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info sheet — Distributions of Employer Stock from 401(k) Plans

Courtesy of:

Corporate wealth is being created from several corporate sources outside of income. For example, wealth has been created through company stock, stock options, and 401(k) plans. In 1997, close to $1 trillion in shares were allocated to employee-incentive programs at Standard & Poor's 500 companies.[1] And the average corporate executive has more assets in company stock than in any other holdings.[2]

Some 401(k) plans allow employees to invest a portion of their accounts in their employer's company stock, which can provide additional tax benefits because of the opportunity to take advantage of favorable tax rates on capital gains. When you retire or change jobs, any distributions of employer stock that are part of a lump sum distribution from a 401(k) plan may receive special tax treatment.

Examining tax implications of your options

If you've participated in an employer-sponsored plan — most notably a 401(k) — and decide to change jobs or retire, you may be faced with some important decisions. "Should I take a lump sum distribution?" or "Should I roll the entire account into an IRA?" Examining the tax implications of your options may help you decide what to do.

Any unrealized appreciation (the difference between the fair market value of the stock on the date of the distribution and the fair market value as of the date it was contributed to the plan) attributable to these securities is not taxed until you sell the underlying stock. Additionally, when the stock is sold, the unrealized appreciation is taxed as a capital gain at the rate of 20% rather than as ordinary income, which may entitle you to more favorable tax rates on this sum. The difference in the two tax rates could be substantial, particularly if you are in the 39.6% tax bracket.

Tax-saving strategy

This tax-saving strategy works extremely well for individuals who have securities in 401(k) plans that have appreciated substantially. And with the difference between the maximum ordinary income tax rates and the long-term capital gain tax rate as high as 19.6 percentage points, the value of getting long-term capital gain tax treatment can be significant.

If you receive greatly appreciated employer securities as part of a lump sum distribution, you should carefully consider whether or not to roll over these securities into an Individual Retirement Account (IRA). All distributions from IRAs are taxed as ordinary income, not as capital gains. Therefore, if employer securities are rolled over into an IRA, any potential for long-term capital gains treatment on the appreciation is foregone.

If a partial rollover is elected instead — with only the portion of the lump sum not consisting of the employer

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securities being rolled over — there will be no current tax on the rolled over portion. However, there will be tax at ordinary income tax rates on the value of the employer stock, less the unrealized appreciation.

Example:

This discussion and example only relates to federal income taxes. State and local income taxes may also be a factor. Individuals should contact a tax or financial consultant before making any decisions regarding distributions from their 401(k).

Purchase price of stock in the 401(k) plan:	**$100,000**
Value of stock upon distribution:	**$1,000,000**
Net unrealized appreciation:	**$900,000**
Amount taxed as ordinary income:	**$100,000**
Amount not taxed until stock is sold:	**$900,000**

If the participant were to hold onto the stock for at least a year, then all of the appreciation or depreciation would be treated as a long-term capital gain or loss. Ten years later, if the stock value had climbed to $2,000,000, the tax advantage of the capital gains rates would be significant.

Value of stock at time of sale:	**$2,000,000**
Amount previously taxed:	**$100,000**
Amount taxable as long-term capital gain:	**$1,900,000**
Capital gains tax due (at 20%):	**$380,000**

If the entire account had been rolled over into an IRA, $1,900,000 would instead be taxed as ordinary income when it was distributed. Using a top federal tax rate of 39.6%, the tax on $1,900,000 is $752,400. By taking advantage of the favorable capital gain rates, this individual could save as much as $372,400 in federal income taxes.

As you can see, there are significant advantages to this strategy. Remember this is a very complex issue and you should discuss your individual situation with your financial and/or tax consultant.

[1] U.S. Census Bureau

[2] U.S. Trust Survey of Affluent Americans

For further information

Rowland, Mary. **A Commonsense Guide to Your 401(k),** Bloomberg Press, 1997, 240 p., $19.95.

Foundation for Enterprise Development. **The Entrepreneur's Guide to Equity Compensation,** 1998, 80 p., $35.

Pastore, Robert R. **Stock Options: An Authoritative Guide to Incentive and Nonqualified Stock Options,** PCM Capital Publishing, 1999, 118 p., $39.95.

Suttle, John C. and Slesnick, Twila. **IRAs, 401(k)s, and other Retirement Plans: Taking Your Money Out,** Nolo Press, 1998, 200 p., $21.95.

Gallea, Anthony M. **The Lump Sum Advisor,** Prentice Hall, 1999, 324 p., $25.00.

This material is not intended to replace the advice of a qualified attorney, tax adviser, or insurance agent. Before making any financial commitment regarding the issues discussed here, consult with the appropriate professional.

For more information or a list of other MFS Heritage Planning educational materials on helping your parents, your children, or yourself, contact your financial consultant.

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