High Exposure to Employer Stock in Your 401K: Good or Bad?

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Is it good or bad to have a lot of employer stock in your 401k plan? *It depends.* Some employees accumulate company stock quickly because their company match is 100% company stock. Other employees load up on company stock because they're bullish on their employer (and don't fear an Enron-type recurrence). On balance, employees are holding a declining share of their 401k assets in company stock: less than 7% versus 19% in 1999*. This is generally positive trend but…in some instances it *can* make tax-sense to leave an employer with a heavy dose of company stock in a 401k plan.

Let's define some of the pros and cons of company stock concentration in 401k plans and other investment assets:

1. A good rule of thumb for all investors is to reduce exposure to any one stock – including company stock – to a maximum of 10-15% of total investments.
2. This is especially true if you have more than 15% exposure to company stock (including options and Restricted Stock Units) *and* you are some years away from leaving your company.
3. On the other hand, if you have more than 15% exposure to your company stock <u>and you are close to leaving your employer</u>, it *may* make sense to hold company stock to benefit from a special IRS tax break called "net unrealized appreciation." This tax break affects employees who leave an employer with a heavy dose of company stock in their 401k plans. This strategy is attractive, for example, *if your cost basis for company*

shares is relatively low (see example, below).
4. Here is the financial trade-off of having a large company position in your 401k: 1) the risk of concentrated company stock tanking and affecting your investment portfolio adversely vs. 2) the potential for tax savings on company stock in your 401k plan when you roll it over after you leave an employer.

Example 1:

Cynthia works at ABC Inc. Her investments total $2 million: a) stock option grants from ABC ($300,000 value today) and b) her 401k account ($1.7 million) with 400K company stock. In total, Cynthia’s total investment exposure to ABC shares is 35% of her investment assets. Cynthia plans to work another 15 years. What should Cynthia do?

Answer: Cynthia’s overall 35% exposure to ABC shares is too high. She plans to hold her stock options for now but her 401k plan is a different matter. Since Cynthia plans to work another 15 years, it makes sense to cut her ABC company shares in her 401k to zero to reduce her ABC exposure to approx. 15% (the percentage varies since options are leveraged).

Example 2:

Cynthia’s situation is the same as Example 1 but she plans to leave the company within a year and roll her 401k over. Cynthia is willing to assume the risk of continuing to hold ABC shares in her 401k in exchange for the “net unrealized appreciation” tax break:

1. If Cynthia does nothing and she rolls her entire $1.7 million 401k over to an IRA, all proceeds eventually will come out and be fully taxable at ordinary income tax rates – anywhere from 15% to 39.6% (current rates) when withdrawn. Let’s assume she will pay a weighted total of 25% taxes on her IRA when she takes Required Minimum Distributions, and her IRA does not change in

value. She has $400,000 of ABC shares, so she'll end up paying **$100,000 of ordinary income tax on the ABC shares, assuming no change in ABC shares value** VERSUS
2. Cynthia applies the "net unrealized appreciation" tax break for employees with concentrated company stock positions in 401k plans. Cynthia confirms that her "cost basis" for the $400,000 of ABC shares in her 401k is a low $125,000 (the initial price of ABC 401k company matches and ABC shares Cynthia "purchased" in her 401k total $125,000 vs. the current $400,000 value). Cynthia rolls her $400,000 ABC shares to a **taxable account (not IRA),** pays ordinary income tax immediately on the $125,000 cost basis, and will pay a lower long-term capital gain tax on ABC share gains when she sells them in the future. (note: the other $1.3 million Cynthia has in her 401k rolls over to an IRA and is taxed in the future at ordinary income tax rates when withdrawn in the future).

By using "net unrealized appreciation," Cynthia pays a total of $86,250 in taxes on ABC shares that transferred to her taxable account vs. $100,000 taxes owed in the future. Cynthia has saved $13,750 of taxes on ABC shares by utilizing this IRS tax break.

For the sake of simplicity, I've assumed tax rates do not change, ABC shares and IRA values do not change, Cynthia's cost basis for ABC shares is low, she sells her ABC shares relatively quickly and the value of a future dollar of tax paid does not vary significantly from the value of a current dollar of tax paid.

In sum, it makes sense to limit your investment exposure to company stock but it may make good tax-sense to hold onto high company stock positions to enjoy the "net unrealized appreciation" tax break. Your financial advisor or CPA can help determine if your financial stars are aligned correctly and it's worth holding out for a tax break while maintaining concentrated company stock risk in the interim. Like so many decisions in financial planning, there is no “one size fits all” answer.

* the Employee Benefit Research Institute and the Investment Company Institute. Data represent 48% of all 401k plan participants.