Morgan Stanley

Employer Stock Distributions and Net Unrealized Appreciation

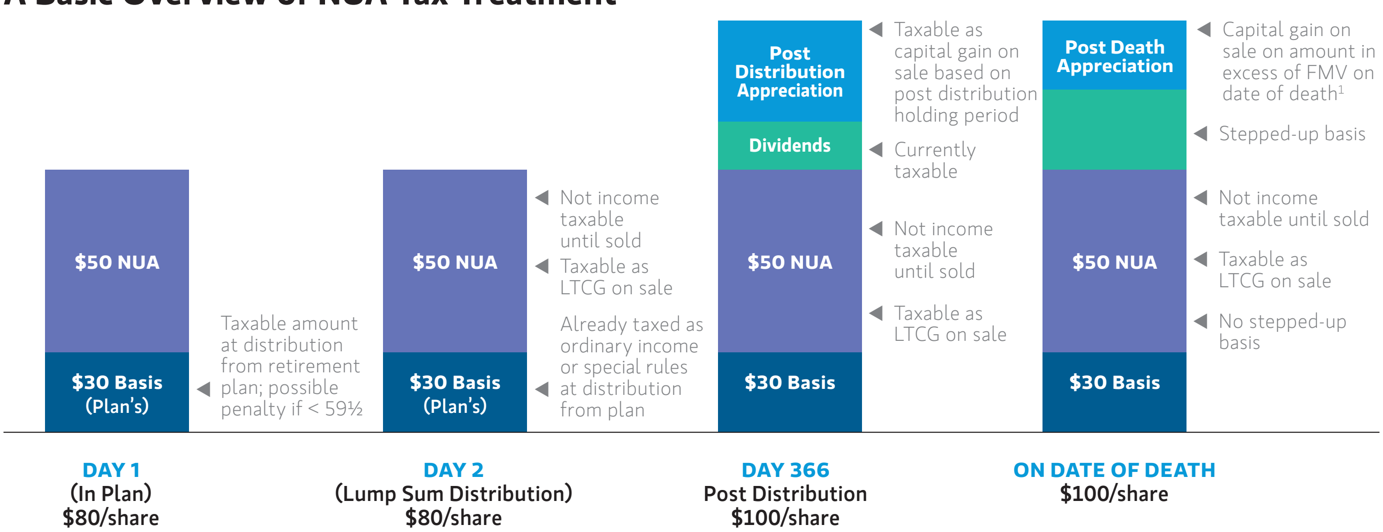
If you hold employer stock in your 401(k) or other employer-sponsored retirement plan, you will need to make some important decisions about the handling of this stock prior to changing jobs or retiring. The stock can receive special tax treatment under certain circumstances and you need to understand your options so that you can make the right decisions. You should discuss these issues with your tax and legal advisors before any action is taken.

In particular, there are four tax strategies that every participant who has invested in employer stock needs to understand and evaluate:

- Special Tax Treatment of Employer Stock Distributions — Net Unrealized Appreciation
- Ten-Year Forward Income Averaging on a Lump Sum Distribution
- Rollover of a Retirement Plan Distribution
- Conversion to a Roth IRA

The following is a discussion on the first of these strategies — Net Unrealized Appreciation.

A Basic Overview of NUA Tax Treatment



[1] In general, the fair market value of the stock is included in the decedent's estate for estate tax purposes.

Special Tax Treatment of Employer Stock Distributions — Net Unrealized Appreciation

Once you leave your employer, if you are vested in your account balance, you may have the option of taking all of the assets in your vested account balance in the form of a lump sum distribution. A lump sum distribution is defined as the disbursement of your entire vested account balance within one taxable year as a result of a "triggering event."[2] For purposes of determining whether a distribution is of your entire vested account balance, all qualified plans of the same type maintained by the same employer must be treated as a single plan. Triggering events are limited to:

- Separation from service (Note: this triggering event does not apply to self-employed individuals; only available to common law employees)
- Attainment of age 59½
- Death
- Qualifying disability of self-employed individual (Note: this triggering event does not apply to common law employees)

If you are eligible for, and choose, the special tax treatment of employer stock distributions, there are two tax benefits you may be eligible to receive:

1. At the time of the lump sum distribution, there is no tax on the net unrealized appreciation ("NUA") of the employer stock. NUA is the difference between your cost basis in this stock (i.e., what you paid for the stock in the plan) and the fair market value of the stock on the date of distribution. The cost basis is taxed as ordinary income in the year the distribution is received unless you are eligible for ten-year forward income averaging tax treatment.

2. When you sell the employer stock, the sale is taxed as long-term capital gains on the NUA rather than ordinary income tax rates.[3] Please consult with your tax advisor for your applicable long-term capital gains rate.

The deferral of tax on NUA can be a particularly significant benefit if:

- You are highly compensated,
- Your employer stock has appreciated significantly, and
- You do not plan to sell the employer stock for some time.

