A Granite Hill Investment Field Guide

Taking Your 401(k) Lumps:
Assessing Lump-Sum Distributions for Highly Appreciated Company Stock

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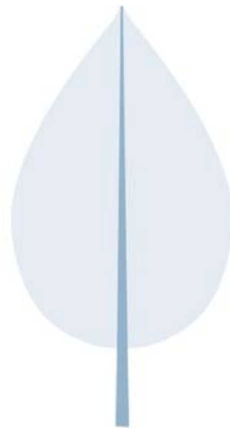

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Congratulations! Your 401(k) account has accumulated healthy holdings in the form of highly appreciated company stock that is now worth a whole lot more than when you received it; a well-deserved reward for the contributions you've made to your company's growth.

But make no mistake. What you've worked so hard to achieve, the IRS can swiftly deplete when you go to reap it in retirement. Before selecting a distribution method, you are well-advised to look carefully before you leap, preferably in alliance with an expert advisor to guide you through the complexities.

Here, we assess one potentially beneficial way to withdraw highly appreciated company stock from your 401(k) upon retirement: the **lump-sum distribution.**[1]

When you own highly appreciated stock *and* you expect to remain in a high tax bracket, there can be distinct advantages to a lump-sum distribution. It can create liquidity for spending needs, plus it can help you save on taxes.

A lump-sum distribution can allow the growth (appreciation) from your company stock to be taxed at more favorable long-term capital gains rates (LTCG) instead of as regular, "marginal rate" income. For those in the top two tax brackets, LTCG rates can save over half of the taxes that would be due if the same distribution were treated as regular income. Basically, the higher your income, the higher your marginal tax rate is compared to the lower LTCG rates. Thus, more tax savings are available by converting the income to LTCG. (See Appendix 1. With capital gains rates 45% or less of marginal income rates for those in the top two brackets, LTCG rates save 55% or more of marginal rates).

However, lump-sum distributions are more complex than rolling the funds into an IRA. Additional careful analysis is warranted.

Other Factors to Consider

- Retirement income. Typically income declines in retirement. Your marginal income tax rate may fall enough to reduce the difference between marginal and LTCG tax rates, thus reducing the attractiveness of a lump-sum distribution.
- Investment returns. If you lump-sum distribute company stock to a taxable account, it's taxed on its purchase cost basis, leaving less principal to compound. In contrast, rollovers generate no taxes until monies are withdrawn, so compounding a larger investment base may offset higher taxes. Alternatively stated, taxes associated with a lump-sum distribution may reduce your principal so much that compounded investment growth may never catch up to the wealth created by a rollover.

[1] To qualify as a lump-sum distribution under our tax codes, you must withdraw the entire balance of your 401(k) within one year after a triggering event, such as separation from service, death, disability or reaching age 59 ½.

- Holding period. The longer the holding period, the greater advantage to the IRA rollover option due to compounding.
- Cost basis. Company stock transferred to a taxable account in a lump-sum distribution is recognized as income and taxed at marginal rates on the stock's cost basis. The lower the cost basis of the stock, the less tax paid and the more compounding of principal.
- Future tax rates. Without knowing the size of LTCG or income tax rate changes beyond 2011, future tax benefits are hazy at best.
- Portfolio construction. While taxes are critical to wealth preservation and creation, your investment choices, diversification and asset location (placing investments into taxable versus tax-deferred accounts according to tax efficiency) influence results enormously.

Lump-sum Distribution Mechanics

To initiate a lump-sum distribution, you transfer all or a portion of your company stock to a taxable account and roll over the remainder to an IRA along with your other 401(k) funds. The transfer of shares to a taxable account is considered taxable income that can push you into a higher tax bracket. However, selecting company shares with the lowest cost basis can help manage the tax bite. The best shares to rollover into your tax-sheltered IRA are those acquired more recently, with a higher purchase cost.

The appreciation above the cost basis for transferred shares will be taxed at more favorable LTCG rates when the stock is sold. No taxes are due on any shares rolled over to an IRA until they are withdrawn. Marginal income tax rates then apply.[2]

Case Study

To illustrate tax implications, we compare a "Remain Invested" scenario to a "Lump-Sum Distribution." Appendix 2 depicts 401(k) company shares with a value of $1 million and cost basis of $300,000.

