THE PRICE GROUP
EVERYONE NEEDS A WEALTH COACH

NET UNREALIZED APPRECIATION

If you've worked for a large publicly traded company, you may find yourself approaching retirement with company stock in your retirement plan, whether directly contributed to you from your employer in a profit-sharing or ESOP plan or purchased by you in your 401(k) plan.

In any case, once company stock has been acquired in a retirement plan, it will ultimately be taxed as ordinary income with marginal income tax rates when distributions are made. However, the Internal Revenue Code allows for the gains on such stock – known as net unrealized appreciation (NUA) – to be taxed at long-term capital gains rates, which are typically more favorable, as long as certain requirements have been met.

The NUA strategy might help you save on taxes, but, given that the cost basis or the original price paid for the stock is taxed immediately, it's important that timing and your situation align in order for NUA to be worthwhile for your long-term financial and retirement plan. As you consider this strategy, be sure to work with your financial and tax advisors who can help you weigh your options and determine the best one for you.

KEY TAKEAWAYS

If the requirements are met, NUA can be a tax-efficient means of distributing all or a portion of employer stock.

Keep in mind that NUA might not ultimately benefit your long-term financial plan should timing or circumstances not align.

Talk to your financial advisor and tax consultant to determine whether or not NUA makes sense for you.

HOW IT WORKS

With the NUA strategy, you pay income taxes on the cost basis in the calendar year of the company stock distribution, including both federal taxes at their marginal tax bracket rate and state taxes where applicable. You do not pay taxes on the NUA amount until you actually sell the stock. When the stock is sold, you pay taxes at the long-term capital gains rate for the NUA portion even if the stock is held for less than one year after the time of distribution. It is important to note that you can use the NUA strategy with a portion or all of your employee stock.

While the difference between marginal tax bracket rates and long-term capital gains rates varies depending on overall income level, paying at long-term capital gains rates always

offers savings. Plus, if your overall taxable income falls under a certain threshold, your long-term capital gains rates could be 0% under the current law.

While the potential savings are certainly enticing, there are a few requirements that must be met before you can take advantage of NUA:

Triggering Event

The stock must be distributed after a qualifying triggering event. This could be:

- When the participant leaves the company
- After the participant reaches age 59½
- After the participant, if a self-employed individual, becomes totally and permanently disabled
- At the time of the plan participant's death

By far, the most common of the above situations is separation from service. As people approach retirement with company stock in their retirement plans, the NUA strategy can be considered.

In-Kind Distribution

The stock must be distributed in-kind. The stock held in the employer-sponsored retirement plan is transferred to a taxable investment account, however other assets in the plan can be rolled over to an IRA.

EARLY WITHDRAWALS

Note that if you withdraw your stock before the age of **59½**, you may be subject to an additional **10%** penalty tax for early withdrawals. However, if you separate from service during or after the year you reach age **55** (age 50 for public safety employees of a state, or political subdivision of a state, in a governmental defined benefit plan), you may obtain relief from the **10%** penalty for withdrawals after separation from service.

TIMING IS EVERYTHING

If the year of distribution is also the year of retirement, you may be in a higher marginal tax bracket than you will be in future years of retirement (due to earned income early in the year of retirement). Therefore, the tax paid on the cost basis amount could be quite high if NUA is implemented in this year. You should consider the tax effectiveness of waiting until the year after retirement to pursue the NUA strategy.

Additionally, for those who want to liquidate the stock after distribution but spread out the tax impact, it may be feasible to do the NUA distribution (triggering taxes on the cost basis) late in one tax year, and then complete the subsequent sale (with long-term capital gains rates on the NUA gain) early in the next tax year.

Lump Sum Distribution

The stock must be distributed as part of a lump sum distribution. A lump sum distribution for this purpose is the distribution or payment of a plan participant's entire balance within a single calendar year from all of the employer's qualified plans of one kind (e.g., 401(k), pension, profit-sharing or stock bonus plans). The NUA distribution and remainder rollovers

must take place in that calendar year or the opportunity is lost until the next triggering event.

It is important to note that the lump sum distribution does not necessarily have to occur in the year of the triggering event. For example, you could separate from service in one calendar year (a triggering event) but wait until the next year to process the NUA stock distribution and rollover.

