Discover Secret Tax Breaks For Employees

Benefits of Company Stock in Retirement Plan

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One of the best-kept secrets in the tax law is a unique opportunity available to employees, including business owners, who own company stock in their retirement plan. If you play your cards right, you can avoid tax on the appreciation in the stock's value, called the "net unrealized appreciation" (NUA) on a distribution, as well as benefitting from favorable capital gain rates on a sale.

Of course, you should not "put all your eggs in one basket." Make sure your retirement account is properly diversified. Nevertheless, the tax benefits for this technique are undeniable.

Background

If you receive a retirement plan payout in the form of company stock, you only pay tax on the original cost of the stock. There is no tax due on the NUA. Furthermore, any subsequent gain on the NUA is treated as long-term capital gain if you have held the stock for more than one year. To qualify for these breaks, a distribution must meet the following three requirements:

1. It must be from a qualified retirement plan such as a 401(k), pension, or profit-sharing or stock bonus plan.
2. The distribution must be due to death, after attaining 59½ years of age, or separation from service.
3. It must be made in one tax year.

Currently, the maximum tax rate on long-term capital gain for most taxpayers is 15%, increasing to 20% if you are a single filer with taxable income above $400,000 or a joint filer above $450,000 (indexed to $406,750 and $457,600, respectively, for 2014). This still compares favorably to the top ordinary income tax rate of 39.6%.

Example

You have acquired 20,000 shares of company stock in your 401(k) over the years. The shares are currently worth $1 million. Originally, the stock was $5 a share, but now it is valued at $50 a share.

If you sell the stock inside the plan and then take a cash distribution, you will receive $1 million. However, the entire distribution will be taxed as ordinary income. If you are already in the 39.6% tax bracket in the year of retirement, you owe federal income tax of $396,000 on the distribution (39.6% of $1 million). Conversely, if you take the distribution in the form of company stock, you are taxed on the original cost of $100,000 (20,000 shares at $5 a share). This results in your federal income tax bill being only $39,600.

Suppose you immediately sell the stock at $50 a share for a total of $1 million. Assuming all of your $900,000 gain is taxed as long-term capital gain at the 20% rate, you pay $180,000 in capital gains tax (20% of $900,000). Therefore, your total federal income tax bill is $219,600 ($39,600 - $180,000), a tax savings of $176,400 ($396,000 – $219,600). Note that other tax factors, including the 3.8% Medicare surtax, and state and local taxes, may also come into play.

Congress has threatened to close this tax loophole in the past, but it remains in place, at least for the time being. This may be an opportune time to take advantage of the NUA tax breaks. Consult your Henry & Horne, LLP professional tax advisers for more information.

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