BAIRD Private Wealth Management

Net Unrealized Appreciation

Employer retirement plans that hold company stock offer a unique planning opportunity

Employees who own employer stock in their company retirement plan can withdraw those shares at a reduced tax cost – turning ordinary income into a capital gain.

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Most employer retirement plans allow employees to choose from a menu of mutual funds or ETFs for their investments. In some cases, however, employees also have the option to invest in stock of the employer. Employees who invest in that stock inside the plan may later be able to take advantage of the Net Unrealized Appreciation rules which can be used to help lower the tax rate applied to withdrawals from the plan. To take advantage of these tax benefits, though, employees must follow very specific rules around the nature and timing of the withdrawals.

NET UNREALIZED APPRECIATION

When an employee leaves an employer, the typical strategy is to roll the assets from the company retirement plan into a plan at a new employer or to an Individual Retirement Account (IRA). Doing so doesn't trigger any immediate tax cost, and it allows the funds to continue growing on a tax-deferred basis.

If the employer plan holds employer stock, however, a different strategy should be considered. The employee can withdraw those shares and place them directly into a taxable account rather than rolling them to another retirement plan. By doing so, two significant tax benefits are available:

- Only the cost basis of the stock is taxable to the employee at the time of withdrawal, rather than its full market value. This taxable amount then becomes the cost basis of the stock in the hands of the employee.
- The difference between that basis and the value at the time of withdrawal is referred to as the Net Unrealized Appreciation, or NUA. This amount is not taxed until the stock is eventually sold, and at that time it's taxed as a long-term capital gain, regardless of how long it's held outside the plan.

While the tax benefits of electing NUA treatment can be significant, several very specific rules must be followed to qualify. Any missteps and the opportunity to elect NUA can be permanently lost.

- The distribution must originate from a qualified employer retirement plan, typically a 401(k) or Employee Stock Ownership Plan (ESOP). Stock that is held in a Traditional IRA, SEP-IRA or Simple IRA, or in a nonqualified deferred comp plan of any type, is not eligible for the NUA treatment.
- Only distributions of employer securities are eligible for NUA treatment. This can include actual shares of the employer stock or in some cases shares from a fund that only holds employer stock. Employees may need to confirm with their employer whether the investment in their plan meets the definition of "employer securities".
- The employer stock must be distributed out of the plan while still in certificate form. That means the employee can't sell the stock in the plan and then transfer the cash out of the account.

- The stock must come directly from the qualified plan to a taxable account. If stock held in a 401(k) is rolled into an IRA and then distributed to a taxable account, even while still in certificate form, the NUA opportunity is lost.

The IRS provides little to no leniency on these requirements, so employees and employers must be careful to follow these rules. In addition, NUA treatment can only be elected when a distribution qualifies as a Lump Sum Distribution.

LUMP SUM DISTRIBUTION REQUIREMENTS

Employees not only have to be concerned about the source and nature of the distribution, but also the timing. To be eligible for NUA treatment, the stock must be distributed as part of a Lump Sum Distribution (LSD) from the plan, which can create a number of traps that can ruin an NUA strategy, but can also lead to some planning opportunities. To qualify as an LSD, the distribution must meet two important tests:

1. Plan Balance – The entire balance in the employer plan that is credited to the employee at the time of a triggering event (defined below) must be distributed within the same calendar year.
2. Triggering Event – The distribution of the entire balance credited to the employee must occur after one of the following events:
    - After the employee turns age 59½.
    - On account of the employee separating from service from the employer.
    - On account of the death of the employee.

While these rules may seem straight forward, there are complicating factors – and advantages – for each rule.

