Net unrealized appreciation

Wealth Management

Net unrealized appreciation (NUA) is the difference in value between the amount that was paid for employer stock within your employer's qualified retirement plan (the cost basis) and the value of that stock when it is being distributed to you as part of a lump-sum distribution. This NUA may be important to you because there is a special tax treatment available for in-kind distributions of employer stock as part of a lump-sum distribution from your employer's qualified retirement plan.

What is the special tax treatment?

If you take the employer stock portion of your plan distribution in-kind, meaning you receive the stock and do not roll it into an IRA, you pay ordinary income taxes on your cost basis (price originally paid for the shares) in the shares when you take the distribution. When you sell the shares, you pay long-term capital gains taxes on the NUA.

How is this an advantage?

Although you pay taxes now on the cost basis, you defer income taxes on the NUA until you sell the shares. At that time, you pay capital gains taxes, which are currently lower than taxes on ordinary income. For example, your federal ordinary income tax rate might be as high as 37% while the highest federal capital gains rate is currently 20%. This could be a better option than rolling the stock into an IRA where all of its value will eventually be taxed as ordinary income.

What qualifies as a lump-sum distribution?

In order to be considered a lump-sum distribution for NUA:

- The entire balance from the plan (and all liketypes of plans offered by the employer) must be distributed to the participant within one tax year.
- The reason for the distribution must be separation from service, attainment of age 59½, or the disability or death of the participant.

Does the mandatory 20% tax withholding apply when I receive employer stock?

Employer stock distributed from a qualified employer-sponsored retirement plan is not subject to the mandatory 20% tax withholding. This exception to the 20% tax withholding only applies to employer stock and not to cash or other assets distributed.

Does the 10% early distribution penalty apply if I take a lump-sum distribution including employer stock?

Unless you are over age 59½ or you are separating from service during the course of the year in which you will attain age 55, you will have to pay a 10% penalty on the currently taxable amount of your distribution. In the following example where the employer stock taken in-kind had a cost basis of $100,000 and the cash received was rolled to an IRA or a new employer's retirement plan, the penalty would be 10% of the $100,000.

Am I required to take all of the company stock as an in-kind distribution?

You do not need to take all of the shares of your employer stock as an in-kind distribution. You may elect to use only a portion of your shares. You may even be able to select which specific shares are to be taken as an in-kind distribution, provided your plan allows you to select specific shares or "tranches" of shares (check with your plan's administrator), so that you can use your shares with the lowest cost basis.

What if some of the distribution is not employer stock?

Portions that are not employer stock may be rolled to an IRA or another employer's qualified retirement plan. They may also be taken as a taxable distribution.

NUA example:

Lynn left ABC Company with a 401(k) balance of $700,000 with $500,000 of ABC Company stock and $200,000 in cash. The cost basis in the ABC stock was $100,000.

1. Lynn takes the stock as an in-kind distribution transferred to a brokerage account and rolls the $200,000 in cash into her IRA.
   — Ordinary income tax is due on the $100,000 cost basis.
2. Five years later Lynn sells all of the stock for $1 million. Long-term capital gains tax is due on:
   — The NUA of $400,000 ($500,000 value less $100,000 of basis)
   — The increase in value since the day of the distribution of $500,000 (because it has been held for more than one year)

Additional benefits of NUA

- If you die without selling the stock after it has already been distributed to you from your qualified retirement plan, your heirs may get a "step-up" in the cost basis of the appreciated portion the shares (the appreciated portion is the increase in share value after the day of the distributions from the 401(k)). The NUA portion will not receive a basis adjustment and will be taxed at capital gains rates when the beneficiary sells the shares.
- Since the employer stock is not rolled into your IRA or a new employer's qualified retirement plan, the value is not subject to required minimum distributions when you reach age 73. You can control when to pay income taxes on the NUA portion.
- If you have charitable interests, you can avoid capital gains taxes on the NUA by gifting shares directly to a charity or to a charitable remainder trust. This may also provide you with a tax deduction and lower the value of your estate.

How RBC Wealth Management can help you

Your qualified employer-sponsored retirement plan may be the largest piece of your retirement income. How you handle this money at retirement can have a serious and long-term impact on your future. Your RBC Wealth Management financial advisor can work closely with you and your tax advisor to help you determine if a lump sum distribution from your qualified retirement plan is right for your specific situation.

Rollover vs. NUA considerations

Factor	NUA	Rollover to an IRA or retirement plan
Diversification intention	**Later** Generally better because appreciation on stock is subject to income tax at capital gain rates.	**Now** Generally better because there is no immediate income tax if asset is in an IRA.
Cash needs	**Now** Generally better because some of proceeds are taxed at capital gain rates.	**Later** Generally better because income tax is deferred until withdraw from IRA.
Original cost basis	**Low (less than 25%)** If the basis is low, there is less income tax at ordinary income tax rates at time of distribution.	**High (more than 25%)** If basis is high, it is generally better to defer income tax until distribution from the IRA.
Avoid 10% penalty income tax	**Age 55 and over (if separating from service)**	**Age 59½ or older**
Your personal tax rates	**Will increase** Generally better if you believe your income tax and capital gain tax rates will increase in the future.	**Will stay the same or decrease** Generally better if you believe you will be taxed at a lower rate at distribution.

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