Stock Options and Restricted Stock --- Aren't they the Same Thing?

Many people think that Stock Options and Restricted Stock are the same thing. Or at least they think it doesn't matter much which one they use. NOT TRUE! There are many differences between the two, and those differences can make one much more attractive than the other to a business owner.

First, let's define what we mean by a Stock Option and Restricted Stock:

- A Stock Option is the right to receive stock in the future. There may be a requirement that certain performance goals are met. There may be a requirement that the employee pay a certain amount of money to buy the stock.

- Restricted Stock is stock that is issued now, but will be forfeited (lost) if certain conditions are not met, such as meeting performance goals.

- Although these are phrased in terms of stock of a corporation, similar rules apply for ownership of a limited liability company or partnership

Stock Options[1]: Assume Employee X is given the option to buy stock in 3 years if Employee X is still employed by the Company.

- No stock is issued initially

- Thus, Employee X has no right to dividends with respect to that stock

- There is no question as to voting power – just because Employee X has the right to acquire stock in the future does not give the power to vote the stock that may eventually be issued

- As the holder of a mere Stock Option, Employee X does not have the right to question the judgment of the other owners or the Board of Directors, or to look at company books and records

- There is no taxable income for Employee X, even if the option is to buy the stock at a low price

[1] We are not talking here about Incentive Stock Options – those have different tax consequences. And we are not talking about Stock Options that are for stock of publicly held companies – again those have different tax consequences.

- Thus, there is no deduction for the Company, even if the option is to buy the stock at a low price

- Employee X will have taxable income at the time the stock is issued if the stock is given as a bonus, or if the Stock Option is to buy the stock at a price less than the "fair market value" of the stock

- The Company gets the deduction at that time

Restricted Stock[2]: Assume Employee X is given stock subject to a vesting over 3 years (1/3 per year). Thus, in 3 years if Employee X is still employed by the Company, Employee X will be fully vested in all of that stock.

- Stock is actually issued to Employee X

- Employee X has the right to dividends with respect to that stock

- Employee X has the right to vote all of the stock immediately (even though there is a 3 year vesting schedule

- Employee X is a shareholder and has the right to question the judgment of the other owners or the Board of Directors, and to look at company books and records

- Employee X may elect to be taxed on the bonus portion of the stock (the current fair market value of the stock less whatever Employee X pays for it) at the time the stock is issued ---- or alternatively may declare that taxable income over the 3 years as the stock becomes vested but then the taxable amount depends on the fair market value of the stock at the time of vesting

- The Company has a deduction for the bonus portion of the stock when Employee X declares the income

So which one is best – a Stock Option or Restricted Stock?

It depends on many things – the tax issues, the goals of the owner, the goals of the employee, and not least importantly the psychological impact of issuing stock immediately versus delaying the issuance of the stock. (Dated: February 2010)

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[2] We are not talking here about securities laws restrictions on reselling stock of a publicly traded company.