Plan Balance

- This rule requires the entire plan to be distributed within one calendar year, although the withdrawals can be made over multiple distributions throughout the year. As a result, if an employee takes a partial distribution from the plan early in the year, it won't qualify as an LSD. If, however, they withdraw the remainder of the balance before the end of that same calendar year, then all of the distributions that year will be considered part of an LSD.
- In addition, the entire account doesn't have to be withdrawn as a taxable transaction. The employer stock must be transferred to a taxable account for the NUA option to apply, but any other investments in the plan can be rolled to a Traditional or Roth IRA, as in a typical rollover transaction.
- The employee is not required to withdraw all the employer stock. Employees who only wish to elect NUA on a portion of the stock in the plan can roll the rest of the stock to an IRA or other plan.
- To be an LSD, however, the employee must withdraw all balances across the plan, including employee contributions, employer matches and profit sharing contributions, as well as balances in both Traditional and Roth accounts.

Triggering Event

- For a distribution from an employer plan to qualify as an LSD, it must be after the occurrence of one of events listed earlier. Any distribution prior to the event will not qualify under the LSD rules and will not be eligible for NUA treatment.
- Once an employee reaches age 59½, they can qualify for an LSD at any point, although if they are still employed, the company plan must allow in-service distributions. The timing of distributions "on account of" death or separation from service may require the distribution to be more closely timed to the event itself.
- Each time a triggering event occurs, an employee has an opportunity to take an LSD. If a distribution taken after the first triggering event fails to qualify as an LSD, the employee must wait until another triggering event occurs to attempt another LSD.

As with the NUA transaction itself, the tax code allows for very little leniency when it comes to these rules. However, if an LSD opportunity is missed, the employee may still have additional opportunities in the future.

- **Example 1** – An employee has a 401(k) with her employer valued at $500,000, which includes $150,000 of employer stock. In the year she turns 56 she leaves her employer. She wishes to elect NUA treatment on a portion of her stock in the plan, so that same year she withdraws $50,000 worth of stock and transfers it to her taxable account, but leaves the remaining $450,000 in the plan through the end of the year. She is not eligible to elect NUA treatment on her $50,000 withdrawal, meaning the entire value of the stock distribution will be taxable.

NUA was not available to this employee because she did not withdraw the entire plan balance within the same calendar year. Had this employee withdrawn the remaining $450,000 – most likely by rolling it to an IRA – before the end of that year, she would have been eligible for NUA on the original $50,000 withdrawal.

- **Example 2** – Continuing with Example 1, this employee realizes her mistake but is still interested in completing an NUA transaction. In the next calendar year, when she is 57, she plans to withdraw the entire $450,000 that remains in the plan, with the remaining $100,000 of employer stock distributed to her taxable account and the $350,000 of other investments rolled to an IRA. However, she is again not eligible to elect NUA treatment on this second stock distribution.

In this second example, she corrected the error made the first time by withdrawing the entire plan balance within one calendar year. However, the second withdrawal still doesn't qualify as an LSD because she must distribute the entire balance that's in the plan as of the date of the triggering event. Even though she withdrew everything that was in the plan in the second year, it wasn't the entire balance when the triggering event occurred in the first year.

- **Example 3** – Continuing with Example 2, the employee does not take a second distribution from the plan after all, knowing it can't qualify as an LSD and therefore NUA is not available to her. Instead, she leaves the remaining $450,000 in the plan until she turns age 59½. At that point, she has a new triggering event which allows her to take an LSD. She rolls the employer stock to a taxable account and the remaining investments in the plan to an IRA. The NUA election is now available to the employee.

Because the employee left the investments in the employer plan until a new triggering event occurred, she had a second chance to elect NUA treatment, even though she missed her chance the first time (when she originally separated from service with the employer). However, this did not represent the last chance for an NUA election on the account.

- **Example 4** – Continuing with Example 3, except that the employee died before withdrawing the funds from the employer plan. Because her death is another triggering event, her heirs are now eligible to correctly complete an LSD and elect NUA treatment on a stock withdrawal.

