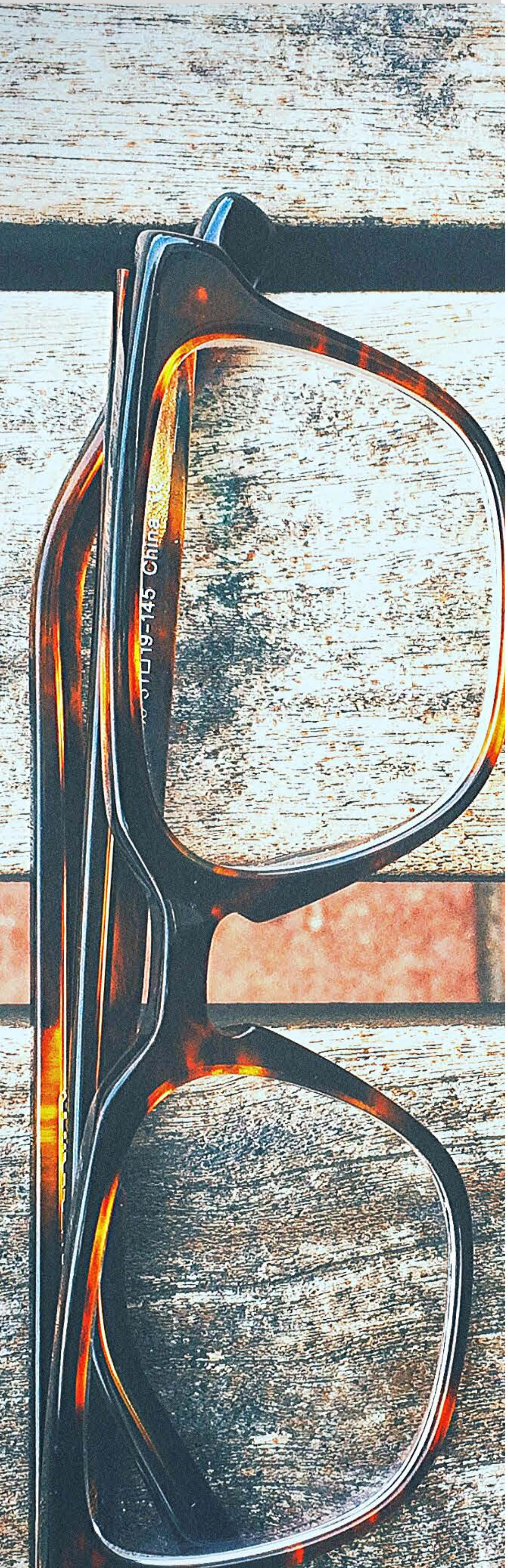
The Retirement Group LLC
PARTNERS IN RETIREMENT

NET UNREALIZED APPRECIATION



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WHAT IS NUA?

Net unrealized appreciation (NUA) is the difference in value between the average cost basis of shares and the current market value of the shares held in a tax-deferred account. This is an important strategy to understand for Chevron employees who hold Chevron stock in their 401(k) savings plan.

When you receive a distribution from your 401(k) savings plan, the distribution is generally taxable to you at ordinary income tax rates. To avoid immediate taxation, a tax-free rollover to a traditional IRA is commonly done. Other than special rules that apply to Roth and other after-tax contributions, ultimately the distributions received from the IRA will be taxed at ordinary income tax rates.

However, if the distribution includes Chevron securities, you may be able to defer paying tax on the portion of your distribution that represents net unrealized appreciation. That portion of untaxed NUA will remain untaxed until you sell the stock or other securities. In addition, the NUA will not be taxed at the ordinary income tax rate; it will instead be taxed as a long-term capital gains tax rate. If used correctly, this strategy can result in significant tax savings. In this article, we will be breaking down, with examples, just what exactly NUA is, how it works and when to use it.

