Personal Finance

GO TAX FREE 2

17 Ways to Get More Choice and Control Over Your Investments and Taxes

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TO NUA OR NOT: WHAT TO DO IF YOU OWN COMPANY STOCK IN YOUR 401K

White Paper

ABSTRACT

Owning your employer's stock within a qualified plan (like a 401k) presents opportunities that are both exciting and complicated. A little-known tax rule called Net Unrealized Appreciation (NUA) may significantly reduce and expedite your taxes. This paper discusses the pros and cons and gives you enough knowledge to make a better decision over the long haul.

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Absolute: Owning your own company stock in a qualified plan gives you some choice and control over when and how much to pay in taxes.

Our Friend, Ted

Ted worked at the same company for 15 years during a time of significant growth, and change. During this time, the founders retired and sold the stock to the employees, like Ted. Our friend ended up with a significant amount of his employer's stock in his 401k.

When it came time for Ted to leave the company, he was presented with a unique opportunity that he had never heard about before, called NUA: Net Unrealized Appreciation. He came to us for advice, and we walked through the pros and cons. We talked with his CPA and ran through different scenarios to help him make a decision that was right for his family, over a timeframe that was meaningful to them.

For his situation, Ted decided to split the difference. He would take some of his equity as NUA and, for the rest of it, he would not take advantage of NUA. This paper explains why.

Net Unrealized Appreciation, Some Absolutes

Let's define Net Unrealized Appreciation (NUA) and layout absolute truths about how this tax savings strategy works. [i,ii]

Net Unrealized Appreciation: The increase in value of equity shares owned by an employee, when the shares are held in qualified account like a 401k. The IRS provides a tax advantage for the owner if certain qualifying events are met.

NUA Changes a High Income Tax Rate into the Lower Long-term Capital Gains Tax Rate

The first advantage of NUA is that it saves taxes, usually, by taking money out of an IRA and taxing it at a long-term capital gains tax rate instead of a marginal income tax rate. Furthermore, it is only the long-term capital gains tax and not the Medicare Surtax that must be paid; at the time of writing, this saves another 3.8%.

Regardless of how long the employee has owned the equity inside the qualified plan, NUA is taxed at long-term capital gains rate.[iii]

NUA Cost Basis

Only own-company equity shares may be transferred out of the 401k plan and into an investment account. The only investments inside a 401k that may be transferred in kind are own-company equity shares. Everything else must be sold and transferred as dollars. NUA provides an exception to that rule.

If the employee's own-company shares, subject to NUA, are transferred in-kind to a taxable account, then the owner must pay income tax on the basis of the shares in the year of transfer. This is a strange and important point. Usually cost basis determines how much an employee does not pay in taxes. But this is reversed in a NUA situation. NUA shares sit in a qualified plan where the employee has never paid income taxes, and thus she must pay taxes on the way out.

NUA cost basis: price paid for the company stock. When an employee owner transfers her shares to a taxable account, she must pay INCOME tax on the NUA cost basis.

Importantly, a NUA transfer makes a person pay income tax in the same year as the transfer. The employee owner adds the NUA cost basis on top of her income to calculate the income tax liability. The NUA cost basis is the employee owner's highest percentage tax burden, the marginal income tax bracket. For more details, refer to *Go Tax Free*.

The good news is that the income tax burden is only due on the price the employee paid for the stock—not the current value. Thus, NUA works best for highly appreciated stock. See further the example below, *Our Friend Ted, Continued*.

The best advice is usually to sell immediately after a NUA distribution and diversify at that point.

NUA is a Choice

An employee-owner does not have to transfer any of the own-company equity to a taxable account. An employee owner may transfer the 401k to an IRA tax-free.

If she chooses to not take advantage of NUA, then all taxes are deferred until her retirement, or the year she must make a required minimum distribution (currently age 72). If she does this, then NUA is gone and every dollar that comes out of the IRA is taxed at the highest marginal income tax rate.

NUA Requires a Lump Sum Withdrawal of Everything

To use NUA strategy, our employee owner must perform a lump sum withdrawal. The entire balance in the account must be transferred. Nothing can remain. Not all of the money must use a NUA strategy. Some money may rollover to an IRA. But all of the money must leave the qualified plan before the year's end.

