

A Tax Break You May Be Missing

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Given the deep recession, many people may need to tap their nest eggs sooner than expected. If your retirement plan contains company stock, some relatively simple steps can significantly reduce the tax bite on those withdrawals.

The strategy, known as net unrealized appreciation, or NUA, is one that any person leaving a job or retiring should consider before moving assets from a company savings plan into an individual retirement account. Too often, though, this tax-code rule gets overlooked.

People who contribute to tax-deferred retirement accounts, such as 401(k)s, have to pay income tax on withdrawals. But under the NUA rules, 401(k) account owners don't have to pay ordinary income tax on all of their company-stock holdings. Instead, they can pay a combination of ordinary income tax and the lower capital-gains tax rate.

Consider a 60-year-old man with \$250,000 of company stock in his 401(k). If he were to withdraw the stock from the 401(k), he would owe ordinary income tax on the entire proceeds. Assuming he is in the 33% tax bracket, the tax bill would come to \$82,500.

To use the NUA tax break, the man would have to transfer the stock from his 401(k) to a taxable account. He would pay ordinary income tax -- but only on the amount he paid for the stock. If the purchase price was \$50,000, the man would owe \$16,500.

(If he received the stock as part of a company match, he would have to use the price of the stock on the date the contribution was made. Also, if he didn't know his purchase price or did dollar cost averaging -- purchasing fixed dollar amounts of stock at regular intervals -- he could check his statements or contact his plan's administrator.)

Upon selling his \$250,000 position, the man would owe tax on the remaining amount -- in this case, \$200,000 in profit. Under the NUA tax break, however, he would pay the long-term capital-gains tax rate of 15%, for a tax bill of \$30,000.

That would bring his total tax payment to \$46,500, far less than the \$82,500 in income tax he would otherwise owe.

"For someone with highly appreciated stock, this is a tremendous benefit," says Tom Skees, partner at Kersten Skees Retirement Planning, Perrysburg, Ohio.

To take advantage of NUA, a 401(k) account holder must follow specific rules. Generally, he or she must have left the company. Alternatively, if still on the payroll, he or she must typically be age 59½ or older -- and the 401(k) plan must allow so-called in-service distributions that make it possible for employees to transfer 401(k) assets to other accounts.

If upon leaving the company the 401(k) account owner rolls his or her company stock into an IRA, rather than a taxable account, the NUA tax break will be lost, says John Neyland, president of JCN Financial Group in Baton Rouge, La.

Moreover, the entire 401(k) must be liquidated within one calendar year. Company stock should be transferred to a taxable account. The rest can be rolled over into an IRA, says Mr. Skees.

If you are under age 55 and want to take advantage of the NUA rules, you'll owe a 10% penalty on the shares you transfer from your 401(k). But the 10% penalty is assessed on the amount you paid for the stock.

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