Restricted Stock Plans

Key Employee Incentives

Some S and C Corporation Considerations

Michael A. Coffey
Lisa J. Tilley, CPA

Corporate Capital Resources LLC

P.O. Box 12025 • Roanoke, VA 24022-2025
Phone: (540) 345-4190 • 1-800-358-2116
Fax: (540) 345-8774 Website: www.ccrva.com

Restricted Stock Plans

How Do They Work?

1. The Board of Directors authorizes the creation of a separate "plan" under which a predetermined number of authorized unissued common shares will be issued or sold, at the discretion of the Board, to Key Employees.

2. The Board of Directors identifies initially or over a period of time the specific employees to whom it wishes to sell or award shares of restricted stock from the pool of available shares.

3. Stock awards/sales are made in such amounts and subject to such restrictions as the Board of Directors deem appropriate. To avoid current taxation, stock *awards* must be subject to forfeiture. *Purchased* restricted shares are bought with after-tax dollars and are fully vested.

4. Employees execute "Restricted Stock Agreements" acknowledging the conditions that must be met in order for restricted stock *awards* to "vest".

5. Note that while restricted, Sub S restricted shares do not receive 'dividends', have no tax consequences and do not violate S corporation rules concerning a second class of stock.

Restricted Stock Plan Discussion

Why Restricted Stock?

1. The holder of Restricted Stock enjoys the benefits of stock ownership from the date of grant (i.e. possible dividend rights, voting rights, future appreciation)

2. The restrictions to be imposed on the "vesting" of the stock need not be uniform but may vary among recipients.

3. The later sale of vested Restricted Stock by the recipient may yield capital gains treatment as opposed to ordinary income tax consequences associated with the pay out of "phantom" stock benefits.

4. The use of Restricted Stock, in most instances, avoids the need for complex bookkeeping often associated with maintenance of nonqualified deferred compensation plans using the value of "phantom" stock as the bench mark for benefits.

5. Care must be taken in the coordination of these plans with ESOPs: a) the issuance of new shares to the program can not dilute the ESOP equity excessively; b) linking the growth in share price to ESOP stock value can provide a sometimes unintended incentive for the minority restricted stockholders to grow a larger ESOP stock buyback obligation than desired.

Restricted Stock Plan Discussion

What Happens When Restricted Stock is *Awarded*?

1. No immediate income tax consequences to the recipient.
2. Employee becomes a stockholder and entitled to all benefits otherwise available to owners of similar class of stock from the date of grant.
3. Restricted shares are not transferable until restrictions lapse due to satisfaction of conditions imposed or until Board elects to waive compliance and "vest" stock early.
4. Restricted shares may be forfeited upon death, disability or termination of employment unless Board chooses more lenient criteria for vesting in the restricted stock agreement.
5. Restrictions imposed need not be the same for each employee.

Restricted Stock Plan Discussion

What Impact Does Restricted Stock Have on Other Stockholders:

1. The recipient becomes a shareholder on the books of the company.
2. The certificates representing the Restricted Stock reflect a written "legend" indicating that the shares are not transferable except in accordance with the terms of the restricted stock agreement in effect with the employee/corporation.
3. The issuance of the Restricted Stock results in some "dilution" of the already issued and outstanding capital stock of the Company, including ESOP stock, so fiduciary considerations come into play.
4. Because of the dilutive effect of restricted stock, the number of shares to be issued may be regulated each year depending upon corporate financial performance and potential impact on share price, venture investors, etc. It is typically wise to grant such shares early in the game.
5. Restricted stock may affect the operation of a Sub S ESOP company, since it is considered 'synthetic equity' for the purposes of IRC §409(p) testing. This can be handled with an appropriate design.

Restricted Stock Plan Discussion

<u>What Type of Restrictions are Commonly Imposed?</u>

1. Restrictions need not be uniform
2. Restrictions may be based upon:
   - Individual performance (i.e. individual sales goals)
   - Years of Service (i.e. similar to a qualified plan vesting schedule)
   - Removal of key owner(s) from financial guaranty or personal liability on behalf of the sponsoring company at a future date.
   - Corporate performance (i.e. increase in growth of "net" corporate revenue or overall % increase in stock value).
   - Change of corporate control for any reason - outside sale, IPO, ESOP sale with controlling ESOP Trustee(s) or management buy out.
   - Any combination of the above.

Restricted Stock Plan

What are the Tax Consequences of Restricted Stock?

1. The recipient must include the Fair Market Value of the stock in income for the year in which the restrictions lapse (i.e. shares "vest").
2. The Corporation is entitled to a tax deduction equal to the amount included in the recipients gross income. This is valuation dependent (non-marketable minority interest value in most cases)
3. The income amount is generally reflected on a form W-2 for employees.
4. To mitigate income tax impact where stock is expected to appreciate in value before it "vests" and recipient is confident of being employed at the "vesting" date a recipient may elect to accelerate the taxability by making an irrevocable election under IRC Section 83(b).
   - Section 83(b) election must be made in writing within 30 days of receipt of stock by employee.
   - Section 83(b) election does not remove the restrictions on transfer but merely permits employee to accelerate the taxability of the transfer when shares have a lower FMV.
   - If forfeiture occurs before restrictions lapse, no refund of taxes previously paid on stock value. Recipient is only permitted as capital loss deduction equal to the amount of the 83(b) election income.

Why?

1. Rising management must be appropriately incentivized to assume the burdens of growing the business and operating the company, especially if they become ESOP Trustees.
2. The incentive should be performance/success based - if management succeeds, the shares 'vest.' If not, they revert to the corporation…protecting the controlling shareholders.
3. Management is 'protected' in the event of an outside sale, in that the shares 'vest' and management receives a benefit for management's share of the equity value created in the restricted stock shares, whether awarded or purchased.
4. Unlike options, for example, restricted shares are never 'under water' and are basically simple to implement.
5. A 'win-win-win' situation from the owners, company and management perspectives. No current cost; no current change of control, but substantial rewards for success.