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Unlocking Tax Savings with the Net Unrealized Appreciation (NUA) Strategy

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If you hold company stock in your 401(k) plan, there's a little-known tax strategy that could unlock significant savings called Net Unrealized Appreciation (NUA). For executives and long-tenured employees who have accumulated company shares inside their retirement plans, NUA can be a powerful way to reduce taxes during retirement or wealth transfer.

What Is Net Unrealized Appreciation?

NUA is the growth in value of your company stock while it has been held inside your 401(k) or other employer-sponsored retirement plan.

When you eventually take a distribution, the IRS gives you a special opportunity: instead of paying ordinary income tax on the entire value of your company stock, you can pay ordinary income tax only on what you originally paid (the cost basis) and then pay the lower long-term capital gains rate on the growth (the NUA portion).

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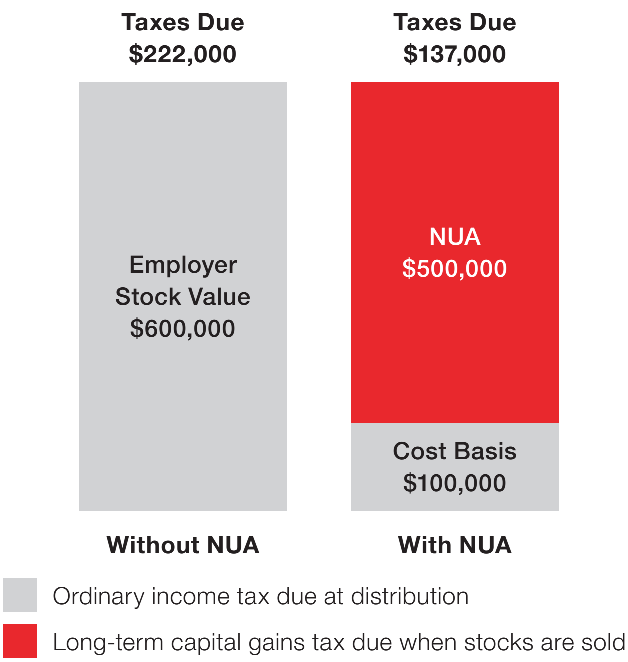
This only applies to employer stock in your qualified plan not to mutual funds or other investments.

This can result in substantial tax savings, particularly for those in high tax brackets.



The example above assumes a 37% tax bracket and 20% long-term capital gain rate.

Key requirements to qualify

NUA isn't automatic — you must follow specific rules:

1. **Lump-Sum Distribution**
   You must distribute the entire 401(k) balance (not just the stock) in a single tax year after a triggering event.
2. **Triggering Event**
   The strategy is only available after:
   - Separation from service (retirement or job change)
   - Reaching age 59½
   - Disability
   - Death (in which case, beneficiaries may use it)
3. **In-Kind Transfer**
   The employer stock must be moved in-kind (not sold) to a taxable brokerage account, not rolled over to an IRA.
4. **Rest of the Plan**
   Any non-stock portion can still be rolled to an IRA to preserve tax deferral.

Who should consider an NUA strategy?

NUA strategy can be particularly beneficial for certain individuals, especially those in higher income brackets. If you're facing top federal income tax rates — typically 37% or more — NUA may offer a way to reduce your overall tax burden. It's also worth exploring if you hold employer stock with a low-cost basis and significant appreciation, as the tax treatment of NUA can be more favorable than traditional retirement distributions.

Executives with concentrated positions in employer stock often look to diversify without triggering the highest tax rates, and NUA can be a strategic way to do so. Additionally, individuals with legacy or estate planning goals may find NUA appealing, since capital gains tax treatment could be more advantageous for heirs compared to inherited IRA distributions taxed as ordinary income.

Risks and considerations

NUA can be valuable, but it comes with trade-offs. The biggest drawback is that the NUA portion does not receive a step-up in basis at death, so heirs may still owe capital gains tax. Once the stock is distributed, its value can fluctuate, exposing you to market risk.

You'll also face tax implications. The cost basis of the stock is taxed as ordinary income in the year of distribution, even if you don't sell the shares right away. You will need to plan accordingly for a source of funds in order to pay the income tax due in the year of distribution. Any additional gains after distribution are subject to capital gains tax, and if you sell within a year, those gains may be taxed at higher short-term rates. Capital gains from NUA count toward income calculations for Medicare and the Net Investment Income Tax, potentially triggering surtaxes. While the NUA distribution itself may not be subject to the 3.8% Medicare surtax when initially taken, the subsequent capital gains from selling the stock could be subject to the surtax if other income sources push the individual's income above the Modified Adjusted Gross Income (MAGI) thresholds.

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Finally, NUA is a one-time, irreversible decision, so it should be evaluated carefully within the context of your overall financial plan.

<table>
<tr><th colspan="4">2025 Ordinary Income vs. Long-Term Capital Gains Tax Rates
Married Filing Jointly (MFJ)</th></tr>
<tr><th>Income (MFJ Filers)</th><th>Ordinary Income Rate</th><th>Long-Term Capital Gains Rate</th><th>Difference</th></tr>
<tr><td>$0 – $23,850</td><td>10%</td><td rowspan="2">0%</td><td>10%</td></tr>
<tr><td>$23,851 – $89,250</td><td rowspan="2">12%</td><td>12%</td></tr>
<tr><td>$89,251 – $96,950</td><td rowspan="5">15%</td><td>–3%</td></tr>
<tr><td>$96,951 – $206,700</td><td>22%</td><td>7%</td></tr>
<tr><td>$206,701 – $394,600</td><td>24%</td><td>9%</td></tr>
<tr><td>$394,601 – $501,050</td><td>32%</td><td>17%</td></tr>
<tr><td>$501,051 – $553,850</td><td rowspan="2">35%</td><td>20%</td></tr>
<tr><td>$553,851 – $751,600</td><td rowspan="2">20%</td><td>15%</td></tr>
<tr><td>Over $751,601</td><td>37%</td><td>17%</td></tr>
</table>

Note: Long-term capital gains tax rates exceed ordinary income tax rates, between income levels of $89,251 and $96,950.

