

Understanding the NUA rule

Investors with highly appreciated company stock in a qualified plan may realize big tax savings

What is the NUA rule?

The federal tax laws contain a little-known rule that applies to certain distributions of company stock from the company's qualified plan. Under this rule, only the cost basis of the shares is subject to tax (and potentially an early withdrawal penalty) at the time of the distribution. In simple terms, the *cost basis* is what a person pays for the stock. The difference between the cost basis and the stock's current price is called the *net unrealized appreciation*, or *NUA*. The NUA is not subject to tax until the company stock is sold and will never be subject to an early withdrawal penalty. When the stock is sold, the NUA is subject to tax at capital gains rates — not ordinary income tax rates, which can be much higher. Additionally, the NUA is not subject to the 3.8% Medicare surtax on net investment income.* The favorable tax treatment for the NUA portion of company stock distributions is what we call the *NUA rule*.

Let's look at an example:

Company stock in employer retirement plan

The illustration assumes \$50,000 in company stock was purchased within a 401(k) plan and appreciated over time to \$300,000.

NUA = market value minus cost basis

\$300,000 (market value)

\$250,000 (NUA)

\$50,000 (cost basis)

* Internal Revenue Bulletin 2013-51, December 2013.

To qualify for the special tax treatment, there are certain guidelines that must be met

The distribution must be a lump-sum distribution.†

In general, a lump-sum distribution is a distribution of the participant's entire account balance within the calendar year taken on account of their separation from service, death, or disability, or after they have attained age 59½.

The company stock must be distributed in kind from the retirement plan.

The NUA rule does not apply if the stock is liquidated in the plan and distributed in cash or rolled over to an IRA. It is important to note that once the stock is rolled over to an IRA, the opportunity to use the NUA rule is lost.

However, any noncompany stock portion of a lump-sum distribution from an employer-qualified plan may be rolled over to an IRA (or another employer plan that will accept it), while the company stock portion is distributed in certificate form. So it is possible to keep the noncompany stock portion of the account (mutual funds, for example) growing tax deferred in a Rollover IRA, even though the entire account must be distributed in a lump-sum distribution to take advantage of the NUA rule.

Best-case scenario for the NUA

The NUA rule is most beneficial for people who have large amounts of highly appreciated company stock in employer-qualified plans. It will also primarily interest people who are willing to include a portion of their distribution in income right away (i.e., the cost basis of their company stock), and who can afford to pay tax on it.

† Lump-sum distributions are generally taxable for the year in which the withdrawal is made; and distributions made prior to age 59½ (unless separation from service occurs after age 55 or another exception applies) may be subject to an additional 10% penalty.

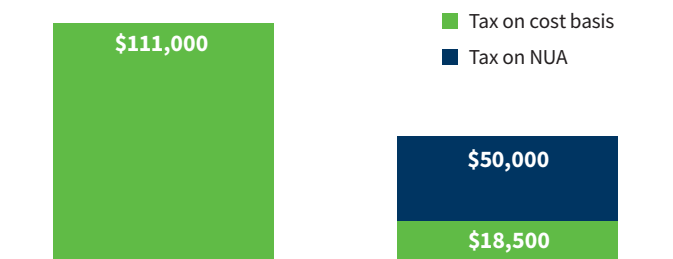
Suppose you have retired at age 60 after working for a company for many years. Let's assume that you have accumulated 5,000 shares of your company's stock in a 401(k) plan and the stock is trading at \$60 per share. The total market value of your company stock is therefore \$300,000. If the stock's cost basis were \$10 per share, your total NUA on the stock would be \$50 per share, or \$250,000.

Scenario one: Roll the stock into an IRA

If you were to liquidate your stock and withdraw it from the plan in cash (or roll your company stock into an IRA and then withdraw it), the entire \$300,000 would be taxed at your ordinary income tax rate. Assuming this rate is 37% (and there is no other income), your total federal tax bill on the company stock would be \$111,000.

Scenario two: Use the NUA rule

If you were to take a lump-sum distribution of your stock in kind, the NUA rule would apply, and you would pay two different tax rates. You would pay ordinary income tax (37% in this example) on the \$50,000 cost basis of the stock (\$10 per share, times 5,000 shares). That tax would be \$18,500.



Rollover IRA **without NUA rule** and 37% income tax bracket applied to total market value of stock.

Lump-sum distribution **using NUA rule** and 37% tax on cost basis, 20% on NUA portion.

Example based on highest marginal tax rates of 37% for ordinary income and 20% for long-term capital gains. Note that the 3.8% Medicare surtax on net investment income does not apply to retirement plan distributions, including NUA.

But if you immediately sold the shares after they were distributed from the plan, you would pay only 20% capital gains tax on the other \$250,000, or \$50,000. Your total tax bill therefore would be \$68,500 — almost \$50,000 less than if you had not taken advantage of the NUA rule. It is important to note that the market value and tax implications would vary if you decided to hold on to the shares after they were distributed from the plan and/or sold them at intervals over a period of years.

NUA or Rollover IRA?

Below are some high-level considerations you should keep in mind when deciding between the NUA strategy or a Rollover IRA. As always, you should consult your financial representative to determine what may be best for your individual needs.

If you	NUA	Rollover IRA
Realize significant market appreciation in company stock	✓	
Are in a high tax bracket	✓	
Are considering an immediate distribution	✓	
Are leaving stock to heirs	✓	
Want to defer taxes as long as possible		✓
Wish to diversify your holdings out of company stock		✓

Using the net unrealized “depreciation” strategy in a down market

Participants holding company stock within a retirement plan that has decreased sharply in value may want to consider resetting the cost basis of that stock by selling the stock within the plan and repurchasing it shortly thereafter. Unlike stock transactions outside of a retirement plan, the “wash sale” rule does not apply. Lowering the cost basis of the stock might improve the potential benefit of applying NUA treatment when distributing the stock from the plan in the future.

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