

401(k) and Employee Ownership: Company Stock

Many companies have chosen to provide employees with an ownership interest by offering company stock through their 401(k) plan. The company can accomplish this in two ways:

1. Your employer can combine an ESOP with a 401(k), creating a KSOP. In a KSOP, the company matches employee 401(k) contributions to the plan with a contribution of company stock. As with a standard 401(k) plan, employee contributions are invested in various fund options offered by the plan. Some companies match employee contributions according to a fixed formula with contributions in company stock, but do not set up a formal ESOP to hold the company contributions. Other companies make their profit sharing matching contributions in company stock. In some cases, the company might place restrictions on how the stock vests or can be sold if it is not publicly traded.

2. Your employer can permit you to purchase company stock with your plan assets, essentially making company stock one of the choices in your asset allocation plan.

If company stock is offered through your 401(k), your company must provide you with additional financial information. In the case of a publicly traded company, this usually takes the form of an annual report and, in some cases, quarterly updates. This financial disclosure is intended to empower you, as an investor, to make an informed investment decision about your overall retirement asset allocation model.

One caveat: Purchasing company stock through your 401(k) or receiving it from your employer's match is not like drawing from a bottomless well. Some companies limit the amount of company stock that you can own in your account. Once you have a percentage of your assets in company stock, for example 25 percent, you may not be allowed to accumulate additional shares.

The Benefits of Company Stock in a 401(k)

So how good is the company stock option in your 401(k)? The payoffs of ownership are potentially substantial, but involve risk. Indeed, when Microsoft Corporation went public and Cain Chemical, Inc. was acquired, the value of the company stock held in both firms' profit sharing plans soared and catapulted to wealth hourly employees and executives alike. Ownership in your company's stock can provide this wealth to you in two ways:

1. When you receive profits distributed in the form of dividends
2. When your company has increased in value and your company stock value goes up

In essence, when the company is well run and profitable, you are included in that success.

Thanks to 401(k) plan regulations, investing 401(k) assets in company stock has additional benefits. Federal rules prohibit investment managers from taking a commission from the sale or purchase of company stock in a defined contribution plan, when the transaction is made directly with the company. Also, there are no investment management fees for 401(k) amounts invested in company stock. Reducing fees in these two ways significantly reduces costs, and can result in better long-term net returns for your 401(k) portfolio.

Another major benefit of owning company stock is the tax regulation known as the net unrealized appreciation exception (NUA), which provides a special tax advantage. This tax treatment provides that when you take a lump sum distribution in company stock from your 401(k) plan, you initially pay regular income taxes on only the initial cost of the shares to the plan (called the cost basis) rather than on their current value. You do not pay tax on the value of the appreciation until you sell the stock, at

which time you pay tax at the capital gains tax rate, even if you sell the stock one day after you receive it from the plan. Figure 9.1 is an example of how the NUA exception can lower the tax liability of a distribution of company stock. This can be a substantial tax break if the current capital gains tax rate is considerably lower than the income tax rate you pay on other 401(k) distributions, which are taxed at ordinary income tax rates.

However, taking a lump sum distribution in order to take advantage of NUA is not always the best approach. Keeping your accumulation tax-deferred may be more appropriate, depending on the situation. You should carefully evaluate this choice before making a decision. You may want to consult with a financial planner or tax advisor to determine what makes the most sense for you. If you decide that you want to take advantage of this tax benefit, your plan sponsor will need to record and track the cost basis of all stock contributed to your account. Most companies have excellent recordkeeping support systems to help you when it is time to take a distribution from your 401(k) plan. Be advised that if you roll your company stock into an IRA, or you roll your stock distribution over into another 401(k) plan, you will not be able to take advantage of this special tax treatment.

Figure 9.1: Determination of Net Unrealized Appreciation (NUA)

Previously, Pat was employed by Company EZ and accumulated 1,000 shares of Company EZ stock in his 401(k) account. He is considering how to handle the distribution of the stock from the 401(k).

Pat's tax liability for selling these shares from his taxable account:

On January 10, 2007, Pat transfers the 1,000 shares of Company EZ from the 401(k) plan to his own taxable account. The plan administrator indicates on the transfer documents that the cost basis in the 1,000 shares is \$50,000. Company EZ shares were valued at \$75 per share on January 10, 2007. Subsequently, on March 31, 2008, Pat sells the 1,000 shares of Company EZ for \$110 per share. Pat's tax rate for capital gains is 15% and for income is 28%. His tax liability would be determined as follows:

	Market Value	Taxable Rate	Taxable Amount	Amount of Tax	Date Taxable
Cost Basis of Shares in the 401(k) Plan	\$50,000	28%	\$50,000	\$14,000	1/10/07
Market Value at Transfer on 1/10/07 from 401(k) to Taxable Account	\$75,000	NA	NA	NA	NA
Market Value at Sale of Shares on 3/31/08	\$110,000	15%	\$60,000	\$9,000	3/31/08
Total			\$110,000	\$23,000	

Pat's tax liability for selling these shares in the 401(k) plan and taking a subsequent distribution in cash:

Alternatively, Pat could leave the shares in the 401(k) plan. No tax liability will arise until he actually sells the shares in the plan and subsequently takes a distribution of the proceeds from the plan. Suppose he sells the shares in the 401(k) plan as above on March 31, 2008 for \$110 per share and then he takes a full distribution of the proceeds from the 401(k) plan in cash.

His tax liability would be determined as follows:

	Market Value	Taxable Rate	Taxable Amount	Amount of Tax	Date Taxable
Cost of Shares in the 401(k) Plan	\$50,000	NA	NA	NA	NA
Market Value at Sale of Shares on 3/31/08	\$110,000	28%	\$110,000	\$30,800	3/31/08
Total			\$110,000	\$30,800	

Diversification

For many who have company stock in their 401(k) plan, the company stock is a substantial percentage of their total assets. In long-standing businesses, a substantial concentration in company stock can be a major bonus. You know that the company stock has been steady for many years, will most likely continue to rise, and you can deposit your dividends, if any are issued, into the plan on a tax-deferred basis.

However, if a company suffers hard times, the value of your stock will decrease. If you previously worked for an Internet startup or dot-com company, you know that company stock may not always be a wise investment. Also, if your company should go out of business, you will lose all or most of the value in your company stock, which is what happened to employees of Enron that owned company stock. The bottom line is that an investment in company stock is focused and far less diversified than is a stock mutual fund, and such focus can lead to significant swings in value. Consider diversifying your retirement funds into several investments with different risk/reward characteristics.

If you want to diversify your portfolio so it has less company stock, you need to know the rules for your plan. If you are in a 401(k) plan, then you must be allowed to diversify your employer's company stock contribution after you have 3 years of service. If you are in an ESOP you may have investment restrictions. Some ESOPs are required to allow you to diversify after 3 years of service. However, in other ESOPs you probably cannot diversify your company's stock until you have reached age 55 and have participated in the plan for 10 years. You will then be eligible to diversify up to 25 percent of your ESOP account balance each year during the next 5 years. In the sixth year, you will be eligible to diversify up to 50 percent of the value of your remaining ESOP account balance.

In other plans, you may be able to exchange your company stock much earlier, sometimes even immediately. It is important to be aware of these rules so you can make the best long-term decisions for your own needs, taking into account the entire range of your retirement savings opportunities.