FIDELITY Research INSTITUTE

RESEARCH INSIGHTS REPORT

Maximizing the Value of Company Stock at Retirement

The Little-Known Benefits of Net Unrealized Appreciation Tax Rules

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INTRODUCTION

As corporate pension and government entitlement systems decline as a percentage of retirement income for most Americans, the burden of funding one's retirement is falling increasingly on the individual. With this in mind, strategies that maximize the after-tax value of retirement investments are of greater importance than ever before. We addressed many of these "tax-wise" strategies in our Fall 2006 Insights Report "Beyond Conventional Wisdom: New Strategies for Lifetime Income." We follow-up those analyses here with a focused look at one particular strategy for utilizing Net Unrealized Appreciation, hereafter referred to as NUA — which applies specifically to those individuals who own company stock in their workplace savings plans[1], e.g. 401k and ESOP. We also address some of the special risks introduced by holding company stock in an investment portfolio and provide strategies to help mitigate those risks.

The employment of the federal tax rules for NUA is a benefit that is available to millions of Americans, but that very few have ever heard of — and which, properly utilized, can result in significant tax savings. While the decision on how to utilize the rules is dependent on a number of factors that will vary by person, it is important for eligible individuals to be aware of the key criteria.

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In Part 1 of this Insights Report, we will provide a basic definition of NUA for the general investor, and discuss the key requirements to elect NUA tax treatment. Part 2 looks at the four basic choices for the disposition of company stock at retirement, and offers guidance for trying to maximize value under various scenarios. Parts 3 and 4 provide additional insight into other relevant topics and our methodology.

We have made every effort to present our case in as simple and straightforward a manner as possible, but given the considerable complexity of the issue, we also strongly recommend that individuals consult with a financial/tax advisor to evaluate their specific situation. Individuals should seek advice before taking a distribution from their plan as the timing and type of distribution taken may partially or wholly exclude one from taking advantage of NUA rules. The tables presented in conjunction with the detailed discussion and special topics sections will be particularly helpful to advisors in preparing this personalized evaluation.

NUA IS THE APPRECIATION OF COMPANY STOCK SHARES PURCHASED AND HELD IN A QUALIFIED PLAN ABOVE THE INITIAL PURCHASE PRICE

NET UNREALIZED APPRECIATION (NUA) DEFINED

PART 1

NUA is the appreciation of company stock shares purchased and held in a qualified plan above the initial purchase price (referred to as cost basis). For example, if an employee purchases 100 shares of company stock for $20/share in a 401(k) plan, and five years later the shares are worth $35 each, the $3,500 current value consists of $2,000 of cost basis and $1,500 of NUA. The cost basis for NUA may be pre-tax or after-tax depending on the type of contribution used to buy the stock. This paper will largely focus on NUA purchased with pre-tax contributions.

Unbeknownst to most individual investors, the Internal Revenue Code (IRC) provides for special tax advantages on the distribution of company stock with NUA. It allows an individual who is retiring or changing jobs to take a distribution of company stock[2] and immediately pay ordinary income taxes on *just the basis of the stock*[3] and not on the appreciated value (the NUA).[4] A 10% early withdrawal penalty may also apply on the cost basis of the stock if the distribution is made before age 59½ — but not on the NUA. This is not an all or nothing election, an individual may elect to use the NUA strategy on only a portion of their company stock.

The NUA is not taxed until the company stock is sold outright[5]. When that event occurs, either immediately or at a later time, the NUA is taxed at the then-applicable long-term capital gains tax rate and <u>not</u> at the higher ordinary income tax rate. With the current maximum federal ordinary income tax rate at 35% and the current maximum federal capital gains tax rate at 15%, the potential tax savings may be substantial.

THE NUA
IS NOT TAXED UNTIL
THE COMPANY STOCK
IS SOLD OUTRIGHT

The IRC requires that several conditions be met to take advantage of the favored tax treatment of NUA[6] :

- A person must be eligible to take a lump-sum distribution from the plan(s). A lump-sum distribution means that distribution of a person's entire vested balance in the plan(s) must be completed within one tax year (e.g., Dec. 31st) — not that all amounts must be distributed at the same time[7].
- All of a person's assets in all of the qualified plans from the same employer must be distributed as a lump-sum, even if only one of the plans holds company stock.
- The distribution of company stock shares on which NUA tax treatment is elected must be taken in-kind directly from the plan, meaning the stock must be distributed as actual shares and ***not converted*** to cash first.
- One of four special events must have occurred: 1) separation from service from the company whose plan holds the stock; 2) death[8]; 3) total disability as defined under the Tax Code, which applies solely to a self-employed person; or 4) attaining age 59½. *Important note: The lump-sum distribution may be taken in the same tax year after one of these special events occurs or in a future tax year.*

THE IRS STRICTLY ENFORCES THE NUA TAX RULES

To utilize NUA tax treatment a person must meet all of the qualifications, perform the necessary actions as specified by federal tax laws, and elect NUA tax treatment of company stock (employer securities) on the appropriate IRS form. Additional requirements may apply depending on the plan's features, special circumstances (for example, company stock mergers) and/or unusual contribution types. The IRS strictly enforces the NUA tax rules. If one of the rules is not followed — such as failing to distribute all assets within one tax year — the NUA election is disqualified, and the entire amount of company stock distributed becomes taxable at ordinary income tax rates. Furthermore, if an early distribution penalty applies and the NUA tax treatment is disqualified by the IRS, the penalty applies to the entire distribution not rolled over into another tax-deferred account instead of just the stock's basis. Further details on how to elect NUA tax treatment for company stock may be found in IRS publication 575, Pension and Annuity Income.

NOT JUST FOR A SELECT FEW[9]

While a relatively small number of total defined contribution (DC) plans offer company stock ownership (6% for all Fidelity Investments Employer Services Company [FESCo] record kept plans), these plans cover 58% of FESCo plan participants and 61% of them own at least some company stock today. Translating this into the entire US defined contribution marketplace, we estimate over 24 million participants own upwards of $400 billion in company stock assets. This represents approximately 35% of all participants and 14% of the total $2.9 trillion in DC assets held by individuals as of the end of 2006.

For the purposes of this paper, we narrowed our focus to those participants between the ages of 55-64 since they are likely near or already in retirement (and, in many cases, have been with a firm for a number of years); the decision to evaluate NUA tax treatment for company stock holdings is most crucial for this target market. There are approximately 4 million participants that fall into this category (17% of all company stock holding defined contribution participants). These 4 million participants hold $553 billion in total DC assets of which approximately $153 billion is held in company stock, thereby accounting for almost 40% of all company stock assets.

After analyzing a sample of 250 plans with company stock record kept by FESCo, we estimate that 60% of the participants in our defined target market of 55-64 year-olds (approximately 2.5 million individuals) would benefit from evaluating the impact of electing vs. not electing NUA tax treatment of their company stock holdings. This estimate is based on an admittedly arbitrary but reasonable threshold of $3,000 absolute NUA and/or an NUA to market value ratio of at least 15%. Notably, these individuals may have as much as $40 billion in NUA currently.

A narrower view of just the top two deciles for our target market helps us to further refine our impact estimate. The average NUA per participant in our top two deciles sample is almost $46,000 per person. This $46,000 times 800,000 participants (20% of the overall 4 million participant target market) results in $37 billion in total NUA, thereby helping us to realize that a relatively small percentage of all company stock holders (20%) account for more than 90% of the $40 billion in NUA cited above. It is this group, therefore, that is truly the target of our report.

NUA Election vs. IRA Rollover: Tax Savings Example

Another alternative for company stock is to roll it over into an IRA (Individual Retirement Account). Rollovers to other types of tax-deferred accounts are permitted, but since we are focusing on distributions at retirement we will assume it is an IRA. If this option is exercised, however, the special NUA tax advantages for company stock are lost: all distributions from IRAs are taxed as ordinary income. It may still make sense, however, to rollover company stock into an IRA if the NUA is a small percentage of the stock's market value, or if a participant's investment time horizon is sufficiently long, since tax-deferred growth may be achieved for many years in an IRA.

