

Revisiting Net Unrealized Appreciation: A Tax-Wise Strategy That May Realize More Benefits Than Ever

by John A. Nersesian, CFP, CIMA, CIS and Frances L. Potter, CFP

Executive Summary

- The tax strategy of net unrealized appreciation is a more practical option than ever because of the lower capital gains rates, the increased use of company stock in defined contribution plans, and the long-term gains of the stock market.
- Under the NUA strategy, employees take a lump-sum distribution of company stock from their retirement plan (upon separation from service) and pay ordinary income taxes on the stock's basis. But the difference between the basis and the fair market value—the net unrealized appreciation—is taxed at long-term capital gains rates only when the stock is sold, regardless of the holding period. This can be a better option than rolling the stock into an IRA where all of its value will eventually be taxed as ordinary income.
- The law technically refers to “employer securities,” so such securities as units of “stock funds” of employer stock are typically eligible.
- If a ten-percent early withdrawal penalty applies, it applies only to the stock's original cost basis.
- Employees who plan to pass the stock on to heirs and not use it for retirement may be better off rolling the stock over into an IRA to take advantage of beneficiary designation opportunities.
- NUA is treated as income in respect of a decedent if the employee dies before the NUA is recognized and taxed.
- The NUA strategy is available to beneficiaries for stock not distributed from a qualified plan before death.

John A. Nersesian, CFP®, CIMA, CIS, is managing director of Wealth Management Services Group at Nuveen Investments in Chicago, Illinois. He is recognized within the financial services industry as an expert in investment consulting and financial planning issues.

Frances L. Potter, CFP®, is a vice president in the Wealth Management Services Group at Nuveen Investments.

Several recent factors, including tax law changes and accumulated capital gains in company stock, offer a compelling reason to revisit the potential benefits of special income tax treatment of net unrealized appreciation (NUA) under Internal Revenue Code (IRC) Section 402(e)4.

Individual investors commonly believe that an IRA rollover is their only option for continuing to defer taxes on qualified plan assets when they leave their employer. When liquidated in retirement, however, the proceeds from an IRA are likely to be taxed as ordinary income, currently at rates of up to 45 percent or more if state or local taxes apply. But if the account includes employer stock, there may be an attractive alternative available by treating the stock differently from other plan assets.

Using the NUA strategy, individuals can take a distribution of employer stock from their qualified plan and pay ordinary income tax only on their basis at the time of distribution, allowing for continued deferral on the balance of their investment. The difference between the basis and the fair market value at distribution—the net unrealized appreciation—is taxed at long-term capital gains rates when the stock is sold, regardless of the holding period.¹ Subsequent appreciation (earned after the distribution from the qualified plan) is taxed at short- or long-term capital gains rates according to the length of the holding period. The hypothetical example in Figure 1 illustrates the potential tax treatment of a share of stock whose value was \$20 when purchased for the qualified account. When the lump-sum distribution was taken, the value had grown to \$100 and at sale had grown to \$150.



Although the tax code has permitted NUA for over 60 years, a number of factors have made it more practical in recent years:

- A significant obstacle to the strategy that existed before 1997 was eliminated by the permanent repeal of the 15 percent excess retirement distribution tax on retirement plan distributions exceeding \$160,000.²
- The increased popularity of defined contribution retirement plans and the subsequent use of employer stock in qualified plans created a larger pool of potentially affected clients.
- The favorable equity market enjoyed during the past two decades produced many outsized gains in employer shares that could benefit from the lower taxation through the special tax treatment of NUA.

Since the enactment of the Jobs and Growth Tax Relief Reconciliation Act of 2003, investors have additional reasons to consider the benefits of NUA: the increased gap between the ordinary income rate (on which distributions from tax-deferred accounts will be taxed), and the long-term capital gains rate that is applied to the gain on NUA shares. With the reduction in the maximum long-term capital gains rate from 20 percent to 15 percent (for individuals in marginal tax brackets of 25 percent and higher), the NUA strategy has become potentially even more valuable. Also, lower ordinary income rates reduce the amount of tax that will be due immediately on the basis.

Important Considerations When Using NUA

Planners should keep in mind important considerations when using the NUA strategy.

Although most commonly applied to employer stock held in a qualified retirement plan (ESOP, pension, 401(k), and others), the IRC refers to “employer securities” as being eligible for NUA treatment. Note also that many companies hold employer stock in “stock funds,” the units of which are composed of shares of stock and cash. These also are eligible for special NUA tax treatment if the plan provides for an “in-kind” distribution of stock from the plan.

