EWM Personal Finance Tips & Solutions

Understanding Net Unrealized Appreciation (NUA)

What is Net Unrealized Appreciation (NUA)?

Net Unrealized Appreciation (NUA) is a tax strategy that applies when you distribute company (employer) stock from an employer-sponsored retirement plan (such as a 401k) into a taxable brokerage account instead of rolling it into an IRA.

The key advantage of NUA is that the appreciation of the company stock (the increase in value while inside the 401(k)) is taxed at more favorable long-term capital gains rates when sold, rather than the higher ordinary income tax rates that apply to traditional retirement account distributions.

How to Elect NUA on Company Stock

1. Verify Eligibility
- The distribution must occur due to a triggering event, such as separation from service, death, etc.
- You must take a lump-sum distribution of your entire 401(k) in a single tax year.
- Your plan must allow in-kind distribution of employer stock.

2. Determine Asset Allocation
- Instruct the Plan Administrator to transfer company stock in-kind to your taxable brokerage account.
- Roll over all remaining 401(k) assets (stocks, bonds, cash) into an IRA to maintain tax deferral.

3. Understand the Tax Implications
- The cost basis of the company stock is taxed at the ordinary income rates in the year of distribution.
- The NUA portion (appreciation in 401k) is taxed at long-term capital gains rates when you sell the stock.
- If you don't sell the shares immediately, any gains after the transfer (post-transfer appreciation) are subject to normal short or long-term capital gains tax treatment, based on your holding period.

4. Report the Distribution Correctly
- Your Plan Administrator will issue a Form 1099-R, detailing the taxable cost basis and NUA amount.
- Your tax professional should ensure proper reporting on your tax return to maximize the tax advantages of NUA.

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Important Considerations:

The entire 401(k) balance must be distributed in a single tax year to qualify for NUA treatment.

Only the cost basis is taxed as ordinary income at the time of transfer, while the NUA portion is taxed later at long-term capital gains rates.

If you decide not to sell the company stock immediately, any additional appreciation after transfer will be subject to standard capital gains tax rules based on your holding period.

You should avoid rolling over the company stock into an IRA, because you will forfeit the NUA benefit, and all future withdrawals will be taxed as ordinary income.

NUA can be a great strategy if:

- You have significant appreciation in your company stock.
- You want to minimize taxes on withdrawals by paying long-term capital gains rates instead of ordinary income tax.
- You don't need immediate access to the funds and can hold the stock for tax-efficient selling.

However, NUA may not be beneficial if:

- Your company stock has low appreciation (the tax benefit may be minimal)
- You plan to hold the stock indefinitely, as it may qualify for a step-up in basis.
- You need to diversify your investments, as holding too much employer stock can be risky.