WHAT IS RESTRICTED STOCK?

BY SPENCER HATFIELD

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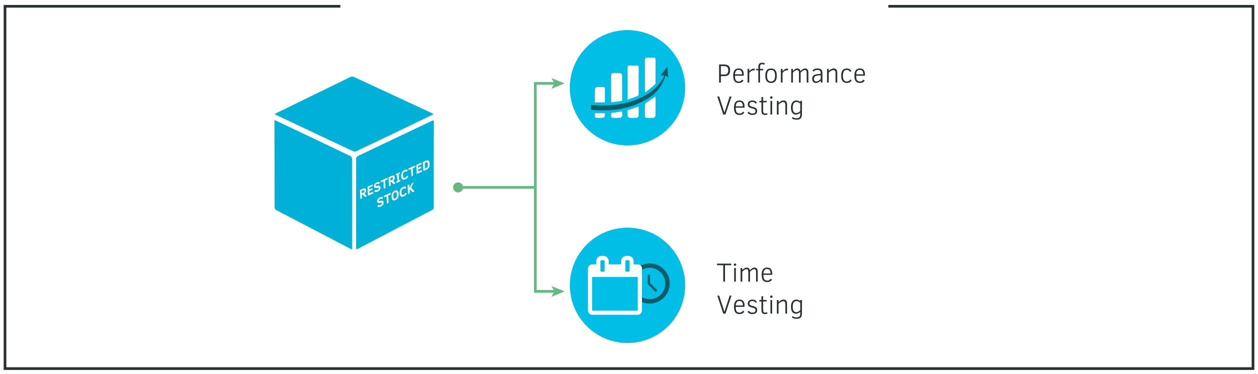
WHAT IS RESTRICTED STOCK?

A restricted stock is a class of equity in a company that cannot be sold until specified requirements are met. The requirement is usually set in one of two ways: the employee needs to meet set performance metrics (performance vesting), or the employee must stay at the company for a set period of time (time vesting). The company uses these restrictions to incentivize the performance and/or to retain the continual employment of key employees. Additionally, these restrictions are meant to deter the premature selling of shares that might adversely affect the company.



Restricted stock is not the same as a stock option. A stock option gives employees the right to buy a stock at a set price, but you don't own the share until you pay for it. With restricted stock, you own the shares from the day they are issued.

TAXES AND RESTRICTED STOCK: DO I NEED TO FILL OUT AN 83(B) ELECTION?

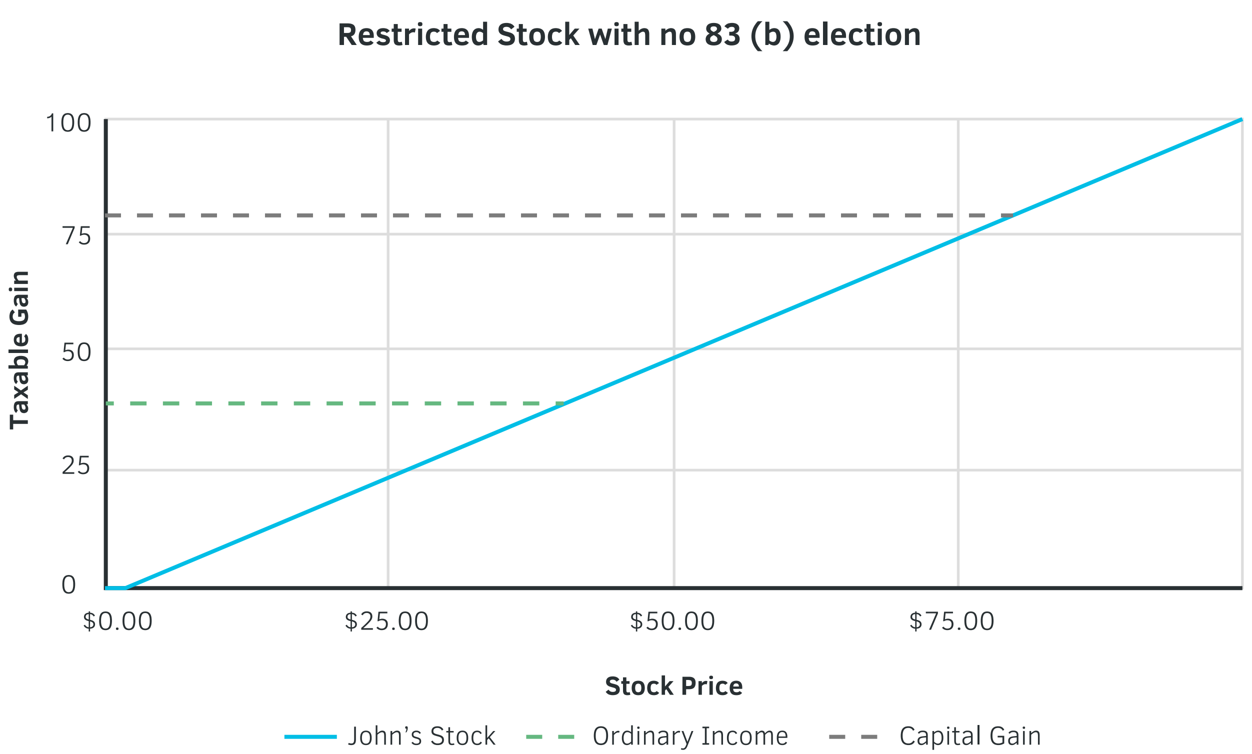
When it comes to compensation, there are two types of taxes to consider: ordinary income tax and capital gains tax. The capital gains tax rate is generally lower than the ordinary income tax rate.

