The NUA-CRT— Better Than an IRA Rollover After JGTRRA?

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Robert Keebler, Peter Melcher and Stephen Bigge compare the tax consequences of rolling employer stock into an IRA or other qualified plan, upon separation of service, with contributing the appreciated stock to a charitable remainder trust to provide income to the taxpayer with the remainder to charity.

At the end of May 2003, President Bush signed the Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA),[1] which offers substantial tax relief for retired individuals. Some of the key opportunities provided by JGTRRA are as follows:

- Long-term capital gains tax will be reduced from 10 percent (available for lower income tax payers) and 20 percent to five percent and 15 percent, respectively.
- "Qualified" dividends will now be taxed at the five-percent and 15-percent long-term capital gains tax rates.
- Individual income tax rates have been reduced as shown in Chart 1.

The capital gains reduction will be particularly helpful for those who have employer securities in qualified plans. Under special provisions of the Tax Code, these taxpayers can convert what would normally be ordinary income to long-term capital gains, thus saving up to 20 percent (35% – 15%) in taxes. To understand this tax advantage, it is first necessary to examine these special provisions.

Net Unrealized Appreciation (NUA)

When a distribution is made from a qualified plan, the full amount is ordinarily treated as ordinary income. Code Sec. 402(e)(4) provides an exception, however, for distributions from qualified plans that hold employer securities. If an

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Chart 1

Old Rates	New Rates
10%	10%
15%	15%
27%	25%
30%	28%
35%	33%
38.6%	35%

employee takes a qualified lump-sum distribution of employer securities, the amount of the distribution is divided into two parts, an ordinary income component and a capital gains component. The ordinary income component is the value of the employer securities at the time they were contributed to the plan (*i.e.,* their cost basis). The appreciation of the securities from the purchase date to the distribution date is referred to as net unrealized appreciation (NUA).

When an individual receives a lump-sum distribution, the cost basis is taxed as ordinary income in the year of distribution. The NUA portion is *not* taxed at the time the distribution takes place, but rather is taxed at the long-term capital gains tax rates when the stock is sold at a later date.

Example 1. David receives a lump-sum distribution of company stock from his qualified plan at a time when the stock is trading at $100. The trustee's cost basis in the security is $15. The difference of $85 between the current trading price ($100) and the trustee's cost basis ($15) represents NUA. The $15 of basis is subject to ordinary income tax when the stock distribution is received from the plan. The remaining $85 ($100 – $15) will be taxed at the lower capital gains tax rate when David eventually sells the shares. Any further appreciation in the stock accruing after the date of distribution will also be taxed at capital gains rates, provided that the stock is held for more than one year after the lump-sum distribution. The tax rate on the NUA portion will be either 15 percent or five percent under the new rates enacted under JGTRRA.

Because of the low capital gains rate, a retiring taxpayer will generally be better off taking a lump-sum distribution and then selling off a portion of the NUA stock each year rather than taking a distribution of the same pre-tax amount from a pre-existing individual retirement account (IRA) (or rolling the NUA stock into a new IRA and taking distributions from that IRA).

Example 2. John, a single taxpayer, decides that he will receive $100,000 of income each year, on a pre-tax basis, during his retirement. In determining whether he should take a distribution from his IRA or sell some of his NUA stock, John will choose the alternative that will produce the lowest overall tax cost. Assume that John has a $0 basis in his NUA stock. In this case, John would sell his NUA stock since the income will be taxed at long-term capital gains rates. John's potential savings are illustrated in Chart 2.

