

Net Unrealized Appreciation & Put Options Case Study

Benefit: By using Net Unrealized Appreciation and Put Options a client reduced his total taxes during retirement by one third and limited the downside of his 401(k) portfolio.

The Client: Jim Campbell, 63, is an engineer who will be retiring in 15 months. Mr. Campbell came to our office to “interview” our firm concerning his retirement plans. He said he wanted to pay “as little taxes as possible during retirement”.

Mr. Campbell’s 401(k) statement looked like this:

<i>Engineer’s 401(k)</i>	
<i>P&G Stock</i>	<i>\$950,000</i>
<i>Cash and other mutual funds</i>	<i><u>\$50,000</u></i>
<i>Total Value</i>	<i>\$1,000,000</i>

The Problem: Mr. Campbell has a highly concentrated, undiversified portfolio which exposes him to severe market risk. A single negative news item or failed product launch could harm his income during retirement. However, simply reallocating his account into the various mutual funds within his 401(k) plan would cost Mr. Campbell a significant tax savings during retirement.

The Tool: Net Unrealized Appreciation/Options strategy

Net Unrealized Appreciation occurs when the value of company stock in a 401(k) plan is higher than what was paid for it. The IRS treats company stock in a 401(k) differently than cash or mutual funds.

If Mr. Campbell had simply put the 401(k) into an IRA he would have paid more in taxes during his retirement than he needed to. Here’s why: If his money was moved to an IRA, any withdrawals from the IRA would be taxed at ordinary income tax rates. Using Net Unrealized Appreciation, the engineer would withdraw the employee stock from the 401(k) plan. He would pay income tax on what he paid for the stock – not what it’s worth now. Later, when he decides to sell that stock, he will pay the *lower* capital gains tax rate on money he made on the stock - not the *higher* ordinary income tax rate.

To lessen his risk, Mr. Campbell bought some P&G put options. Buying put options is similar to buying insurance for a risky portfolio. Put options allow the client to “put” the stock to someone else at a specified price sometime in the future. The terms of a put option would be that you can sell P&G in the next 3 months for \$100 per share. This option is valuable because the buyer of the option can profit even more.