Executive Benefits

Net Unrealized Appreciation (NUA) Strategy

A Net Unrealized Appreciation (NUA) strategy may allow a person who is retiring or changing jobs to convert some of their qualified plan distributions from ordinary income to capital gains.

Introduction.

If you retire or change jobs you can often roll over your qualified plan monies into another qualified plan or IRA. However, if a portion of your plan assets are held in highly appreciated employer company stock, it may be advantageous to use the Net Unrealized Appreciation (NUA) strategy.

"Net unrealized appreciation" is the excess of the fair market value of employer securities at the time of a lump sum distribution over the cost basis of the securities to a qualified plan trust. For NUA purposes, "employer securities" may include shares of a parent or subsidiary corporation.

NUA strategy.

The NUA strategy refers to the special tax treatment of company stock that is distributed from employer sponsored qualified plans.[1] With this strategy, you will immediately be taxed at ordinary income rates on the cost basis of the stock—not the current market value. Although you will be taxed on the cost basis, the NUA strategy permits you to hold the shares in a non-qualified account, and the gains are not taxed until the stock is sold. Therefore, some retiring participants may want to take a taxable, in-kind distribution of the company stock shares, and roll the remaining non-stock assets into an IRA.

If the price of the stock has appreciated considerably, this could be a significant advantage when the stock is eventually sold. The NUA (the difference between the cost basis and the current market value at time of distribution) generally qualifies for long-term capital gains treatment.[2]

If the same company stock were rolled over into an IRA, any future distribution from the IRA would be taxed at ordinary income tax rates rather than long-term capital gain rates.

In addition, since the stock no longer resides in a qualified retirement plan, the value of the stock is no longer subject to Required Minimum Distributions (RMDs). If the participant holds the NUA stock until death, the heirs may get a step-up in basis and the unrecognized gain may never be recognized.

For example, Katharine, age 60, purchased 1,000 shares of company stock within her retirement plan, at a cost of $20 per share. When she leaves the company, the stock is trading at $50 a share. Therefore:

- The current market value of the stock is $50,000 (1,000 x $50 a share).
- Her cost basis is $20,000 (1,000 x $20 a share), subject to ordinary income tax rates up to 39.6% upon distribution.
- The NUA is $30 a share ($50 minus $20 a share), or a total of $30,000, subject to capital gains rates of 15% or 20% when sold. The 3.8% net investment income tax (NIIT) may also apply.

While the tax savings under the NUA strategy are compelling, the strategy may not be appropriate for everyone.

The NUA strategy works best when the following factors are present:

- The employer stock is highly appreciated.
- You can afford the tax liability on the ordinary income tax on the stock basis portion of your distribution.
- Your ordinary income tax rate is higher than your capital gains rate.

Other considerations.

- The distribution of the stock must generally be as a lump-sum distribution, as defined by the IRS.
- The stock must be distributed in-kind. The NUA strategy doesn't apply if the stock is liquidated and taken in cash.
- The NUA strategy doesn't apply if you roll the company stock into an IRA. If you have already rolled the stock into an IRA, the ability to apply the NUA strategy is generally lost.
- If you are under age 59½, a 10% early withdrawal penalty may apply to the cost basis of the in-kind stock distribution, if you do not qualify for an exception.

1 Only distributions from employer sponsored qualified plans can qualify for lump-sum distribution treatment, and thus for NUA treatment. Distributions from IRAs, SEP-IRAs and 403(b) plans are not eligible for NUA treatment.

2 Any additional gains after the distribution are subject to the short-term capital gains rate, if the sale is made within one year of the distribution.

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