Chart 2

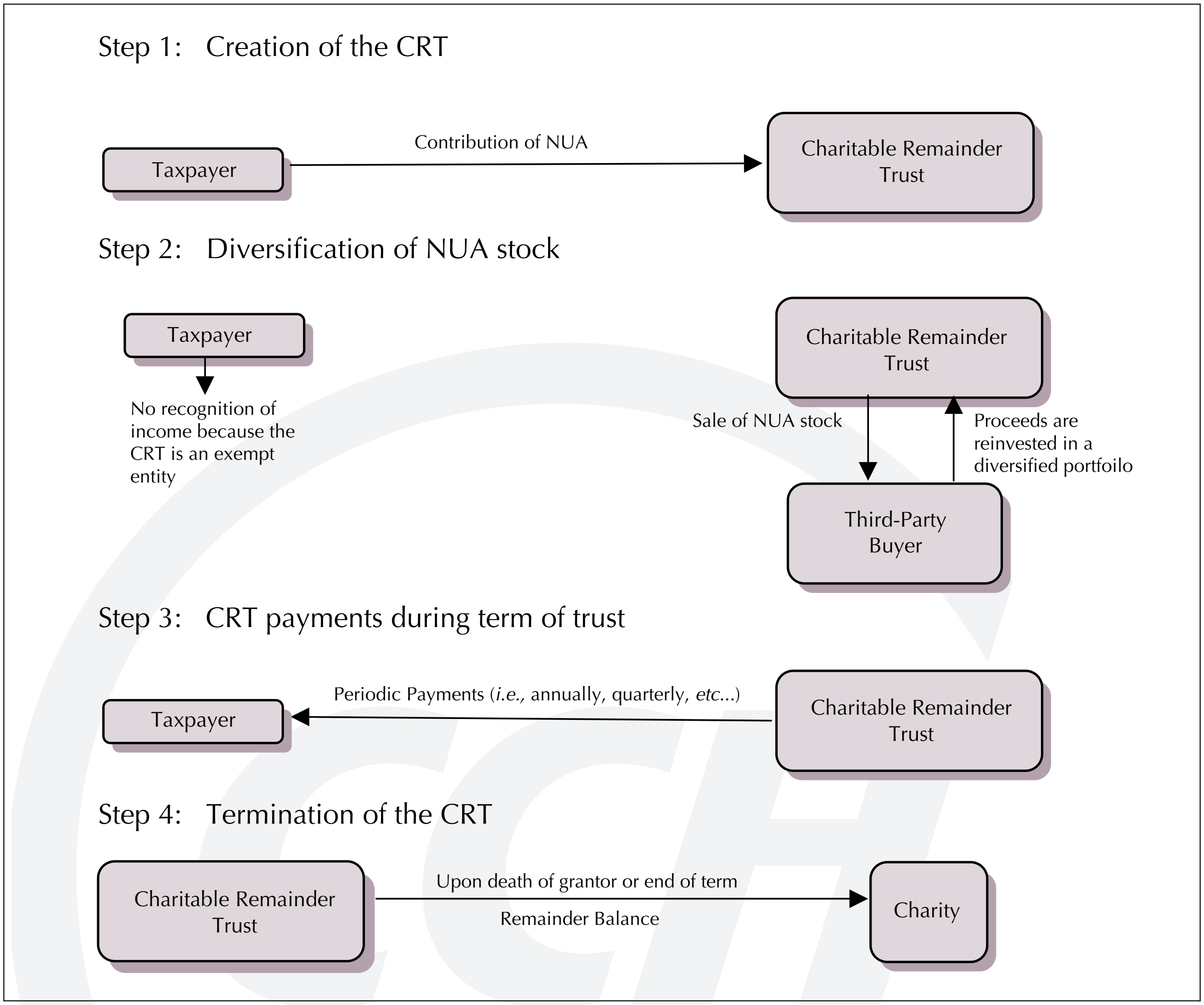
	IRA	NUA Stock
Taxable Income	$ 100,000	$ 100,000
Ordinary Income Tax	$ (22,746)	$ –
Capital Gains Tax	$ –	$ (12,160)
Net Proceeds	$ 77,254	$ 87,840
Savings	$ –	$ 10,586

Diversification Issue

Suppose that the taxpayer does take a lump-sum distribution of the NUA stock. What is the best timetable for selling the stock? From a pure tax standpoint, the best strategy would be to hold the stock as long as possible before selling, maximizing the benefit of deferral. From an investment perspective, however, this strategy carries added risk. In the post-Enron era, many clients have learned the hard way how important it is to have a well-diversified portfolio rather than keeping most of their wealth in employer stock. Not only is it dangerous to have "all your eggs in one basket," diversification should increase the expected return for any given level of risk. Thus, while holding employer stock as long as possible may be the best possible strategy for tax purposes, it may be the worst possible strategy for investment purposes.