Strategic planning opportunities

When integrated thoughtfully into a financial strategy, NUA can complement other planning techniques. For example, it can work well alongside Roth conversions by helping reduce future Required Minimum Distributions (RMDs). It also allows for smoother income recognition across retirement years.

For those looking to diversify away from concentrated stock positions, NUA offers a way to do so without immediately triggering the highest tax rates.

How It Helps Diversify

- **Immediate Tax Advantage**
  - — You pay ordinary income tax only on the cost basis, not the full market value.
  - — The appreciation is deferred and taxed at lower capital gains rates (0%, 15%, or 20%) when sold.
- **Strategic Selling Over Time**
  - — Once the stock is in a taxable account, you can sell gradually to avoid pushing yourself into higher tax brackets.
  - — For example, sell enough shares each year to stay within the 0% or 15% capital gains bracket.
- **Flexibility for Tax Planning**
  - — Combine NUA sales with other strategies like charitable gifting (donating appreciated shares), tax-loss harvesting, or using gains in years with lower income.
  - — This approach spreads out the tax impact and reduces concentration risk without triggering a large tax bill all at once.

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NUA Analysis:

Assumptions in this example:

- Ordinary income tax rate = 37%
- No state tax included for simplicity.
- Long-term capital gains tax rate = 20%
- The post distribution gain is the increase in value after the date of distribution.

	Strategy	Stock Value at Distribution	Cost Basis (at Distribution)	Net Unrealized Appreciation (NUA)	Tax Ordinary Income	Tax Capital Gains or Post-Distribution Gain	Total Tax Paid
1	Roll into IRA, then sell later	$130,000	$25,000	$105,000	None now; Ordinary Income taxed later on entire amount	When withdrawn/sold, entire $130,000 taxed as ordinary income rate (37%)	$48,100 ($130,000 x 37%)
2	Use NUA strategy, distribute stock, and sell immediately	$130,000	$25,000	$105,000	Ordinary income tax on $25,000 cost basis (37%) = $9,250	Long-term capital gains (20%) on $105,000 NUA = $21,000	$30,250
3	Use NUA strategy, distribute, and hold more than 1 year before selling	$130,000, growing to $150,000 by the time of sale	$25,000	$105,000	Ordinary income tax on $25,000 cost basis (37%) = $9,250	NUA taxed at long-term capital gains (20%) = $21,000. Additional gain post distribution ($20,000) taxed at long-term capital gains (20%) = $4,000	$34,250

Insights from the chart

- Strategy 2 (immediate sell with NUA) gives the lowest total tax bill among the examples, assuming you are willing and able to sell immediately.
- Strategy 3 is slightly higher in tax but gives the opportunity for further growth; it is still much better than rolling into an IRA and having the entire value taxed at ordinary income rates.
- The difference in tax rate between ordinary income and long-term capital gains is the lever that drives the savings. The larger the gap, the greater the benefit of NUA.

Final thoughts: Don't miss the window

NUA is one of the few remaining tax arbitrage opportunities for those with appreciated employer stock in retirement plans. But it's easy to miss, especially if you roll everything into an IRA by default.

NUA can be a powerful tool for reducing taxes on appreciated employer stock held in a qualified retirement plan if the timing and circumstances are right. If you think you might be in a qualifying situation, such as nearing retirement or holding significant employer stock, it's wise to run the numbers. Compare the outcomes of rolling everything into an IRA versus using the NUA strategy and consider whether selling the stock immediately or holding it longer makes the most sense for your goals.

For more information, please contact your advisor.

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About the Author

As a Relationship Manager for Key Private Bank, Gretchen Miller focuses on ensuring her clients' wealth management plans are carried through to meet their unique financial objectives and grow and preserve wealth. Gretchen coordinates the implementation of wealth management strategies with the relationship team and ensures clients have the tools and information to keep track of their financial situations and make informed decisions. She also coordinates regular communications and updates with the team and delivers the latest insights and advice to benefit clients' particular situations.

Gretchen has more than 30 years of experience in financial services and is well-qualified to help clients implement strategies to achieve their goals. Most recently, prior to joining Key, Gretchen served as Director of Advanced Planning for Prudential Financial, where she was a subject matter expert on financial and estate planning and on retirement topics such as Social Security, Medicare, and tax-efficient distribution strategies. Gretchen earned a Bachelor of Science degree in management from Springfield College and an MBA from the University of Phoenix. Gretchen obtained her certification as a Certified Financial Planner.™ Most recently, she obtained her Certified Private Wealth Advisor® certification in 2024. She is a member of the Financial Planning Association, the Investments & Wealth Institute, and the Institute for Divorce Financial Analysts®.

The Key Wealth Institute is a team of highly experienced professionals representing various disciplines within wealth management who are dedicated to delivering timely insights and practical advice. From strategies designed to better manage your wealth, to guidance to help you better understand the world impacting your wealth, Key Wealth Institute provides proactive insights needed to navigate your financial journey.

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