

Net Unrealized Appreciation on Employer Stock

Distribution Decisions

The focus of this guide is to help you understand the specific issues and opportunities pertaining to employer stock distributed to you from your company's 401(k) or other retirement plan. Deciding which distribution strategy is most advantageous to your particular circumstances needs to be grounded in an understanding of all the choices available to you. This brochure discusses the immediate and ongoing income tax consequences of holding your employer's stock outside of a 401(k) or Rollover IRA and electing a tax strategy called net unrealized appreciation (NUA).

Given the complexity of the distribution regulations, Smith Barney urges you to consult with a knowledgeable tax accountant or attorney. Smith Barney does not offer personal tax or legal advice. For a discussion of all the retirement plan distribution options now available, ask for "The Smith Barney Guide to Lump-Sum Distributions."

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Net Unrealized Appreciation on Employer Stock

A lump-sum distribution from a company retirement plan that includes employer stock gives you the unique opportunity to convert taxable income into a long-term capital gain. You can do this by electing to create *net unrealized appreciation (NUA)* on the appreciated value of company stock that is in excess of what you paid for the stock.

In order to create net unrealized appreciation, you need to pay ordinary income taxes on the average cost of the shares at the time of distribution. At your option, you will be able to defer all tax on the difference between the current fair market value and the average cost (the difference is the NUA) until the

shares are actually sold. When you sell shares, the net unrealized appreciation will be taxed at the capital gains rate, which is currently a maximum of 15%. For those individuals in the 10% or 15% tax bracket, a 5% capital gains rate will apply from May 6, 2003 through 2007. In 2008, the rate will be 0%.

Only employer contributions and pretax employee contributions are eligible for this net unrealized appreciation tax strategy, and only if they are distributed as a lump-sum distribution. If you made any *after-tax employee contributions* to the plan, be sure to refer to the following section for special instructions on how to handle this portion of your stock distribution.

<h3>Components of NUA</h3> <p>The <i>net unrealized appreciation</i> distribution strategy typically includes three components:</p> <ul style="list-style-type: none">1 Average Cost Basis represents what your company's 401(k) or other retirement plan paid for your shares. This component is taxed at ordinary income tax rates when the shares are distributed from the plan.2 Net Unrealized Appreciation is the difference between the average cost basis and the stock's fair market value when your company shares are distributed. This component is always taxed at capital gains rates at the time of sale, unless you specifically elect to pay the tax at the time of distribution.3 Additional Appreciation is the difference between the fair market value of your company shares at the time of distribution and the price you receive when you dispose of the shares. The additional appreciation will be taxed as capital gains.	<h3>Conditions for Lump Sum Distributions</h3> <p>A distribution will qualify as a <i>lump-sum distribution</i> if it is on account of:</p> <ul style="list-style-type: none">• Death• Attainment of age 59 ½• Disability• Separation from service• Retirement
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Voluntary After-Tax Employee Contributions

Beginning in 2002, after-tax employee retirement plan contributions are eligible to be rolled over into an IRA. Alternatively, you can remove this portion of your balance without incurring any income tax liability. If your after-tax employee contributions were invested in employer stock, the ability to remove shares without an immediate tax liability provides a substantial benefit. Rolling these after-tax shares into an IRA is allowed, but any appreciation will be subject to ordinary income taxes when you begin to take distributions.

The first step is to determine the number of shares that represent your after-tax contributions. Because these shares are based upon the actual dollars you contribute, rather than the current value, you will receive more shares tax-free. As long as you hold these shares there are no taxes due. When you do sell these shares, only the net unrealized appreciation and additional appreciation components will be taxable. The average cost basis is never taxed. If these shares are inherited by your beneficiaries, upon sale they will pay capital gains tax on the unrealized appreciation only. The cost basis and the additional appreciation components will not be taxed.

Case Study—How NUA Works

Joan Winters, age 60, receives a lump-sum distribution of 1,000 shares of employer stock on January 15 of this year with an average cost basis of \$20 per share, and a current market value of \$50 per share. All shares were purchased with employer contributions and are eligible for the NUA tax strategy.

Ms. Winters will pay ordinary income tax (28%) on the average cost basis of the shares ($1,000 \times \$20 = \$20,000$) rather than the current value ($1,000 \times \$50 = \$50,000$). By making this election, she has created \$30,000 of NUA (\$30 per share) that will be subject to capital gains tax (currently 15% maximum) at the time the shares are sold. What will be her tax liability if she sells all 1,000 shares at \$60 per share?

