RESTRICTED STOCKS & RSUs

STONEHEARTH CAPITAL MANAGEMENT

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WHAT ARE THEY?

Restricted stock and restricted stock units (RSUs) are two forms of equity-based compensation granted to employees as an employee benefit. Restricted stock and RSUs are sometimes granted alongside or instead of stock options. With restricted stock and RSU plans, after the grant date, the employee is not permitted to sell or transfer the shares until they are vested. The vesting schedule is based on continued employment with the company or can be based on performance goals stated in the plan. Once vesting is achieved, the employee owns the shares outright with no further restrictions.

Restricted stock and restricted stock units have some similarities, however, there are important differences with these plans which are outlined below.

Restricted Stock

With restricted stock plans, company shares are granted to employees on the grant date. As the employee, you own the shares granted, however, there is a restriction placed on the shares until a vesting period is met. You are deemed to own the shares when granted, therefore, you are entitled to receive dividends and have voting rights during the vesting period. With the restriction during the vesting period, you are not permitted to sell or transfer the shares. Upon vesting, the restricted period ends, and you own the shares outright, allowing you to sell or transfer the shares.

Restricted Stock Units (RSUs)

With restricted stock units, you are not actually granted shares on the grant date. Instead, your employer is making a promise to provide you with the actual shares when the vesting period is met. Employers sometimes use RSUs for this reason, as they can choose to provide employees with a cash payment, equivalent to the value of the shares upon vesting, instead of granting actual shares. If the plan provides for shares to be granted, you receive shares once vesting is met and there is no further restriction.

Like restricted stock, you can sell or transfer the shares after the vesting date. Since no shares are issued at the grant date with RSU plans, you do not have voting rights and do not receive dividends during the vesting period.

HOW ARE THEY TAXED?

Restricted Stock
With restricted stock plans, you are issued shares at the grant date, however, there are no taxes due until vesting. On the vesting date, restricted stock is taxed as ordinary income based on the value of the shares on that date. For example, if you are granted 100 shares of restricted stock and the value of the stock on the vesting date is $20/share, you will have $2,000 of ordinary income, subject to federal, state, Social Security and Medicare taxes. Any future gains after the vesting date would be taxed at short-term or long-term capital gains rates depending on how long you hold the shares after vesting.

83(b) Election
There is a special tax provision known as an 83(b) election that can be made with restricted stock plans. If you make this election within 30 days after the grant date, you are electing to trigger the taxable event upon the grant date, rather than waiting until the vesting date.

Restricted Stock Units (RSUs)
With restricted stock unit plans, there is no tax at the grant date. RSUs are taxed as ordinary income on the vesting date, based on the share value. If you are granted 100 RSUs and they vest three years later when the share price is $20, you will have $2,000 of ordinary income, subject to federal, state, social security and Medicare taxes.

Some companies may elect to provide a cash payment to you at the vesting date, in lieu of shares, that is tied to the share price. Using the same example above, if you were granted 100 RSUs and upon vesting three years later, the share price is $20, your company may provide a cash payment to you of $2,000, in lieu of granting you 100 shares of company stock. In either case, the taxation is the same.

Notably, the 83(b) election is not available with RSU plans. Since shares are not actually granted to you at the grant date with RSU plans, you cannot elect to be taxed on property that you do not own.

CONSIDERATIONS WITH THE *83(b) Election*

Careful consideration is advised before making the 83(b) election. With this election, you are accelerating the timing of when you are taxed on your restricted stock. Without this election, you are taxed upon vesting of your restricted stock. When making this election, you are taxed on the value of the shares at the grant date. Most restricted stock plans have a three-year vesting period. If you believe that the value of the stock will rise sharply after the grant date (perhaps an impending IPO), then you could benefit from making the election to be taxed at grant since you pay taxes on the lower amount at the grant date.

There are risks involved with this election. You are not able to rescind the election once it is made and you cannot recover the taxes once they are paid. If you are terminated or elect to leave your employer prior to the vesting date, you would forfeit the restricted stock. You would have paid taxes on something that you never received.

Even if you end up meeting the vesting requirements and owning the shares, there are still risks with the 83(b) election. If the stock price decreases after the grant date, and the value is less upon vesting, you are not able to take a tax deduction or receive a tax credit for the excess tax paid. In this case, you would have owed less in taxes by waiting to be taxed at the vesting date since the share price decreased. Upon vesting, you can sell the shares and take a capital loss, but you can't recover the extra tax you had paid up front by making the 83(b) election.

PLANNING CONSIDERATIONS

Restricted stock and RSU plans provide an opportunity for you to benefit from an increase in your company's stock price. Like other types of equity compensation plans, such as stock options, it is important to plan ahead with restricted stock and RSUs. First, you will want to know if your company has elected to use a restricted stock plan or an RSU plan. Additionally, you will want to be aware of the provisions in your plan document, which will outline the vesting schedule and explain what happens to unvested shares upon certain life events, such as retirement or a company merger.

If you have a restricted stock plan, you will want to carefully consider whether an 83(b) election makes sense for you. As discussed above, there are pros and cons to making this election. If your company has implemented an RSU plan, you will want to know if you receive actual shares at vesting, which is common, or if you are given a cash payment equivalent to the share value instead.

As is the case with other equity-based compensation plans, it is common to receive grants of restricted stock and RSUs annually. It is important to be aware of how much of your company stock is in your overall portfolio. If you are also exercising stock options and/or buying company shares through an *Employee Stock Purchase Plan*, you may end up with a substantial amount of your net worth tied up in your company stock. You may also have some company stock in your 401(k) plan and you are deriving your salary from the same company. This can create a concentration risk with owning too many shares and it may be necessary to sell shares to diversify your portfolio.

Remember that everyone's financial plan is different and there are no one-size-fits-all solution with restricted stock and RSU plans. You will want to consider how best to leverage the potential value from these plans within the context of your financial goals and your comprehensive financial plan.

CONTACT US

Stonehearth Capital Management
199 Rosewood Drive, Suite 200
Danvers, MA 01923

978.624.3000

info@stonehearthcapital.com
www.stonehearthcapital.com