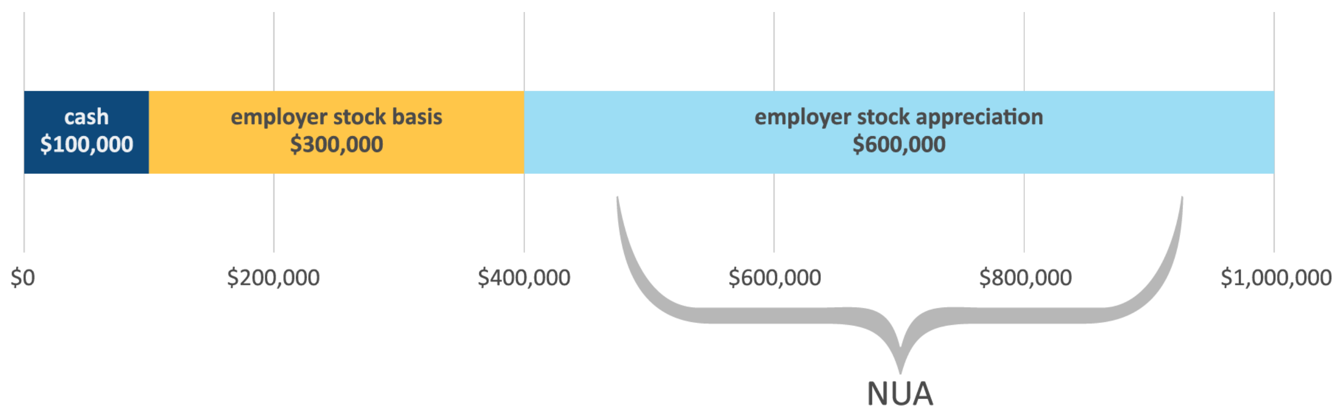
Northwestern Mutual

Net Unrealized Appreciation

What to know about employer stock in a qualified plan

Generally, all amounts distributed from a qualified plan are taxed as ordinary income unless they are rolled over into an eligible qualified plan or IRA. However, special treatment is available for Net Unrealized Appreciation ("NUA") with respect to employer stock held in the plan.[1] NUA is the amount by which the value of employer stock exceeds the amount paid by the plan for the stock.



If the requirements for NUA treatment are met: (1) the NUA is not taxed when the stock is distributed from the plan to a non-qualified account, and (2) when the stock is sold, the NUA is taxed as long-term capital gain.

Because of the favorable tax treatment afforded to NUA, it is important to understand how it works and what planning opportunities exist when retirement accounts include employer stock.

NUA distributed from a qualified plan will be taxed as long-term capital gains if:

1. The distribution is made as a result of a specified triggering event; and
2. the employee's entire account balance is distributed in one calendar year after the occurrence of the most recent triggering event.

[1] I.R.C. §402(e)(4)(A) & (B).

Lump Sum Distributions

To qualify for the favorable NUA tax treatment, the stock must be distributed to a non-qualified account of the employee as part of a "lump sum distribution." There are three requirements for a lump sum distribution:

1. the distribution is from a "qualified plan";
2. the distribution is being made as a result of a permitted triggering event; and
3. the employee's entire account balance is distributed in one calendar year.

What is a "Qualified Plan"

For purposes of a lump sum distribution, only distributions from Section 401(a) pension, profit sharing, or stock bonus plans qualify. This includes 401(k) plans and ESOPs, but not IRAs, SEP-IRA's, SIMPLEs, or 403(b) plans.

What is a Permitted Triggering Event

Only distributions made due to the following events qualify as lump sum distributions.

1. **On account of the employee's death.**[2]

   A distribution is not eligible simply because it is made after the death of the employee. It must be made "on account of" the employee's death. A distribution made as a result of the death of a surviving spouse does not qualify as a permitted triggering event.[3]

2. **After the employee attains age 59 ½.**[4]

   As long as the distribution occurs on or after the date on which the participant turns 59 ½, the triggering event requirement is satisfied.[5]

3. **Unless the participant is self-employed, on account of the employee's separation from service.**[6]

   A separation of service occurs when the employee dies, retires, resigns or is discharged, and not when the employee continues in the same job for a different employer as a result of the liquidation, merger or consolidation, etc. of the former employer.[7]

"on account of"

When a distribution must be "on account of" a particular event, the event must be a cause of the distribution. It does not have to be the sole reason for the distribution.

