Net Unrealized Appreciation: A Tax-Wise Treatment for Employer Securities Distributed from a Qualified Plan

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Introduction

An individual who is retiring or changing employers faces a critical decision regarding what to do with his or her qualified retirement plan assets. Often, company stock comprises a sizeable portion of an employee's retirement account. While an IRA rollover may be an appropriate solution for moving plan assets out of the account, it is not the only option. For those who have accumulated employer securities in their plans, the net unrealized appreciation (NUA) strategy may save a considerable amount in taxes, while simultaneously diversifying away from concentrated positions.

Internal Revenue Code Section 402(e)(4) provides a unique opportunity to convert taxable income into a long-term capital gain. This favorable NUA tax treatment provides certain tax deferral and capital gain treatment for employer stock held within a retirement plan until the subsequent sale of the stock. This paper will explain the NUA strategy, identify who might consider utilizing the strategy, discuss factors that may impact the decision to elect NUA, and note additional considerations regarding the proper execution of the strategy.

Fundamental Concepts

The NUA strategy permits individuals to take a distribution of employer stock from their qualified plan, pay ordinary income tax only on the basis at the time of distribution, and allows for continued deferral of taxes on the balance of their investment. As illustrated in the chart on page two, if the difference between the basis and the fair market value at distribution (the net unrealized appreciation) is positive, it is taxed at long-term capital gains rates when the stock is sold regardless of the holding period[1]. Any subsequent appreciation (earned after the distribution from the qualified plan) is taxed at short- or long-term capital gains rates according to length of holding period. Note that the NUA benefit is lost if the fair market value of the stock is less than the basis. The NUA strategy:

- Applies to employer stock held in qualified retirement plans (ESOP, pension, 401(k), etc.).
- Pertains to a lump sum, in-kind distribution from the plan (a complete distribution of all plan assets in a single calendar year).
- Allows employees to trade ordinary income taxation for long-term capital gains treatment.
- Causes original basis in shares to be immediately taxable to employee as ordinary income.
- Allows any positive remaining value (net unrealized appreciation) to be taxed at long-term capital gains rates when liquidated.

[1] IRS Notice 98-24

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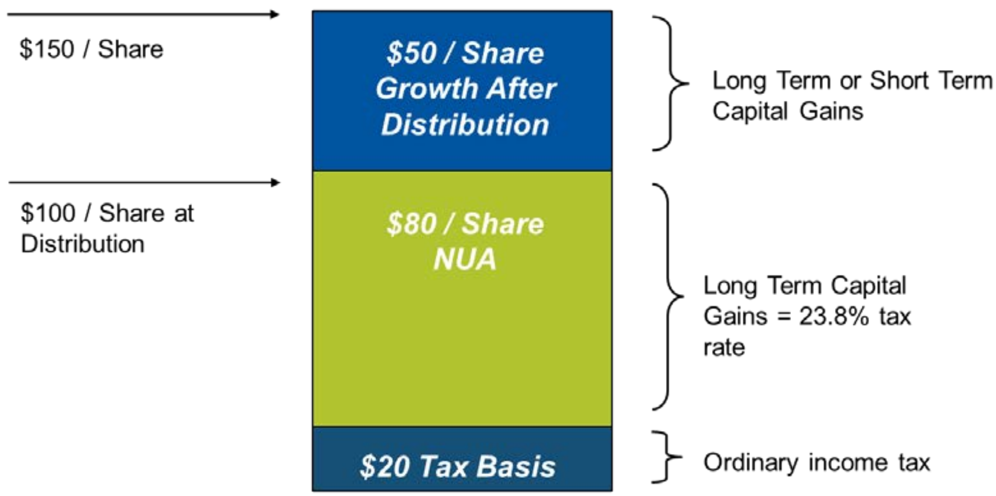
- Eliminates the step-up of basis at death on the net unrealized appreciation portion of stock.
- Subject to premature distribution penalty for qualified plans (applies only to original basis).

Tax Implications – Incentive Stock Options



Remember: Distributions from IRAs are taxed at ordinary rates.

