

The Power of RSUs – Understanding Your Restricted Stock Units

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2019 is shaping up to be a big year for tech company initial public offerings (IPOs). Uber, Pinterest, Airbnb, and Slack are looking to follow in the footsteps of Lyft which was first to the party in April. These unicorns - privately-funded startups with a market value of at least \$1 billion - are just a few examples that are making [headlines](#) for the large windfalls early investors are expecting to receive as a result.

There are many other employees of these companies who will also experience significant paydays from an IPO, yet they often go overlooked. Tens of millions of restricted stock units (RSUs) have been issued by tech startups in recent years as a means of attracting and retaining top talent. Once those companies go public, RSU shares will suddenly provide a very meaningful windfall to individuals who have received them as part of their overall compensation.

RSUs are nothing new, but they've become a popular means of awarding company equity to higher level employees not just by tech startups, but by much larger and more established companies as well. In a [2017 survey](#) by Ayco's Compensation and Benefits

group of 325 companies they work with, 72% reported using RSUs in their long-term incentive compensation programs compared to only 37% ten years earlier.

No matter if you are an employee of a tech unicorn, or an established Fortune 500 company, it's important that you understand how RSUs work and know what to do if you are fortunate enough to be offered them.

What are RSUs?

Restricted stock units (RSUs) are compensation in the form of company stock grants. Importantly, receiving a grant is not the same as receiving actual shares of a company's publicly traded stock. Recipients have to wait for shares to vest based on a schedule determined by the company before they actually "earn" shares of the stock.

Are They Stock Options?

RSUs are different from stock options. As the name implies, stock options give the *option* to buy a share of a company at a certain price (strike price) on or after a certain date (vesting). RSUs do away with the optionality. The recipient is simply given shares at the market price on a future vesting date, effectively making RSUs a deferred form of compensation using company stock as currency.

Since RSUs give the recipient shares at whatever price the stock is at on the vesting date, they will always be worth something as long as the company's stock is trading above \$0. Stock options on the other hand, can be what's called underwater (essentially worthless) if at the time of vesting the stock price has fallen below the strike price.

What Restrictions?

The "restricted" nature of RSUs comes from their required vesting period. Vesting periods vary from company to company, but will usually be based on either a single vest or double vest structure.

A single vest is time-based – some percentage of RSUs vesting each year, quarterly, monthly, etc.

A double vest combines the time-based structure with some event. Double vesting is often used by private companies or companies being acquired. The event would be an IPO or acquisition that then kicks off a time-based vesting schedule.

Once the vesting date is reached, two things will happen – you'll now own common shares of company stock and you'll owe ordinary income taxes based on the market value of your shares.

A Word About Taxes

It's important to understand how RSUs are taxed in order to plan ahead for vesting dates and to avoid potential surprises come April. Your company will most likely assist with income tax withholding (like they do for regular payroll) by making sure a portion of

your liability is paid for you. This is done through a sale of a portion of the newly vested shares (surrendering stock) to cover taxes before distributing the remaining amount of shares to you.

However, often times the withholding won't be enough to cover the entire tax liability so it's wise to plan ahead for extra cash you may need to come up with at tax time.

For example: Assume a single filer making \$200,000 per year has 2,000 RSUs vesting with a stock price @ \$50. The additional \$100,000 of ordinary income from the RSUs would fall almost entirely in the 35% tax bracket. If the company only withholds 25% for federal taxes from the award, that would leave the recipient with a shortfall of \$10k they need to come up with when it comes time to file.

If you choose to continue to hold shares beyond the vesting date, any gain in the value of your stock from that point forward will be taxed at capital gains rates. Sell the stock less than a year after vesting and you'll be subject to short term capital gains rates. Sell the stock more than a year after vesting and you'll pay long term capital gains rates.

I'm Vested, Now What?

In almost all situations, it will be in your best interest to sell RSUs immediately upon vesting. As mentioned above, there is no tax benefit to holding on to RSU shares. Yes, hanging on to them for a year before selling allows you to pay long term capital gains rates. But that's true for any common stock. Since you will have already paid income taxes on the initial market value of your RSUs anyway, selling immediately prevents any additional taxes from accumulating.

More importantly, being disciplined about selling when shares vest will limit the sizable risk you already have wrapped up in your employer. Between salary, 401k match contributions, company provided health care, and company provided life and disability insurance coverage, most employees have more riding on the continued success of their company than they realize.

Rather than adding to that reliance, don't allow a large portion of your savings to accumulate in shares of a company that already supports so much of your ongoing financial well-being. Instead, diversify your holdings across a wide range of investments to minimize the risks associated with putting all of your eggs in one basket.

Want to keep some money invested in your company because you believe the stock will do well? That's ok, but keep it to a small, single digit percentage of your overall investment portfolio. If that sounds like too little, consider that in 2018 there were over 75 companies in the S&P 500 index whose stock was down more than 30% for the year. While 2018 wasn't a particularly great year for stocks overall (S&P 500 down roughly 4%), it would have been much worse for anyone who had a large portion of their savings invested in any of those particular companies.

The Biggest Mistake

Doing nothing. Whether it's because you don't know what to do, or just don't have the time, doing nothing and allowing RSU shares to accumulate each year compounds the risk to your savings over time. Creating a plan as soon as you receive RSU grants will help you avoid pitfalls down the road. Coordinating with a [financial advisor](#) and tax professional to build a strategy for handling such a significant portion of your compensation should help put you on a better path to reaching your financial goals.

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