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Equity Compensation Highlight: Stock Options and Restricted Stock

Start-up and early stage companies commonly offer equity compensation to attract talent, encourage employee retention, and align company and employee interests on business objectives. There are several different types of equity and equity-based awards that a company may potentially utilize. This highlight discusses some of the differences between two common forms of equity awards – stock options and restricted stock.

Key Highlights

- Stock options and restricted stock are economically different awards. A share of restricted stock is generally a "full value" award, while an option conveys value only with respect to the appreciation above the exercise (or strike) price of the option.
- The tax treatment of stock options and that of restricted stock is different (*e.g.*, in regards to the taxable amount and the timing of income inclusion, ability to make an 83(b) election, etc.).
- The situations in which it makes sense to grant stock options and those in which it makes sense to grant restricted stock often overlap, and it may be important to understand the differences and nuances of these two types of awards so that the one that best suits business objectives is used.

Summary Comparison of Certain Aspects of the Equity Awards

	Stock Options	**Restricted Stock**
Basics	A stock option is a contract that gives the employee the right to purchase a certain number of shares at a fixed price (the "exercise price" or "strike price"). Generally, the value of an option is equal to the excess, if any, of the underlying shares over the exercise price, and so the employee only receives the value of the appreciation of the stock above the exercise price.	Restricted stock is a grant of shares of stock of a company, which is subject to vesting and forfeiture conditions. When restricted stock becomes vested, the employee generally becomes vested in the full value of a share of company stock.
Rights as Shareholder	Until the option is exercise and shares are acquired, the optionholder is not a shareholder and does not have any of the rights of a shareholder (*i.e.*, voting or dividend rights).	The employee is a shareholder upon grant and, unless otherwise agreed to with the company to limit such rights, generally has the rights of a shareholder.
Vesting	Generally, service-based and/or performance condition-based vesting can apply depending on contract terms.	Generally, service-based and/or performance condition-based vesting can apply depending on contract terms.

Tax Treatment	For nonqualified options, upon exercise, the excess (if any) between the fair market value on the exercise date and the original strike price is taxable as compensation (the "spread"). The later sale of the shares acquired upon exercise of the option may be eligible for capital gains treatment. Incentive stock options (or ISOs) may be subject to different tax treatment that is more favorable to the employee (generally, no taxable event upon exercise, and capital gains on the spread value upon later sale), if certain holding period requirements are met. The company does not get a compensation deduction for ISOs.	Unless a Section 83(b) election is made, upon the lapse of the vesting or forfeiture restriction, the then fair market value of the shares of restricted stock is taxable as compensation. The later sale of the vested shares may be eligible for capital gains treatment. At the time of grant, the employee may elect to treat as taxable compensation the fair market value of the unvested shares of restricted stock by making a Section 83(b) election. This is often done when the value of the shares is relatively low at the time of grant, but the employee bears the risk of forfeiting the shares and having already paid taxes on them.
Qualified Small Business Stock (QSBS) Exclusion	Stock options may ultimately qualify for QSBS treatment, which may allow up to a 100% tax exclusion of gain from the sale of stock in certain small businesses. However, the requisite five-year holding period begins when the stock options are exercised and shares of the company have been acquired by the employee.	Restricted stock may qualify for QSBS treatment, which may allow up to a 100% tax exclusion of gain from the sale of stock in certain small businesses. The five-year holding period for restricted stock may begin either when the restricted stock vests, or upon grant if a timely Section 83(b) election is made.
Estate Planning	Stock options are contractual rights and may be more difficult to use to achieve estate planning goals. Transfer or assignment of stock options is generally not permitted under the terms of most equity incentive plans.	Restricted stock is property and may be easier to transfer to certain estate planning vehicles, subject to any contractual transfer or assignment restrictions that may apply to the restricted stock (*e.g.*, in an equity incentive plans or an award agreement).

Patterson Belknap has a multi-disciplinary team of lawyers who are focused on the legal needs of founders and entrepreneurs. A description of the full range of our services and attorney contacts can be found here. Please visit the Founder Focus Resource Center for more content on broad range of topics of interest to founders and their professional advisors.

This alert is for general informational purposes only and should not be construed as specific legal advice. If you would like more information about this alert, please contact a member of the Founder Focus team:

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