The tax treatment of restricted stock can be complicated, and knowing how taxation works with these forms of equity compensation can help employees minimize their tax liability.

Restricted stock is taxed at the ordinary income tax rate at issuance if an 83(b) election has been made and at vesting if no election has been made. Let's assume John has an ordinary income tax rate of 30% and a capital gains tax rate of 15%. John is given restricted stock worth $1 per share vesting over two years. After two years, John's stock is worth $40 per share. The value of the stock upon vesting is subject to ordinary income tax. Taxable income of $40 or $40 x his ordinary income tax rate of 30% = $12 of taxes owed.

Any gains after the stock has vested will be subject to capital gains tax. Two years after the stock originally vested, John decides to sell his stock for $80. With that sale, John's increase from the time of vesting is taxable. Taxable income of $40 ($80 - $40) or $40 x his capital gains tax rate of 15% = $6 of taxes owed.

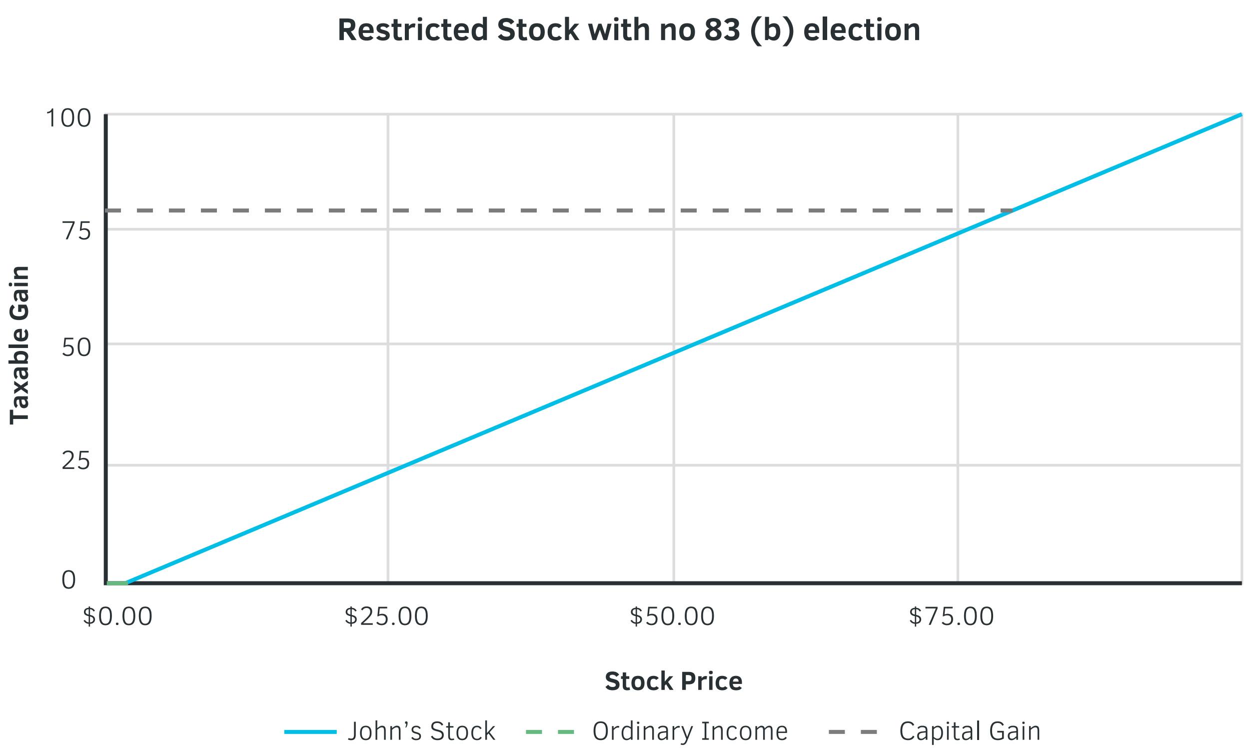
Four years after being granted a restricted stock of $1 per share and selling it for $80 per share, John has paid $18 per share in taxes



