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Transitioning From Stock Options to RSUs

Terry Newth

MANAGING DIRECTOR

Deb Lifshey

MANAGING DIRECTOR

Summary

Many growing companies reach a point in their maturity when they consider incorporating restricted stock (RS) or restricted stock units (RSUs) as a long-term incentive for employees to either supplement or replace stock options, which tend to be the traditional vehicle for companies in their early stages. The reasons for transition may vary, but often come down to competitive pressures or a diminishing available share pool. Some will also make the case that this type of award is more easily understood by employees, and hence more valued, as it resembles a share of stock more than a traditional stock option.

While there are a number of fundamental differences between RSUs and stock options, one of the most important practical items for consideration is the tax impact on the grantee. Because of the complexities associated with taxation of restricted stock and RSUs, it may be difficult for an employee to see this change positively. Companies have a significant interest in their employees fully understanding the tax implications of RS and RSUs. Companies should also ensure that RS and RSUs are properly structured to ultimately bolster attraction, retention, and engagement.

While we are not taxation experts, there is some fundamental information about tax treatment of RS and RSUs for US filers that can help companies approach adding these vehicles to their pay mix in a smart way. Here are some important details, definitions, and alternatives a company can explore for payment of taxes, as well as some of the common traps we observe as companies make this important transition.

What is restricted stock (RS) and restricted stock units (RSUs)?

In its most simple form, RS is an equity vehicle that is awarded at no cost to the employee and that vests over a certain period of time, or is based on achieving certain future performance, with the employee receiving the underlying shares upon distribution and/or vesting date. An RSU is an unsecured promise to deliver a share of stock not upon vest, but at a later specified deferred payout date following the date of vest. If the company does not specify a deferral date or the employee does not select a deferral date on an RSU, the RSU is typically paid out upon vest (essentially operating identical to RS). Most commonly, RS or RSUs vest ratably over three to five years.

These equity vehicles are quite different from a stock option, which is the right to purchase company stock at a given price, in that RS and RSUs have an underlying value at grant—essentially, the value of the RS or RSU is not solely tied to appreciation from the date of grant.

Prior to 2006, there was no company expense associated with stock options, but when those accounting rules changed and options were required to be expensed similar to other forms of stock, RS and RSUs became a much more prevalent long-term incentive vehicle. RS and RSUs are often considered as a complement to stock options as they have inherent value at grant and employees do not need to rely on stock price appreciation to recognize value upon vesting.

Because employees have not paid for the underlying stock, whether the company's stock price increases or decreases, the awards always have value. RS and RSU may provide a better incentive for long-term growth since these arrangements are not as leveraged as stock options and therefore do not benefit as much from short-term spikes in stock value. Finally, employees may place a higher value on stock that they receive at no cost than they do on stock options, which inherently involve more risk.

From a company perspective, the number of RS or RSU awards delivered may be significantly smaller than the number of stock options that would be delivered for the same award, thereby reducing the company's overall expense for the plan and plan dilution.

How are RS and RSUs taxed for employees?

In the case of stock options, recipients have control over their tax impact as they generally have the right to choose the time at which the option is exercised, which then creates the taxable event. In contrast, taxes on RS are generally due when the award vests, with the recipient owing taxes on all applicable federal, state, local, and employment (e.g., FICA) taxes at that juncture. If either the company or the recipient have structured the award so that it pays out at a time later than the vesting date, only FICA is due at vest, and all other taxes would be due upon the later distribution date of the shares.

In addition to the compensation income recognized at vesting of an RS (or distribution of an RSU), there is also a subsequent capital gains tax upon sale of the shares if they were held after the vesting and the value of the shares increased. Also note that RSUs are considered deferred compensation and as such must comply with Section 409A of the Internal Revenue Code.

The following chart summarizes some of the concepts discussed above:

	Restricted Stock	Restricted Stock Unit
Price to Employees	$0	$0
Vesting	Shares typically vest over three to five years	Shares typically vest over three to five years
Issuance of Shares	Shares issued at grant with certain conditions; when conditions lapse, the participant receives the actual share free of restrictions	Shares are not issued until specified distribution date (could be at vesting or a later date)
Taxation on Vest	Shares are taxed (federal, state, local, and FICA) at vest	FICA taxed upon vesting; all other taxes incurred upon distribution (distribution is most commonly also the vesting date)

Taxation on Sale	Incremental gain upon sale of shares taxed at capital gain rate if held long enough	Incremental gain upon sale of shares taxed at capital gain rate if held long enough
Section 409A	Not applicable	Must comply with tax rules on distribution and timing

What options are available for employees to pay taxes on RS vesting (or RSU payouts)?

