



Ruminations on Things Most Advisors Don't Know

We frequently find circumstances in which a financial advisor's lack of knowledge of some specific tax-related techniques may have cost the client money. Upon asking a number of financial advisors and CPAs about these situations, the unawareness on these points in particular appears to be widespread:

- 1) Net Unrealized Appreciation or NUA. Assume that you have a 401(k) with employer stock that was purchased far below the current value. Upon separation from service and *prior* to doing an IRA rollover, you may take the stock out directly (in-kind distribution). You will pay ordinary income taxes on the amount of the original purchase price, *not* the current market value. When the stock is then sold, the remaining gain is at capital gains rates, not ordinary income rates. Three circumstances will make this technique more advantageous: 1) the original purchase price is very small relative to the current fair market value of the stock; 2) you will need the money shortly anyway, so the continued tax-deferral is less of an issue; 3) the spread between the ordinary income rate and capital gain rate is high. All of these factors do not have to be true, but to the extent they are, the advantage of using the NUA tax treatment is greater.
- 2) Losing tax basis in a permanent insurance policy. If you are surrendering a permanent insurance product for less than the premiums paid, you should probably do a 1035 exchange into a low-cost annuity instead. In spite of my well-known dislike of variable annuities in most situations, in this case, you will get *tax free* earnings until the "losses" from the insurance are earned back. Moreover, you can even add additional funds to the annuity to accelerate the time to achieve breakeven from a tax perspective. This means the poor tax treatment (all ordinary income) of the annuity never comes into play.
- 3) The earlier withdrawal date from a 401(k). Funds may be withdrawn from a 401(k) upon separation of service without a 10% penalty at age 55 *not* 59½ as with an IRA. This is *without* a 72(t) (substantially equal periodic payment) schedule. In other words, if you are retiring at age 56, the funds that may be needed prior to 59½ probably should not be rolled over to an IRA without some further thought and analysis.

Notes:

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