There is no bright line rule regarding the degree of causation necessary.

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[2] I.R.C. §402(e)(4)(D)(i)(I).

[3] Gunnison v. Comm., 461 F.2d 496, 499 (7th Cir. 1972) (the distribution was made on account of the surviving spouse's death more than a year after the death of the employee, therefore it did not qualify).

[4] I.R.C. §402(e)(4)(D)(i)(II).

[5] PLR 85-41-089, PLR 2004-10-023.

[6] I.R.C. §402(e)(4)(D)(i)(III).

[7] See, U.S. v. Haggart, 410 F.2d 449 (8th Cir. 1969).

For a distribution to be "on account of" the separation from service, the time between the separation and distribution is not determinative. A distribution that was received 10 years after separation from service was found by the IRS to be on account of the separation.[8]

4. **If the participant is self-employed, after the employee has become disabled.**[9]

   A person is disabled if he is unable to engage in any substantial gainful activity by reason of any medically determinable physical or mental impairment which can be expected to result in death or to be of long-continued and indefinite duration.[10]

Distribution of the Account Balance all in one Taxable Year

The entire amount credited to the participant must be distributed in one taxable year. The account balance is determined based on the balance to the credit of the employee as of the first distribution **following the most recent triggering event.**[11] The following are examples of distributions which meet and do not meet this rule:

NOT A DISTRIBUTION OF THE ACCOUNT BALANCE ALL IN ONE TAXABLE YEAR

Participant retires from employment in Year 1 at age 62. In Year 1, she withdraws $50,000 from her $1,000,000 401(k) account. In Year 2, she withdraws the remaining $950,000. Because the most recent triggering event was the participant's separation from service, her entire $1,000,000 would have needed to be distributed during the Year 1 taxable year, the year in which the first distribution after it occurred.

APPROPRIATE DISTRIBUTION OF THE ACCOUNT BALANCE ALL IN ONE TAXABLE YEAR

Participant retires from employment in Year 1 at age 55. In Year 1, participant withdraws $50,000 from her $1,000,000 401(k). In Year 6, at age 60, participant withdraws the remaining $950,000 from her 401(k). Because the most recent triggering event is the participant turning 59 ½, the distribution in year 6 qualifies as a distribution all in one taxable year for purposes of a lump sum distribution.

Options for Distributions from Qualified Plan Accounts that have NUA

Option 1 — Leave the account assets with the employer

- The participant may have the option of doing nothing if the employer's plan allows the participant to keep the account after retirement. However, eventually the participant will have to take required minimum distributions from the plan; doing so will likely prevent eligibility for NUA treatment due to the lack of distribution of the entire balance in one taxable year.

[8] PLR 2003-02-048.

[9] I.R.C. §402(e)(4)(D)(i)(IV).

[10] I.R.C §72(m)(7).

[11] Notice 89-25, 1989-1 CB 662, A-6; Prop. Reg. 1.402(e)-2(d)(1)(ii); Rev. Rul. 69-495, 1969-2 CB 100.

- If the employee is under 59 ½ and not ready to move the employer stock to a nonqualified account, they might be interested in leaving the stock until a later triggering event occurs.

Option 2 — Rollover all account assets to IRA

- The participant could transfer the entire balance in the employer's plan to an IRA as a rollover. This will delay taxation until the assets are distributed from the IRA. IRA distributions will be taxable at ordinary income tax rates.
- An IRA rollover may offer additional benefits, including increased investment choices and lower expenses.
- This prevents eligibility for NUA treatment in the future. However, this permits any proceeds from the sale of employer stock to be reinvested on a tax-deferred basis.

Option 3 — Partial rollover to IRA and outright distribution of stock

- The participant can take an outright distribution of the employer stock and roll over the remaining assets to an IRA. The amount rolled over to the IRA will not be taxed until it is distributed.
- With respect to the employer stock, the participant will pay ordinary income tax on the plan's basis in that stock. If applicable, a 10% penalty would also apply to the basis amount.
- The amount currently included in ordinary income is equal to the basis in the stock. The NUA will only be taxed when the stock is sold and then at the long-term capital gain rate. In addition, post-distribution appreciation will be long-term capital gain if the stock is held for more than 12 months after distribution.
- While proceeds from the sale of the stock are taxed at capital gains rates, this prevents re-investment of the proceeds on a tax-deferred basis.

