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Did Someone Say Roll Over?

A little-known strategy for reducing taxes on company stock in your 401(k)

By LESLEY ALDERMAN

Linda Harris had an enviable problem. After 15 years at Schwab & Co., the shares in her employee stock ownership plan had grown in value to $3 million. Harris, a 43-year-old network analyst, was concerned about having virtually all of her wealth tied up in the stock of a single company. But what could she do? As long as she stayed at Schwab, she couldn't trade out of the stock. But if she left her job and cashed out of her ESOP, the taxes and penalties would eat up half of her savings.

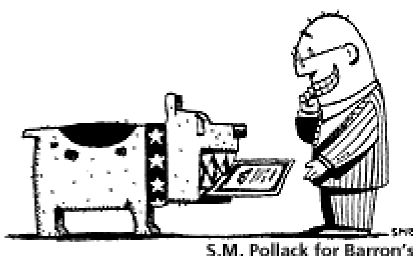
Harris' problem was not so unusual, though the amount of money at stake perhaps was. And the solution, which limited her tax and penalty liability to just over 20%, applies to 401(k) participants and ESOP holders alike.

First a little background. For the past 15 years or so, workers at many publicly held companies have been collecting shares of their employers' stock. Usually, it has come as the match on their 401(k) contributions, with the employees contributing a portion of their own money into the stock. And in the case of ESOPs, which are considerably more rare, all of their retirement contributions have gone into company stock.

The upshot is, some 18% of the estimated $1.6 trillion now in 401(k) plans is invested in company stock. And at companies like Coca-Cola, Dell Computer and Pfizer, the percentage is significantly higher -- 92%, 87% and 85% respectively.

Indeed, it's not unusual for rank-and-file employees at some highflying companies to have six- and even seven- figure sums in their 401(k) plans invested in company stock. And down the road, that can make for some pretty serious tax liabilities.

As Linda Harris found, however, there is a way to dodge a big tax bullet. So if you're nearing retirement or simply preparing to jump to a new job, please pay close attention.


S.M. Pollack for Barron's

Typically, when people change jobs or retire, they roll their 401(k) or ESOP into an IRA. That means taking a lump-sum distribution from the plan and transferring the funds, tax-free, into an IRA. Later, when the money is withdrawn from the IRA, it is taxed at ordinary income rates.

But thanks to an obscure provision in the tax code, you may be able to cut the tax bite substantially. Here's how: When you take the lump-sum distribution, ask to have the shares distributed separately and placed in a

taxable account. You will then be taxed on the cost basis -- not the present value -- of the stock. That is, your tax liability will be limited to what you or the trustees of your plan paid when the stock was purchased.

Later, when you sell the stock, you'll be taxed at the long-term capital-gains rate, which tops out at 20%, on the net unrealized appreciation, or NUA. "Not many people know about the NUA benefit," says David Foster, a certified financial planner and CPA in Cincinnati who counsels high-level execs on retirement planning. "Very often benefits departments don't even know how this provision works." That's in part because this strategy wasn't useful when the top capital-gains rate was 28%, rates on ordinary income weren't substantially higher, and the stock market was plodding along. What's more, financial institutions that want your rollover money aren't likely to suggest alternatives that would take those assets out of their hands.

The Windfall

Now, back to Linda Harris. Last year she left her job at Schwab and, on the advice of Twila Slesnick, a tax- and retirement-plan specialist in Dublin, California, she moved $1 million worth of Schwab stock into a taxable account; the rest was rolled over into an IRA. And since the cost basis for all of her shares was just $31,200, she owed taxes on only one-third of that, or $10,400. Because she withdrew the shares early -- that is, before the minimum retirement age of 59 1/2 -- she owed an additional 10% penalty. But the penalty, like the taxes, was on the cost basis, so it came to only $1,040. Now when she sells her Schwab shares, she'll owe only 20% on her gains. "I had this enormous windfall, but I couldn't touch it," says Harris. "This has given us more options in our life."

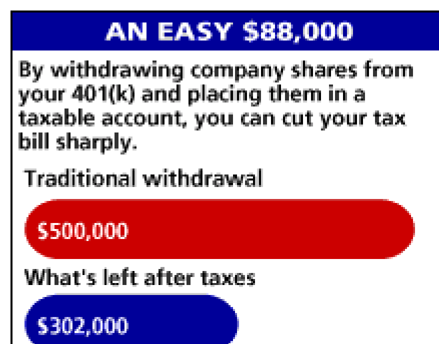
Cut Your Taxes by 45%

Here's how you can put the same technique to work for you. Let's say that over the years you have accumulated company stock in your 401(k) worth $500,000 and that the cost basis is $50,000. If you simply roll it over into an IRA and withdraw the money, your tax liability could be as much as $198,000, assuming a top 39.6% federal tax rate -- and significantly more if you live in a high-tax state like New York or California.

Instead, let's say you moved the shares into a taxable account. You'll immediately owe taxes on the cost basis -- $19,800, assuming the highest federal bracket. But now you have the choice of either selling the shares, which would create a second tax liability of $90,000 (20% of the $450,000 gain) or hanging on to some or all of them in the hope of future appreciation. If you sell, your total federal tax liability will be $109,800 ($90,000 plus $19,800), or about half of what you would owe if you withdrew the money using the more common technique. Put another way, that means you have an extra $88,200 free and clear.

"One of the biggest mistakes I've seen near-retirees make is selling the appreciated company stock without understanding the NUA issue," says Foster. "Once you sell the stock you can't recover the basis."

Your heirs stand to gain, too. If you hold on to the NUA stock until you die, your heirs will receive a step-up in basis, meaning they will owe capital-gains taxes only on the difference between the price when you died and the price when they sell it. In other words, all of those gains over the years will be passed on free of capital-gains taxes (though not free of estate taxes). If, on the other hand, you roll the stock into an IRA, your heirs won't get this step-up in basis. All distributions will be taxed as ordinary income, and then what's left will be taxed in your estate.



Okay. Now let's say you're changing jobs, not retiring. What then? One option is to remove the company stock and pay a penalty for early withdrawal, as Linda Harris did. (In the example above, the penalty would be $5,000.) But you also have the option to do nothing. That is, you can leave the stock and other investments in your old employer's plan, let the value accrue and withdraw the stock when you finally reach retirement age (assuming, of course, that the law doesn't change between now and then).

"Be a Pit Bull"

Understanding the economic case for withdrawing your company stock is the easy part. Actually accomplishing it can be more difficult. The first thing you need to do is find out if your company will allow in-kind distributions of their own stock. Almost all companies allow lump-sum distributions, but not all allow stock distribution. Ask your benefits department about the rules governing such distributions and see if they can tell you the basis on your stock. "Be a pit bull," says Foster. "The first person you talk to may not understand what you're talking about, so ask to speak to a supervisor." Even if the company says no, be persistent and ask to see the written rules in the plan documents.

Then decide if this strategy makes sense for you. Is the NUA large enough? Can you afford to pay the taxes right away? Will hanging on to the shares leave you overexposed to a single stock? This is especially pertinent if you have a significant number of stock options as well.

And remember, you don't have to take the full distribution. You can take some of the profits now, as Linda Harris did, and roll the rest into an IRA. But certainly any time the Internal Revenue Service offers you a tax break, it makes sense to pursue it.

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