One solution to this problem, of course, would be to simply sell all or most of the employer stock and invest the proceeds in a diversified portfolio. Investors are reluctant to do this, however, because they would lose tax deferral. Fortunately, there are ways to diversify without recognizing an immediate gain for tax purposes. One strategy would be to transfer the NUA stock into an IRA. If the individual rolls the NUA stock into an IRA, no

Illustration 1
A CRT in the NUA Context



income will be recognized at the time of distribution from the qualified plan. In addition, all of the NUA stock could be sold within the IRA and reinvested in a diversified portfolio without incurring any income tax. The IRA distributions would be subject to ordinary income tax treatment when taken out at a later date, however. Thus, deferral could be obtained only at the price of converting capital gain into ordinary income.

A better strategy might be to transfer the NUA stock into a charitable remainder trust (CRT). This would enable the taxpayer to defer gain recognition without losing favorable capital gains treatment on all or a portion of the distribution. Note that the individual would still currently recognize ordinary income on the portion of the lump-sum distribution constituting the "basis" in the employer securities. The individual may be able to offset the ordinary income, however, with a charitable deduction (subject to limitations) for the portion of the CRT that will pass to charity at a later date. In the remainder of this article, we analyze whether an NUA-CRT produces better economic results than an IRA rollover.

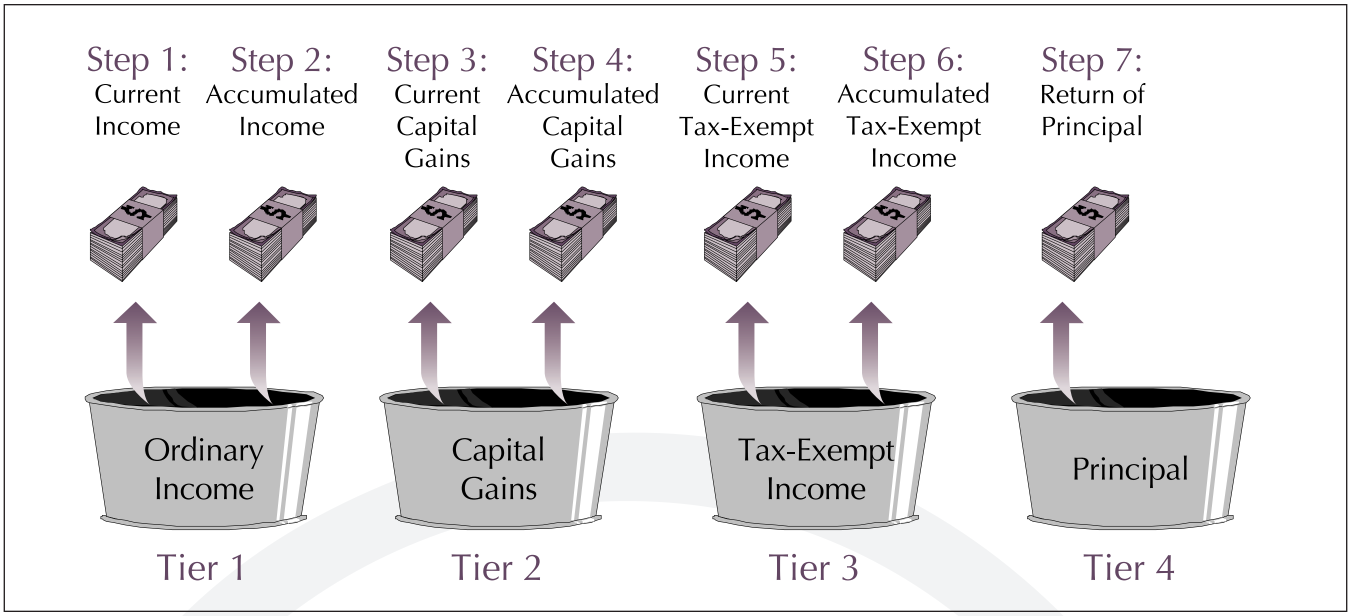
NUA-CRT vs. IRA Rollover

Before proceeding to the analysis, it is important first to understand the economic and income tax aspects of CRTs.

