

Special Report

Company Stock in Qualified Retirement Plans – How to Manage the Asset

Since my early working days when Silicon Valley was in full swing there was never a more exciting phrase than “employee owned company stock”. It generated an almost immediate vision of wealth and power. Reality was of course something much different.

There are many versions of employee owned company stock. It can be purchased directly, granted, gifted, deferred, restricted, qualified, non-qualified and many other versions. Creativity has never been in short supply when it comes to configuring a company stock benefit for employees. Unfortunately, the complexity of plans has created a large void of how to manage employee owned stock and an even larger void when it comes to the employee managing this asset. In many cases, the designers are not completely familiar with plans designed by the company 20 and 30 years earlier.

EMPLOYEE OWNED STOCK HAS SEVERAL ALTERNATIVES THAT SHOULD BE MANAGED FOR THE INVESTORS BENEFIT.

This special report on the company stock in qualified retirement plans focuses on the specific area of net unrealized appreciation or NUA. Many investors forget about company owned stock that is held in retirement trusts such as a 401(k) plans and end up treating it as all of the another retirement plan investments rather than giving it special treatment. Employee owned stock has several alternatives that should be managed for the investors benefit.

Back when 401(k) plans were known as savings plans, company stock was a widespread investment option and in many cases dominated plan offerings. (Yes, I know I am dating myself by acknowledging that I knew them first as savings plans.) The never-ending list of investment alternatives available today did not exist when these plans were created.

Since those early days, the amount of company stock in retirement plans has declined. Since 2005 the number of plans that feature company stock has declined by 18% and the number of investors that hold company stock in their directed plans has fallen to 33%. Total assets placed in this asset category is down from 17% in 1999 to 10% a decade later.¹ Even with these trends, it is estimated that over 15 million people have over \$400 billion of company stock locked up in employers retirement plans.

There are several good discussions on the relevant risks associated with employees owning company stock within retirement plans. It includes dangers related to mixing human capital with financial capital and the most conflicting risk of aligning income, retirement and current investment within a single center of influence – your employer. Risks relevance is a function of how important current income and retirement assets are in relationship to your complete current and future investment program. Company stock may represent a large position within the specific retirement plan, but if the total of company stock is not dominate within your complete investment program, diversifying away from or eliminating the position, may not be in your best interests.

When the position does begin to dominate the overall investment program the risk of significant decline in value becomes real. Enron is the poster child for such conditions as many employees bought Enron stock within retirement plans. It may be a case study for the future, as Wells Fargo Bank employees wonder why the bank's stock is in their 401(k). Last count had 33% of total assets in the program.



It is always interesting why employees continue to invest in company owned stock even after knowing the related dangers. The most common explanation has been a belief that an employee has an informational advantage. Sometimes I wonder if it is an informational disadvantage? Being so close to the situation can many times fog rational thought, especially when conditions get tough. When conditions are favorable everyone thinks they are an expert. When conditions turn, it is hard to admit that the securities need to be trimmed or possibly eliminated from the portfolio.

Selling company stock is hard emotionally. Many employees think it is disloyal to sell company stock. Making matters worse, some employers require a certain percentage of company stock ownership for employees at higher management levels implying that a position less than the "recommendation" is non-supportive of the company. Emotions run high at all levels when selling is contemplated. It can get even more complicated if a higher-level executive of the company sells stock and then market analysts start asking, what's wrong?

Getting past the emotional concerns is important so that we can concentrate on the financial decision making. This is where net unrealized appreciation (NUA) comes into play. NUA is the difference between the acquisition cost and the current market value. This gain can receive favorable tax treatment if you meet the restrictive conditions. Not everyone can use this election; the restrictions are not onerous and they are specific.

If you take the NUA election you must take the stock in shares. You cannot sell them within the plan and then take the cash. You can sell them after you remove them from the confines of the company qualified plan, but not before. You must also be completely separated from the employer at the time of the election. If you have recently retired, or decided this company is not the place to continue your career, continuing to leave a 401(k) plan within the previous employer's plan, or rolling your account into another account is an option. If the NUA option is to be used, all of your investments in the employer plan must be taken out. You cannot pick and choose or just take a portion. You can move the assets out at different times, but they must all be taken out. The only time restriction is that the withdrawals must be within the same taxable year. The last restriction is age based, you need to be older than 59 ½ years of age.