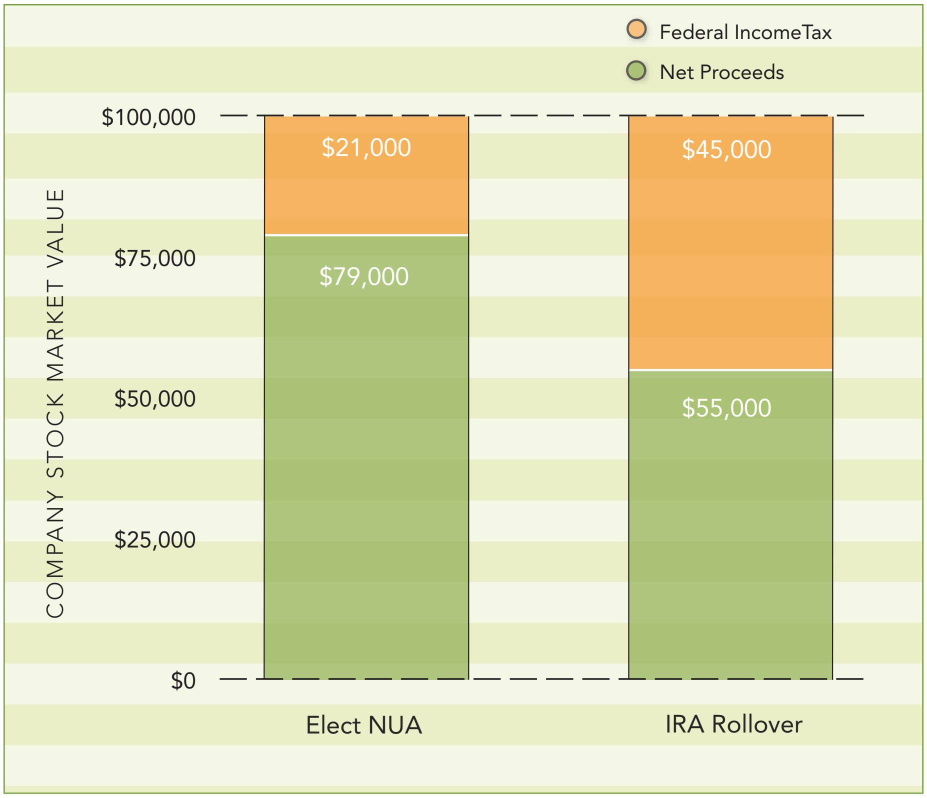
The following example outlines the difference in the two choices (NUA election vs. IRA Rollover) for a hypothetical 50-year-old executive who has a significant amount of company stock in her 401(k) plan at time of retirement. In this example, the executive would save $24,000 in federal income taxes by ensuring she meets all the criteria and then electing NUA tax treatment. The example assumes she immediately sells the company stock after distribution — before there is any additional appreciation or depreciation on the shares.

The more NUA you have,

the more potential advantage

from the Tax Code's NUA rules

Company Stock: Electing NUA Tax Treatment vs. Rollover to an IRA



Assumptions: (1) Company stock with a $100,000 market value, a $20,000 pre-tax basis, and appreciation of $80,000 is distributed in-kind from a 401(k) plan as part of a lump-sum distribution, (2) in the Elect NUA scenario, the stock is immediately sold after being distributed from the plan, (3) in the Rollover IRA scenario, the stock rolled over to the IRA is immediately sold and the proceeds distributed in cash, (4) 35% federal ordinary income tax rate on the $20,000 basis in the NUA scenario and on the entire $100,000 in the IRA scenario, (5) 15% federal long-term capital gain tax rate on the NUA in NUA scenario, and (6) participant is subject to an early withdrawal penalty of 10% on the $20,000 basis in the NUA scenario and on the entire $100,000 in the IRA scenario. State and local taxes are not taken into account. All the other non-stock assets distributed from the plan are assumed to be rolled over to a tax-deferred account to maintain their tax-deferred status and are not considered for purposes of this example.

		NUA Rules Employed		IRA Rollover
COMPANY STOCK (CS) DETAILS				
Market Value at Distribution		$100,000		$100,000
Pre-Tax Cost Basis		$20,000		$20,000
NUA		$80,000		$80,000
FEDERAL INCOME TAXES	Basis of $20,000x35%	$7,000	$100,000x35%	$35,000
	10% Early Withdrawal Penalty	$2,000	10% Early Withdrawal Penalty	$10,000
	NUA of $80,000 at 15%	$12,000		
Total Taxes		$21,000		$45,000
NET PROCEEDS		$79,000		$55,000

This is a particularly stark example — in that the NUA in this case is so much higher than the basis — but the basic lesson is clear: the more NUA you have, the more potential advantage from the Tax Code's NUA rules.

If a retired person has company stock and other assets in a qualified plan (as is usually the case), the non-company stock assets should generally be rolled over to an IRA. There is usually no reason to distribute non-company stock assets to a taxable account unless the money is needed right away — as ordinary income taxes would be due on the distributed assets.

PART 2

DETAILED DISCUSSION OF FOUR CHOICES FOR DISPOSITION OF COMPANY STOCK AT RETIREMENT

Once a retiree has understood the basic parameters of NUA and IRA tax rules, the next step is to become familiar with the *four basic choices* for handling company stock at retirement, which are outlined in the grid.[10]

Four Company Stock Retirement Scenarios — Actions & Results

Choices	Actions	Results/Federal Tax & Other Considerations
#1	• Take a lump-sum distribution of the entire vested balance in the plan • Elect NUA tax treatment for company stock and put it in a taxable account • Roll over other assets into an IRA or other tax-deferred account • Hold the company stock in a taxable account until the assets are needed at a later date, perhaps even leaving the stock to beneficiaries	NUA tax treatment is elected, but depending on the percentage of company stock to the entire investment portfolio, concentration risk (excess volatility) remains due to the retention of company stock.* The basis of the stock is subject to income taxes in the year the stock is distributed from the plan. The NUA and any additional appreciation are not subject to income taxes until the stock is sold. The NUA is taxed at long-term capital gains rates regardless of how soon the stock is sold after distribution from the plan. Additional appreciation is taxed at short- or long-term capital gain tax rates depending on how long the stock was held after distribution from the plan. The inclusion of basis in income could potentially push a person into a higher tax bracket or cause other income to become subject to the federal alternative minimum tax (AMT) depending on the taxable income involved. For illustrative purposes, however, our examples assume the additional income does not affect either.
#2	• Take a lump-sum distribution of entire vested balance in plan • Elect NUA tax treatment for company stock and put it in a taxable account • Roll over other assets into an IRA or other tax-deferred account • Immediately sell the company stock in the taxable account and reinvest the proceeds in a diversified 100% equity portfolio, or any other desired set of investments	NUA tax treatment is elected, and the risk of the portfolio being overloaded with the company stock is removed by immediately selling the stock. The basis of the stock is subject to income taxes in the year the stock is distributed from the plan at ordinary income tax rates. The NUA of the stock sold is taxed in the year of its sale at the long-term capital gain tax rate. Any additional appreciation that occurred between the distribution from the plan and the actual sale of the shares is taxed at the short-term capital gain rate because the sale was immediate. For hypothetical comparison purposes, we assume no further appreciation or depreciation before the shares are sold. The additional income from selling all the shares at once in a taxable account could potentially push a person into a higher tax bracket or cause other income to become subject to the federal alternative minimum tax (AMT) depending on the taxable income involved. For illustrative purposes, however, our examples assume the additional income does not affect either.

