

NUA Tax Strategy: How to Roll Over Appreciated Company Stock

Charlotte A. Dougherty, CFP®
Dougherty & Associates

8044 Montgomery Road
Suite 450
Cincinnati, OH 45236

513-745-7007

charlotte@dougherty-associates.com
www.dougherty-associates.com



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WEALTH PLANNING AND MANAGEMENT

By Grace W. Weinstein

When you leave a job with a significant amount of appreciated company stock, you might want to explore possible tax breaks related to its “net unrealized appreciation.”

Although it’s generally wise to roll a lump sum distribution from a 401(k) plan into an IRA when changing jobs or retiring, sometimes it’s advisable to think twice before doing so, especially if you hold significant amounts of highly appreciated company stock in your employer-sponsored retirement plan.

Instead of rolling over the entire account, you can take advantage of a little-known tax break dealing with net unrealized appreciation, or NUA. This is the growth in value of the company stock held in your retirement plan from the time of its purchase by the plan until you take it out.

NUA tax break

Assets rolled over into a traditional IRA continue to grow tax-deferred until they are withdrawn. Then, even if growth was generated by capital gains within the account, the distributions are taxed at ordinary income tax rates. If you transfer appreciated company stock to a taxable account instead of rolling it over into an IRA, tax will be due at the time of the transfer—but only on the original cost of the shares to the plan, not on the current market value.

Three important points: The NUA tax break applies only to stock issued by the employing company, not to any other securities that may be held in your plan. The original cost of the shares will have to be provided by your employer. And you may be subject to a 10% tax penalty if you are taking early distributions because of separation of service before reaching age 55.

The tax on the difference between the original cost basis and the market value at the time of distribution—the NUA—can be deferred until the stock is sold. Then, instead of paying the tax at ordinary income tax rates, the tax will be no more than the maximum capital gains rate, currently 20%.

This long-term capital gains rate on the NUA is applicable whether the stock is sold on the day after the distribution or 20 years later. Tax on additional appreciation beyond the date of distribution will be based on the length of the holding period.

To qualify for the NUA tax break, says Ed Slott, CPA and author of *The Retirement Savings Time Bomb*, the entire plan balance must be withdrawn

as a lump-sum in-kind distribution in one tax year. However, while the company stock is transferred to a taxable account, the balance of the account can be rolled over into an IRA.

In a dollars-and-cents example, let's say you hold company stock in your 401(k). The stock makes up 90% of your 401(k) assets. It has a cost basis of \$100,000 and a current market value of \$1 million. If the stock is transferred to a taxable account, you must pay tax immediately on the \$100,000 cost basis at ordinary income tax rates. The balance of \$900,000 will be taxed at capital gains rates, but not until it is sold. Conversely, there is no immediate tax liability if the stock is rolled over into an IRA, but the eventual tax on the entire amount withdrawn will be at ordinary income tax rates.

One nice feature of moving the stock into a taxable account is that there will be no required minimum distributions. You can leave the stocks in place forever, if you like. The downside, though, is that future dividends will be taxable.

Making the most of NUA

Moving company stock to a taxable account and paying current tax is not for everyone. It works best when company stock makes up a significant proportion of your retirement account and when it has greatly appreciated. If the current value is close to the cost basis, there would be little point in paying tax earlier than necessary.

And if the appreciated stock makes up more than 10% of the your total portfolio, says Bernard Kent, a partner in PricewaterhouseCoopers Human Resource Services in Detroit, using NUA may be a bad move, leaving you badly in need of

diversification. If the stock is rolled into an IRA, you could sell the stock and diversify the portfolio with no tax consequences until distributions are taken from the IRA. "The younger the taxpayer," Kent points out, "the more sense it makes to roll over into an IRA, sell the stock within the IRA to diversify, and continue to accumulate tax-deferred earnings."

However, there are what Kent calls "niche situations" in which using the NUA tax break might be beneficial. For example, if you need the money right away—perhaps as start-up money for a new business venture—it would make sense to take advantage of the lower rate on capital gains by using NUA.

Another situation could arise if you have large capital loss carry-forwards. You could put the company stock into a taxable account, sell it, and diversify without owing any current tax.

Yet another situation occurs when someone is retiring and starting distributions immediately, is at least age 70, and can take advantage of what Kent calls "vestiges" lingering in the tax code. One such holdover is 10-year forward averaging, available only to taxpayers born before 1936. The other is preferential capital gains treatment to the extent of participation in a retirement plan before 1974. Someone able to garner both of these tax breaks might want to add NUA to the mix.

"The downside here," Slott notes, "is that to gain the double tax break, you must also distribute and pay tax now on the noncompany stock assets that could have otherwise been rolled over to an IRA and kept growing tax-deferred."

Holding on

Bear in mind, too, that there is no step-up in basis on the NUA in company stock transferred from a 401(k) plan to a taxable account and held until death. Instead, as Slott explains, when beneficiaries sell the stock, they receive the same tax treatment as the original owner of the shares. They owe capital gains tax on the NUA, but they receive a step-up in basis on appreciation after the date of distribution.

There is another wrinkle to this scenario. According to Kent, the IRS has said that distributed company stock retains its character as “income in respect of decedent.” IRD is income earned by but not received by a decedent, at the time of death. Because IRAs are considered IRD, amounts in the accounts at death are subject to both estate and income tax.

Beneficiaries can claim an offsetting deduction for estate tax paid on the IRD. Of course, if there is no estate tax—either because the estate is under the exclusion amount or because the beneficiary is a surviving spouse entitled to the marital exemption—there will not be an offsetting deduction.

NUA: Yes or no?

Making a decision about using NUA is not easy. You will need to run the numbers to see if it makes sense. Be sure to include a tax professional in the discussion.

Most likely, NUA will be a worthwhile strategy if you're in a high tax bracket with diversified taxable portfolios and a large proportion of your retirement assets is in greatly appreciated company stock. You should also consider whether you have the cash on hand to pay the immediate tax bill generated by the transfer to a taxable account—and whether paying that tax bill will trigger the alternative minimum tax.

Grace W. Weinstein is a freelance writer based in Englewood, N.J. She has been a columnist for The Financial Times and Investor's Business Daily and is the author of 13 books, most recently The Procrastinator's Guide to Taxes Made Easy.

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