**3862. 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]](http://pro.nuco.com/taxfacts2015/tfempb/p9-pps/taxdist/Pages/3862-00-TF1.aspx?k=3862" \l "_ftn1)

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provisions for capital gain treatment of pre-ERISA accounts under a plan and certain income averaging rules that were repealed in 1986 ([Q 544](http://pro.nuco.com/taxfacts2015/tfins/p1-anns/esttax/Pages/0544-00-TF1.aspx)). 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]](http://pro.nuco.com/taxfacts2015/tfempb/p9-pps/taxdist/Pages/3862-00-TF1.aspx?k=3862" \l "_ftn2)

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 Earlier IRC provisions that allowed for five year averaging of lump sum distributions were repealed for tax years beginning after 1999.

*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]](http://pro.nuco.com/taxfacts2015/tfempb/p9-pps/taxdist/Pages/3862-00-TF1.aspx?k=3862" \l "_ftn3) 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]](http://pro.nuco.com/taxfacts2015/tfempb/p9-pps/taxdist/Pages/3862-00-TF1.aspx?k=3862" \l "_ftn4) 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]](http://pro.nuco.com/taxfacts2015/tfempb/p9-pps/taxdist/Pages/3862-00-TF1.aspx?k=3862" \l "_ftn5) 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 ([Q 3864](http://pro.nuco.com/taxfacts2015/tfempb/p9-pps/taxdist/Pages/3864-00-TF1.aspx)). The employee’s cost basis is reduced by any previous distributions excludable from his or her gross income.

[[1]](http://pro.nuco.com/taxfacts2015/tfempb/p9-pps/taxdist/Pages/3862-00-TF1.aspx?k=3862" \l "_ftnref1)

.IRC Sec. 402(e)(4)(D).

[[2]](http://pro.nuco.com/taxfacts2015/tfempb/p9-pps/taxdist/Pages/3862-00-TF1.aspx?k=3862" \l "_ftnref2)

.Let. Ruls. 9031028, 9013009.

[[3]](http://pro.nuco.com/taxfacts2015/tfempb/p9-pps/taxdist/Pages/3862-00-TF1.aspx?k=3862" \l "_ftnref3)

.Treas. Reg. §11.402(e)(4)(B)-1.

[[4]](http://pro.nuco.com/taxfacts2015/tfempb/p9-pps/taxdist/Pages/3862-00-TF1.aspx?k=3862" \l "_ftnref4)

.TRA ’86, Sec. 1122(h)(5); TAMRA ’88, Sec. 1011A(b)(15)(B).

[[5]](http://pro.nuco.com/taxfacts2015/tfempb/p9-pps/taxdist/Pages/3862-00-TF1.aspx?k=3862" \l "_ftnref5)

.TRA ’86, Sec. 1122(h)(3).

