RETIREMENT PERSPECTIVES

Appreciating Net Unrealized Appreciation

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Net unrealized appreciation allows for favorable tax treatment of withdrawals of an employer's stock—but understanding the rules is crucial.

Of all the various ways to reduce one's taxes in retirement, net unrealized appreciation (NUA) is often misunderstood or overlooked altogether. The rules may be complicated, but a plan participant who owns company stock and is separating from service or retiring should be aware of NUA before rolling his/her retirement account into an IRA or a new employer's plan.

Net unrealized appreciation of employer stock held in an employer-sponsored retirement plan permits gains that occurred inside the plan to be taxed outside the plan (e.g., brokerage account) at preferential long-term capital gains rates.

NUA defined is the increase in the value of the employer stock from the time it was acquired by a plan (its cost basis) to the date of the distribution to an employee. As such, he or she can elect to defer the tax on the NUA until the stock is sold. When sold, the retirement investor will pay tax only at his/her current capital-gains rate.

Thus, NUA creates an opportunity to convert unrealized gains from ordinary individual income rates into lower long-term capital gains rates instead. However, there is a requirement that in order to be eligible for NUA treatment, the account owner must report the stock cost basis immediately subjected to immediate income tax–paying taxes at ordinary income tax rates.

Consider the example of a 401(k) participant who owns 100 shares of company stock with a cost basis of $10. Upon retirement the stock has increased in price and is now valued at $25 per share. The participants' cost basis is $1,000, the price originally paid, while the NUA is $1,500—the worth of the stock appreciation since the purchase price.

Generally, qualified plan distributions are subject to ordinary income tax on the fair market value upon withdrawal, unless the cash value is rolled over into a tax-advantaged account, such as a traditional IRA. When a distribution from a qualified plan includes employer securities, the same rule applies unless the NUA provision is applied to the stock holdings.

Net unrealized appreciation offers retirement investors receiving an in-kind distribution of employer's stock from their plan a tax break by assessing income taxes only on the cost basis. Later, when the stock is sold, the NUA is taxed at long-term capital gains rates, which tend to be lower than federal income tax rates. The maximum rate of that tax currently is 37%, compared to the maximum capital gains tax rate of 20%, or 23.8% for those higher-earners who qualify for the 3.8% Medicare surtax on net investment income. Either way, the potential savings is substantial.

Suppose, for example, Tom left his job at Life's a Dream Inc., with a 401(k) account valued at

$500,000. Of that total, $200,000 is invested in employer stock that was purchased for $50,000 (cost basis). Tom can transfer $200,000 of company stock to a taxable brokerage account, paying ordinary income tax only on the original $50,000. The increase ($150,000) is the NUA, which means Tom would qualify for long-term capital gains rates upon selling the stock—even if sold within the one-year holding period. The remaining 401(k) nonstock (i.e., mutual funds) balance of $300,000 can be rolled tax-free into a traditional IRA.

At any time, Tom can sell stock and pay taxes on the appreciated amount at long-term capital gains rates. The nonstock amount that was rolled over to the IRA would be taxable at ordinary income upon taking a distribution. The employer or plan administrator would determine participants' cost basis.

NUA Requirements

Satisfying the myriad of NUA requirements, there are very specific requirements that must strictly adhered to.

In order to qualify for the NUA tax break, the Internal Revenue Code rules under Section 402(e)(4) are clear: distribution (of employer stock) must be distributed in-kind, as a lump-sum distribution *after* a triggering event. Events that qualify for NUA include death; age 59½ (plan must allow); separation from service (not for self-employed); retirement; or disability (self-employed only).

Share basis will be immediately tax as ordinary income however the stock gains will be taxable at long-term capital gains rates regardless of the actual holding period.

Tip: If the appreciated company stock is rolled over to an IRA, the NUA tax break is lost, and *any IRA distribution will be taxed as ordinary income.*

What's a Lump-sum Distribution?

An individual's *entire* account balance must be distributed in a single tax year. This doesn't just mean all the *stock* must be taken out of the plan; it means the *entire account* must be distributed including non-stock assets (e.g. mutual funds).

Tip: IRS rules permit an individual to facilitate an NUA distribution for just part of their account, and roll over the rest directly to a traditional IRA. However, account assets must be zero at the end of the year.

