



The 411 on Restricted Stock Units

Towerpoint Wealth's Complimentary Guide to RSUs

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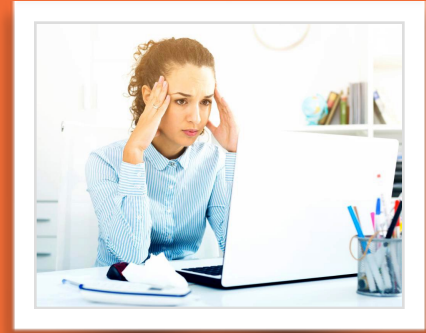


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Restricted Stock Units (RSUs) can be a significant component of an employee's compensation package. But what exactly is an RSU? How are they treated for tax purposes? How do you plan most effectively when your RSUs vest? The 411 on Restricted Stock Units will tackle these questions and more.



What are Restricted Stock Units?

RSUs are a form of stock compensation whereby an employee receives rights to shares of stock in a company that are **subject to certain restrictions**. These units do not represent actual ownership or equity interest in the company and as such hold no dividend or voting rights.¹ However, once the restriction is lifted, the units are converted to *actual company shares* and an employee owns the shares outright (same as traditional stock ownership).

The restriction on the units is generally based on a vesting schedule. Most vesting schedules will fall into one of two categories:

- **Time-based:** based on the period of employment. Common time-based vesting schedules are between three to five years and are either pro-rata or “cliff” based. For a “cliff” based schedule, all shares vest fully at the end of the schedule.
- **Performance-based:** based on the company achieving a performance goal. Common performance-based vesting schedules are based on a company achieving a particular stock price or a return on equity, or earnings per share.

*There is a hybrid-approach between time-based and performance-based known as **time-accelerated**. Vesting is on a time-based schedule but may be accelerated by the company achieving a performance-based goal.

How Are RSUs Different Than Stock Options?

When most people think of stock compensation, stock options, or the right to buy a company's stock at some future date at a price established now (the strike price), are typically what first comes to mind.

Historically, stock options have been the most popular form of stock compensation. And up until 2004, stock options merited favorable accounting treatment as a company could avoid recognizing

¹ While RSUs hold no automatic dividend rights, companies may choose to issue dividend equivalents. For example, when a company pays cash dividends to common stock holders, RSUs can be credited dividends for the same amount. These credits may ultimately be used to pay the taxes due when RSUs vest or can simply be paid out in cash.

compensation expense by issuing the options.

In 2004, this loophole was eliminated and subsequently, RSUs emerged as the preferred form of equity compensation.

RSUs and stock options have some notable differences:

	RSU	Stock Option
Risk to Employee	Less risky - value regardless of stock price performance. See Scenario 1.	More risky - may expire worthless. See Scenario 2.
Term	Become actual shares on vesting.	Expire a maximum of 10 years after the grant date.
Taxation	Generally, less favorable tax treatment.	Generally, more favorable tax treatment.

Scenario 1: An employee is granted 1,000 RSUs when the market price of the company's stock is \$10. When the RSUs vest, the stock price has fallen to \$8. The shares are still worth \$8,000 to the employee.

Scenario 2: An employee is granted 1,000 stock options with a strike price of \$10. During the window to exercise these options, the market price of the stock is always below \$10. These options will expire worthless to the employee.

*There are many other forms of nontraditional compensation, such as Stock Appreciation Rights (SARs), Phantom Stock, and Profit Interests. None of these are as widely used as RSUs or Stock Options and will not be a focus in this paper.

How Are RSUs Taxed?

RSUs are taxed upon delivery of the shares (i.e. when the restriction has been lifted).

At time of delivery, the shares are included in an employee's taxable income as compensation at the fair market value of the total shares. The tax treatment is identical to normal wage income and as such, is included on an employee's W-2.²

The shares are subject to federal and employment tax (Social Security and Medicare) and state and local tax as well.

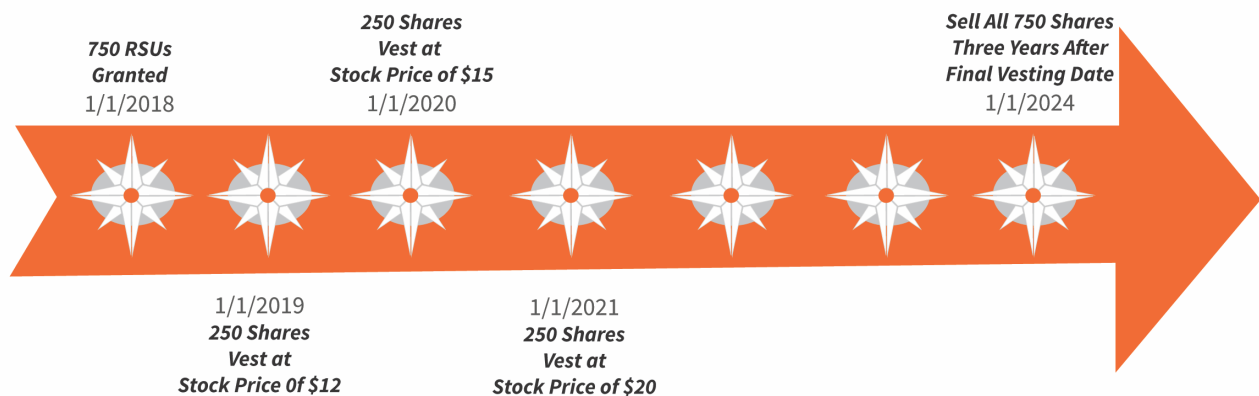


² When received, dividend equivalents are subject to the same tax rules as RSUs.

