Stock-Based Compensation: Part 3

That’s more than I thought…AND I have to pay more taxes?

John A. Mariscalco, CFA, CFP®

Stock compensation can generate powerful feelings, challenging even the most prudent investors to make rational, research-based decisions and optimize this compensation. After years of experience working with clients who receive equity-based compensation, we’ve seen time and again how hard it can be to cast emotional biases aside when dealing with this component of wealth.

To help address this, we created this multi-part series to highlight some of the most important lessons for managing equity-based compensation. In Part One, we discussed how clients’ busy lives can cause them to delay dealing with their awarded shares, which can in turn seriously impact their wealth. In Part Two, we turned to the emotional biases and thinking errors that can lead to detrimental behaviors. In this third section, we will discuss specific strategies to help you minimize your investment risks—as well as your capital gains taxes.

Although we all like to focus on the potential upside of equity-based compensation, a prudent investor is also always aware of the factors that can jeopardize their wealth. One of the biggest risks involving equity compensation arises when one stock or security makes up a significant portion of a person’s financial assets. In the financial planning industry, this is referred to as “concentration risk.” Another challenging issue is the additional capital gains taxes that are incurred when equity compensation is sold.

“That’s (a LOT) More Than I Thought!”

The previous installment explained how emotional biases and thinking errors often prompt people to hold onto investment positions for far too long. When you’re regularly receiving company stock, your balances can pile up quickly if you do not deliberately manage them. What exactly makes this “concentration risk” so risky? To answer that question, we must first explore what concentration risk is and how to spot it.

Concentration risk arises when a single, non-diversified security, such as an individual company stock, makes up a large portion of an individual’s financial assets. An asset is classified as “non-diversified” when no other factors or holdings balance out its risk profile. In the case of equity compensation, you’re holding a position that is 100% invested in one company, so you have a high degree of company-specific risk. By comparison, mutual funds, exchange-traded funds (ETFs), and separate account strategies are typically diversified among many individual positions, industries, and economic sectors. That spreads the total risk across the entire portfolio rather than focusing it on one individual security. If one company in the Russell 3000 ® Index goes bankrupt, there are many other companies within the index that can generate additional stock price gains. Let’s reexamine the graphic from the first installment that compared the risk of an individual company stock to a more diversified basket of stocks such as the Russell 3000® Index.[1]

RUSSELL 3000 STOCKS OVER 35 YEARS (1986-2022)

of Russell 3000 stocks had a greater volatility than the index over their lifetimes

the median stock was more than three times as volatile, as the Russell 3000 index

of Russell 3000 stocks suffered permanent capital impairment[1]

Source: FactSet, Goldman Sachs Asset Management as of 12/31/22

1.Permanent capital impairment is defined as a stock that loses more than 75% of its value and does not recover to 50% of its original value. Diversification does not protect an investor from market risk and does not ensure a profit.

Although there is no hard-and-fast rule, the customary guideline is that concentration risk becomes a concern when ***a single stock comprises 10% to 20%*** of an individual’s total financial assets.

This is because when a single stock dominates an individual’s financial assets, the risks to the investment program increase, and the projected outcomes become more uncertain. In the following section, we’ll use a hypothetical example to illustrate these points.

Assumptions:

- Husband and wife both work
- Both make maximum annual 401k contributions and receive an employer match
- 20-years until retirement
- $1,200,000 in total financial assets (retirement accounts + non-retirement accounts) to start
- There is a concentrated stock position arising from the accumulation of vested RSUs totaling nearly 35% of the financial assets
- The husband and wife have an average risk tolerance (i.e. not too aggressive, nor too conservative), which will be referred to as a "balanced objective"
- The required rate of return to meet their longer-term planning needs is roughly 5%, which is consistent with a "balanced objective"

Table 1: Financial Asset Comparison

	Finacial Asset Allocation	
	Cash & Bonds	Stocks & Alternatives
Client Current	33.0%	67.0%
Balanced Objective	50.0%	50.0%

Table 2: Financial Asset Comparison + Financial Planning Risk & Return Projections

	Finacial Asset Allocation		Financial Planning Projections	
	Cash & Bonds	Stocks & Alternatives	Expected Return	Expected Risk
Client Current	33.0%	67.0%	5.3%	10.7%
Balanced Objective	50.0%	50.0%	4.9%	8.4%

As Table 1 shows, by holding a concentrated stock position, the couple's total stocks & alternatives weight is much greater than what their planning profile recommends (67% v. 50%). Table 2 shows that their current allocation is subject to nearly 30% more risk (10.7% v. 8.4%), but generates only incrementally more return.[2] In the financial planning industry, we describe this as a **risk/reward imbalance**. As such, the client's current allocation would be expected to perform less efficiently than the Balanced Objective, if all other factors are equal. So, what about the longer-term outcomes for these two allocations?

