

Reaping the Benefits of Net Unrealized Appreciation

THIS LITTLE-KNOWN STRATEGY CAN GENERATE BIG SAVINGS.

Transferring assets out of a company's retirement plan can present formidable tax-planning challenges. Most people who leave their jobs choose to roll everything into a traditional IRA in order to prolong tax deferral on their investments. But investors may be unaware of an alternative strategy that has the potential to offer even greater tax benefits – particularly for those who have acquired significant shares of employer stock in a qualified plan.

The strategy takes advantage of the concept of net unrealized appreciation (NUA), and it can help generate considerable savings when utilized properly. Assuming that a stock has risen in price, NUA is the difference in value between shares' cost basis and their current market value when held in a tax-deferred account.

If you were to roll the shares into an IRA, their value will be taxed as income when they are distributed from the IRA (holders under 59½ would pay a 10% penalty). But the NUA offers special tax treatment of employer stock when it is distributed in-kind directly from the firm's retirement plan. You'll pay income tax right away on the cost basis of the shares. But the difference between the cost basis and the fair market value of the shares at the time of distribution – the net unrealized appreciation – will be taxed at long-term capital gains rates when the shares are sold. Any additional appreciation earned between the time of distribution and the time of the sale would be treated as either a short-term or long-term gain, depending on the length of the holding period.


The primary advantage of this approach is that it leverages the disparity between today's income tax rates, which currently

max out at 35%, and long-term capital gains rates, which, thanks to the 2006 Pension Protection Act, have been permanently capped at 15%. (See story on page 13.) In addition, rolling fewer assets into your IRA helps reduce required minimum distributions (calculated on the prior end-of-year IRA balances) that kick in April 1 following the year in which you reach 70½.

As with most tax strategies, there are tradeoffs to be considered. NUA won't be useful to everyone. You may sell the shares shortly after distribution to meet your short-term liquidity needs, but if you plan to sell the shares to diversify your portfolio, you might be better off rolling them into an IRA. That way, you could diversify your portfolio without incurring the income tax or any capital gains tax due when the shares are sold.

It's important to realize that unlike appreciated stock held in an IRA or other tax-deferred account, NUA shares receive no step-up in basis upon death. Therefore, your estate planning goals may figure prominently in your decision whether to adopt the strategy.

Under the right circumstances, the NUA strategy can offer powerful financial benefits. You might consider, for example, an entirely different dimension of benefits that could occur if you chose to roll your company plan assets into a Roth IRA, indirectly now or directly after January 1, 2008.

Stringent regulations make professional assistance a must in order to ensure proper implementation of any NUA strategy. Your financial advisor will be able to help you assess your options. Together, you can determine the most tax-efficient approach to managing your retirement funds. 

NUA in Action

Investors can gauge the possible value of NUA from the example below. Here, the option of rolling the entire company stock holding into an IRA is contrasted with the option of removing the stock from the employer plan, paying the required tax on the basis, then holding it for 10 years. Examples assume growth only, with no dividend or taxes involved during the appreciation period – and also assume the account is liquidated at the end of the holding period, a marginal income tax rate of 35% and a permanent capital gains tax rate of 15%.

Rollover into Traditional IRA:

Current Fair-Market Value	\$320,000
Future Value (10 Years at 8.0% Annual Total Appreciation)	\$690,856
Tax Due at Marginal Rate of 35%	\$241,800
.....► Net Distribution After Taxes	\$449,056

Lump-Sum Distribution and Hold Stock:

Current Fair-Market Value:	\$320,000
Stock Cost-Basis:	-\$65,000
Net Unrealized Appreciation	\$255,000

To Hold in Brokerage Account:

Current Fair-Market Value	\$320,000
Income Tax on Basis	-\$22,750
Net to Hold in Brokerage (Future Value [10 Years at 8.0% Annual Total Appreciation])	\$297,250
	\$641,740

Future Value	\$641,740
Stock Cost Basis (on which tax was previously paid)	\$65,000
Net Unrealized Appreciation (taxable amount)	\$576,740
Capital Gains Tax at 15%	-\$86,511
.....► Net Distribution After Taxes	\$555,229

NUA Advantage	\$106,173
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This chart is for illustrative purposes only and does not represent any actual investment.