Menninger & Associates Financial Planning

TRICKS OF THE TRADE

NET UNREALIZED APPRECIATION (NUA)

Prepared by Michael Menninger, CFP

May 2020

Net unrealized appreciation (NUA) is a little-known rule among financial advisors, and even many accountants and tax preparers. This tax-advantaged rule applies to individuals who own their company stock inside their 401K and intend to rollover their 401K into a self-directed IRA.

In short, if an individual leaves their company and they own company stock inside the plan, they are afforded the one-time opportunity to carve out the company stock, pay ordinary income tax on the cost basis, and the growth portion becomes taxed as a long term capital gain. The tax code for the past 20+ years has always favored long term capital gains over ordinary income. Long term capital gains are ALWAYS taxed at a lower Federal tax rate than ordinary income, which is how 401K and IRA distributions are taxed.

Let's use this example of a real client, but with modified information. John Smith had a 401K worth $400,000, of which $100,000 was in ABC stock that he had been purchasing over the years. His cost basis (what he paid and subsequently got a tax deduction for) in the stock was only $20,000. When he retired, he opened an IRA and a regular non-qualified brokerage account. His IRA received a rollover of $300,000 and was not taxed, as per the standard rollover rules. However, the $100,000 in ABC stock was placed into a brokerage account, and he received a 1099 for $20,000, so he had to pay tax on $20,000 of ordinary income. The remaining $80,000 was considered long term capital gain, and he could have sold all of his stock and paid a reduced tax on the portion that was subject to capital gains tax.

In John Smith's case, he paid 22% Federal tax on the $20,000 of ordinary income and could have paid 15% capital gains tax on the remaining $80,000. Thus, he could save at least 7% tax (15% instead of 22%) on the $80,000, saving a total of $5,600 in tax. However, we structured it so that John withdrew the stock to supplement his cost of living for two years following his retirement, and we were able to keep his income below a threshold that enabled him to pay 0% Federal capital gains tax, because his income was lower in the next 2 years. This strategy saved John up to $17,600 in Federal taxes.

2605 Egypt Road, Suite 205, Trooper, PA 19403 | **O:** 610.422.3773 | **F:** 484.290.0113 | www.maaplanning.com
1035 B Mill Creek Drive, Feasterville, PA 19053 | **O:** 215.355.3426 | **F:** 215.355.5036 | www.jmefinancial.com

It is important to note that NUA may not work for the following reasons:

1. There needs to be enough gain in the stock to warrant paying tax on the ordinary income during the year of exercising NUA.
2. If the individual exercises NUA in a year that his or her taxable income is high, the cost savings may be overcome by the additional tax for taking the ordinary income in that year.
3. If an individual hasn't reached age 59.5, that cost basis receives a 10% early withdrawal penalty.
4. A 401K must be rolled over in its entirety, or else it is in ineligible for NUA treatment. So, if one took a withdrawal in prior years, NUA is not available.

In my 20-year career as a Certified Financial Planner, I have only seen this opportunity to be cost-effective about 8 to 10 times. This is due, in part, to the fact that we have had two significant market corrections in the last 20 years, notably between 2000 – 2002, and the global financial crisis in 2008. In both cases, stocks lost about 50% of their value, so their unrealized gains were not large enough to warrant NUA. That said, about half of our NUA cases have occurred within the last three years.

As you can see, being familiar with NUA rules can provide an extraordinary tax advantage to the client if they meet certain criteria. With many technology and healthcare businesses located in the area, there are likely many more individuals who would benefit from this little-known rule. Also note that this rule may also apply to companies who issue private stock, too, as we have had one client who met these criteria. So, if you (or anyone you know) are considering retiring in the near future and have been contributing to company stock for many years, we encourage you to give us a call to see if you could also benefit from this tax-advantaged strategy.