Table 3: Planning Outcome Dispersion

	Hypothetical Value in 20 Years (Future Dollars)			
Projected Results	Client Current	*Diff High v. Low*	Balanced Objective	*Diff High v. Low*
High Value:	$9,821,889	*$7,185,814*	$8,255,179	$5,279,053
Median Value:	$5,208,933		$5,093,031	
Low Value:	$2,636,075		$2,976,126	

Table 3 shows that the dispersion between returns (the difference between the highest likely outcome and the lowest likely outcome—or Diff High v. Low) is much greater for the client's current allocation compared to the Balanced Objective. This is because the client's current allocation is much riskier than that of the Balanced Objective. Even more compelling, the median (i.e., middle) value is nearly the same for both the current approach and the Balanced Objective portfolio, but the low value **is worse for the current approach, which is the riskier allocation**. Many of our clients are surprised to learn this, particularly since the return of one allocation is greater than another.

To be sure, the high value of the current allocation is a lot greater than the Balanced Objective. Still, the main point remains—the current allocation exposes the client to **more risk than is necessary**. This is arguably the most important point we talk with our clients about, particularly those who are mid-career, have a long time to invest, and tend to take on risk. These examples powerfully illustrate the **trade-offs associated with the risks investors need to take versus the risks they want to take**. Importantly, our clients can see that they may actually be able to assume less risk and still achieve their goals.

AND I Have to Pay More Taxes?

So far, we've focused on maximizing your earnings, but now we turn to the money you have to pay—your taxes. For this discussion, we'll look specifically at how restricted stock units (RSUs) are taxed since other forms of equity-based compensation, like non-qualified stock options, are taxed somewhat differently and are outside the scope of this discussion.

First things first, when a grant of restricted stock vests, the total value of that grant is taxed as ordinary income. Let's assume that, a few years ago, an employee received 400 shares of stock at $250.00 per share, and the vesting date has finally arrived. Hooray! Now, for simplicity's sake, let's assume the shares today are worth the same price they were originally, $250.00. (This is unlikely, but it simplifies our analysis.) Upon vesting, the total value of $100,000 is treated as ordinary income and will be subject to the same tax rates as the person's annual earned income (i.e., their W-2 wages). Below are the updated brackets and rates for 2024 as outlined by the IRS:[3]

For tax year 2024,
The top tax rate remains 37% for individual single taxpayers with incomes greater than $609,350 ($731,200 for married couples filing jointly).
The other rates are:
35% for incomes over $243,725 ($487,450 for married couples filing jointly)
32% for incomes over $191,950 ($383,900 for married couples filing jointly)
24% for incomes over $100,525 ($201,050 for married couples filing jointly)
22% for incomes over $47,150 ($94,300 for married couples filing jointly)
12% for incomes over $11,600 ($23,200 for married couples filing jointly)
The lowest rate is 10% for incomes of single individuals with incomes of $11,600 or less ($23,200 for married couples filing jointly).

Source: IRS https://www.irs.gov/newsroom/irs-provides-tax-inflation-adjustments-for-tax-year-2024

As you can see from the table, the amount of tax owed on bonus stock compensation can be large. Frankly, for many employees, it can easily push their taxable income into the 32% or higher brackets.

When our hypothetical employee's $100,000 of stock compensation vests, their employer, like yours, will withhold a portion of the vested shares to pay the estimated tax. Table 4 shows what this looks like:

Table 4: Stock Grant Vesting and Taxes Paid via Shares Withheld

	ABCD Co. Stock Grant Q1 2021
Shares granted	400
Vesting date	Q1 2024
Share price @ vesting date	$250.00
Total value	**$100,000.00**
Assumed tax rate	*32%*
Tax due	$32,000.00
Number of shares withheld for taxes	128
Unrestricted shares kept	272
Unrestricted, after-tax value	**$68,000.00**

As outlined in Table 4, after those shares are sold, the employee will then receive 272 shares for a total value of $68,000. I know what you're thinking "Umph…That's a lot of tax!" That's the good and the bad with equity-compensation programs: they can be extremely lucrative, but they tend to meaningfully increase your tax liability.

At this point, our clients often turn to us and ask, "Now what do I do?" As we've covered at length in this series, there are benefits and drawbacks to holding onto an individual company's stock, especially after multiple vesting periods and when the unrestricted balances are approaching concentration risk. Putting aside the dangers of concentration risk so we can focus only on how tax bills are calculated, let's look at two primary outcomes that can occur when you hold onto stock after it vests: 1.) the stock price rises or 2.) the stock price falls.

