

## Net Unrealized Appreciation (NUA)



### Net Unrealized Appreciation and Other Special Tax Rules

If you participate in a 401(k), ESOP, or other qualified retirement plan that lets you invest in your employer's stock, you need to know about net unrealized appreciation--a simple tax deferral opportunity with an unfortunately complicated name. When you receive a distribution from your employer's retirement plan, the distribution is generally taxable to you at ordinary income tax rates. A common way of avoiding immediate taxation is to make a tax-free rollover to a traditional IRA.

However, when you ultimately receive distributions from the IRA, they'll also be taxed at ordinary income tax rates. (Special rules apply to Roth and other after-tax contributions that are generally tax free when distributed.) But if your distribution includes employer stock (or other employer securities), you may have another option--you may be able to defer paying tax on the portion of your distribution that represents net unrealized appreciation (NUA). You won't be taxed on the NUA until you sell the stock. What's more, the NUA will be taxed at long-term capital gains rates--typically much lower than ordinary income tax rates. This strategy can often result in significant tax savings.

<b>NUA at a glance</b>	
You receive a lump-sum distribution from your 401(k) plan consisting of \$500,000 of employer stock. The cost basis is \$50,000. You sell the stock 10 years later for \$750,000.*	
<b><i>Tax payable at distribution--stock valued at \$500,000</i></b>	
Cost basis--\$50,000	Taxed at ordinary income rates; 10% early payment penalty tax if you're not 55 or disabled
NUA--\$450,000	Tax deferred until sale of stock
<b><i>Tax payable at sale--stock valued at \$750,000</i></b>	
Cost basis--\$50,000	Already taxed at distribution; not taxed again at sale
NUA--\$450,000	Taxed at long-term capital gains rates regardless of holding period
Additional appreciation--\$250,000	Taxed as long- or short-term capital gain, depending on holding period outside plan (long-term in this example)

\*Assumes stock is attributable to your pretax and employer contributions and not after-tax contributions

### What is net unrealized appreciation?

A distribution of employer stock consists of two parts: (1) the cost basis (that is, the value of the stock when it was contributed to, or purchased by, your plan) and (2) any increase in value over the cost basis until the date the stock is distributed to you. This increase in value over basis, fixed at the time the stock is distributed in-kind to you, is the NUA. For example, assume you retire and receive a distribution of employer stock worth \$500,000 from your 401(k) plan, and that the cost basis in the stock is \$50,000. The \$450,000 gain is NUA.

### How does the NUA tax strategy work?

At the time you receive a lump-sum distribution that includes employer stock, you'll pay ordinary income tax only on the cost basis in the employer securities. You won't pay any tax on the NUA until you sell the securities. At that time the NUA is taxed at long-term capital gain rates, no matter how long you've held the securities outside of the plan (even if only for a single day). Any appreciation at the time of sale in excess of your NUA is taxed as either short-term or long-term capital gain, depending on how long you've held the stock outside the plan.

Using the example in the chart above, you would pay ordinary income tax on \$50,000, the cost basis, when you receive your lump-sum distribution. (You may also be subject to a 10% early distribution penalty if you're not age 55 or disabled when you receive the payment.) Let's say you sell the stock after ten years, when it's worth \$750,000. At that time, you'll pay long-term capital gains tax on your NUA (\$450,000). You'll also pay long-term capital gains tax on the additional appreciation (\$250,000), since you held the stock for more than one year. Note that since you've already paid tax on the \$50,000 cost basis, you won't pay tax on that amount again when you sell the stock. If your

distribution includes cash in addition to the stock, you can either roll the cash over to an IRA or take it as a taxable distribution. And you don't have to use the NUA strategy for all of your employer stock-- you can roll a portion over to an IRA and apply NUA tax treatment to the rest.

## What Is a Lump-Sum Distribution?

In general, you're only allowed to use these favorable NUA tax rules if you receive the employer securities as part of a lump-sum distribution. To qualify as a lump-sum distribution, both of the following conditions must be satisfied:

- It must be a distribution of your entire balance, within a single tax year, from all of your employer's qualified plans of the same type (that is, all pension plans, all profit-sharing plans, or all stock bonus plans)
- The distribution must be paid after you reach age 59½, or as a result of your separation from service (if you're an employee), disability (if you're self-employed), or death.

There is one exception: Even if your distribution doesn't qualify as a lump-sum distribution, any securities distributed from the plan that were purchased with your after-tax contributions will be eligible for NUA tax treatment. (After-tax contributions for this purpose do not include your Roth 401(k) contributions.)



## NUA Is for Beneficiaries and Heirs, Too

If you die while you still hold employer securities in your retirement plan, your plan beneficiary can also use the NUA tax strategy if he or she receives a lump-sum distribution from the plan. The taxation is generally the same as if you had received the distribution yourself. The stock won't receive a step-up in basis, even though your beneficiary receives it as a result of your death.

