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Net Unrealized Appreciation: A Retirement Distribution Strategy to Reduce Taxes

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A RETIREMENT DISTRIBUTION STRATEGY TO REDUCE TAXES

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Several recent factors, including tax law changes and accumulated capital gains in company stock, offer a compelling reason to revisit the potential benefits of the special income tax treatment of net unrealized appreciation (NUA) under Internal Revenue Code (IRC) Section 402(e)(4).

Individual investors commonly assume that an individual retirement account (IRA) rollover is their only option to continue to defer taxes on qualified plan assets when they leave an employer.

When distributed in retirement, however, the proceeds from an IRA are likely to be taxed as ordinary income, currently at rates of up to 45 percent or more if state or local taxes apply. But if the account includes employer stock, an alternative may be available by treating the stock differently from other plan assets under the NUA election.

EXECUTIVE SUMMARY

- Net unrealized appreciation is a retirement distribution strategy that may provide timely benefits because of (1) the significant spread between ordinary income and long-term capital gains tax rates, (2) the increased availability of company stock as an investment option in defined contribution plans, and (3) the significant gains produced in a positive equity market during the past few decades.
- Under the NUA strategy, employees take a lump-sum, in-kind distribution of company stock from their qualified retirement plan (employee stock option plan, 401(k) plan, etc.) upon separation from service, recognizing ordinary income taxes only on the stock's cost basis. The difference between the basis and the fair market value (FMV)—the NUA—is taxed at long-term capital gains rates only when the stock is sold, regardless of the holding period. This option may produce better results than rolling the stock into an individual retirement account (IRA) where the entire value eventually will be taxed as ordinary income upon distribution.
- Internal Revenue Code 402(e)(4) technically refers to "employer securities," including common shares and units of "stock funds" of employer stock that may be eligible if the distribution can be made in-kind.
- If a 10-percent early withdrawal penalty is triggered, it applies only to the stock's original cost basis, not the full distribution amount.
- NUA is treated as income in respect of a decedent if the employee dies before the NUA is recognized and taxed. The NUA portion of the position does not receive a step-up in basis as is typically provided for appreciated assets on death.
- The NUA strategy also is available to beneficiaries for stock not distributed from a qualified plan before death.

THE NUA STRATEGY

In short, the NUA strategy is an election for retirement asset distribution. NUA applies only to employer stock held in qualified retirement plans such as 401(k) plans, employee stock option plans, pension plans, etc. Under IRC Section 402(e)(4), there are three requirements to qualify for NUA tax treatment:

1. The employer stock must be distributed in-kind. Employer stock should be transferred directly to a taxable account.
2. The employer retirement plan must make a "lump sum distribution." The total distribution of all assets, meaning the entire account balance of the employer retirement plan, must be distributed in a single calendar year. Additional money deposited in the account after the lump-sum distribution that is not withdrawn before year-end can impact the ability to claim NUA.
3. The lump-sum distribution must be made after a "triggering event." To be eligible for NUA treatment, the lump-sum, in-kind distribution must occur after one of the following triggering events: death of plan participant, permanent disability, reaching age 59.5, or retirement or separation of service.

Keep in mind that distributions are subject to premature distribution penalty rules for qualified plans for employees younger than age 55 at the time of distribution upon termination of employment. The additional 10-percent tax applies only to the original cost basis, not the full value of the distribution, providing an opportunity to make a premature distribution in a more favorable fashion. In addition, using NUA for one plan does not inhibit availability for use with a different plan.

Although the tax code has permitted NUA for more than 70 years, several factors have made it more applicable in recent years.

TAX TREATMENT

Using the NUA strategy, an individual can take a distribution of employer stock from a qualified plan and pay ordinary income tax only on the basis at the time of distribution, allowing for continued deferral on the balance of the investment. The difference between the basis and the fair market value (FMV) at distribution—the NUA—is taxed at long-term capital gains rates when the stock is sold, regardless of the holding period. Subsequent appreciation (earned after the distribution from the qualified plan) is taxed at short- or long-term capital gains rates according to the length of the holding period. The hypothetical example in figure 1 illustrates the potential tax treatment of a share of stock that had a value of $25 when purchased in the qualified account. When the lump-sum distribution was taken, the value had grown to $100 and at sale had grown to $130.