Returning to our example, our hypothetical employee now owns 272 shares outright, each worth $250.00, for a total of $68,000. Let's assume that the **price of the stock doubles**, rising from $250.00 to $500.00, totaling $136,000. Instead of holding on for more potential gains, our employee decides to sell all of their shares and bank the gain. So, what's the potential tax implication? Well, that depends on whether they've held the stock for longer than 12 months or not. If they've held the shares for more than 12 months, then their long-term capital gains are taxed at 0%, 15%, or 20%, depending on their income tax bracket. However, short-term capital gains are taxed at the much higher ordinary income tax rates that we outlined earlier. If you're thinking, "Wow! That's a big difference," it certainly is. On the following page is a table that highlights how stark the difference can be.

Table 5: Long-Term v. Short-Term Capital Gains Tax

Holding Period Long-Term

	ABCD Co.
Unrestricted shares kept	272
Share price upon vesting	$250.00
Unrestricted, after-tax value	$68,000.00
Stock price doubles	$500.00
New value	**$136,000.00**
Trading action	Sell entire position
Total dollar gain	$68,000.00
Holding period	More than 12 months = **Long-term**
Capital gains tax rate	15%
Taxes due	$10,200.00
Post-sale, after-tax value	**$125,800.00**

Holding Period Short-Term

	ABCD Co.
Unrestricted shares kept	272
Share price upon vesting	$250.00
Unrestricted, after-tax value	$68,000.00
Stock price doubles	$500.00
New value	**$136,000.00**
Trading action	Sell entire position
Total dollar gain	$68,000.00
Holding period	Less than 12 months = **Short-Term**
Ordinary income tax rate	32%
Taxes due	$21,760.00
Post-sale, after-tax value	**$114,240.00**

As you can see, there is a massive difference between paying long-term capital gains versus ordinary income tax— nearly $126,000 versus $114,000. This is why the holding period is critically important when investment gains are realized in taxable accounts.

Lastly, let's compare the total taxes paid from the time the RSUs vest until the time they are sold. This highlights what we call the "total economic gain"--the amount an individual will realize between the time the RSU grant vests until the shares are sold.

Table 6: Total Taxes Paid v. Total Economic Gain

Long-Term Hold (LTH)

Total Taxes Paid w/ LTH	**$42,200.00**
RSU vesting	$32,000.00
LT capital gains tax	$10,200.00
After-tax value	**$125,800.00**
Original RSU Grant	$100,000.00
Total Economic Gain	*26%*
ABCD Co. Stock Price Gain	100%

Short-Term Hold (STH)

Total Taxes Paid w/ STH	**$53,760.00**
RSU vesting	$32,000.00
ST ordinary income tax	$21,760.00
After-tax value	**$114,240.00**
Original RSU Grant	$100,000.00
Total Economic Gain	*14%*
ABCD Co. Stock Price Gain	100%

So, even though ABCD Co. gained 100%, the employee's total after-tax return on the original bonus compensation is not nearly as high when it's subjected to short-term capital gains instead of long-term capital gains. You might have noticed that the total taxes paid range from 42.2% to 53.7% when measured against the original $100,000 RSU grant that vested. Why is this important? Because the difference between short-term capital gains tax is massive at high-income levels. By deferring your gains for longer than a year, you can secure a more advantageous tax rate and hold onto more after-tax income.

Now that we've covered what happens when the stock price doubles, let's examine what happens when the stock price gets cut in half. Again, given the risk characteristics of an individual stock, this is certainly possible. Recall the graphic from the first installment: 38% of Russell 3000 Index stocks have suffered capital impairment, meaning they've experienced a decline of 75% or more and never recovered to 50% of their original value. Said another way, a stock starting at $250 drops by 75% to $62.50 but never rises to $125. To emphasize this point, exactly how much return is needed to fully recover from this 75% setback? Exactly 300%.

Below, we'll walk through a similar example, but now we'll assume the stock price falls by 50% to $125 per share from $250 per share. Not ideal, but there is a silver lining.