Hypothetical example for illustrative purposes only. There can be no assurance that an investment will provide positive performance over any period of time. An investor could lose money. Tax rates and IRS regulations are subject to change at any time, which could materially affect the results of this analysis. Clients should consult their professional advisors before making any tax or investment decisions.

To use the NUA strategy, the employee must elect a lump sum, in-kind distribution from the plan. A lump sum distribution is defined as "distribution or payment within one taxable year of the recipient of the balance to the credit of an employee which becomes payable to the recipient on account of the employee's death, after the employee attains age 59 ½, on account of the employee's separation from service, or after the employee has become disabled."[2]

Please note, premature distribution penalty rules for qualified plans apply to employees under age 55 at time of distribution. The penalty applies only to the original cost basis, not the full value of the distribution, providing an opportunity to affect premature distribution in a less punitive fashion.[3] (For more information on lump-sum distributions, see Appendix B, Common Error #1.)

Two key factors impacting the viability of the NUA strategy include:

- The difference between the cost basis and fair market value of the stock. A larger disparity in these prices may enhance the benefit of electing NUA.

[2] IRC 402(e)(4)(D)

[3] To review instances in which the 10% penalty does not apply to qualified plan distributions: those that are made on or after attainment of age 59 ½, made to a participant's beneficiary or estate after death, due to participant's disability, that are part of a series of substantially equal periodic payments, made after separation from service after attainment of age 55, made to former spouse, child or other dependent under a QDRO, distributions to the extent of medical expenses deductible for the year.

- The gap between the ordinary income tax rate (on which distributions from tax-deferred accounts will be taxed) and the long-term capital gains rate that is applied to the gain on NUA shares. A larger spread between the long-term capital gains rate and the marginal tax rate tends to make the strategy more valuable.

Who Should Consider the NUA Strategy?

- **Retiring Corporate Executives.** Consulting with retiring executives about different NUA election strategies can guide them in making the proper choices during the retirement distribution decision making process.
- **Younger Executives.** Educating younger executives about NUA benefits can influence qualified plan investment choices and prevent rollovers to other qualified plans or IRAs that would eliminate NUA election eligibility. In addition, informing these executives about NUA could enable them to benefit from the NUA election in the future.
- **Executives Holding Depressed Stock.** Contrary to conventional wisdom, adding to qualified plan positions of depressed employer stock could magnify the tax benefits of NUA election, assuming favorable long-term appreciation potential.
- **Human Resource Executives.** Educating human resource executives about NUA benefits can build strong relationships, which may lead to highly qualified employee referrals.

Factors Impacting Decisions About NUA

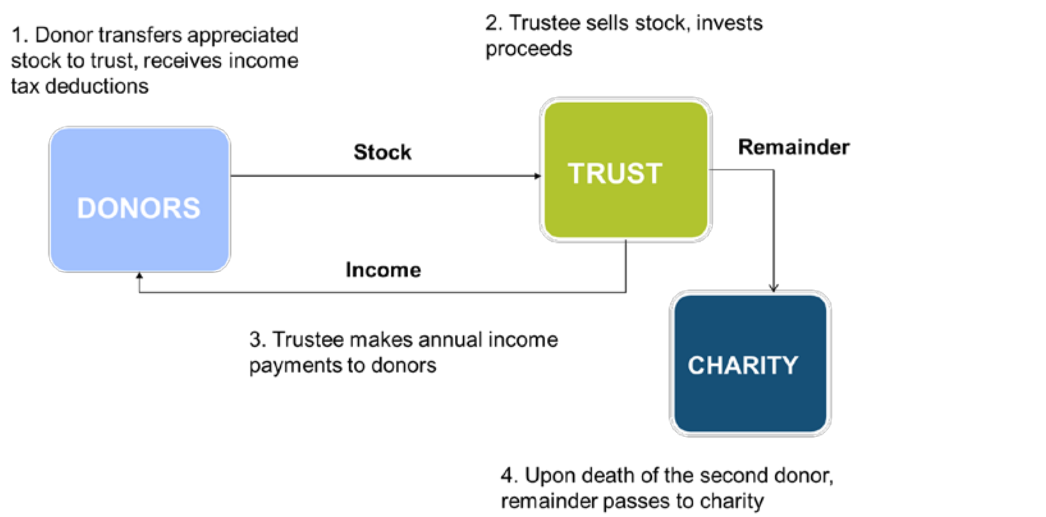
The NUA strategy may not be appropriate for everyone. Be sure to review these following factors:

- **Size of retirement account.** Individuals owning large amounts of employer stock are likely to benefit most. Consider the NUA election if you have long tenure or high positions with your companies.
- **Time horizon.** Individuals not likely to retire or liquidate the stock for many years may benefit most. Consider how long shares may be left to appreciate after the distribution from a retirement account.
- **Marginal tax benefit**. Calculate the potential taxes for both the NUA election and a direct rollover into an IRA. If you are likely to retire into a lower tax bracket, you may pay less tax overall by simply rolling the stock into a new qualified account. However, if you do not anticipate retiring into a lower tax bracket, you may find NUA a preferred option.
- **Risk tolerance.** For many employees, employer stock held both inside and outside their qualified plan may be a majority of their investment portfolio. Be aware of the impact a concentrated position has on a portfolio's risk level.
- **Diversification.** An individual with an over-weighted employer stock position may utilize the NUA strategy to diversify the portfolio. Two NUA election methods provide a means to reduce concentration risk. One option is to elect NUA on all company shares, and sell a portion of the stock to diversify the portfolio. This results in capital gains recognition on the shares sold. Another option is to elect NUA on only a portion of the distribution. The balance could be rolled over into an IRA, where shares can be sold to purchase other investments. The potential tax savings may be lower under the second strategy, but may allow you to diversify a portion of the concentrated position while simultaneously deferring taxes.

- **Estate plan.** Explore whether the strategy might shift any undue tax burdens to beneficiaries. Stock on which the NUA election has been exercised will become part of the client's taxable estate at death. Heirs receiving NUA stock will realize a different income tax treatment than on other assets. There is no step-up in basis because NUA, like an IRA, is subject to Income in Respect of Decedent (IRD). However, heirs can still use the capital gains rates for the embedded NUA when shares are sold, and appreciation in excess of the NUA receives a step-up in basis at the time of death. The NUA strategy is also available to beneficiaries for employer stock held in a qualified plan that has not been distributed prior to death. Individuals who do not plan to use the assets for their retirement and want to leave them to children may want to roll them over to an IRA, taking advantage of the beneficiary designation opportunities available to stretch the account into succeeding generations.
- **Charitable Intent.** As with other highly appreciated assets, employer stock distributed from a qualified plan may be an appropriate asset to use for a charitable remainder trust. In this way, an individual could receive an income stream and fulfill a charitable intent. The income deduction for a charitable contribution could offset the additional tax due on the basis.[4]

In the example below, the individual takes a distribution of stock from the plan, paying ordinary income tax on the basis. The value of the charitable contribution is determined using the stock's fair market value at the time of the gift, even though the individual may not recognize the NUA at that time. If gifted immediately upon distribution (and no short-term capital gain is recognized in excess of the FMV at distribution) then the entire gift will be considered long-term capital gain (LTCG) property. When the stock is sold by the trust and income is taken by the donor, the NUA will be characterized as LTCG in the four-tier accounting system. Individuals who are considering a charitable remainder trust will want to seek the counsel of a tax advisor who can explain the four-tier system and its application to a particular situation. Depending on how the proceeds of the sale are reinvested, a large portion of trust distributions may be characterized as LTCG and taxed at a maximum of 15% (assuming the beneficiary of the trust is a public charity; there are additional considerations if Section 170 (c) (l) applies, for example if it is a private foundation).

Chart Remainder Trust



[4] PLR 200202078

Hypothetical example for illustrative purposes only.

Additional Considerations When Using NUA

There are some important considerations to keep in mind when using the NUA strategy.

