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Incentive Compensation: Let the Tax Code Be Your Guide

By: Holly Swan | January 17, 2024

Many U.S. companies grant equity awards at year-end, and advisors come face-to-face with clients who might not know what their employer's stock is worth.

It can be difficult for clients to see the risks associated with a concentration in their employer's stock, particularly senior level executives. This often happens when emotional biases come into play, such as:

Overconfidence about their own investment prowess and the prospects for their employer. This may cause some clients to think the only direction their employer stock can possibly move is up, making them reluctant to diversify.

The endowment effect causes the stockholder to value their employer's stock more highly and less objectively than if they didn't already own it. This is like the seller of a house asking more than buyers are willing to pay: To the seller, it's a home, but to the buyer, it's just a house.

Status quo bias relates to the tendency to do nothing instead of making a change, even though a change may be warranted. Less senior employees who may not fully understand their rights to their stock have this bias more often.

How can you help clients with employer stock manage these biases? Instead of challenging them head-on, consider a different conversation entirely—one about the tax code. Invite clients to consider the composition of their exposure to employer stock by asking:

"Have you considered letting the tax code guide your exposure to employer stock?"

While clients should consult a CPA or tax attorney for tax advice, you can point out that the tax code provides information about which shares should typically be disposed of first.

For instance, the most common type of incentive compensation, restricted stock units (RSUs) are generally taxed as ordinary income on the day they vest. When this is the case, there is no tax benefit to continuing to hold them beyond vesting.

The same is true for non-qualified stock options (NQSOs). The difference between the strike price and the fair-market value is taxed as ordinary income at the time of exercise. While the timing of exercise should be considered as it will impact the timing of ordinary income, once exercised there is no tax benefit to continuing to hold those shares.

On the other hand, incentive stock option (ISOs), shares acquired through an employee stock purchase plan (ESPP) and shares held inside a qualified retirement plan all receive forms of preferential tax treatment so holding onto them longer can make sense.

Bottom line: Help clients move beyond their emotional biases to employer stock by encouraging them to let the tax code guide their exposure.

The Firm does not provide tax advice. The tax information contained herein is general and is not exhaustive by nature. Tax laws are complex and subject to change. Investors should always consult their own legal or tax professional for information concerning their individual situation.

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