Dealing With Company Stock in Your 401(k)

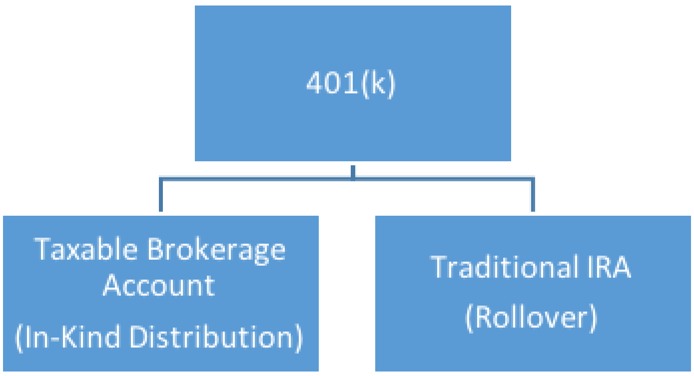
[Editor's Note: This is a guest post from Thomas Tkachuk at 3WiseMenFinance.com. It's well-written and an important subject, although probably not applicable to most docs and other high-income professionals. Although attorneys working for big corporations, or perhaps even physicians as we move more and more into employee positions, could benefit. Certainly many of us have spouses for whom this strategy could be applied. The basic idea is to pay less in taxes on company stock in your 401(k) than you otherwise would by taking advantage of Net Unrealized Appreciation. Thomas and I have no financial relationship.]

If you are lucky enough to work in the same company for your whole career, then you may have acquired a good amount of company stock in your 401(k) over the years. Many businesses offer stock incentives for their employees, and in most cases, employees end up with more company stock than they know what to do with. Over a 30+ year career, those shares will most likely have appreciated quite a bit, and because of that, taxes can apply. If you're in this situation, a portion of your 401(k) is made up of stock in your company. Hopefully not too much, since no single stock should make up more than 10%

of your entire portfolio, even if *[especially if-ed]* it's company stock. If you just leave the stock in the 401(k) until you're ready to spend it, then sell it and pull the money out of the 401(k), you'll pay your ordinary marginal income tax rate on the withdrawals, just like any other 401(k) investment.