Key Issues in Electing the Special Tax Treatment of NUA

- If you purchased shares of employer stock within your 401(k) account using after-tax contributions, the distribution of such shares generally will not be subject to income taxation because you generally do not pay income tax on the distribution of after-tax contributions. You should discuss with your own tax advisor.
- Employer stock acquired with after-tax contributions is eligible for NUA treatment even if the distribution is not part of a qualifying lump sum distribution, subject to certain conditions.[4] Any after-tax contributions you made before January 1, 1987, are deemed to be distributed first, before any earnings. If you used pre-1987 after-tax contributions to acquire employer stock, your plan administrator should be able to tell you how many shares may be withdrawn, free of all current taxes.
- If the distribution is considered premature because you are under age 59½, the 10 percent early distribution penalty tax may apply to the taxable portion of the distribution. Note that the 10 percent penalty tax does not apply if the distribution is made from the employer-sponsored retirement plan because you separated from service during or after the year in which you attain age 55.
- You may elect to combine the NUA tax treatment with 10-year forward averaging if you were born before January 2, 1936 and would otherwise qualify.
- You may roll over part of your lump-sum distribution and still elect to use the NUA special tax treatment for employer stock that is not rolled over.
- You cannot avoid taxes on the cost basis at the time of distribution, unless it represents after-tax contributions. Consequently, you may be forced to prematurely liquidate some shares to pay the additional taxes due.
- Your Modified Adjusted Gross Income ("MAGI") increases when you take a taxable distribution. This can impact your eligibility for certain tax advantages limited to AGI's below certain amounts, such as deductions

[2] Note: If you receive a partial distribution as a result of a prior triggering event (e.g., in-service distribution after attainment of age 59½), it appears you may still be able to take advantage of the special tax rules for NUA in employer stock if you receive a lump sum distribution of your entire vested account balance within one taxable year as a result of a subsequent triggering event (e.g., separate from service). Before taking any action, you should consult with and rely on your own independent legal and tax advisor.

[3] You may also be subject to the Net Investment Income ("NII") tax of 3.8 percent if your modified adjusted gross income (as defined for purposes of the NII Tax) exceeds certain thresholds.

[4] There are different tax benefits available if you purchased employer stock under a Roth 401(k) option. For example, all distributions attributable to Roth 401(k) contributions after 59½ will not be subject to income tax if you satisfied the Roth 401(k) five-tax-year holding period. Also the Roth 401(k) account can be rolled over to a Roth IRA. You should consult your tax advisor if you will receive a distribution of employer stock under a Roth 401(k) option.

for contributions to an IRA (if you or your spouse is an active participant in an employer-sponsored retirement plan) or contributions to a Roth IRA or to an Education Savings Account. Taxable distributions can also affect penalty-tax-free distributions from your IRAs for medical expenses, Social Security benefit taxation, income tax deductions and tax credits. In addition, Medicare premiums may be increased in the year following a taxable distribution due to an increase in taxable income. Check with your tax advisor for your specific details.

- You may elect to not use the NUA special tax treatment but instead treat the full value of your distribution as current ordinary income. Your cost basis will then be the fair market value of the stock on the distribution date, and capital gains rules will apply on a later sale.

Applying the Capital Gains Tax to Your Employer Stock

When you sell employer stock distributed from a qualified plan, the sale proceeds are treated as capital gains or losses, depending on whether the sale price is more or less than the cost basis. To the extent you recover the NUA from a sale of the stock, you treat the NUA actually received as a long-term capital gain. If you sell the stock for more than its fair market value as of the distribution date (you receive more than the cost basis and NUA), the excess is taxed as a long-term or short-term capital gain, depending on how long you hold the employer stock after the distribution date. (The current holding period must be for more than 12 months to use the long-term capital gains tax rate.)

If you roll over employer stock into an IRA, you will lose the ability to apply capital gains tax treatment to that stock's NUA. Instead, when this stock is distributed from your IRA, it will be taxed as ordinary income based on its fair market value as of the IRA distribution date.