Choices	Actions	Results/Federal Tax & Other Considerations
#3	• Take a lump-sum distribution of the entire vested balance in plan • NUA is not elected • Roll over all assets, including company stock, into an IRA • Immediately sell the company stock in the IRA and reinvest the proceeds in a diversified 100% equity portfolio, or any other desired set of investments	NUA tax treatment of company stock is forfeited when the stock is rolled over to an IRA. Once the stock is sold in the IRA and reinvested in a diversified equity portfolio, the concentration of risk associated with the company stock is removed. There is no tax incentive for holding company stock in an IRA. This choice should have no effect on taxable income until a distribution is taken from the IRA. Pre-tax contributions and any associated earnings in the tax-deferred accounts will be taxed at ordinary income tax rates when they are distributed from the account. Individuals should consider whether they will be in a lower or higher tax bracket when taking distributions in the future. In our examples, we assume the same tax bracket both now and in the future.
#4	• Keep company stock in the qualified plan	The company stock is kept in the plan. There are problems with this course of action if a retiree still wants to gain the benefits of NUA rules and needs access to plan assets before taking a lump-sum distribution. Since NUA tax treatment generally requires a lump-sum distribution of a participant's entire vested balance in the plan, non-company stock assets are essentially locked up in the plan until the lump-sum distribution is made. This is because partial distributions in one year generally void the ability to make a lump-sum distribution in a future tax year. In addition, the Minimum Required Distribution (MRD) rules applicable to qualified plans require participants to take (partial) distributions beginning at about age 70 ½, thus making it virtually impossible to qualify for a lump-sum distribution after they have begun. Depending on the percentage of company stock to the entire investment portfolio, this choice also retains the concentration of risk inherent in having a large portion of the retiree's plan holdings in one company's stock. This choice should have no effect on taxable income until a distribution is taken from the plan.

* In our calculations for this choice, we assume a sufficient amount of shares of company stock is sold to pay taxes on the distributed pre-tax basis in the stock. Selling such shares may generate some capital gains, and, in addition, some of the NUA becomes a realized gain. Therefore, enough shares need to be sold to pay for the capital gains taxes, too. The taxes can of course be paid from other assets so that no company stock need be sold. However, in order to facilitate apples-to-apples comparisons with other choices, we'll assume some of the stock is sold to pay the taxes.

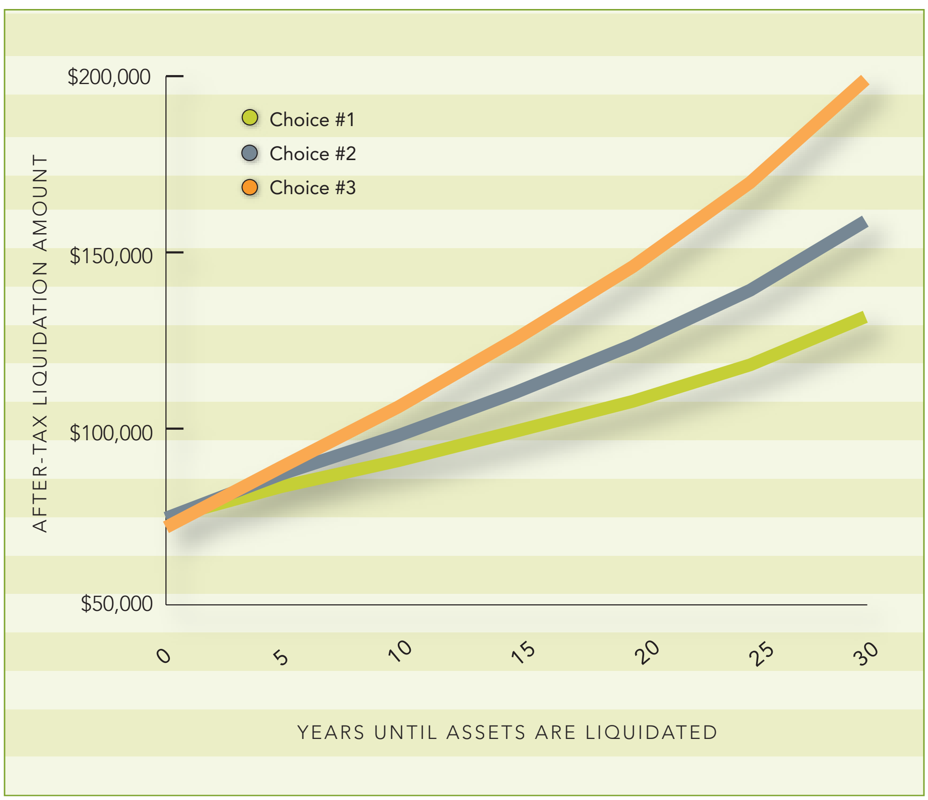
Now let's look at hypothetical examples of the choices in action. We assume an employee has reached age 65 and has just decided to retire with company stock currently valued at $100,000 — we assume all the stock in the qualified plan was purchased with pre-tax contributions. In the diversified equity portfolio of the taxable account, we assume 20% of unrealized gains and losses are turned over each year. Further, we'll assume the company stock has 25% greater volatility than a diversified equity portfolio (see Part 3 — Special Topic A for more discussion on the effect of concentration risk). Since many individual stocks have much greater volatilities, this is a conservative assumption. We also assume that company stock is distributed from the plan under each of the first three distribution choices discussed above. At the end of each holding period, all assets are liquidated, and any federal income taxes not previously paid are paid out of the liquidation proceeds. See Part 4. *About Our Methodology*, for more details about our assumptions.

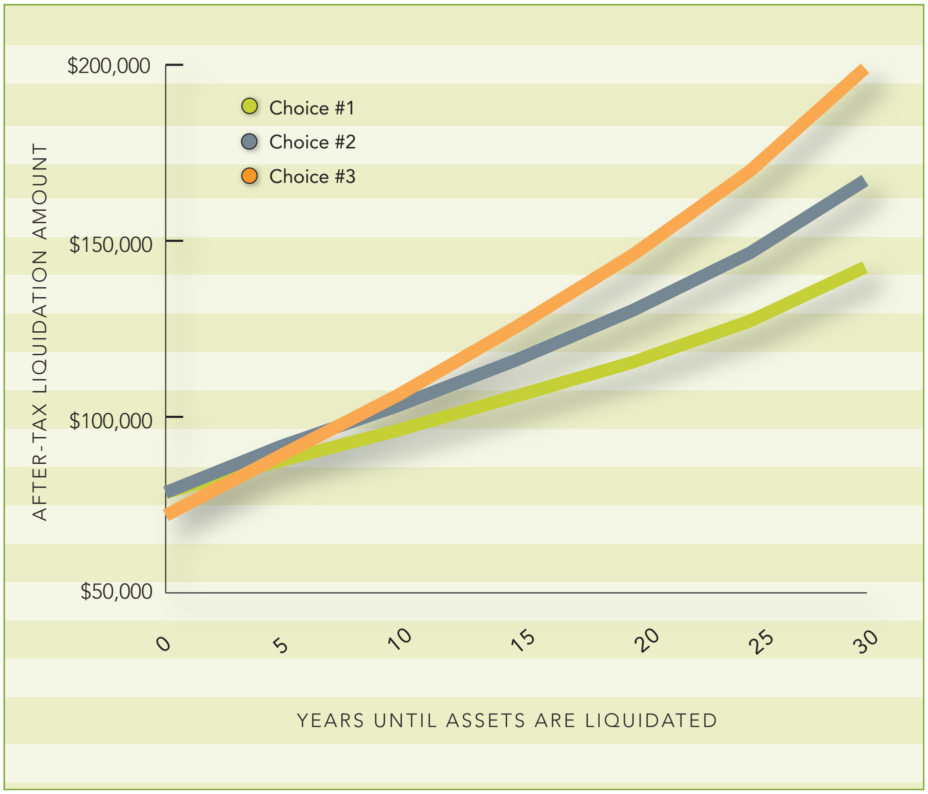
Going forward, our analysis covers only the first three choices outlined above across varying holding periods and varying levels of NUA as a percentage of market value. The fourth choice — keeping company stock in the plan — is not considered viable due to the possibility of voiding the ability to elect NUA tax treatment due to partial distributions (whether voluntary or to satisfy MRD requirements) and, therefore, is not explored further.

The charts on pages 10–11 display the estimated after-tax amounts from company stock for each of the three viable choices under average (median) market conditions. An average market means that 50% of the time stock returns would be higher, and 50% of the time they would be lower. Each chart represents a different NUA to Market Value Ratio to highlight how that factor, along with the number of years until assets are to be liquidated, impact the after-tax liquidation amount. Further details and specific values can be found in the tables starting on page 21.

