RAYMOND JAMES

Net unrealized appreciation

Maximize your employer stock distribution with this tax-efficient strategy

If you've worked for a large publicly traded company, you may find yourself approaching retirement with company stock in your retirement plan, whether directly contributed to you from your employer in a profit-sharing or ESOP plan or purchased by you in your 401(k) plan.

In any case, once company stock has been acquired in a retirement plan, it will ultimately be taxed as ordinary income with marginal income tax rates when distributions are made. However, the Internal Revenue Code allows for the gains on such stock – known as net unrealized appreciation (NUA) – to be taxed at long-term capital gains rates, which are typically more favorable, as long as certain requirements have been met.

The NUA strategy might help you save on taxes, but, given that the cost basis or the original price paid for the stock is taxed immediately, it's important that timing and your situation align in order for NUA to be worthwhile for your long-term financial and retirement plan. As you consider this strategy, be sure to work with your financial and tax advisors who can help you weigh your options and determine the best one for you.

KEY TAKEAWAYS

If the requirements are met, NUA can be a tax-efficient means of distributing all or a portion of employer stock.

Keep in mind that NUA might not ultimately benefit your long-term financial plan should timing or circumstances not align.

Talk to your financial advisor and tax consultant to determine whether or not NUA makes sense for you.

HOW IT WORKS

With the NUA strategy, you pay income taxes on the cost basis in the calendar year of the company stock distribution, including both federal taxes at their marginal tax bracket rate and state taxes where applicable. You do not pay taxes on the NUA amount until you actually sell the stock. When the stock is sold, you pay taxes at the long-term capital gains rate for the NUA portion even if the stock is held for less than one year after the time of distribution. It's important to note that you can use the NUA strategy with a portion or all of your employee stock.

While the difference between marginal tax bracket rates and long-term capital gains rates varies depending on overall income level, paying at long-term capital gains rates always offers savings. Plus, if your overall taxable income falls under a certain threshold, your long-term capital gains rates could be 0% under the current law.

While the potential savings are certainly enticing, there are a few requirements that must be met before you can take advantage of NUA:

▸ **A triggering event**
The stock must be distributed after a qualifying triggering event. This could be:

- When the participant leaves the company
- After the participant reaches age 59 1/2
- After the participant, if a self-employed individual, becomes totally and permanently disabled
- At the time of the plan participant's death

By far, the most common of the above situations is separation from service. As people approach retirement with company stock in their retirement plans, the NUA strategy can be considered.

▸ **In-kind distribution**
The stock must be distributed in-kind. The stock held in the employer-sponsored retirement plan is transferred to a taxable investment account, however other assets in the plan can be rolled over to an IRA.

▸ **Lump-sum distribution**
The stock must be distributed as part of a lump-sum distribution. A lump-sum distribution for this purpose is the distribution or payment of a plan participant's entire balance within a single calendar year from all of the employer's qualified plans of one kind (e.g., 401(k), pension, profit-sharing or stock bonus plans). The NUA distribution and remainder rollovers must take place in that calendar year or the opportunity is lost until the next triggering event.

It's important to note that the lump-sum distribution does not necessarily have to occur in the year of the triggering event. For example, you could separate from service in one calendar year (a triggering event) but wait until the next year to process the NUA stock distribution and rollover.

EARLY WITHDRAWALS

Note that if you withdraw your stock before the age of **59 1/2,**, you may be subject to an additional **10%** penalty tax for early withdrawals. However, if you separate from service during or after the year you reach age **55** **(age 50 for public safety employees of a state, or political subdivision of a state, in a governmental defined benefit plan)**, you may obtain relief from the **10%** penalty for withdrawals after separation from service.

TIMING IS EVERYTHING

If the year of distribution is also the year of retirement, you may be in a higher marginal tax bracket than you will be in future years of retirement (due to earned income early in the year of retirement). Therefore, the tax paid on the cost basis amount could be quite high if NUA is implemented in this year. You should consider the tax effectiveness of waiting until the year after retirement to pursue the NUA strategy.

Additionally, for those who want to liquidate the stock after distribution but spread out the tax impact, it may be feasible to do the NUA distribution (triggering taxes on the cost basis) late in one tax year, and then complete the subsequent sale (with long-term capital gains rates on the NUA gain) early in the next tax year.

NUA IN ACTION

MEET ALEX

Alex retired from his employer at age 57 in 2017, after spending 25 years with the company. He has a 401(k) plan with a total account balance of $900,000, including $300,000 of employer stock with a cost basis of $35,000.