QUALIFIED OR NON-QUALIFIED

In order to understand just how NUA can be used, it is helpful to understand qualified accounts that this tax trick can be used in and how they differ in tax treatment compared to non-qualified accounts. **Qualified accounts (i.e. Traditional 401(k)) are designed to offer individuals added tax benefits. In a qualified account you can make contributions with pre-tax dollars from your income, which lowers your tax bill for that year.** In addition, no tax is paid on appreciation until withdrawals are made. At the point withdrawals are made (tax penalty for withdrawals before 59½ and required minimum distributions [RMDs] after 70) both appreciation and invested amounts are taxed as ordinary income.

On the other hand, non-qualified plans are those (i.e. a standard brokerage account) that are not eligible for tax-deferral benefits. Investments are paid for with after-tax dollars. When appreciated shares are liquidated (a gain is “realized”), the difference between cost basis (original cost at purchase) and sales price is taxed at either short-term or long-term capital gains rate depending on how long they were held, in addition to taxes paid on dividends the year they are received. Funds from non-qualified accounts are neither subject to early withdrawal penalties nor RMDs.

Still not sure if you're qualified, call (800) 900-5867 to speak with an adviser!

HOW TO CREATE SAVINGS

Now that you understand the differences between qualified and non-qualified accounts, let's look at net unrealized appreciation in detail and how it can result in significant tax savings.

A distribution of Chevron stock consists of two parts:

- The cost basis or value of stock when it was contributed to, or purchased by, your plan
- Any increase in value (if any) over the cost basis until the date the stock is distributed to you. This increase in value over basis, fixed at the time the stock is distributed in-kind to you, is the NUA.

HOW TO CREATE SAVINGS

For example, assume you retire and receive 2,500 shares of Cheveron stock worth $250,000 from your ESIP, and that the cost basis of the stock is $25,000, the $225,000 gain is NUA.

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So, exactly how does it work? At the time you receive a lump-sum distribution that includes Chevron stock; you will pay ordinary income tax only on the cost basis in the Chevron securities. You will not pay any tax on the NUA until you sell the securities. At that time, the NUA is taxed at long-term capital gain rates; no matter how long you've held the securities outside of the plan (even if only for a single day). Any appreciation at the time of sale in excess of your NUA is taxed as either short-term or long-term capital gain, depending on how long you've held the stock outside the plan.

HOW TO CREATE SAVINGS

Using the example above, the $25,000 would be taxed at the ordinary income tax rate upon receiving the distribution. Ten years later, the stock has appreciated and is now worth $500,000 and you decide to liquidate the entire position. You will then pay long-term capital gains tax on the NUA portion ($225,000) in this example). Because the investment was held for longer than a year, you will also pay long-term capital gains tax on the additional $250,000 of appreciation ($500,000-$250,000). Since tax was already paid on the $25,000 cost basis when the Chevron stock was distributed, you will not pay tax on that amount again when the stock is sold (see table below for summary of example).

NUA at a glance	
You receive a lump-sum distribution from your ESIP consisting of 2,500 shares of Chevron stock at $100 each ($250,000). The cost basis is $10 per share ($25,000). You sell 10 years later at $200 per share ($500,000)*	
Tax payable at distribution - stock valued at $250,000	
Cost basis - $25,000	**Taxed at ordinary income rates; 10% early payment penalty tax if you're not 55 or disabled**
NUA - $ 225,000	**Tax deferred until sale of stock**
Tax payable at sale - stock valued at $500,000	
Cost basis - $25,000	**Already taxed at distribution; not taxed again at sale**
NUA - $225,000	**Taxed at long-term capital gains rates regardless of holding period**
Additional appreciation - $250,000	**Taxed as long- or short-term capital gain, depending on holding period outside plan (long-term in this example)**

*Assumes stock is attributable to your pretax and Chevron contributions and not after-tax contributions

HOW TO CREATE SAVINGS

If the distribution stock or other securities in addition to Chevron stock, two options are to roll over that portion to an IRA or take it as a taxable distribution. Also, the NUA strategy does not have to be used on 100% of Chevron stock – a portion can be rolled over to an IRA and the NUA tax strategy can be applied to the rest.