20% NUA to Market Value Ratio

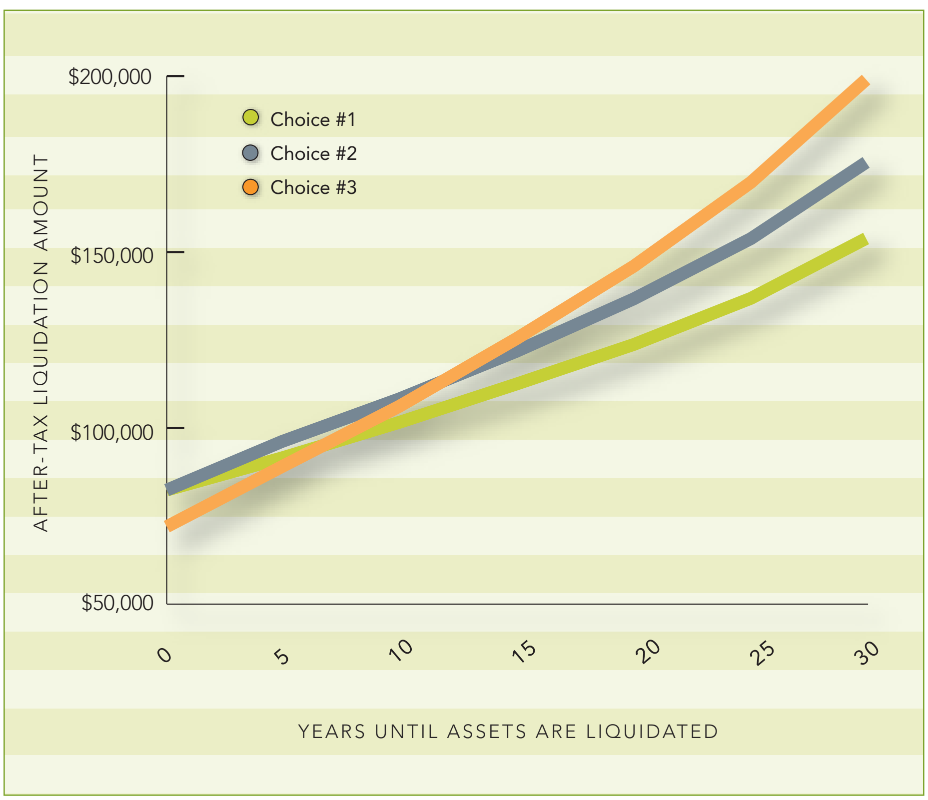
Choice #3 Is Best Choice For ALL TimeFrames EXCEPT Five Years or Less





50% NUA to Market Value Ratio

Choice #2 Is Best Choice When Less Than 10 Year Holding Period; Choice #3 Becomes Best Choice for 10+ Year Holding Periods



80% NUA to Market Value Ratio

Choice #2 Is Best Choice When Holding Period is 10 Years or Less; Choice #3 Becomes Best Choice for 15+ Year Holding Periods

The analysis reveals the following:

- For short holding periods, Choice #2 — Electing NUA, distributing company stock to a taxable account, immediately selling the stock and reinvesting in a diversified equity portfolio — provides the highest net after-tax liquidation value. Choice #2 should be strongly considered for holding periods of 10 years or less.
- For longer holding periods, Choice #3 — Not electing NUA, rolling over company stock to an IRA, immediately selling the stock and reinvesting in a diversified 100% equity portfolio — provides the highest net after-tax liquidation value. Choice #3 should be strongly considered for holding periods of 15 years or more.
- The higher the NUA as a percentage of market value, the greater the potential benefit from distributing company stock to a taxable account (Choice #2).
- The generally higher volatility of company stock reduces expected future values to such a degree that electing NUA and keeping the company stock in the taxable account, as in Choice #1, is never the best choice given the assumptions of the model. Under poor market conditions, Choice #1 significantly underperforms the other choices.

We also direct you to Part 3 — Special Topics at the end of this paper for discussion around some unique circumstances such as the effects of concentration risk, passing company stock onto heirs, holding company stock purchased with after-tax dollars, electing NUA tax treatment on specific shares of company stock and charitable giving.

CONCLUSIONS FOR PARTS 1 & 2

Given the significant amount of company stock held in defined contribution plans, an increased awareness of IRS rules for Net Unrealized Appreciation is needed to help educate millions of individuals about this tax-advantageous strategy. To that end, we have covered in some detail the considerations that an individual should weigh in determining if NUA election is the best choice for their circumstances.

Our analysis indicates that 1.) In the majority of cases, the best strategy for most individuals is to sell the company stock after retirement, whether it is distributed to a taxable account or rolled over to an IRA; and 2.) The investment time horizon, company stock volatility, current and anticipated future tax rates, amount of appreciation (NUA) and the NUA to market-value ratio all contribute to determining the best course of action as to whether or not to elect NUA tax treatment of the stock. In general, the larger the amount of NUA to current market value, the more advantageous it is to elect NUA tax treatment. In almost all cases, however, if one is planning to elect NUA tax treatment for company stock, we do not recommend leaving the assets in a qualified employer plan after retirement. Partial distributions — whether voluntary or required to satisfy MRD rules, generally void the ability to elect NUA.

Given the number of factors and the strict rules enforcement by the IRS, it bears repeating that we recommend individuals consult with a financial/tax advisor who can appropriately evaluate individual circumstances to determine the most appropriate strategy. The potential tax savings are too great to ignore.

FOUR KEY FACTORS WHEN CONSIDERING NUA ELECTION VS. IRA ROLLOVER

1 **Tax Rates — Ordinary Income Tax and Capital Gains Tax:** The greater the difference between the ordinary income tax rate and the long-term capital gains tax rate, the greater the potential tax savings of electing NUA tax treatment of company stock (as of this writing, the maximum ordinary income tax rate is 35% and the current maximum capital gains rate is 15% — making the potential savings substantial).

2 **Absolute Net Unrealized Appreciation:** The greater the sheer dollar amount of NUA of company stock — regardless of the percentage of appreciation — the greater the potential tax savings. For example, an absolute NUA of $1000 would yield a maximum tax savings of only $200 (assuming a 35% federal tax bracket and a 15% capital gains rate), whereas an absolute NUA of $10,000 would yield ten times that amount.

3 **Ratio of the Net Unrealized Appreciation to Total Company Stock Market Value:** The more appreciation that has occurred in the stock, (and, therefore, the higher the ratio of NUA to the total market value of the employee's stock), the higher the potential tax savings that can be realized since more of the proceeds are taxed at the lower capital gains rate. So, for example, if none of the company stock value is comprised of NUA, the effective tax on the proceeds (if rolled into a taxable account) would equal the ordinary income tax. On the other hand, if 99% of the market value is comprised of NUA, almost all of the tax paid would be at the long-term capital gains rate.

4 **Time Horizon:** The potential benefit of tax-deferred growth within an IRA account increases with the number of years that the distributed assets will remain invested. Conversely, when the time horizon before spending the assets is short, NUA election becomes more attractive.

The best strategy for most individuals is to sell the company stock after retirement

PART 3

SPECIAL TOPICS

A. The Effect of Concentration Risk — Excess Risk

The effect of concentration risk is excess volatility (risk) as compared to a fully diversified 100% equity portfolio. Basically, company stock that has the same annual expected return as a diversified 100% equity portfolio but has higher volatility will have a lower expected geometric mean annual return.

What does all this mean? It means that everything else being equal, the greater the volatility of the company stock the lower the expected future value. In this research brief, the diversified equity portfolio's stock volatility is assumed to be 19.38% per year and the annual expected return on a diversified equity portfolio is assumed to be 8.29%. For a company stock that has 25% more volatility than a diversified equity portfolio, the volatility is 24.22%. The effect of this increase in volatility for a 30-year investment period is a decrease in expected geometric mean return of about .89%. If the company stock had instead 50% more volatility, then the decrease in geometric mean return would jump to about 1.94%. Needless to say, volatility has a large impact on expected future values.

B. Passing Company Stock to Heirs and Beneficiaries

If a person dies before selling the stock on which NUA tax treatment was elected, NUA is considered income in respect of a decedent and is also considered part of that person's estate for estate tax purposes. The step-up in basis tax rules that usually allow beneficiaries and heirs to claim a basis in securities equal to the fair market value of the securities at the time of the decedent's death, are only applicable on the capital gains above the NUA. The NUA still remains taxable, although beneficiaries get to use long-term capital gains tax rates on the NUA, rather than ordinary income tax rates.

