Company stock and your plan payout

Taxes play an important role in your retirement planning. For instance, if you are a 401(k) or other retirement plan participant and will receive a lump sum distribution, taxes may affect your choice of what to do with the payout.

Several approaches

In broad outline, when the time comes to receive a payout from your company retirement plan: (1) You can take the lump sum, pay the tax owed (at ordinary income tax rates) and then invest what's left. (If you are under age 59 1/2 when you take your funds, you may be hit with a 10% penalty, too.); or (2) you can roll over your distribution directly from the plan to an IRA. Your retirement assets then continue to grow tax deferred.

Do you own employer stock? It's not unusual. According to a survey conducted by the Employee Benefit Research Institute, 41% of 401(k) participants held more than 20% of their assets in company stock. And that fact may dictate a different approach to how you manage your payout—one that combines elements of both of the strategies above. Why? You may be able to achieve significant tax savings by segregating your company stock from what you intend to roll over—often referred to as the "net unrealized appreciation" (NUA) approach.

Mapping out a Rollover IRA

For many people the decision to roll over at least part of a retirement payout will be the best one.

The first step in the rollover approach is to make advance arrangements for a direct rollover of the balance from your plan account to an IRA. Do not receive the funds from the plan yourself. If you do, your employer, by law, is required to withhold 20% of your distribution for income taxes.

It's not fatal if you don't arrange for a direct rollover, but matters do become a bit complicated. You still can execute the rollover, as long it's done within 60 days. You also are allowed to contribute from other savings the amount that was withheld for taxes. (You will be entitled to a tax refund for the amount that has been withheld.) If you don't add in the withheld amount, it's considered a distribution and taxed as ordinary income.

Using an NUA approach

A combined Rollover IRA/NUA approach works like this: You arrange for a direct rollover of your lump sum, minus the employer-stock portion. Instead, the employer stock becomes part of your personal portfolio. The rollover portion of your payout escapes current tax, but it will be taxed at ordinary income tax rates when withdrawn.

To understand how the tax on your employer stock is calculated, it's best to think of four taxable blocks that, together, make up what you will owe:

• Block one consists of what your company paid for all of the stock contributions made to your plan account (the stock's *average cost basis*). This amount is taxed at ordinary income tax rates at the time of the stock's distribution.

• Block two is the NUA—the difference between the average cost basis and the market value of the stock at the time of the distribution. NUA always is taxed at long-term capital gain rates determined at the time of distribution (currently, a maximum of 15%), not at ordinary income tax rates (up to 35%), but the tax doesn't have to be paid until the stock's eventual sale.

• Block three is the dividends earned on the company stock after the distribution. Under current rules the dividends may be eligible for special tax treatment—a 15% tax rate. (Had the stock been rolled over into an IRA, dividends earned would have come out of the IRA taxed at ordinary income tax rates.)

• Block four is the additional appreciation (if any) that occurs between the distribution and the sale of the stock. This block is taxed at either short-term or long-term capital gain rates, depending upon how long that the shares are held.

The other side of the coin

Along with the potential rewards of taking an NUA approach, there are some reasons to look before you leap. For instance, by making your company stock a part of your taxable portfolio, you lose the opportunity to diversify out of the stock without paying capital gains tax. In addition, assets not sheltered from a tax-deferred retirement account may have less protection

from creditors. Finally, tax rates can change, or the price of the company shares may decrease, eliminating some of the anticipated tax benefits with the NUA approach.

Obtaining professional guidance is strongly recommended. In our roles as trustee or investment advisor, we have helped many a retiree shape and execute a tax strategy for a retirement plan payout, designed specifically to meet his or her goals and needs. We would be glad to discuss how we can assist *you*.

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Any developments occurring after January 1, 2009, are not reflected in this article.