WHAT SHOULD I DO WITH COMPANY STOCK IN A 401(K)?

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When you retire from a job that includes a 401(k) plan, it is common to roll over that balance into a Traditional IRA. This allows continuation of tax deferral until you begin taking distributions. But if your 401(k) includes publicly held stock in the company you're leaving, you shouldn't automatically roll these assets over to an IRA. It may make more sense to move the company stock to a brokerage account and pay a little tax upfront. The main reason to pause before rolling over company stock is net unrealized appreciation (NUA). The NUA is the difference between the basis of the company stock (purchase price) and its fair market value when transferred out of the 401(k). The appreciation in the stock's value will be taxed differently depending on what account the stock is transferred to.

You don't pay any tax immediately if the transfer is to an IRA. This can be very helpful, but you are liable to pay income tax on the stock's full NUA when you sell it. If you move the company stock to a brokerage account instead, you will owe income tax immediately on the cost basis of the stock. If you have long owned the stock, your cost basis may be low, resulting in lower taxes. The long-term advantage is that when you sell the stock, the NUA will be taxed as a capital gain at lower rates than most pay in income taxes.

Avoiding an IRA transfer of your stock also allows you to avoid required minimum distributions. Once you turn 73, a certain amount of the account's value must be taken out annually. However, when you take advantage of NUA tax treatment by transferring it to a brokerage account, you avoid the required minimum distributions on your company stock.

Another advantage to NUA is that the company stock being transferred from a 401(k) plan maintains a long-term holding period. In brokerage accounts, if you hold stock for more than one year before selling it, you qualify for long-term capital gain tax treatment. If stock is held for less than one year before selling it, you must pay ordinary income tax on any gains. With NUA, you can sell the shares the day after you transfer them out of the 401(k) and only pay long-term capital gains tax. However, this break does not apply to any further appreciation in the stock after it is transferred out of your 401(k).

These same benefits flow to your heirs upon inheriting the company stock transferred from your 401(k). Upon inheritance, your heir will receive a stepped-up cost basis as of the date of death and automatically maintain a long-term holding period regardless of when your heir sells the stock. Your heir avoids paying tax on any increase in the value of the stock during the time you owned it. That would not be the case if they inherited the stock in an IRA rather than a brokerage account.

The NUA rule strictly applies to shares in the company you work for. Other 401(k) assets, such as mutual funds, do not receive it. You should only consider taking advantage of NUA tax treatment if the stock has appreciated significantly since your plan purchased it. If not, you may be better off rolling it over to your IRA.