In the Lump-Sum Distribution scenario, half of the company stock ($500,000) is transferred to a taxable account and half is rolled over to an IRA. The roll-over is immediately sold and invested in broadly diversified funds. The shares transferred to the taxable account have the lowest cost basis, totaling $50,000; shares rolled over to the IRA have a cost basis of $250,000.

All other factors are held constant:

- The investor's marginal tax rate is 35% and remains so in retirement.
- All investments earn a compound 7% rate of return.
- After 10 years, all investments are liquidated, sold or withdrawn entirely.

While this is not a realistic retirement scenario, it allows us to focus on isolated tax treatment possibilities for the purpose of this white paper.

[2] Assuming no after-tax contributions to your account.

As depicted in the Lump Sum Distribution Advantage summary line in Appendix 2, taxes saved by capturing LTCG rates are nearly $117,000. In this illustration, despite the initial tax hit, the LTCG tax treatment at liquidation on shares with a higher cost basis is far less than that of marginal rates on the entire investment.

However, were conditions to vary — such as a drop in the investor's marginal tax rate in retirement, an increase in the rate of return or a longer holding period — tax savings could be reduced to non-existent. Consultation with a professional to assess your particular circumstances can be well worth the investment.

A Final Note: Estate Planning

A final caveat regarding the lump-sum distribution. If your intention is to hold the stock and pass it on to your heirs, they must pay LTCG rates on the net unrealized appreciation (NUA). However, appreciation beyond NUA will receive a step-up in basis. In contrast, not taking a lump sum distribution and leaving your funds in an IRA will allow your beneficiaries the opportunity to take small taxable distributions over their lifetimes, leaving the rest to grow.

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Bibliography

Nersesian, John and Potter, Francis. "Revisiting Net Unrealized Appreciation: A Tax-Wise Strategy That May Realize More Benefits Than Ever" Journal of Financial Planning (2004).

Disclosures

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Past performance is not a guarantee of future results, and there is always the risk that an investor may lose money. Although investors may form their expectations from the past, there is no assurance that future investment results will reflect historical performance.

Diversification neither assures a profit nor guarantees against loss in a declining market.

Model performance is hypothetical and is for illustrative purposes only.

Appendix 1: Federal Tax Rates -- Marginal Income, Dividend, and Long-term Capital Gains tax rates[1]

If your filing status is Married Filing Jointly

2012

Taxable Income Over -	But not over -	Marginal Income Tax Rate	Dividend Tax Rate: Ordinary	Dividend Tax Rate: Qualified	Long-term Cap. Gains (LTCG)	LTCG % of Marginal Income Tax Rate
$0	**$17,000**	**10%**	10%	0%	0%	**n.m.**
$17,000	**$69,000**	**15%**	15%	0%	0%	**n.m.**
$69,000	**$139,350**	**25%**	25%	15%	15%	**60%**
$139,350	**$212,300**	**28%**	28%	15%	15%	**54%**
$212,300	**$379,150**	**33%**	33%	15%	15%	**45%**
$379,150	**and over**	**35%**	35%	15%	15%	**43%**

2013

Taxable Income Over -	But not over -	Marginal Income Tax Rate	Dividend Tax Rate	Long-term Cap. Gains (LTCG)
$0	**$17,500**	**10%**	0%	10%
$17,500	**$59,300**	**15%**	0%	10%
$59,300	**$71,000**	**15%**	0%	10%
$71,000	**$143,350**	**25%**	15%	15%
$143,350	**$218,450**	**28%**	15%	15%
$218,450	**$241,900**	**33%**	15%	15%
$241,900	**$390,050**	**36%**	20%	20%
$390,050	**and over**	**39.6%**	20%	20%

[1] Proposed in 2013 budget. Under current law, for those in the 25% - 33% brackets (1) marginal income tax rates increase 3% (i.e., 28%, 31%, 36%) and (2) long-term capital gains rates increase to 20%. Dividend tax rates rise to marginal income tax rates at all income levels.

2013 Medicare tax

A new 3.8% Medicare tax is assessed on the lesser of:

1. "Net investment income" OR
2. The excess of "modified adjusted gross income" ("MAGI") over the "threshold amou

   The threshold for those Married Filing Jointly is $250k.

