What is a lump sum distribution? What special tax treatment is available for a lump sum distribution from a qualified plan?

A distribution is a lump sum distribution if it:

(1) is made in one taxable year;

(2) consists of the balance to the credit of an employee;

(3) is payable on account of the employee’s death, after the employee attained age 59½, or on account of the employee’s separation from service; and

(4) is made from a qualified pension, profit sharing, or stock bonus plan.[[1]](#footnote-1)

The classification will be relevant to certain distributions of employer securities that consist of net unrealized appreciations.

The distinction between lump sum distributions has become less important as fewer participants are able to use the pre-ERISA grandfather provisions for capital gain treatment of pre-ERISA accounts under a plan and certain income averaging rules that were repealed in 1986 . The following discussion applies to the grandfathered tax treatment of certain participant accounts that are conditioned on a distribution constituting a lump sum distribution.

The same requirements apply to distributions to self-employed individuals, except that full distributions made after a self-employed person has become disabled are considered lump sum distributions, and distributions made on account of “separation from service” are not.

The balance to the credit includes all amounts in the participant’s account, including nondeductible employee contributions, as of the first distribution received after the triggering event.[[2]](#footnote-2)

Certain eligible employees may elect ten-year averaging of certain lump sum distributions and special treatment of certain capital gains. For this purpose, an eligible employee is an employee who attained age fifty before January 1, 1986. Earlier IRC provisions that allowed for five year averaging of lump sum distributions were repealed for tax years beginning after 1999.

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*Ten-year averaging*. An eligible employee makes a special averaging election by filing Form 4972 with his or her tax return; the election may be revoked by filing an amended return.[[3]](#footnote-3) An eligible employee can make this election only once and it must apply to all lump sum distributions the employee receives for that year.

Under ten-year averaging, the tax on the ordinary income portion of the distribution is ten times the tax on 1/10 of the total taxable amount, reduced by the minimum distribution allowance. 1986 tax rates must be used, taking into account the prior law’s zero bracket amount.[[4]](#footnote-4) Generally speaking, the larger the distribution, the less likely that ten-year averaging will be advantageous.

*Long-term capital gain treatment*. An eligible employee also may elect capital gain treatment for the portion of a lump sum distribution allocable to his or her pre-1974 plan participation.[[5]](#footnote-5) This portion is determined by multiplying the total taxable amount by a fraction, the numerator of which is the number of pre-January 1, 1974 calendar years of active plan participation and the denominator of which is the total number of calendar years of active plan participation.

For these purposes, the minimum distribution allowance is the lesser of $10,000 or one-half of the total taxable amount. This must be reduced by 20 percent of the total taxable amount in excess of $20,000. Thus, if the total taxable amount is $70,000 or more, there is no minimum distribution allowance. The total taxable amount is the amount of the distribution that exceeds the employee’s cost basis. The employee’s cost basis is reduced by any previous distributions excludable from his or her gross income.

1. IRC Sec. 402(e)(4)(D). [↑](#footnote-ref-1)
2. Let. Ruls. 9031028, 9013009. [↑](#footnote-ref-2)
3. Treas. Reg. §11.402(e)(4)(B)-1. [↑](#footnote-ref-3)
4. TRA ’86, Sec. 1122(h)(5); TAMRA ’88, Sec. 1011A(b)(15)(B). [↑](#footnote-ref-4)
5. TRA ’86, Sec. 1122(h)(3). [↑](#footnote-ref-5)