20 per share on the grant date. John decides to declare the stock at vesting while Frank elects for Section 83(b) treatment. Therefore, John declares nothing in the year of grant while Frank must report $200,000 as ordinary income. Five years later, on the date the stock becomes fully vested, the stock is trading at $90 per share. John will have to report a whopping $700,000 of his stock balance as ordinary income in the year of vesting ($90-$20=$70), while Frank reports nothing unless he sells his shares, which would be eligible for capital gains treatment. Therefore, Frank pays a lower rate on the majority of his stock proceeds, while John must pay the highest rate possible on the entire amount of gain realized during the vesting period.

Unfortunately, there is a substantial risk of forfeiture associated with the Section 83(b) election that goes above and beyond the standard forfeiture risks inherent in all restricted stock plans. If Frank should leave the company before the plan becomes vested, he will relinquish all rights to the entire stock balance, even though he has declared the $200,000 of stock granted to him as income. He will not be able to recover the taxes he paid as a result of his election. Some plans also require the employee to pay for at least a portion of the stock at the grant date, and this amount can be reported as a capital loss under these circumstances. (To learn more about employee stock strategies, read *Solutions For Concentrated Positions*.)

Taxation of RSUs

The taxation of RSUs is a bit simpler than for standard restricted stock plans. Because there is no actual stock issued at grant, no Section 83(b) election is permitted. This means that there is only one date in the life of the plan on which the value of the stock can be declared. The amount reported will equal the fair market value of the stock on the date of vesting, which is also the date of delivery in this case. Therefore, the value of the stock is reported as ordinary income in the year the stock becomes vested.

Conclusion

There are many different kinds of restricted stock, and the tax and forfeiture rules associated with them can be very complex. This article only covers the highlights of this subject and should not be construed as tax advice. For more information, consult your financial advisor.

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Mark P. Cussen has more than 15 years of experience in the financial industry, which includes working with investments, insurance, mortgages, taxes and financial planning. He has five of experience as a financial author and has written many educational articles for various financial websites as well as revising and updating training material for insurance and securities licenses. He has also worked in retail, discount and bank brokerage systems and is currently working as a financial planner for the U.S. military. Mark has a Bachelor of Science in English from the University of Kansas and completed his CFP coursework at the Bloch School of Business at the University of Missouri-Kansas City in August of 2001.