Reminders:

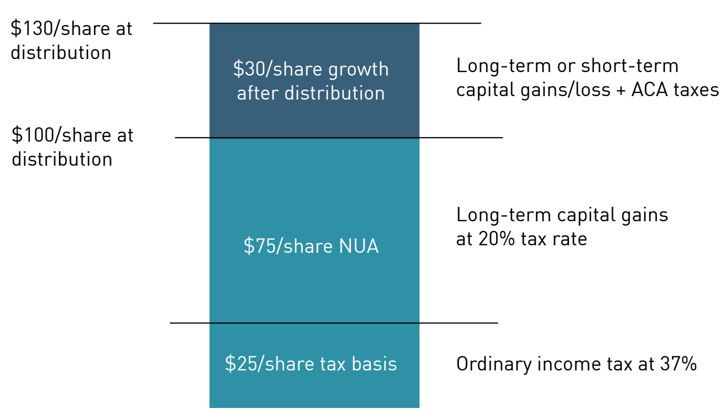
- Distributions from IRAs are taxed at ordinary income tax rates
- Distributions from IRAs are not subject to Affordable Care Act taxes
- Distributions under NUA election are not subject to Affordable Care Act taxes

Although the tax code has permitted NUA for more than 70 years, several factors have made it more applicable in recent years:

- A significant obstacle to the strategy that existed before 1997 was eliminated by the permanent repeal of the 15-percent excess retirement distribution tax on retirement plan distributions exceeding $160,000.
- The increased popularity of defined contribution retirement plans (versus defined benefit plans) and the subsequent use of employer stock in qualified plans created a larger pool of potentially affected clients.

Figure 1

TAX TREATMENT: NUA ELECTION



Source: Author. For illustrative purposes only.

- The favorable equity markets enjoyed during the past two decades produced many outsized gains in employer shares that could benefit from the lower taxation through the special tax treatment of NUA.

Since the enactment of the Tax Cut and Jobs Act in 2018, investors have an additional reason to consider NUA: the significant gap between the ordinary income rate (on which distributions from tax-deferred accounts will be taxed) and the long-term capital gains rate that is applied to the gain on NUA shares. With the continued spread between the maximum long-term capital gains rate of 20 percent (for income above $517,200 married filing jointly or MFJ) versus the maximum ordinary rate of 37 percent (for income above $647,800 MFJ), the NUA election can offer a tax benefit. Finally, assets that are removed from a tax-deferred retirement account via an NUA distribution (including qualified plans and IRAs) no longer are subject to required minimum distributions (RMDs) for account owners or beneficiaries, providing additional planning flexibility and control.

IMPORTANT CONSIDERATIONS WHEN USING NUA

For individuals who want to diversify a portion of their company stock holdings, the NUA strategy can be used on a partial or full distribution of employer stock. An individual can roll over some of the company stock (generally higher cost-basis shares) to an IRA and use the NUA treatment on the balance. Note that the special NUA treatment is lost on shares rolled over to an IRA. Similarly, individuals whose qualified plan assets include both company shares and other securities (mutual funds, cash, etc.) can elect NUA on the shares and choose an IRA rollover for the other holdings.

An individual might want to obtain the cost basis of various lots of employer stock from the plan administrator and review them to determine which shares might benefit most from the special NUA tax treatment. For example, it might make sense to use the NUA strategy on shares with the lowest cost basis relative to FMV at distribution (and thus the lowest ordinary tax bill on the cost basis and the greatest amount of NUA) and roll over shares with a higher cost basis relative to the FMV at distribution.

An important factor in deciding whether to implement NUA for employer stock is the future plan for the assets. Individuals who plan on using a significant portion of the assets to fund immediate retirement income needs may not realize the same benefits that are enjoyed by investors who allow the additional compounding of these assets for a longer time horizon.

The NUA on shares purchased with after-tax employee contributions also is eligible for the NUA strategy.

For a client with an immediate liquidity need, the NUA strategy may offer an important source of assets—the employer securities—to provide the needed funds. Given that only the basis is subject to the penalty and ordinary income taxes (with capital gains applied to NUA), the total taxes on the distribution likely are to be less than if the entire distribution were subject to the 10-percent additional tax and ordinary income tax rates.