Operation of Charitable Remainder Trusts

A charitable remainder trust is a split-interest trust consisting of

Illustration 2



a lead interest and a remainder interest. In the typical scenario, the creator of the trust (grantor) receives an annuity interest for a term of years, not to exceed 20.[2] At the end of this term, all property in the trust passes to the charitable remainderman with no further tax consequences.

The concept of a CRT in the NUA context is shown in Illustration 1.

There are two basic types of charitable remainder trusts:

- **Charitable Remainder Unitrust (CRUT).** The lead beneficiary receives a stated *percentage* of the trust's assets each year. On an annual basis, the trust assets are revalued (appraised) and the stated percentage is applied to the new value. Thus, the amount of the distribution will vary from year to year depending on the investment performance of the trust assets and the amount withdrawn.
- **Charitable Remainder Annuity Trust (CRAT).** The lead beneficiary again receives a stated *amount* of the trust assets each year, but the base for calculating this amount is fixed at the beginning of the trust term and will not change during the term of the trust regardless of investment performance (unless inadequate investment performance causes the trust to run out of assets).

Income Tax Consequences of a Contribution of NUA Stock to a Charitable Remainder Trust

The contribution of appreciated property to a CRT normally does not trigger any immediate recognition of capital gain or other taxable income to the individual, except for any unpaid dividends that have been declared to the shareholders of record before the date of the contribution to the trust. The general rules covering the transfer of property to CRTs are similar to those covering other types of charitable contributions. Thus, the gain on the NUA portion would not be triggered by the charitable contribution because Reg. §1.402(a)-1(b)(i) provides that such gain is recognized only *"to the extent that such appreciation is realized in a subsequent taxable transaction."* Since the Treasury Regulations do not provide any additional guidance for special extraordinary treatment of NUA with regard to transfers to CRTs, the NUA stock held by an individual should be afforded the same tax treatment for purposes of ultimate disposition as any other capital assets held by that individual. Therefore, no gain or loss should be recognized when the NUA stock is contributed to a CRT.[3]

Charitable Remainder Trusts—Characterization of Income

When a CRT is funded with appreciated securities, these assets are typically sold immediately to diversify the client's concentrated investment position. Once the CRT is funded, the CRT will make payments to the lead beneficiaries in the amount indicated in the CRT document. Code Sec. 664(b) dictates the character of distributions from the CRT. Under this section, CRT distributions are characterized under the following four-tier system (*see* Illustration 2):

1. **Ordinary income**—current and accumulated undistrib-

Chart 3

	IRA	CRT
FMV	$ 100	$ 100
Less: Tax*	$ (35)	$ (15)
Less: Net Charitable Contribution**	$ –	$ (7)
Net Amount to Investor	**$ 65**	**$ 78**

* It is assumed that the taxpayer is in the highest marginal tax bracket.
** The charitable contribution is 10 percent of the FMV of the assets contributed less the tax benefit from the deduction (35 percent).

uted income of the trust for prior years

2. **Capital gains**—current and accumulated undistributed capital gains of the trust for prior years
3. **Tax-exempt income**—current and accumulated undistributed tax-exempt income of the trust for prior years
4. **Principal**—nontaxable distribution of trust corpus

The sale of the NUA stock by the CRT will obviously fix the character of a substantial amount of income as capital gain. Beyond that, the character of the income recognized on the CRT distributions will depend on how the proceeds of the stock sale are invested. If the CRT invests entirely in capital gains assets, the tax rate will be equal to the employee's marginal capital gains rate.

