Price & Farrington's Estate and Tax Planning *Fast*Facts

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Estate, Tax , Business and Wealth Planning for Advisors and Clients

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Retirement Planning and Net Unrealized Appreciation (NUA): *5 Big Mistakes*

Net Unrealized Appreciation (NUA) on employer stock in a qualified plan, like a 401(k), enjoys favorable tax treatment, but only if you play by the rules and don't mess up. Mistakes being made over and over wipe out one of the best tax breaks available to employees.

NUA Basics. The NUA tax break applies when you have *highly appreciated employer stock of the company you work for* in your qualified plan and you elect to take a *lump-sum distribution* from your plan. The employer stock is distributed to you and the other assets in the plan are generally rolled over to an IRA. You owe income tax *only on the cost basis* of the employer stock. *The difference between the cost basis and the market value of the stock becomes the NUA which is taxed at long term capital gain rates when it is sold.* When there is a large difference between the cost basis and the current market value (the NUA), you should consider using the NUA strategy.

To qualify as a *lump sum distribution* (LSD) under the tax code, the entire plan balance must be withdrawn in one taxable year after a *triggering event*, such a separation from service, death, disability or reaching age 591/2.

"Yes, I enjoy the concept of wealth, but I really love the actual money, too."

If your employer stock is highly appreciated and the distribution qualifies as a lump sum distribution (LSD), then you can elect to use the NUA option and enjoy a dramatic tax break.

NUA Example. Harry will retire from his company in 2006. His company 401(k) plan balance is $1 million, of which $800,000 is employer stock and $200,000 is assorted mutual funds. The cost of the employer stock to the company plan (i.e., its basis) is $100,000. If Harry takes a qualifying lump sum distribution (distributing the entire plan balance by the end of 2006), and transfers the $800,000 of stock to a taxable brokerage account (a non-IRA account), Harry only has to pay tax on $100,000. The other $700,000 is NUA and is not taxed on the transfer of those shares to the brokerage account.

When any or all of the employer stock is sold, Harry will pay long-term capital gain rates, currently only 15%, on the NUA attributable to that stock, regardless of how long (or short) the stock was held after it was distributed from the plan. The other $200,000 of mutual funds must also be withdrawn from the plan by the end of 2006, but these funds can be rolled over tax-free to an IRA, maintaining their tax deferral in the IRA while the employer still enjoys the NUA tax break. This is a great deal for Harry, unless Harry blows it by making one of the following five NUA mistakes.

Five NUA Mistakes You Cannot Afford to Make.

1. Quick Draw McGraw. Some advisors and financial institutions are a little too quick on the draw with IRA rollovers. Advisors must first ask their

Glenn Price and Chuck Farrington.

clients if there is any employer stock in their plan and see if there is any appreciation. *Once you roll your employer stock to an IRA, the NUA tax break is lost forever. See* IRS Private Letter Ruling (PLR) 200442032 (October 15, 2004). In this case, the taxpayer made the fatal error of doing an IRA rollover and then realized that he had incorrectly retitled his stock. He asked the IRS if he could revoke his IRA rollover election and treat the employer stock as if it were distributed to him personally so the stock would qualify for NUA treatment. The IRS refused because the rollover election was irrevocable, "...therefore, the eligible rollover distribution is not eligible for the exclusion from gross income for net unrealized appreciation on employer stock." The NUA tax break was irretrievably lost.