(If you are not 59 ½, but older than 55, you can complete the option, but you will incur and additional 10% tax penalty that needs to be considered if the option is taken.)

Now that you have the restrictions a natural question would be why would someone consider using this option? When you separate from an employer there are many

decisions to be made regarding retirement plans and compensation assets that have been earned along the way. A 401(k) plan can remain with the past employer, but I rarely recommend this option. Usually, the assets should be moved into a new

What to do with retirement plan assets if you are separating from your current employer?

employer's plan or into a new rollover IRA. The most common action taken is to move the existing assets into the new IRA account. Many times, the assets in the old plan are sold and then cash is transferred into the new account. The most common explanation for selling and then repurchasing the same assets is that it is tax-exempt so it doesn't matter.

I have several allergic reactions to that rationale on many levels. First, how long will the transfer take to sell and reinvest? The usual delay is in the transfer from the plan to the

investment account. The initial selling of stock is easy, but how much did the plan charge you in commissions? Make sure you get the details. Did they execute the trade at a market price on the day of the sale? Make sure you get the details. Did they transfer the money from the sale after settlement was confirmed? Make sure you get the details. This is just a few days under normal conditions. If the transfer takes longer than 5 days you should ask what created the delay. Make sure you get the details. You will be out of the market.

You can ask for a transfer in-kind. This should also not take any longer than five days. Unfortunately, the industry average is closer to 30 days and I have witnessed transfers that have taken 60 days. That is a long time to be out of the market.

There are also transfer costs associated with the selling of the securities and reinvesting the cash when it arrives. The transfer in-kind may incur charges as well, but they can easily be less than the charges associated with selling and buying.



Transferring the company stock into a new plan or separate rollover IRA may be the best alternative. However, there may also be a better option. If you meet the previous restrictions and have company stock in your retirement account, it may be to your advantage to elect to move the company stock into a separate taxable investment account while the other assets move into a rollover IRA. The reason for this option is that the company stock value is separated into two tax treatment classes. The first class is the cost basis or what it cost you to obtain the shares. This amount is taxed at your current income tax rate. The second class is the gain; this value is taxed at the capital gains rate which could be significantly less than your income tax rate.

If you elect to transfer the entire amount now into another qualified plan you would not pay any tax, today. However, you will pay income tax on the value of the assets as you receive them in the future. If you decide to exercise the NUA option on the company stock, you would only need to pay income tax on the cost basis value and the current capital gains tax rate on the gain. This could be the difference between an income tax rate of 33% and a capital gains tax rate of 15%. There are many income tax rates that range from a low of 10% to a high of 39.6% and capital gains tax rates of 15% or 20%. In

general, the higher your income tax rate the more advantageous it is to use the NUA option.

While it sounds like an easy decision, it requires some effort. To complete the analysis you must make a projection into the future on your expected income tax rate. What if they move downward? What if capital gains tax rates increase? Additionally, estimates must also be made in regards to investment returns going forward. If the NUA option is taken, the tax paid currently will not be available for compounding investment returns. One of the most important questions is will the investment return be greater than the tax savings?

In this report we have made some estimates on market returns and tax rates in order to develop some understanding on when taking the NUA election makes sense. While we do not have a perfect crystal ball, we used some reliable long term trends on market returns going forward.

The evaluation process is not just about taxes. It must also take into consideration potentially conflicting objectives. One objective might be to increase the total value of the retirement account over a specific period of time such as 10 years. This ends up in conflict with an objective of maximizing the after-tax income from the account after 10 years. Maximizing the value of the account is achieved by keeping the company stock assets in the rollover account and delaying the tax. Maximizing income is achieved by electing the NUA option as long as your future income tax rate is above approximately 25%.

We have created several simulations to discover under what circumstances the NUA option is better than simply rolling over the assets into a new qualified account. Here are the general conditions of the simulations:

1. After the separation event, there is a ten-year period where the value of the company stock is re-invested into a portfolio that will at least generate a long-term return that is equal to the market long-term return. No income is withdrawn from the account during this period. This period of time is identified as 0 – 10 and labeled the “investment period”.

