Now, I’d like to present some information about retirement planning situations and assets that I think may apply to you as a highly compensated employee or business owner. In my experience, these situations mean additional assets to draw on in retirement, but also more complex tax and income planning. Due to the complexities and potential tax pitfalls, I suggest that clients get advice on these topics several years before actually retiring.
A great example of the little-known details that can make a big difference to retirement income involves company stock held in a corporate retirement plan. When you leave the company or retire, you can request a distribution of the shares of company stock you purchased while you participated on the company retirement plans. What’s more, you can ask that those shares be distributed directly to you “in kind.”

The shares must be received as part of a lump sum distribution as defined by the Internal Revenue Code. A lump sum distribution must be a distribution of the entire balance, within a single year, and it must be paid after the individual reaches age 59 ½, or a result of the employee’s separation from service, disability or death.

How you handle the shares after you receive them can change your tax liability and, as a result, how much you have left after taxes. The reason is a special tax treatment known as net unrealized depreciation, or NUA, that may apply. You’ll need to make sure that all your assets in the plan are distributed to you in the same year, and you’ll have to be certain you do not place the company shares into a tax-deferred account like an IRA. If you meet these requirements, you may be eligible to receive a tax break on the NUA.

Let’s look a bit closer at how this works, using a hypothetical example.
The following example shows a 60-year-old investor with $500,000 in company stock in an employer plan. The amount the investor paid for the shares, known as the cost basis, is $200,000. The distribution of shares in kind is considered a taxable event (unless they are rolled over to a Traditional IRA). However, the net unrealized appreciation is not taxable until the shares are sold. At that point, a special provision of the tax law stipulates that the NUA is taxable at long-term capital gain tax rates.

In this example, the investor holds the stock for an additional 10 years, earns a 5% annual rate of return and is in the highest federal income tax bracket of 39.6% during the initial distribution and at the time of sale.

In the IRA rollover example, the investor is taxed at the top federal income tax rate of 39.6% and pays $322,521. For the NUA strategy, the investor pays 20% capital gains tax plus a 3.8% Medicare tax only on the NUA at the time of sale, for a total of $146,238.

In this case, using the NUA strategy versus rolling over the assets into an IRA could result in over $176,283 in additional assets over the 10-year period.
Finally, let's look at the far right column. Here you see the tax obligation if you were to receive the shares in kind and have them directly rolled over to a Traditional IRA. No tax is due at the time of the distribution—or, in fact, until after the final sale. However, the special tax treatment for NUA is lost when the shares are rolled over to the Traditional IRA, and the full market value of the shares at the time of distribution from the Traditional IRA is taxable as ordinary income (not at capital gains rates as in the prior example), or $42,000 in this hypothetical example. In this example, the NUA strategy offers a tax savings of $13,000.

In addition, beneficiaries of employer-sponsored plans that hold company stock can also take advantage of the NUA treatment.

You should consider carefully when to take advantage of this special tax benefit. Of course, before making any decisions like this, you'll want to talk with your tax or legal advisor.
Sometimes I have clients who want to take early withdrawals from their tax-advantaged retirement plans. By “early,” I mean that they want access to the account funds well before federal tax laws allow penalty-free withdrawals from retirement plans at age 59½. A provision of the Internal Revenue Code, Section 72(t) lists exceptions to the penalty tax on distributions before age 59 ½.

Section 72(t) stipulates that if the retirement plan allows it, you may make penalty-free withdrawals from IRAs, 401(k)s and various qualified retirement plans at any age, as long as you meet certain conditions. Distributions that are received as substantially equal periodic payments are not subject to the penalty tax, as long as the payments continue for a minimum of five years or until you reach age 59½, whichever occurs later. If an individual modifies the payments prior to the completion of five years or reaching age 59 ½, the individual will be subject to a 10% IRS premature distribution tax penalty, plus interest, for all years. Finally, to determine your substantially equal periodic payments, on a regular basis at least annually, you need to use one of three IRS-approved formulas: RMD, Fixed Amortization or Fixed Annuity methods.

Nuances of the tax laws like Section 72(t) are one of the primary reasons why you should consider working with a retirement solutions specialist well before you think you will actually retire. With knowledgeable, professional assistance, you evaluate options that may allow you to move up your retirement date.
Stock options that have been awarded or “granted” by an employer also present specific challenges and opportunities. Stock options have a vesting period, often 3-5 years, during which an employee cannot sell or transfer the stock or options because the employee does not yet own them unconditionally. Usually, a proportion of the shares vest each year, until the end of the vesting period.

Both exercising stock options and selling option-acquired shares can have a major impact on your cash flow and tax burden in retirement. There are two points—at exercise and upon sale or disposition of your option shares—that are likely to trigger tax implications. I’ll start with non-qualified stock options and exercise.