In general, NUA tax rules can only be used if the Chevron securities were received as part of a lump-sum distribution. The distribution must meet the following conditions to be classified as a lump-sum:

- It must be a distribution of your entire balance, within a single tax year, from your ExxonMobil 401(k) savings plan.
- The distribution must be paid after you reach age 59½, or as a result of separation of service, or after death.

There is one exception: even if your distribution does not qualify as a lump-sum distribution, any securities distributed from the plan that were purchased with your after-tax (non-Roth) contribution will be eligible for NUA tax treatment.

HOW TO CREATE SAVINGS

The NUA tax treatment can be used by your beneficiaries as well. If you pass away while still holding Chevron securities in your retirement plan, they can use the NUA tax strategy as long as they receive the distribution in lump sum form. In this case, the taxation will be the same as if you had received the distribution (the stock will not receive a step-up basis, even though your beneficiary receives it as a result of your death).

If you have received the distribution prior to passing away and elected NUA, but did not sell before death, your beneficiary will have to pay long-term capital gains tax on NUA when he or she sells the stock. However, any appreciation at the time of death will escape taxation forever because they would be eligible for step-up basis in this scenario. Using the same example as earlier, if you pass away when the stock is worth $500,000, your beneficiary will receive a step-up in basis for the $250,000 that appriciated.

Call (800) 900-5867 for more information about NUA!

HOW TO CREATE SAVINGS

In excess of NUA at time of death. If the beneficiary later sells the stock at $600,000, they will pay long-term capital gains on the $225,000 of NUA in addition to the capital gains tax on any appreciation since death (in this case, $100,000). The appreciation between distribution and death will not be taxed due to the step-up in basis.

While we have covered the basics of an NUA tax strategy, here are some additional ways to avoid mistakes commonly made by Chevron employees:

- NUA cannot be used after an IRA rollover. Once the stock is rolled over to an IRA, the NUA tax opportunity will be gone forever for that stock

- Not using the NUA tax strategy is another option. The distribution in this case would be taxed at the ordinary income tax rate at time of distribution

- Consider any state tax laws that might impact the strategy

- After distribution to a brokerage account, the funds will lose the significant protection from creditors that it had in a qualified account

- Depending on other assets and investment strategy, holding large amounts of Chevron stock may not be appropriate for everyone. You maybe should consider diversifying investments.

CHEVRON EMPLOYEES

In order to take advantage of NUA, Chevron employees must meet all of the following:

- **You must distribute your entire balance in the ESIP by Dec. 31st in the same year as your distribution (though you don't have to take all distributions at the same time).**
- **You must take the distribution of Chevron stock as actual shares. You may not convert them to cash before distribution.**
- **You must have experienced one of the following triggering events:**
  - Separation from service from ExxonMobil
  - Reached age 59½
  - Death

For more information call The Retirement Group today to speak with a Financial Adviser!

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CHEVRON EMPLOYEES

Here are a few options for what you can do with your Chevron stock once you retire:

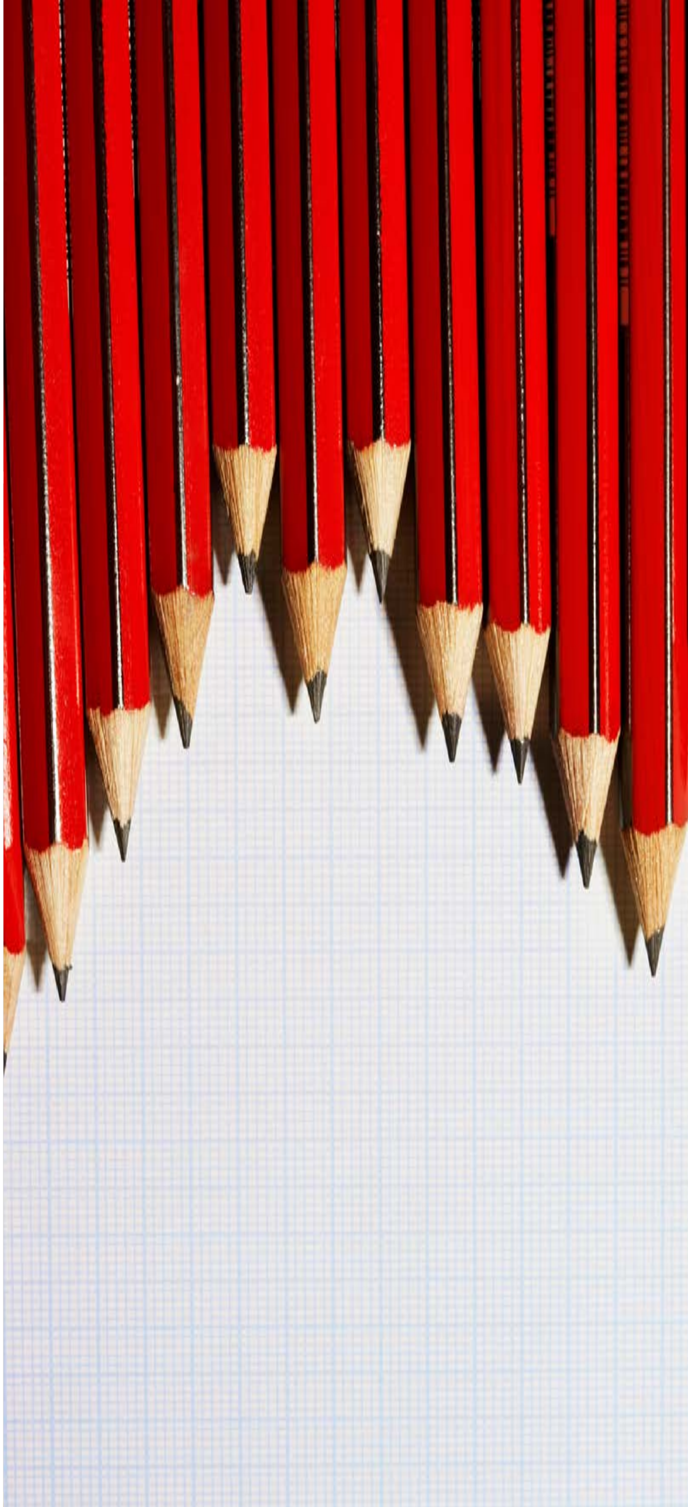
- **Roll Over Your Chevron Stock To An IRA**
  - When you leave Chevron, you have the option to roll over your Chevron stock from your ESIP account directly to an IRA (called an in-kind distribution). With this option, you're generally not taxed at the time of rollover. However, the special NUA tax advantages will not apply because distributions from IRAs are taxed at ordinary income tax rates. This option may still make sense if the NUA is a small percentage of the stock's market value, or if your investment time horizon is long enough, since tax-deferred growth may be achieved for many years in an IRA.

- **Transfer Your Chevron Stock To A Taxable, Non-Retirement Brokerage Account**
  - When you leave Chevron, you may also have the option of transferring your Chevron stock in kind to a taxable, non-retirement brokerage account (to discuss distribution options for your other ESIP investment options please call The Retirement Group.) The cost basis of the stock is taxed at ordinary income rates in the year the stock is distributed from the plan. When you finally sell your shares of Chevron stock, you are subject to long-term capital gains on the net unrealized appreciation at distribution. Any additional appreciation should be taxable as short-term or long-term capital gains, depending on how long you held the stock after it was distributed in kind from the plan.