After he retired in 2017, Alex took a $5,000 distribution to pay a one-time debt. He was able to avoid the 10% early withdrawal penalty due to the rule allowing retirees who separate from service during or after the year in which they turn 55 to take a distribution from their employer retirement plan without penalty.

In 2018, Alex decided he wanted to pursue the NUA distribution strategy for the $300,000 of company stock. However, Alex's retirement was his triggering event and the $5,000 distribution in 2017 was his first distribution after a triggering event. Since he didn't do a lump-sum distribution in that year, he was disqualified from the NUA strategy. He can't do a NUA distribution in 2018 as it will no longer be a lump-sum distribution after a triggering event, because a non-lump sum distribution already occurred in a year after the triggering event.

However, since reaching age 59 1/2 is also a triggering event, Alex will still be able to do an NUA distribution in 2019 once he actually turns 59 1/2 and a new triggering event occurs. He will need to make certain that once he does take a distribution after age 59 1/2, that he does a full lump-sum distribution within that year, takes out all of the employer stock in-kind and rolls over the remainder of the retirement plan balance to an IRA.

If Alex had separated from service after age 59 1/2, the separation from service and age 59 1/2 triggering events would have both passed and the disability trigger is not applicable once retired. In that case, under the same scenario as above, the NUA strategy would be totally lost to him until his death, which would be the last triggering event option available.

Upon his death, his heirs could do a NUA distribution from the inherited employer retirement plan. However, this would require Alex to keep the employer retirement plan and hold the stock, without using it, until he dies. There are a few reasons he might not want to do that, including the retirement plan's withdrawal options, investment selection and the security risk from holding the stock.

CONSIDERATIONS

Just like with most other wealth planning strategies, there are some factors to consider before deciding whether the NUA strategy makes sense for you. As you review them, remember that even if you meet the NUA criteria, you have a few options at hand for distributing your assets:

- Leave all of your assets inside of the plan and do not take advantage of NUA, taking distributions from the plan as needed. You'll continue to benefit from things like creditor protection and lower expense ratios while paying ordinary income tax on all distributions.
- Roll over all of your assets to an IRA and do not take advantage of NUA, taking distributions as needed. You'll have more control over your investment selection, while paying ordinary income tax on all distributions.
- Utilize the NUA strategy if you meet the requirements and distribute the company stock – either all of the shares or a partial amount – to a taxable account. Roll all other assets to an IRA within the same calendar year.

It's always important to remember that future updates to the tax law could make the NUA strategy less advantageous if marginal tax rates of long-term capital gain rates change. Plus, be aware that assets held outside of a qualified employer plan or IRA may have less protection from creditor claims.

MAKING THE MOST OF NUA

While in the right circumstances the NUA strategy can potentially help you save money, that's not a given depending on your particular situation and time horizon.

To determine whether the NUA strategy is right for you, it's important that you consider a couple of key factors:

YOUR COST BASIS

Each dollar that is lost to tax in the initial year of NUA stock distribution means one less dollar for future portfolio growth, so a low cost basis is crucial for keeping that loss down. However, even with a small cost basis percentage, distributing all of the shares could cause you to pay a considerable amount in tax in the initial year of distribution, especially for large NUA stock positions.

This case study is for illustrative purposes only. Individual cases will vary. Any information is not a complete summary or statement of all available data necessary for making an investment decision and does not constitute a recommendation. Prior to making any investment decision, you should consult with your financial advisor about your individual situation.

For example, even with a cost basis that is 15% of the total market value of the shares, a $1,000,000 employer stock position would generate $150,000 of ordinary income, which is potentially enough to drive you into substantially higher marginal tax brackets and lose a considerable sum to taxes immediately. Whereas if the NUA strategy was not implemented, your money would have remained in the qualified account environment to grow into the future, until perhaps you reach a lower tax bracket in retirement. With the NUA strategy some money is immediately lost leaving less principal to grow.

Keep in mind, if the plan record keeper has maintained individual cost basis records and not merely average cost basis, it may be possible to cherry pick the lowest cost basis shares for the NUA distribution.