NUA IS CONSIDERED INCOME IN RESPECT OF A DECEDENT AND IS ALSO CONSIDERED PART OF THAT PERSON'S ESTATE FOR ESTATE TAX PURPOSES

Our prior analysis has assumed the person is living at the end of the holding period and must pay long-term capital gains taxes on the liquidated shares. If instead, a person were to die at the end of the holding period, the shares could be passed to beneficiaries with potentially some step-up in basis (for appreciation above the NUA). We investigated how the same three choices would have performed if the assets were left to beneficiaries.

All the comparisons were performed with an NUA to fair market value (MV) ratio of 50% (at the time the decedent originally distributed the stock from his or her plan) **under average (median) market conditions**. All other assumptions are the same as those indicated on page 21 except that we assume the participant died at the end of the holding period, the beneficiaries received a step-up in basis for all appreciation beyond NUA and the beneficiaries immediately sell the shares, before any additional gain or loss.

Choice #1— NUA tax treatment elected. Company stock kept in taxable account and not liquidated until end of holding period — would have these after-tax values:

Heirs get step-up in non-NUA basis only after original owner dies

	Years Until Original Owner Dies And Assets Are Liquidated						
NUA/MV	**0**	**5**	**10**	**15**	**20**	**25**	**30**
50%	$78,500	$90,250	$101,149	$113,004	$124,565	$138,405	$156,380

Choice #2 — NUA tax treatment elected. All company stock immediately sold in taxable account. Net after-tax proceeds re-invested in a diversified 100% equity portfolio – would have these after-tax values:

Heirs get step-up in basis after original owner dies

	Years Until Original Owner Dies And Assets Are Liquidated						
NUA/MV	**0**	**5**	**10**	**15**	**20**	**25**	**30**
50%	$78,500	$93,862	$106,134	$119,502	$133,745	$150,739	$172,146

In this situation both Choices #1 and #2 benefit from a step-up in basis, though Choice #3 — NUA tax treatment not elected, company stock rolled over into an IRA, sold immediately and proceeds reinvested in a diversified equity portfolio — would not since there is no step-up in basis for assets in an IRA.

As modeled, Choice #1 receives a greater step-up in basis than Choice #2 but not by enough to become the best strategy. Compare with the 50% NUA / MV after-tax values under average market conditions shown in the table on page 21. In cases where the owner dies before selling the stock, the difference in after-tax value between Choice #1 and Choice #2 is reduced. For example, for a 15-year investment period, the advantage of Choice #2 over Choice #1 reduces from about $10,000 to $6,500. Choice #1 benefits more from the step-up in basis due to the strategy of 0% turnover. Since the stock is held in the account and not sold, there is greater potential for unrealized capital gain above the NUA. Choice #2 assumed a 20% turnover each year of previously unrealized capital gains and losses.

C. Opportunities for the Individual Who's Bought Company Stock with After-Tax Contributions

For the subset of individuals holding company stock purchased with employee after-tax non-Roth contributions, there are some special opportunities. First of all, when company stock is distributed, the portion of the distribution which is deemed a return of these after-tax contributions is not taxable. The tax rules are rather complicated and depend on whether the shares purchased with such after-tax contributions can be identified or not. If the shares cannot be identified, then a portion of the after-tax contributions are attributed pro-rata to each share. Further details on determining the return of basis can be found in 1989-12 Internal Revenue Bulletin 68; 1989-1 C.B. 662; Notice 89-25. Suffice it to say that the application of these tax rules is probably best left to the tax experts.

If an investor has both company stock purchased with pre-tax contributions and company stock purchased with after-tax non-Roth contributions, the company stock purchased with after-tax contributions may be distributed to a taxable account with elected NUA tax treatment without distributing the shares purchased with pre-tax contributions. Even better for young investors, no 10% early withdrawal penalty is due when these shares purchased with after-tax non-Roth contributions are distributed to a taxable account before age 59½. Another important tax advantage is that for shares purchased with after-tax contributions, a lump-sum distribution of all a participant's assets in the Plan is not required to elect NUA tax treatment on shares attributable to the after-tax contributions. Although if such a partial distribution is taken, it will void the ability to take a lump-sum distribution in a future year and thus eliminate the ability to elect NUA on shares attributable to pre-tax contributions.

Relatively few investors have company stock purchased with after-tax contributions as compared to the millions of investors who have company stock purchased with pre-tax contributions.

THE TAX RULES ARE RATHER COMPLICATED AND DEPEND ON WHETHER THE SHARES PURCHASED WITH SUCH AFTER-TAX CONTRIBUTIONS CAN BE IDENTIFIED OR NOT

D. Electing NUA Tax Treatment on Specific Shares of Company Stock

A person could substantially benefit from selecting specific shares of company stock on which to elect the special tax treatment afforded net unrealized appreciation (NUA). This is especially true if the company has had a number of ups and downs and some company stock shares are at a loss while others are at a substantial gain. Selecting specific shares could also be extremely advantageous for investors who have company stock that was purchased over long time periods with some shares purchased a long time ago having very high NUA and other shares purchased more recently having relatively little NUA.

Net unrealized appreciation of employer securities equals the excess of the fair market value of the securities on the date of distribution over their cost or other basis. Although NUA and its associated basis may be derived based on the cost and appreciation of each individual share of company stock purchased within the plan, for tax purposes, at the time the stock is distributed from the plan, the appreciation all the shares is aggregated and then divided by the aggregate cost of those shares. The NUA will be allocated to each distributed share on a pro-rata basis, and each share will have the same basis for the purpose of determining future gain or loss. If a distribution of company stock includes some shares that have an unrealized capital gain and other shares that have an unrealized capital loss, NUA exists only to the extent unrealized gain exceeds unrealized loss. See 1) Bosley and Hutzelman, Qualified Plans — Taxation of Distributions, Portfolio 370-3rd Tax Mgmt. (BNA) U.S. Income @ A-48 (2001 and 2004), 2) Treasury Regs §1.402(a)-1(b)(2)(i), and 3) Revenue Rul. 57-514, 1957-2 C.B. 261. These regulations would appear to explicitly prohibit the selection of specific shares for NUA tax treatment — NUA is attributed pro-rata to each share distributed.

However, there may be hope. There appears to be no regulation explicitly prohibiting the sale of specifically identified shares of company stock before a distribution is made from the plan. That is, a participant could, at least theoretically, direct the plan trustee to sell specific shares of company stock in the qualified plan with low or no NUA before any planned distribution. The tax-saving technique is to sell shares with low NUA or shares that are at a loss and elect NUA tax treatment on the remaining shares, which have a high NUA as a percentage of market value.
For example, suppose a person determines that for his or her personal situation it only makes sense to elect NUA tax treatment on shares that have an NUA to market value ratio of 50% or higher. Shares meeting these criteria could get NUA tax treatment while the other shares could be sold in the plan and the sale proceeds then directly rolled over to an IRA. In fact, the sale of securities could occur at any time allowed under the plan before separation from service from the employer or even

after separation from service as long as they were sold before the election of NUA tax treatment. Proceeds from any shares sold would simply become non-employer-stock assets within the qualified plan, and at a later date, could be rolled over to an IRA when a lump-sum distribution is made.

Unfortunately for most investors, the tracking of specific share purchases by plan trustees is generally not available. Trustees are not required to track company stock purchases in such detail. Most investors only get aggregate level information — number of shares, total market value and total company stock basis. Only the "fortunate few" receive information on their specific shares of company stock. As record keeping and reporting systems continue to improve, availability of this information should significantly increase. Note, however, it is the Plan Trustee, not participants, who determines and reports basis and NUA in company stock, and such trustees may be reluctant to provide this service without a Private Letter Ruling from the IRS approving such an approach.