CHEVRON EMPLOYEES

Chevron employees that have previously taken a distribution from their savings plan and wish to receive NUA stock distribution must wait until the next triggering event. For example, if you received a partial withdrawal from the savings plan at age 57, you cannot request an NUA distribution until the next triggering event at age 59½. **It is important to consider that making withdrawals prior to taking an NUA distribution may exhaust the after-tax balance and jeopardize the ability to receive an NUA distribution of “tax-paid” shares at a later date.**

CHEVRON EMPLOYEES



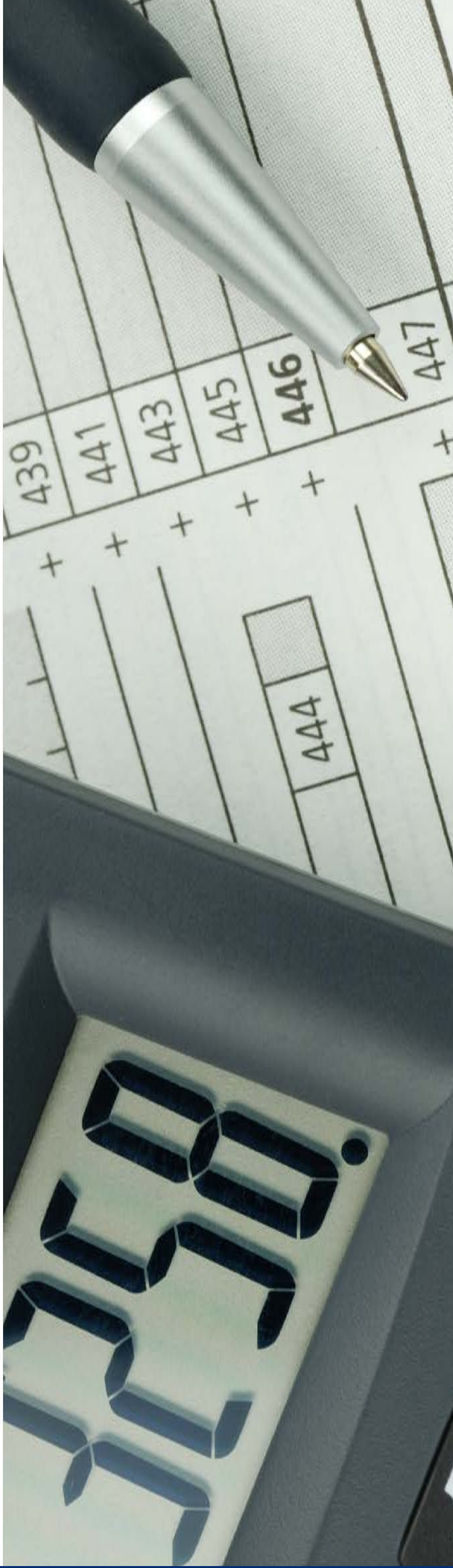
Here are a few options for Chevron employees who want to receive retirement income prior to age 59½:

- A Chevron employee retires at age 56 and rolls over their pension lump sum to an IRA. The employee could also rollover their ESIP balance to an IRA. If they needed to make penalty free IRA withdrawals, they could do so via IRS code 72(t). However, there are two drawbacks to this code. First, the employee can only withdraw up to a certain amount based on their life expectancy. Second, the employee must withdraw the same amount for at least five consecutive years or until they turn 59½, whichever comes last.

CHEVRON EMPLOYEES

- The employee could also leave their assets in the savings plan and receive annual penalty free withdrawals via the age 55 rule. The rule states that employees who have separated from their company during or after the year they turn 55 can receive penalty free withdrawals from the savings plan, variable in amount, from year to year, one to two times annually. After-tax assets are not taxable, and pre-tax assets are subject to ordinary income taxes. The employee would still have the ability to:
  - Receive IRA distributions from the pension lump sum rollover under the 72(t) tax guidelines or wait until reaching age 59½; and
  - Be able to receive an NUA stock distribution once they reach 59½ or older (reaching the next triggering event after taking non-NUA withdrawal).
- A retiree over age 59½ receives a distribution from the savings plan, they must withdraw their full balance during that calendar year in order to utilize NUA. If they do not, then they have to wait until the next triggering event to receive an NUA distribution.