Income Tax Qualifications for Charitable Remainder Trusts

In order for the CRT to qualify as a tax-exempt entity, the trust must be designed to qualify the remainder interest for a charitable deduction. Code Sec. 664 places certain restrictions on the design of CRTs. The payout percentage must not be less than five percent or greater than 50 percent.[4] Furthermore, the present value of the remainder interest, at the time of initial funding, must not be less than 10 percent of the fair market value of the assets initially contributed to the trust.[5] Whether 10 percent of the trust's assets actually pass to charity at a later date does not matter since the terms of the trust were fixed at time it was created.

The NUA-CRT/IRA Rollover Decision

How does the NUA-CRT compare with the IRA rollover option? The advantages and disadvantages of the NUA-CRT are as follows:

Advantages

- Distributions taxed at capital gains rates rather than ordinary income tax rates
- Charitable deduction for present value of charity's remainder interest
- Benefit for charity

Disadvantages

- Ordinary income must be recognized on the basis (non-NUA portion) of the employer securities when they are taken out of the qualified plan; no ordinary income is recognized on a rollover into an IRA.
- At least 10 percent of the present value of the assets transferred to the NUA-CRT must go to charity.
- The amount remaining in the NUA-CRT at the taxpayer's death goes to charity, whereas the residual of an IRA goes to the taxpayer's family (net of income and estate taxes).

Although the NUA-CRT was always a viable option under the right circumstances, JGTRRA makes it more favorable when compared with an IRA rollover because the gap between ordinary income and capital gains rates has widened. Capital gains rates have dropped by five percentage points while ordinary income tax rates have only dropped by two percentage points. The following example provides a very basic comparison of the two alternatives.

Example 3. Assume that an individual has $100 ($0 basis) that can be diversified in either an IRA or an NUA-CRT. Assume further that the employee is in the highest marginal ordinary income tax bracket of 35 percent and a 15-percent marginal bracket for capital gains. The value of the charity's remainder

Chart 4

FMV of Stock Contributed to CRT	$ 500,000
Basis of Stock Contributed to CRT (Ordinary Income)	$ 60,000
Net Unrealized Appreciation (Capital Gain)	**$ 440,000**
Taxable Portion of Distribution (Ordinary Income)	$ 60,000
Less: Charitable Deduction (10% x $500,000)	$ (50,000)
Net Taxable Income	**$ 10,000**
Marginal Ordinary Income Tax Rate	35%
Net Tax Liability	**$ 3,500**

Chart 5

IRA	2003	2004	2005	2006	2007
Taxable Lump-Sum Distribution (Ordinary Income)	$ –	$ –	$ –	$ –	$ –
IRA Distribution (Ordinary Income)	$ 35,000	$ 35,000	$ 35,000	$ 35,000	$ 35,000
Total Taxable Income	**$ 35,000**	**$ 35,000**	**$ 35,000**	**$ 35,000**	**$ 35,000**
Income Tax @ 35%	$ (12,250)	$ (12,250)	$ (12,250)	$ (12,250)	$ (12,250)
CRT	**2003**	**2004**	**2005**	**2006**	**2007**
Taxable Lump-Sum Distribution (Ordinary Income)	$ 10,000	$ –	$ –	$ –	$ –
CRT Distribution (Capital Gains)	$ 35,000	$ 35,000	$ 35,000	$ 35,000	$ 35,000
Total Taxable Income	**$ 45,000**	**$ 35,000**	**$ 35,000**	**$ 35,000**	**$ 35,000**
Income Tax @ 15% (Except Lump-Sum Distribution)	$ (8,750)	$ (5,250)	$ (5,250)	$ (5,250)	$ (5,250)
ANNUAL TAX SAVINGS	**$ 3,500**	**$ 7,000**	**$ 7,000**	**$ 7,000**	**$ 7,000**
CUMULATIVE TAX SAVINGS	**$ 3,500**	**$ 10,500**	**$ 17,500**	**$ 24,500**	**$ 31,500**

interest is set at the minimum of 10 percent. *See* Chart 3.