Option 4 — Partial rollover of stock to IRA and outright distribution of NUA

- With this option, in addition to rolling over any property other than employer stock that's in the account to an IRA, a portion of the employer stock is rolled over as well. The amount of stock that's rolled into the IRA is equal to the plan's basis in the employer stock. The ordinary income amount (i.e. basis) follows that stock.[12]
- As a result, there is no income to recognize with respect to the remaining employer stock that's distributed. The stock that's distributed has a value equal to the NUA which would be taxed at long-term capital gains rates.
- There is no basis for the stock distributed. In addition, post-distribution appreciation will be long-term capital gain if the stock is held for more than 12 months after distribution.
- While proceeds from the sale of the stock are taxed at capital gains rates, this prevents re-investment of the proceeds on a tax-deferred basis.

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[12] See I.R.C. §402(c)(2) (in the case of a rollover "the amount transferred shall be treated as consisting first of the portion of such distribution that is includible in gross income…"), PLR 2011-44-040.

The following example illustrates the tax treatment of the different methods, without considering appreciation or the time value of money.[13]

Facts

Participant's 401(k) account	
Cash	$100,000
Employer Stock Value	$900,000
Total Value	$1,000,000

NUA calculation	
Employer Stock Value	$900,000
(Employer Stock Basis)	($300,000)
NUA	$600,000

	Option 1 Remain in 401(k)	Option 2 Rollover to IRA	Option 3 Partial Rollover to IRA w/Outright Stock Distribution	Option 4 Partial Rollover of Stock w/Outright NUA Distribution
Initial Value	$1,000,000	$1,000,000	$1,000,000	$1,000,000
Value rolled over to IRA	$0	$1,000,000	$100,000	$400,000
Value distributed to brokerage account	$0	$0	$900,000	$600,000
Current ordinary income tax on distribution	$0	$0	($105,000)	$0
Ordinary Income tax on distributions over time	($350,000)	($350,000)	($35,000)	($140,000)
10% penalty on basis portion if no exception applies	$0	$0	($30,000)	$0
Long-term capital gains on NUA	$0	$0	($120,000)	($120,000)
Total Tax	($350,000)	($350,000)	($290,000)	($260,000)
Net Value	**$650,000**	**$650,000**	**$710,000**	**$740,000**

According to these assumptions, the participant will have additional cash under either option that incorporates an NUA distribution (i.e., Option 3 or Option 4). The difference between the NUA Options is that with Option 4 that includes the partial rollover of stock to the IRA (1) there is no current income tax on the "basis" portion of the employer stock (and 10% penalty if applicable), and (2) any appreciation of the employer stock rolled into the IRA is taxed at ordinary income tax rates, including the existing appreciation.

[13] Assumptions: 35% ordinary income tax rate and 20% capital gain rate

Additional Considerations

Although running the numbers will influence which option to go with, other factors to consider include:

- **The age of the employee.** If the employee is under 59 ½, the 10% penalty might apply to the employer's basis portion distributed to a brokerage account. In this case, Option 3 (outright distribution of all stock) might not be attractive.
- **The relative importance of tax-deferred growth on sales proceeds compared to the lower tax rate on the NUA.** If the account represents the employee's primary retirement assets, the employee might not plan to access the proceeds until the future. As a result, any gain realized on the sale of stock within an IRA could be reinvested in other assets without any tax being paid until there is a distribution from the IRA, making Option 1 or 2 (no NUA benefit) more attractive. In contrast, if the employee has other retirement accounts, it might be more important to be able to access the cash at a lower tax rate, which would lean in favor of either option that incorporates NUA.
- **The amount of the NUA.** If the NUA represents a significant amount of the qualified plan account, the savings associated with the lower tax rate could make preserving NUA treatment under either Option 3 or Option 4 an important goal of planning.
- **Whether the qualified plan account is a Roth account.** If the employer stock is held in a Roth 401(k), any appreciation will not be subject to tax and there might not be any tax benefit from NUA treatment.

Conclusion

Employer stock in a qualified plan presents an opportunity for tax savings for an employee.

If a qualified plan contains employer stock, the availability or desirability of NUA treatment should be considered before taking any distributions or making any rollover decisions. Although NUA treatment might result in a lower tax rate overall, it might not be the right option for a particular employee.

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Advanced Planning, October 2019

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