*Remember: Do not use NUA just because of the tax treatment. NUA maintains the risk of Chevron stock exposure until sold after distribution. In some cases, it may be more beneficial to diversify in a tax-deferred account.

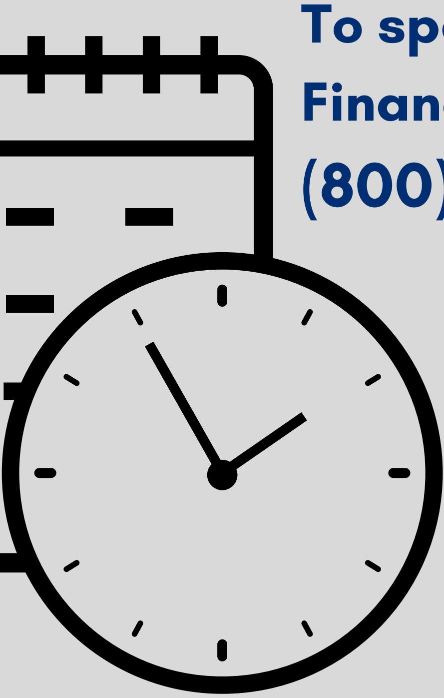


WHEN NUA MAY MAKE SENSE FOR YOU

There are still certain scenarios when you should consider NUA:

- **If you have highly appreciated Chevron stock in your ESIP**
  - If you have Chevron stock that has gone up substantially in value, net unrealized appreciation may be something to consider. The larger the spread between the cost basis and the current market value, the stronger the argument for net unrealized appreciation. This is because the larger the capital gain, the larger the opportunity to pay capital gains tax in lieu of ordinary income tax. Paying 15% in lieu of paying 33% may lead to major tax savings.

- **Large Spread in Tax Brackets**
  - Tax brackets change based on levels of income for both ordinary income tax and capital gains tax. The larger the spread between the two, the greater the opportunity will be to utilize preferential long-term capital gains treatment.



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WHEN NUA MAY MAKE SENSE FOR YOU

- **When You Are Seeking to Lower Your Required Minimum Distributions**
  - Diversification is a common term that is used when it comes to investing. In short, it simply means don't have all your eggs in one basket.
  - As diversification pertains to retirement income planning, it may also mean tax diversification, or having different types of assets in retirement. This means taxable assets, tax-deferred assets, and tax-free assets. Net unrealized appreciation can be a strategy that efficiently transitions tax-deferred assets and makes them taxable. Since the portion of your assets that is subject to NUA are no longer in an IRA or 401(k), the account value will not be included in the RMD calculation. This transaction has the net effect of lowering RMDs in retirement.

- **Implemented appropriately, net unrealized appreciation may lower your overall net tax liability, therefore leaving you with more cash in your pocket.**

CONCLUSION

The “best” time to do NUA depends on the individual situation. In general, this strategy makes the most sense for people who hold large amounts of NUA and a relatively small cost basis. However, it is also dependent on other factors, such as age, estate planning goals, and anticipated tax rates. In some cases, rolling over to an IRA might make more sense. If you hold a large amount of Chevron stock, the NUA tax strategy should at least be discussed as part of your overall financial plan.

If you are unsure of whether or not you should use the NUA tax strategy, it may be wise to speak to a financial adviser.

Visit theretirementgroup.com to schedule an appointment with an advisor!
OR
Call The Retirement Group today (800) 900-5867 to speak with an adviser today!

SOURCES

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The Value Investing Strategy

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