E. Charitable Giving

Electing NUA tax treatment of company stock can be an extremely tax-efficient strategy for charitable giving. Ordinary income tax is paid on just the pre-tax cost basis, but the federal itemized charitable tax deduction is usually based on the fair market value of the stock at the time it is donated, assuming all appreciation would have been taxable at the long-term capital gain tax rate if the individual sold the shares rather than donated them. Note that additional appreciation beyond NUA should only be deductible if the shares were held longer than one year after they were distributed from the plan. The following example illustrates the concept. Suppose someone has $100,000 in company stock with $40,000 in pre-tax basis and $60,000 in NUA. Assuming a 28% tax rate, $11,200 (28% x $40,000 basis) in federal ordinary income tax would be due on the distribution. If the distributed shares were then immediately given to a qualified charity, before there was any further appreciation or depreciation, he or she may be eligible to claim a tax-deduction of $28,000. The net result is the charity gets $100,000 and the individual gets a tax deduction of $16,800 ($28,000 – $11,200).

Of course, the actual details are more involved. The increase in adjusted gross income (AGI) from taking a distribution of company stock could reduce or eliminate some tax credits or deductions, or cause other income to become subject to the federal alternative minimum tax (AMT), thus somewhat reducing the overall tax benefit. If the charitable contribution is large relative to AGI, the deduction may be limited for the current year — although, generally "excess" charitable contributions can be carried forward for up to five years. State tax treatment of both NUA and charitable donations varies. Needless to say, for a specific individual it's critical to actually calculate the potential tax savings rather than rely on simple marginal tax rate calculations.

If the $100,000 in the above example were instead given directly to charity from an IRA, as is permitted in 2007, no federal income taxes would be due on the donation, the donation would not affect AGI or AMT because the distribution would not be includable in gross income, but there would also be no additional tax benefit to the individual. It's important to note, however, that some states have indicated they will consider these direct IRA donations to be fully taxable at the state level. Taking a distribution of $100,000 from an IRA and then making a donation of $100,000 would be even less advantageous — generally resulting in a net increase in tax due to the effects of increasing AGI and differences in state and local taxes.

Of course, this strategy for charitable giving largely depends on the amount of NUA. In the example above, if NUA were instead only $10,000 and the basis $90,000, $25,200 in ordinary income tax would be due, resulting in a maximum net tax deduction of only $2,800.

GENERALLY "EXCESS" CHARITABLE CONTRIBUTIONS CAN BE CARRIED FORWARD FOR UP TO FIVE YEARS

TABLES OF AFTER-TAX LIQUIDATION AMOUNTS FROM COMPANY STOCK

All amounts are in today's dollars. They are all based on company stock with a market value (MV) of $100,000 at the time the retiree, age 65, made their initial distribution choice. Net after-tax values are shown by number of years until final liquidation. NUA is shown as a percentage of market value at the time the retiree is age 65. The initial cost basis ("NUA Basis") in the stock is all assumed to be from pre-tax contributions. A 28% federal ordinary income tax rate and a 15% (20% after 2010) federal long-term capital gain tax rate were used in all scenarios. An annual turnover rate of 20% was assumed in the diversified 100% equity portfolio in the taxable amount. State and local taxes, fees and expenses and the potential effects of additional income pushing participants into higher tax brackets or causing other income to become subject to the AMT was not taken into account. See Part 4, About Our Methodology, for details on returns of diversified equity portfolios.

An average market means that 50% of the time stock prices would be higher, and 50% of the time they would be lower

Tables

Average (median) Market Conditions

An average market means that 50% of the time stock return would be higher, and 50% of the time they would be lower. For each combination of holding period and NUA/MV (NUA as a percent of Market Value at the beginning of the period), the highest value across the three tables is highlighted in green.

Choice 1: NUA tax treatment elected. Stock kept in taxable account and not liquidated until end of holding period (except for shares initially sold to cover taxes on NUA basis (at 28% tax rate) and on the capital gains (at 15% tax rate) of shares sold for that purpose). Volatility is 125% of a diversified 100% equity portfolio.

	Years Until Assets Are Liquidated						
NUA/MV	0	5	10	15	20	25	30
0%	$72,000	$80,801	$87,411	$94,942	$102,722	$112,243	$124,908
10%	$73,300	$82,169	$89,160	$97,083	$105,228	$115,148	$128,291
20%	$74,600	$83,525	$90,913	$99,253	$107,752	$118,087	$131,742
30%	$75,900	$84,875	$92,657	$101,434	$110,279	$121,080	$135,257
40%	$77,200	$86,219	$94,422	$103,625	$112,891	$124,161	$138,847
50%	$78,500	$87,557	$96,206	$105,839	$115,506	$127,224	$142,512
60%	$79,800	$88,887	$98,010	$108,055	$118,200	$130,366	$146,263
70%	$81,100	$90,211	$99,807	$110,238	$120,949	$133,581	$150,089
80%	$82,400	$91,526	$101,613	$112,512	$123,738	$136,869	$153,857
90%	$83,700	$92,823	$103,433	$114,814	$126,607	$140,200	$157,940
99%	$84,870	$93,982	$105,064	$116,910	$129,143	$143,267	$161,592

Choice 2: NUA tax treatment elected. Stock immediately sold in taxable account. Taxes paid on NUA Basis (at 28% tax rate) and on NUA (at 15% tax rate) out of the company stock sale proceeds. Net after-tax proceeds are re-invested in a diversified 100% equity portfolio.

	Years Until Assets Are Liquidated						
NUA/MV	0	5	10	15	20	25	30
0%	$72,000	$84,039	$94,620	$106,429	$119,447	$134,413	$153,326
10%	$73,300	$85,556	$96,328	$108,350	$121,604	$136,840	$156,095
20%	$74,600	$87,074	$98,037	$110,272	$123,760	$139,267	$158,863
30%	$75,900	$88,591	$99,745	$112,194	$125,917	$141,694	$161,632
40%	$77,200	$90,109	$101,453	$114,115	$128,074	$144,121	$164,400
50%	$78,500	$91,626	$103,162	$116,037	$130,230	$146,548	$167,168
60%	$79,800	$93,143	$104,870	$117,959	$132,387	$148,975	$169,937
70%	$81,100	$94,661	$106,579	$119,880	$134,544	$151,402	$172,705
80%	$82,400	$96,178	$108,287	$121,802	$136,700	$153,829	$175,474
90%	$83,700	$97,695	$109,996	$123,723	$138,857	$156,256	$178,242
99%	$84,870	$99,061	$111,533	$125,453	$140,798	$158,440	$180,733

Choice 3: NUA tax treatment not elected. Company stock shares rolled over to an IRA and immediately sold in IRA. Stock sale proceeds are re-invested in a diversified 100% equity portfolio. No taxes are due at time of rollover, and no amounts are includable in income until they are distributed from the IRA. All distributions from the IRA are taxed at a 28% rate.

	Years Until Assets Are Liquidated						
NUA/MV	0	5	10	15	20	25	30
0%	$72,000	$89,050	$106,166	$125,407	$145,975	$169,813	$199,005
10%	$72,000	$89,050	$106,166	$125,407	$145,975	$169,813	$199,005
20%	$72,000	$89,050	$106,166	$125,407	$145,975	$169,813	$199,005
30%	$72,000	$89,050	$106,166	$125,407	$145,975	$169,813	$199,005
40%	$72,000	$89,050	$106,166	$125,407	$145,975	$169,813	$199,005
50%	$72,000	$89,050	$106,166	$125,407	$145,975	$169,813	$199,005
60%	$72,000	$89,050	$106,166	$125,407	$145,975	$169,813	$199,005
70%	$72,000	$89,050	$106,166	$125,407	$145,975	$169,813	$199,005
80%	$72,000	$89,050	$106,166	$125,407	$145,975	$169,813	$199,005
90%	$72,000	$89,050	$106,166	$125,407	$145,975	$169,813	$199,005
99%	$72,000	$89,050	$106,166	$125,407	$145,975	$169,813	$199,005

Tables
Poor Market Conditions

A poor market means that 90% of the time stock returns would be higher, and 10% of the time they would be lower. For each combination of holding period and NUA/MV (NUA as a percent of Market Value at the beginning of the period), the highest value across the three tables is highlighted in blue. This analysis dramatically demonstrates the impact of excess volatility, or excess risk, on equity portfolio performance.