(A) Current value of shares	\$50,000 (1,000 x \$50)
(B) Cost basis of shares	\$20,000 (1,000 x \$20)
(C) Unrealized Appreciation	\$30,000 (A - B)
(D) Tax due on distribution	\$5,600 (20,000 x .28)
(E) Tax due on subsequent sale	\$6,000 (1,000 x \$40 x .15)
(F) Total tax (D + E)	\$11,600

(For illustrative purposes only)

Using the *Smith Barney Net Unrealized Appreciation Calculator*, a comprehensive and detailed analysis can be created for you and your tax advisor that will:

- Analyze company stock values, distribution information, tax payment methods, financial objectives and IRA beneficiary information
- Determine tax implications of moving company stock into a taxable account versus an IRA account
- Estimate net proceeds expected from NUA and IRA rollover strategies

Ask your Smith Barney Financial Consultant for additional information on having a Net Unrealized Appreciation analysis prepared for you.

Combination of IRA Rollover and Net Unrealized Appreciation Tax Strategy

A typical lump-sum distribution may include cash or mutual funds in addition to employer stock. A combination strategy may be employed in this situation. To employ this strategy, the cash and mutual funds are rolled over to an IRA, and appreciated employer stock is kept out of the IRA. The stock that is not rolled over will be taxed using ordinary income tax rates on the average cost basis only. No tax is due on the net

unrealized appreciation at the time of distribution unless you specifically elect to pay it at the time of distribution rather than at the time of sale. If you use a combination strategy, you will not be eligible for the special ten-year averaging tax treatment on the assets kept outside of the IRA. See the separate section on ten-year averaging on page 7 for more details on this tax treatment.

Example: Combination of Pretax and After-tax Contributions

Charles Summers, age 69, receives a lump-sum distribution of 1,700 shares of employer stock with an average cost of \$12 per share, and a current market value of \$80 per share. Over the years, he contributed \$7,500 on an after-tax basis to the plan.

Mr. Summers elects the net unrealized appreciation strategy for the shares. First, he has to determine the number of shares that represent his after-tax contributions. He may exclude 625 shares ($\$7,500/\12) from current tax. He will pay current tax on the 1,075 remaining shares. Because he is 69, and born before January 1, 1936, he may wish to combine the net unrealized appreciation strategy with another special tax treatment called ten-year averaging. See the separate discussion on ten-year averaging on page 7.

When the 625 shares representing after-tax contributions are sold, Mr. Summers will calculate his taxes using a cost basis of \$12. He will owe capital gains tax on the net unrealized appreciation of \$68 ($\$80 - \12). The average cost basis will never be taxed. Any additional appreciation beyond \$80 will also be taxed as capital gains. If these shares were rolled into an IRA, subsequent appreciation would be taxed as ordinary income.

EXAMPLE: COMBINATION OF PRETAX AND AFTER-TAX CONTRIBUTIONS

Total number of shares	1,700		
Cost basis	\$12 per share		
After-tax contributions	\$7,500		
Shares that represent after-tax contributions	625 ($\\$7,500/\\12)		
Shares subject to current income tax	1,075 (1,700 - 625)		
TAX DUE ON PRETAX SHARES		TAX DUE ON AFTER-TAX SHARES	
Current tax on cost basis	\$3,612	Current tax on cost basis	\$0
(1,075 x \$12 x .28)			
Tax on NUA	\$10,965	Tax on NUA	\$6,375
(1,075 x \$68 x .15)		(625 x \$68 x .15)	
Total tax on pretax shares	\$14,577	Total tax on after-tax shares	\$6,375
Tax on complete liquidation of company shares: \$20,952 = (\$14,577 + \$6,375)			

(For illustrative purposes only)

Caution: A 10% premature distribution penalty tax may be due on the average cost basis component (not the fair market value) of a stock distribution if you terminate employment before the year in which you attain age 55 and do not roll over the employer shares to an IRA. Voluntary after-tax employee contributions are never subject to the premature distribution penalty tax.

