Net Unrealized Appreciation (NUA): A Little-Known Hidden Opportunity

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If you've participated in a 401(k), ESOP, or other qualified retirement plan letting you invest in your employer's stock, you will want to know about net unrealized appreciation – a simple tax deferral opportunity with a really complicated name.

Whenever one receives distributions from their employer's retirement plan, those distributions are generally taxable at ordinary income tax rates. A simple way that avoids immediate taxation? Make a tax-free rollover to a traditional IRA. However, when one eventually receives distributions from their IRA, those will also be taxed at ordinary income tax rates. (Exceptions apply to Roth IRAs and other post-tax contributions that are generally tax free when distributed.)

However, when distributions include employer stock (or other employer securities), there's another option – it might be possible to defer one's tax liability on the portion of their distribution represented by net unrealized appreciation (NUA). They won't be taxed on the NUA until the stock is sold. Additionally, the NUA is taxed at long-term capital gains rates – usually lower than ordinary income tax rates. This strategy can frequently result in significant tax savings.

Net unrealized appreciation: what is it?

A distribution of employer stock has two parts: (1) the cost basis – the value of the stock when it was received or purchased by one's plan and (2) any increase in its value above the cost basis until the date the stock is distributed to the owner. The increase in value over one's basis in the stock, fixed at the time the stock is distributed in-kind to the owner, is the NUA.

EXAMPLE: Let's assume one retires and receives a distribution of employer stock worth $250,000 from their 401(k) plan, and that the cost basis in the stock is $25,000. The $225,000 gain is considered NUA.

NUA tax strategy: How does it work?

When one receives a lump-sum distribution which includes employer stock, ordinary income taxes are owed, but only on the cost basis. Therefore, there's no tax owed on the NUA until one sells the securities. At the time it's sold, the NUA is taxed at long-term capital gain rates, regardless of how long one's held the securities outside of the plan (even if only for a single day). Any and all appreciation at the time of sale exceeding one's NUA will be taxed as capital gain income, either short or long-term, depending on how long the stock's been held outside the plan.

NUA at a glance

You receive a lump-sum distribution from your 401(k) plan consisting of $250,000 of employer stock. The cost basis is $25,000. You sell the stock 7 years later for $500,000.*

Tax payable at distribution from IRA-stock valued at $250,000	
Cost basis-$25,000	Cost basis-$25,000 rates; 10% early payment penalty tax if you're not 55 or disabled
NUA-$225,000	Tax deferred until sale of stock

Tax payable at sale-stock valued at $500,000	
Cost basis-$25,000	Already taxed at distribution; not taxed again at sale
NUA-$225,000	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 the stock consists of your pretax and employer contributions and not any after-tax contributions.

Using the example above, one would pay ordinary income tax on $25,000, the cost basis, when they receive their distribution. (They may also be subject to a 10% early distribution penalty if they're not age 55 or totally disabled.) Let's say they sell the stock after seven years, when it's worth $500,000. At that time, they'll pay long-term capital gains tax on their NUA ($225,000). They'll also pay long-term capital gains tax on the additional appreciation ($250,000), since they held the stock for more than one year. Note that since they've already paid tax on the $25,000 cost basis, they won't pay tax on that amount again when the stock is sold.

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

What exactly is a lump-sum distribution?

In general, one is only permitted to use these favorable NUA tax rules *if they receive the employer securities as part of a lumpsum distribution*. To qualify as a lump-sum distribution, both of the following conditions must be satisfied:

- It must distribute one's entire balance within a single tax year, from all of one's employer's qualified plans that are of the same type (so, all pension plans, all profit-sharing plans, or all stock bonus plans)
- The distribution must be paid after one reaches age 59½, or as a result of their separation from service, or after their death

One exception: Even if one's distribution doesn't qualify as a lump-sum distribution, any securities distributed from the plan that were purchased with one's after-tax (non-Roth) contributions will be eligible for NUA tax treatment.

Beneficiaries & heirs: NUA is for them, too

If one dies while still holding employer securities in their retirement plan, plan beneficiaries can also use the NUA tax strategy if they receive a lump sum distribution from the plan. The taxation is generally the same as if the original plan owner had received the distribution. (The stock won't receive a step-up in basis, even though one's beneficiaries receive it as a result of one's death.)

If one has already received a distribution of employer stock, elected NUA tax treatment, and they die before they sell the stock, heirs will face a long-term capital gains tax on the NUA when they sell the stock. However, any appreciation as of the date of one's 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 one dies when their employer stock is worth $500,000, heirs will receive a step-up in basis for the $250,000 appreciation in excess of NUA at the time of one's death. If heirs later sell the stock for $650,000, they will pay long-term capital gains tax on the $225,000 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.

Additional thoughts to consider

- If one desires to take advantage of NUA treatment, they mustn't roll the stock over to an IRA – that would be irrevocable, and it results in forever losing NUA tax treatment.
- One may refrain from using the NUA option. In such case, the NUA will be subject to ordinary income tax (and a potential 10% early distribution penalty) at the time one receives the distribution.
- Stock held in an IRA or employer plan is entitled to significant protection from creditors. You'll lose that protection if you hold the stock in a taxable brokerage account.
- Holding significant amounts of employer stock may not be appropriate for everyone, and in some cases, it may make sense to diversify your investments.
- One should be mindful of any applicable state tax laws.

When is NUA treatment the best choice?

In general, the NUA strategy tends to makes the most sense for individuals who have large amounts of NUA and minimal cost basis. However, whether it's right for someone depends on many variables, including one's age, their estate planning goals, and anticipated tax rates. In some cases, rolling one's distribution over to an IRA may be the better choice. And if one was born before 1936, other special tax rules might apply to their lump-sum distribution, making a taxable distribution their best option.

If one is expecting a distribution of employer securities from a qualified retirement plan, they should speak with their financial or tax professional before taking any action so that they fully explore and understand all the available options. Only then can one be assured of making the decision that best meets their individual tax and nontax goals.

CHARITABLE PLANNING TIP: *NUA stock can be a really good asset with which to make charitable gifts, either outright or for life-income gift arrangements through gift annuities and charitable trusts. Contact us for more information on these plans.*