What You Need to Know About RSUs

By Mark Farrelly, CFP®, CDFA®

If you work for a technology company in the Bay Area, there is a good chance you have received restricted stock units (RSUs) as part of your compensation package. Here is what you need to know about them and how to view them within the context of your long-range financial plan.

WHAT IS A RESTRICTED STOCK UNIT?

RSUs are a form of equity compensation that many companies offer in addition to salaries, bonuses, and other benefits. Companies use RSUs to attract the best talent and give them an incentive to remain as employees over a period of years.

By restricting when the employee receives shares, through a vesting schedule, the employer gains reasonable assurance that the employee will stay longer, resulting in less turnover and higher profits. The employee, meanwhile, has an incentive to stay through the vesting period, since it means more money and greater financial security.

HOW DO RSUS WORK?

The date the company pledges shares to the employee is called the "grant date." No shares are issued at the grant date. Instead, the shares are released to the employee on the "vest date."

The granted shares essentially represent the company's promise to distribute shares in the future, either when performance goals are reached or if a specific amount of time has passed. Before vesting, RSUs do not hold voting rights and do not pay dividends. However, a company may choose to pay dividend equivalents on RSUs.

A common vesting schedule, known as "graded vesting," occurs over three to five years, in which shares are distributed in increments. For example, an employer grants 1,000 RSUs to an employee, in which 250 shares will vest annually for four years. Once shares have vested, the employee is entitled to 100% ownership of those shares.

Additional forms of vesting include reaching performance goals or "cliff vesting," in which all granted shares are distributed after a specific amount of time has passed.

HOW ARE RSUS TAXED?

At the grant date, there is no immediate tax liability.

Withholding taxes, such as Social Security, Medicare, federal, state, and local income taxes, are owed when the RSUs vest and the employee receives a payout of the remaining shares of stock.

At the vesting date, income is reported based on the fair market value of the stock. As an example, if the stock price is $100 per share on the vesting date, the employee whose 250 shares vest would recognize $25,000 (i.e., 250 shares * $100 per share) as ordinary income, which would be reported on their W2.

Companies typically provide employees three options on paying withholding taxes:

- The employee pays withholding taxes out of pocket with their own cash. This results in no shares being sold.
- The employee opts to "sell to cover," which means they make a partial sale of shares equal to the tax amount. We see this often as financial advisors. Typically, this option includes an automatic "share surrender" in which shares are withheld to pay for taxes.
- A third choice is to do a same-day sale by performing a full liquidation of the shares.

Note: Because of the tax implications, talk with your CPA to make sure you're withholding the appropriate amount of taxes when your RSUs vest.

WHAT HAPPENS TO NON-VESTED RSUs?

If an employee leaves or is terminated before a vesting date, the shares are almost always forfeited. However, it's important to view the original grant agreement to confirm possible exceptions to vesting, such as death, disability, retirement, or mergers and acquisitions.

SHOULD I HOLD OR SELL MY RSUS ONCE THEY HAVE VESTED?

We generally recommend treating vested RSUs as cash compensation. In other words, take the money once it's available and funnel it into your financial goals, whether your goals include building up an emergency fund, paying down debt, or adding to a long-term diversified portfolio that is in line with your risk tolerance and geared to meet the goals and objectives of your long-term financial plan.

If you decide to hold on to the vested shares, it is just like holding any other stock and will be subject to capital gains tax treatment. If you decide to sell within a year of vesting, you will incur either a short-term gain or loss, taxed at your ordinary income rates. If you decide to sell after a year, you will incur a long-term capital gain or loss.

If you are optimistic about your employer's future growth and decide to hold on to the stock, consider limiting exposure to 5% or less within the entirety of your overall investments. In other words, avoid putting all your eggs in one basket, as too much exposure increases risk and potentially can lead to financial ruin if the stock does not perform as you hope.

Schedule a **complimentary meeting** with a wealth advisor to discuss your personal situation.