The main point here is that John is paying tax when his shares vest. Given that these shares are in a privately held entity, they are likely illiquid (meaning he can't sell them) at the time they vest and the tax bill comes due. The stock he received may plummet in value after they vest, and the shares could be worthless. It is important to note that after John has already paid the tax, the IRS will not refund his payment. However, in making an 83(b) election, he could lower his ordinary income tax liability.

If John makes an 83(b) election, he elects to recognize the income when he receives the restricted stock rather than the default of waiting until the stock has vested. It's important to note that there is a 30-day deadline from the grant date to file an 83(b) election. After this window passes, John will not be able to file the election.

Using the same example from above, John's taxes would now look like this: John is given restricted stock worth $1 per share vesting over two years. John chooses to make an 83(b) election right away, so he will immediately pay ordinary income taxes on $1 x his ordinary income tax rate of 30% = $0.30 of taxes owed. Similar to the previous example, John's stock is worth $40 per share two years after he receives it—awesome! Two years after the stock vests, John decides to sell it for $80. John will now pay taxes at his capital gains rate of 15% on the $79 increase in value from when he received the stock at $1 per share to when he sold at $80 per share. The total taxes owed at sale will be $79 x 15% = $11.85. our years after being issued restricted stock at a value of $1 per share and selling it for $80 per share, John has paid $12.15 per share in taxes.



Note that when the restricted stock vested, John will have paid no additional tax. Instead, he paid only a capital gains tax on the full $79 gain when he sold his shares. This is favorable for two reasons:

1. He is able to maximize the amount of the gain that is taxed at the lower capital gains rate.

2. His risk of paying a higher tax bill is reduced with the ability to pay at issuance with the 83(b) election rather than at vesting.

DO RESTRICTED STOCKS NEED A VALUATION? IS THAT A 409A?

A valuation is needed in order to set the amount of ordinary income received and to set the basis for capital gains. If an 83(b) election is made, the valuation is needed at the time of issuance, but if no 83(b) election is made, the valuation is needed once the stock vests.

Christian gave a good overview of what a 409A is in a previous post, “If I Sell Common Stock, Do I Need a 409A Valuation?” as follows:

> *Section 409A of the IRS code (“IRC 409A”) regulates nonqualified deferred compensation. Typically, this type of compensation is issued in the form of stock options. Section 409A requires that the strike price of these options be set at or above the fair market value (FMV) of common stock. For private companies—within which shares are not actively traded on an open market—a third-party valuation firm is usually hired to determine the value of common stock.*

Source : (https://scalar.io/insights/if-i-sell-common-stock-do-i-need-a-409a-valuation)

Restricted stock is not subject to IRC 409A. Restricted stock is not deferred compensation; it is considered compensation the day the stock vests. So while restricted stocks do not need a strike price set through a 409A, there are tax implications in receiving restricted stock, and a valuation may be necessary.

CONCLUSION

In conclusion, does restricted stock need a valuation? For tax purposes, yes. A valuation is needed when the stock vests in order to determine fair market value of the stock and a tax basis going forward.

If an 83(b) election is made, a valuation is also needed to determine the value of the restricted stock at the time of issuance. The best decision is to enlist a reputable valuation firm to provide this valuation. With that in hand, you and your tax preparer will be confident the share price being reported meets the requirements set forth by the IRS for fair market value.

Sources
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