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MFS INVESTMENT MANAGEMENT®

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Retirement

By the numbers

- If you roll over employer stock, the federal tax rate could be as high as **35%** when distributed from your IRA.
- If you take distribution of the stock and sell it at a later date, the net unrealized appreciation may be taxed at the long-term capital gain tax rate of **15%.**
- The portion of 401(k) assets in company stock was **13%** in 2005.[1]

[1]ebri.org

Distributions of employer stock from 401(k) plans: taking advantage of net unrealized appreciation

If you participate in an employer-sponsored retirement plan and decide to change jobs or retire, you will be faced with some important decisions. While many choose to roll over their plan balance to an Individual Retirement Account (IRA), if you have company stock in your plan, you could forfeit a significant tax advantage — net unrealized appreciation (NUA) — by rolling over company stock.

Net unrealized appreciation is the increase in the value of the employer stock while held in a qualified retirement plan. When a plan participant receives a lump-sum distribution that includes employer stock, special federal tax rules allow the participant to defer paying federal taxes on the NUA.

Tax-saving strategy

If you receive greatly appreciated employer securities as part of a lump-sum distribution payment within a single tax year of your entire retirement plan interests, you should carefully consider whether or not to roll over these securities into an IRA. All distributions from IRAs are taxed as ordinary income, not as capital gains. Therefore, if employer securities are rolled over into an IRA, any potential for long-term capital gains treatment on the NUA and subsequent appreciation is lost.

If a partial rollover is elected instead — with only the portion of the lump sum not consisting of the employer stock being rolled over — there will be no current tax on the rolled-over portion. However, there will be tax at ordinary income tax rates on the value of the stock when obtained by the plan. And if you are under age 59½, you may be subject to a 10% penalty on the value of the stock.

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Key points

- If any part of your 401(k) plan is invested in employer stock, make sure you understand the tax implications of either rolling over or taking a lump-sum distribution from your 401(k) when you change jobs or retire.
- Make sure you tell beneficiaries that the NUA tax break may apply to them.
- Note that the potential NUA tax break will be void if the participant's entire interest in the plan is not distributed in the same calendar year.

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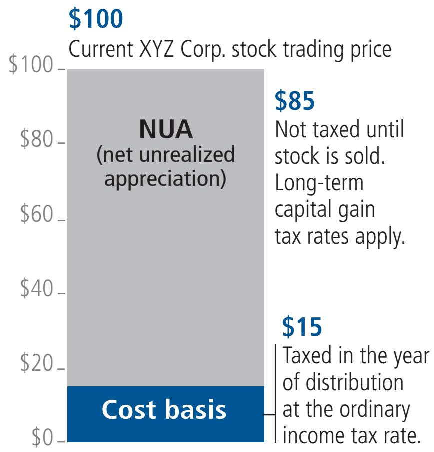

How stock is taxed

Any net unrealized appreciation (the difference between the fair market value of the stock on the date of the distribution and the fair market value as of the date it was contributed to or purchased by the plan) attributable to these securities is not taxed until you sell the stock. Additionally, when the stock is sold, the net unrealized appreciation as of the date of the lump-sum distribution is taxed at the long-term capital gain rate, currently 15%, rather than as ordinary income, which may entitle you to more favorable tax rates on this sum. Any additional appreciation that accumulates after the date of the lump-sum distribution would need to be held for at least a year to be given long-term capital gains treatment. The difference in the two tax rates could be substantial, particularly if you are in the highest tax bracket, which for tax year 2007 is 35% on ordinary income.

What are the short-term benefits of NUA?

One of the key benefits of receiving employer securities from a qualified plan, other than deferred taxation on the NUA portion, is that the NUA portion will be taxed at the applicable capital gain tax rates.

Mr. Smith, age 62, receives a share of XYZ Corp. stock (company stock) from his employer's qualified retirement plan that is currently trading at $100. The employer's qualified retirement plan trustee's cost basis of the stock is $15. The difference of $85 between the current trading price ($100) and the trustee's cost basis ($15) represents NUA. Only the $15 of the cost basis is subject to taxation at the ordinary income tax rates in the year of distribution. The $85 NUA will not be taxed until the year that the stock is sold.

What are the long-term benefits of NUA?

The following hypothetical example is for illustrative purposes only. Company stock is subject to the same risks as non-company stock. The stock could be worth more or less than its original cost at the time it is liquidated. By holding company stock an investor assumes the risks of any shareholder.

Initial assumptions

Purchase price of stock in the 401(k) plan	$100,000
Value of stock upon distribution	$1,000,000
Net unrealized appreciation	$900,000
Amount taxed as ordinary income	$100,000
Amount not taxed until stock is sold	$900,000

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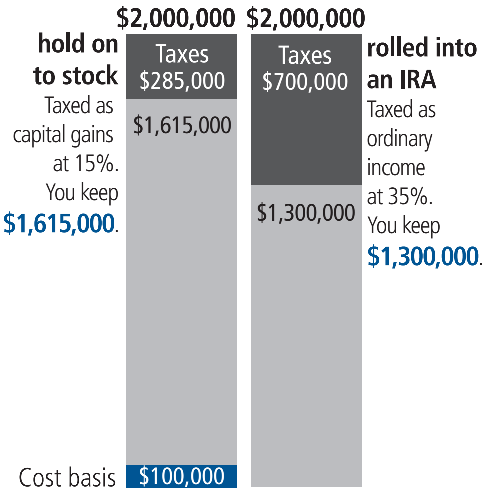

10 years later

If the participant takes a distribution of employer stock and holds on to the stock for at least one year, then all of the appreciation or depreciation would be treated as a long-term capital gain or loss. Ten years later, if the stock value climbs to $2,000,000, the tax advantage of the capital gains rates would be significant.

Value of stock at time of sale	$2,000,000
Amount previously taxed	$100,000
Amount taxable as long-term capital gain	$1,900,000
Capital gains tax due (at 15%)	$285,000

If the $1,000,000 of stock had been rolled over into an IRA, $2,000,000 would instead be taxed as ordinary income when it was distributed. Using a top federal tax rate of 35%, the tax on $2,000,000 is $700,000. By taking advantage of the favorable capital gains rates, this individual could save as much as $315,000 in federal income taxes.

This discussion and example relate only to federal income taxes. State and local income taxes also may be a factor. Individuals should contact a tax or investment professional before making any decisions regarding distributions from their qualified retirement plan.

Final considerations

Because there are significant income and estate tax advantages when you take employer securities from an employer-qualified plan, strong consideration should be given to taking a portion of the employer shares in kind from the employer-qualified plan. The number of in-kind shares of employer stock ultimately taken from a qualified plan will depend largely on a number of tax and investment decisions. As such, it will be important for the retiree to work with his or her tax advisor and investment professional to determine which strategy to employ.

Company stock is subject to the same risks as any stock. The stock could be worth more or less than its original cost at the time it is liquidated. By holding company stock, as opposed to liquidating the stock, an investor assumes the risks of any shareholder. Additionally, many investors, as a result of employer stock purchase programs, may have a significant percentage of their assets in company stock. It is important that you speak with your tax advisor and investment professional to ensure that your portfolio is in alignment with your goals, time frame, and appetite for risk.

Contact your investment professional for more information, or visit **mfs.com**.

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