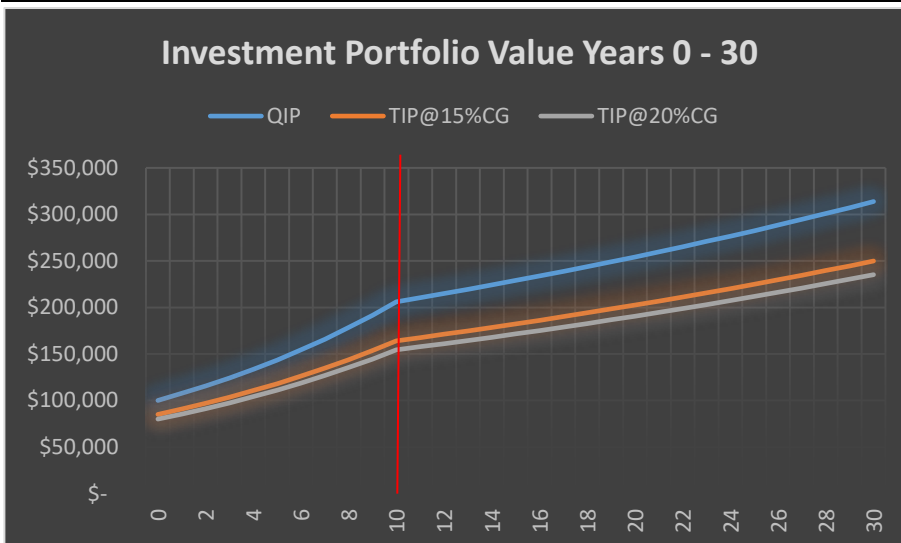
CONFLICTING OBJECTIVES

Maximizing the value of the account is achieved by keeping the company stock assets in the rollover account and delaying the tax. Maximizing income is achieved by electing the NUA option as long as your future income tax rate is above approximately 25%.

2. After the investment period (0 – 10), there is a 20 year period where the account is invested into a portfolio that will at least generate a long-term return and dividend yield that is equal to the market long-term return. Income is withdrawn during this time and labeled “retirement period”. This period of time is identified as 11 – 30.
3. During the retirement period (11 – 30), withdrawals are made from the account equal to 5% of the total value at the end of the previous year. For example, year 15 rate of withdrawal is determined by the value of the account at the end of year 14.
4. The portfolio generates a long-term price return of 5.5% and a dividend yield of 2.0% for a total return of 7.5%.
5. During the retirement period, dividends are taxed at the representative income tax rate that was used to determine the NUA option.
6. Once the company stock is received into the new investment account, it is sold and a market representative portfolio is created. This occurs whether or not the investment account is tax-exempt or taxable.

It was no surprise that the NUA option should not be elected if maximizing the total value of the account is the objective. This is valid during both the investment period and retirement period. It is very difficult for the portfolio to make up the compounding benefit achieved in a tax-exempt portfolio by keeping delaying the tax obligation. Once the tax is paid, the money is not available for investing. Figure 1 demonstrates the

Figure 1: Investment Portfolio Value During Investment and Retirement Periods

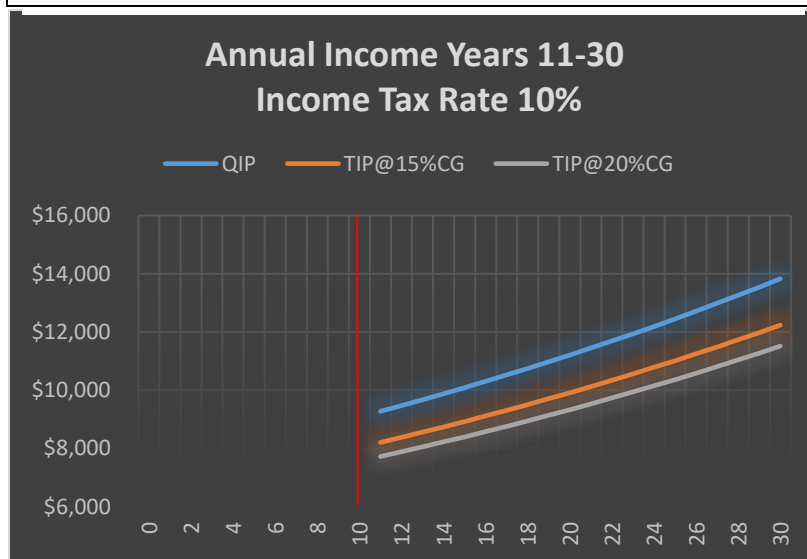


benefit of leaving the money within an investment account through the entire 30 year period. There are three lines in the chart. The solid blue line is the total value of the portfolio when moved into a tax-exempt Qualified Investment Portfolio (QIP). The second