Eligibility

- The Internal Revenue Code refers to "employer securities" as being eligible for NUA treatment, although the strategy is most commonly applied to employer stock held in a qualified retirement plan (ESOP, pension, 401(k), etc.). Note also that many companies hold employer stock in "stock funds", the units of which are comprised of shares of stock and cash. These are also eligible for NUA treatment as long as the plan provides for an "in-kind" distribution of stock from the plan.
- Any individuals who want to diversify a portion of their company stock holdings can use the NUA strategy on a partial or a full distribution of employer stock. An individual can rollover some of the company stock to an IRA and use the NUA treatment on the balance. (Note that the NUA treatment is lost on shares rolled over to an IRA.) Individuals might want to obtain the cost basis of various lots of their employer stock from their Plan Administrator and review them to determine which might benefit most from the NUA treatment. For example, it might make sense to use the NUA strategy on shares with the lowest cost basis relative to fair market value at distribution (and thus the greatest amount of NUA) and roll over shares with a higher cost basis relative to the fair market value at distribution.
- Those individuals whose qualified plan assets include mutual funds and/or cash in addition to company stock can choose an IRA rollover for the mutual funds and cash and use the NUA strategy for the stock.
- A partial distribution from an employer's plan clearly does not qualify as a lump sum distribution. However, in a partial distribution, NUA treatment is available, but only for any employer shares purchased with after-tax contributions.

Impact

- A distribution solely in company shares does not result in a 20% tax withholding. However, if cash and stock are distributed together, 20% of the trustee's cost basis will be withheld from the cash portion of the distribution.
- An individual who has an immediate liquidity need (and has separated from service but not taken any distributions) may find that the NUA strategy provides an important source of assets, the employer securities, to provide needed funds. Given that only the basis is subject to the penalty and ordinary income taxes (with capital gains applied to NUA), total taxes on the distribution will likely be less than if the entire distribution were subject to penalty and ordinary income tax rates.

Process

- An individual who plans to use the NUA strategy must notify his or her plan administrator in advance to obtain the specific documentation required and to insure that any withholding is based only on the cost basis not on the entire distribution. The administrator reports the amount of tax withheld on the basis to the IRS upon implementation of the NUA strategy.

The amount of net unrealized appreciation is reported in Box 6 of Form 1099-R, Distributions from Pensions, Annuities, Retirement or Profit-Sharing Plans.

- Individuals may elect not to exclude NUA in employer securities distributed as part of a lump sum distribution. This election is made by attaching a signed statement to that effect to the income tax return filed for the year in which the distribution was received and by including the NUA as part of the distribution on Form 4972 or if no Form 4972 is filed, on line 16 of Form 1040[5].

While electing NUA can offer beneficial tax treatment for employer securities, many factors impact this strategy. It is important to weigh the considerations presented in this paper and consult a tax professional when choosing how to distribute assets from a qualified retirement plan.

For additional guidance on the NUA strategy, please refer to the hypothetical case study in Appendix A and the discussion on NUA Landmines: Five Common Errors when Considering the Net Unrealized Appreciation Strategy in Appendix B.

About Nuveen Wealth Management Services

Nuveen Wealth Management Services is focused on delivering wealth management education and practice development guidance to successful financial advisors who have a relationship with our firm. Please contact us directly at 312-920-6955 to arrange an engagement for this topic or inquire about our other wealth management services.

Disclosure

[5] Section 402(e)(4)(J) as amended by TRA '86; IRS Notice 89-25

Appendix A: Using the NUA Strategy—A Hypothetical Case Study

To understand the potential benefits of the NUA strategy, consider the case of a hypothetical investor, Mary Pearce, 60 years old, who is planning to retire this year with a substantial amount of company stock in her retirement plan in addition to mutual funds. She wants to continue deferring taxes on these assets and has planned to use an IRA rollover for all of the plan assets. However, during the course of developing her retirement plan, her financial planner constructs six scenarios to illustrate alternatives for Mary's corporate stock portion of her retirement plan.

Scenario 1: Rollover to IRA

Mary chooses to include all of the company stock in her IRA, where it grows tax-deferred and upon distribution all of the assets are subject to ordinary income tax.

Scenario 1: Rollover into IRA	
Current Fair Market Value of Employer Stock	**$1,300,000**
Future Value in 10 years (Compounded @ 8.00% annually)	$2,806,602
Tax Due @ Marginal Tax Rate of 39.6%*	$1,111,414
Net Distribution After Tax	**$1,695,188**

*Projected top marginal income tax rate in 10 years. Example is hypothetical only, does not represent any specific investment and assumes all share of stack are held for the 10 year period illustrated. Net values after tax could be less if portions of the shares are liquidated periodically during the holding period. There can be no assurance that an investment will provide positive performance over any period of time. An investor could lose money. Tax rates and IRS regulations are subject to change at any time, which could materially affect the results of this analysis. Clients should consult their professional advisors before making any tax or investment decisions.