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| **3863. How is net unrealized appreciation taxed when employer securities are distributed from a qualified plan?**Net unrealized appreciation (“NUA”) is the excess of the fair market value of employer securities at the time of a lump sum distribution over the cost or other basis of the securities to a qualified plan trust.[[1]](http://pro.nuco.com/taxfacts2015/tfempb/p9-pps/taxdist/Pages/3863-00-TF1.aspx?k=3863#_ftn1) Employer securities for this purpose include shares of a parent or subsidiary corporation.[[2]](http://pro.nuco.com/taxfacts2015/tfempb/p9-pps/taxdist/Pages/3863-00-TF1.aspx?k=3863#_ftn2)  If employer securities are distributed as part of a lump sum distribution ([Q 3862](http://pro.nuco.com/taxfacts2015/tfempb/p9-pps/taxdist/Pages/3862-00-TF1.aspx)) from a qualified plan, the net unrealized appreciation is excluded from the employee’s income at the time of distribution to the extent that the securities are attributable to employer and nondeductible employee contributions. Taxation of NUA following a lump sum distribution is deferred until the securities are sold or disposed of, unless the employee elects out of NUA treatment.[[3]](http://pro.nuco.com/taxfacts2015/tfempb/p9-pps/taxdist/Pages/3863-00-TF1.aspx?k=3863#_ftn3) The election is made on the tax return for the year in which the distribution must be included in gross income and does not preclude an election for special income averaging.[[4]](http://pro.nuco.com/taxfacts2015/tfempb/p9-pps/taxdist/Pages/3863-00-TF1.aspx?k=3863#_ftn4) On a sale or other disposition of employer securities, the NUA amount is treated as long-term capital gain, regardless of the distributee’s actual holding period. The taxpayer’s basis in the stock is the same as the basis in the hands of the qualified plan trust; that is, it does not include the NUA amount.[[5]](http://pro.nuco.com/taxfacts2015/tfempb/p9-pps/taxdist/Pages/3863-00-TF1.aspx?k=3863#_ftn5) Gain accruing after distribution of the securities and before the later disposition of them is treated as long-term or short term capital gain, depending on the holding period after distribution.[[6]](http://pro.nuco.com/taxfacts2015/tfempb/p9-pps/taxdist/Pages/3863-00-TF1.aspx?k=3863" \l "_ftn6) The distributee’s holding period begins the day after the day the plan trustee delivers the stock to the transfer agent with instructions to reissue the stock in the distributee’s name.[[7]](http://pro.nuco.com/taxfacts2015/tfempb/p9-pps/taxdist/Pages/3863-00-TF1.aspx?k=3863" \l "_ftn7) **Planning Point:** The portion of the fair market value of the employer securities in excess of their net unrealized appreciation and the amount of the participant’s after-tax contributions to the plan, if any, is included in income and potentially subject to the 10 percent tax, so that tax should be taken into account in determining whether and how much of the distribution should be rolled over to an IRA if the participant has not yet attained age 59½ and has separated from service before age fifty-five. *Martin Silfen, J.D., Brown Brothers Harriman Trust Co., LLC.* An employer’s shares, if acquired and credited to an employee’s account, still are considered employer stock, even if later transferred to the trust of an acquiring or subsidiary corporation.[[8]](http://pro.nuco.com/taxfacts2015/tfempb/p9-pps/taxdist/Pages/3863-00-TF1.aspx?k=3863" \l "_ftn8) The basis does not change.[[9]](http://pro.nuco.com/taxfacts2015/tfempb/p9-pps/taxdist/Pages/3863-00-TF1.aspx?k=3863" \l "_ftn9) The balance of the value of the stock is taxable to the recipient under the regular rules for taxing lump sum distributions ([Q 3862](http://pro.nuco.com/taxfacts2015/tfempb/p9-pps/taxdist/Pages/3862-00-TF1.aspx)).[[10]](http://pro.nuco.com/taxfacts2015/tfempb/p9-pps/taxdist/Pages/3863-00-TF1.aspx?k=3863" \l "_ftn10) Unrealized appreciation that is excluded from income is not includable in the recipient’s basis in the stock for the purpose of computing gain or loss upon a later sale or other taxable disposition.[[11]](http://pro.nuco.com/taxfacts2015/tfempb/p9-pps/taxdist/Pages/3863-00-TF1.aspx?k=3863" \l "_ftn11) If part or all of the unrealized appreciation is excluded as something other than unrealized appreciation, only the part excluded as unrealized appreciation is not added to basis.[[12]](http://pro.nuco.com/taxfacts2015/tfempb/p9-pps/taxdist/Pages/3863-00-TF1.aspx?k=3863" \l "_ftn12) Excluded appreciation prior to distribution that is realized on sale of the stock by the recipient of a distribution on account of the death of the employee or by a person inheriting the stock from the employee is income in respect of a decedent. As such, it is taxed as long-term capital gain and a deduction may be taken for the estate tax attributable to the inclusion of any part of the appreciation prior to distribution in the deceased employee’s estate.