The employee must elect a lump-sum, in-kind distribution from the plan (a complete distribution of all plan assets in a single calendar year). A lump-sum distribution is defined as “distribution or payment within one taxable year of the recipient of the balance to the credit of an employee which becomes payable to the recipient on account of the employee’s death, after the employee attains age 59 1/2, on account of the employee’s separation from service, or after the employee has become disabled.”³

For individuals who want to diversify a portion of their company stock holdings, the NUA strategy can be used on a partial or full distribution of employer stock. An individual can roll over some of the company stock to an IRA and use the NUA treatment on the balance. (Note that the special NUA treatment is lost on shares rolled over to an IRA.) Similarly, individuals whose qualified plan assets include mutual funds or cash in addition to company stock can choose an IRA rollover for the mutual funds and cash, and use NUA on the stock.

Individuals might want to obtain the cost basis of various lots of their employer stock from their plan administrator and review them to determine which shares might benefit most from the special NUA tax treatment. For example, it might make sense to use the NUA strategy on shares with the *lowest* cost basis relative to fair market value at distribution (and thus the greatest amount of NUA), and roll over shares with a *higher* cost basis relative to the fair market value at distribution.

An important factor in deciding whether to use NUA for employer stock is the future plan for the assets. Individuals who do not plan to use the assets for their retirement and want to leave them to children or grandchildren may want to roll them over to an IRA to take advantage of the beneficiary designation opportunities available with an IRA to “stretch” the account into succeeding generations.

The net unrealized appreciation on shares purchased with after-tax employee contributions is also eligible for the NUA strategy.

Distributions are subject to premature distribution penalty rules for qualified plans for employees under age 55 at the time of distribution upon termination of employment. The additional ten percent tax applies only to the original cost basis, not the full value of the distribution, providing an opportunity to effect a premature distribution in a less punitive fashion.⁴

For the client who has an immediate liquidity need (and has left their job but not taken any distributions), the NUA strategy may provide an important source of assets—the employer securities—to provide needed funds. Given that only the basis is subject to the penalty and ordinary income taxes (with capital gains applied to NUA), the total taxes on the distribution are likely to be less than if the entire distribution were subject to the ten percent additional tax and ordinary income tax rates.

Individuals who plan to use the NUA strategy must notify their plan administrator in advance to obtain the specific documentation required and to ensure that any withholding is based only on the cost basis, not on the entire distribution. The administrator reports the amount of tax withheld on the basis to the IRS upon implementation of the NUA strategy. The amount of net unrealized appreciation is reported in Box 6 of Form 1099-R (Distributions from Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.).

Individuals may elect not to exclude NUA in employer securities distributed as part of a lump-sum distribution. Individuals make this election by attaching a signed statement of that election to the federal income tax return filed for the year in which the distribution was received and by including the NUA as part of the distribution on Form 4972 or, if no Form 4972 is filed, on line 16 of Form 1040.⁵

A Case Study in NUA

To understand the potential benefits of NUA, consider the case of a hypothetical investor, Mary Pearce, 58 years old, who is planning to retire this year with a substantial amount of company stock in her retirement plan in addition to mutual funds. She wants to continue deferring taxes on these assets and has planned to use an IRA rollover for all of the plan assets. But during the course of developing her retirement plan, her financial planner constructs four scenarios to illustrate alternatives for the corporate stock portion of Mary’s retirement plan.

Assume that Mary’s marginal federal income tax rate will be 35 percent. (Examples are hypothetical illustrations only and do not guarantee any specific outcome. Net values after tax could be less if portions of shares are liquidated periodically during the holding period. This also assumes current tax rates are in effect at distribution.)

Scenario 1: Rollover into IRA. Mary chooses to include all of the company stock in her IRA, where it grows tax deferred and upon distribution all of the assets are subject to ordinary income tax (see Table 1).

TABLE 1		
Scenario 1: Rollover into IRA		
Current Fair Market Value of Employer Stock	\$1,300,000	
Future Value in Ten Years (Compounded at 8.00% Annually)		\$2,806,602
Tax Due at Marginal Tax Rate of 35.00%		\$982,311
Net Distribution After Tax		\$1,824,292

In each of the next three scenarios, Mary elects to remove all the employer stock from her qualified plan and use the NUA strategy. In the year of distribution, she will pay ordinary income tax on the basis of the shares in the plan. If it were applicable, the premature distribution penalty would apply to the basis. This lower penalty amount may represent an additional benefit of the NUA strategy.

