1108 PLANNING FOR DISTRIBUTIONS OF EMPLOYER SECURITIES

1108.1 Favorable tax rules apply when a lump sum distribution [LSD—as defined in IRC Sec. 402(e)(4)(D)] is composed in whole or in part of securities of the employer corporation. Under those rules, employees are not taxed on the net unrealized appreciation (NUA) when the securities are distributed [IRC Sec. 402(a) and (e)(4)(B)]; in other words, upon distribution, the employees are not taxed on the full fair market value (FMV) of the securities. NUA is defined as the excess of the aggregate FMV of the securities on the distribution date over the aggregate cost or other basis of such securities to the plan.

1108.2 The NUA in an LSD of employer securities is excluded from the recipient's gross income [IRC Sec. 402(e)(4)(B)]. NUA can be excluded from income even if the employee receiving the distribution has not been a plan participant for five years. The amount included in income by the recipient (i.e., the FMV less NUA) is taxed under the LSD rules discussed in IRC Sec. 402(e)(4)(D). The employee's share of the plan's basis in the employer securities distributed is the amount included in gross income.

1108.3 **Note:** If the distribution is not part of an LSD, the NUA excluded from the recipient's gross income includes only the amount attributable to nondeductible employee contributions. The NUA attributable to deductible voluntary employee contributions is taxable [IRC Sec. 402(e)(4)(A); *Szilagyi(1)*].

1108.4 When employer securities are sold after distribution, any gain realized is long-term capital gain subject to a maximum 15% capital gains rate, to the extent attributable to NUA not taxed at the time of receipt. The long-term or short-term status of any capital gain in excess of this amount depends on how long the distributee actually holds the securities after distribution from the plan [IRS Notice 98-24; Reg. 1.402(a)-1(b)(1)(i)(b)]. For this purpose, the employee's holding period in the securities begins on the day after the date the securities are delivered to the transfer agent with instructions to reissue the stock in the employee's name (Rev. Rul. 82-75; Ltr. Rul. 8724049).

Rolling over Appreciated Employer Stock

1108.5 Distributions of employer securities can be rolled over to an eligible retirement plan whether they are distributed in an LSD or not. (See section 1107 for a discussion of the rollover rules applicable to noncash property.) However, retaining direct ownership of appreciated employer stock received in an LSD instead of rolling over to an eligible retirement plan provides the following tax advantages:

a. The employee is taxed only on the cost basis of the shares, not the FMV. (See paragraph 1108.2.)

b. The 10% early distribution penalty (see section 1105) that is generally applicable if the employee has not attained age 59½ at the distribution date is based on the cost basis of the shares (to the extent this basis is currently taxable) rather than the FMV of the stock.

c. Any gain on disposition of the stock is normally taxed as long-term capital gains instead of ordinary income. (See paragraph 1108.4.)

d. Because the stock is not in a traditional IRA or qualified plan, it is not subject to the minimum distribution rules discussed in section 1104. Accordingly, taxes on the NUA can be deferred indefinitely until the shares are sold.

e. If the stock is still owned at death, the employee's heirs will receive a stepped-up basis for any appreciation in the stock during the time the employee holds it; there is no increase in basis for the NUA in the stock before the securities were distributed [IRC Sec. 1014(a) and (c)]. The NUA amount is considered income in respect of a decedent.

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Example 11-40: Benefits of *not* rolling over an LSD of employer securities.

Sally leaves her job and receives an LSD from her employer's 401(k) plan when she is age 50. The distribution consists of $200,000 of cash and $100,000 worth of employer stock. The cost basis of the distributed stock is $10,000. Thus, there is $90,000 of NUA attributable to the stock ($100,000 – $10,000). If Sally rolls over the $200,000 of cash into an IRA and keeps the stock, she'll pay income tax plus the 10% early distribution penalty tax on only the $10,000 of stock basis. She then can continue to defer tax on the $90,000 of NUA on the stock.

When Sally sells the stock, the first $90,000 of gain will be taxed as a long-term capital gain. Any additional appreciation in the stock at the time of sale will also receive capital gain treatment. The long-term or short-term nature of this additional appreciation will depend on whether Sally has held the stock for more than a year before selling it.

Variation: Instead of keeping the stock, assume Sally rolls over the entire $300,000 LSD into an IRA. She will pay no income or early distribution penalty tax now, but will not be able to use the preferential long-term capital gains tax rate on any subsequent distributions from the IRA. This is because the $90,000 of NUA loses its long-term capital gain status and is taxed at ordinary income tax rates when distributed from the IRA. Thus, by *not* rolling over the appreciated stock into an IRA, Sally pays a relatively small amount of income tax and penalty tax now in exchange for receiving favorable long-term capital gain treatment in the future.

1108.6 **Caution:** This favorable tax treatment for employer securities only applies to an LSD. If the distribution is not part of an LSD, the full FMV of the securities (in excess of any nondeductible contributions made to the plan) is generally included in the employee's income. However, even in this situation NUA attributable to nondeductible (i.e., after-tax) employee contributions can still be excluded [IRC Sec. 402(e)(4)(A)]. (See paragraph 1108.3.)

1108.7 Each of the advantages listed in paragraph 1108.5 represents some not-so-commonly-known provisions of the tax law that can save clients substantial tax dollars. However, these strategies are not for everyone. They work best when the employer stock is highly appreciated and 10-year averaging is not available or does not make sense. As is the case with most tax planning alternatives, the numbers on all available alternatives should be analyzed before making a decision.

Electing to Be Taxed on the Full Fair Market Value

1108.8 Employees who receive a distribution of employer securities may elect to include the full FMV of the LSD, including the NUA of the securities in income. Although making this election generally accelerates the recognition of income, it may be beneficial for individuals using the favorable LSD 10-year averaging method.

Recognizing Losses on Distributions of Employer Securities

1108.9 It is possible for taxpayers to sustain losses on employer securities received as part of an LSD. If the employee receives worthless securities in which he has a tax basis (i.e., the employee made nondeductible contributions to the plan), an ordinary loss under IRC Sec. 165 can be claimed in the year of the distribution. The loss is the total amount of the employee's nondeductible contributions to the plan (Rev. Rul. 72-328) and is claimed as a miscellaneous itemized deduction subject to the 2% of AGI floor. If the employee receives securities that are not worthless but have a value less than the employee's nondeductible contributions to the plan, no loss can be claimed at the time of distribution. However, the employee may have a recognizable loss (or gain) at the time the securities are sold or exchanged. The loss is the excess of the employee's nondeductible contributions over the selling price and is reported as a capital loss (Rev. Rul. 71-251, as amplified by Rev. Rul.

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72-15).

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Endnotes

1 (Popup - Case Citation)

Szilagyi, Alexander J., 45 TCM 88, TC Memo 1982-656 (1982).

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