Net Unrealized Appreciation: The Forgotten Retirement Strategy

When our clients retire, they face many questions and challenges regarding goals, investments and taxes. We help them model goals within financial plans and illustrate investments through allocation and cash flow analysis. We also review taxes in relation to these models relative to individual circumstances both current and projected.

Hopefully, we have a chance to work with our clients during this important transition time—especially if they have company stock held in an employer retirement account.

Why? It gives us a chance to explain the potential benefits of making a net unrealized appreciation (NUA) election before simply rolling all company plan retirement assets into a traditional IRA.

Defining NUA

Net unrealized appreciation is the difference between the acquired value (basis) of company stock and its fair market value when held in an employer retirement plan. If someone received company stock worth $20 years ago and it was now valued at $100, the NUA would equal $80.

Why Does This Matter?

A retiring employee with concentrated stock holdings faces two challenges, namely (1) investment diversification to protect against loss (think Enron or WorldCom) and (2) the drain of taxes as retirement accounts make distributions subject to higher, ordinary income tax rates.

Depending on individual circumstances, a retiring employee can use an NUA strategy to solve both these challenges at once.

Specifically, an employee can separate the company stock from other company retirement plan assets on a tax-advantage basis and reinvest the company stock into a more diverse (risk averse) portfolio over time.

The process involves distributing the company stock to a taxable investment account and rolling over the remaining plan assets into a traditional IRA. The individual would recognize ordinary income tax equal to the basis of the company stock and defer any future capital gains tax on the NUA until a later date (when sold).

The NUA would be taxed at long-term capital gains rates regardless of when the individual sells the stock after its distribution from the company retirement account. In other words, NUA stock is treated as long-term capital gain property immediately following distribution.

How to Qualify?

In order to qualify for an NUA election, an employee first must experience a qualifying event, which includes separation from service (retirement), disability, age (59½) or death.
The employee then must follow certain key rules when handling the NUA transfer, including distribution of:

» The entire account within a single tax year;
» All company retirement accounts (if multiple exist); and
» All company shares in kind (do not sell within account and distribute cash).

When is an NUA Strategy Beneficial?

When should someone consider taking advantage of an NUA strategy? Whenever an employee is facing a qualifying event and has low (average cost) basis in company stock relative to its current fair market value; has a large concentration of company stock within an employer retirement account; and can take advantage of a greater difference between ordinary income and capital gains tax rates (tax arbitrage).

The time value of money also may impact the decision to proceed with an NUA strategy. For this purpose, however, the deferred growth of retirement account investments will not always outweigh the asset diversification and tax savings of the NUA strategy.

Example

Here’s a quick overview of the illustration that appears below.

Let’s assume an individual owns employer stock in the company 401(k) that is worth $1,000,000. The individual’s marginal income tax rate is 33%. The cost basis of the stock is $150,000, meaning that the NUA equals $850,000. Upon retiring from the company, the individual must choose between a lump-sum distribution and a rollover into an IRA.

As you can see in the illustration, if the individual chooses the rollover option, he or she won’t have to pay income tax at the time of the distribution. However, when distributing the stock (or its proceeds) from the IRA, ordinary income tax will be assessed on the entire distribution amount of $1,000,000. The individual’s resulting income tax would total $330,000.

<table>
<thead>
<tr>
<th>Total Value of Employer Stock Cost Basis</th>
<th>ROLLOVER OPTION</th>
<th>NUA OPTION</th>
</tr>
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<tbody>
<tr>
<td>$1,000,000</td>
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<table>
<thead>
<tr>
<th>Income Tax at Time of Distribution</th>
<th>Rollover is Tax-Free</th>
<th>$49,500</th>
<th>33% Income Tax on $150,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tax When Stock is Sold for $1 Million</td>
<td>$330,000</td>
<td>$127,500</td>
<td>15% Capital Gains Tax on $850k NUA</td>
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<tr>
<td></td>
<td>33% Income Tax on $1 Million</td>
<td></td>
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</tr>
<tr>
<td>Total Tax Paid</td>
<td>$330,000</td>
<td>$177,000</td>
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</tbody>
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| TAX SAVINGS                             | $153,000             |

Note: This hypothetical illustration is intended only to show how the NUA Strategy works. It does not reflect the tax or investment value of any specific investment, any transaction fees or any state and local income taxes.
By comparison, with an NUA stock transfer, the individual would pay current income tax of $49,500 based on the $150,000 cost of the stock. When he or she eventually sells the stock, the individual only would have to pay a capital gains tax of $127,500 (15% of the $850,000 NUA). With the NUA Strategy, the total tax liability is $177,000, representing a tax savings of $153,000 versus the rollover option. The NUA tax strategy works in this case because the company stock is highly appreciated.

As noted above, individual circumstances vary and require separate analysis. When appropriate, though, the NUA strategy provides a retiring employee with a chance to emancipate the company stock position with tax savings included.

ABOUT THE AUTHOR

Terry LaBant, J.D. is Vice President and Sr. Wealth Strategist at Calamos Wealth Management. He has more than 20 years of experience consulting with clients in the core areas of wealth creation, preservation and protection. These include: strategic planning for tax, estate, retirement, asset protection/allocation and succession planning for business owners.
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