[[13]](http://pro.nuco.com/taxfacts2015/tfempb/p9-pps/taxdist/Pages/3863-00-TF1.aspx?k=3863" \l "_ftn13) **Planning Point:** In the case of divorce, be sure that the non-participant spouse has the QDRO drafted to specifically provide for an alternate payee to receive a pro-rata share of employer securities with the same cost basis; otherwise the ability to utilize NUA tax treatment may be lost. Many plans do not preserve this benefit for alternate payees in their sample QDRO language, so customized language may be required. *Helen Modly, CFP, ChFC, Focus Wealth Management, Ltd.* NUA in employer securities distributed in other than a lump sum distribution is excludable only to the extent that the appreciation is attributable to nondeductible employee contributions.[[14]](http://pro.nuco.com/taxfacts2015/tfempb/p9-pps/taxdist/Pages/3863-00-TF1.aspx?k=3863" \l "_ftn14) Thus, a rollover of employer securities to an IRA will preclude the taxpayer from receiving NUA treatment.  A transfer to an IRA of less than all of a participant’s account under an ESOP, with a distribution of the balance to the participant, does not bar treatment as a lump sum distribution, however. The IRS determined that a participant could exclude the net unrealized appreciation on the stock distributed until the participant disposes of it.[[15]](http://pro.nuco.com/taxfacts2015/tfempb/p9-pps/taxdist/Pages/3863-00-TF1.aspx?k=3863" \l "_ftn15)  Similarly, a participant who had received a series of substantially equal periodic payments ([Q 3631](http://pro.nuco.com/taxfacts2015/tfempb/p8-irp/earlydist/Pages/3631-00-TF1.aspx), [Q 3854](http://pro.nuco.com/taxfacts2015/tfempb/p9-pps/taxdist/Pages/3854-00-TF1.aspx)) from his plan account prior to retirement was not precluded from treating a distribution of the remaining amounts, including stock, in his plan account as a lump sum distribution ([Q 3859](http://pro.nuco.com/taxfacts2015/tfempb/p9-pps/taxdist/Pages/3859-00-TF1.aspx)), nor from excluding net unrealized appreciation on the stock.[[16]](http://pro.nuco.com/taxfacts2015/tfempb/p9-pps/taxdist/Pages/3863-00-TF1.aspx?k=3863" \l "_ftn16) [[1]](http://pro.nuco.com/taxfacts2015/tfempb/p9-pps/taxdist/Pages/3863-00-TF1.aspx?k=3863#_ftnref1).See Treas. Reg. §1.402(a)-1(b)(2)(i).[[2]](http://pro.nuco.com/taxfacts2015/tfempb/p9-pps/taxdist/Pages/3863-00-TF1.aspx?k=3863#_ftnref2).IRC Sec. 402(e)(4)(E).[[3]](http://pro.nuco.com/taxfacts2015/tfempb/p9-pps/taxdist/Pages/3863-00-TF1.aspx?k=3863#_ftnref3).See IRC Sec. 402(e)(4)(B).[[4]](http://pro.nuco.com/taxfacts2015/tfempb/p9-pps/taxdist/Pages/3863-00-TF1.aspx?k=3863#_ftnref4).IRC Sec. 402(e)(4).[[5]](http://pro.nuco.com/taxfacts2015/tfempb/p9-pps/taxdist/Pages/3863-00-TF1.aspx?k=3863#_ftnref5).Treas. Reg. §1.402(a)-1(b)(1)(i).[[6]](http://pro.nuco.com/taxfacts2015/tfempb/p9-pps/taxdist/Pages/3863-00-TF1.aspx?k=3863" \l "_ftnref6).See Treas. Reg. §1.402(a)-1(b); Notice 98-24, 1998-1 CB 929; see also Rev. Rul. 81-122, 1981-1 CB 202.[[7]](http://pro.nuco.com/taxfacts2015/tfempb/p9-pps/taxdist/Pages/3863-00-TF1.aspx?k=3863" \l "_ftnref7).Rev. Rul. 82-75, 1982-1 CB 116.[[8]](http://pro.nuco.com/taxfacts2015/tfempb/p9-pps/taxdist/Pages/3863-00-TF1.aspx?k=3863" \l "_ftnref8).Rev. Rul. 73-29, 1973-1 CB 198; Ltr. Rul. 201242019.[[9]](http://pro.nuco.com/taxfacts2015/tfempb/p9-pps/taxdist/Pages/3863-00-TF1.aspx?k=3863" \l "_ftnref9).Rev. Rul. 80-138, 1980-1 CB 87.[[10]](http://pro.nuco.com/taxfacts2015/tfempb/p9-pps/taxdist/Pages/3863-00-TF1.aspx?k=3863" \l "_ftnref10).See Rev. Rul. 57-514, 1957-2 CB 261.[[11]](http://pro.nuco.com/taxfacts2015/tfempb/p9-pps/taxdist/Pages/3863-00-TF1.aspx?k=3863" \l "_ftnref11).Treas. Reg. §1.402(a)-1(b).[[12]](http://pro.nuco.com/taxfacts2015/tfempb/p9-pps/taxdist/Pages/3863-00-TF1.aspx?k=3863" \l "_ftnref12).Rev. Rul. 74-398, 1974-2 CB 136.[[13]](http://pro.nuco.com/taxfacts2015/tfempb/p9-pps/taxdist/Pages/3863-00-TF1.aspx?k=3863" \l "_ftnref13).Rev. Rul. 69-297, 1969-1 CB 131; Rev. Rul. 75-125, 1975-1 CB 254.[[14]](http://pro.nuco.com/taxfacts2015/tfempb/p9-pps/taxdist/Pages/3863-00-TF1.aspx?k=3863" \l "_ftnref14).IRC Sec. 402(e)(4)(A).[[15]](http://pro.nuco.com/taxfacts2015/tfempb/p9-pps/taxdist/Pages/3863-00-TF1.aspx?k=3863" \l "_ftnref15).Let. Ruls. 9721036, 200038057.[[16]](http://pro.nuco.com/taxfacts2015/tfempb/p9-pps/taxdist/Pages/3863-00-TF1.aspx?k=3863" \l "_ftnref16).See Let. Rul. 200315041. |