In each of the next three scenarios, Mary elects to remove all the employer stock from her qualified plan and use the NUA strategy. In the year of distribution she will pay ordinary income tax on the basis of the shares in the plan. If it were applicable, the premature distribution penalty would apply to the basis. This lower penalty amount may represent an additional benefit of the NUA strategy.

Scenario 2: Lump Sum Distribution and Hold Stock

Mary chooses to take a lump-sum distribution of company stock in one calendar year and continues to hold the stock for 10 years.

Tax on the basis is subtracted from the current fair market value and the remaining amount is compounded to determine the future value at the end of the holding period. This analysis assumes the account is liquidated at the end of the holding period and long-term capital gains tax is paid on the net unrealized appreciation – the difference between the basis and fair market value at liquidation.

Scenario 2: Lump Sum Distribution and Hold Stock

Current Fair Market Value of Employer Stock Total Basis (original contribution)* Net Unrealized Appreciation	$1,300,000 - $117,780 $1,182,220	
Net to Hold in Brokerage Account		
Current Fair Market Value of Employer Stock Income Tax on Basis @ 39.6% Net to Hold Future Value in 10 years (compounded @ 8.00% annually)	$1,300,000 - $46,641 $1,253,539	$2,705,908
Tax Appreciation		
Future Value Basis Net Unrealized Appreciation—Taxable Amount Capital Gains Tax @ 23.8%**	$2,705,908 - $117,780 $2,588,128	-$615,975
Net Distribution After Taxes and Penalties		**$2,089,933**
Incremental Benefit of Scenario 2		**$394,745**

* Subject to 10% premature distribution penalty of application
** Projected top capital gains tax rate in 10 years plus 3.8% surtax on investment income. Example is hypothetical only, does not represent any specific investment and assumes all share of stack are held for the 10 year period illustrated. Net values after tax could be less if portions of the shares are liquidated periodically during the holding period. There can be no assurance that an investment will provide positive performance over any period of time. An investor could lose money. Tax rates and IRS regulations are subject to change at any time, which could materially affect the results of this analysis. Clients should consult their professional advisors before making any tax or investment decisions.

Scenario 3: Lump Sum Distribution and Sell Stock

Mary chooses to take a lump-sum distribution of company stock in one calendar year and immediately sells the stock, reinvesting the proceeds.

In this scenario, ordinary income tax is again paid on the basis and the entire net unrealized appreciation is taxed at the long-term capital gains rate of 15%. The balance is invested in a diversified portfolio, which is held for 10 years earning an after tax rate of 6.2%*. At the end of the holding period, the entire account is liquidated. Because tax was paid initially on the basis and the original net unrealized appreciation, this amount is deducted from the future value of the portfolio and the long-term capital gains rate applied to subsequent appreciation.

Scenario 3: Lump Sum Distribution and Sell Stock		
Current Fair Market Value of Employer Stock Total Basis (original contribution)* Net Unrealized Appreciation	$1,300,000 - $117,780 $1,182,220	
Tax on Basis		

Income Tax on Basis @ 39.6% Capital Gains Tax @ 23.8% Total Taxes and Penalties	$46,641 +$281,368 $328,009	
Net to Reinvest (New Basis)		
Current Fair Market Value Total Taxes Net to Reinvest (New Basis) Future Value in 10 years (compounded @ 6.4%* annually)	$1,300,000 - $328,009 $971,991	$1,807,501
Tax on Appreciation		**N/A****
Net Distribution After Taxes and Penalties		**$1,807,501**
Incremental Benefit of Scenario 3		**$112,313**