WHEN YOU NEED THE MONEY

If you plan to use the money soon, NUA can be an ideal means of distributing those funds. However, if you're looking to use the NUA strategy to diversify your assets, remember that you can already diversify within the qualified account environment with no immediate tax consequences. Whereas if you distribute shares to a taxable account and immediately diversify by selling the shares, not only will the cost basis portion be subject to ordinary income tax, but the NUA portion will be lost to long-term capital gains tax – leaving a considerably lower amount of principal to be invested for the future.

Remember that NUA triggers the immediate taxation of the cost basis amount which, if it's a high percentage of the total fair market value of the shares, can even push you into a higher marginal tax bracket when distributed and can incur substantial taxes.

UNDERSTANDING NUA TAXATION

If you decide to implement the NUA strategy, in the calendar year of the company stock distribution you will pay income taxes on the cost basis, including both federal taxes at their marginal tax bracket rate and state taxes where applicable. Your employer's plan representative should be able to assist you in determining the cost basis of the shares.

The difference between the original cost and the current market value of the shares at the time of distribution is the net unrealized appreciation. You do not pay taxes on the NUA amount until you actually sell the stock. When the stock is sold, you pay taxes at the long-term capital gains rate for the NUA portion even if the stock is held for less than one year after the time of distribution. NUA gain is subject to the standard 0%, 15% or 20% long-term capital gain rates, plus state income taxes where applicable. The NUA gain is not subject to the 3.8% Medicare surtax on net investment income.

Any change in the stock's value from the time of the transfer to the time it is sold is taxed separately from the NUA amount. Additional gains will be taxed at the long-term capital gains rate if held for a year or more before being sold. If held for less than a year, it will be taxed at the higher short-term capital gains rate. If shares are held past the distribution date and losses occur, it will reduce the amount of net unrealized appreciation gain reported on the sale. If losses cause the price to fall below the original cost basis, a capital loss will occur.

Diversification and asset allocation do not ensure a profit or protect against a loss.

Dividends paid on NUA stock are taxed at qualified dividend tax rates, which are less than the ordinary income rates if the stock was rolled over and distributions were taken later. However, if the shares remained inside of a qualified account environment, tax paid on dividends would be deferred until ultimate distribution.

NUA amounts do not receive a step up in cost basis at the owner's death. When your beneficiaries sell the stock they inherit, they will owe long-term capital gains tax on the NUA. Any additional appreciation between the date of distribution and the date of death would be entitled to a stepped-up basis in the shares they inherit under the current law.

AS WITH ALL TAX-RELATED STRATEGIES, YOUR TAX ADVISOR SHOULD BE CONSULTED BEFORE IMPLEMENTING THE STRATEGY.

NUA CASE STUDIES

CASE STUDY 1: LOW COST BASIS AND IMMEDIATE SALE

Bob has worked at his current employer for 10 years and plans to retire on October 1, 2022, at age 65. He's married and will be in the 22% marginal tax bracket in 2022 and the 12% bracket in 2023 and beyond.

Bob's employer has made contributions of company stock to his profit-sharing plan account and the current value of the shares is $20,000 with a cost basis of just $5,000. He also has a large traditional IRA from rollovers from past employer plans and a 401(k) from his current employer.

Bob plans on taking distributions for living expenses of $20,000 in the first year of his retirement, 2023. If Bob were to roll the entire profit-sharing account over to an IRA, no taxes would be due for the year of rollover. However, when he takes his first distribution of $20,000 in 2023, taxes will be due at his marginal tax bracket of 12%, for a total tax bill of $2,400.

Alternatively, if Bob utilizes the NUA strategy, he can wait until January of 2023 to complete his company plan rollovers. The $5,000 cost basis of the NUA stock will be taxed at his year 2023 marginal tax bracket of 12% incurring $600 of taxes. The $15,000 of NUA will be taxed at his capital gains rate. Assuming that the entire capital gain can be incurred at the 0% long-term capital gain rate commensurate with his income level, Bob's total tax paid will be $600.

In this case, Bob would pay $2,400 in taxes without utilizing NUA and just $600 in taxes with NUA – making this a perfect example of when utilizing the NUA strategy may be advantageous.

CASE STUDY 2: HIGH COST BASIS AND A LONG TIME HORIZON

Debbie has worked for her current employer for 20 years. She plans on retiring at the age of 60 on August 1, 2022. She is single and will be in the 24% marginal tax bracket in 2022 and the 22% bracket in 2023 and beyond.

