Net unrealized appreciation for tax deferment on employer stock distributions

Whenever you participate in an employer retirement plan, how the distribution of the investment will be taxed should be one of your key questions. Net unrealized appreciation (NUA) is an important way you can defer taxation on the increase in value of your employer's stock you receive through a retirement plan. While NUA can seem complex at first, understanding how to use it effectively can help you trim your tax burden.

Stock distribution and taxation

When you receive a distribution from a 401(k), ESOP or other qualified retirement plan that lets you invest in your employer's stock, the distribution is normally taxed at ordinary income tax rates. You have the option to roll over the funds to a traditional IRA without paying any tax now, but in the future when you receive distributions from the IRA, you'll be taxed at ordinary income rates. However, there's a way to reduce your taxes on these distributions using net unrealized appreciation.

Tip: Special rules apply to Roth and other after-tax contributions that are generally tax-free at distribution.

Stock valuation

Distributions of employer stock have three parts to their valuation:

- **Cost basis.** This is the value of the stock when it was purchased by your plan.
- **Net unrealized appreciation.** This is the total increase in the value of the stock minus the cost basis on the date the stock is distributed to you.
- **Post-distribution gain.** This is the increase in value that occurs after the stock is distributed to you from the plan, but before you sell it.

For example, if you receive a distribution of employer stock worth $500,000 from your 401(k) which has a cost basis of $50,000, the NUA is $450,000. If you hold the stock until it is worth $600,000 and then sell it, the post-distribution gain is $100,000.

Tip: Your goal is to keep as much of the increase in the value of the stock as possible in NUA, which means keeping stock in the plan as long as possible before it is distributed to you.

Deferred taxation on NUA

When you receive a lump-sum distribution of employer stock, you pay ordinary income tax on the cost basis at the time it is distributed to you. So, using the example on the previous page, you have $50,000 in cost basis which will be taxed at that time. However, you may be able to defer taxation on the NUA until you sell the stock. And the NUA will be taxed at long-term capital gains rates, which are generally much lower than ordinary income tax rates. This applies no matter how long you hold the stock in the plan—a few days or years. The result is significant tax savings.

Let's say you sell the stock after 10 years, when it's worth $750,000. You'll pay long-term capital gains tax on your NUA ($450,000). You'll also pay long-term capital gains tax on the post-distribution gain ($250,000), since you held the stock for more than one year (the gain would be taxed as a short-term capital gain if you owned it for less than a 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.

Tip: 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 your employer stock: You can roll a portion over to an IRA and apply NUA tax treatment to the rest.

Lump-sum distributions

In general, you're allowed to use these favorable NUA tax rules only 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 account within a single tax year and 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 a triggering event: after you reach age 59½, or as a result of your separation from service or after your 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 (non-Roth) contributions will be eligible for NUA tax treatment.

Tip: To qualify for a lump-sum distribution, you have to receive the entire account as a distribution, not just the stock within the account.

NUA for beneficiaries

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. The stock doesn't receive a step-up in basis because it is transferred while still in the plan, even though your beneficiary receives it as a result of your death, so the cost basis remains the same.

If you've already received a distribution of employer stock from the plan, elected NUA tax treatment and die before you sell the stock, your heirs will have to pay long-term capital gains tax on the NUA when they sell 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 when it transfers to the beneficiary at your death.

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, so their cost basis becomes $750,000, the value at 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.

Tip: Choosing stock for distribution with the lowest basis can help you maximize your saving when you elect to use NUA.

Deciding if you should use NUA

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, other special tax rules might apply, making a taxable distribution your best option.

Get complete benefits from NUA

Keep these factors in mind as you make decisions about NUAs:

- 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 that case, the NUA will be subject to ordinary income tax (and a potential 10% early distribution penalty) at the time you receive the distribution.
- Stock held in an IRA or employer plan is entitled to significant protection from your creditors. You'll lose that protection if you hold the stock in a taxable brokerage account.
- Holding a significant amount of employer stock may not be appropriate for everyone. In some cases, it may make sense to diversify your investments.*
- Be sure to consider the impact of any applicable state tax laws.

If you're expecting a distribution of employer securities from a qualified retirement plan, make sure you speak with your financial or tax professional before you take any action so that you can fully explore and understand all the options available to you. Only then can you be assured of making the decision that best meets your individual tax and nontax goals.

For more information, please contact your Key Private Bank Advisor.

*Diversification is a method used to help manage investment risk; it does not guarantee a profit or protect against investment loss.