*8% Rate of Return, taxed as follows: 25% muni tax free, 15% qualified dividends taxed at 23.8%, 10% short-term capital gains taxed at 43.4% (39.6% plus 3.8% surtax on investment income), 20% long-term capital gains realized annually and 30% long-term capital gains realized at the end taxed at 23.8%.
**Assumes the 20% capital gains rate and the 3.8% surtax on investment income enacted in 2013 remains in force. No new taxes will be applied to appreciation on the final value in 10 years as it assumed taxes are paid throughout the holding period, and thus the 8% is reduced to 6.4%. Example is hypothetical only, does not represent any specific investment. There can be no assurance that an investment will provide positive performance over any period of time. An investor could lose money. Tax rates and IRS regulations are subject to change at any time, which could materially affect the results of this analysis. Clients should consult their professional advisors before making any tax or investment decisions.

Scenario 4: Lump Sum Distribution; Hold Half and Sell Half of Stock

Mary chooses to take a lump-sum distribution of company stock in one calendar year and immediately sells half the stock, reinvesting the proceeds, and holds half the stock.

This scenario combines the benefits of the two previous strategies, providing an opportunity to continue to own half the stock plus diversify by selling half the stock.

Scenario 4: Lump Sum Distribution; Hold Half and Sell Half of Stock

	Total Value	One-Half Value	
Current Fair Market Value of Employer Stock Total Basis (original contribution)* Net Unrealized Appreciation	$1,300,000 - $117,780 $1,182,220	$650,000 - $58,890 $591,110	
Tax on Basis			
Income Tax on Basis @ 39.6%	$46,641	$23,320	
Net to Hold in Brokerage Account			
Current Fair Market Value Total Taxes Net to Reinvest (New Basis) Future Value in 10 years (compounded @ 8% annually)	$650,000 - $23,320 $626,680		$1,352,954

Tax on Appreciation		
Future Value ½ of the Basis Taxable Amount Capital Gains Tax @ 23.8%	$1,352,954 - $58,890 $1,294,064	$307,987
Net Distribution After Taxes		**$1,044 ,967**
Net to Reinvest (New Basis)		
Current Fair Market Value Capital Gains Tax @ 23.8% Income Tax on Basis Net to Reinvest (New Basis) Future Value in 10 years (compounded @ 6.4%* annually)	$650,000 -$140,684 -$23,320 $485,995	**$903,750**
Tax on Appreciation		**N/A****
Net Distribution after Taxes and Penalties		**$903,750**
Combined Net Distribution for Hold Half, Sell Half Scenario		**$1,948,717**
Incremental Benefit of Scenario 4		**$253,529**

*8% Rate of Return, taxed as follows: 25% muni tax free, 15% qualified dividends taxed at 23.8%, 10% short-term capital gains taxed at 43.4% (39.6% plus 3.8% surtax on investment income), 20% long-term capital gains realized annually and 30% long-term capital gains realized at the end taxed at 23.8%.
**Assumes capital gains rate and the 3.8% surtax on investment income enacted in 2013 remains in force. No new taxes will be applied to appreciation on the final value in 10 years as it assumed taxes are paid throughout the holding period, and thus the 8% is reduced to 6.4%. Example is hypothetical only, does not represent any specific investment. There can be no assurance that an investment will provide positive performance over any period of time. An investor could lose money. Tax rates and IRS regulations are subject to change at any time, which could materially affect the results of this analysis. Clients should consult their professional advisors before making any tax or investment decisions.

Summarizing the Potential Benefits of the Four Strategies

Potential Benefits	
Scenario 1: IRA Rollover	
Net Distribution After Tax	$1,695,188
Scenario 2: Elect NUA and Hold Employer Stock	
Net Distribution After Tax Incremental Benefit of Scenario 2	$2,089,934 $394,754
Scenario 3: Elect NUA and Sell Employer Stock	
Net Distribution After Tax Incremental Benefit of Scenario 3	$1,807,501 $112,313

Scenario 4: Elect NUA; Sell Half/Hold Half Employer Stock	
Net Distribution After Tax	$1,948,717
Incremental Benefit of Scenario 4	$253,529

Scenarios are hypothetical only, does not represent any specific investment. Net values could be less if portions of shares are liquidated periodically during the holding period. There can be no assurance that an investment will provide positive performance over any period of time. An investor could lose money. Tax rates and IRS regulations are subject to change at any time, which could materially affect the results of this analysis. Clients should consult their professional advisors before making any tax or investment decisions.

