

NET UNREALIZED APPRECIATION TAX BREAK

FEBRUARY 2007

A problem that many retirees with significant amounts of company stock inside a retirement plan are encountering is good ole Uncle Sam. Rather than follow the conventional wisdom that is pushed down your throat by ignorant brokers and financial firms who are telling you to roll it all over, we have a better way.

A tax strategy known as Net Unrealized Appreciation (NUA) allows for investors to receive a distribution of their company's stock and only pay income tax on the average cost basis of the shares rather than the current market value.

For example: An employee qualifies for a lump-sum distribution from a qualified retirement plan. The "conventional wisdom" strategy of simply rolling the distribution into an IRA, the investor would pay up to 35% in ordinary income tax on the stock's value including all gains at the time of withdrawal. Using the NUA technique the employee would receive the stock and pay ordinary income tax on the average cost basis of the shares. This allows for the investor to continue deferring tax on any appreciation that accrues from the time the stock is distributed until it is finally sold. At that point in time, the individual is taxed on the appreciated value at the long term capital gains rate, which is capped at 15%.

Columnist Rick Rodgers of Wealth Manager gives us this case: **Rodney Hartwell, an executive of a medical supply company was planning to leave at year-end. Hartwell held \$100,000 worth of his employer's stock held in the company's 401(k) plan, with a cost basis of \$20,000. A local broker recommended that Hartwell roll his company stock into a low-cost IRA. He explained the advantages of the IRA and told Hartwell that his account would grow larger because the tax would be deferred and because of the potential returns of the hot mutual fund he was recommending. What the advisor did not explain (or perhaps didn't understand) is when Hartwell's IRA distributed income, he would not only be taxed ordinary income rates on his \$20,000 cost basis but he would also be paying the highest rate on his \$80,000 gain, 35 percent. If Hartwell simply took the stock out and did not roll it over into an IRA his tax on the \$80,000 would be treated as long-term capital gains and taxed at a maximum rate of 15%. Of course the \$20,000 basis would be treated as ordinary income. This tactic would result in potential tax savings of \$12,000 for Hartwell.**

The NUA tax-break like everything else in financial and tax planning is not right for everyone and every situation. We at Markowski Investments have a system for determining whether utilizing the NUA break is warranted. For further information contact Matthew Markowski CFP® at (888) 950-0940.