An individual who plans to use the NUA strategy must notify the plan administrator in advance to obtain the specific documentation required and to ensure that any withholding is based only on the cost basis, not on the entire distribution. The administrator reports the amount of tax withheld on the basis to the Internal Revenue Service upon implementation of the NUA strategy. The amount of NUA is reported in Box 6 of Form 1099-R (Distributions from Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.).

Table 1

SCENARIO 1: HOLD IN THE PLAN OR ROLL OVER

Current Value of Stock	$1,300,000
Basis (Original Contribution)	$130,000
Future Value in 10 Years @ 8.00%	$2,806,602
Income Tax @ 37.00%	$1,038,443
Net After Tax	$1,768,159

Source: Author. For illustrative purposes only.

Table 2

SCENARIO 2: ELECT NUA AND HOLD

Current Value of Stock	$1,300,000
Basis (Original Contribution)	$130,000
Income Tax on Basis @ 37.00%	$48,100
Net to Hold in Brokerage Account	$1,251,900
Future Value in 10 Years @ 8.00%	$2,702,758
Taxable Amount (Future Value – Basis)	$2,572,758
Capital Gains Tax on NUA of $1,170,000 @ 20.00% = $234,000 Capital Gains Tax on post-distribution gain of $1,402,758 @ 23.80% = $333,856	$567,856
Net After Tax	$2,134,902

Source: Author. For illustrative purposes only.

Subject to 10-percent premature distribution penalty if applicable. The example assumes all shares of stock are held for the 10-year period illustrated. Net values after tax could be less if portions of the shares are liquidated periodically during the holding period. The example assumes 20-percent long-term capital gains rate plus 3.8-percent surtax on investment income. There can be no assurance that an investment will provide positive performance over any period of time. Tax rates and IRS regulations are subject to change at any time, which could materially affect the results of this analysis.

PIMCO does not provide legal or tax advice. Please consult your tax and/or legal counsel for specific tax or legal questions and concerns.

Individuals may elect not to exclude NUA in employer securities distributed as part of a lump-sum distribution. Individuals make this election by attaching a signed statement of that election to the federal income tax return filed for the year in which the distribution was received and by including the NUA as part of the distribution on Form 4972 or, if no Form 4972 is filed, on line 16 of Form 1040.

A CASE STUDY IN NUA

To illustrate the potential benefits of NUA, consider the case of a hypothetical investor, Margaux Tavitt, age 62, who is planning to retire this year with a substantial amount of company stock in her retirement plan. She wants to continue deferring taxes on these assets and initially had planned to use an IRA rollover for all the plan assets. But during the course of developing her retirement plan, her financial planner constructs four scenarios to illustrate alternatives for the corporate stock portion of Margaux's retirement plan. Assume that Margaux's marginal federal income tax rate will be 37 percent. (Examples are hypothetical illustrations only and do not guarantee any specific outcome. Net values after tax could be less if portions of shares are liquidated periodically during the holding period. This also assumes current tax rates are in effect at distribution.)

Scenario 1: Rollover into IRA. Margaux chooses to roll over the entire balance of her qualified retirement plan into an IRA, where it grows tax deferred and upon distribution all the assets are subject to ordinary income tax (see table 1).

In each of the next three scenarios, Margaux elects to remove all the employer stock from her qualified plan and use the NUA strategy. In the year of distribution, she will pay ordinary income tax on the basis of the shares in the plan. If it were applicable, the premature distribution penalty would apply to the basis. This lower penalty amount may represent an additional benefit of the NUA strategy.

Scenario 2: Lump-sum distribution and hold stock. Margaux chooses to take a lump-sum distribution of company stock in one calendar year and continues to hold the stock for 10 years (see table 2).

Tax on the basis is subtracted from the current FMV, and the remaining amount is compounded to determine the future value at the end of the holding period. This analysis assumes the account is liquidated at the end of the holding period and long-term capital gains tax is paid on the NUA—the difference between the basis and FMV at liquidation. This scenario produces a potential incremental benefit of $366,743 when compared to the rollover option in table 1.

Scenario 3: Lump-sum distribution and sell stock. Margaux chooses to take a lump-sum distribution of company stock in one calendar year and immediately sells the stock, reinvesting the proceeds (see table 3).