2. Not Going All the Way. An LSD means that *all of the company plan funds must be distributed in one taxable year.* This doesn't mean that you must pay tax on all of the plan funds withdrawn. You can roll the non-employer stock plan funds over to an IRA. *Whatever you do, you must go all the way,* *emptying the entire plan balance in one tax year.* If there is any balance in the plan at the end of the year, you will blow the NUA tax break. Close is not good enough, as one sorry taxpayer found out in PLR 200434022 (August, 2004). In this case, the taxpayer attempted a lump-sum distribution from his company plan but not all of the plan funds were distributed during the year. The taxpayer realized this too late. The IRS would not grant relief, told the taxpayer he wouldn't be eligible for the NUA tax break, and that he would have to pay income tax, at ordinary tax rates, on the entire amount of employer stock withdrawn from the plan. Since he didn't receive the distribution within one taxable year, the taxpayer hadn't taken a LSD and therefore could not "exclude from gross income the net unrealized appreciation attributable to that part of the distribution which consists of employer securities…"

Using the "Harry" example, above, what happened in this case is that the $800,000 of stock was withdrawn from the plan and transferred to a taxable brokerage account, but due to an oversight, the remaining $200,000 of mutual funds in the plan weren't withdrawn from the plan until early the next year. The result of this error is a tax on the entire $800,000 of stock withdrawn from the plan at ordinary income tax rates. If a 10% penalty applied due to an early withdrawal, the penalty would be $80,000. This is not pretty. The moral? *Advisors must monitor all lump-sum distribution attempts to make sure that the plan balance is zero at year-end; otherwise the consequences will be costly.*

3. Failing the LSD Test With RMDs and Other Distributions. Partial plan distributions such as required minimum distributions (RMDs) and in-service distributions taken after a triggering event, like separation from service, can kill the NUA tax break. Remember that the entire plan balance must be withdrawn in one taxable year *after* a triggering event. For example, if you retired in 2005 and take a required distribution in 2006 at age 701/2, and then take a lump-sum distribution from the plan in 2007, you no longer qualify for the NUA election since you failed the LSD test.

4. Selling Out. Don't sell out too quickly. After all the Enron publicity, many employees got scared and sold their employer stock without even checking to see if the stock had appreciated from the amount they paid for it in the plan. Once they sold those shares in the plan, they killed the NUA break on the appreciation to date. Advisors have reported cases where employees who worked for 20, 30 years or more sold stock in a panic, even though they were sitting on 20 or 30 years of appreciation.

5. Not Telling Beneficiaries About NUA. NUA isn't just for plan participants; beneficiaries get it too. But most people don't know this and beneficiaries miss out. If you are in a qualified plan and die with the funds still in the plan, your beneficiary can claim the NUA tax break on an LSD. This is more common than you may think. If you die while your funds are still in your qualified plan, and you have a non-spouse beneficiary (e.g., your child or grandchild), the plan will probably not allow a lifetime payout over the beneficiary's life expectancy (like the stretch out from an inherited IRA). The plan is likely to force an LSD and the beneficiary will owe all the tax at one time. But if the plan forces an LSD and there is employer stock in the plan, the beneficiary qualifies for NUA treatment, the same as the plan participant would have. This may save a ton of tax, plus the tax on the NUA can be deferred until the stock is sold. The beneficiary then pays only 15% capital gains rate on the NUA. ■

As always, we wish you good planning!

Thanks to Ed Slott's IRA Advisor, May 2006, feature article: "5 NUA Mistakes" for much of the information in this month's FastFacts. You can order Ed Slott's IRA Advisor at (800) 663-1340.

"Your 401(k) rolled over nicely, sat up briefly, then expired."

VERY *TAXING* FACTS

- ☑ **Over the past 20 years the U.S. Congress has made more than 15,000 changes in the tax code.**
- ☑ **In the past 6 years the Internal Revenue Service has added almost 100 new forms.**
- ☑ **During just the past 6 years the number of pages in the tax code and related documents has increased 42% to more than 66,000.**
- ☑ **More than 60% of U.S. citizens now hire someone to do their taxes.**
- ☑ **It is estimated that the cost of record-keeping, education and compliance totals more than $265 billion for the country as a whole.**
- ☑ **A recent poll indicates that 80% of filers favor major changes or a complete overhaul of the tax system.**
- ☑ **A recent poll found that 58% of taxpayers say the income tax system is unjust. This is virtually unchanged from two decades ago. Most felt that high income earners didn't pay their fair share of taxes.**