Scenario 2: Lump-sum distribution and hold stock. Mary chooses to take a lump-sum distribution of company stock in one calendar year and continues to hold the stock for ten years (see Table 2).

TABLE 2		
Scenario 2: Lump-Sum Distribution, Use NUA and Hold Stock		
Current Fair Market Value of Employer Stock	\$1,300,000	
Total Basis	-\$117,780	
Net Unrealized Appreciation	\$1,182,220	
Net to Hold in Brokerage Account		
Current Fair Market Value	\$1,300,000	
Income Tax on Basis	-\$41,223	
Net to Hold	\$1,258,777	
Future Value in Ten Years (Compounded at 8.00% annually)		\$2,717,605
Tax on Appreciation		
Future Value	\$2,717,605	
Basis	-\$117,780	
Net Unrealized Appreciation—Taxable Amount	\$2,599,825	
Capital Gains Tax at 15.00%		-\$389,974
Net Distribution After Taxes and Penalties		\$2,327,631
Incremental Benefit of NUA		\$503,340

Tax on the basis is subtracted from the current fair market value, and the remaining amount is compounded to determine the future value at the end of the holding period. This analysis assumes the account is liquidated at the end of the holding period and long-term capital gains tax paid on the net unrealized appreciation—the difference between the basis and fair market value at liquidation.

Scenario 3: Lump-sum distribution and sell stock. Mary chooses to take a lump-sum distribution of company stock in one calendar year and immediately sells the stock, reinvesting the proceeds (see Table 3).

TABLE 3

Scenario 3: Lump-Sum Distribution, Use NUA and Sell Stock

Current Fair Market Value of Employer Stock	\$1,300,000	
Total Basis	-\$ 117,780	
Net Unrealized Appreciation	\$1,182,220	
Tax on Basis		
Income Tax Due on Basis at 35.00%	\$41,223	
Capital Gains Tax on NUA at 15.00%	+\$ 177,333	
Total Taxes	\$218,556	
Net to Reinvest (New Basis)		
Current Fair Market Value	\$1,300,000	
Total Taxes	-\$218,556	
Net to Reinvest (New Basis)	\$1,081,444	
Future Value in Ten Years (Compounded at 8.00% annually)		\$2,334,756
Taxes on Appreciation		
Future Value	\$2,334,756	
New Basis	-\$1,081,444	
Taxable Amount	\$1,253,312	
Capital Gains Tax at 15.00%		-\$187,997
Net Distribution After Taxes and Penalties		\$2,146,760
Incremental Benefit of NUA		\$322,468

In this scenario, ordinary income tax is again paid on the basis and the entire net unrealized appreciation is taxed at the long-term capital gains rate of 15 percent. The balance is invested in a diversified portfolio that is held for ten years. At the end of the holding period, the entire account is liquidated. Because tax was paid initially on the basis and the original net unrealized appreciation, this amount is deducted from the future value of the portfolio and the long-term capital gains rate applied to subsequent appreciation.

Scenario 4: Lump-sum distribution—hold half and sell half of stock. Mary chooses to take a lump-sum distribution of company stock in one calendar year and immediately sells half the stock, reinvesting the proceeds, and holds half the stock (see Table 4).

TABLE 4

Scenario 4: Lump-Sum Distribution, Use NUA, Hold Half and Sell Half of Stock

	Total Value	One-Half Value
Current Fair Market Value of Employer Stock	\$1,300,000	\$650,000
Total Basis	-\$117,780	\$58,890
Net Unrealized Appreciation	\$1,182,220	\$591,110
Hold Half of the Stock		
Tax on Basis		
Income Tax at 35.00%	\$41,223	\$20,612
Net to Hold in Brokerage Account		
Current Fair Market Value	\$650,000	
Income Tax on Basis	-\$20,612	
Net to Hold in Brokerage Account	\$629,389	
Future Value in Ten Years (Compounded at 8.00% annually)		\$1,358,803
Tax on Appreciation		
Future Value	\$1,358,803	
7% of the Basis	-\$58,890	
Taxable Amount	\$1,299,913	
Capital Gains Tax at 15.00%		\$194,987
Net Distribution After Taxes		\$1,163,816
Sell Half of the Stock		
Net to Reinvest (New Basis)		
Current Fair Market Value	\$650,000	
Capital Gains Tax on NUA at 15.00%	-\$88,667	
Income Tax on Basis	-\$20,612	
New Basis	\$540,722	
Future Value in 10 Years (Compounded at 8.00% annually)		\$1,167,378
Taxes on Appreciation		
Future Value	\$1,167,378	
New Basis	-\$540,722	
Taxable Amount	\$626,656	
Capital Gains Tax at 15.00%		-\$93,998
Net Distribution After Taxes and Penalties		\$1,073,380
Combined Net Distribution for Hold Half, Sell Half Scenario		\$2,237,195
Incremental Benefit of NUA		\$412,904