Net Unrealized Appreciation Tax Strategy Advantages and Disadvantages

The NUA tax strategy is not for everyone. Before deciding to keep employer shares outside of an IRA, give some thought to the following issues:

- What are the long-term prospects for the stock?
- Does the stock represent a reasonable percentage of your overall portfolio, or does the stock seriously skew your asset allocation?
- Does the stock's volatility, and the amount of stock you propose to hold, match your current and long-range retirement risk profile?
- Do you anticipate holding the stock for an indefinite number of years, or are you planning to liquidate shares for living expenses?
- Do you have the cash available to pay the taxes on the average cost basis when the shares are distributed?
- If the shares generate substantial dividends, will this affect your marginal tax bracket or the taxability of Social Security benefits you may receive?

Rolling Over Employer Stock to an IRA—Benefits and Disadvantages

An IRA rollover may still be a viable strategy for you. By electing to roll over employer shares into an IRA, there is no immediate taxation, dividends are not taxed annually, and you may buy and sell shares of any stock within the IRA, including the shares of your employer, without recognizing any gains or losses.

Younger lump-sum recipients may find that the long-term deferral of tax in an IRA for both the cash and employer stock components will surpass other tax strategies, especially if the 10% premature distribution penalty tax would apply to amounts not rolled over to an IRA.

Another benefit of an IRA rollover is your ability to name beneficiaries who may inherit the account. A surviving spouse who is your designated beneficiary may actually treat your IRA as his or her own IRA and name new beneficiaries. Or, you may name your children or

grandchildren as beneficiaries, who may be eligible to continue the IRA through their own life expectancies. If you have converted any part of your IRA to a Roth IRA, these distributions will be tax-free to your beneficiaries who will have to receive a certain amount each year, based on life expectancy.

A disadvantage for some Traditional IRA account owners is the requirement to receive annual distributions beginning at age 70½. This amount is determined using life expectancy factors and typically increases from year to year. All Traditional IRA distributions are taxed as ordinary income, even if shares of stock are distributed.

See our brochures, *The Smith Barney IRA Distribution Manual* and *Give Your IRA a Second Life* for more information.

Distribution Choices When Lump Sum Includes Employer Stock

DISTRIBUTION CHOICE	TAXATION	ADVANTAGES	DISADVANTAGES
IRA ROLLOVER DIRECT ROLLOVER OF CASH AND STOCK INTO AN IRA	<ul style="list-style-type: none"> • No tax until withdrawn • When withdrawn, ordinary income tax 	<ul style="list-style-type: none"> • Defer taxation • Tax-deferred growth of investments • Buy or sell investments without tax implications • Can create diversified portfolio • Beneficiaries may inherit the IRA and arrange distributions per IRS regulations 	<ul style="list-style-type: none"> • No capital gains advantage • No step-up in basis at death • Must start required minimum distributions at age 70½
COMBINATION DIRECT ROLLOVER OF CASH INTO AN IRA KEEP EMPLOYER STOCK OUTSIDE OF AN IRA	<ul style="list-style-type: none"> • No tax on cash until withdrawn from IRA • Pay tax on average cost basis of stock at ordinary income tax rates, plus 10% penalty tax if distribution is received: (1) under age 59½; or (2) if separated from service before age 55 	<ul style="list-style-type: none"> • Cash is preserved in tax-deferred IRA • Beneficiaries may inherit IRA and arrange distributions per IRS regulations • Capital gains treatment of net unrealized appreciation when stock is sold • If stock is held until death, heirs inherit at stepped-up cost basis • See other advantages for IRA under "IRA Rollover" above 	<ul style="list-style-type: none"> • Some taxes due when stock is distributed • Special ten-year averaging tax treatment not allowed on stock unless an election is made to pay tax at time of distribution rather than at time of sale • If stock must be sold unexpectedly (emergency or rapid decline in price), additional taxes due immediately and tax-saving strategy is defeated • Must start IRA required minimum distributions at age 70½ • Could cause client's income to be taxed at higher tax rate
NO ROLLOVER KEEP BOTH CASH AND EMPLOYER STOCK OUTSIDE OF AN IRA	<ul style="list-style-type: none"> • Pay ordinary income taxes on cash and average cost basis of stock, plus 10% penalty tax if distribution is received: (1) under age 59½; or (2) if separated from service before age 55 	<ul style="list-style-type: none"> • Capital gains treatment of net unrealized appreciation when stock is sold • If stock is held until death, heirs inherit at stepped-up cost basis 	<ul style="list-style-type: none"> • Some taxes due when stock is distributed • Could cause client's income to be taxed at higher tax rate • If stock must be sold unexpectedly, additional taxes due immediately and tax-saving strategy is defeated
THE FOLLOWING METHODS APPLY TO TEN-YEAR AVERAGING TAX TREATMENT, WHICH IS NOT AVAILABLE TO EVERYONE. SEE THE INFORMATION ON PAGE 7 FOR MORE DETAILS.			
ALL STOCK / NO ROLLOVER KEEP STOCK OUTSIDE OF AN IRA	<ul style="list-style-type: none"> • Pay ten-year averaging tax on <i>average cost basis</i> of stock or <i>fair market</i> value of stock, if eligible, plus 10% penalty tax if distribution is received: (1) under age 59½; or (2) if separated from service before age 55 	<ul style="list-style-type: none"> • If stock is held until death, heirs inherit at stepped-up cost basis • Paying ten-year averaging tax on the fair market value of stock is potentially the lowest tax due if the capital gains rate is higher when the stock is sold 	<ul style="list-style-type: none"> • Some taxes due at time of lump-sum distribution • Taxes due annually on any dividends • If stock must be sold unexpectedly (emergency or rapid decline in price), additional taxes due immediately and tax-saving strategy is defeated