In this scenario, ordinary income tax is again paid on the basis and the entire NUA is taxed at the long-term capital gains rate of 20 percent. The balance is invested in a diversified portfolio that is held for 10 years. At the end of the holding period, the entire account is liquidated. Because tax was paid initially on the basis and the original NUA, this amount is deducted from the future value of the portfolio and the long-term capital gains rate applied to subsequent appreciation. This scenario provides a lesser incremental benefit of $70,282.

Table 4 summarizes the potential benefits of these three strategies.

Scenario 4: Rollover with RMDs versus NUA. Although table 4 illustrates the possible benefits of NUA in a lump-sum scenario, NUA also may provide advantages when compared with the option of rolling over plan assets and taking RMDs over a life expectancy. In table 5, Margaux elects a rollover of her plan balance upon separation and allows the balance to compound to a total value of $2,806,602 until RMDs begin at age 72. The gross RMD for the first distribution is $102,430 or $68,629 after tax (subject to ordinary income tax rates).

Table 3

SCENARIO 3: ELECT NUA/REMOVE AND SELL

Current Value of Stock	$1,300,000
Basis (Original Contribution)	$130,000
Income Tax on Basis @ 37.00%	$48,100
Net Unrealized Appreciation	$1,170,000
Capital Gains Tax @ 20.00%	$234,000
Net to Reinvest (New Basis = Current Value – Income, Cap Gains Tax)	$1,017,900
Future Value in 10 Years @ 6.09%*	$1,838,441
Taxable Amount (Future Value – Basis)	NA**
Net After Tax	$1,838,441

Source: Author. For illustrative purposes only.

** Example assumes 8.00-percent return annually, 20-percent long-term capital gains rate, plus 3.8-percent surtax on investment income.*

*** No new taxes will be applied to the final value in 10 years as it is assumed taxes are paid throughout the holding period and thus the 8.00-percent annual return is reduced to 6.09-percent.*

Table 4

SCENARIOS 1, 2, AND 3 COMPARED

Scenario	Strategy	Net After Tax	Incremental Benefit
1	Hold in plan or roll stock over into IRA	$1,768,159	NA
2	Elect NUA and hold stock for 10 years	$2,134,902	$366,743
3	Elect NUA and sell stock (reinvest proceeds)	$1,838,441	$70,282

Source: Author. For illustrative purposes only.

Table 5

DISTRIBUTIONS FROM AN IRA ROLLOVER

FMV of Stock in IRA Rollover at Age 72	$2,806,602
RMD at Age 72 (pre-tax)	$102,430
RMD (after tax @ 37.00%*)	$68,629
Remaining Balance	$2,704,172

Source: Author. For illustrative purposes only.

** Example assumes 37.00-percent ordinary income tax rate.*

Table 6

SCENARIO 4 COMPARED TO DISTRIBUTIONS WITH NUA

FMV of Stock in Brokerage Acct at Age 72	$2,702,758
Stock Sold at Age 72	$86,872
Stock sold (after tax @ 21.00%*)	$68,629
Remaining Balance	$2,615,886

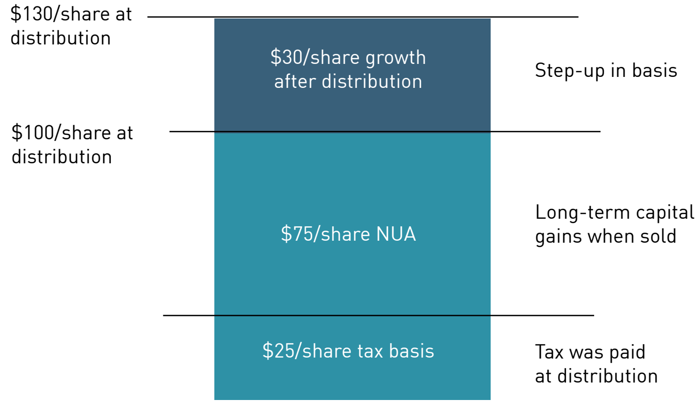
Source: Author. For illustrative purposes only.