Choice 1: NUA tax treatment elected. Stock kept in taxable account and not liquidated until end of holding period (except for shares initially sold to cover taxes on NUA basis (at 28% tax rate) and on the capital gains (at 15% tax rate) of shares sold for that purpose). Volatility is 125% of a diversified 100% equity portfolio.

	Years Until Assets Are Liquidated						
NUA/MV	0	5	10	15	20	25	30
0%	$72,000	$47,215	$40,041	$35,823	$33,109	$30,587	$29,314
10%	$73,300	$47,462	$40,220	$35,997	$33,342	$30,826	$29,619
20%	$74,600	$47,668	$40,364	$36,148	$33,540	$31,048	$29,908
30%	$75,900	$47,831	$40,477	$36,276	$33,707	$31,242	$30,185
40%	$77,200	$47,950	$40,547	$36,371	$33,853	$31,421	$30,440
50%	$78,500	$48,022	$40,564	$36,430	$33,953	$31,587	$30,663
60%	$79,800	$48,046	$40,536	$36,447	$34,019	$31,707	$30,851
70%	$81,100	$48,021	$40,463	$36,405	$34,051	$31,797	$31,001
80%	$82,400	$47,943	$40,344	$36,328	$34,046	$31,851	$31,150
90%	$83,700	$47,811	$40,155	$36,200	$33,971	$31,891	$31,254
99%	$84,870	$47,644	$39,934	$36,041	$33,912	$31,872	$31,282

Choice 2: NUA tax treatment elected. Stock immediately sold in taxable account. Taxes paid on NUA Basis (at 28% tax rate) and on NUA (at 15% tax rate) out of the company stock sale proceeds. Net after-tax proceeds are re-invested in a diversified 100% equity portfolio.

	Years Until Assets Are Liquidated						
NUA/MV	0	5	10	15	20	25	30
0%	$72,000	$52,623	$47,244	$44,896	$43,820	$43,222	$44,136
10%	$73,300	$53,573	$48,097	$45,707	$44,611	$44,002	$44,933
20%	$74,600	$54,523	$48,950	$46,518	$45,402	$44,782	$45,730
30%	$75,900	$55,473	$49,803	$47,328	$46,193	$45,563	$46,527
40%	$77,200	$56,423	$50,656	$48,139	$46,985	$46,343	$47,324
50%	$78,500	$57,374	$51,509	$48,950	$47,776	$47,124	$48,121
60%	$79,800	$58,324	$52,362	$49,760	$48,567	$47,904	$48,918
70%	$81,100	$59,274	$53,215	$50,571	$49,358	$48,684	$49,714
80%	$82,400	$60,224	$54,068	$51,382	$50,149	$49,465	$50,511
90%	$83,700	$61,174	$54,921	$52,192	$50,941	$50,245	$51,308
99%	$84,870	$62,029	$55,689	$52,922	$51,653	$50,948	$52,026

Choice 3: NUA tax treatment not elected. Company stock shares rolled over to an IRA and immediately sold in IRA. Stock sale proceeds are re-invested in a diversified 100% equity portfolio. No taxes are due at time of rollover, and no amounts are includable in income until they are distributed from the IRA. All distributions from the IRA are taxed at a 28% rate.

	Years Until Assets Are Liquidated						
NUA/MV	0	5	10	15	20	25	30
0%	$72,000	$51,413	$48,393	$48,336	$49,543	$50,498	$53,170
10%	$72,000	$51,413	$48,393	$48,336	$49,543	$50,498	$53,170
20%	$72,000	$51,413	$48,393	$48,336	$49,543	$50,498	$53,170
30%	$72,000	$51,413	$48,393	$48,336	$49,543	$50,498	$53,170
40%	$72,000	$51,413	$48,393	$48,336	$49,543	$50,498	$53,170
50%	$72,000	$51,413	$48,393	$48,336	$49,543	$50,498	$53,170
60%	$72,000	$51,413	$48,393	$48,336	$49,543	$50,498	$53,170
70%	$72,000	$51,413	$48,393	$48,336	$49,543	$50,498	$53,170
80%	$72,000	$51,413	$48,393	$48,336	$49,543	$50,498	$53,170
90%	$72,000	$51,413	$48,393	$48,336	$49,543	$50,498	$53,170
99%	$72,000	$51,413	$48,393	$48,336	$49,543	$50,498	$53,170

Company Stock with Same Risk as a Diversified Equity Portfolio
To further understand the impact of excess stock volatility vs. the tax advantages of the NUA strategy, Choice #1 (continuing to hold company stock in the taxable account after electing NUA tax treatment) was recomputed assuming the volatility was the same as in a diversified equity portfolio. Under this new hypothetical assumption, Choice #1 generally provides the highest expected net after-tax liquidation value for NUA / MV ratios of 70% and higher. As shown in the yellow highlighted values, under these assumptions, Choice #1 would be the best choice across all time frames except for the immediate time frame for which it is equal to Choice #2 (elect NUA, immediately sell stock in taxable account and invest sale proceeds in diversified portfolio) and the 5-year period for which it is slightly below the values for Choice #2. Under poor market conditions, Choice #1 is the best performing strategy in even more situations, as shown in the orange highlighted values.

If company stock had the same risk as a diversified equity portfolio

Taxable account, keep company stock
Volatility is 100% of diversified equity portfolio.
Sufficient company stock is sold to pay taxes due on distributed NUA basis.

Choice 1: Average (Expected) Market Conditions

	Years Until Assets Are Liquidated						
NUA/MV	0	5	10	15	20	25	30
0%	$72,000	$84,317	$95,620	$109,151	$124,454	$143,135	$167,466
10%	$73,300	$85,802	$97,624	$111,738	$127,650	$147,054	$172,264
20%	$74,600	$87,281	$99,643	$114,350	$130,874	$151,012	$177,092
30%	$75,900	$88,758	$101,680	$117,016	$134,155	$155,042	$182,076
40%	$77,200	$90,233	$103,736	$119,713	$137,501	$159,138	$187,150
50%	$78,500	$91,703	$105,813	$122,432	$140,918	$163,349	$192,396
60%	$79,800	$93,171	$107,911	$125,199	$144,410	$167,627	$197,710
70%	$81,100	$94,637	$110,038	$128,017	$147,958	$172,058	$203,109
80%	$82,400	$96,100	$112,180	$130,844	$151,595	$176,629	$208,579
90%	$83,700	$97,560	$114,339	$133,773	$155,336	$181,134	$214,293
99%	$84,870	$98,870	$116,311	$136,441	$158,752	$185,327	$219,583

Choice 1: Poor Market Conditions

	Years Until Assets Are Liquidated						
NUA/MV	0	5	10	15	20	25	30
0%	$72,000	$54,335	$50,008	$48,303	$47,969	$47,563	$48,986
10%	$73,300	$54,829	$50,533	$48,898	$48,695	$48,373	$49,929
20%	$74,600	$55,283	$51,035	$49,477	$49,403	$49,171	$50,897
30%	$75,900	$55,696	$51,487	$50,028	$50,086	$49,958	$51,844
40%	$77,200	$56,075	$51,903	$50,557	$50,751	$50,741	$52,763
50%	$78,500	$56,416	$52,278	$51,063	$51,400	$51,504	$53,700
60%	$79,800	$56,718	$52,624	$51,542	$52,008	$52,261	$54,599
70%	$81,100	$56,978	$52,931	$51,999	$52,601	$52,990	$55,510
80%	$82,400	$57,195	$53,204	$52,433	$53,174	$53,731	$56,376
90%	$83,700	$57,367	$53,442	$52,845	$53,724	$54,455	$57,235
99%	$84,870	$57,474	$53,631	$53,137	$54,210	$55,064	$58,110

ADDENDUM

Initial Starting Balances and Basis in Taxable Accounts and IRA

When NUA is elected and the company stock is distributed to a taxable account, the pre-tax basis in the stock is currently taxable at ordinary income tax rates. For $100,000 in company stock, the federal income tax on the pre-tax NUA basis is:

Tax (at 28% rate) due on basis of company stock with a fair market value of $100,000 when it is distributed in-kind from a qualified plan.

NUA/MV	0%	10%	20%	30%	40%	50%	60%	70%	80%	90%	99%
Tax	$28,000	$25,200	$22,400	$19,600	$16,800	$14,000	$11,200	$8,400	$5,600	$2,800	$280

NUA/MV = Net unrealized appreciation as a percent of Fair Market Value.