Table 7: Long-Term and Short-Term Capital Losses

Holding Period Long-Term

	ABCD Co.
Unrestricted shares kept	272
Share price upon vesting	$250.00
Unrestricted, after-tax value	$68,000.00
Stock price cut in half	$125.00
New value	**$34,000.00**
Trading action	Sell entire position
Total dollar loss	($34,000.00)
Holding period	More than 12 months = **Long-term**
Capital gains tax rate	0%
Taxes due	$0.00
Post-sale, after-tax value	**$34,000.00**

Holding Period Short-Term

	ABCD Co.
Unrestricted shares kept	272
Share price upon vesting	$250.00
Unrestricted, after-tax value	$68,000.00
Stock price cut in half	$125.00
New value	**$34,000.00**
Trading action	Sell entire position
Total dollar loss	($34,000.00)
Holding period	Less than 12 months = **Short-Term**
Ordinary income tax rate	0%
Taxes due	$0.00
Post-sale, after-tax value	**$34,000.00**

Table 8: Total Taxes Paid & Loss Incurred

Long-Term Hold (LTH)

Total Taxes Paid w/ LTH	**$32,000.00**
RSU vesting	$32,000.00
LT capital loss	($34,000.00)
After-tax value	**$34,000.00**
Original RSU Grant	$100,000.00
ABCD Co. Stock Price Loss	50%

Short-Term Hold (STH)

Total Taxes Paid w/ STH	**$32,000.00**
RSU vesting	$32,000.00
ST capital loss	($34,000.00)
After-tax value	**$34,000.00**
Original RSU Grant	$100,000.00
ABCD Co. Stock Price Loss	50%

As we can see in the aforementioned tables, when a stock price declines, there is no difference in the after-tax value whether the investor pays long-term or short-term capital gains. In this situation, there is no tax paid, so either way, the individual ends up with 272 shares worth a total of $34,000. Losing $34,000 after paying $32,000 in tax [which the company withheld upon grant vesting] doesn't feel very good; however, if you're in this position, it may work out to your advantage.

That's because the tax code allows individuals to use their capital losses to:

1. Offset other taxable gains that may have been generated in other taxable accounts they own, and/or
2. Lower their overall income

Specifically, the IRS code allows individuals to claim up to $3,000 in capital losses ($1,500 if married filing separately) against their income to the extent there are no realized gains that would offset the loss.[4]

As we explored in part two of this series, it can be hard for employees to sell company stock, even when it's performing poorly, so we diligently educate our clients about how selling a losing stock can actually benefit them. Known in the financial industry as "tax-loss harvesting," this strategy involves selling stocks at a loss to offset the gains your winning investments generated. Doing this reduces your realized gains and, therefore, your tax bill. Although it might feel counter-intuitive to sell stocks at a loss, it can improve your bottom line.

Another notable benefit of the current U.S. tax code is that capital losses can be carried forward into future years if they are not fully exhausted in a given tax year. Let's go back to our example where the stock price fell by 50% and the client's realized loss amounted to $34,000. If that client had no other gains that year, they could use $3,000 (or $1,500 if married filing separately) to lower their overall income. They could then carry forward any leftover amount to future tax years indefinitely, up to $3,000 per year (or $1,500 if married filing separately), until the losses are exhausted.

As detailed in the last installment, the emotional biases that come with equity compensation are really hard to overcome. Our job as advisors is not simply to identify the most quantitatively optimal strategy. A reputable and helpful wealth advisor will combine risk management with an understanding of the client's specific goals and values, including the emotional biases we explored in Part 2. Even though it is clear that an individual stock carries more risk than a diversified set of securities, we're not doing our job as advisors if we don't listen to our clients and incorporate their financial values and beliefs. Therefore, the programs we build blend what the "science" tells us **and** what's important to the client. But to do this, we must first listen to our clients and then craft a plan from there.

In the final installment, we'll bring this topic full circle by comparing two hypothetical families, one that receives stock-based compensation and the other that does not. We'll examine why a "one-size-fits-all" approach is generally not well suited for high-income-earning families that also receive a large portion of their compensation in the form of company stock. Although "one-size-fits-all" is an easy, straightforward approach, the drawbacks can more than outweigh the benefits of simplicity and efficiency. By the end of this four-part series, you'll be more prepared to tackle your company-stock "to-do's," spot concentration risk, improve tax-efficient decision-making, and build a program that is best suited for you and your family's unique goals and objectives.

For those who would like more information on any of the topics covered in this series, please give us a call at 312-736-8567 or email jmariscalco@103advisory.com. When you're ready, we're here to help.

P.S. Do you have friends or colleagues who also wrestle with how to handle their stock compensation? If so, please share this series with them. Below is a link to our website that you can copy and paste.
https://103advisory.com/our-thinking/

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Sources

1. FactSet, Goldman Sachs Asset Management as of 12/31/2022
   - Permanent capital impairment is defined as a stock that loses more than 75% of its value and does not recover 50% of its original value. Diversification does not protect an investor from market risk and does not ensure a profit.
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3. Tax Bracket Table: IRS, https://www.irs.gov/newsroom/irs-provides-tax-inflation-adjustments-for-tax-year-2024
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