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The Rise of Restricted Stock Units: What Are They and Why Do They Seem to Be Everywhere?

By Joshua A. Agen

In recent years, many companies have switched to using restricted stock units (RSUs) in place of restricted stock in their long-term incentive compensation programs. The trend is striking. A recent survey indicated that 62% of participating companies reported using RSUs compared to only 12% ten years earlier.[1] At the same time, the prevalence of restricted stock decreased significantly, falling to 22% in 2013 from 60% ten years earlier.[2]

This article provides a brief explanation of what RSUs are and how they are taxed. It also highlights some potential advantages to RSUs that may explain their growing popularity as a form of long-term incentive compensation.

What Are RSUs?

RSUs represent a contractual right to receive shares, or a cash payment of equivalent value, in the future. This contractual right is unfunded, meaning that it is a mere promise to pay on the part of the issuer. The contractual nature of RSUs is the primary difference between RSUs and restricted stock. An award of restricted stock, unlike RSUs, consists of currently issued and outstanding shares that are subject to a risk of forfeiture and restrictions on transferability. Ultimately, both RSUs and restricted stock represent compensation equal to the value of a share of stock, but the contractual nature of the RSUs permits greater flexibility in the areas of tax planning and capital structure.

As one example of this flexibility, RSUs may be paid in cash or in shares, whereas restricted stock always involves the issuance of shares. Cash-settled RSUs can allow employees to participate in their employer's equity appreciation without diluting the employer's shareholders or giving the employees voting or other minority shareholder rights.

Whether RSUs are paid in cash or shares affects the accounting treatment of the RSUs. A full discussion of RSU accounting is beyond the scope of this article, but, in general, RSUs that can be settled only in shares receive accounting treatment similar to restricted stock. The fair value of the award, based on the stock price at the time of the grant, is expensed over the service period. If the RSUs may be settled in cash, on the other hand, then they may be subject to liability accounting, requiring them to be marked to market periodically.

As another example of the flexibility of RSUs, the income taxation of RSUs may be delayed beyond vesting. The tax event may be delayed until termination of employment, a specified date or a change of control. The tax treatment of RSUs, and how their taxation may be delayed, is discussed further in the section titled *How are RSUs Taxed?*

Like restricted stock, RSU awards may include vesting requirements or performance conditions that must be satisfied for the award to be earned. RSUs may include a right to receive payments similar to dividends, known as "dividend equivalent payments," or they may include no dividend rights. RSUs do not include a right to vote.

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[1] *Our Restricted Stock/RSU Survey*, Ayco Compensation & Benefits Digest, July 12, 2013, Volume XXI Issue VII.
[2] *Id*.

How Are RSUs Taxed?

The basic tax treatment of RSUs may be easiest to understand in contrast to the tax treatment of restricted stock.

Restricted stock is considered "property" for income tax purposes. This means that restricted stock is generally includible in taxable income when it becomes vested or readily transferable. The one exception is that a recipient of restricted stock can elect to have the value of the stock included as taxable income immediately upon grant by filing an election under Section 83(b) of the Internal Revenue Code (Code) with the IRS within 30 days after grant.

RSUs, in contrast to restricted stock, are not considered property and are subject to normal constructive receipt principles. Under these principles, RSUs are includible in taxable income when payment of the RSUs is actually or constructively received. The Section 83(b) election available for restricted stock is not available for RSUs.

The timing of actual or constructive receipt of an RSU, and the time at which it is taxed, depends on the contractual terms of the RSU. Some RSUs are paid immediately after vesting, in which case the taxation of the RSU is the same as for restricted stock. Other RSUs, however, delay the income tax event by deferring payment until an event or date that will occur later than vesting. As described below, delaying the income tax event for RSUs can be advantageous for the recipient. However, the FICA tax event, in contrast to the income tax event, for employee holders of RSUs cannot be delayed. FICA tax is due for RSUs upon vesting, even if payment of the RSUs is delayed.

What Are Some Potential Advantages of RSUs?

Deferral of Income Taxation. As described above, the income taxation of RSUs can be deferred beyond the vesting date. Deferring the tax event can allow an employee or director to pay fewer taxes in the short-term. If the RSU recipient is given the opportunity to choose the timing of the future payment event, moreover, he or she can coordinate the timing of the tax recognition on the RSUs with his or her overall financial plan. The deferral of the tax event for the RSU recipient may be disadvantageous to the issuer, however, since it also delays the issuer's tax deduction.

Any deferral of RSUs must comply with Section 409A of the Code, which governs all nonqualified deferred compensation, including deferred RSUs. RSUs that do not comply with Section 409A can be subject to significant adverse tax consequences to the award recipient, including immediate taxation upon vesting, a 20% additional income tax and an interest penalty.

