Net Unrealized Appreciation

Quick-Take: When the market is a rollercoaster ride, its time to consider the net unrealized appreciation (NUA) tax strategy.

Background: The net unrealized appreciation allows gains from employer stock held in a retirement account to be taxed at long-term capital gain rates. Only the cost basis of the employer stock is taxed as ordinary income tax rates, which is the basic rule for the taxation of distributions from a retirement account. This strategy allows an individual to pay ordinary income tax on the cost basis of company stock from his/her workplace retirement plan, and long-term capital gains on the stock's appreciation. In short, an employee-participant could look at the drop in company stock held in their 401(k) account as an opportunity to establish a new basis for their stock. A couple of examples explain this strategy.

Example: Nora, age 55, participates in her employer's 401(k) plan. Within Nora's 401(k) account she owns shares of stock issued by her employer in which she has an average cost basis of $50 a share. When the stock market was at its highest, that stock reached a price of $80 a share. Then comes along the tariff wars. Nora's company stock has suddenly dropped to $40 a share. Nora sells all her company stock held in her 401(k) account and she then promptly buys back the company shares at $40 a share. By doing so, Nora has reestablished her cost basis in her company stock at $30 a share. [The *wash-sale rule* does not apply to Nora's sale-buy back situation.) If this company stock rebounds in value over the following years, Nora has created a more favorable NUA distribution as she nears her retirement years.

NUA 'Refresher': It is important to remember some of the pros and cons to the NUA rules.

Capital Gain Tax on Company Stock: When taking company stock out of a 401(k) account, the participant can defer taxes on the NUA portion of the distribution until the stock is sold. At that point, the NUA is taxed at long-term capital gains rates. The balance of the distribution is taxed as ordinary income tax rates when received as the balance of the distribution from the qualified plan account.

IRAs: If the participant maintains a separate IRA in which he/she has invested in their company's stock, he/she cannot apply the NUA to the appreciation of the company stock held in their IRA

Lump Sum Distribution: However, to take advantage of the NUA tax rules, the participant must take a lump-sum distribution, which involves withdrawing all his/her company stock from the 401(k) and any other sponsored retirement account(s) of the same type in a single taxable year. This is not a strategy that can be used piecemeal; it is an all-or-nothing strategy that requires careful planning.

Timing: The lump-sum distribution must also be taken by the plan participant because the participant leaves their job, reaches age 59 ½, becomes disabled, or dies.

No Lump Sum Distribution: If there is no lump-sum distribution, tax is only deferred on the NUA that results from nondeductible employee contributions to the retirement account. Any NUA that results from deductible voluntary employee-participant contributions to the retirement account is taxed in the year of the distribution.

Opt-Out: An employee-participant can also opt-out of these NUA rules. Accordingly, the participant would elect to include NUA in his/her taxable income for the year in which he/she receives it. If the participant was born before January 2, 1936, and he/she goes this route, he/she might be able to calculate the tax on his/her NUA using an alternative method, such as 20% capital gains election, or the 10-year tax option [which is well beyond my paygrade to explain.]

NIIT: The net investment income (NIIT) surtax does not apply to NUA. But it does apply to any increase in the company stock's value after it is taken out of the participant's retirement account.

Selling High, Buying Low Rick: The most obvious point to this NUA strategy to reset basis in company stock is that it involves market timing, which carries significant risk. The strategy is based on sell-high-buy-low principle, which can easily get reversed, since it is premised on the participant knowing when to buy back the company stock in their retirement account. We know only too well that market timing is impossible. Selling out the company stock and then buying it back at a higher share price can ruin what was thought to be a solid NUA opportunity.

Conclusion: Resetting the NUA tax basis is an intriguing tax planning strategy, just so long as you recognized that it could go both ways and potentially blow up in your face.