WELLS FARGO Advisors

Net unrealized appreciation (NUA)

Net unrealized appreciation (NUA) is a tax planning strategy that you should understand when facing a decision about your qualified employer sponsored retirement plan (QRP) distribution. Many individuals participate in QRPs — generally 401(k)s — that include investments in employer securities. Employer securities might include stocks, bonds, or debentures with the employer company, a parent company, or a subsidiary company. A mistake that many participants make is rolling this stock into an IRA when they change jobs or retire without considering alternatives. This decision can be costly.

What is NUA?

NUA is defined as the difference between the value at distribution of the employer security in your plan and the stock's cost basis. The cost basis is the original purchase price paid within the plan. Assuming the security has increased in value, the difference is NUA.

NUA of employer securities received as part of a QRP eligible lump-sum distribution qualifies for capital gain tax. In most cases, NUA will be available only for **lump-sum distributions** — partial distributions do not qualify.

GENERAL RULE: You will owe ordinary income tax on the cost basis of the employer security in the year of distribution. The appreciated value is taxed at the long-term capital gains rate when the stock is sold. Since the appreciated value is taxed as long-term capital gains instead of ordinary income, and the long-term capital gains rate is generally lower than ordinary income tax rates, it is important to evaluate this strategy before taking a distribution from your QRP.

NUA treatment can be lost

NUA treatment is lost if you directly roll your QRP assets to an IRA or another employer's QRP. However, you will owe no tax on the rollover. Instead, the securities are taxed as ordinary income when they are eventually distributed.

Lump-sum distribution

An eligible lump-sum distribution is the payment or payments, within a single tax year, of your entire balance from all your employer's qualified plans of one kind (for example, pension, profit-sharing, or stock bonus plans). A lump-sum distribution is generally one that was paid:

- After you attain age 59½
- When you leave your company at any age (not applicable to self-employed individuals)
- Due to your death

Your qualified lump-sum distribution will typically allow you to roll over all or part of the distribution to another QRP or IRA. No tax is currently due on the part rolled over. If you keep any of the distribution, you must report the entire taxable part as ordinary income for that tax year.

NUA hypothetical examples

We'll use a hypothetical case study to clarify the issues. Elena, as a participant in her employer's 401(k) plan, owns 10,000 shares of company stock. These shares, over the years, were purchased at a total cost of $40,000. Elena retires at age 65 and needs to decide what to do with the shares. The fair market value of these employer securities at the time of distribution is $100,000, all of which is before-tax.

Investment and Insurance Products: • NOT FDIC Insured • NO Bank Guarantee • MAY Lose Value

Let's look at some of the options Elena might choose:

- **Transfer the stock into an IRA or sell stock and transfer cash to an IRA**. Elena will pay no current income tax if she rolls her QRP to a Traditional IRA. She will then treat any future distributions from her Traditional IRA as ordinary income and pay tax at ordinary income tax rates. Elena could roll the stock into a Roth IRA, but that would be considered a Roth conversion. She would owe ordinary income tax on the $100,000 in the year of the conversion. Any desire to take advantage of the NUA tax strategy in the future would be lost once the stock is rolled into either a Traditional or Roth IRA.
- **Transfer the stock into another QRP or sell stock and transfer cash to another QRP.** This option would only be available if Elena went to work for a new employer and the new QRP allows the movement of assets into that plan. Elena will pay no current income tax if she transfers to a new QRP. However, any desire to take advantage of the NUA tax strategy in the future would be lost.
- **Distribute the stock into a non-IRA retail brokerage account, then sell the stock and pay taxes on the gross proceeds.** Elena will be taxed at ordinary income tax rates on the $40,000 cost basis of the employer securities. If the stock is sold immediately, $60,000 NUA or the growth over the cost basis of $40,000 will be taxed as a long-term capital gain.
- **Distribute the stock into a non-IRA retail brokerage account, but wait to sell the stock.** Elena will be taxed at ordinary income tax rates on the $40,000 cost of the employer securities. However, in this example she waits three months to sell the stock. The value of the shares has increased by $3 per share for a total portfolio value of $130,000. While the original $60,000 gain attributable to NUA will still be taxed as a long-term capital gain, the $30,000 appreciation will be taxed as a short-term capital gain. Therefore the $30,000 plus the $40,000 will be taxed at ordinary income tax rates.
- **Distribute the stock into a non-IRA retail brokerage account, but wait to sell the stock.** If Elena had waited for 12 months or longer after the plan distribution to sell the stock, all earnings over the initial cost basis of $40,000 would be taxed as long-term capital gain, no matter the value of the stock.

Keep in mind

- You may face the IRS additional 10% pre-59½ tax (10% additional tax) in addition to ordinary income tax on distributions from your QRP.
- You will have 60 days to roll over the stock or proceeds.
- This must be a qualified lump-sum distribution.
- Know your plan and consult with your plan administrator.
- Please consult your tax advisor before taking any distributions from the plan.

Questions to ask

Consider the following questions if you have employer securities in a QRP and want to review some of the options available to you:

- What is the cost basis for the employer stock you own in your QRP in relation to its current value?
- How do you feel about keeping the securities or selling them?
- Do you expect the securities to increase or decrease in value?
- Given the relative value of your employer stock as compared to your total portfolio, how important is it that you diversify?
- Do you expect your federal and/or state income tax rates to increase or decrease in the future?
- Could years of tax-deferred growth in an IRA provide a greater benefit than long-term capital gains treatment?
- Do you have the funds needed to pay for the tax liability?
- Will you owe the 10% additional tax on the cost basis?
- What is the difference between your ordinary tax rates and long-term capital gains rates?
- The decisions surrounding employer securities in a QRP are complex. You should analyze your individual situation with a qualified tax or legal advisor.

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