Triggering events

Our employee owner may not use a NUA strategy if she is currently employed at that employer, unless she is age 59 ½ or older. She may use the NUA strategy if she becomes disabled. Her beneficiaries may use it if she passes away. And she may perform a NUA strategy after she separates from service. Note, however, separation of service before age 59 ½ will cause a 10% early withdrawal tax penalty on the NUA cost basis (not the full fair market value).

> *A 10% early withdrawal penalty applies to the cost basis of the shares that transfer using a NUA strategy if the owner is under age 55.*

One Unnecessary Complexity Easily Avoided

If an employee owner decides to use a NUA strategy and then hold onto the equity after she distributes it from her employer's plan, she adds a new complexity to her tax situation. Now she has two capital gains rates to track:

1. Whatever she's earned while the equity was in the plan is always taxed at long-term capital gains rate.
2. Whatever happens to the equity price after distribution has a second capital gains rate.

Gains or losses are short-term if she sells within 12 months of distribution. Gains or losses are long term if she waits 366 days.

> *It bears repeating: the best advice is usually to sell immediately after a NUA distribution and diversify at that point.*

In the real world, it may take a few weeks between the distribution date and the sale date if the employer sends a paper copy of the securities (or a paper statement of ownership). Thus, there may be a short-term gain or loss.

Our Friend Ted, Continued

Following our example, if Ted purchased the stock for $12 and the current value was $100, then his income tax burden due this year would be on the $12 share price. If Ted decides to roll-over his account into an IRA, eventually he will pay income taxes on the future value of the investments—if it never grew, it would be $100.

Ted owns 100,000 shares. He has $1.2 million cost basis and a $10,000,000 investment in his company stock. This is Ted's single largest asset. If he decides to take advantage of NUA, then he's looking at an immediate tax burden at the highest marginal income tax bracket: 37% this year.

Cost basis of NUA shares	Marginal Income Tax Rate	This Year's Tax Burden
$1,200,000	37%	**$440,000**

From here forward, these investments are going to be taxed-as-earned. With the help of a prudent financial advisor, the annual taxation could be controlled. Ted can spend this money as he sees fit, without having to account for an additional tax burden of an IRA withdrawal.

In spite of the 10% early withdrawal penalty, the NUA strategy allows younger owners to access retirement funds that are otherwise locked up.

Absolute Truths about a NUA Strategy

Here are a few absolute truths about a NUA strategy:

1. NUA is optional. An employee may use NUA for some, all or none of the shares.
2. NUA may save taxes over the long term.
3. NUA increases taxes over the short term (always).
4. NUA works best for highly appreciated equity—the higher, the better.
5. NUA requires a lump-sum withdrawal and certain triggering events.

NUA May Save Taxes Over the Long Term

It might seem apparent, at first glance, that NUA saves taxes. But the nuances of NUA are important. Let's take a look at Ted's example. He could either do a rollover over use a NUA strategy. If he chooses a rollover, he defers the income tax until a later date. But the taxes are still due—so we will compare the results on an after-tax basis.

		Inc Tax	LTCG Tax	Total Tax
Rollover	37%	$3,700,000		$3,700,000
NUA Strategy	20%	$ 444,000	$1,760,000	$2,204,000

The NUA strategy saves Ted nearly 15%, $1.496 million. It seems like a no-brainer!

Indeed, for owners of companies with significant gains, a NUA strategy can save a lot of money. But the caveats are important.

Age 59 ½ Works Best for a NUA Strategy

The NUA stock is in a qualified account, and subject to qualified withdrawal rules. If a person is under the age of 59 ½ and makes a NUA withdrawal, the IRS imposes a 10% penalty on the NUA cost basis. In Ted's case, this effectively wipes out $120k of NUA benefits.

	Inc Tax	LTCG Tax	10% Penalty	Total Tax
Rollover	$3,700,000			$3,700,000
NUA Strategy	$444,000	$1,760,000	$ 120,000	$2,324,000

Counting the penalty tax, Ted is still ahead.

Age 55 May Also Be Good

In another twist in the NUA rules, an employee who separates from service in the year she turns age 55, or older, may make a NUA transfer and avoid the 10% penalty. This falls under the early retirement rules. So, really the NUA rules apply for folks above age 55—but it might be important to know the differences. Why?