CONSIDERATIONS

Just like with most other wealth planning strategies, there are some factors to consider before deciding whether the NUA strategy makes sense for you. As you review them, remember that even if you meet the NUA criteria, you have a few options at hand for distributing your assets:

- Leave all of your assets inside of the plan and do not take advantage of NUA, taking distributions from the plan as needed. You'll continue to benefit from things like creditor protection and lower expense ratios while paying ordinary income tax on all distributions.
- Roll over all of your assets to an IRA and do not take advantage of NUA, taking distributions as needed. You'll have more control over your investment selection, while paying ordinary income tax on all distributions.
- Utilize the NUA strategy if you meet the requirements and distribute the company stock – either all of the shares or a partial amount – to a taxable account. Roll all other assets to an IRA within the same calendar year.

It is always important to remember that future updates to the tax law could make the NUA strategy less advantageous if marginal tax rates of long-term capital gain rates change. Plus, be aware that assets held outside of a qualified employer plan or IRA may have less protection from creditor claims.

MAKING THE MOST OF NUA

While in the right circumstances the NUA strategy can potentially help you save money, that's not a given depending on your particular situation and time horizon.

To determine whether the NUA strategy is right for you, it is important that you consider a couple of key factors:

1) YOUR COST BASIS

Each dollar that is lost to tax in the initial year of NUA stock distribution means one less dollar for future portfolio growth, so a low cost basis is crucial for keeping that loss down. However, even with a small cost basis percentage, distributing all of the shares could cause you to pay a considerable amount in tax in the initial year of distribution, especially for large NUA stock positions.

For example, even with a cost basis that is 15% of the total market value of the shares, a $1,000,000 employer stock position would generate $150,000 of ordinary income, which is potentially enough to drive you into substantially higher marginal tax brackets and lose a considerable sum to taxes immediately. Whereas if the NUA strategy was not implemented, your money would have remained in the qualified account environment to grow into the future, until perhaps you reach a lower tax bracket in retirement. With the NUA strategy some money is immediately lost leaving less principal to grow.

Keep in mind, if the plan record keeper has maintained individual cost basis records and not merely average cost basis, it may be possible to cherry pick the lowest cost basis shares for the NUA distribution.

2) WHEN YOU NEED THE MONEY

If you plan to use the money soon, NUA can be an ideal means of distributing those funds. However, if you're looking to use the NUA strategy to diversify your assets, remember that you can already diversify within the qualified account environment with no immediate tax consequences. Whereas if you distribute shares to a taxable account and immediately diversify by selling the shares, not only will the cost basis portion be subject to ordinary income tax, but the NUA portion will be lost to long-term capital gains tax – leaving a considerably lower amount of principal to be invested for the future.
Remember that NUA triggers the immediate taxation of the cost basis amount which, if it's a high percentage of the total fair market value of the shares, can even push you into a higher marginal tax bracket when distributed and can incur substantial taxes.

Dividends paid on NUA stock are taxed at qualified dividend tax rates, which are less than the ordinary income rates if the stock was rolled over and distributions were taken later. However, if the shares remained inside of a qualified account environment, tax paid on dividends would be deferred until ultimate distribution.

NUA amounts do not receive a step up in cost basis at the owner's death. When your beneficiaries sell the stock they inherit, they will owe long-term capital gains tax on the NUA. Any additional appreciation between the date of distribution and the date of death would be entitled to a stepped-up basis in the shares they inherit under the current law.

3) NUA TAXATION

If you decide to implement the NUA strategy, in the calendar year of the company stock distribution you will pay income taxes on the cost basis, including both federal taxes at their marginal tax bracket rate and state taxes where applicable. Your employer's plan representative should be able to assist you in determining the cost basis of the shares.

The difference between the original cost and the current market value of the shares at the time of distribution is the net unrealized appreciation. You do not pay taxes on the NUA amount until you actually sell the stock. When the stock is sold, you pay taxes at the long-term capital gains rate for the NUA portion even if the stock is held for less than one year after the time of distribution. NUA gain is subject to the standard 0%, 15% or 20% long-term capital gain rates, plus state income taxes where applicable. The NUA gain is not subject to the 3.8% Medicare surtax on net investment income.

Any change in the stock's value from the time of the transfer to the time it is sold is taxed separately from the NUA amount. Additional gains will be taxed at the long-term capital gains rate if held for a year or more before being sold. If held for less than a year, it will be taxed at the higher short-term capital gains rate. If shares are held past the distribution date and losses occur, it will reduce the amount of net unrealized appreciation gain reported on the sale. If losses cause the price to fall below the original cost basis, a capital loss will occur.

Does a NUA distribution make sense for you?

Net Unrealized Appreciation is a complicated subject and coming to a decision for your personal situation will take time, effort and study. **The Price Group has developed a niche serving retirees in the greater Houston area. Do you want to take the first step together? We would love to help.**