RSUs: The Tax Problems in the Startup Context

Restricted Stock Units (RSUs) are not a good choice of equity compensation for a startup.

RSUs work great for big public companies, like Amazon or Microsoft. And sometimes RSUs can work great for private companies. But it has to be a really unique private company for RSUs to make sense. Examples would be a company ramping to its IPO, or a private company that is so profitable or has so much in cash that it can afford to help its employees pay the tax on their vesting unit awards. These are very unusual circumstances.

In most instances, if you are in a startup, your choice of equity award should be either stock options or restricted stock awards.

How do RSUs work?

The company awards you "Restricted Stock Units." Each unit represents one share of stock to which you will become entitled once your units vest.

For example, you might get 40,000 RSUs, vesting in equal increments over 4 years of service. After 1 year of service, the company would issue you 10,000 shares of stock.

This sounds great, and it is, except for the tax problems.

The Tax Problems

When you receive the 10,000 shares in the example above, you will owe tax on the value of those 10,000 shares at the time the shares are issued. So, in the above example, if after 1 year of service the shares are worth $20 a share, you will owe tax as if you had received $200,000 in cash. You will have to write a check to your employer so that your employer can send your share of the federal income and employment taxes to the IRS. Or you will have to forfeit the shares instead of receiving them.

The tax withholding the company is obligated by law to collect from the employee on $200,000 of income is substantial. You will have to write a big check to the company, or the company won't have to issue you your shares and you will forfeit them.

On $200,00 in value of vested RSUs, the income tax withholding will be about $50,000 (the supplemental wage withholding rate varies from time to time, but assume the current 25%). In addition to that, there will be FICA or Hospital Insurance taxes. Most employees do not have this kind of money to send to the IRS to receive shares in a private company which can't be sold.

Big, public companies, like Amazon or Microsoft--can manage this problem. These companies can establish programs that allow their employees to get liquidity on their shares immediately to pay the taxes. This can't be done in the private company context. So if you receive RSUs in a private company, with no public market for its shares, be careful. You might be stepping into an unexpected tax trap.