Because they are two different triggering events! A person who separates from service who is at least age 55 but younger than 59 ½, has her first triggering event. She may make a withdrawal from her 401k without penalty—but with income taxes—to do anything she wants. Then, when she reaches age 59 ½ , she could follow a NUA strategy because it was a second trigger.

Theoretically there are two other triggers—disability and death—of course no one plans for either!

Separated from Service is Good

A person who is separated from service may follow the NUA strategy. However, if they are under the age of 55, she receives no additional protection from the 10% penalty rule. She must pay 10% of the NUA cost basis in additional tax.

NUA Works Best Over Time

The most advantageous way to use a NUA strategy in a real-life financial planning situation is to consider the length of time that a person will own all of the investments—not just the individual equity.

Taking two steps back, a person separated from employment has no need to own the company equity nor any particular insight into the company. The more time passes, the more important it is to separate from the former employer financially, and in other ways as well. The risks only grow as time passes.

Furthermore, a portfolio that consists of some of the best run companies in the USA and the world will provide a more meaningful, pleasant journey over the duration of a person's life than will any individual equity, subject to the whims of Wall Street and other vagrant forces. Diversity is humility in the face of the great unknown future. Spreading out the risks is prudent.

Finally, with proper guidance, a person can exercise choice and control over when and how much taxes to pay. With a NUA strategy, the proceeds will be put into a taxable brokerage or advisory account. The prudent management of the investments and their (eventually taxable) gains is a determinant of a person's success. In comparison, choosing not to NUA means that the investment decisions can be made free of tax issues because the entire account is tax deferred.

There are advantages to either strategy, and time will compound the differences for the better, or worse.

Taxed at Death

NUA shares do not receive the same favorable tax treatment as other investments. NUA shares will be taxed as income in respect to the decedent, whereas other equities receive a step-up in basis. There is no estate tax advantage to owning NUA shares until death.

NUA Increases Taxes in the Short Term (Always)

As an absolute rule, NUA causes a tax burden this year and likely next year as well. So an investor has a choice to make.

If the employee owner is not already in the highest marginal tax bracket, then she may choose the NUA strategy for a certain amount of her shares that keeps her in one of the lower tax brackets. This can increase the benefits of the NUA strategy in the short-term. Perhaps surprisingly, it also decreases the benefits over the long term if she is going to stay in one of the lower tax brackets as she ages.

Ted in a Lower Tax Bracket

Let's imagine that Ted is in the 24% marginal income tax bracket now. Let's say that his income is $100,000 away from pushing him into the next higher tax bracket, and so he wants to use a NUA strategy that keeps him in this low tax bracket. If all of our other assumptions remain true, Ted may choose 1,000 shares for the NUA strategy.

Income tax rate	**24%**
LTCG rate	15%
Amount of room to stay in tax bracket	$100,000
Number of shares	1,000

The percentage tax savings are huge, nearly 8% savings. But the absolute dollars are small.

		Inc Tax	**LTCG Tax**	**Total Tax**
Rollover	24%	$24,000		$24,000
NUA Strategy	15%	$ 2,880	$13,200	$16,080

In this example, the percentage savings are large but the absolute dollars might not be enough to make a difference. Usually NUA works best for large conversions on equity with large gains when the benefits will be realized over a long period of time.

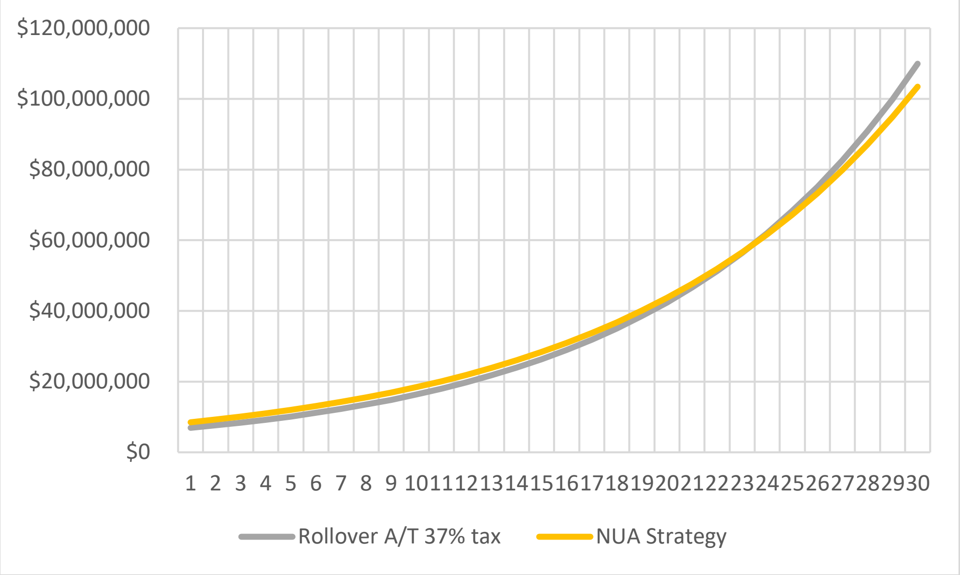
Situations When NUA May be More Expensive than Deferral