Key Issues in Taking a Lump Sum Distribution and Retaining Your Employer Stock

- Your distribution of employer stock is not subject to the 20 percent mandatory federal income tax withholding at the time of distribution. However, its value — excluding NUA — will be included to calculate the 20 percent withholding. If your distribution does not include cash or other property, or if you roll over everything except employer stock (and up to $200 of cash in lieu of fractional shares), you may have no withholding or a withholding of less than 20 percent.
- You have up to 60 days to decide whether or not to roll over the distribution of stock into an IRA.
- Employer stock that is taken out as a retirement distribution is not required to be sold, once you attain RMD Age due to IRS minimum distribution requirements.[5]
- You may borrow against employer stock that is taken out as a retirement distribution.
- In general, your heirs will receive a step-up in cost basis of the value of the employer stock for any appreciation from the distribution date to the date of your death. Any appreciation after the date of your death will be taxed as long- or short-term capital gains depending on the holding period. However, there is no step-up on the NUA itself. Your heirs will have to pay the tax on the NUA if they sell the stock and recover any NUA. However, your heirs may receive an income tax deduction for any federal estate tax paid as a result of the NUA being included in your taxable estate. Consult your tax advisor for additional information.
- You have to pay taxes on any dividends received each year in connection with employer stock that is taken out as a retirement distribution.
- Your AGI increases when you take a taxable distribution. As has been noted, any change in your AGI can impact your eligibility for certain AGI-sensitive tax advantages or other tax consequences.
- Your investment portfolio may be so heavily weighted with employer stock that it lacks the diversification needed to reduce market risk. For a complete picture of your financial exposure, be sure to consider all of your investments.
- The full market value of the stock would be included in your estate for estate valuation purposes, whether you own it directly or hold the stock in a Rollover IRA.

NUA Example

EXAMPLE 1

Let's assume you take a lump-sum distribution of 1,000 shares of your employer's stock in September, and you sell the 1,000 shares in January of the following year. Assume you used pretax contributions to acquire the stock at an average cost of $30 per share, the fair market value on the date of distribution in September is $80 per share, and the sale price of the stock in January of the following year is $100 a share. Based

[5] IRA owners must take an RMD each year starting with the year in which they attain age 70½ (if born before July 1, 1949), age 72 (if born after June 30, 1949, but before 1951), age 73 (if born after 1950, but before 1960) or age 75 (for all other birth years – note, there appears to be a drafting error in the statutory language, making it unclear when age 75 starts to apply in lieu of age 73, but it appears it was intended to apply to individuals born after 1959) (collectively, "RMD Age").

upon this scenario, the tax calculation is as follows:

COST BASIS

$30/share x 1,000 shares = $30,000

This amount is recognized as part of your ordinary income for the year of the distribution.

NET UNREALIZED APPRECIATION

Fair market value on the date of distribution (September) minus average cost:

$80/share – $30/share = $50/share

Net unrealized appreciation ("NUA")

$50/share x 1,000 shares = $50,000

Recognized as long-term capital gain in the year the stock is sold (no matter what the holding period is)

SALE PROCEEDS IN EXCESS OF NUA

Sale price minus fair market value on the date of distribution:

$100/share – $80/share = $20/share

$20/share x 1,000 shares = $20,000

Recognized as short-term capital gain in the year the stock is sold since the holding period was 12 months or less.

Note: If the holding period had been for more than 12 months, the additional gain in excess of the fair market value on the distribution date would have been subject to long-term capital gains treatment.

EXAMPLE 2

Assume the same facts as in Example 1 except the stock is sold at a price of $75 per share. Based upon this scenario, you still have a cost basis of $30,000, which is currently treated as ordinary income. You also still have the NUA of $50,000 as of the distribution date. But your sale proceeds of $75,000 (1,000 shares x $75/share) consist of a return of your $30,000 cost basis and a recovery of $45,000 of NUA. You treat the $45,000 as a long-term capital gain. You cannot claim a capital loss based on the decline in fair market value from $80 to $75 per share. You could claim a capital loss only if the sale price is less than the stock's cost basis (in our example, less than $30).

Conclusion

The prospect of receiving employer stock as a distribution from a retirement plan, such as a 401(k), can present unique and complex tax-planning opportunities. Because of the potential tax consequences, it is important that you familiarize yourself with the various tax strategies that may be available to you. Using the NUA special tax treatment can make sense if you have a substantial amount of highly appreciated employer stock that you do not plan to sell in the near future. If you wish to keep the stock outside of an IRA, you could further reduce your taxes by using forward averaging — but eligibility for using this option is limited.

If you contemplate using a tax-deferred account for your distribution, rolling over some or all of your assets other than employer stock into an IRA may be an attractive alternative. If you have many years before retirement, and future tax-free income for you or your heirs is your primary concern, you may also want to consider a full or partial Roth IRA conversion from your Traditional IRA (if eligible).

Obviously, there is no "one size fits all" answer to the question of how to handle employer stock. There are many factors to consider in determining which course of action is best for you. The right course depends on such factors as your age and the ages of your intended beneficiaries, your current and anticipated tax brackets, the extent to which your employer stock has appreciated, and the stock's future return potential versus other investments. You also need to consider whether you can afford to pay taxes upfront if you don't choose to roll over the employer stock into an IRA, and whether you need to diversify out of employer stock in order to reduce excessive exposure to a single investment.

Making the right decisions regarding the treatment of your employer stock distribution can play an important role in helping you achieve your retirement goals while minimizing your taxes.

Your Morgan Stanley Financial Advisor or Private Wealth Advisor is a trained and experienced investment professional who is prepared to assist you and your tax advisors with appropriate investment strategies that can help you transform your retirement goals and objectives into reality.

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