Although appealing, this analysis does not take into account the fact that in the NUA-CRT scenario the employee must pay tax on the ordinary income portion of the stock when it comes out of the qualified plan. Let us now refine our analysis to take this factor into account. Consider Examples 4 and 5 below.

Ordinary Income Portion and Charitable Deduction

Example 4. Michelle, age 62 and recently retired, decided to roll out $500,000 of NUA stock that was in her profit sharing plan (basis of $60,000). The annual payout was set so that the present value of the remainder interest was equal to 10 percent of the value of the trust assets. Because the basis is considered taxable ordinary income in the year of distribution, Michelle will have to pay tax if she does not roll the stock into an IRA within the 60-day time period allowed for qualified plan distributions. When the charitable deduction for the transfer to the NUA-CRT is taken into account, however, it offsets almost all of the ordinary income. Michelle's net tax liability can be calculated as illustrated in Chart 4.

Example 5. Assume these facts:

- Michelle (age 62) has $500,000 of NUA stock in a qualified plan.
- Michelle either transfers the stock to an NUA-CRT and retains a lifetime income interest or rolls the full amount into an IRA.
- The ordinary income component of the NUA stock is $60,000.
- In the NUA-CRT scenario, the present value of the remainder interest is $50,000 (10 percent of $500,000).
- Both transactions are structured to produce distributions of $35,000 per year. *See* Chart 5.

Effect of Giving Remainder Interest to Charity over Time

Even though the immediate ordinary income recognition in the NUA-CRT scenario has now been taken into account, it is still necessary to factor in the effect of giving away the 10-percent interest to charity over time. The following somewhat simplified example incorporates this factor. Although refinements could be made, the illustration conveys the basic economics of the decision.

Example 6. Assuming the same facts as Example 5 along with the following additional facts:

- Assets grow at six percent in both the NUA-CRT and the IRA.
- Assets distributed to Michelle grow at the same six-percent rate.

Chart 6 is for taxpayers with relatively low incomes. It compares the amount passing to the family

Chart 6

	CRT (Assuming Tax @ 5%)					IRA (Assuming Tax @ 15%)		
	Annual Payment	Future Value of Cumulative After-Tax Payments Reinvested @ 6%	Future Value of After-Tax Residue Passing to Family @ 6%	LESS: Future Value of Income Tax Cost of NUA Roll-out @ 6%	Future Value of Total Amount Passing to Family	Future Value of Cumulative After-Tax Payments Reinvested @ 6%	Future Value of After-Tax Residue Passing to Family @ 6%	Future Value of Total Amount Passing to Family
1	$35,000	$33,250	$0	($3,500)	$29,750	$29,750	$420,750	$450,500
5	$35,000	$187,433	$0	($4,419)	$183,015	$167,704	$401,042	$568,746
10	$35,000	$438,261	$0	($5,913)	$432,348	$392,129	$368,982	$761,110
15	$35,000	$773,926	$0	($7,913)	$766,013	$692,460	$326,077	$1,018,537
20	$35,000	$1,223,121	$0	($10,590)	$1,212,531	$1,094,371	$268,661	$1,363,033
25	$35,000	$1,824,245	$0	($14,171)	$1,810,074	$1,632,219	$191,826	$1,824,045

where it is assumed that the tax rate on CRT distributions is five percent and the tax rate on IRA distributions is 15 percent. Chart 7 compares the future value of amounts passing to the family when the tax rate on NUA-CRT distributions is 15 percent and the tax rate on IRA distributions is 35, 33, 28 or 25 percent.

The charts show that whether the NUA-CRT or the IRA rollover is better under the facts assumed in Example 6 is a function of time and the ordinary income tax rate that is assumed. The NUA-CRT alternative starts out behind, but catches up over time. Chart 6 shows that when the tax rates on NUA-CRT and IRA distributions are five percent and 15 percent, respectively, it takes more than 25 years before the NUA-CRT breaks even. Chart 7 indicates that if we assume that the taxpayer is in the 35-percent marginal income tax bracket, it takes about 19 years before the NUA-CRT outperforms the IRA alternative. For a 25-percent ordinary income tax bracket, the break-even point is almost 25 years.