An heir to an employer retirement plan is eligible to not only take an LSD from the plan, but also to elect NUA treatment on a distribution of employer stock from the plan. In this set of examples, there were three different chances to complete an LSD – when the employee left the employer, when they later turned age 59½ and for her heirs after her death.

WORKING WITH AN EMPLOYER ON AN NUA TRANSACTION

Employees looking to complete an NUA transaction should work closely with their employer during the entire process. Most importantly, the employee must be certain the employer understands that the stock in the plan should be delivered to a taxable account, without being sold, with the remainder rolled to an IRA. This is not the typical treatment of employee balances at retirement, and the withdrawal paperwork used by the employer may not explicitly offer this option. If the stock is sold or transferred to an IRA before going to the taxable account, the NUA option is lost.

The employer and employee must also be clear on the cost basis of the shares rolling to the taxable account. The basis of these shares must be determined by the employer, not the employee, as that will determine the amount of NUA reported by the employer. The IRS provides employers with different methods for calculating this basis, based on how and when the stock is credited to the employee's retirement account in the employer's plan.

If the employer is able to accurately track the cost basis on individual lots of stock within the plan, the employee may be able to carefully choose exactly which shares are withdrawn. This would allow the employee to only withdraw the shares with the lowest cost basis (and therefore the lowest up-front tax cost) and then roll the other shares to an IRA. Again, the employer and employee must work together to ensure the tax reporting is handled correctly.

Employees looking to withdraw only some shares, while rolling others to an IRA, may be able to further maximize the tax benefits of NUA. In this scenario, the employee would allocate all of the cost basis to the shares rolled to the IRA, and none to the withdrawn shares, making the withdrawal of stock tax-free.

- **Example 5** – An employee owns $300,000 worth of employer stock in a plan with a total cost basis of $75,000 and NUA of $225,000. If at separation of service the employee withdrew all the stock to a taxable account, they would be taxed on the $75,000 basis. Instead, the employee rolls $75,000 worth of stock to an IRA, which represents all the basis in the stock. The other $225,000 of stock, representing all the NUA in the plan, is withdrawn and deposited in a taxable account. Because no basis is withdrawn, there is no immediate tax cost to the employee.

After the year of withdrawal, the employer must be careful to report the transaction correctly on the 1099-R that will be issued to the employee:

- **Example 6** – An employee has a 401(k) worth $700,000, which includes $200,000 of employer stock that has a cost basis of $50,000. The employee wishes to elect NUA treatment on the $150,000 of gain in the stock. The employee withdraws the entire balance, rolling all the stock to a taxable account and the remaining investments to an IRA.

  At tax time, the employer will issue the employee a Form 1099-R that shows a total distribution of $700,000 in Box 1, Gross Distribution. Box 2, Taxable Amount, will reflect $550,000, the full distribution amount less the amount of NUA in the total. In Box 2b, the Total Distribution box will be checked, and the $150,000 of NUA will be show in Box 6, Net Unrealized Appreciation in Employer's Securities. If some of the stock is also rolled to the IRA, the NUA amount in Box 6 will be reduced, and the Taxable Amount in Box 2 will be increased.

ADDITIONAL TAX CONSIDERATIONS

Even though an NUA election may change the taxability of a withdrawal from a retirement plan, it doesn't change the fact that it's still a distribution from a plan. As such, even an NUA withdrawal can be subject to the 10% early withdrawal penalty on plan distributions. Fortunately, in an NUA scenario, the penalty only applies to the taxable cost basis of the stock that is distributed. This penalty can be avoided if the employee is at least age 59½ at the time of withdrawal, or is at least age 55 when they leave the employer.

The NUA amount that is not taxed at the time of the withdrawal from the employer plan is eventually taxed as a long-term capital gain when the stock is sold. However, because the NUA originated within a retirement plan, the NUA gain is not subject to the 3.8% Net Investment Income Tax (NIIT) like other capital gains. Any gain in the stock's value after the distribution is also taxed as a capital gain, but it must be held for more than a year after the withdrawal in order to be a long-term gain. This post-withdrawal gain may be subject to the 3.8% tax, however.