Sources: http://www.taxpolicycenter.org/taxtopics/2013-Allow-top-two-rates-to-rise.cfm
http://www.taxpolicycenter.org/taxtopics/Tax-Net-Long-Term-Capital-Gains.cfm

Appendix 1: Federal Tax Rates -- Marginal Income, Dividend, and Long-term Capital Gains tax rates[1]

If your filing status is Single

2012

Taxable Income: Over -	Taxable Income: But not over -	Marginal Income Tax Rate	Dividend Tax Rate: Ordinary	Dividend Tax Rate: Qualified	Long-term Cap. Gains (LTCG)	LTCG % of Marginal Income Tax Rate
$0	**$8,500**	**10%**	10%	0%	0%	**n.m.**
$8,500	**$34,500**	**15%**	15%	0%	0%	**n.m.**
$34,500	**$83,600**	**25%**	25%	15%	15%	**60%**
$83,600	**$174,450**	**28%**	28%	15%	15%	**54%**
$174,450	**$379,150**	**33%**	33%	15%	15%	**45%**
$379,150	**and over**	**35%**	35%	15%	15%	**43%**

2013

Taxable Income: Over -	Taxable Income: But not over -	Marginal Income Tax Rate	Dividend Tax Rate	Long-term Cap. Gains (LTCG)
$0	**$8,750**	**10%**	0%	10%
$8,750	**$35,500**	**15%**	0%	10%
$35,500	**$86,000**	**25%**	15%	15%
$86,000	**$179,400**	**28%**	15%	15%
$179,400	**$199,350**	**33%**	15%	15%
$199,350	**$390,050**	**36%**	20%	20%
$390,050	**and over**	**39.6%**	20%	20%

[1] Proposed in 2013 budget. Under current law, for those in the 25% - 33% brackets (1) marginal income tax rates increase 3% (i.e., 28%, 31%, 36%) and (2) long-term capital gains rates increase to 20%. Dividend tax rates rise to marginal income tax rates at all income levels.

2013 Medicare tax

A new 3.8% Medicare tax is assessed on the lesser of:

1. "Net investment income" OR
2. The excess of "modified adjusted gross income" ("MAGI") over the "threshold amount." The threshold for those Filing Single is $200k.

Sources: http://w w w .taxpolicycenter.org/taxtopics/2013-Allow -top-tw o-rates-to-rise.cfm
http://w w w .taxpolicycenter.org/taxtopics/Tax-Net-Long-Term-Capital-Gains.cfm

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Appendix 2: Scenarios for Company Stock Held within 401(k)

			Lump-Sum Distribution		
		Remain Invested	IRA Rollover	+ NUA	= Total
1	Market value	$1,000,000	$500,000	$500,000	$1,000,000
	- Basis		250,000	50,000	300,000
	= Net Unrealized Appreciation (NUA)			450,000	
	Taxes on Stock Placed in Taxable Acct. & Sold				
	Marginal income tax rate applies to Basis			*35.0%*	
	Income tax due on Basis (50,000 * 35%)			17,500	
	Long-term Cap. Gains Tax rate applies to NUA			*15%*	
	Long-term Capital Gains Tax on NUA (450,000 * 15%)			67,500	
2	Taxes on Lump Sum Distribution			85,000	85,000
	Market value *(1 above)*		500,000	500,000	1,000,000
	- Total taxes *(2 above)*		0	85,000	85,000
3	Net to Reinvest		500,000	415,000	915,000
	Future value				
	Compounded growth rate	7.0%	7.0%	7.0%	
	Holding period (X years)	10	10	10	
	Future value in X years	1,967,151	983,576	816,368	1,799,943
	Taxes on appreciation				
	Future value	1,967,151	983,576	816,368	
	- New Basis *(3 above on NUA only)*			415,000	
	Taxable Amount	1,967,151	983,576	401,368	
	Long-term Capital Gains Tax rate			*15.0%*	
	Long-term Capital Gains Tax	0	0	60,205	60,205
	Taxes on ordinary income				
	Marginal income tax rate	*35.0%*	*35.0%*		
	Marginal income tax	688,503	344,251		344,251
	Net distribution after tax	**1,278,648**	**639,324**	**756,163**	**1,395,487**
	- Value of Remain Invested				1,278,648
	Lump Sum Distribution Advantage (Disadvantage)				**116,838**
					19%