**Example assumes 21.00-percent blended tax rate: gross amount: $2,702,758, taxable amount: $2,572,758, taxable at 20 percent: $1,170,000 (45.5 percent), taxable at 23.8 percent: $1,402,758 (54.5 percent), blended rate: 22.07% x 0.952 = 21.01%. FMV=Fair Market Value*

Figure 2

ESTATE PLANNING TAX CONSIDERATIONS

Step-up at death/cost basis
NUA shares do not receive step-up in basis at death

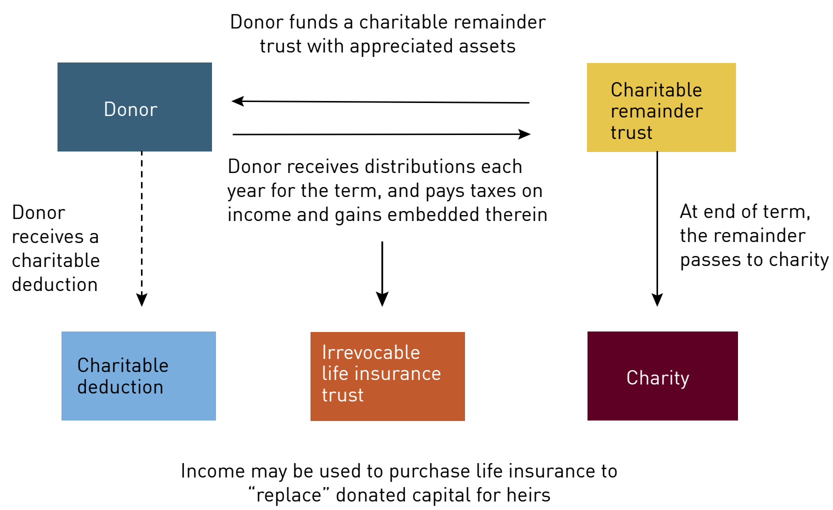


Source: Author. For illustrative purposes only.

Figure 3

ESTATE PLANNING CONSIDERATIONS

Gifting to charity: charitable remainder trusts



Source: Author. For illustrative purposes only.

When compared against the alternative under NUA (see table 6), Margaux allows the stock to continue to grow to a value of $2,702,758 at age 72, then liquidates a lesser amount of stock of $86,872 to equal the same $68,629 after tax (subject to the lower capital gains rate). The differential in tax rates allows Margaux to liquidate a smaller amount of assets to produce the same after-tax income stream, keeping more capital invested to produce the potential for greater total value when compounded over an extended retirement experience.

ESTATE PLANNING CONSIDERATIONS

If the individual dies before the NUA is recognized and taxed, treatment of the NUA component is different than for other appreciated assets. As with other retirement assets, NUA is considered income in respect of a decedent and considered part of the estate. Additionally, the step-up in basis to date-of-death value, which usually occurs at death, is not available for the portion of the value of the stock that is NUA. But heirs still can use the capital gains rates for the embedded NUA when shares are sold, and appreciation in excess of the NUA receives a step-up in basis at the time of the individual's death. The NUA strategy also is available to beneficiaries for employer stock held in a qualified plan that has not been distributed before death. The hypothetical example in figure 2 illustrates the potential tax consequences to heirs on a share of stock with a value of $25 when purchased for the qualified account. The NUA of $75 (the difference between the basis and the value at distribution) will be taxed at long-term capital gains rates when sold. The heirs enjoy a treatment of $30, the amount of appreciation between the date of distribution and the date of death.

USING NUA TO FULFILL CHARITABLE INTENT

As with other highly appreciated assets, employer stock distributed from a qualified plan may be an appropriate asset to use for a charitable remainder trust. In this way, an individual could receive an income stream and fulfill a charitable intent. The income deduction for a charitable contribution could offset the additional tax due on the basis.

In figure 3, the individual takes a distribution of stock from the plan, paying ordinary income tax on the basis. The value of the charitable contribution is determined using the FMV of the stock at the time of gifting, even though the individual does not recognize the NUA at the time of the gift. If gifted immediately upon distribution (and no short-term capital gain is recognized in excess of the FMV at distribution), then the entire gift will be considered long-term capital gain property.

When the stock is sold by the trust, the NUA will be characterized as long-term gains in the four-tier accounting system.