line that is solid yellow shows the value of the account when moved into a Taxable Investment Portfolio after paying capital gains tax on the cost basis at the rate of 15%. There is a solid gray line that is the same of the solid yellow line except the capital gains tax rate is 20%.

All three lines rise rapidly during the investment period, 0 – 10. The rate of growth slows during the retirement period as 5% is withdrawn from the portfolio for income. The portfolio remains fully invested during the retirement period.

Figure 2: Annual Income Generated from Account During Retirement Period – Tax Rate at 10%



Sometimes it is forgotten or overlooked that the reason for investing is to generate a future income. Since income tax is unlikely to be eliminated in the near future, or at least over the next 30 years, analysis should include determining the real values received by the investor after-tax. Figure 2 shows a chart of the income received by the investor during the retirement period.

Income increases overtime because the investor elected to take 5% annually in income while the portfolio is generating a total return of 7.5%.

At a tax rate of 10% it appears that keeping the company stock within a tax-exempt investment program (QIP, blue line) is the best alternative. In this case the NUA option would not be beneficial to the investor (TIP, yellow and gray lines).

As the income tax rate increases, income received by the investor drops as well. Notice how in the next chart, Figure 3, the income lines all shift downward which is no

surprise, but see how the spacing between the three lines has changed, especially the distance between the QIP and TIP@15%CG and TIP@20CG. There is a significantly smaller difference between the QIP and TIP option.

By the time income taxes reach 28% there is a clear advantage in taking the NUA election as shown in Figure 4.

At this point both of the TIP estimates on after-tax income are above the after-tax income generated from the QIP. It does not matter whether the capital gains tax rate is 15% or 20%, both TIP options are beneficial to the investor on an after-tax income basis. The gap between income generated in a TIP versus a QIP increases as the income tax rate moves to 39.6%.

Figure 3: Annual Income Generated from Account During Retirement Period – Tax Rate 15%

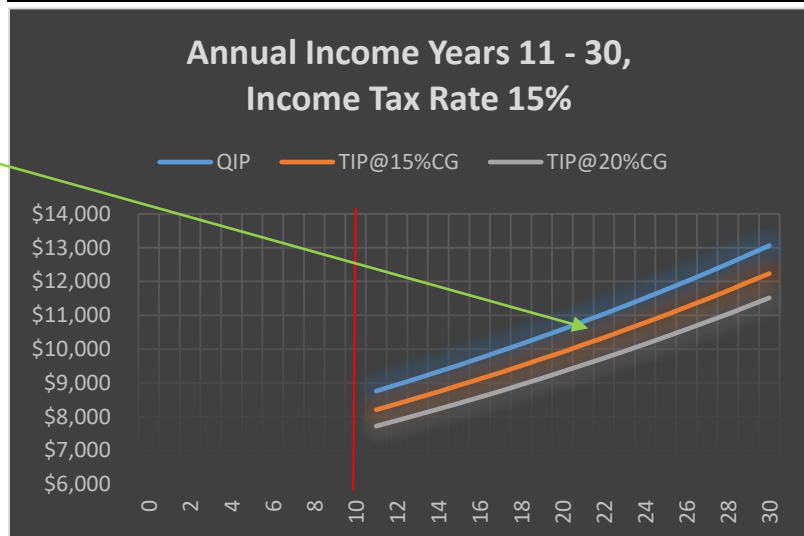
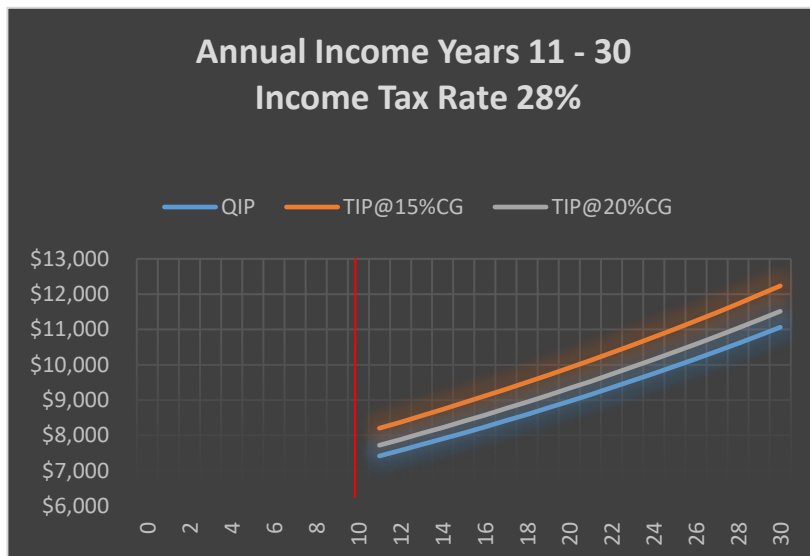