Other Considerations

It is important to point out that Example 6 illustrates only one of many possible fact situations. With different assumptions, the results could be quite different, and we present the examples merely as a model for planners to use in analyzing the desirability of using an NUA-CRT under their clients' specific fact situations.

Note also that the analysis does not take into account the satisfaction the taxpayer might derive from helping the charity. If the taxpayer places a high value on helping charity, the NUA-CRT would often be the clear winner. Suppose, for example, that the taxpayer would have given the $50,000 amount to charity even without the potential tax benefit. In that case, it might make sense

Chart 7

Year	Annual Payment	CRT	IRA			
		Future Value of Total Amount Passing to Family @ 15% Tax Rate	Future Value of Total Amount Passing to Family @ 35% Tax Rate	Future Value of Total Amount Passing to Family @ 33% Tax Rate	Future Value of Total Amount Passing to Family @ 28% Tax Rate	Future Value of Total Amount Passing to Family @ 25% Tax Rate
1	$35,000	$26,250	$344,500	$355,100	$381,600	$397,500
5	$35,000	$163,285	$434,923	$445,802	$481,761	$501,835
10	$35,000	$386,215	$582,026	$592,149	$644,705	$671,568
15	$35,000	$684,547	$778,881	$787,996	$862,761	$898,709
20	$35,000	$1,083,782	$1,042,319	$1,050,082	$1,154,569	$1,202,676
25	$35,000	$1,618,048	$1,394,858	$1,400,814	$1,545,073	$1,609,452

to compare the NUA-CRT with an IRA from which 10 percent was contributed to charity immediately after the distribution from the qualified plan. The result would be that the future value of all the amounts in the IRA scenario would be 10 percent less at any given point in time making the NUA-CRT look like the preferred strategy much earlier.

Whether the IRA or CRT is a better investment vehicle also depends upon the rates of return assumed. The higher the rate of return, the greater the amount remaining in the investment vehicle at the end of any given time period. Amounts left in an IRA will pass to family members while amounts left in an NUA-CRT pass to charity. Thus, an increased rate of return favors the IRA scenario. If the assets produce a high enough rate of return for a long enough period of time, this factor will trump the tax advantages regardless of the difference in tax rates. As a result, one must perform a sensitivity analysis to determine which investment vehicle will produce the best after-tax result given a specific rate of return. Charts 8 and 9 show the results of the analysis in Example 6 with a six-percent and a 10-percent rate of return.

Note that with a 10-percent rate of return, the NUA-CRT alternative never catches up. If the rate of return were reduced below six percent, however, the crossover point would be reached sooner (*i.e.,* in less than 19 or 20 years).

NUA-CRT vs. IRA Rollover—Summary

The following observations can be made about the above analysis:

- Once assumptions about tax rates and investment return are fixed, whether using the NUA-CRT or IRA is a better strategy is simply a function of time—the IRA starts out ahead, but the NUA-CRT catches up over time because of the more favorable tax rate.
- Eventually, there is a break-even point.
- The longer the taxpayer lives, the more favorable the NUA-CRT will be (assuming the NUA-CRT is created for the life of the donor rather than for a term of years).
- A low basis in the employer's securities favors the NUA-CRT alternative; a high basis favors the IRA alternative.
- The larger the gap between the taxpayer's marginal ordinary income tax rate and the capital gains tax rate, the more favorable the NUA-CRT. By decreasing capital gains rates more than ordinary income rates, JGTRRA favored the NUA-CRT.
- High growth assets favor an IRA because they increase the residual value passing to the taxpayer's family.
- Higher Code Sec. 7520 rates might favor the NUA-CRT if it is a CRAT (higher payouts can be made from the CRT). If the

