Qualified Plans and the Net Unrealized Appreciation Rules

Take-Away: As a generalization, any distribution from a qualified plan (401(k) or an IRA is taxed as ordinary income to the recipient. However, there is the exception when a qualified plan holds stock in the company that sponsors the qualified plan, where the company stock will be taxed at long term capital gains rates if certain conditions are met.

Background: Some employers offer company stock as part of the qualified retirement plan that they sponsor, like a 401(k) plan. The Tax Code gives special favorable treatment to certain distributions of employer securities or stock; securities could be stocks or bonds. [IRC 402(e)(4)(E).] Some employer plans hold the employer securities inside some type of 'single stock fund' rather than directly.

Tax Benefits: Tax benefits can arise with this company stock, and particularly the **net unrealized appreciation, or NUA,** of that company stock NUA is the excess of the stock's fair market value at the time of distribution over the qualified plan's basis in the stock. [Regulation 1.402(a)-1(b)(2)(i).]

Basis, Not Gain, Taxed: The NUA is excluded from the participant's gross income at the time the securities are distributed to the participant. [IRC 402(e)(4)(A)(B). Consequently, the participant is liable for income tax (and the 10% early distribution penalty, if applicable) **only on the plan's basis in the company stock.**

Capital Gain Tax on NUA: When the company stock is later sold, the NUA is **taxed as long-term capital gain, regardless of how long the recipient (or the plan) held the stock.** [Regulation 1.402(a)-1(b)(1)(i).] The sales proceeds attributable to the NUA and any post-distribution gain are not subject to the early-distribution penalty.

NITT: Capital gain income realized on the sale of NUA stock, to the extent that it represents appreciation during the period the stock was incise the qualified plan, is not subject to the net investment income tax (NITT) because it is a retirement plan distribution. However, any gain that represents post-distribution appreciation will be subject to the NITT. [Regulation 1.1411-8(b)(4)(ii).]

IRD: The IRS has concluded that the NUA, like any other post-death retirement plan distributions, constitutes *income in respect of a decedent*, or IRD. If a participant's estate beneficiaries sell the company stock that is distributed to them from the qualified plan in a qualifying distribution, the NUA portion of the sales proceeds is long-term capital gain. Those beneficiaries will also receive an IRC 691(c) income tax deduction for the federal estate taxes paid on the NUA, if any.

To summarize, if the plan participant takes a **lump sum distribution in the same calendar year** of his/her retirement account, the NUA enables that former account owner to pay long-term capital gains tax on the growth of the company stock that occurred while the company stock was held in the owner's qualified plan account. When an NUA 'trigger' is activated, the plan participant does not have to act immediately on an NUA distribution. If the 'trigger' is activated by certain transactions, e.g., a normal distribution on termination of employment, the NUA lump sum withdrawal must occur within the same calendar year as the 'trigger.' If not, the 'trigger' to achieve the tax benefits will be lost. **Caution:** An in-plan Roth conversion is a 'distribution' which, in turn, will activate the NUA 'trigger.' Consequently, be careful if a Roth conversion of a 401(k) account holds company stock since that will require a lump sum distribution of the entire account within the same calendar year to take advantage of the NUA.

Step-up in Basis-No, and Yes: The appreciation in the company stock that is held in the qualified plan account prior to the lump sum distribution to the former plan participant **never receives a step-up in income tax basis**. If the company stock is still held by the former plan participant upon his/her death, the beneficiary who inherits the company stock will still have to pay long term capital gains tax on the NUA of the company stock, no matter when the company shares are sold. However, any appreciation in the company shares experienced **after** those company shares were distributed from the qualified plan **will receive a full step-up** in income tax basis on the death of the share owner.

Example: Ned, who retired 10 years ago, completed a proper NUA distribution of his company stock (lump sum, within one year.) The company stock was worth $500,000 when it was distributed to Ned. At the time of the lump sum distribution from the plan, Ned paid ordinary income tax on the cost basis of his company shares ($100,000) that he received; Ned expects to pay long term capital gains on the NUA of $400,000 when he decides sells the company shares. Ned, however, held all his company shares until his death, when the total value of those company shares had increased to $750,000. Ned's son, Jim, who inherits the company shares from Ned immediately sells the company shares. Jim will pay long term capital gains on the $400,000 of NUA. However, Jim will receive a step-up in income tax basis on the $250,000 of additional appreciation in the company stock after it had been distributed to Ned. Jim will owe no tax on that part of his sale of the company stock. The original $100,000 is also tax-free as a return of basis to Jim.

Value of Stock and its NUA: Retirement plans often use an 'average cost per share' to determine NUA of the company stock. As the years pass, as the company stock price goes up and down, the plan participant will acquire shares at different price points with each salary deferral. Yet the plan may not track all these different purchase prices of the company stock. Instead, the qualified plan could use the total purchase amount (i.e., the cost basis) vs the current value of the company stock. Note, however, that if the plan participant keeps detailed records and documents the historical company stock purchase prices, that participant could decide to only include the low-cost basis in an NUA transaction, while rolling the balance of the high-cost basis into an IRA and exclude those high-cost basis company shares from the NUA calculation, to avoid an 'averaging' of the cost per company share. By following a *specific identification method* to target the low basis company shares, a participant could further maximize the NUA tax strategy.

Age 55 Penalty: If a plan participant is under age 55 at the time he/she separates from service with their employer that sponsors the qualified plan that holds the company shares, he/she cannot leverage the age-55 exception (termination from employment in the Tax Code) to avoid a 10% early withdrawal penalty. However, with a NUA transaction before age 59 ½, (rolling over the non-stock funds) the participant would owe the 10% penalty only on the cost basis of the company shares distributed to the former plan participant from his/her account. If the appreciation of the company shares is high enough, it might be advantageous to pay the 10% penalty on the 'lower' cost basis in those company shares to preserve the long-term capital gain tax break on the NUA of the company shares.

Conclusion: While company stock is seldom encountered when a plan participant separates from service and takes a lump sum distribution from their qualified plan account, it is important to be aware of the possible benefits of NUA associated with the distribution of company stock. Some strategic planning with the company stock, like funding a charitable remainder trust, might be considered as well. Just remember to follow the 'lump sum in the same calendar year' condition to be able to qualify for the NUA tax-treatment.

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