

October 2017

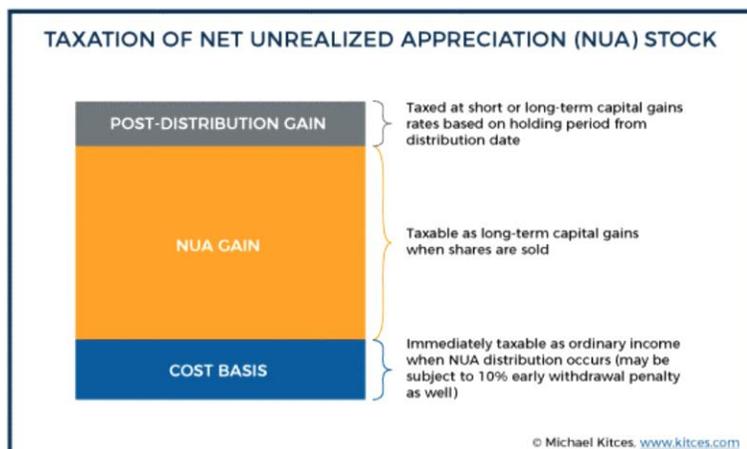
## Strategies for Employer Plan Participants that Hold Employer Stock...

Do you participate in an employer's retirement plan in which you own your employer's stock? Before selling shares or rolling your account over to an IRA, you should consider a special election that could save you significant tax dollars. For taxpayers with employer stock held inside a qualified employer plan, the IRS allows a special election to distribute those shares at their cost basis and recognize the appreciated gain at preferential capital gain tax rates (avoiding "ordinary" income tax rates).

This strategy is known as "Net Unrealized Appreciation" and is outlined in IRS code section 402(e)(4). The net unrealized appreciation is referring to the excess fair market value (FMV) of your employer shares over their cost basis. The election creates an immediate income tax liability on the cost basis of the distributed shares, but allows for continued deferral and favorable tax rates on the embedded and future gain.

There are three requirements to qualifying for and executing an "NUA" election strategy. First, the stock must be distributed out of your employer plan "in kind." Transferring stock "in kind" means you take distribution of the stock itself, not its liquidated cash value. Second, the NUA election must be made as part of a lump sum distribution in a single tax year. You can make the NUA election on all or a portion of your employer stock and make a tax-free rollover with the rest of your account. The rules only stipulate that the entire account must be distributed/rolled over in a single tax year. Lastly, the lump sum distribution must transpire from one of four situations: death, attaining age 59 ½, leaving the company, or disability.

Below is a chart that outlines the tax treatment of employer stock distributed in an NUA election ([www.kitces.com](http://www.kitces.com))



t: 503.905.3100 5335 SW MEADOWS ROAD, SUITE 450, LAKE OSWEGO, OR 97035

AS A FIDUCIARY, HUMAN INVESTING IS PASSIONATELY COMMITTED TO PUTTING OUR CLIENTS' FINANCIAL INTERESTS FIRST AND FOREMOST

For example, let's say you were a Nike employee and inside your 401(k) you hold 150k of Nike stock. Those shares have been purchased inside your 401(k) over a 20-year career and have an average cost basis of 50k. You retired last month and are looking to roll over your 401(k) assets into an Individual Retirement Account (IRA). Before making the rollover, you decide to make the NUA election on all your Nike stock. The distribution of those shares at their cost basis is immediately taxable at your ordinary income tax rates (i.e.  $33\% * 50k = \$16,500$ ). Those assets are now outside a qualified plan and all embedded and future appreciation can be realized at capital gain rates. Let's say you then held those Nike shares until they were worth 200k. That 150k gain ( $200k \text{ FMV} - 50k \text{ basis}$ ) would be taxable at 15%, or \$22,500. So, in total with an NUA election, you paid \$39,000 in Federal income tax. In contrast, by not making the NUA election, and rolling the entire 401(k) into your IRA there is no immediate income tax bill on the rollover, but all embedded and future gains are taxed at ordinary income tax rates. So, using the \$200,000 fair market value assumption, and a lower 25% Fed tax rate, your tax bill would be \$50,000 when drawn out of the rollover IRA account. The NUA election would have saved \$11,000 in Federal income taxes.

Because there is a tradeoff between recognizing income immediately on an "in kind" stock distribution (NUA election) and a full retirement plan rollover, the cost basis in those employer shares is a significant consideration. The lower the cost basis in the shares, the better. Studies have shown unless your cost basis is 50% or less of the stock's FMV at the date of distribution it is hard to make a case for the NUA election, and a full rollover to an IRA likely makes the most sense ([www.kitces.com](http://www.kitces.com)).

That said, everyone's situation is different and there are varying factors that may lead to one recommendation over another. Even your desire for charitable giving may weigh in on the decision. For example, let's say you were to make the NUA election and receive 100 shares with a cost basis of \$40 and a FMV of \$100; this would create 40k of gross income in the year of distribution. But, if you were to donate 40 of those 100 shares to a charitable organization or donor advised fund, you could create an offsetting 40k charitable contribution deduction. This offsetting deduction could mute the immediate income tax impact and leave you with 60 shares (60k value) that can appreciate at preferential tax rates outside of a retirement account.

There are a multitude of taxpayer specific situations and profiles that may or may not support making the NUA election. So, if you hold employer stock in a qualifying retirement plan and are getting close to retirement, looking to rebalance the account, or sell out of any of those employer shares, please reach out to us and see if an NUA election strategy makes sense for you.

If you would like to talk with one of our advisors please call Jill Novak at 503-905-3100.