The two primary requirements of Section 409A relate to (1) the timing of payment and (2) the timing of the election to defer payment. With respect to the timing of payment, Section 409A requires that deferred RSUs be paid (or begin to be paid if installments are elected) on the earliest or the latest of one of the following Section 409A-permitted events:

- Separation from service
- Change in control event
- Specified time or fixed schedule
- Death
- Disability
- Unforeseeable emergency

The payout triggered by the permitted event may occur in a lump sum or in installments, but in general it cannot be accelerated. For publicly traded companies, there is an additional requirement of a six-month delay on payments to certain specified employees that result from a separation from service.

In addition to these restrictions on the timing of payments, Section 409A includes detailed rules on when the permissible payment event and the form of payment must be selected. A full discussion of these initial deferral election requirements is beyond the scope of this article, but the general rule is that the time and form of payment for any deferred compensation must be irrevocably elected in the year before the year in which the services to earn the compensation are performed. For example, for a grant of RSUs in 2015 by a calendar year company, the initial deferral election rules may require the deferral election to be made by December 31, 2014.

A deferral election can also be made within the first 30 days following grant, but only with respect to RSUs that will vest at least 12 months after the date of the deferral election. The fact that RSUs may vest within such 12-month period due to death, disability or a change in control event (as defined in Section 409A) does not preclude the deferral election but, if the RSUs actually vest within the first 12 months, the deferral election cannot be honored.

Section 409A requires that any deferral election be documented in keeping with its rules. An election to defer RSUs can be documented as part of the RSU award agreement, a separate deferral election form signed by the company and the RSU holder or a nonqualified deferred compensation plan maintained by the company.

Solving the Issue of Taxation Upon Retirement Eligibility. RSUs can help to address one common problem encountered by issuers who accelerate vesting of restricted stock upon the award holder's retirement. This type of retirement vesting can inadvertently trigger taxation upon retirement eligibility, rather than actual retirement. Restricted stock becomes taxable when it is vested for tax purposes, which occurs when the award is no longer subject to a substantial risk of forfeiture. For example, if an award of restricted stock provides for accelerated vesting upon the award holder's retirement, and defines retirement as any termination of employment after reaching age 65, the IRS considers that award to be vested when the award holder reaches age 65, even if he or she continues working. Because the award holder can quit at any time and keep the award, it is no longer subject to a substantial risk of forfeiture. Thus, the restricted stock becomes taxable to the employee even though he or she has not retired, and, depending on the terms of the award, the liquidity of the shares and any insider trading considerations, the employee may not be able to sell shares to cover the taxes.

RSUs can address this issue by providing that the award will not be paid until separation from service, even if it vests before then. As described above under *What Are Some Potential Advantages of RSUs? – Deferral of Income Taxation*, choosing separation from service as the payment date will delay income taxation of the RSUs until actual retirement.

Reduction of State Income Taxes. RSUs can be used to reduce state income tax liability in some circumstances. As a general rule, compensation is taxed by the state in which it is earned. Under the federal source tax rule, however, "retirement income" may be taxed only by the state of which the recipient is a resident or domiciliary.

RSUs that are deferred until separation from service and paid out in 10 or more annual installments are considered retirement income for purposes of this rule. This suggests some possible tax planning strategies. As an example, if a recipient of RSUs intends to reside in a low-tax state, such as Florida or Texas, after retirement, he or she may arrange for the RSUs to be taxed in the low-tax state by deferring payment of his or her RSUs until separation from service, and choosing payment in 10 annual installments.

Easier Satisfaction of Stock Ownership Guideline Requirements. RSUs can help executives to satisfy stock ownership requirements. Many publicly-traded companies have stock ownership guidelines that require their executive officers or directors to hold a number of shares representing a multiple of their compensation. These requirements are thought to encourage the alignment of the interests of the company's decision-makers with the interests of the company's shareholders.

Typically, when restricted stock vests, the award holder surrenders a portion of the shares subject to the award to satisfy the taxes that are due as a result of the vesting and settlement. This leaves the award holder with only the "net" amount of shares to count toward the stock ownership guidelines.

If deferred RSUs are used instead, the income taxes will not be due immediately, and the total, pre-tax number of shares subject to the RSUs can continue to count toward the award holder's compliance with the ownership guidelines.

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As described in this article, the flexibility offered by RSUs explains much of their growing popularity as a component of long-term incentive compensation. However, RSUs are also subject to complex tax requirements that can be a trap for the unwary. RSUs should therefore be designed and administered carefully to ensure that they achieve the desired results.

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