Under a stock option plan, the stated price at which an employee is able to purchase shares of stock is called the exercise price (also known as the strike price). The difference between the value of the stock on the exercise date and the amount paid for the stock is called the bargain element. When dealing with non-qualified stock options, this bargain element is considered compensation, just like a salary. As a result, you must generally pay ordinary federal income taxes on it at your top marginal income tax rate, which currently ranges from 10% to 39.5%. State income taxes may apply as well. The income tax is due in the year of exercise. What’s more, the bargain element may also be subject to FICA taxes (for Social Security and Medicare).

There are generally no restrictions on when you may dispose of or sell the non-qualified stock options-acquired shares. When you do gift or sell them, there will be additional tax implications. For sales, just like selling shares of stock purchased on the open market, the taxes associated with the sale of non-qualified stock options-acquired shares will be based on your net profit (or loss). That’s the difference between the current market value at exercise and at the time you sell, minus certain trading expenses. So, you could realize a
capital gain or capital loss at the time of sale.
Now, let’s look at grants of incentive stock options. These involve a two-part, holding-period rule. If you meet those timing requirements and thus make what is known as a “qualified sale,” an incentive stock option will be treated differently than non-qualified stock options for tax purposes.

You must hold stock acquired by exercising the incentive stock option until at least two years from the date of grant and at least one year from the date of exercise. If you do so, both the bargain element AND any post-exercise gain in price are taxable at long-term capital gain tax rates, currently 0%, 15% or 20%.

In contrast to non-qualified stock options, no withholding is required for incentive stock options. Even though the bargain element you receive at the time you exercise an incentive stock option could be viewed as a form of compensation, as of today, the IRS does not require your employer to withhold income or payroll taxes when you exercise an incentive stock option.
If you’ve participated in an employee stock purchase plan, or ESPP, you know it can be a tax-efficient way to purchase shares of your employer’s stock. They’re also convenient, since contributions are made through payroll deductions. For those who haven’t as yet used an employee stock purchase plan, I’ll review quickly how they work.

You can make regular contributions between the plan offering date (or when you join the company, if later) and the purchase date, which is the designated day when the company will use the contributions from all employees to purchase shares of the corporate stock on behalf of all plan participants. Often, the purchase price stipulated in the employee stock purchase plan may intentionally be less than the fair market price on the purchase date, so there’s a potential for immediate profit.

From a tax standpoint, employee stock purchase plans have some similarities to incentive stock options. First, there is a two-part holding period involved for qualified, or tax-advantaged, sales of the shares acquired. Provided you hold your shares until two years after the offering date and at least one year after the purchase date, you will achieve a qualified disposition. The potential tax obligation on a qualified sale generally involves figuring the profit on the shares as of the purchase date, which is considered compensation taxable at your marginal income tax rate, and the capital gain or loss on the later disposal.
A stretch IRA strategy is a consideration for someone who may not need their IRA assets in retirement. You may believe that when you retire, your accumulated assets, Social Security and company-provided retirement benefits will be more than sufficient to meet your income needs. If so, you could pass assets to someone younger.

Unfortunately, if the assets are held in a Traditional IRA, the tax law will thwart your designs. The regulations require that you take annual distributions from your Traditional IRA(s) beginning in the year after the year you reach age 70½. There’s no way around this; if you’re alive at the end of that following year, you must take a distribution, and the amount will be based on your life expectancy (or, if your spouse is your sole beneficiary, life expectancy for the two of you). However, for whatever amount remains in the IRA after you die, you can do several things to reduce or postpone the amounts that must be withdrawn, so that tax deferral can continue to work its magic on the value of the IRA.

• If your spouse is at least 10 years younger than you and the only beneficiary, the IRS will assume that the account balance must be distributed over a longer time period, so each withdrawal can be smaller. If the age difference is less that 10 years and your spouse if the sole beneficiary, he or she can elect to treat the IRA as his or her own. At least until your spouse passes age 70½, the money can continue growing tax deferred.
• Name someone much younger, like a grandchild, as a beneficiary. He or she will have to take distributions annually, but the minimum required distribution will be calculated based on his or her much longer life expectancy. As a result, the distributions will be smaller and stretched over a longer period. More assets will remain in the account, growing tax deferred for a longer period of time.

Let me put this in more concrete terms.

Imagine someone who has $100,000 in a Traditional IRA. He names his one-year-old grandson as the beneficiary and then dies that same year. According to the IRS life expectancy tables, his grandson’s life expectancy is 81.6 years, and the required minimum distribution in year 1 is $1,225. ($100,000 ÷ 81.6 = $1,225). That will barely make a dent in the value of the IRA, leaving $98,000-plus to continue growing tax deferred. Of course, they may withdraw all the assets at any time as well.

If any of these situations apply to you, you’ll want to see a tax expert about the implications of taking action. At the same time, as a retirement solutions specialist, I can help you understand how to integrate them into your future income plan.