Don't Knock Taking Your Employer Stock

Given the growth of employee-employer savings to meet retirement goals, it is not uncommon for employees to have a significant amount of employer stock in their qualified retirement plans. When it comes time for employees to leave the nest, most are willing to directly rollover all qualified plan assets into a traditional IRA. A traditional IRA rollover offers avoidance of an immediate income tax consequence, the retiree remains in control of his/her retirement assets and the benefits of tax deferral can continue.

However, there may be another option available that should be considered, a type of combination approach. This option involves distributing employer stock to the retiree and directly rolling over the remaining balance of the plan assets into a traditional IRA. This combination approach, though not for everyone, may have significant advantages.

By not including the employer stock in the traditional IRA rollover, the retiree is exposed to income taxes immediately. This is because he/she is receiving the shares as a taxable distribution. However, the taxes due will be only on the cost basis of the stock. Therefore, it's important to know what the actual cost basis of your employer shares are in your retirement plan. The cost basis is essentially what the plan Trustee paid for the stock. Exposing the stock to taxes now may be more advantageous in the long run because, in most cases, this cost basis of the employer stock will be much lower compared to the current market value.

The stock held outside the traditional IRA will continue to defer taxes on any appreciation. When the retiree ultimately decides to sell the shares, he/she will pay long-term capital gain rates - currently capped at 15% - rather than at ordinary income tax rates, which could run 35% or more. In addition, there are no minimum distribution requirements starting at age 70 1/2 or other nasty penalty taxes for this block of employer stock, allowing for more planning flexibility.

And lastly, the retiree's heirs may miss out on another big tax break. If these same shares of employer stock were rolled into a traditional IRA, the heirs would ultimately owe ordinary income taxes on the employer stock, as they would on any asset held in a traditional IRA. This could result in a sizable income tax bill due at death, taxed at a potential 35%. By rolling into a traditional IRA, the heirs are unable to utilize the benefits of long-term capital gains treatment when they decide to sell the stock and may lose a tax saving opportunity.

There are many technical requirements that must be met in order for this type of distribution to qualify as what's known as a lump sum distribution. Of course, diversification considerations and other investment fundamentals may show that rolling over stock to a traditional IRA may be the most prudent choice in many cases. Therefore, it is highly recommended that retirees considering such a maneuver obtain professional advice. Be sure to check with your financial planner or financial advisor whether you can reap the full benefits of holding on to your employer stock.

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