The previous four scenarios compared the advantages of the NUA election associated with a lump sum distribution after holding the position for 10 years vs. an IRA Rollover. The final two scenarios compare the benefits of NUA vs. an IRA Rollover assuming periodic distributions.

Scenario 5: Periodic Distributions from an IRA Rollover

Mary keeps all of the company stock in her IRA Rollover, and begins taking Required Minimum Distributions at age 70 ½.

In this scenario, Mary's life expectancy would be 27.4 years at age 70 ½, based on the Uniform Table. This factor is used to calculate her Required Minimum Distribution (RMD) for the first year, and is recalculated every year using the appropriate factor from the table. All income is taxed at Mary's current ordinary income tax rate upon distribution. When Mary passes away, her entire IRA Rollover is includable in her taxable estate, and her beneficiaries would be responsible for income tax as well.

Scenario 5: Periodic Distributions from an IRA Rollover			
FMV of Stock at Age 60		**$1,300,000**	
FMV of Stock in IRA Rollover at Age 70 ½		**$2,806,603**	
	Pre-Tax	**After Tax**	
Required Minimum Distribution at 70 ½	$102,431	$66,580	
Required Minimum Distribution at 89	$353,856	$212,667	
Total Distributions at Ages 70 ½–89	$4,235,935	$2,545,497	
Account Value at Age 89	$4,203,805	$2,526,487	
Total After-Tax Benefit (Income Plus Account Value)			**$5,071,984**

Example is hypothetical only, does not represent any specific investment. It assumes 8% rate of return, and 39.6% ordinary income tax rate. Required Minimum Distribution calculated using the Uniform Table. There can be no assurance that an investment will provide positive performance over any period of time. An investor could lose money. Tax rates and IRS regulations are subject to change at any time, which could materially affect the results of this analysis. Clients should consult their professional advisors before making any tax or investment decisions.

Scenario 6: Periodic Distributions with NUA

Mary takes the NUA election, holds onto the stock, and takes distributions at age 70 ½ that match the after tax distributions she would have received had she elected an IRA Rollover.

In this scenario, the appropriate amount of shares are sold to match the after tax payout determined from Mary's IRA Rollover. Mary would pay long term capital gain tax rates on the distributions. (In the first several years, a portion of the sale would be considered a non-taxable return of principal because of taxes already paid on the basis when the NUA option was elected.) The remaining portion of NUA, if any, remaining at age 89, would be taxed at long term capital gains rates, with the appreciation on the NUA stepped up to the value of the account at death, as discussed earlier in this white paper.

Scenario 6: Periodic Distributions with NUA			
FMV of Stock at Age 60 **FMV of Stock in IRA Rollover at Age 70 ½**		**$1,300,000** **$2,241,726**	
	Pre-Tax	**After Tax**	
Required Minimum Distribution at 70 ½	$77,735	$66,580*	
Required Minimum Distribution at 89	$279,091	$212,667	
Total Distributions at Ages 70 ½–89	$3,337,494	$2,543,171	
Account Value at Age 89	$5,978,656	$4,643,447	
Total After-Tax Benefit (Income Plus Account Value)			**$7,186,618**

*Includes a non-taxable return of principle. Example is hypothetical only, does not represent any specific investment. It assumes 8% rate of return, 20% capital gains tax and 3.8% surtax on investment income enacted in 2013 remains in force. Required Minimum Distribution calculated using the Uniform Table. Net values are tax could be less if portions of share are liquidated periodically during the holding period. There can be no assurance that an investment will provide positive performance over any period of time. An investor could lose money. Tax rates and IRS regulations are subject to change at any time, which could materially affect the results of this analysis. Clients should consult their professional advisors before making any tax or investment decisions.

Summarizing the Potential Benefits of Scenarios 5 and 6

Potential Benefits	
Scenario 5: Periodic Distributions from an IRA Rollover	
Net Distribution After Tax	$5,071,984
Scenario 6: Periodic Distributions with NUA	
Net Distribution After Tax	$7,186,618
Incremental Benefit of Scenario 6	$2,114,633

Example is hypothetical only. Net values are tax could be less if portions of share are liquidated periodically during the holding period. There can be no assurance that an investment will provide positive performance over any period of time. An investor could lose money. Tax rates and IRS regulations are subject to change at any time, which could materially affect the results of this analysis. Clients should consult their professional advisors before making any tax or investment decisions.