This scenario combines the benefits of the two previous strategies, providing an opportunity to continue to own half the stock and enjoy additional appreciation, plus diversify by selling half the stock.

Table 5 summarizes the potential benefits of these four strategies.

TABLE 5

Potential Benefits of Four NUA Strategies

Scenario	Net Distribution After Tax	Incremental Benefit of NUA
Scenario 1: IRA Rollover	\$1,824,292	
Scenario 2: Lump-Sum Distribution and Hold Employer Stock	\$2,327,631	\$503,340
Scenario 3: Lump-Sum Distribution and Sell Employer Stock	\$2,146,760	\$322,468
Scenario 4: Lump-Sum Distribution, Sell Half/Hold Half Employer Stock	\$2,237,195	\$412,904

Estate Planning Considerations

What happens if the individual dies before the net unrealized appreciation is recognized and taxed? As with other retirement assets, NUA is considered income in respect of a decedent and considered part of the estate. Additionally, the step-up in basis to date-of-death value, which usually occurs at death, is not available for the portion of the value of the stock that is NUA. But heirs can still use the capital gain rates for the embedded NUA when shares are sold, and appreciation in excess of the NUA receives a step-up in basis at the time of the individual's death. The NUA strategy is also available to beneficiaries for employer stock held in a qualified plan that has not been distributed before death. The hypothetical example in Figure 2 illustrates the potential tax consequences to heirs on a share of stock whose value was \$20 when purchased for the qualified account. The net unrealized appreciation of \$80 (the difference between the basis and the value at distribution) will be taxed at long-term capital gains rates when sold. The heirs enjoy a step-up in basis of \$50, the amount of appreciation between date of distribution and date of death.

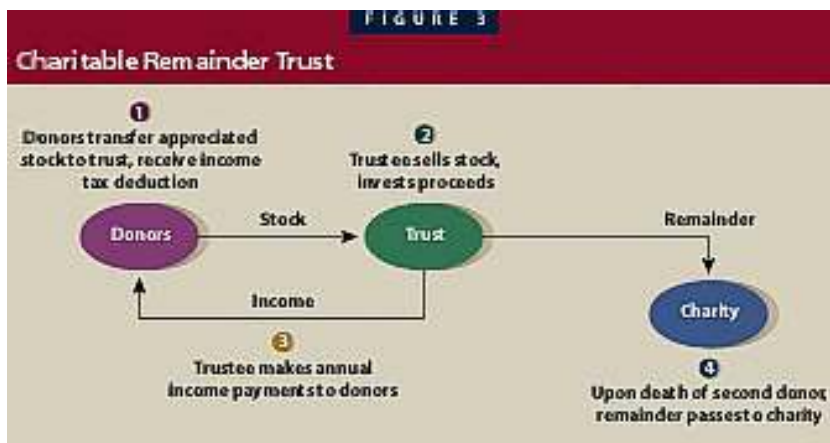


Using NUA to Fulfill Charitable Intent

As with other highly appreciated assets, employer stock distributed from a qualified plan may be an appropriate

asset to use for a charitable remainder trust. In this way, an individual could receive an income stream and fulfill a charitable intent. The income deduction for a charitable contribution could offset the additional tax due on the basis.⁶

In the example in Figure 3, the individual takes a distribution of stock from the plan, paying ordinary income tax on the basis. The value of the charitable contribution is determined using the fair market value of the stock at the time of gifting, even though the individual does not recognize the net unrealized appreciation at the time of the gift. If gifted immediately upon distribution (and no short-term capital gain is recognized in excess of the FMV at distribution), then the entire gift will be considered long-term capital gain property. When the stock is sold by the trust, the NUA will be characterized as long-term gains in the four-tier accounting system. Depending on how the proceeds of the sale are reinvested, a significant portion of trust distributions may be characterized as long-term capital gains and taxed at a maximum of 15 percent. (This assumes that the beneficiary of the trust is a public charity; there are additional considerations if Section 170(e)(1)(A) applies—for example, if it is a private foundation.)



