Mind the NUA

By Bruce Schmiedlin, ISCPA Financial Literacy Committee

Used correctly, net unrealized appreciation (NUA) is a powerful tax and retirement planning tool. Overlooking NUA or making a simple mistake may expose your practice to five-figure damage settlements.

NUA typically comes from employer stock held in a 401(k) or an Employee Stock Ownership Plan (ESOP). When distributed as shares directly from that specific plan into a taxable account, ordinary income taxes are due only on the plan's cost basis in those shares rather than their fair market value. When shares are sold, even the next day, the difference is a long-term capital gain up to the amount of the NUA. Gains above the NUA are either short- or long-term measured from the distribution date.

The spread on listed marginal tax rates typically is 7-12 percent (potentially 17 percent), and six-figure NUAs do happen with older ESOPs or older workers — hence the five-figure malpractice risk. Distributing the NUA at least one tax year before starting Social Security avoids having the share basis trigger Social Security taxation, and it greatly lowers future RMDs (required minimum distributions). After distribution, the shares even enjoy a basis step-up upon death for estate planning purposes.

Four rules require strict adherence:

1. Distribute entire vested balance in same tax year
2. Distribute all assets from all qualified plans (e.g., pension, stock bonus, etc.) with the employer
3. Distribute company stock as actual shares. Do not convert to cash before distribution
4. Must have experienced one of the following:
    a. Separation from service from the company whose plan holds the stock (except in the case of self-employed workers)
    b. Reached age 59-½
    c. Total disability (for self-employed workers only)
    d. Death

When a plan holds both employer stock and other assets, first do a trustee-to-trustee transfer of everything except the employer stock into another qualified plan. Then distribute the employer stock as shares into a taxable account. This sequence avoids mandatory withholding, so no other assets are sold to cover taxes (which would increase the taxable distribution). Though permissible to distribute fewer than all shares, the portion rolled over or sold by the plan loses its NUA tax benefit — nothing can remain in the plan.

If an employee dies before executing the NUA distribution, the entire distribution process must be completed in the tax year of death. The basis of the shares in the plan represents income in respect of a decedent (taxed at ordinary rates) and the beneficiary's basis is not stepped up.

Clients needing cash from a retirement plan after losing their job should consider an NUA distribution (after exhausting any Roths) due to the lower blended tax rate and lower amount subject to the 10 percent premature distribution penalty.

Some financial advisors push clients to roll over a 401(k) from past employers without considering whether NUAs exist. Other advisors use high-pressure sales to get surviving spouses to roll over the decedent's 401(k). Any rollovers irrevocably forfeit NUA treatment. There is no "in-kind" exception; everything must stay in that employer's plan even if the employee is 40 years from retirement.

One NUA drawback is less diversification, especially if the stock appreciates rapidly. Though in-plan diversification rules allow selling some employer shares inside the plan, it comes at a steep cost. Incurring a 25 percent tax rate spread to diversify against a temporary 25 percent decline in value simply locks in a 25 percent hit. A different strategy may be to direct future contributions into different investments.

This article won't make you an NUA expert, but it should help you identify questions to ask. Fortunately, many 401(k) administrators have departments specializing in NUA transactions to guide you and your clients through this complex but lucrative tax benefit.

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