Debbie has purchased company stock in her 401(k) over her career and the current value of the shares is $100,000 with a cost basis of $60,000. She also has other investments in her 401(k) of $1,000,000 bringing her total 401(k) value to $1,100,000. In addition, Debbie has taxable account savings of approximately $800,000, and she will be receiving a small pension and a Social Security widow benefit starting at age 60. She estimates that between her income sources and taxable account savings, she should not have to touch her qualified money until RMDs begin at age 72.

There are two initial concerns with Debbie utilizing NUA: the fact that the cost basis of her company stock is 60% of the total fair market value and that she won't need the money for at least 10 years. With these factors in mind, she works with her financial advisor who performs an analysis using a NUA calculator.

For the analysis, it's assumed Debbie will be able to remain in the 24% bracket if she utilizes NUA even with the $60,000 of additional ordinary income, however it's understood this may not ultimately be the case. Should the NUA distribution push Debbie into higher marginal tax brackets, this would negatively affect the outcome of the NUA strategy.

Utilizing the NUA calculator, the following inputs are assumed:

- **$100,000** fair market value of stock
- **$60,000** cost basis
- **10** years until distribution
- Assumed **6%** rate of return
- **24%** combined marginal tax bracket at time of initial NUA distribution
- **15%** long term capital gain rate at time of initial NUA distribution
- **22%** marginal tax bracket at time of final distribution
- **15%** long term capital gain rate at time of final distribution

Given these inputs, the final value of the NUA strategy is $4,252 less than rolling everything over to an IRA at retirement. Even though the total amount of taxes will be less with the NUA strategy, $14,400 of principal is lost to taxes in year one when utilizing NUA. Therefore, instead of $100,000 growing at 6% for 10 years before any taxation, only $85,600 is available to grow in a taxable account for the same 10 years.

If Debbie waited until calendar year 2023 before utilizing the NUA strategy, thereby assuming a 22% marginal tax bracket for the full NUA distribution amount, the NUA strategy still loses by over $2,100.

Debbie decides to roll everything over to an IRA and properly diversify her investments for retirement. She will then slowly make distributions from the IRA over time in an attempt to keep her marginal tax bracket in retirement as low as possible.

CASE STUDY 3: PARTIAL NUA

Dan has worked at his current employer for 30 years and will retire on January 1, 2019, at age 65. Dan is married and anticipates he will be in the 22% marginal tax bracket in retirement. He lives in a state with high state income taxes.

Dan has $1,000,000 in company stock in his 401(k) and ESOP plan. The total cost basis of the shares is $450,000 and the company's retirement plans administrator keeps specific share cost basis. Some of the earliest shares purchased have cost basis as low as $1 per share. Dan also has considerable additional monies in his 401(k), profit-sharing plan and taxable investments to support him and his wife in retirement.

Many of Dan's colleagues have already retired and taken advantage of NUA and he's wondering if he should do the same. However, Dan's financial advisor reminds him that he doesn't need to utilize the NUA strategy on all of his shares and that to do so would mean immediately paying ordinary income taxes at the federal and state level on the total $450,000 of cost basis. They also consider the diversification risk involved with holding $1,000,000 of company stock indefinitely in retirement.

With these factors in mind, Dan's advisor recommends that he uses the NUA strategy for only a small portion of his $1,000,000 in company stock. After calling the company administrator, Dan determines that he can withdraw $100,000 of company stock with the lowest specific share cost basis of only $10,000. This will only add $10,000 of ordinary income to Dan and his wife in 2019 and will allow them to pay capital gain taxes on $90,000.

Dan decides to move forward with the NUA strategy on the $100,000 of lowest cost basis shares. He plans to sell the shares in the first couple of years of retirement as needed for living expenses. As for the remaining $900,000 in company stock and the rest of his 401(k) investments, Dan will roll over those assets to an IRA and diversify them for retirement.

These case studies are for illustrative purposes only. Individual cases will vary. Any information is not a complete summary or statement of all available data necessary for making an investment decision and does not constitute a recommendation. Prior to making any investment decision, you should consult with your financial advisor about your individual situation

Please note, changes in tax laws or regulations may occur at any time and could substantially impact your situation. While familiar with the tax provisions of the issues presented herein, Raymond James financial advisors are not qualified to render advice on tax or legal matters. You should discuss any tax or legal matters with the appropriate professional.

RAYMOND JAMES®

INTERNATIONAL HEADQUARTERS: THE RAYMOND JAMES FINANCIAL CENTER
880 CARILLON PARKWAY // ST. PETERSBURG, FL 33716 // 800.248.8863