Chart 8
Net Wealth to Family

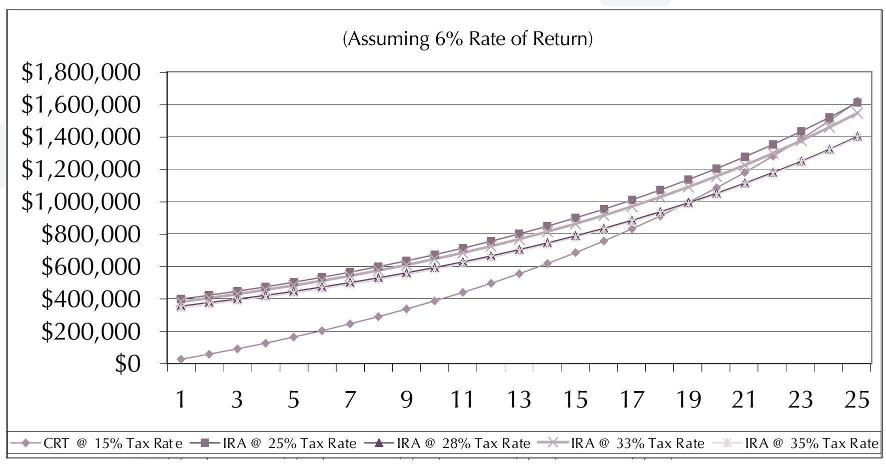
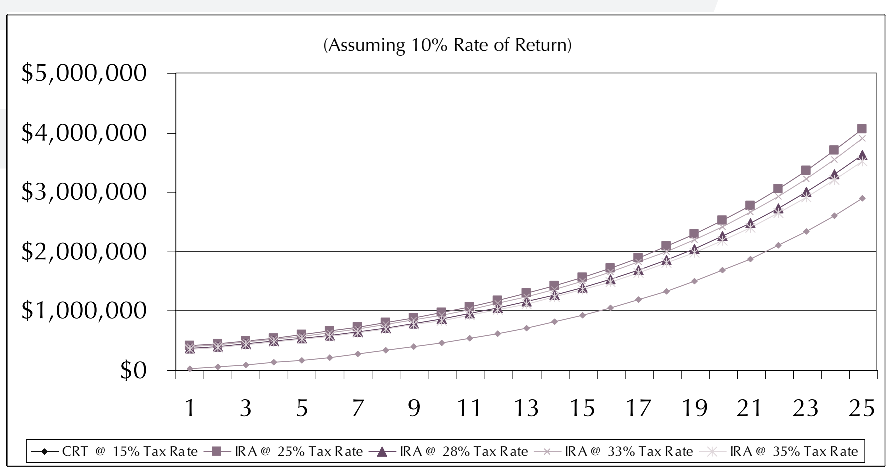


Chart 9
Net Wealth to Family



NUA-CRT is a CRUT, changes in the Code Sec. 7520 rate have little effect on the maximum percentage payout.

Conclusion

Advisors should take a closer look at NUA strategies following JGTRRA. The increased gap between ordinary income and capital gains rates make the NUA-CRT alternative more favorable than before. Whether the NUA-CRT technique is more desirable than an IRA rollover is a very fact-specific quantitative analysis, however. The NUA-CRT is an excellent strategy in the right circumstances and may even make sense for some clients who are not charitably inclined. If the client does place a high value on giving to charity, the NUA-CRT is likely to be the better alternative. Finally, although this article focuses on a comparison between using an NUA-CRT and an IRA for NUA stock, consideration should also be given to selling the NUA stock immediately following distribution from the qualified plan. For taxpayers who are not as concerned about losing the tax deferral, an immediate sale of a portion of the NUA stock may be the best strategy in the long run.

ENDNOTES

1 Jobs and Growth Tax Relief Reconciliation Act of 2003 (P.L. 108-27).
2 Code Sec. 664(d)(1)(A) and (2)(A).
3 Rev. Rul. 60-370, 1960-2 CB 203, and *S.P. Blake,* CA-2, 83-1 USTC ¶9121, 697 F2d 473; LTR 199919039 (Feb. 16, 1999), LTR 200038050 (June 26, 2000) and LTR 200202078 (Oct. 19, 2001).
4 *Supra* note 2.
5 Code Sec. 664(d)(1)(D) and (2)(D).