RETIREMENT

DISTRIBUTIONS OF EMPLOYER STOCK FROM 401(k) PLANS: TAKING ADVANTAGE OF NET UNREALIZED APPRECIATION

If you participate in an employer-sponsored retirement plan and decide to change jobs or retire, you will be faced with some important decisions. While many choose to roll over their plan balance to an individual retirement account (IRA), if you have company stock in your plan, you could forfeit a significant tax advantage — net unrealized appreciation (NUA) — by rolling over the stock.

Net unrealized appreciation is the difference between the original cost and the current fair market value of the employer stock while held in a qualified retirement plan. When a plan participant receives a lump-sum distribution that includes employer stock, special federal tax rules allow the participant to defer paying federal taxes on the NUA.

Tax-saving strategy

If you receive greatly appreciated employer securities as part of a lump-sum distribution payment of your entire retirement plan assets within a single tax year, you should carefully consider whether or not to roll over these securities into an IRA. All distributions from IRAs are taxed as ordinary income, not as capital gains. Therefore, if employer securities are rolled over into an IRA, any potential for long-term capital gains treatment on the NUA and subsequent appreciation is lost.

If you elect a partial rollover instead — with only the portion of the lump sum not consisting of the employer stock being rolled over — there is no current tax on the rolled over portion. However, there is tax at ordinary income tax rates on the value of the stock when it was obtained by the plan (*i.e.,* cost basis). And if you are under age 59½, you may be subject to a 10% penalty on the cost basis of the stock.

Key points

- If any part of your 401(k) plan is invested in employer stock, make sure you understand the tax implications of either rolling over or taking a lump-sum distribution from your 401(k) when you change jobs or retire.
- Make sure you tell beneficiaries that the NUA tax break may apply to them.
- Note that the potential NUA tax break is void if your entire interest in this plan or potentially other employer plans is not distributed in the same calendar year.

This material should be used as helpful hints only. Each person's situation is different. You should consult your investment professional or other relevant professional before making any decisions.

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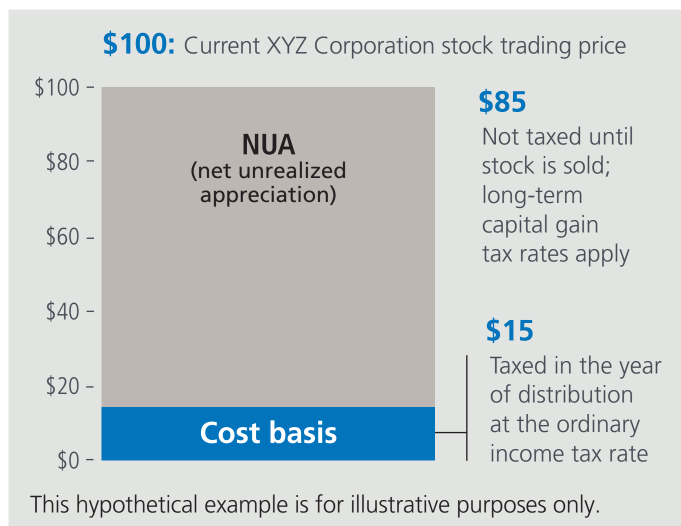

This hypothetical example is for illustrative purposes only.

How stock is taxed

The cost basis of the stock is taxable when distributed; any net unrealized appreciation attributable to employer stocks is not taxed until you sell the stock. Additionally, when the stock is sold, the net unrealized appreciation as of the date of the lump-sum distribution is taxed at the long-term capital gain rate, rather than as ordinary income, which may entitle you to more favorable tax rates on this sum. Any additional appreciation that accumulates after the date of the lump-sum distribution needs to be held for at least a year to be given long-term capital gains treatment. The difference in the two tax rates can be substantial, particularly if you are in the highest tax bracket of nearly 37% for 2019.

The benefits of NUA

One of the key benefits of receiving employer securities from a qualified plan is that the NUA portion will be taxed at the applicable capital gain tax rates.

Assume Mr. Smith, age 62, receives a share of XYZ Corporation stock (company stock) from his employer's qualified retirement plan, which is currently trading at $100. The employer's qualified retirement plan trustee's cost basis of the stock is $15. The $85 difference represents NUA. Only the $15 is subject to taxation at the ordinary income tax rates in the year of distribution. The $85 NUA will not be taxed until the year that the stock is sold.

Final considerations

Because there may be significant income and estate tax advantages when you take employer securities from an employer-qualified plan, you should consider whether taking a portion of the employer shares in kind from the employer-qualified plan is the right strategy for you. The number of in-kind shares of employer stock ultimately taken will depend largely on a number of tax and investment decisions. It is important for you to work with your tax and financial advisors to determine which strategy to employ, as owning too much of a single investment could expose you to significant investment risk.

Employer stock is subject to the same risks as any stock. The stock could be worth more or less than its original cost at the time it is sold. By holding company stock, as opposed to selling it, an investor assumes the risks of any shareholder. Additionally, some investors, as a result of employer stock purchase programs, may have a significant percentage of their assets in company stock. Selling a portion of the employer stock may allow you to diversify your portfolio. Speak with your tax advisor and financial advisor to review what percentage of your holdings is in employer stock and ensure that your portfolio is in alignment with your goals, time frame and appetite for risk.

There are advantages and disadvantages to an IRA rollover depending on investment options, services, fees and expenses, withdrawal options, required minimum distributions, tax treatment and the investor's unique financial needs and retirement goals. Please be aware that rolling over retirement assets into one IRA account could potentially increase fees as the underlying funds may be subject to sales loads, higher management fees, 12b-1 fees, and IRA account fees such as custodial fees. For assistance in determining if a rollover to an IRA is appropriate for you, consult your investment professional.

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