5 reasons to consider net unrealized appreciation (NUA) for your Profit-Sharing Trust (PST) at Procter & Gamble

Most financial decisions get made in isolation without considering other factors. Truly great decisions are made holistically. Below is a summary of how the Net Unrealized Appreciation (NUA) strategy can be integrated with, and complementary to a comprehensive planning strategy. This strategy does not replace a financial plan & should be made in coordination with your CFP® & CPA.

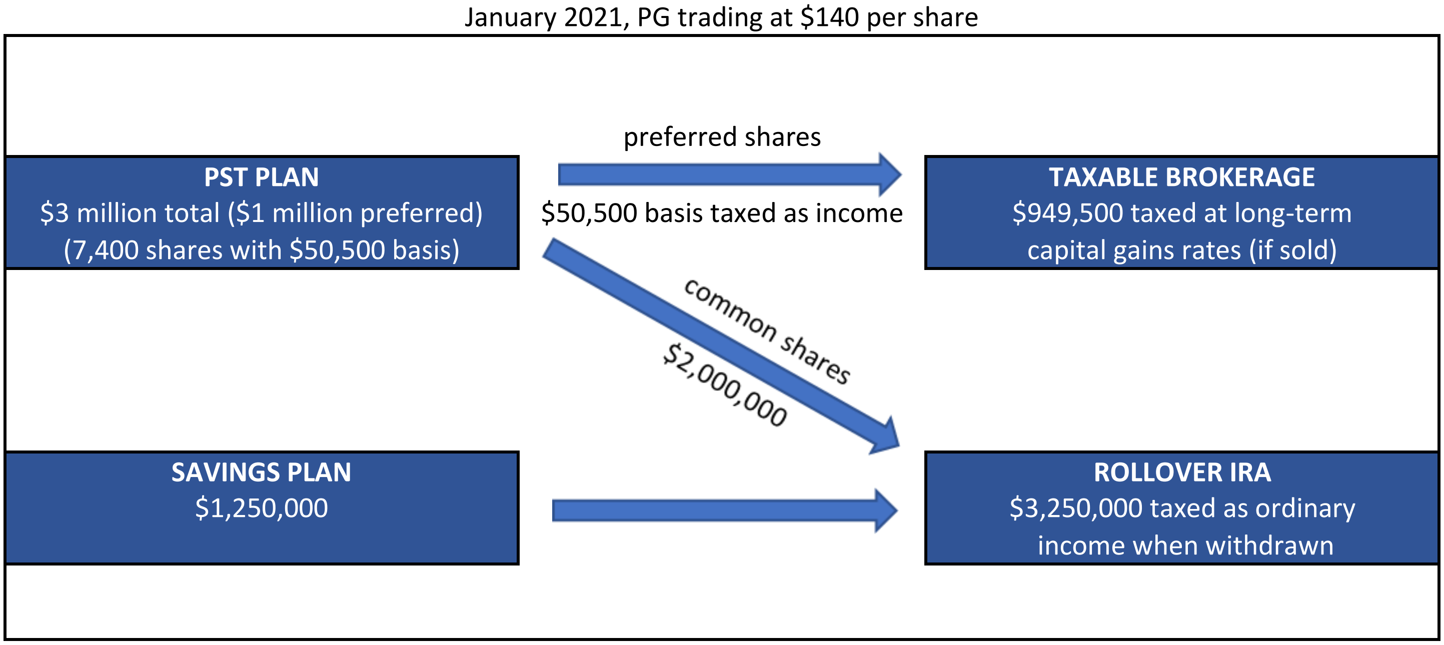
What is NUA?

Internal Revenue Code 402(e)(4) governs the rules that allow employees, to access PST at a more favorable tax rate than is typically associated with income distributions from 401(k) and IRAs. More specifically, NUA is a strategy whereby a P&G alum transitions highly-appreciated P&G shares from the PST plan to a brokerage account, thereby avoiding ordinary income in favor of a more favorable long-term capital gains tax on the appreciated value when the shares are ultimately sold.

In concept, NUA can work for stock held at other companies. But, practically, very few companies have the right combination of low cost-basis relative to the current share price. In this regard, preferred shares within PST at P&G are uniquely appropriate for this strategy.

Split, Qualified Lump Sum Distribution

January 2021, PG trading at $140 per share



NUA works best when transferring low cost-basis, highly appreciated stock. Cost basis refers to the acquisition cost of the asset. Preferred… not common… shares within PST are best suited due to their low cost-basis of $6.82 per share. And, the appreciation is the difference in value between the acquisition cost and the current market price.

