Minimizing taxes with net unrealized appreciation

A NET UNREALIZED APPRECIATION STRATEGY MAY ALLOW FOR POTENTIAL TAX SAVINGS FOR INVESTORS WITH HIGHLY APPRECIATED COMPANY STOCK IN AN EMPLOYER-SPONSORED RETIREMENT PLAN.

IN A NUTSHELL

If highly appreciated company stock is held in an employer-sponsored retirement plan, transferring the shares in-kind to a taxable brokerage account may potentially be a better option than rolling the shares over to an IRA. An NUA strategy that applies to distributions from a brokerage account could potentially take advantage of the long-term capital gains tax rate, which is often lower than the ordinary income tax rate that applies to distributions from an IRA.

WHAT IS IT?

Net unrealized appreciation (NUA) is the difference between the price originally paid for a stock (the cost basis) and the current market value. For example, if an investor purchased a share of stock for $10 through an employer-sponsored retirement plan, and the share is now worth $50, the appreciation is $40. If the stock has not been sold, the $40 gain has not been realized, and is thus referred to as the net unrealized appreciation.

An NUA strategy allows the net unrealized appreciation of the stock to be taxed at the long-term capital gains tax rate instead of the ordinary income tax rate when sold in a taxable brokerage account. This strategy is relevant for individuals who own highly appreciated company stock in an employer-sponsored retirement plan, since the long-term capital gains tax rate is often lower than the ordinary income tax rate and may result in significant tax savings upon distribution.

HOW DOES IT WORK?

When company stock is transferred in-kind from an employer-sponsored retirement plan to a taxable brokerage account as part of an NUA strategy, the investor pays ordinary income tax only on the original cost basis portion of the company stock. The NUA portion of the stock is not subject to taxation until the shares are sold, at which point it is subject to the favorable long-term capital gains tax, regardless of holding period. If they choose to roll over the stock into an IRA instead, they will not pay any taxes initially.

However, upon distribution from the IRA, they will pay ordinary income tax on the ENTIRE amount (including the NUA). Paying long-term capital gains tax on the appreciated portion with an NUA strategy may be better if the shares have appreciated significantly.

NUA strategy example

Let's assume an investor bought 10,000 shares of company stock in their retirement plan at $10 per share. The cost basis is $100,000 (10,000 x $10). If the stock is now trading at $50 per share, the total market value is $500,000 (10,000 x $50), and the NUA is $400,000 ($500,000 - $100,000). Assuming that the investor pays 28% ordinary income tax and 20% long-term capital gains tax at distribution, the total tax liability with an NUA strategy will be $118,000 vs. $190,000 if they roll over and distribute the stock from an IRA.¹

In this hypothetical example, the investor may save up to $72,000 by transferring the shares to a taxable brokerage account.²

1. This calculation assumes 5% hypothetical rate of return. This calculation considers federal taxes; state and local taxes are not included.

2. Source: The E*TRADE NUA Calculator.

Have questions or need help? Call 1-877-921-2434

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WHO MAY WANT TO CONSIDER AN NUA STRATEGY?
- Individuals who own highly appreciated company stock in an employer-sponsored retirement plan
- Individuals eligible to take a distribution from their employer-sponsored retirement plan and are considering an immediate distribution
- Individuals in a higher tax bracket

WHAT IS THE BENEFIT?
The key advantage of an NUA strategy is the ability to pay long-term capital gains tax on the appreciated portion of company stock, which is generally lower than ordinary income taxes.

IMPORTANT FACTS AND CONSIDERATIONS
- NUA treatment is only applicable to company stock. Other assets in the account, such as mutual fund shares, are not eligible.
- Only lump-sum distributions are eligible for NUA treatment.¹

• Distributions prior to age 59½ may be subject to a 10% early withdrawal penalty, but only on the cost basis amount.
• To take advantage of the NUA strategy, investors must transfer company stock in-kind from a retirement plan. If the stock is liquidated or rolled over into an IRA, the NUA treatment will not apply.
• Tax liability (capital gains) on the NUA portion of the stock is deferred until the shares are actually sold in a brokerage account.
• Investors may apply the NUA strategy to all or a portion of their company stock; however, to qualify for NUA treatment, all assets from the employer-sponsored retirement account must be removed at distribution.

HOW TO GET STARTED
- E*TRADE NUA Calculator (www.etrade.com/nuastrategy) can help determine whether the NUA strategy may be appropriate.
- Investors should discuss the NUA strategy option with a tax and/or legal advisor and with the plan sponsor.
- Consider opening an E*TRADE brokerage account.
- Transfer the company stock in-kind to a brokerage account.
- The remaining balance in the employer-sponsored plan may be rolled over to an E*TRADE IRA.
Frequently asked questions

Q: Can I use the NUA strategy on selected shares of company stock?

A: An investor may apply the strategy to any shares they choose in their employer-sponsored retirement plan. For example, if shares were purchased over time, some shares may have appreciated in value more than others. Depending on the recordkeeper’s policy, the NUA strategy may be applied to highly appreciated shares only. Investors can contact their plan administrator to determine if this may be an option.

Q: If an investor uses the NUA strategy, do they have to transfer all assets to a brokerage account?

A: No. An investor may choose to transfer only a portion of the company stock to a brokerage account. However, the rest of the assets from the former employer’s retirement account must be removed within one calendar year; investors can do this by rolling the remaining assets to a new plan, rolling them over to an IRA, or taking a cash distribution. Investors should be aware of the benefits and consequences of each option.

Q: If an investor transfers shares in-kind to a brokerage account and does not sell them immediately, what taxes will they pay on any subsequent gain on the shares?

A: Any additional gain realized between the time of the in-kind transfer and the time when the shares are sold will be taxed at the long- or short-term capital gains rate, depending on how long the stock was held in the brokerage account after distribution from the retirement account.

E*TRADE’s NUA Calculator
Own highly appreciated company stock in a retirement plan?
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PLEASE SEE IMPORTANT DISCLOSURES BELOW.

E*TRADE Financial Corporation and its affiliates do not provide tax advice, and you always should consult your own tax adviser regarding your personal circumstances before taking any action that may have tax consequences.

Before deciding whether to retain assets in a former employer plan or roll over to an IRA an investor should consider various factors including, but not limited to, investment options, fees and expenses, services, withdrawal penalties, protection from creditors and legal judgments, required minimum distributions and possession of employer stock. View the FINRA Investor Alert for additional information.

1. In general, distribution is treated as a lump sum distribution if the following requirements are met: 1) the entire balance is distributed over the same tax year and 2) the distribution is taken as a result of employee turning age 59½, being deceased, separated from service, or disabled.

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