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Paying tax penalty sometimes can bring bigger tax savings

Consider this option before rolling company stock into other retirement account

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When you see the word "penalty," do you immediately think of a punishment, something you have to pay in time or money because you broke a rule or a law?

Imagine, if you will, a situation where paying a penalty might put you in a more favorable financial position. (Hint: It has to do with company stock in your retirement account and what you do with it when you leave the company.)

If you want to defer paying taxes and avoid paying a penalty when you leave a company, conventional wisdom dictates rolling everything over from your retirement account—including company stock—into another retirement account such as an IRA or into your new company's retirement plan, if permitted. But if your former company's stock has appreciated significantly, it might be better to transfer that stock to a taxable account and pay the penalty rather than roll it over to a new retirement account.

Here's why: The IRS has established a special tax break on distributions of company stock called net unrealized appreciation (NUA). If you were to take a distribution of company stock and not roll it over into a retirement account, only the cost basis, or original price of the asset, would be taxed as ordinary income.

The additional appreciation—the NUA—would be taxed at the favorable long-term capital gain rate (currently the maximum is 15 percent), and only when you sell the stock. Additional appreciation, if the stock is held for more than a year after the distribution, also would be taxed at the long-term capital gain rate. And if you were under 59 1/2 years old on the date of the distribution, only the cost basis would be subject to the 10 percent early-withdrawal penalty. But if you decided instead to roll the company stock into an IRA, that entire amount, when withdrawn, would be taxed as ordinary income.

Here's an example. You're 50 years old and the fair market value (FMV) of your company stock is $200,000 on the date of distribution (let's say Oct. 30, 2006). You paid $50,000 for the stock. On the distribution date, you choose not to sell the stock but instead decide to hold it for 15 more years. During this time the stock grows at an annual rate of 8 percent, and on Oct. 30, 2021, the stock is worth $634,434. When you turn 65 years old, you decide to sell the stock.

You're in the 28 percent tax bracket, which means that if you had rolled the stock over into an IRA at the time of the distribution, your total tax—based on a fair market value of $634,434 on the company stock at the time of the sale—would have been $177,642.

If you had transferred the company stock into a taxable account instead of an IRA at the time of distribution, your total tax would be just $106,665, for a savings of $70,977. That tax bill includes 28 percent of the $50,000 cost basis, or $14,000; a 10 percent penalty on that cost basis, or $5,000; 15 percent of the $150,000 NUA, or $22,500; and 15 percent of the $434,434 in additional appreciation, or $65,165.

If you think the stock might appreciate more, you could hold it as long as you like while it continues to grow in value. Also, since the stock is not in a retirement account, you aren't subject to the required minimum distributions when you turn 70 1/2 years old.

If you don't need the money and plan to leave the stock in your estate after your death, your beneficiaries will get what's called a step-up in basis. Let's assume you live another 10 years and die on Oct. 30, 2031. The stock has earned 8 percent a year, and the fair market value now is $1,369,695. The beneficiaries are under the same tax rules you would have been had you lived and sold the stock, except for the higher step-up in basis.

Your beneficiaries sell the stock a year later on Oct. 30, 2032. During that one-year period the stock's fair market value remained at $1,369,695. Their basis now is $1,219,695—the difference between the fair market value on the date of death ($1,369,695) and the fair market value on the date of distribution ($200,000)—plus the original cost basis of $50,000. They only need to pay capital gains tax on $150,000, which was the NUA amount way back on Oct. 30, 2006.

Here are a couple of caveats. To qualify for the NUA tax break, the entire distribution from your retirement plan must be made within one calendar year of the distribution start date. Any dividends received during each year thereafter are taxed as ordinary income. Because of the distribution, you must come up with money to pay the taxes and the penalty.

The IRS is inflexible when it comes to certain tax matters. Any distribution error of company stock or errors in reporting dates could result in you losing your tax advantage. With all the nuances of NUA, it's important to seek professional advice.

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