- **Example 7** – An employee elects NUA treatment on a withdrawal of $50,000 of employer stock that had a cost basis of $20,000. That $20,000 was taxable to the employee at the time of the distribution and became their cost basis in the stock. Six months later the employee sells the stock for $55,000. The $30,000 of NUA from the original withdrawal is taxed as a long-term gain, but is exempt from the 3.8% NIIT. The $5,000 of gain that occurred after the withdrawal is taxed as a short-term capital gain, and is also subject to the additional 3.8% NIIT (assuming the employee's AGI exceeds the threshold for that tax).

Assets owned by an individual at the time of their death have their basis adjusted to the asset's fair market value at that time. NUA, however, is considered Income in Respect of a Decedent to the heirs, which is not eligible for a basis adjustment at the owner's death. Any appreciation subsequent to the withdrawal from the plan is eligible for the basis adjustment, however.

- **Example 8** – Continuing with Example 7 above, assume the employee died before selling the stock when it was worth $55,000. The basis in the stock to the heirs would be increased from the original $20,000 to $25,000 to reflect the $5,000 increase in value since the plan withdrawal. The basis would not be increased for the $30,000 of NUA, although that amount would still be taxed as a long-term gain upon sale.

PLANNING CONSIDERATIONS FOR NUA

Electing NUA treatment on a withdrawal of stock from an employer plan ultimately comes down to deciding between two scenarios:

- Paying some tax on the withdrawal from the plan up front, but then paying less tax at the time the funds are actually needed (by only paying the lower capital gain tax rate when the stock is sold).
- Not paying any tax today when rolling the stock from the employer plan to an IRA or other plan, but then being subject to the higher ordinary tax rates when the value is eventually withdrawn in the future.

To help make the decision as to which is better now (some tax now/lower tax in the future OR no tax now/higher tax in the future), there are two important variables to consider:

- **The cost basis of the stock** – The lower the basis of the stock inside the plan, the less income that must be recognized for tax purposes (and if applicable, the early withdrawal penalty) at the time of withdrawal. A higher cost basis means the tax cost of the transaction may be more than the employee is willing to incur up front.
- **The time frame for needing to access the value** – If the employee plans to use some of the money in their employer plan shortly after leaving the company, taking a distribution under the NUA rules can cost less tax than a withdrawal from an IRA. Someone who is retiring and plans to immediately use their 401(k) money for living expenses may even want to withdraw a few years worth of spending under the NUA rules, especially if the cost basis of the stock is low enough. This is especially true for younger employees who may be many years away from retirement.

Younger employees who separate service likely won't have an immediate need for the money in the employer plan. However, they can maintain the option of a future NUA election by either leaving everything in the employer plan until later in life or by doing a partial rollover:

- **Example 9** – Continuing with Example 6, the employee takes a partial distribution from the plan of the non-employer stock investments, which are then rolled to an IRA. The $200,000 of stock remains in the plan, and can be later withdrawn under an NUA election once the employee has another triggering event, such as turning age 59½. In this case, the employer plan would have to allow a former employee to make a partial distribution while leaving a balance in the plan after separating from service.

In cases where the employee knows they won't need some or all of the employer stock in the plan to support their retirement, they can consider a charitable giving strategy with the stock. Stock that is withdrawn under an NUA election can be immediately given to charity, resulting in a tax deduction equal to the stock's full fair market value. In this case, the employee will recognize income due to the withdrawal but can then claim a larger tax deduction for the donation.

Another thing to consider is the investment aspects of owning the company stock. When the stock is rolled to an IRA, it can be sold and moved into a diversified portfolio at no tax cost. If the stock is withdrawn under an NUA transaction, it likely won't be sold immediately. The employee will want to consider how the stock investment fits into their overall portfolio strategy, including how big a position is appropriate to continue owning.