Appendix B: NUA Landmines – Five Common Errors When Considering the Net Unrealized Appreciation Strategy

Internal Revenue Code Section 402(e)(4) provides for favorable tax treatment of distributions of employer securities from a qualified plan when those securities are part of a lump sum distribution. This treatment includes certain tax deferral and capital gain treatment for the securities until the subsequent sale of the stock. When considering the Net Unrealized Appreciation (NUA) treatment for employer stock within a qualified plan, there are several common errors that can occur. These errors can be very costly to a taxpayer. Following are five of the most common errors which have been identified by the Nuveen Investments Wealth Management Services Group, along with an explanation and additional considerations.

Common Error #1:
Assumption that all lump sum distributions made after age 55 are exempt from the 10% early withdrawal penalty (even if separation from service occurred before age 55).

Explanation: Any distributions made to an employee "after separation from service after attainment of age 55" are exempt from this penalty. Note that the key determinant is separation after age 55 not distribution after age 55. Notice 87-13,1987-1 C.B. 432, A-20 further provides that separation from service can occur on or after January 1 of the year the employee reaches age 55.

Hypothetical Example #1: If an employee separates from service in March and his 55th birthday is in May of the same year, any distributions made to him after separation will be exempt from the 10% penalty because his date of separation occurred on or after January 1 of the year he reached 55.

Hypothetical Example #2: If an employee separates from service at the age of 52, but waits until he turns 55 to take a lump sum distribution, he will still be subject to a 10% penalty on the cost basis of the stock being considered for NUA because he terminated prior to the year he turned 55. However, if he waits until he turns 59½, he will not be subject to the penalty.

Special care should be taken for those between the ages of 55 and 59½ to ensure that this penalty is appropriately considered.

Common Error #2:
Assumption that if the 10% penalty applies, it will be imposed on the entire value of the distribution.

Explanation: If the employee is under age 59 ½ at the time of distribution, the 10% penalty will apply only to the portion of the distribution that is includible in the employee's gross income (cost basis of the NUA stock). It will not apply to the income resulting from later sale of the stock (net unrealized appreciation).

Common Error #3:
Post-distribution additions made to an employee's qualified account in any year after the employee took a lump sum distribution.

Explanation: If additional contributions are made to an account after a lump sum distribution is taken, it can negate the eligibility of that lump sum distribution. To avoid this, when terminating the plan (distributing all assets through lump sum distribution), the plan trustee can sign a blanket assignment of all remaining assets, claims, etc., known and unknown, to the recipient. This will cause the recipient, not the plan trustee, to become the owner of any stray distributions, which will protect the lump sum distribution status of the terminating distribution

Common Error #4:
Employee wishes to take a lump sum distribution and NUA treatment on his employer stock, but has taken in-service withdrawals from his qualified plan prior to termination.

Explanation: Any taxable distribution from a qualified plan in any year, including in-service withdrawals, will destroy the lump sum status of the final distribution. This includes loans that fail to meet the requirement of §72(p), and as a result, are considered a taxable distribution.

Common Error #5:
After an employee has begun taking distributions from his qualified plan, he decides to take advantage of NUA treatment on his remaining employer stock and takes a complete distribution of the remaining assets. He assumes this distribution qualifies as a lump sum distribution.

Explanation: If the first distribution was taken at any time earlier than the current taxable year, a subsequent complete distribution of assets does not qualify as a lump sum distribution and the employer's stock is no longer eligible for NUA treatment. However, if there is a complete distribution of assets within one taxable year, the distributions would be considered lump sum and the employee stock would be eligible for the NUA election.

It is important to note that a lump sum distribution is an entire distribution of assets from a qualified plan within **one calendar year**, not simply within a 12-month period. If the first distribution is made in May 2017, all assets must be distributed before December 31, 2017, in order for the distributions to be considered lump sum.