“Net Unrealized Appreciation” Untangled

By Claire E. Toth, JD, MLT, CFP™

Investment professionals warn clients against investing in their employers’ stock. After all, if your present income stream is dependent on one corporation’s fortunes, why risk your nest egg in precisely the same way? Many employees of large corporations have no choice but to invest in their employers’ stock—that’s what the employer contributes to their retirement plans.

Sometimes, it works just as it should—the employer’s stock does well, and at retirement a significant piece of the employee’s retirement accounts consists of highly appreciated company stock. These lucky employees have a choice not available to most of us. They can choose to take the employer stock in kind, pay tax on just the cost basis, and avoid higher taxes on the built-up appreciation.

This strategy requires some unpacking. Typically, when an employee leaves a job, she can leave her retirement money with the former employer, roll it out tax free into an IRA, or cash out the money. If she chooses to cash it out, the distribution is taxed as ordinary income. Plus, if she is under age 59-1/2, she pays an additional 10 percent penalty.

A special exception exists for employer stock held in a company retirement plan. If an employee meets several specific criteria, she can roll out the company stock portion of the retirement plan into a taxable brokerage account and pay ordinary income tax on just the cost basis of that stock—its value at the time the company contributed it to the plan. If the employee is under age 59-1/2, she still must pay a 10 percent penalty, but again—only on the cost basis. The employee then holds taxable stock in her former employer, with that low basis. The stock is always long term, so any gain on sale is taxed at a maximum federal rate of 20 percent, perhaps with the ACA (Obamacare) surtax of 3.8 percent. That is called the Net Unrealized Appreciation, or NUA.

In order to qualify for NUA treatment, the employee must meet all five of the following criteria; any misstep subjects the entire rolled out value of the employer stock to immediate ordinary income tax:

- The employee must distribute her entire vested balance of all the employer’s retirement plans in a single tax year (though she can do it in stages throughout the year);
- The employee must distribute all assets from all company plans, even if only one holds employer stock;
- The employee must take the distribution of employer stock as actual shares—no selling first and taking the cash;
- The employer stock can only be from the current employer; former employer stock or companies spun off from a current employer aren’t eligible; and

- The employee must have experienced a qualifying event: separation of service (self-employed workers cannot use this event), reaching age 59-1/2, or death.

When does it make sense to elect to go the NUA route? Here are some factors to consider:

Your Relative Tax Rates. The larger the spread between your ordinary income tax rate (as much as 39.6 percent) and your capital gains rate, the more attractive the NUA treatment looks. Be sure to consider whether you must pay the ACA surcharge, as well as any state taxes.

The Absolute and Relative Size of the NUA. The more NUA, the more valuable taking the stock directly can be. This is even more the case if the original basis is very low. The lower the basis, the lower the tax cost to avail yourself of this technique.

Your Time Horizon. If you plan to dip into your retirement plans immediately to fund your living expenses, the NUA becomes even more attractive. You aren't foregoing much of the tax-free build up an IRA would provide, and you're paying retirement costs with dollars taxed at a lower rate.

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