When NUA May Be Advantageous

Departing plan participants should consider the following when deciding whether to roll all their retirement plan assets into an IRA or transfer the stock portion to a taxable account:

- *Tax rates*—Greater the difference between a participant's income tax rate and the capital-gains tax rate, the greater is the potential savings with the NUA strategy.
- *Appreciation*—Greater the stock appreciation, the higher the dollar amount that can qualify for NUA. And the more appreciation contributes to the overall asset value, the higher the amount that qualifies for the lower capital gains rate.
- *Holding period*—Longer holding periods may favor investing all assets in an IRA, which will continue to grow tax deferred. A shorter holding period more likely would favor the NUA approach.

While the NUA tax break offers potential benefits to plan participants who hold appreciated company stock in the retirement accounts, *there are some strict rules that apply*:

- An NUA transaction can be made only after a distributable or "triggering" event occurs, including separation from service, reaching age 59½ (only if allowed by the plan), or

disability (self-employed only). NUA also can apply when stock is distributed to an employee's beneficiary, provided the beneficiary takes lump-sum distribution.
When *a* distribution occurs after the triggering event, *that must be the year for the NUA distribution* (or the NUA opportunity is lost until the next triggering event).

- An in-service distribution generally does *not* qualify for NUA tax treatment, unless it is a distribution that taxes place after a qualifying triggering event.

Distribution (from the plan) must qualify as a "lump-sum distribution." The participant's *entire account balance* (from all "like" plans of the employer) must be distributed in one calendar year, including stock and any nonstock assets, such as mutual funds. Said another way, a participant's year end account balance must be zero.)

- NUA treatment requires stock to be transferred to a taxable brokerage account, meaning it must be employer stock, that is able to be transferred in-kind. Once stock is rolled into an IRA, NUA treatment is gone—forever. Nonstock assets can be rolled into an IRA; only company stock is allowed the preferential NUA treatment.

- The 10% early-withdrawal penalty for taking a distribution before turning 59½ may apply unless an exception applies (e.g. Rule 55). Although the penalty applies only to the amount an individual paid for the stock. In other words, the penalty applies only to the taxable portion of the distribution.

- NUA is reported on IRS Form 1099-R.

- A number of retirement plans hold employer securities in a "stock fund." Individuals will need to check with the plan administrator or tax attorney to determine whether the securities qualify for NUA treatment.

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 though you had received the distribution yourself. The stock won't receive a step-up in basis, even though your beneficiary receives it as a result of your death. Further, NUA is of no use if the current market value of employer's stock is less than the individual's cost basis.

If you have any questions about this or another retirement topic, please e-mail me at **roadtoretirement@lordabbett.com**.

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GLOSSARY OF TERMS

Traditional IRA contributions plus earnings, interest, dividends, and capital gains may compound tax-deferred until you withdraw them as retirement income. Amounts withdrawn from traditional IRA plans are generally included as taxable income in the year received and may be subject to 10% federal tax penalties if withdrawn prior to age 59½, unless an exception applies.

A **Roth IRA** is a tax-deferred and potentially tax-free savings plan available to all working individuals and their spouses who meet the IRS income requirements. Distributions, including accumulated earnings, may be made tax-free if the account has been held at least five years and the individual is at least 59½, or if any of the IRS exceptions apply. Contributions to a Roth IRA are not tax deductible, but withdrawals during retirement are generally tax-free.

A **SIMPLE IRA** plan is an IRA-based plan that gives small-business employers a simplified method to make contributions toward their employees' retirement and their own retirement. Under a SIMPLE IRA plan, employees may choose to make salary reduction contributions and the employer makes matching or nonelective contributions. All contributions are made directly to an individual retirement account (IRA) set up for each employee (a SIMPLE IRA). SIMPLE IRA plans are maintained on a calendar-year basis.

A **simplified employee pension plan (SEP IRA)** is a retirement plan specifically designed for self-employed people and small-business owners. When establishing a SEP-IRA plan for your business, you and any eligible employees establish your own separate SEP-IRA; employer contributions are then made into each eligible employee's SEP IRA.

A **401(k)** is a qualified plan established by employers to which eligible employees may make salary deferral (salary reduction) contributions on an aftertax and/or pretax basis. Employers offering a 401(k) plan may make matching or nonelective contributions to the plan on behalf of eligible employees and may also add a profit-sharing feature to the plan. Earnings accrue on a tax-deferred basis.

A **403(b) plan** is a retirement savings plan that allows employees of public schools, nonprofit, and 501(c)(3) tax-exempt organizations to invest on a pretax and or Roth aftertax basis. Contributions to a 403(b) plan are conveniently deducted directly from your paycheck. In addition, your employer may elect to make a contribution on your behalf.

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