SMART INSIGHTS FROM FINANCIAL PROFESSIONALS

Own Company Stock Within Your 401(k)? That Could Mean a Tax Advantage

Net unrealized appreciation (NUA) can be a great deal for those who qualify. Here's a look at how it works and what type of tax savings it can deliver.

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Roth conversions have, for good reason, become popular among people who want to avoid paying income taxes on the money they withdraw from their IRAs and 401(k)s in retirement.

But there's another tax-saving option to consider for those whose 401(k) accounts are invested at least partially in their employer's company stock.

This option involves something called net unrealized appreciation, or NUA, and those who qualify would do well to explore whether this might be a better alternative for them than a Roth. The key point being, of course, whether you qualify.

With my clients I find that those in certain professions, such as engineers and people who work in IT, are often more likely to have company stock in their 401(k)s, though others may as well. For them, the NUA can have terrific advantages and, in some cases, drive their tax liability down to nearly zero.

HOW NUA CAN CUT YOUR TAX BILL

First, for the sake of comparison, consider a typical 401(k) of $500,000 that has no company stock. When you begin to withdraw money from that account, you pay income tax based on ordinary tax rates, as if it were part of a salary. For a married couple, that rate is at least 22% for taxable incomes over about $81,000.

But now let's say that your 401(k) includes your company's stock, and that $100,000 of the $500,000 value of your 401(k) is in that stock. That's a situation where the beauty of the NUA kicks in.

Here's why: You pay ordinary income tax only on the cost basis of the stock; that is, the original amount you invested. So, let's say you originally paid $10,000 for that stock, which has now grown to $100,000. If you withdraw the $100,000 of stock and sell it, you pay the ordinary tax rate only on $10,000. For the remaining $90,000, you instead pay long-term capital gains taxes. Now this long-term capital gain is only taxable if you sell your company stock.

"OK," you may think. "That's still going to be a hefty tax bill."

Not really, because in 2021 a married couple filing jointly pays no taxes on the first $80,800 of their total taxable income. That's right. Zero. And from $80,801 to $501,600, the long-term capital gains rate is just 15%. So, let's break this down for this scenario of $100,000. The couple might pay 22%, or $2,200, for the first $10,000, the basis. They would pay zero for the next $80,800. And they would pay 15%, or $1,380, for the final $9,200. That's a total of $3,580, compared with possibly $22,000 or more if they didn't qualify for the NUA.

Alternatively, you can choose to hold your company stock after the NUA in your own individual account and choose when you want to pay capital gains taxes (if any) on the sale.

SOME CAVEATS TO KEEP IN MIND

Are there caveats or additional factors to be aware of with all this? Yes.

- One rule with NUAs is that you can't own more than

5% of the company. For the average person, that should not come into play, but it's worth being aware of if you happen to be a major stockholder.

- In the tax year that you do the NUA, you would have to roll tax-free the remaining portion of the 401(k) into an IRA.
- In your retirement years, anytime you withdraw money from an account, you need to be mindful of the potential impact on your Medicare IRMAA, which stands for Income Related Monthly Adjustment Amount. When your income exceeds a certain amount, IRMAA comes into play and can increase the premiums you pay for Medicare Parts B and Part D. So, once you are 65 and are on Medicare, you want to watch carefully the amounts you withdraw from your 401(k) or your IRAs to see how that's going to affect your IRMMA. Remember, too, that at least part of your Social Security is taxable, so that adds to the overall total.

- Some stocks pay dividends, and in that case, you might want to hang onto the stock after the NUA rather than sell it. The dividends would be taxed at qualified dividend rates, which is 0%, 15% or 20%, depending on your taxable income or filing status. But once again, this would be lower than your tax rate for ordinary income.

You should also compare and contrast the NUA and a Roth conversion to determine which is going to be the better move for you. The answer will depend on a variety of factors, such as what your basis is for the company stock you own. For example, in some cases you might want to use the NUA for only shares with the lowest cost basis and roll over the rest.

A financial professional with experience working with NUAs can help you navigate the pros and cons of the NUA and the Roth conversion, and assist you in figuring out what the most efficient and cost-effective option is for you.

Ronnie Blair contributed to this article.

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