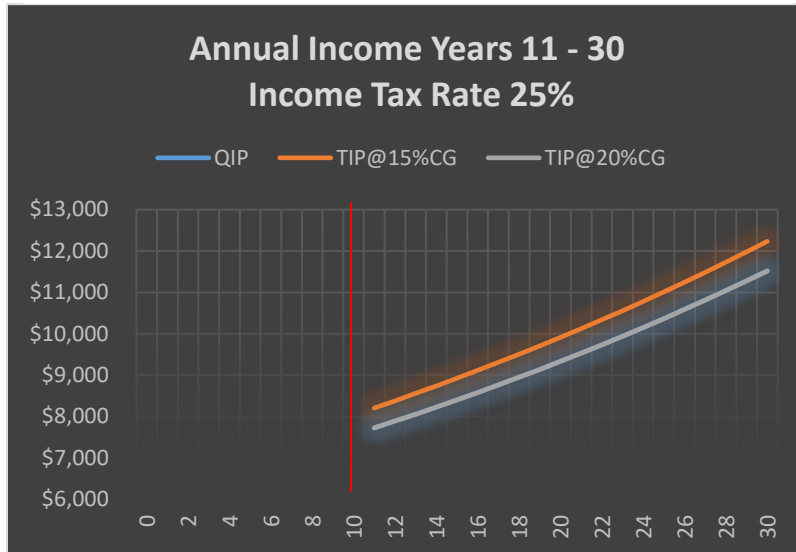
Figure 4: Annual Income Generated from Account During Retirement Period - Tax Rate 28%



It is very interesting when the investors income tax rate is closer to 25%. The chart that follows in Figure 5 shows an interesting position where at a 20% capital gains rate the taxable investment portfolio after-tax income is equal to the tax-exempt after-tax income. However, the 15% capital gains tax rate remains the best alternative for the investor in a taxable portfolio.

If you decide to use the NUA option you can exercise the

Figure 5: Annual Income Generated from Account During Retirement Period - Tax Rate 25%



tax benefit only on the company stock holdings. The option does not apply to any other holdings.

Fortunately, as you move the assets from the old plan to your new investment accounts, you can split the roll out so that the company stock transfers move to a taxable investment account and the other holdings move to a tax-exempt portfolio such as a rollover IRA.

However, you are not allowed to split the withdrawal in a manner whereby you only take part of the distributing assets from the old plan. You must take all of the assets from the old plan and leave nothing behind and it must be taken within the same taxable year that the separation occurs.

Fortunately, if you have more than one tax-exempt plan that holds company stock, you can consolidate the stock into a single plan. This would allow you to consolidate the company stock that may be spread across several accounts into a single investment account. The tax code treats distributions from several plans as a single distribution.

This option only applies to company stock held within a tax-exempt qualified plan like a regular 401(k). It does not apply to a Roth 401(k) because of the different tax treatment situation between a regular 401(k) and a Roth 401(k).

The net unrealized appreciation option can be beneficial to an investor that has company stock held within a qualified retirement plan. This appears to be especially beneficial as income tax rates increase above 25% for the individual. If you are considering using this option, make sure you follow the rules and conditions while calculating the expected results for your specific situation.

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