In Choice #1 where the company stock is distributed to a taxable account and held as company stock until liquidation at a later date, the initial taxable account balances ("Net Assets") and the after-tax basis in the taxable account ("Basis") are as follows:

Company stock after taxes on distributed company stock of $100,000. Sufficient stock sold to pay taxes only. Assumed ordinary income tax rate of 28% on company stock basis and 15% tax rate on NUA.

NUA/MV	0%	10%	20%	30%	40%	50%	60%	70%	80%	90%	99%
Net Assets	$72,000	$74,416	$76,907	$79,476	$82,128	$84,865	$87,692	$90,615	$93,636	$96,763	$99,671
Basis	$72,000	$66,975	$61,526	$55,634	$49,277	$42,432	$35,077	$27,184	$18,727	$9,676	$997

In Choice #2 where the company stock is distributed to a taxable account and then immediately sold with the net after-tax proceeds reinvested in a diversified 100% equity portfolio, the initial taxable account balances ("Net Assets") and the after-tax basis in that account are the same, namely:

Stock transferred to taxable account and immediately sold: Starting value of taxable account after subtracting taxes (28% rate) on basis and taxes (15% rate) on all NUA.

NUA/MV	0%	10%	20%	30%	40%	50%	60%	70%	80%	90%	99%
Net Assets	$72,000	$73,300	$74,600	$75,900	$77,200	$78,500	$79,800	$81,100	$82,400	$83,700	$84,870

In Choice #3, where NUA is not elected and the company stock is rolled over to an IRA, the initial balance of the IRA is $100,000, all pre-tax, because no taxes are due at that time.

ABOUT OUR METHODOLOGY

PART 4

These comparisons of NUA distribution strategies are provided for illustrative purposes only, do not represent the performance of any specific security, and may not apply to your specific federal tax situation.

Some 10,000 financial market return scenarios were run to determine how the stock portfolios may have performed. Monte Carlo simulations are mathematical methods used to estimate the likelihood of a particular outcome based on historical analysis. Hypothetical performance simulations are conducted to determine the likelihood of various financial outcomes. Each Monte Carlo simulation reproduces random sets of results by generating random returns for the scenario. When analyzed together, these results suggest a probability of occurrence. A 50% confidence level (average market conditions), means that 50% of the hypothetical market scenarios we ran, or for every 1 out of 2 simulations, a hypothetical stock portfolio would have performed at least as well as the results shown. We consider the 50% confidence level a representation of average market results. Increasing the confidence level provides a more conservative analysis. A 90% confidence level (poor market conditions), means that 90% of the hypothetical market scenarios we ran, or for every 9 out of 10 simulations, a hypothetical stock portfolio would have performed at least as well as the results shown. We consider the 90% confidence level a representation of poor market results.

The estimated returns for the stock and bond asset classes are based on a "risk premium" approach. The risk premium for these asset classes is defined as their historical returns relative to a 10-year Treasury bond yield. Risk premium estimates for stocks and bonds are each added to the 10-year Treasury yield. Short-term investment asset-class returns are based on a historical risk premium added to an inflation rate which is calculated by subtracting the TIPS (Treasury Inflation Protected Securities) yield from the 10-year Treasury yield. This method results in what we believe to be an appropriate estimate of the market inflation rate — a rate of 2.47% was used in this paper's analysis.

Volatility of the stocks, bonds and short-term asset classes is based on the historical annual data from 1926 through the most recent year-end data available from Ibbotson Associates, Inc. Stocks, bonds and short-term debt are represented by the S&P 500®, U.S. Intermediate Term Government Bonds and 30-day U.S. Treasury bills, respectively. Annual returns assume the reinvestment of interest income and dividends, no transaction costs, no management or servicing fees and the rebalancing of the portfolio every year. It is not possible to invest directly in an index. All indexes include reinvestment of dividends and interest income. Although past performance does not guarantee future results, it may be useful in comparing alternate investment strategies over the long term. Performance returns for actual investments will generally be reduced by fees or expenses not reflected in these hypothetical illustrations.

Tax Factors: The results presented in this report are significantly dependent on the applicable tax rates. As modeled, the difference between the federal ordinary income tax rate and the federal long-term capital gains tax rate is 13% (28%–15%). After 2010, the maximum federal long-term capital gains tax rate is scheduled to return to 20% and the 28% tax bracket is scheduled to return to 31%. So starting in 2011, a person currently in the 28% tax bracket would have an NUA tax rate advantage of 11% (31%–20%) assuming both tax rates return to their prior values and 8% (28%–20%) assuming only the long-term capital gains tax rate returns to its prior value. The greater the difference in tax rates between the ordinary income tax rate and long-term capital gains tax rate, the greater the potential advantage of electing NUA tax treatment on company stock. A person in the 35% federal tax bracket would experience greater rewards from electing NUA tax treatment on company stock than shown above, and a person in the 25% tax bracket would experience smaller rewards.

Other Important Tax Assumptions Used in the Scenarios:

- Analysis was performed as of 1/1/2007.
- Federal ordinary income tax rate is 28% for all years; i.e. we assume the 28% tax rate does not increase to 31% after 2010
- Federal long-term capital gains tax rate is 15% from 2007 through 2010 and 20% thereafter.
- Qualified dividends are taxed at 15% from 2007 through 2010 and at 28% thereafter.
- All capital gains are taxed at long-term capital gain tax rates.
- Taxable accounts with the diversified 100% equity portfolios have a 20% turnover of previously unrealized capital gains and losses.
- It is assumed that the diversified 100% equity portfolio will distribute 2% in qualified dividends each year, all of which will be reinvested in the same diversified equity portfolio.
- It is also assumed that company stock will distribute 2% in qualified dividends each year. It is further assumed that the net after-tax proceeds from dividends will be reinvested in the company stock.
- All company stock was purchased with pre-tax contributions.

IMPORTANT LEGAL INFORMATION

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1 NUA only applies to company stock in qualified plans..

2 The distribution of company stock must be taken in-kind, which is simply a distribution in shares.

3 Assuming the stock was purchased with pre-tax dollars; basis here is a special kind of basis that only applies to the NUA of company stock.

4 One common exception to the 10% early withdrawal penalty is if a participant in a qualified plan separates from service in the year they turn age 55 or older. If instead a person separates from service before this age, absent another exception, distributions from the plan will be subject to the 10% penalty until they are age 59 ½. This age 55 exception only applies to participants in qualified plans, It does not apply to owners of any type of IRA.

5 A person may elect to include the entire market value of the company stock distributed in current gross income.

6 See IRC Sec. 402(e)(4)

7 The only exception is assets purchased with after-tax non-Roth contributions (also called employee voluntary contributions) which do not have to follow the lump-sum rule. Specifically, shares of employer stock purchased with after-tax employee contributions are still eligible for NUA tax treatment if the shares are distributed in a partial distribution of assets rather than in a lump-sum distribution of assets. It is important to note, however, that partial distributions usually void the ability to make a lump-sum distribution in a later year, thus preventing the election of NUA tax treatment in the future on shares attributable to pre-tax contributions.

8 In the event that a participant dies with the assets still in the plan, the beneficiaries may elect NUA tax treatment with NUA based on the participant's cost basis in the stock. If electing NUA tax treatment on pre-tax contributions, a beneficiary will need to take a lump-sum distribution of his or her share of the account's assets. Only the portion of company stock to which the NUA rules will be applied needs to be distributed in-kind. The balance of the stock and other assets may be rolled over to an IRA or may need to be distributed to cash depending on the type of beneficiary and the plan's rules. Beneficiaries should make a decision before taking required distributions, e.g., MRDs.

9 Sources: Cerulli Quantitative Update: Retirement Markets 2005; Fidelity Investments Building Futures, 2006; FRI calculations

10 The discussion of the choices assumes the participant's basis in the stock is all pre-tax, and only federal income taxes are considered. In making a choice, an individual should be sure to consider the potential effect of state taxes especially if someone is currently living in a state with high income taxes and/or are thinking of moving to a state in the future that has lower or no income taxes.

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