As part of the RS/RSU design process, employers will need to determine how they anticipate taxes will be handled by or for employees. Some companies will provide a choice to participants, but in many cases the employer, based on several considerations, will choose between one of the following alternatives and require participants use that method:

Alternative	Description	Considerations
Out of Pocket	Individual pays the taxes "out of pocket"	Company wants a simple, easy to administer program that puts the onus on the employee to handle taxes
Share Sale	Individual sells shares from the RS to RSUs vesting (or other owned shares) to cover the expected taxes	Same as above
Automatic Sell to Cover	Company (or plan broker) automatically sells share to cover the minimum tax requirements	Company wants to provide the employee some assistance in handling taxes, but does not want to have a cash outlay associated with taxes on RS or RSUs
Net Settlement	Company holds back the number of shares required to pay the minimum taxes, remits payment to the tax authority on the individual's behalf, and delivers the individual the net number of shares after tax	Company wants to handle the taxes for employees and is less concerned about the cash outlay associated with paying taxes on the individual's behalf

What are the common traps we observe?

1. **Employees do not understand the tax treatment for RS or RSUs.** We find that companies do not adequately communicate the tax implications of RS or RSU grants to employees, leading to frustrated employees when they realize that they owe taxes on shares that have vested, and that they had not planned for the tax liability.
2. **Short-swing profit rule compliance for executive officers.** The SEC has developed a regulation, called short swing profit rule, or 16b, that is intended to prohibit insiders (here referring to executive officers) from generating short-term profits from the purchase and sale of a company's securities. For companies electing to use automatic sell to cover or employee stock sales, failing to properly manage the transactions for insiders can create legal and governance issues. Under the rule, the person must return

any profit from a sale and purchase of company stock that each occur within a six month period. If the executive officer is selling RS or RSUs to cover taxes, then in theory the person is prohibited from purchasing company stock in the six month period before and after such sale. For this reason, in many cases companies will make use of net settlement for executive officers.

3. **Employers do not effectively communicate how taxes are remitted.** Companies in some cases fail to communicate with employees (or fail to advise them to discuss with a tax professional) that the withholding rate they use for settling taxes can be different from their actual tax rate, which may result in the individual owing more taxes out of pocket that they have not planned for.
4. **Employers don't understand that net settlement requires a cash outlay on the part of the company, or don't properly model potential outcomes.** In some instances the proper experts do not get involved at the right time and companies can unknowingly implement an approach to settling taxes that is not the best alternative, or at worst impactful to the company's ongoing operations given a company's cash position.

What should we do if we are considering RSUs?

For companies considering RSUs, thoughtful planning is everything. Make sure that you do the following during the design and implementation phase:

1. **Get the right people on the team upfront.** This includes HR, compensation advisors, finance, legal, and corporate communications. Construct a team responsible for researching and recommending the best course of action in terms of tax payment options and the associated strategies and tactics for implementing this change. This will help ensure that the company has done all it can in terms of structuring the tax in the way that best balances employee and company interests, and is effectively communicated to participants.
2. **Educate the decision makers so that they fully understand the implications of different alternatives.** Whether this is the CEO, the compensation committee, or the board of directors, ensure that the individuals responsible for finalizing the decision are well informed as to the alternatives and recommended approaches so they can make effective decisions.
3. **Monitor the experience.** It will be important over time to monitor the experience of participants to ensure that the chosen approach is creating positive sentiment from grantees.

The use of RS and RSUs can be particularly impactful and may have significant positive impact on company strategy if structured and communicated effectively. Being planful and thorough in the process will help ensure that employees see the value of the grant, mitigate any associated negative tax issues, and allow them to focus on their respective jobs.

About the Authors

Terry Newth is a managing director at Pearl Meyer. He consults on the design, development, and assessment of executive compensation programs that support each organization's business objectives, long term business strategy, and organizational culture. His clients range from Fortune 500 organizations to pre-IPOs to private and family-owned companies in a wide range of industries. Terry's areas of expertise include pay strategy and philosophy development, market-based pay studies, incentive plan design, severance and CIC arrangements, outside director pay, transaction-related compensation, CD&A and supporting table disclosures, corporate governance, and share plan authorizations.

Deborah Lifshey is a managing director at Pearl Meyer, where she specializes in advising clients on compensation matters from a legal perspective including securities disclosure, taxation and corporate governance issues, negotiation contracts, and reasonableness opinion letters.

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