Leaving Company Shares to Your Beneficiaries

If your intention is to hold distributed company shares indefinitely, and pass them on to your beneficiaries, the net unrealized appreciation tax strategy may be an especially valuable election. Upon your death, your beneficiaries will owe tax on the unrealized appreciation amount that was never taxed, but any additional appreciation in share value since the time of distribution from the plan will escape taxation.

Example: Leaving Shares to Your Beneficiaries

Assume that the average cost of your company stock was \$20 per share, the distribution price was \$50 per share and \$90 per share at the time of death. Your beneficiaries will owe capital gains tax on the \$30 per share (\$50 – \$20) net unrealized appreciation when the shares are sold, but the additional appreciation of \$40 (\$90 – \$50) per share will never be taxed. The beneficiaries will benefit from a partial step-up in cost basis to \$60 (\$90 – \$30) when they determine any additional taxable gain that may be incurred when these shares are sold in the future.

(For illustrative purposes only)

Can a Beneficiary Elect the Net Unrealized Appreciation Tax Strategy?

Spouse Beneficiary If you should die before receiving a distribution from your employer's retirement plan, your spouse will have all the same options available as you would have had. This includes the net unrealized appreciation tax strategy as well as an IRA rollover.

Nonspouse Beneficiary A nonspouse beneficiary may use the net unrealized appreciation tax strategy, but may not roll over your retirement plan distribution to an IRA.

Gifting Company Shares with NUA During Your Lifetime

Gifting company shares with NUA has additional advantages to you as the donor and to your estate. A gift of company stock removes the current value and any future appreciation from your gross estate.

Shares that are gifted to individuals are limited to \$11,000 per year and married couples filing a joint tax return may gift up to \$22,000 per year without gift tax.

- There is no immediate tax consequence because a gift within the limits is not a taxable transaction.
- The basis in the stock is passed to the recipient of the NUA shares.

Shares that are gifted to a charity have additional advantages to both you and the charity.

- There is no gift tax, regardless of the size of the annual gift to charity.
- You receive a tax deduction for the fair market value of the shares so long as it does not exceed 30% of your Adjusted Gross Income.
- The charity pays no capital gains tax on the sale of the shares as a not-for-profit entity.

Special Tax Break: Ten Year Averaging

Ten-year averaging is a once-in-a-lifetime preferential tax election applied to qualified lump-sum distributions. Only individuals born before January 1, 1936 are eligible. Ten-year averaging tax is paid in the year the distribution is received, although the tax rate simulates a payout that is received over ten years. The tax is calculated separately from all other income, so it will not affect your marginal tax bracket.

At your option, ten-year averaging may be combined with the net unrealized appreciation tax strategy. You may not use ten-year averaging if you use a combination strategy and roll part of your lump-sum into an IRA unless you elect to pay tax at time of distribution, rather than at time of sale.

What to Do Next—Get Advice

Receiving a lump-sum distribution is always an occasion to seek the counsel of competent tax, legal, and investment professionals. This is especially true if you receive employer stock and you wish to consider holding the shares outside of your IRA. Once the decision is made, it is irrevocable.

At Smith Barney, we are very concerned that you make the appropriate decisions about your retirement assets. Since no two clients' situations are exactly alike, you should first talk directly with your Smith Barney Financial Consultant, who can start the decision-making process by preparing customized net unrealized appreciation illustrations for you.

Smith Barney: The Right Choice

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