Maintaining Beneficial Tax Treatment of Employer Stock After Job Loss

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A combination of low interest rates, abundance of cash in company coffers, and a need for growth has led to an explosion of corporate mergers and acquisitions this year. An August 10 *Wall Street Journal* article stated that if projections carry through, there would be more M&A activity in 2015 than in any other year on record. Some executives of acquired companies might soon find themselves unemployed as organizations merge and cut costs by adjusting their top ranks. Indeed, a month after Kraft Foods and H.J. Heinz combined, the newly merged enterprise, The Kraft Heinz Company, announced plans to eliminate 2,500 jobs in Canada and the United States, with Heinz executives taking control of eight of the top ten positions.

These high-salaried executives most likely have access to financial professionals who can assist them in maximizing the value of their work-related benefits and avoiding costly errors. Expertise in handling employee stock options, restricted stock, and company stock maintained in an employer-sponsored 401 (k) Plan is a specialized area. Nonetheless, CPAs and financial advisors with general knowledge of alternative forms of employee compensation will distinguish themselves from their peers and be better able to serve clientele.

Diversification of one's financial capital (stocks, bonds, real estate, etc.) among different asset categories is a tenet of prudent investing. Unfortunately, human capital (the present value of one's future wages) is often not evaluated when an investor is allocating his assets. For example, consider a young woman with an advanced degree who is employed by a successful organization. She has a tremendous amount of human capital, due to her youth and acumen. Confident in her abilities and her company's prospects, she invests all of her money in employer stock. By doing so, she has combined her human and financial capital and has failed to properly diversify her assets. In the event the company goes bankrupt, her financial capital is wiped out. Her human capital, however, remains high. Compare her situation with that of an older co-worker, a few years from retirement and with rudimentary skills. He likewise invests his money in employer stock. When the company goes under, he loses not only his job, but also his life savings: his overall wealth is irrevocably damaged. It is, therefore, not advisable for employer stock to comprise a large percentage of one's financial capital, especially if one is an older employee.

Workers nevertheless will continue to invest their money in employer stock, whether induced by purchase discounts, tie-ins with employer matching contributions, or simply out of loyalty. Many of these people will need assistance in managing these funds when they separate from service. Some might instinctively roll over employer stock held in a 401 (k) Plan to an IRA, unaware that terminated employees with significantly appreciated company stock in a 401(k) Plan can reduce tax obligations by taking advantage of special rules regarding the net unrealized appreciation (NUA) on those securities. Under the IRC, an employee has the option to shift the company stock into a taxable account while transferring any remainder to an IRA. The employee will then pay ordinary income tax on the cost basis of the company stock, but lower long-term capital gains tax on subsequent liquidation. Contrast that with rolling over the entire distribution: while there are no immediate consequences, the employee will be taxed at ordinary income rate on the entire payout upon withdrawal.

To illustrate, let us take a 50-year-old executive in the 39.6% tax bracket who is forced out of employment in a corporate re-structuring. She is given a substantial severance package and decides to take a lengthy world cruise to take her mind off the change in job status. She plans on using the $100,000 of company stock in her 401 (k) Plan for the journey. The cost basis of these shares is

$20,000; thus, she has $80,000 in NUA. Upon separation of service, she transfers these shares into a taxable account rather than rolling them over into an IRA. Because she is only 50, a 10% early withdrawal penalty is applicable, but only on the cost basis, not the entire amount. Thus, she is liable for ordinary income taxes of $9,920 [20,000 × (39.6% + 10%)] on the cost basis of the shares distributed. When she sells, she will owe the maximum capital gains taxes of 20% on the NUA of $80,000. We will add a Medicare surcharge of 3.8% (it was a very generous package) to the 20% capital gains rate, so the liability is $19,040 [$80,000 × (20% + 3.8%)]. Thus, the total tax bill is $28,960. This compares most favorably to an obligation of $49,600 if she rolls the stock over to an IRA and immediately liquidates [$100,000 × (39.6% + 10%)].

Those contemplating the NUA strategy for themselves or their clients should be aware that the total vested balances from all qualified retirement plans in which the worker participates must be distributed within one year of the "triggering" event. "Triggering" events include death, disability, reaching age 59 ½, or separation of service. If the distribution does not meet IRS regulations, the entire amount will be subject to taxation at ordinary income rates, and a 10% premature withdrawal penalty might result. It is important to note as well that workers do not have to employ the NUA strategy for all their company stock: they can rollover a portion to their IRAs and apply NUA treatment to the rest.

It would be appropriate for terminated workers to utilize the NUA strategy as long as the difference between the ordinary income tax rate and the capital gains tax rate is meaningful; the NUA of their company stock should also be considerable. Another situation in which it would be suitable to not rollover assets to an IRA is if the worker would be otherwise forced to take the money in the near future, such as in a required minimum distribution (RMD). Assets in a taxable account are not subject to RMD rules that apply to IRAs and qualified plans; therefore, a 70-year-old might want to employ the NUA strategy in order to avoid the tax liability associated with an RMD. Stocks held in an IRA or employer plan are entitled to significant protection against creditors, however, and an individual would lose that if the stock were maintained in a taxable account. Most importantly, for someone planning to keep employer stock in an IRA for an extended period, the potential for substantial tax-deferred growth makes the argument for a direct transfer to a taxable account less compelling.

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