

Special Benefit for Company Stock in Your 401(k)

Topic:	Reduced Tax on Distribution of Company Stock at Retirement
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Executive Summary:	A special tax benefit is available for employer stock when it comes time to roll it over from your 401(k) to an IRA. Most executives are not aware of this benefit or in what situations it may be advantageous. This article explains the benefit and why you might want to use it.

Did you know that investing in company stock inside your 401(k) gives you a potential tax savings opportunity when you retire? The special tax benefit given to employer stock in a 401(k) is one of the most overlooked opportunities for tax savings that we see in our practice of serving corporate executives.

Meet Jim, a 57 year old corporate executive with 30 years at XYZ Company. He has a 401(k) savings plan which is worth \$1,000,000, \$400,000 of which is invested in XYZ stock. The rest is invested in mutual funds allowed by the plan. Jim is about to retire. He comes to us assuming he will roll over the entire 401(k) into one or more IRA's. We ask Jim what his cost basis is on his XYZ stock; that is, how much did he pay for the stock each time it was over his 30 years? We determine that it is only \$150,000 (the plan administrator has this number) leaving a net unrealized appreciation gain of \$250,000.

After we gather all of Jim's financial data, we meet with him and his spouse to explain that he has another option as to the distribution of his 401(k) upon retirement. Yes, he may roll his entire 401(k) over into an IRA and defer any taxation. However, with regard to his XYZ stock, he may instead use the special income tax treatment afforded to the "net unrealized appreciation" (NUA) amount.

Using the NUA strategy, Jim can take a distribution of the company stock and pay ordinary income tax only on the cost portion of the XYZ stock of \$150,000. Thereafter, he may sell the stock and only pay 15% capital gains on the unrealized appreciation of \$250,000. Assuming Jim is in the 35% bracket for the \$150,000 portion, his total tax liability would be \$90,000. In addition, any subsequent appreciation while owning the stock will also be taxed as either short or long term capital gains depending on the holding period since the distribution. One downside of the taxable account is that annual dividends are subject to tax, but qualified dividends are only taxed at 15% (through 2008).

In contrast, if Jim had rolled over the entire amount into an IRA, he will be taxed at ordinary rates on the entire amount when distributed. Jim's total tax liability on the ultimate distribution of \$400,000 if he is in the 35% bracket would be \$140,000 or \$50,000 more than the NUA strategy (ignoring the time value of money).

If Jim wanted to diversify his portfolio further by selling some of his XYZ stock, he could distribute only the XYZ stock he wanted to keep (the early low basis shares) and roll the rest into an IRA where he could sell without tax consequences. However, once the portion of the XYZ stock is rolled into an IRA, the NUA strategy is not available for those shares in the future.

Using the NUA strategy is not for everyone. For example, if Jim does not intend to use the proceeds in retirement but will pass the assets to his heirs, he may be better off rolling the XYZ stock into the IRA to take advantage of the ability to spread the distribution over the lives of his beneficiaries. On the other hand, if Jim needed the assets immediately upon retirement, he would pay less tax by using the NUA strategy.

Due to the time value of money and the use to which the stock or proceeds is applied may vary, the NUA strategy should be evaluated by a tax professional or financial advisor for how this strategy may apply to your situation. In addition there are technical requirements which may make the election impractical. However, in the right situations, this strategy can generate a substantial tax savings.

The information contained herein is of a general nature and should not be relied upon without first consulting a financial advisor. If you would like further information please email info@vantagefinancial.com.

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