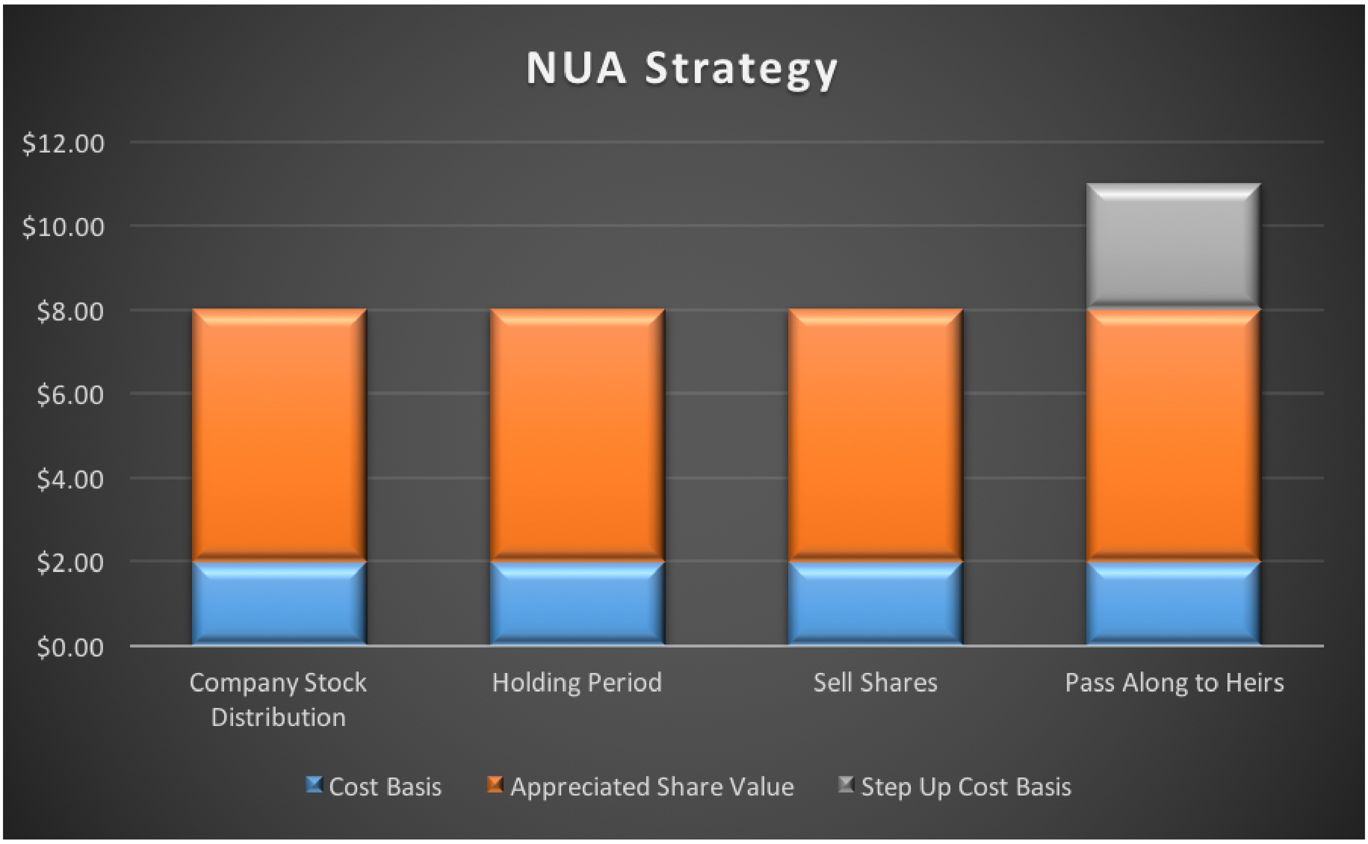
However, there is a strategy to help avoid having your profits eliminated by taxes. The Net Unrealized Appreciation (NUA) tax treatment is an option to consider when you become eligible to take a distribution from your 401(k). Using this strategy can mean the difference between paying taxes at your current ordinary income rate versus capital gains rate.

Here's how it works:



The idea is that you clear out your 401(k) and separate out your company stock from the rest of your assets. The company stock is moved into a brokerage account and the other assets are rolled into an IRA.

At the time of distribution from the 401(k), you will pay ordinary income tax only on the cost basis of the company stock. For example, if shares cost $2 when you received them 30 years ago, then you owe taxes based on that price. The NUA strategy is designed to address the appreciation of those shares over time. If your shares are now worth $8 per share, you would rather not pay your ordinary income rate on those gains. Instead, with the NUA strategy, you only pay long term capital gains rates and only for the shares you sell. If you are able to pass those shares on to your heirs at death, then they will receive a step-up cost based on the share price when the transfer is made. In other words, the heirs are not on the hook to pay taxes on the appreciated value of your company shares. This gives them the option to cash out or to hold onto the shares and hope they continue to appreciate over time. *[You could also use the appreciated shares for your charitable giving-ed.]* Keep in mind that dividends earned on company stock are always taxable.



So when you decide to sell the shares that are now in your brokerage account, you will pay taxes at the long term capital gains rate, which is going to be lower than paying your ordinary income rate. The benefit to you is the difference between your ordinary income rate and the capital gains rate, which could be significant!

[Editor's Note: This strategy isn't the best strategy for everyone, especially if the stock hasn't appreciated much. You're weighing the tax savings on paying for your gains at LTCG rates instead of ordinary rates (or better yet not paying them at all) against the value of continued tax deferral of dividends, better diversification, additional asset protection, and easier estate planning including a stretch IRA. The lower the basis, the lower the dividend rate, and the more likely you are not to sell the shares at all (die or give to charity) the better the NUA strategy is. But if you have high basis and are still young (so lots of time for tax-protected growth to do its thing), then you may be better off leaving the money invested in shares inside the tax-deferred account. Plus, you can then sell the shares and diversify your portfolio better.]

What do you think? Have you used the NUA strategy for yourself, a family member, or a client? How did it work out? Are you a professional who owns company shares in your 401(k)? What do you plan to do with them? Comment below!