The biggest benefits for investing are gained from the time value of money. The NUA strategy takes money out of a tax-deferred account and puts it into an account that is taxed-as-earned. Taxes must be paid on the NUA proceeds include short-term and long-term capital gains, qualified and non-qualified dividends. This is "tax drag" and can significantly reduce the benefits of the NUA strategy over time.

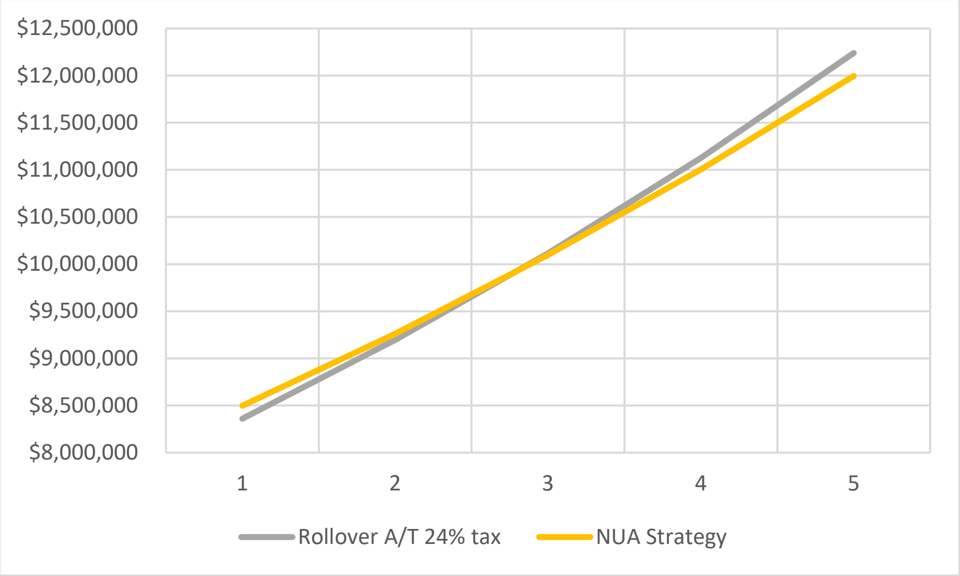
If Ted has two accounts, both earning 10% per year, but one of them has a tax drag of one percent, then his after-tax gains on the NUA strategy are only 9%.

	Returns	**Initial investment**
Rollover	10%	$10,000,000
NUA Strategy	9%	$7,796,000

The NUA strategy benefits shrink as time passes. The following chart assumes Ted stays in the highest marginal tax bracket. The Rollover makes more sense—and the NUA makes less sense—later in life. A simple way to think about it is the cross-over point. In 23 years, the rollover provides more spendable money.



If Ted falls into a lower tax bracket later in life, then quickly the traditional rollover makes even more sense for his family. The next chart assumes he falls into the 24% bracket. The crossover point is only three years away for a lower tax bracket, when the rollover provides more spendable money than the NUA strategy.



A qualified financial advisor can do a scenario analysis and forecast what it might look like for a given portfolio. Tax drag may be more, or less, on any given account.

"One straightforward approach is simply to set a cost basis threshold – for instance, don't do NUA for any stock with basis more than 20 cents on the dollar.[iv]

Sometimes a simple rule makes it easy to make a decision. Consider a good rule of thumb to be the 20% rule. Don't follow a NUA strategy if the cost basis is greater than 20% of the fair market value. Again, talk with your CFP and CPA to make the right decision.