If you've already received a distribution of employer stock, elected NUA tax treatment, and die before you sell the stock, your heir will have to pay long-term capital gains tax on the NUA when he or she sells the stock. However, any appreciation as of the date of your death in excess of NUA will forever escape taxation because, in this case, the stock will receive a step-up in basis. Using our example, if you die when your employer stock is worth \$750,000, your heir will receive a step-up in basis for the \$250,000 appreciation in excess of NUA at the time of your death. If your heir later sells the stock for \$900,000, he or she will pay long-term capital gains tax on the \$450,000 of NUA, as well as capital gains tax on any appreciation since your death (\$150,000). The \$250,000 of appreciation in excess of NUA as of your date of death will be tax free.



## Advantages and Disadvantages of NUA Treatment

### What are the advantages of NUA treatment?

Your distribution of NUA will be taxed at long-term capital gains rates, rather than ordinary income tax rates. Long-term capital gains rates are generally much more favorable, and currently are as low as 0% for some taxpayers.

- Your distribution won't be subject to the required minimum distribution rules that would apply if you rolled the distribution over to an IRA. You need never sell the stock if you don't want to.
- The NUA portion of your distribution will never be subject to the 10% early distribution penalty tax.

## What are the disadvantages of NUA treatment?

Your cost basis in the stock is subject to tax at ordinary income tax rates when the stock is distributed to you. A 10% early distribution penalty tax may also apply if you're not age 55 or disabled when you receive your payment. (The 10% penalty tax generally doesn't apply if you're self-employed.)

- You'll lose the benefit of tax-deferred growth offered by a rollover IRA.
- NUA treatment applies only to employer stock and other securities. But holding a significant amount of employer stock may not be appropriate for everyone. In some cases, it may make sense to diversify your investments.



## When Is NUA Treatment the Best Choice for You?

In general, the NUA strategy makes the most sense for individuals who have a large amount of NUA and a relatively small cost basis. However, whether it's right for you depends on many variables, including your age, your estate planning goals, and anticipated tax rates. In some cases, rolling your distribution over to an IRA may be the better choice.

And, if you were born before 1936, two other special tax rules (described below) might also apply to your lump-sum payment, potentially making a taxable distribution your best option.

## What is the 10-year averaging method?

The 10-year averaging method is a special formula for calculating the federal income tax due on the ordinary income part of a lump-sum distribution from a qualified employer-sponsored retirement plan. You pay this tax only once--the year in which you receive the distribution; it's not paid over the next 10 years.

Essentially, you calculate the tax on one-tenth of the taxable portion of your distribution, using 1986 income tax rates for single filers. You then multiply this tax by 10 to determine the income tax due on your lump-sum distribution.

Because your adjusted gross income (AGI) doesn't include distributions calculated according to the 10-year averaging method, AGI-sensitive tax breaks won't be adversely affected by the income from your lump-sum distribution.

## What is the capital gain election for pre-1974 participation?

Capital gain treatment applies only to the taxable part of a lump-sum distribution resulting from participation in a qualified retirement plan before 1974. The amount treated as capital gain, reported on your Form 1099-R, is taxed at 20%, which may be lower than your ordinary marginal income tax rate.

If you make the capital gain election, you can either treat the remainder of the taxable distribution (i.e., the portion representing participation from 1974 to the present) as ordinary income, or use the 10-year averaging method for that portion.



## What are the eligibility requirements for the 10-year averaging method and the special capital gains tax treatment?

To qualify for 10-year averaging and/or the special capital gains tax treatment, the following requirements apply to your lump-sum payment:

- The plan participant (whether alive or dead in the year of distribution) must have been born before 1936.
- The plan participant must have received the distribution after belonging to the plan for at least 5 tax years. Exception: the 5-year rule doesn't apply if the distribution was paid because of the plan participant's death.

- The plan participant (or the beneficiary) must elect to use the 10-year or capital gains tax treatment (and this election can generally be made only once). So, if you elected 5-year or 10-year averaging or the capital gains tax treatment in the past, you probably don't qualify for special tax treatment again. However, if you made the election before 1987 and were under age 59½ at that time, you can make the 10-year or capital gain election once again if you meet all of the other requirements.

The rules for 10-year averaging and the capital gains election are complicated, and other significant restrictions apply. You should consult your financial professional to decide which option (or combination of options) makes the most sense for your particular situation.

## Some Additional Considerations

- If you want to take advantage of NUA treatment, make sure you don't roll the stock over to an IRA. That will be irrevocable, and you'll forever lose the NUA tax opportunity.
- You can elect not to use the NUA option. In this case, the NUA will be subject to ordinary income tax (and a potential 10% early distribution penalty) at the time you

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