Methodology

The separated employee takes a split, qualified lump-sum distribution (SQLSD), whereby the PST plan is split into the cost basis (Trustee's cost) of the originally granted shares. And, the "net unrealized appreciation", or the appreciated value of the preferred shares can be moved tax-free to a brokerage account. That appreciated value can avoid taxation until the shares are sold at a later date, providing the opportunity to employ additional tax-minimizing strategies. To qualify under the Internal Revenue Code, the stock must be distributed in-kind, as part of a lump-sum distribution, after a specific triggering event.

The Frank Duke Method

This strategy applies the partial NUA basis allocation approach set forth in private letter ruling (PLR 8538062), issued to former P&G employee, Frank Duke. Many clients and practitioners now refer to the strategy as the "Frank Duke method". The primary difference between the split, qualified lump-sum distribution and the "Frank Duke Method" is that the additional transfer from the brokerage account to the rollover IRA helps avoid paying ordinary income tax on the cost basis of the distributed shares.

Frank Duke Method

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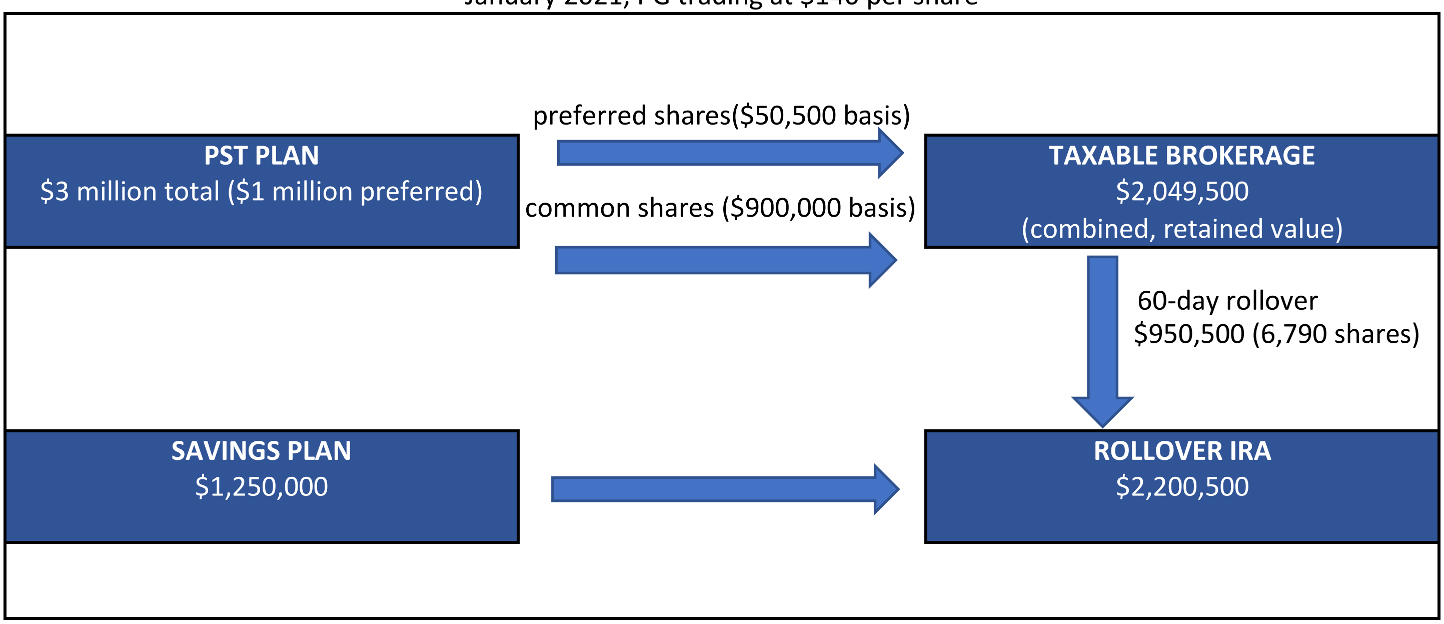

Split, QLSD NUA may make the most sense if:

- If you are charitable.
    - Using the appreciated NUA shares held in a brokerage account to donate or help fund charitable accounts and trusts can provide additional tax advantages making the NUA strategy even more attractive… especially for individuals in the top tax bracket. Consider combining NUA with a Donor Advised Fund (DAF) to super-charge a tax-efficient asset transfer strategy.

