If you’re thinking about transferring company stock* from your employer-sponsored retirement plan to an account in your name, you may wish to consider the net unrealized appreciation (NUA) strategy to determine whether it would enable you to potentially save significantly on taxes.

What’s NUA and how does this strategy work?

NUA is the difference between the current market value and the cost basis (the price originally paid for the shares). Under certain circumstances, the NUA may be eligible for favorable tax treatment.

If you roll over your stock to an IRA or withdraw it from the plan in cash, the entire amount of the distribution will be taxed at your ordinary income tax rate, which may be as high as 39.6%, depending on your personal situation.

If you instead distribute the stock from your qualified plan in-kind (without liquidating it) to a taxable brokerage account, you’ll immediately pay ordinary income tax on the cost basis, but you’ll pay the long-term capital gains tax rate (ranging from 0% to 20%, depending on the level of your taxable income) on the NUA when the assets are sold.

Key points

- You must take your company stock in-kind as a lump-sum distribution (a total distribution within one taxable year, which may be taken in one or more payments, of your entire balance from all like-type qualified plans sponsored by your employer) following a “triggering event.” Triggering events are death, disability, attainment of age 59½, or separation from service. If you have more than one triggering event, the NUA option is available to you after each such event.** The NUA strategy doesn’t apply if the stock is liquidated in the plan and distributed in cash, or rolled over to an IRA.

- If an in-kind distribution doesn’t meet the requirements, the entire amount distributed will be subject to taxation at your ordinary income tax rate in the year of distribution.

- If you use the NUA strategy before you reach age 59½ or have separated from service before reaching age 55, and didn’t meet any other IRS exceptions, you may be subject to a 10% premature distribution penalty tax on the cost basis.

- The NUA strategy applies only to company stock. However, you don’t have to use the NUA strategy for all of your employer stock; you can roll over a portion to an IRA and apply NUA tax treatment to the rest.

Additional considerations

- If your portfolio is heavily weighted in stocks, your risk of loss may be greater than the potential tax savings.

- Future legislative action may increase capital gains rates and make the NUA strategy less valuable for you. Or your ordinary income tax rate may decrease in retirement.

- You’ll immediately pay ordinary income tax on the cost basis, and you’ll lose the ability to diversify out of the company stock without paying capital gains taxes.

Potential benefits

- When shares are sold, a portion of the proceeds is taxed at the long-term capital gains rate rather than your ordinary income tax rate. At the time of a subsequent sale of the stock, any appreciation in excess of your original NUA will be taxed as either short- or long-term capital gains, depending on how long you’ve held the stock in the taxable account.

- Long-term capital gains tax rates apply to the NUA as of the date of the distribution, regardless of the subsequent holding period. So you’ll be able to diversify out of company-specific risk without having to hold the shares for a full year.

- Your portfolio will have greater tax diversification.

- Assets in a taxable account won’t be subject to the required minimum distribution rules that apply to IRAs and qualified plans.

*Company stock as used here refers to qualifying employer securities. Confirm with a tax advisor whether your stock is a qualifying employer security.

**For example, if you’re actively employed, attain age 59½, and take a partial distribution, that distribution wouldn’t be eligible for NUA treatment. Nor would any following distribution, unless another triggering event occurred, such as separating from service. If you later separate from service and take a lump-sum distribution of the remaining balance, the stock distributed after the separation of service would be eligible for the NUA.
Key points (continued)

- Stocks held in an IRA or employer plan are entitled to significant protection from your creditors. You’ll lose that protection if you hold the stock in a taxable account. If you’re concerned about creditor protection, consult with an attorney in your state.
- Be sure to compare the potential tax savings of the NUA strategy against the increased market risk associated with investing heavily in a few stocks. In general, mutual funds may help limit risk by increasing diversification.
- You should consider the implications of state income tax before making a decision.
- The NUA strategy may also be valuable for your beneficiaries if you haven’t previously sold your shares of company stock.

Calculate how much you could save

The NUA strategy is generally most beneficial if you have highly appreciated company stock in your employer plan. To determine how the NUA strategy works, review the example below. **Note:** This hypothetical example may not apply to your personal situation. For assistance, consult your tax advisor.

<table>
<thead>
<tr>
<th>Factor</th>
<th>Example</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current market value of company stock</td>
<td>$200,000</td>
</tr>
<tr>
<td>Cost basis</td>
<td>$50,000</td>
</tr>
<tr>
<td>NUA:</td>
<td></td>
</tr>
<tr>
<td>Market value – cost basis = NUA</td>
<td>$200,000 – $50,000 = $150,000</td>
</tr>
<tr>
<td>Ordinary income tax rate</td>
<td>25% (0.25)</td>
</tr>
<tr>
<td>Long-term capital gains rate</td>
<td>15% (0.15)</td>
</tr>
<tr>
<td>Tax if using the NUA strategy:</td>
<td></td>
</tr>
<tr>
<td>[(Cost basis \times \text{ordinary income tax rate}) + (\text{NUA} \times \text{long-term capital gains rate})]</td>
<td>[($50,000 \times 0.25) + ($150,000 \times 0.15) = $12,500 + $22,500 = $35,000]</td>
</tr>
<tr>
<td>Tax if not using NUA strategy:</td>
<td></td>
</tr>
<tr>
<td>Current market value \times \text{ordinary income tax rate}</td>
<td>$200,000 \times 0.25 = $50,000</td>
</tr>
</tbody>
</table>

Next steps

Once you’ve determined whether the NUA strategy is right for you, a Vanguard representative will be happy to assist you.

This information isn’t intended to be, nor should it be construed as, tax or legal advice. Each person’s tax situation is different and the NUA strategy may or may not be right for you. Tax laws are complex and subject to change. Due to the complexity of the strategy, we highly recommend that you discuss your personal situation with a tax advisor.