Factors Affecting Decisions About NUA

The NUA strategy may not be appropriate for all investors. Review these factors when advising on employer stock.

Size of retirement account. Investors owning large amounts of employer stock are likely to benefit most. Consider the NUA election for clients who have long tenure or high positions with their companies.

Time horizon. Investors not likely to retire or liquidate the stock for many years may benefit most. Consider how long shares may be left to appreciate after the distribution from a retirement account.

Marginal tax benefit. Calculate the potential taxes for both the NUA strategy and a direct rollover into an IRA. A client likely to retire into a lower tax bracket may pay less tax overall simply by rolling the stock into a new qualified account such as an IRA.

Risk tolerance. Because the NUA election may be most effective for stock held long term, consider whether the client is willing to keep the asset even if the price falls or stagnates for a time. For many employees, at all levels, employer stock held both inside and outside their qualified plan may be a majority of their investment portfolio. For this reason it's important to consider the "concentration risk" that the employer stock may represent.

Diversification. A client over-weighted with employer stock could consider the NUA election for a portion of the distribution. The balance could be rolled over into an IRA, where shares can be sold to purchase other

investments. The potential tax savings may be lower, but the portfolio can be diversified more effectively.

Estate plan. Explore whether the strategy might shift any undue tax burdens to beneficiaries. Stock on which the NUA election has been exercised will become part of the client's taxable estate at death. Heirs receiving NUA stock will realize a different income tax treatment than other assets. There is no step-up in basis because NUA, like an IRA, is subject to income in respect of a decedent.

Determining Who Might Benefit Most

A comprehensive understanding of net unrealized appreciation can be a powerful tool for obtaining a larger percentage of prospective and existing client assets. Focusing NUA educational efforts on these individuals should prove to be most beneficial.

Retiring corporate executives. Consult with retiring executives about different NUA election strategies to guide them in making the proper choices for retirement distributions.

Younger executives. Educating younger executives about NUA benefits can influence qualified plan investment choices and prevent rollovers to other qualified plans or IRAs that would eliminate NUA election eligibility. In addition, informing these executives about NUA could enable them to benefit from the NUA election in the future.

Executives holding depressed stock. Adding to qualified plan positions when the price of employer stock is depressed could magnify the tax benefits of NUA when the stock is eventually distributed from the plan, assuming favorable long-term appreciation potential.

Human resource executives. Many human resource executives have limited knowledge of the special NUA tax treatment. Educating them about NUA benefits so they can counsel retiring employees can build strong relationships, which may lead to highly qualified employee referrals.

NUA Summary Concepts

- A beneficial strategy for retirement asset distribution under IRC 402(e)(4).
- Applies to employer stock held in qualified retirement plans (such as ESOPs, pensions, 401(k)s).
- Employee must elect a lump sum, in-kind distribution from the plan (a complete distribution of all plan assets in a single calendar year).
- Original basis in shares is immediately taxable to employee as ordinary income.
- Remaining value (net unrealized appreciation) taxed at long-term capital gain rates when liquidated.
- Subject to premature distribution penalty rules for qualified plans for employees under age 55 at time of distribution (applies to original basis only).
- Allows employee to trade ordinary income taxation for long-term capital gains treatment.
- No step-up of basis at death on NUA portion of stock.

Endnotes

1. IRS Notice 98-24, 1998-1 CB 929.
2. Code Section 4980A, repealed by Section 1073(a) of PL 105-34, effective for distributions received after 1996.
3. IRC 402(e)(4)(D).
4. To review instances in which the ten percent penalty does not apply to qualified plan distributions, the additional tax does not apply (1) to distributions made on or after age 59 1/2; (2) to a participant's

beneficiary or estate after death; (3) due to participant's disability, to distributions that are part of a series of substantially equal periodic payments; (4) to distributions made after separation from service after age 55; (5) to a former spouse, child or other dependent under a QDRO; or (6) to the extent of medical expenses deductible for the year.

5. Section 402(e)(4)(B).
6. PLR 200202078.

This analysis contains no investment advice or recommendations and is provided for information and education purposes only. The statements contained herein are the opinions of Nuveen Investments Wealth Management Services and are subject to change without notice.