“NUA? What’s that”

In most cases, when one receives a lump sum distribution from an employer’s retirement plan, the best tax option is to roll the entire amount over into an IRA. That preserves the tax deferral for the retirement money for years, potentially for decades.

However, there is an important exception to this conventional wisdom. If the lump sum includes employer securities, there is an alternative tax strategy to look at. The distribution of employer securities from an employee stock ownership plan or a 401(k) plan will have two components for tax purposes. First, there is the value of the shares when they were acquired by the retirement plan. Then there’s the growth in the value of the stock while it was held by the qualified plan, which is called *net unrealized appreciation* (NUA).

Choices

In the year that the lump sum is received, the cost of the employer securities will be taxable at ordinary income rates. The NUA will not be taxed until the shares are sold, and then it will be taxed at long-term capital gain rates. This is true even if the shares are sold in the same year as they are received.

Example 1. At retirement Oscar received 2,000 shares of Old Employer stock, valued at $100 per share. The average cost basis of the shares was $25. Accordingly, Oscar will have $50,000 of ordinary income, and $150,000 of NUA. If he’s in the top tax bracket of 39.6%, that comes to a $19,800 income tax.

Alternatively, Oscar could arrange to roll the employer securities into an IRA. Then he would pay no tax in the year of the distribution, and all his money would be growing to build a larger capital base for retirement. The trouble with that approach is that the NUA advantage is lost, as all the distributions from the IRA will be taxed as ordinary income.

If Oscar were to sell all the shares and realize the $150,000 gain, he would owe $30,000 in long-term capital gain taxes if he is in the top bracket of 20%. (Note that the 3.8% surtax that applies to investment income of top taxpayers does *not* apply to distributions, such as Oscar’s, from qualified plans). That’s roughly half of the tax he would pay when his IRA sold the shares and distributed the proceeds to him, assuming he’s still in the top tax bracket during retirement.

Having your cake and eating it, too

There is a middle ground to consider. In Private Letter Ruling 8538062, the IRS held that a partial rollover of employer shares to an IRA could eliminate income taxation in the year of the lump sum, and the remaining shares could still enjoy NUA treatment.

Example 2. Oscar rolls 500 shares of Old Employer stock into an IRA, with a value of $50,000. According to the ruling, the rollover defers the $50,000 of ordinary income that otherwise would be taxed. The remaining shares may be held in a taxable portfolio, and all of the NUA is attributable to them, so they have a cost basis of zero.

What happens when Oscar sells those shares in five years? Let’s assume that they have grown in value to $175,000. If Oscar is in the top tax bracket, and if capital gains tax rates have not been changed again by Congress, $150,000 of the gain will be taxed at 20%, and the remaining $25,000 will be taxed at 23.8%. Any growth in value after the distribution of the shares is not considered to be received from a qualified plan, and so is subject to the surtax.

One more twist

If Oscar has philanthropy as one of his estate planning goals, he might consider funding a charitable remainder trust with the employer securities received in the lump sum distribution. A charitable income tax deduction will be computed on the full fair market value of the shares. The charitable trust can sell the shares with no tax consequences. This can provide valuable portfolio diversification at no tax cost. Oscar may reserve a lifetime income for himself from the trust, and a portion of it may be taxed at long-term capital gain rates.

See your tax advisors

If your retirement nest egg will include employer securities from a qualified retirement plan, you will have a number of important decisions to make, decisions that will affect your retirement security for the rest of your life. See your tax advisors to learn more about your choices and work through the numbers.

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