For paying the taxes due on delivery, companies will provide an employee with either one uniform withholding method or several options as follows:

- **Net-settlement:** a company “holds back” shares to cover the taxes and then the company pays the tax from its own cash reserve. This is the most common practice.
- **Pay cash:** an employee receives all shares and covers the income tax burden out of their own pocket. This is a riskier strategy than net-settlement, as the result is a more concentrated equity allocation in their portfolio while at the same time reducing their cash balance by the amount needed to pay the taxes.
- **Sell to cover:** an employee sells the shares needed to cover the income tax burden on their own. This method provides no real advantage over net-settlement and places the additional burden of selling the shares on the employee.

When an employee ultimately sells their vested shares, **they will pay capital gains tax on any appreciation over the market price of the shares on the vesting date.** If the shares are held longer than one year after vesting, the sales proceeds will be taxed at the more favorable long-term capital gains rate.³



Example:

An employee is granted 750 RSUs on January 1, 2018. The market price of the stock at the time of grant is \$10 and the RSUs vest pro-rata over three years:

January 1, 2019:	Stock price is \$12	250 shares X \$12 = \$3,000 of ordinary income
January 1, 2020:	Stock price is \$15	250 shares X \$14 = \$3,500 of ordinary income
January 1, 2021:	Stock price is \$20	250 shares X \$20 = \$5,000 of ordinary income

Each increment is taxable on its vesting date as ordinary income. The total ordinary income paid over the three years is \$11,500.

³ Important to note that the shares must be held more than one year for long-term capital gains treatment. If sold exactly one year from the vesting date, they will be taxed at the higher short-term capital gains.

The employee then sells all 750 shares of stock three years after the last shares vest:

January 1, 2024: Stock price is \$30. $750 \times \$30 = \$22,500$ realized upon sale

The employee held each share for more than one year, so the gain is treated as long-term. The employee's long-term capital gain is \$11,000 (\$22,500 less \$11,500) to be reported on Schedule D of their U.S. individual tax return.

What Are the Risks of Holding RSUs?

Utilized correctly, RSUs can be a wonderful complement to a traditional compensation package and can contribute substantially to an employee's net worth. This can be, however, a double-edged sword.

The overlying risk is that an employee can have too much of their net worth concentrated in one individual stock and for that matter, one individual company.

Let's explore a scenario:

Jim has a net worth of \$200,000, not including 2,000 shares of RSUs with his employer, Snap Inc. On January 1, 2019, 100% of Jim's 2,000 RSUs vest at \$50 per share.

Great news! Jim's net worth, on paper, has now increased by \$100,000 overnight. Jim's overall net worth is now \$300,000.

Jim decides to keep all his shares in Snap Inc. with the belief the stock price will continue to go up.

He also sees his colleagues choosing to hold most of their shares, and fears that if Snap Inc.'s price soars, he will have missed out and his colleagues will all become wealthier than him.

On July 1, 2019, Snap Inc. releases a weak earnings report and the share price drops to \$20. Jim's net worth is now \$240,000, down 20% from January 1st.

Even worse, Jim paid taxes at his ordinary rate on the original share value of \$100,000 when the shares are now only worth \$40,000.

*And finally, because Jim has a significant portion of his net worth in the company he works for, **he faces an additional and potentially catastrophic risk**. What if Snap Inc. runs into serious financial struggles and he loses his job? Not only will Jim's net worth plunge from further declines in Snap Inc.'s share price, he also will now have lost his primary source of income.*

You probably see Jim as foolish but his predicament is a common one. We often see employees dealing with the hesitation to sell the shares for emotional but not always rational reasons.

How Can I Most Effectively Plan For RSUs?

We recommend you discuss how to effectively plan for RSU shares with your financial advisor to ensure a decision is not made in a vacuum, but rather in the broader spectrum of your entire financial picture. Of course, we encourage collaboration with your tax advisor to determine the optimal strategy from a tax perspective as well.

In reality, when RSUs vest, you may be better off by immediately (or over a short-term schedule) selling a sizeable portion of the vested units and using the proceeds to add to or build a diversified investment portfolio.

Regardless, before you make any decisions, it can be helpful to explore the following questions:

- *How much of your overall wealth is tied up in RSUs?*
- *Is your company growing quickly or slowly?*
- *What is your current tax situation? Is it better to wait more than one year after the shares vest to sell them to receive the more favorable long-term capital gains tax treatment?⁴*
- *How long do you plan to be with the company?*
- *What is your tolerance for risk?*
- *If the market value of the stock was instead received in the form of a cash bonus, how much of this would you invest in the company stock?*

How Can We Help?

While we at Towerpoint Wealth continue to believe in the importance of a diversified portfolio, we also understand every individual situation is unique and understand emotions can play a significant albeit oftentimes problematic role in making sound financial decisions. This is especially the case for RSUs.

If you would like to speak further about RSUs (or any nontraditional compensation for that matter), I encourage you to call, 916-405-9166, or email spitchford@towerpointwealth.com.

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⁴ Reminder: If you sell RSUs one year or less after vesting, the difference between the market value at sale versus at vesting will be taxed at the less favorable short-term capital gains rate. However, a near immediate sale should result in a minimal gain and thus, a minimal tax hit.