- If you will be in a zero percent capital gains bracket (less than $80,000 of income).
    - While $80,000 may seem modest to many, the current standard deduction for couples, integrated with several other planning strategies that may enable you to manage your tax bracket to a level that produces the most favorable outcome… a 0% long-term capital gains rate.
- If your IRA distributions (and other retirement income) place you in higher tax bracket.
    - You'll find the NUA strategy most favorable if the difference between the federal ordinary income tax rate (e.g. marginal rate at 37 and long-term capital gains rate at 23.8%) is large. This tends to be individuals with significant retirement assets and income. Changes to future capital gains and ordinary income tax rates will impact the efficacy of the NUA strategy.
- If you have a need for liquidity and tax diversification.
    - Having the ability to access different assets at different tax rates may be especially attractive if ordinary income tax rates rise faster than capital gains rates.
- If you will be making IRA withdrawals very soon after separation or you're older when you separate.
    - If your time horizon to income distributions is very short (or immediate), or you separate from employment at a more traditional age of 65, 67 or 70, the time for the assets to grow tax-deferred in an IRA is shorter. Similarly, the difference between the cost basis and the share price is likely to be larger the longer you've held the shares.

However, NUA is not for everyone.

- If you are younger than 59 ½, or plan to delay IRA distributions for more than 5 years, the advantages of tax-deferred growth in an IRA are likely to outweigh the benefits of NUA.
    - In addition to the potential 10% penalty on withdrawals prior to age 59 ½, the NUA distribution tends to be less effective for younger employees that separate from P&G due to the inherent advantages of tax-deferred growth within an IRA. A general rule of thumb is that if you plan to wait more than 10 years to make distributions (e.g. you are earning income in a post-P&G "second act", or are strategically avoid IRA withdrawals until RMDs begin at age 72), then the advantages of tax-deferral in an IRA likely outweigh the NUA distribution strategy. And, remember, tax deferral in an IRA doesn't end at retirement. Tax deferral will likely provide a benefit well into retirement until the account balance is depleted, or at death.
- If you are in the 22% or 24% marginal income tax bracket now, and expect a similar income (and therefore tax rate in retirement)
    - The smaller the difference between your marginal tax rate based on expected retirement income, and the long-term capital gains rate, the less advantageous the tradeoff between ordinary income and LTCG tax rates
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- Those who are uncomfortable recognizing a significant amount of taxes up-front
    - While on paper, paying a lower long-term capital gains rate now, versus a higher ordinary income rate later is likely the optimal financial outcome, some people are averse to committing to paying the taxes. They would rather preserve a larger account balance.

Caveats

- The SQLSD method is simpler to execute but offers less tax minimization. The Frank Duke method is supported by the private letter ruling, but that does not mean that the IRS has "approved" the strategy. While the private letter ruling provides guidance, an individual client, audited by the IRS may find that the strategy is disallowed in their particular situation.

- To qualify based on IRS rules, the stock must be distributed in-kind. The qualified lump-sum distribution must occur after a triggering event. These events include termination of employment due to retirement, separation or disability, death, or the employee reaching age 59 ½. And, both the PST plan and the Savings Plan balance must be drawn down to zero by December 31 in the year you take the first distribution. In other words, the entire account balance must be distributed in a single tax year. There are no do-overs.
- The modification of the stretch IRA as part of the SECURE Act, passed in 2019, limiting most inherited IRA distributions to 10 years, may actually make the NUA strategy more attractive for individuals leaving significant IRAs as part of their estate planning
    - The option tosell shares out of a brokerage account over an unlimited period of time could be more favorable than a significant, forced distribution from an IRA over a limited (10-year) window because of the higher levels of income tax paid by the individual distributing inherited IRA assets at ordinary income tax rates.

Final Thoughts

While NUA may be an attractive strategy for some, its benefits are not the same for everyone. To be clear, NUA will not help avoid paying taxes altogether. Rather, it helps you control the type and timing of taxes paid (i.e. ordinary income, long-term capital gains, short-term capital gains.) based on your unique situation. And, there may be additional cost. The loss of future, tax-deferred growth in an IRA may actually result in higher future taxation for certain individuals. As a result, there are trade-offs that need to be accurately assessed.

The NUA transaction requires a lump-sum distribution, so occurs at one point in time. However, the decision to use NUA will change over time as an individual's circumstances evolve Thus, it is a decision-making framework that may help reduce taxes as one transitions assets from the P&G PST and Savings Plan. SQLSD versus the Frank Duke Method is an additional nuance that can complicate the decision. And, like many strategies, it's not one-size-fits-all. Nuances in timing, tax rates/income, charitable intent, the concentration of your P&G positions, and other aspects of one's comprehensive financial plan will dictate whether the NUA strategy is right for you.

Guidance from a planning professional and your tax advisor will help avoid irrevocable mistakes. Overall, thoughtfully considering ways to balance the tradeoffs should result in the best outcome.