Depending on how the proceeds of the sale are reinvested, a significant portion of trust distributions may be characterized as long-term capital gains and taxed at a maximum capital gains rate of 20 percent. (This assumes that the beneficiary of the trust is a public charity.)

A client likely to retire into a lower tax bracket may pay less tax overall simply by rolling the stock into a new qualified account such as an IRA.

FACTORS AFFECTING DECISIONS ABOUT NUA

NUA may provide advantages over the decision to elect an IRA rollover, but the strategy may not be appropriate for all investors. Review these factors when advising about employer stock.

Size of retirement account. Investors owning large amounts of highly appreciated employer stock are likely to benefit most. Consider the NUA election for clients who have long tenure with their companies and who own stock that has enjoyed significant appreciation.

Time horizon. Investors not likely to retire or liquidate the stock for many years may benefit most. Consider how long shares may be left to appreciate after the distribution from a retirement account.

Marginal tax benefit. Calculate the potential taxes for both the NUA strategy and a direct rollover into an IRA. A client likely to retire into a lower tax bracket may pay less tax overall simply by rolling the stock into a new qualified account such as an IRA.

Risk tolerance. Because the NUA election may be most effective for stock held long term, consider whether the client is willing to keep the asset even if the price falls or stagnates for a time. For many employees, at all levels, employer stock held both inside and outside the qualified plan may be a majority of an investment portfolio. For this reason, it's important to consider the concentration risk that the employer stock may represent.

Diversification. A client overweighted with employer stock could consider the NUA election for a portion of the distribution. The balance could be rolled over into an IRA, where shares can be sold to purchase other investments. The potential tax savings may be lower, but the portfolio can be diversified more effectively.

CHECKLIST FOR AN NUA MEETING WITH CLIENT

- ❏ Recent statements from 401(k), profit sharing, or other retirement accounts at current employer and any legacy plan accounts from previous employers
- ❏ Plan documents that describe the 401(k) plan, profit sharing, etc., along with fee disclosure
- ❏ Documentation from employer of the cost basis of stock
- ❏ Recent tax filing information to review current tax bracket and potential changes in years ahead
- ❏ Contact information for the benefits administrator at current employer and prior employers to clarify any questions and confirm information
- ❏ Statements and information on other retirement accounts to evaluate the impact NUA may have on retirement savings and diversification

Estate plan. Explore whether the strategy might shift any undue tax burdens to beneficiaries. Stock on which the NUA election has been exercised will become part of the client's taxable estate at death. Heirs receiving NUA stock will realize a different income tax treatment than on other assets. There is no step-up in basis because NUA, like an IRA, is subject to income in respect of a decedent.

DETERMINING WHO MIGHT BENEFIT MOST

A comprehensive understanding of NUA can be a powerful tool for obtaining a larger percentage of prospective and existing client assets. Although the strategy may not be broadly applicable for many client scenarios, it can be very powerful for certain clients. Focusing NUA educational efforts on these individuals may prove to be most beneficial.

Retiring corporate executives. Consult with retiring executives about different NUA election strategies to guide them in making the proper choices for retirement distributions.

Younger executives. Educating younger executives about NUA benefits can influence qualified plan investment choices and decisions concerning rollovers to other qualified plans or IRAs that would eliminate NUA election eligibility. In addition, informing these executives about NUA could enable them to potentially benefit from the NUA election in the future.

Executives holding depressed stock. Adding to qualified plan positions when the price of employer stock is depressed could magnify the tax benefits of NUA when the stock eventually is distributed from the plan, assuming favorable long-term appreciation potential.

Human resource executives. Many human resource executives have limited knowledge of the special NUA tax treatment. Educating them about NUA benefits so they can counsel retiring employees can build strong relationships, which may lead to referrals.

Tax advisors. Some tax advisors may not be familiar with the inherent advantages afforded through an NUA election. Financial planners offering education on this strategy can establish credibility and the opportunity for referral business.

CONCLUSION

NUA can be an appealing strategy for many clients, but it requires a close examination of trade-offs: upfront tax impact versus deferring taxes in addition to taxation considerations for beneficiaries. Advisors who help clients evaluate NUA strategies provide the potential for valuable tax savings and retirement advice.

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