Lowest Basis Shares into NUA, Defer the Rest

Because of the rules we talked about herein, the strategy that may be best is to cherry-pick the shares with the lowest cost basis and utilize a NUA strategy for them, while the rest of the shares are deferred until later. This way, the maximum amount of money gets taxed at the low long-term capital gains rate, and the majority of it is taxed as late as possible. Plus, this way the employee owner doesn't have the risks of having too large a portfolio wrapped up in one stock.

Average cost basis: Some companies use an average cost basis and will not allow an employee owner to cherry pick the lowest cost basis shares. It is important to ask the employer.

Let's look at Ted's situation a little closer. He has 100,000 shares, and in all of our previous examples, we've assumed a $12 per share price. However, the odds are good that he has purchased shares at different prices over the years, something like the following:

Date	Shares	Price	Date	Shares	Price	Date	Shares	Price
15 yrs ago	1,000	$12.00	10 yrs ago	4,000	$15.00	5 yrs ago	7,000	$40.00
14 yrs ago	1,500	$12.50	9 yrs ago	4,500	$18.00	4 yrs ago	7,500	$50.00
13 yrs ago	1,750	$10.50	8 yrs ago	5,000	$23.00	3 yrs ago	8,000	$60.00
12 yrs ago	2,250	$11.50	7 yrs ago	5,500	$26.00	2 yrs ago	20,000	$80.00
11 yrs ago	5,000	$13.50	6 yrs ago	6,500	$30.00	1 yr ago	20,500	$90.00

If Ted were to choose the oldest shares with the lowest cost basis, he would benefit the most from the NUA Strategy. Consider the math for the first tranche, from 15 years ago. Again, we'll compare the after-tax values, and compare it to the deferred "rollover tax."

shares	Basis/share	FMV/share	Rollover tax	NUA Strategy	NUA Savings
1,000	$12	$100	$37,000	$22,040	$14,960

The first five years, shown in the first column above, has a weighted average cost basis of $12. This makes the results similar to those shown in the rest of this paper.

shares	Basis/share	FMV/share	Rollover tax	NUA Strategy	NUA Savings
11,500	$12	$100	$425,500	$253,460	$172,040

Every year thereafter the cost basis increased, which reduces the NUA benefits he could realize today and in the future. The declining tax advantages brings up a final point for consideration:

> *Is it worth it to use NUA if your company stock has not had significant gain?*

This is a question to ponder with a prudent and capable financial advisor.

Next Steps and Questions to Ask

To decide whether a NUA strategy is right for you, find answers to these key questions and seek the help of a competent and experienced financial advisor and tax expert to help you calculate your costs today, and likely costs over the long haul.

1. Does the employer use an average cost basis for NUA shares? Or does the employer allow you to select which shares (called "lots") with the lowest cost basis to sell?
2. What is your income tax rate and long-term capital gains tax rate this year without NUA?
3. What will these same tax rates be with NUA?
4. In other words, what is the incremental cost of a NUA strategy this year?
5. What do you expect the income tax rate to be in the future—no later than the age of required minimum distribution(RMD)? At the time of printing, RMDs start at age 72.
6. What do you expect for future capital gains tax rates?

If you do not want to forecast future tax rates, then use today's tax schedule. Email info@assetsandincome.com for a NUA decision tool.

Afterward

For up to date information, including tax brackets and more financial planning ideas, visit www.gotaxfreebook.com

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i. IRC Section 402(e)(4) is the section of the code that deals with Net Unrealized Appreciation.

ii. Treasury Regulation 1.411-8(b)(4)(ii) states that the 3.8% Obamacare surtax on net investment income does not apply for NUA.

iii. IRS notice 98-24 https://www.irs.gov/pub/irs-drop/not98-24.pdf states "the actual period that an employer security was held by a qualified plan need not be calculated in order to determine whether, with respect to the net unrealized appreciation, the disposition qualifies for the rate for capital assets held for more than 18 months."

iv. Michael Kitces, https://www.kitces.com/blog/net-unrealized-appreciation-irs-rules-nua-from-401k-and-esop-plans/, accessed in August, 2020.

About the Author

Karl Frank is a Certified Financial Planner® and owner of A & I Financial Services LLC, a Colorado based wealth management business founded in 1986.

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In the winter, you can find Karl and his family skiing the Colorado slopes.

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