Net Unrealized Appreciation: Opportunities in Your Company's Retirement Plan

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Many taxpayers have employer-sponsored 401(k) Plans. Employees of publicly traded companies often choose to purchase their employer's stock through their 401(k) Plans. If the stock purchased in a 401(k) Plan appreciates after its purchase, the employee has an opportunity to convert ordinary income to long-term capital gain. The rules, however, are complex, and a misunderstanding of the rules can result in the loss of this opportunity.

The Strategy applies to the "Net Unrealized Appreciation" ("NUA") of the company stock. The NUA Strategy is a legitimate, Congressional-approved, tax-saving technique. In its basic form, the NUA Strategy permits an employee to elect to withdraw company stock from a 401(k) plan and pay only ordinary income tax on the *cost basis* of the stock. Upon receipt of the stock, the stock can then be sold for its value at the date of distribution over the amount previously included as ordinary income (which will be its tax basis) for long-term capital gain regardless of how long the employee owns the stock after distribution. Here are some considerations before using the NUA strategy:

1. For the distribution of the stock to qualify, there must be a "Triggerin' Event." There are three (3) Triggerin' Events:

(a) The Participant Attaining 59 ½ years of age;

(b) The Participant's "Separation from Service;"

(c) The Participant's Death

An employee may have several Triggerin' events. For example, the employee could attain age 59 1/2, continue working, and 5 years later Separate from Service. Each Triggerin' Event is considered separately, and the NUA Strategy is available after each Triggerin' Event. The fact that an employee decides not to use the NUA Strategy after one Triggerin' Event does prohibit the employee from electing to us the NUA Strategy after to occurrence of a subsequent Triggerin' Event.

2. Once a Triggerin' Event occurs, the Employee can employ the NUA Strategy any time after such occurrence, even years afterward, so long as the employee is not otherwise disqualified (see discussion in Paragraph 3 below).

3. If an employee wants to utilize the NUA Strategy after a Triggerin' Event, the employee must take a *lump-sum distribution* in *one calendar year*.

***Example*:** Arnold is employed by BigCo at the time he attains age 59 ½. Five years later, when Arnold is 64 years of age, he decides to employ the NUA Strategy. If Arnold has not taken a disqualifying distribution after he attained age 59 ½, Arnold can use the NUA Strategy five years later by taking a lump-sum distribution in one calendar year.

4. To qualify for the NUA Strategy, all company stock that is intended to qualify must be *moved to a taxable account* upon distribution. **The stock cannot be moved first to an IRA.** The taxpayer/employee can rollover any amount distributed, assuming the employee is not otherwise restricted (such as some amount would qualify as a Required Minimum Distribution). **However, any amount of company stock rolled over to an IRA will no longer qualify for NUA Strategy .** Furthermore, all other assets titled in the employee's 401k plan must also be rolled over to an IRA.

***Example*:** Arnold attains age 59 ½ while he is working for BigCo. Arnold decides to use the NUA Strategy for half of the stock that he receives in a lump-sum distribution. Arnold receives 1000 shares of BigCo stock and $300,000 in cash in a lump-sum distribution in one calendar year. Arnold rolls over 500 shares of stock of BigCo, and all the cash, to an IRA, and *immediately* sells the remaining 500 shares of stock for a gain. The gain from the stock qualifies for long-term capital gain treatment (assuming no further appreciation after distribution, see discussion in Paragraph 5, below). The rollover of the remaining 500 shares of stock and cash continues to defer the tax. However, the remaining 500 shares of stock that was rolled over cannot later qualify for NUA treatment.

5. While the gain from the shares of stock that is distributed qualifies for long-term capital gain tax treatment on the difference between the fair market value at the time of distribution of the stock over the cost basis of the stock (which is included by the employee as ordinary income), gain from sale of stock attributable to increases in value *after* distribution qualifies for long-term capital gain only if the stock is held for more than 1 year:

Example: Same as the previous example, except the 500 shares of stock held for sale appreciate 10% *after* distribution, and Arnold sells the stock six months after receiving the distribution. The additional appreciation after the distribution is a short-term capital gain because the stock that Arnold sells was not held for more than 1 year after distribution.

6. The 3.8% Net Investment Tax does not apply to the appreciation of the stock while held in the BigCo 401(k) plan, but does apply to appreciation after the distribution from the 401(k) plan.

***Example*:** In the prior example in Paragraph 5, above, only the short-term capital gain from the appreciation after the stock is distributed is subject to the 3.8% Net Investment Tax.

7. If the 401(k) plan permits dividends on the stock held in the plan to be distributed *before* the stock is distributed, the distribution of dividends will *not* disqualify a later distribution of the stock from the NUA Strategy.

8. If an employee dies and the stock is distributed from the plan after death, there is no date-of-death value basis adjustment to the stock, but the employee's estate or beneficiary can use the NUA Strategy.

9. While the NUA Strategy is most often used for *Publicly Held* companies, it can be used by Privately held companies, especially Privately Held companies owned in part or whole by an ESOP. The company stock must be distributed first and cannot be sold while in the ESOP. Most Privately Held company plans that want to offer an NUA Strategy to their employees will want to require the stock that an employee receives to be redeemed by the Company immediately after distribution.

10. For taxpayers who have attained their Required Beginning Date for taking Required Minimum Distributions from their retirement plans, a distribution of Company stock qualifies towards meeting the RMD amount on the *entire value* distributed as of the date of distribution, not just the cost basis of the stock.

11. In planning how much stock an employee must sell, a taxpayer needs to consider the potential income tax liability that may result from the distribution. The taxpayer may need to sell more stock than he planned.

***Example*:** Arnold wants to have $1 million in after-tax money to buy a new home. If a sale of 500 shares of stock will result in Arnold receiving $1 million ($2,000 per share), Arnold may have to sell 750 shares of stock or more in order to pay the income tax liability on the distribution and the taxes on the sale.

12. There are several planning issues that must be examined when an employee is considering the NUA Strategy. The best advice is “looking before you leap.” Confer with your financial and tax professionals to see if the NUA Strategy is a proper strategy for you to consider.